Rethinking Risk Tolerance

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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
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

- 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*
• 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.*

• 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

- High risk capacity ⤵️ Low risk capacity

  Risk Capacity spectrum

  Low required return ⤵️ High required return
  Low goal risk ⤵️ High goal risk

- 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
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?
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- 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

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

Low risk/required rate <------> High risk/required rate
Actual risk level of portfolio

Range of risk that may be perceived

- 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
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- 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?

- 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?
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- 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

Client’s selected portfolio Maximum tolerable risk

Goal

Range of risk that may be perceived
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- Stability of Risk Tolerance
  - Scores trended down slightly
  - Perceptions shifted significantly!
  - Tolerance rebounded quickly, perceptions did not

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- 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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