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# planner

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## Managing the Risky Business of Advice

By Geoff Davey

*Note: This article is first in a series of articles on risk tolerance.*

The planner and client share a common interest: neither one wants the relationship to end unhappily.

Sloppy risk processes make planners vulnerable to claims by unhappy clients. It can be all too easy for a client who has lost money to say, “*The strategy was too risky for me. My planner should have understood that. What’s more, I didn’t understand the risks because they weren’t explained properly. If they had been, I would not have proceeded.*”

The most likely cause of an abrupt, unhappy ending is mismanaged risk. In a bear market, what was previously thought of as a risk becomes a reality. This may trigger, at best, simple dissatisfaction. At its worst, it could trigger a crisis of confidence in the planner’s competence.

The actual impact of this realized risk will depend on the client’s risk tolerance and expectations. Does the client understand the risks? Is the client’s investment strategy consistent with his or her risk tolerance?

Planners talk to clients all the time about risk issues, and compliance departments dedicate an enormous percentage of their time to the risk-related aspects of advice. Yet, even with all this ostensible focus on risk, many planners do not handle the conversation well. It may be because they, themselves, are not clear about the fine points.

Risk has three primary aspects:

1. *Risk required.* The risk associated with the return that would be required to achieve the client’s goals (a financial characteristic).
2. *Risk capacity.* The extent to which the future can be less favorable than predicted without derailing the client’s plans (a financial characteristic).
3. *Risk tolerance.* The level of risk the client prefers to take (a personality characteristic).

### Risk Required

How can risk be required? Strictly, it is return, not risk, that’s required. The planner determines the return required to achieve goals, and there will be a level of risk associated with that return. Hence, a risk required.

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Of course, the first time these calculations are made, the return required might be impossibly high (for example, inflation plus 20%). In this case, some reality checking and goal reviews will be needed to bring the return down to a level that is at least feasible.

## Risk Capacity

*Risk capacity* is the extent to which an individual's financial plan can withstand the impact of negative events.

Although *risk required* means a return that is expected to achieve the client's goals, what happens if the actual return falls short of the expected return? What if the client lives longer or living costs are higher than expected? Will there be funds available when they are needed?

Clearly, unexpected negative outcomes might derail the client's plan, which means that the plan must be stress-tested, which will involve Monte Carlo modeling or some other form of stochastic testing.

Monte Carlo modeling will estimate the likelihood of achieving any particular goal. If investment returns were the only variable, then the risk and return required would be expected to deliver the desired goals 50% of the time, provided the distribution of investment returns is symmetrical (that is, mean = median = mode). If the distribution of the returns is asymmetrical, then the median will be more or less than the mean, and the likelihood of achieving the expected (mean) return will be more or less than 50%. However, for the purposes of this article, we can assume the distribution of returns is symmetrical.

Let's assume that there is only a single goal—an income stream in retirement—and investment returns are the only variable. If the likelihood of achieving the goal is 50%, then the plan has no risk capacity because any underperformance by the investments will result in the goal not being achieved. In an accumulation scenario and a deaccumulation scenario, it is not just the average return (arithmetic or geometric) that determines performance, but rather it is the dollar-weighted return. With any investment strategy, there will be good years and bad years. In an accumulation scenario, you hope the good years occur at the end, and in a deaccumulation scenario, you hope they occur at the beginning.

For a goal as important as income in retirement, a 50% chance of success is unlikely to be acceptable, which means that trade-offs will be required.

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**EDITOR:** Amy Krasnyanskaya, JD, MA, [akrasnyanskaya@aicpa.org](mailto:akrasnyanskaya@aicpa.org). For questions or assistance with your PFP Section membership, please contact [pfp@aicpa.org](mailto:pfp@aicpa.org) or call (888) 777-7077. If you need assistance with the log in process to the PFP Section's website, contact the AICPA Service Center through [service@aicpa.org](mailto:service@aicpa.org) or call (888) 777-7077 (option #3, then option #3).

