Time for Another Look at Client Risk Tolerance?

by Ed McCarthy, CFP®

A long-time client has stopped by your office unexpectedly to tell you that the gyrations in his portfolio's value are keeping him awake at night. "I can't take it anymore," he says—"I want you to sell everything and buy T-bills." You understand his discomfort with the market, but he cuts you off before you can explain why you believe his request is a mistake. He's not interested in discussing his decision so you immediately start liquidating his holdings. Later that day you review his file, which includes a completed risk-tolerance questionnaire. The client's responses indicated a high degree of risk tolerance and you try to figure why he's hitting the panic button.

By any measure, 2008 was an *annus horribilis* for investors and financial advisors. Investors' pessimism grew as the year progressed and the economy worsened, and news stories featured seasoned investors who had given up on the markets by taking their losses and moving to cash. Their decisions were supported by television commentators telling anyone within five years of retirement to sell stocks and anything else with an element of risk and buy Treasurys. Mutual fund statistics supported the notion of heightened investor anxiety. According to the Investment Company Institute, investors withdrew a record $127 billion from U.S. bond and stock mutual funds in October. Fund outflows remained high in November, as well, with another $86.4 billion in withdrawals. Although T-bill and short-term securities rates were at historic lows, money market funds' assets rose to a record $3.78 trillion in early December.

These panic-driven flows raise a problematic question: Why have so many investors—along with their financial advisors—overestimated their ability to tolerate risk? Market volatility isn't a new phenomenon. The dot-com crash is still fresh in many investors' memories and the S&P 500 has had corrections of 30 percent or more three times since August 1987. Admittedly, the U.S. markets were extraordinarily volatile both inter- and intra-day during late 2008. For example, from October 1 through December 10, there were 14 days in which the Dow Jones Industrial Average made over 50 percent of its gain or loss for the day during the final trading hour.

While these short-term gyrations are unsettling, in theory they shouldn't cause investors to depart radically from their long-term asset allocations. Financial planners routinely measure clients' risk tolerance, either formally with a written questionnaire, informally through conversation, or most likely with a combination of the two discovery methods. Likewise, registered reps are required to follow a similar process under the "know your client" rules. Many mutual fund companies and investor education sites provide questionnaires that allow investors to rate themselves on a conservative to aggressive scale; many of these questionnaires are available online. Although some new investors might be unaware of the concept of risk tolerance, it's likely that most encountered and considered it at some point before the bear market started.

It's impossible to know how the degree of selling differs between investors who do not use an advisor versus those who do. It appears, at least anecdotally, that investors who work with advisors are exhibiting less panic than investors overall. According to a survey of 331 Financial Planning Association Research Group members in mid- to late-October, clients were remaining calm. The survey found that less than 20 percent of most planners' clients had called with portfolio concerns and less than 10 percent of most planners' clients had asked to sell stocks.

Nonetheless, the reported degree of investor panic raises questions about the value of risk-tolerance questionnaires (RTQs). Is it possible to measure risk tolerance accurately? Are current market conditions—up or down—the primary determinants of contemporaneous risk tolerance? If it can be measured, what is the best method for doing it correctly?

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A Range of Approaches

In contacting prospective sources for this article, it quickly became apparent that advisors unanimously agree on the value of assessing clients' risk tolerance—that's a given. But there is a much wider range of opinion on the value of RTQs and the approaches used to assess risk tolerance.

Bert Whitehead, J.D., president of Cambridge Connection Inc. in Franklin, Michigan, represents the anti-RTQ sentiment that several advisors expressed. "I have long been a believer that 'risk tolerance' tests are outright dangerous," he wrote in an e-mail. "First, risk tolerance is much too situationally variable to measure psychologically. Second, and more important, it is an abrogation of our responsibility as financial advisors to use a paper and pencil parlor game as a basis for asset allocation. Our obligation as advisors is to advise clients how much risk is appropriate for their personal situation—based on (a) the amount of risk they need to take, (b) the amount of risk they are already taking, and (c) the financial responsibilities they have already committed to."

