Rethinking Risk Tolerance

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Michael E. Kitces

MSFS, MTAX, CFP®, CLU, ChFC, RHU, REBC, CASL

Partner. Director of Research, Pinnacle Advisory Group

Publisher. The Kitces Report, www.kitces.com

Blogger. Nerd's Eye View, www.kitces.com/blog

Twitterer. @MichaelKitces, www.twitter.com/MichaelKitces

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Rethinking Risk Tolerance

- Outline
  - Reviewing the traditional risk tolerance approach
  - Exploring the new paradigm
  - Distinguishing risk capacity from tolerance
  - Incorporating risk perception
  - Risk perception and client behavior
  - Integrating application of aspects of risk
  - Approaches to properly measure risk attitude
  - Psychometrics and risk tolerance questionnaires
  - Bringing it all together – the client risk profile
  - Summary & Q&A

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Rethinking Risk Tolerance

- Reviewing the traditional approach
  - Time Horizon
  - Need for Income
  - Availability of other assets
  - Higher knowledge level about investments
  - Unwillingness to stay invested in down markets
- Individual questions tested, creating a total “risk” score

Rethinking Risk Tolerance

- Breaking apart the traditional approach
  - *Risk capacity*
    - Time Horizon
    - Need for Income
    - Availability of other assets
  - *Risk perception*
    - Higher knowledge level about investments
  - *Risk attitude/tolerance*
    - Unwillingness to stay invested in down markets

Rethinking Risk Tolerance

- The new risk profile paradigm

Risk Profile
- Risk Capacity
- Risk Perception
- Risk Tolerance

Rethinking Risk Tolerance

- Distinguishing Risk Capacity from Attitude
  - Separating income needs, time horizon, etc., from the client's willingness to trade-off risk for return
  - ***Capacity for risk = ability to withstand adverse market events***

Rethinking Risk Tolerance

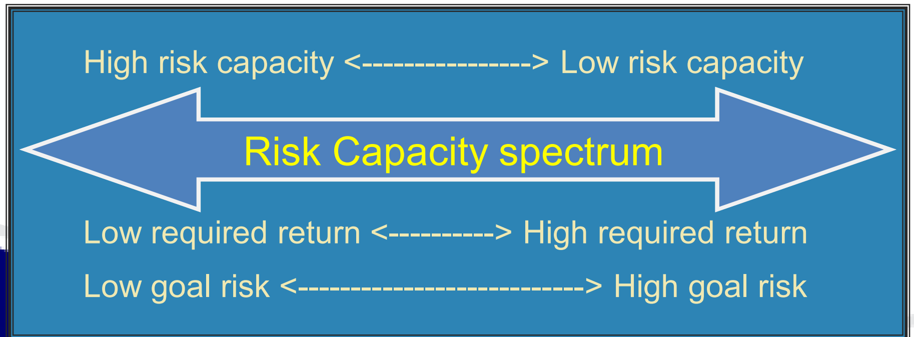
- Distinguishing Risk Capacity from Attitude
  - Examples
  - John Smith needs income in 15 years. Income goal of $15,000/year; future portfolio projected to be $1,500,000. ***High capacity for risk.***
  - Betty Burton needs income of $65,000/year, starting immediately, from a $1,000,000 portfolio. ***Low capacity for risk.***

Rethinking Risk Tolerance

- Interaction between Risk Capacity and Attitude
  - Should be evaluated independently to evaluate conflicts
- Examples in the case of a low risk attitude
  - John Smith: High capacity for risk; low risk attitude. Can afford to invest for his low risk tolerance level.
    - *Traditional approach: Moderate growth portfolio*
  - Betty Burton: Low capacity for risk; low risk attitude. Cannot achieve his goals with his low risk tolerance level!
    - *Traditional approach: Conservative portfolio*

Rethinking Risk Tolerance

- Understanding Risk Capacity
  - Risk capacity measures the required rate of return necessary to (optimally) achieve the client's goals



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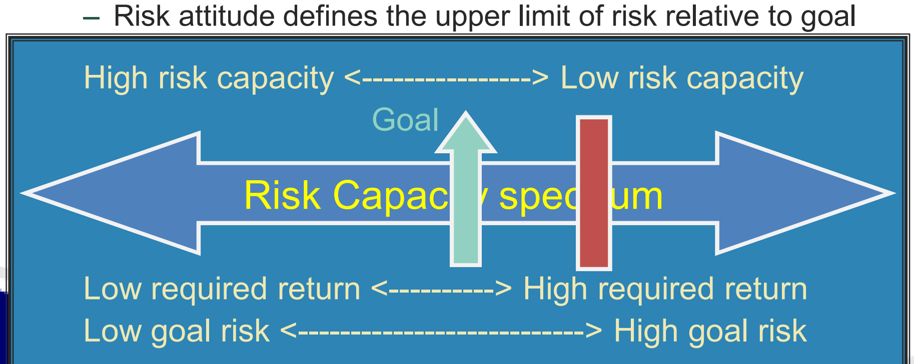
Rethinking Risk Tolerance

- Understanding Risk Capacity
  - High risk capacity allows for any risk attitude
  - Low risk capacity *requires* high tolerance!
  - Risk attitude defines the upper limit of risk relative to goal



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Rethinking Risk Tolerance

- What about risk perception?
  - Does client risk attitude change with the markets?
  - Stability of risk attitude vs. variability of risk perception
  - Client behavior changes as perception of the market's risks shift
    - Bull market perceptions
    - Bear market perceptions

Rethinking Risk Tolerance

- Understanding risk perception?
  - The betting game: Flip a coin
    $2 for heads, $0 for tails
  - How much will you pay to play?
    - High or low risk attitude?