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Trade-offs can only be made between those variables over which the client has control. This includes the level of savings and the targets for the retirement date, income in retirement, and investment return. Saving more, retiring later, reducing the income in retirement target, or taking more investment risk will increase the likelihood of achieving the retirement income goal.

Suppose the initial plan has a 70% chance of delivering the desired income in retirement, but the client wants a 90% chance. For two reasons, taking more investment risk won't necessarily increase the 70% likelihood of achieving the target. First, although increasing risk and return might increase the mean return, it might also result in a fatter downside tail—meaning that the chance of achieving a poor return could increase. Second, a riskier investment strategy will usually have greater volatility, so the probability of a negative timing effect—good years versus bad years—will increase.

In an actual plan, things will be more complicated. There will be multiple goals with differing priorities, and more variables exist than just investment performance. The likelihood of achieving a goal is a measure of the plan's risk capacity in respect to that goal.

A stochastic modeling exercise such as Monte Carlo will also be a valuable educational experience for the client. It demonstrates the impossibility of being 100% certain of achieving goals and also identifies which of the variables the plan is most sensitive to, including the things that really matter. The exercise also educates the client about the trade-offs between upside potential and downside protection.

## Risk Tolerance

Risk tolerance is psychological. It is how an individual feels about taking risk. Where does the person strike the emotional balance between seeking a favorable outcome versus risking an unfavorable outcome?

An individual's risk tolerance will be expressed in all situations involving risk.

Although risk capacity is simply the margin above 50% of the likelihood of achieving goals, risk tolerance will be expressed through the trade-offs made between upside potential and downside risk in arriving at a plan that has acceptable risk capacity. For example, would the client target a higher retirement income if that meant decreasing from 90% to 80% the likelihood of achieving a lower, but still acceptable retirement income? Risk tolerance is also expressed over the life of the plan through the level of risk in the chosen investment strategy. Too much risk can lead to a panicked sale in a downturn.

The client has a problem when his or her risk tolerance is less than the risk in the investment strategy determined through Monte Carlo modeling. In fact, most clients have this problem. It can be solved through taking more risk than the client prefers, but risk tolerance can only be stretched so far. Other solutions, such as saving more; converting personal use assets to investment assets; and lowering, deferring, or foregoing goals, should also be considered.

In a few cases, the client's risk tolerance will be greater than the risk in the modeled investment strategy. This is a nice problem to have. Here, the client is faced with a choice of which bonus to aim for. The client can take more investment risk in the expectation of achieving higher returns, subject to the constraint that the increased investment risk does not decrease the risk capacity below an acceptable level. As a result, allowing more spending now or a more ambitious set of goals is wise. Or, the client may simply opt for a smoother ride.

## About the Author

**Geoff Davey** is cofounder of FinaMetrica, a company focusing on the psychological factors relevant to financial decision making in terms that are meaningful to individuals and their advisers. Contact him at [geoff.davey@finametrica.com](mailto:geoff.davey@finametrica.com).

This scenario begs several questions: how risk tolerance is assessed in the first place, how that assessment is expressed in terms of portfolio risk, and how portfolio risk can be best explained in terms that will be meaningful to the client. All of these will be covered in subsequent articles in this series.

## **Managing Risk = Reward**

Managing risk requires understanding and skill, but it is not rocket science. With the appropriate tools, planners can identify the three ingredients and examine their interaction so that mismatches can be resolved openly based on what is important to the client and with the client's full understanding. The bottom line is to have the client give his or her properly informed commitment to the riskiness of the recommended portfolio.

Dealing with risk professionally will result in better advice and more quickly build the trust necessary for good client relationships. Clients don't have to be persuaded that risk is an important issue. The more planners can demonstrate that the three aspects of risk are being dealt with appropriately, the more client relationships will improve.

Recent market turbulence will have focused clients' minds on risk. Now is the time to feature the risk conversation in your client induction and review processes. ■

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