Robyn L. Bahlinger, CFP®, J.D., is chief compliance officer and a financial planner with Towneley Capital Management Inc. in Laguna Hills, California. Her firm does not use a separate RTQ, but they do ask clients about risk tolerance and expectations for their portfolio, such as whether they want to grow their assets or they want to draw an income. Similarly, William Droms, Ph.D., finance professor at Georgetown University and a principal with the advisory firm Droms Strauss Advisors Inc. in St. Louis, Missouri, no longer uses a formal RTQ with his firm's clients. That practice might surprise *Journal of Financial Planning* readers who recognize Droms as one of the first, perhaps *the* first, advisor to publish the RTQ he was using with clients at the time. (The *Journal of Financial Planning's* archives contain Droms's articles and numerous others on measuring risk tolerance.)

"I think we transitioned from having people actually fill out the questionnaire, scoring them, and then cross-referencing that to a fairly elaborate asset allocation spreadsheet, to just asking the questions and going through and keeping our own score," Droms says. "Now we just talk about risk tolerance and what we think is appropriate because there's so much more to risk tolerance than what you can capture in seven questions."

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Other advisors rely on written RTQs developed by a third party. Conway Halsall, CFP®, CLU, an independent contractor with Ameriprise Financial Services Inc. in Vienna, Virginia, provides clients with a written RTQ created by Morningstar's Ibbotson Associates as part of the initial interview. He asks them to complete it at home; if the clients are married or have a partner, he suggests the couple work on it together. When the clients return for their next meeting, they and Halsall review their responses as part of the portfolio strategy meeting.

Halsall explains risk to clients by simplifying the statistical concepts behind the range of potential outcomes. "I try to use an industry standard and explain that, for example, for a moderate investor, 99 percent of the time you're going to be between 10 percent and 15 percent either on the high side or on the low side of your expected return of 6 to 8 percent," he says. "I have on my laptop a diagram that walks them through this."

Another option that some advisors have adopted is to create their own questionnaire. Tim Parker, CFA, president of Hudson Capital Management LLC in Ridgewood, New Jersey, has been using a self-developed RTQ since he started his firm in 2004 and has found the questionnaire to be very helpful. He often walks clients through the form by explaining questions as needed. Similarly, Leslie Beck, CFP®, CFA, owner of Beck Investment Management LLC in Palo Alto, California, has used some form of an RTQ for much of her 28 years as a financial advisor. She developed her own form when she started her firm in 2007. She created her own RTQ because she wanted to keep the form short—ten questions or fewer—so clients wouldn't "feel like they are working for me." Most of the questions focus on investment experience; she avoids the usual questions about gambling outcomes because her clients resent gambling questions in an investment questionnaire.

Whether the advisors used written RTQs or interview-based assessments, all reported that very few or no clients have panicked and shifted to all cash during the current market pullback, which confirms the previously cited FPA Research Group study. Bahlinger, for instance, could recall just two retiree-clients who pulled completely out of equities, and those clients had been with her firm only since the summer. Similarly, Parker could cite only one case where he believes the clients' risk tolerance changed substantially and led to an all-cash portfolio. He had taken the couple through his RTQ and they reassured him that they were in fact risk-takers. Their outlook changed as the economy and the markets soured, however.

"The couple was a relatively new client, both in their mid sixties, looking not to stop working but to scale back work," Parker says. "Both were entrepreneurs who were investing in some real estate and everything was kind of the perfect storm. The real estate market downturn impacted them and their work was slowing down. Having the stock and the bond market also going down really woke them. They saw literally every single piece of their broader portfolio, including earnings, being hit. Because they are on the cusp of starting to draw down on their investments, it has a huge impact for someone like that, rather than someone who's, say, 40 years old who has time on their side to work through the ups and the downs. These folks just saw literally everything going down and they retrenched, essentially."

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Characteristics of Risk Tolerance

- Risk tolerance is normally distributed so that the standard statistical formulae and techniques can be applied to risk-tolerance observations.
- Males are more risk tolerant than females by about a standard deviation.
- Risk tolerance decreases with age.
- Risk tolerance correlates positively with income wealth and education, and negatively with marriage and number of dependants. However, the correlations aren't strong and some researchers came up with different results.
- Test/re-test studies over periods of ~30 to ~120 days produced correlations of 0.8 and higher between the first and second tests. Strong evidence of the stability of risk tolerance.
- Financial advisers are more risk tolerant than their clients by slightly less than a standard deviation.

