Measuring Risk Tolerance: Avoid Industry-Standard Questionnaires

By Geoff Davey

The previous article (*The Planner, Sept/Oct 2010*) in this series, "Using Psychometrics to Assess Risk Tolerance," argued that *psychometrics*, a blend of psychology and statistics, was the best methodology for assessing risk. Psychologists have spent more than 100 years developing psychometrics; yet the financial services industry is largely unaware of this discipline, which has had dire consequences for the accuracy of financial planners' estimates of their clients' risk tolerance.

Instead, the vast majority of planners use some form of a readily available risk questionnaire obtained from their software supplier, compliance department, or broker-dealer. Perhaps the planners develop the questionnaire themselves. Regardless what the source may be, many advisers should be aware that industry-standard risk questionnaires are not a panacea to determine risk tolerance.

Two Problems

Usually comprised of five to 20 questions, industry-standard questionnaires are neither valid nor reliable. They are arbitrarily constructed without any scientific discipline, containing too many bad questions that are irrelevant or too technical and not enough good questions that are essential for acceptable reliability.

Years ago, it was not uncommon to find questions relating to physical risk tolerance in questionnaires designed to measure financial risk tolerance. Today, too many risk tolerance questionnaires deal with financial matters that have little to do with risk tolerance. This stems from ubiquitous asset allocation calculators designed to produce an asset allocation (or model portfolio) recommendation based on brief questionnaires about risk tolerance, time horizon, withdrawal expectations, investment experience, risk capacity, and other areas.

Although time horizon and other matters are relevant to investment advice, they are not relevant to risk tolerance, so the first problem with standard questionnaires is that they include irrelevant questions. With low financial literacy as a major obstacle, the second problem is that they use too many technical terms.

The conceptual flaws in industry-standard questionnaires are evident in practice. Although a number of research studies prove these surveys produce unreliable results, the most definitive research comes from Dr. Douglas Rice of Golden Gate University who tested 131 industry-standard questionnaires: "The findings show alarming results. For example, when all questions were answered in the most conservative way possible, the percentage of assets allocated to equities ranged from 0 to 70%. When answered in the most aggressive way, the percentage of assets allocated to bonds, or bonds and cash, ranged from 0 to 50%. This is perhaps the most telling finding of the entire study."

Advisers' Estimates

Although most advisers use some form of questionnaire, other professionals rely on their interviewing skills to determine a client's risk tolerance. However, psychology tells us that interview-based assessments are even less reliable than test-based assessments, even when the interviewer is a highly trained professional.

Given the shortcomings of the approaches used by advisers, it is not surprising that advisers' estimates of client risk tolerance are alarmingly inaccurate, with estimates typically correlating to test results at only ~0.4. Industry research shows that advisers assign too much diagnostic value to certain demographic variables to estimate risk tolerance, including gender, income, wealth, and marital status. In addition, strong evidence exists of gender stereotyping; advisers overestimated the risk tolerance of male clients and underestimated the risk tolerance of female clients—a problem that is as true for female advisers as for male advisers.

Although some may not be too concerned about a correlation of 0.4, what does it mean for an adviser's clients? It actually means that there are gross errors in one in six cases! Thinking in terms of clothing sizes, this is the equivalent of mistaking a small for a large or even a XXL. Given that risk tolerance is normally distributed and most responses will cluster around the mean, advisers would be more accurate if they made no effort to assess their clients' risk tolerances at all and simply assumed everyone was average!

Advisers' Responses

Changing the way an adviser works with his or her clients is difficult. Advisers using industry-standard approaches are reluctant to accept that their estimates might be inaccurate. Even if they realize other estimates might be inaccurate, many advisers believe they, themselves, are the exception to the rule, mistaking experience for expertise. Possibly not coincidentally, advisers have high risk tolerance—significantly higher than investors, which can lead to its own set of problems—and risk tolerance correlates with overconfidence!

Corporate management often acknowledges that psychometric testing is a superior methodology. However, large companies are reluctant to make this kind of testing mandatory because of resistance from some advisers who are often big producers. Companies also are reluctant to make testing optional because this leads to two different compliance regimes, thereby raising difficulties in defending the nonpsychometric approach. It is also often the case that a company's compliance department developed the current questionnaire and does not want to be seen to be acknowledging its shortcomings.

Making mistakes about the client's risk tolerance will not necessarily result in dangerous advice. However, some clients will be overexposed to risk, which can have disastrous consequences in a market downturn. Increasing anxiety can cause a panicked sale at or near the bottom, destroying financial and emotional well-being.

Planners aspiring to meet a professional standard must ensure that they have a proper understanding of their clients' risk tolerance, without which they cannot act in their clients' best interests. The evidence of the failure of the industry-standard approaches to meeting this obligation is overwhelming—don't rely on these questionnaires just because they are easy to obtain and easy to complete. In the long run, the client suffers, and you put your practice at risk.

Risk Tolerance Resources

Geoff Davey has several examples of a valid risk tolerance questionnaire on www.riskprofiling.com. In addition, a recording of his spring 2010 seminar, "Best Practice Risk Profiling," is available to Personal Financial Planning Section members, along with presentation materials. Section members may register for a free 30-day trial of the FinaMetrica system and are eligible for a 10% discount. ■

About the Author

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