Rethinking Risk Tolerance

- Understanding risk perception?
  - Playing the game
    - 5-game winning streak
    - 10-game winning streak
    - Changing the odds

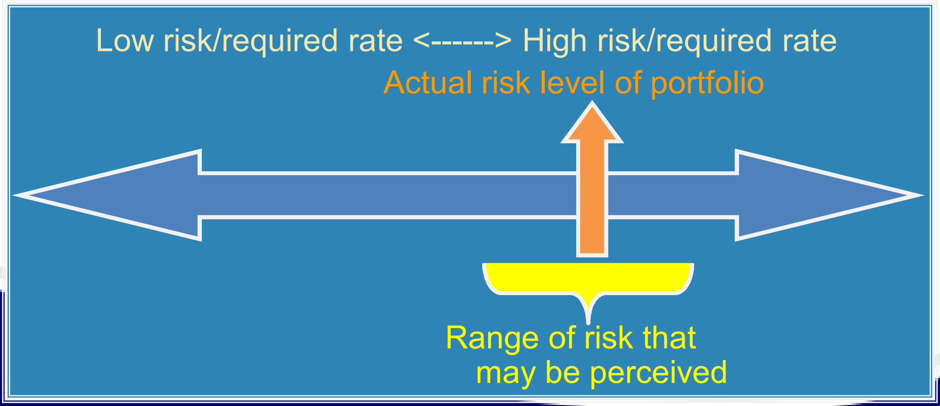
  - Did the attitude change, or just the perception of risk

Rethinking Risk Tolerance

- Risk perception and behavioral finance
  - Common mental heuristics in risk perception
    - Availability
    - Overconfidence
    - Loss Aversion
    - Representativeness
    - Familiarity
    - Recency
  - Knowledge and education vs. fear of the unknown

Rethinking Risk Tolerance

- Risk perception relative to actual risk
  - Clients tend to perceive risk in a range around the portfolio's actual level of risk



Rethinking Risk Tolerance

- Integrating the risk profile components
  - Risk capacity determines how much risk a client can afford to take, or needs to take, to achieve goals
  - Risk attitude establishes the upper limit on the amount of acceptable risk
  - Risk perception connects the client's evaluation of whether the implemented portfolio is consistent with the client's risk attitude
    - Requires constant tuning and management

Rethinking Risk Tolerance

- Measuring risk attitude – questionnaires & psychometrics
  - Psychometrics – the science of psychology test construction
  - Evaluate questions for understandability and answerability
  - Test the test questions on subjects
  - Evaluate test results relative to anticipated behaviors
    - Validity – does the test measure what it purports to measure?
    - Reliability – does the test measure consistently?

Rethinking Risk Tolerance

- Measuring risk attitude – questionnaires vs. conservations
  - Conversational approach
    - Easier and more comfortable for some advisors
    - Able to explore nuanced client issues
    - Difficult to perform consistently
    - Risk of planner affecting client results
  - Questionnaire approach
    - Critical to use well-designed measure (www.finametrica.com)
    - Easier to measure abstract concepts
    - Standard process, allowing for comparison but lacking flexibility
  - *Blended approach best practice?*

Rethinking Risk Tolerance

- Bringing it all together
  - Risk capacity
    - Measured using the financial planning process
    - Key capacity measures incorporated in retirement planning analysis
  - Risk attitude/tolerance
    - Measured via questionnaire
    - May incorporate conversation aspects as well
  - Risk perception
    - Critical both upfront, and as part of the ongoing process
    - Key aspect of managing client expectations

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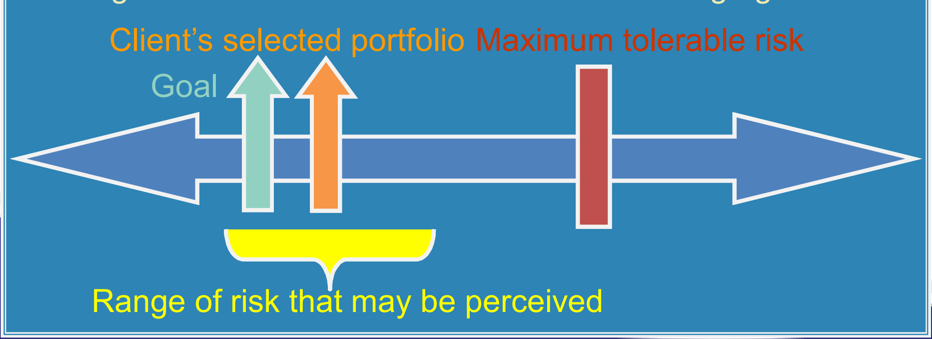
Rethinking Risk Tolerance

- Bringing it all together

High risk capacity <--------------------------> Low risk capacity

Low required rate <--------------------------> High required rate

Low goal risk <-------------------------------------> High goal risk



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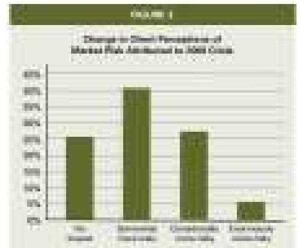
Rethinking Risk Tolerance

- Stability of Risk Tolerance



  - Scores trended down slightly
  - Perceptions shifted significantly!
  - Tolerance rebounded quickly, perceptions did not

Rethinking Risk Tolerance

- Summary
  - Risk capacity must be measured separately from risk attitude/tolerance!
  - Risk capacity is evaluated as part of the financial planning process
  - Risk attitude is best evaluated via a psychometrically-designed questionnaire
  - Risk perception shifts and must be managed constantly
  - An integrated approach allows the planner to optimally address the client's overall risk profile


Questions?
Handouts & additional materials:
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Contact: michael@kitces.com
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