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Important but Irrelevant Questions

Regardless of whether the advisor uses no questionnaire, a third-party RTQ, or one developed internally, each source stressed that clients' responses to questions that address risk tolerance directly are only one factor to consider in assessing risk tolerance. The additional considered factors typically include time horizons, human capital, family situation, and financial goals like saving for college or retirement. These factors and anecdotal feedback from clients help determine clients' required risk to reach goals and risk capacity, which measures the risk clients can accept without changing their life goals.

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Clare Stenstrom, CFP®, with Bourne Stenstrom Lent Asset Management Inc. in New York City, believes that clients' financial experiences are critical to assessing risk tolerance. "When you sit and work with a client, a risk-tolerance test, black and white, doesn't do it," she says. "Stories do it. So you try to get them to tell you when they've had financial difficulties, and ask them how they feel about it, and that's more important than asking them what happens if the stock market goes down 400 points."

This additional information is valuable for understanding clients' broader financial attitudes and goals and developing portfolio recommendations. According to RTQ developers, however, this information is superfluous to measuring risk tolerance because the questions often address the separate topics of required risk and risk capacity, not risk tolerance. To understand that perspective, it's helpful to have a basic understanding of psychometrics. According to Geoff Davey, co-founder of FinaMetrica Pty Limited in Sydney, Australia, psychometrics is a psychological discipline used to develop questionnaires that measure something. More formally, it's defined as "the field of study concerned with the theory and technique of educational and psychological measurement, which includes the measurement of knowledge, abilities, attitudes, and personality traits. The field is primarily concerned with the study of measurement instruments such as questionnaires and tests." (Source: Wikipedia.com.)

Everyone encounters psychometrics at some point in the form of IQ tests or the Meyers-Briggs Type Indicator, for example. Davey, whose firm created the FinaMetrica Risk Profiling System, notes that psychologists have been using psychometric techniques to measure individuals' risk tolerance for roughly 50 years. Contrary to the opinion held by some financial advisors, research has shown that it is possible to measure a person's risk tolerance.

"I run into people who say it can't be done, and it just depends whether they are saying it can't be done for risk tolerance, or it can't be done for anything," says Davey. "And the reason they might say it can't be done for risk tolerance is they've never seen an RTQ that looks as though it would work, and they have decided it's not possible to do it."

A general problem with advisor-developed RTQs, says Davey, is that there are not enough good questions and too many questions that are off-topic. As an example of bad queries, he points to questions about time horizon, investment experience, and projected retirement dates. He understands that advisors need this information, but he argues that those questions don't belong in an RTQ. Another practice that creates bad questions is writing questions that clients don't understand. "It's surprising how little clients actually know," he says. "When we were putting our questionnaire together, we did usability trials. We found that with quite a few of the questions we'd selected initially, respondents said that either they couldn't understand or they couldn't answer. Most home-grown risk-tolerance tests haven't been through that type of testing of the questions."

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Another common problem with home-grown RTQs is that they don't ask a sufficient number of questions. That's understandable: who wants to risk aggravating a prospect or client by asking them to answer a long list of questions? But Davey maintains that a valid RTQ requires about 20 good questions.

John Grable, CFP®, Ph.D., professor at Kansas State University's Institute of Personal Financial Planning, has conducted extensive research into RTQs. He concurs that the RTQs being used by many financial advisors probably are not giving accurate estimates of clients' risk tolerance. As an example, he cites how some advisors connect clients' time horizon—typically a projected retirement date—with risk tolerance. The current market illustrates the drawback with this approach.

"Just because you have a long time to invest doesn't mean you have the ability to withstand those losses or even the willingness to take the loss," says Grable. "So you look at today's market and people who are 40 years old are bailing out of the stock market. That's totally irrational but totally consistent with their risk tolerance. We assumed that they had 30 years until they needed the money and they should hang in there. But time horizon is not the same as risk."

From a researcher's perspective, RTQs require validity and reliability to ensure accurate measurements. Says Grable, "As a researcher, if I give you a survey and I get a score from it, can I then say, 'This is truly or very close to the subject's risk tolerance'? That's what we mean by validity. Reliability is a little bit different. I want to know if I give you that survey today, are you going to score similarly in a year from now, in a couple of years? Further, if I give it to 100,000 people, am I going to be confident that scores I am getting from those 100,000 people are in fact accurate? From a research perspective, those are the two things we are looking for."

Few, if any, advisors would rely solely on an RTQ; however, most believe that in-depth interviews with prospects and clients are vital tools in gauging risk tolerance. But the potential problem with relying on interviews is that some respondents will be less than fully truthful when discussing how they might react to investment volatility. Grable has observed that many financial advisors frame the risk-tolerance conversation with questions about possible losses. For example, the advisor might ask what the client would do if the markets fell by some percentage over a given period. Grable believes those questions often fail to elicit candid responses.

"I think that kind of question is a bad question, and it's going to lead to an interpretation of that client's risk tolerance that's totally inaccurate for a couple of reasons," Grable says. "First of all, unless you've lived through a major correction in the market, you probably have no idea what that feels like. It's hard to conceptualize what a 20 percent loss actually feels like. So your initial reaction is probably not correct. And men in particular tend to not answer that question honestly. Even if they would get out of the market in reality, they're not going to tell another man that. They don't want to be perceived as a financial wimp."

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How Variable Is Risk Tolerance?

Assuming that a properly designed RTQ leads to more honest assessments and measures risk tolerance accurately, the question remains: just how variable is an investor's risk tolerance? The correlation between investment performance and risk tolerance is readily observed, at least anecdotally: bullish markets increase risk tolerance and bear markets cause it to decline. That would mean that the results from an RTQ completed during an up market would overestimate risk tolerance in a down market. But does investors' risk tolerance change with the markets or are there other factors at play? Davey says that until recently, he was firmly convinced and the research supported the idea that events in the market did not change an investor's risk tolerance. Instead, he believed it was the investor's perception of their market-risk exposure that changed and led to behavior changes such as panic selling. In other words, when things are going well, clients don't realize the risk they are taking with their portfolios; when things are going badly, clients overestimate the level of risk they're taking. That change in their perceptions of risk, not a change in underlying risk tolerance, leads to changes in behavior.

"I was very confident about that up until three months ago," says Davey. "I'm still fairly confident, but this market downturn is an unusual event. We've started a study to test what's going on in the circumstances we've got. We've asked our advisor-clients to retest their clients now so we can look for changes in risk tolerance if there are any there. I don't think we'll find any significant changes, but we might."

Similarly, Grable notes that prior research indicated that risk tolerance was fixed, but more research questions that axiom. He conducted a study several years ago that found that a person's risk tolerance lags the stock market by about two weeks. "So if the market is up today then drops dramatically, and I come back and measure the same person using the same scale, risk tolerance will actually decline. Are we influenced by the environment? Definitely."

What Next?

The current bear market creates both a dilemma and an opportunity for gaining a better insight into clients' risk tolerance. The dilemma stems from the possibility that risk tolerance varies with market conditions. That means assessments conducted during a past bull market will overstate a client's risk tolerance for downside volatility. If some of your clients have been exhibiting less risk tolerance than their RTQs indicated, bullish market conditions at the time they completed the questionnaire could help explain their anxiety.

Conversely, it's a very good time to retest clients' risk tolerance. The markets' meltdown has battered investors' confidence, and RTQ results from the depths of a major bear market could serve as valuable benchmarks when the markets rebound.

"For many advisors, the first and last time they really talk about risk tolerance with their clients is in the initial stage of the process," says Grable. "I would suggest advisors do an ongoing evaluation of a client's risk tolerance. Because if it varies, if you walk into my office today and I measure your risk tolerance, it's probably going to be pretty accurate because the environment is very negative. And if the markets get better, I'd like to assess your risk tolerance then. If your risk tolerance hasn't moved, that gives me a good feeling that I've got an accurate estimate. If it's moving all around, if it's significantly higher in the future and then it drops, that tells me I want to be taking special care in how I invest that client's assets. My recommendation is that this isn't a one-shot deal: don't fill out the risk questionnaire and file it. I think it should be an ongoing discussion with the client. Just as you would discuss values and objectives on an annual basis, discuss the risk tolerance, too."

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