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Measuring Risk Tolerance

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Much like happiness or wealth, investor risk tolerance is hard to quantify. Risk and investing are inseparable, and various metrics attempt to quantify investment risk, such as the Sharpe ratio and standard deviation. But for most investors, risk tolerance is less about wonky statistics and more about emotions. And that's a big consideration for financial advisors working with clients.

"How many clients can say, 'Well, the S&P 500's average standard deviation is around 20%, therefore my risk tolerance is slightly below that. I can take a standard deviation of 17.5% on average over a 15-year period of time'?" asks Sean Sebold, president of Sebold Capital Wealth Management in Naperville, Ill. "Most clients judge risk on how they feel, and this is not the way to run a portfolio."

Any advisor worth their fee would agree—and can take different approaches to account for risk and help prevent investors from pushing the panic button when the markets tumble.

Sebold's firm models its clients' cash flow and capital requirements 20 to 30 years out. Then it tells them what kind of risk they must take in order to achieve their financial goals in an average world. If the required risk level is unacceptable to them, Sebold changes the outcomes of their financial projections.
"In our opinion, it is senseless to go the other way around—i.e., [first] ask the client what their risk tolerance is," Sebold says. "If a client could take behavior and emotion out of their perceived risk tolerance and keep a static risk tolerance, then it might be achievable."

Sebold says his firm's modeling approach helps clients make meaningful decisions using a risk profile that makes sense to them. "Say a person wants a 9% rate of return," Sebold explains. "We tell them that means in any given time their account value can go down 20% to 25% in a year. If they're not comfortable with that, we have to revisit our assumptions."

That approach helped keep his clients in check during the downturn in 2008 and 2009. "We've lost just three clients since I started this firm in 1998, and we owe a lot of that to managing expectations and the risk component."

Metric System

Some advisors use psychometric tools, such as a risk tolerance questionnaire, to gauge their clients' mind set. One well-known questionnaire is the FinaMetrica risk profiling system, which was developed in Australia and launched in 1998. According to the company's Web site, the 25-question profile has been used by financial advisors, brokers and private banks in 15 countries, and more than 450,000 people have completed a FinaMetrica profile.

Michael Leonetti, CEO and wealth manager at Leonetti & Associates LLC in Buffalo Grove, Ill., says he's used FinaMetrica for roughly 10 years. "I find it valuable in that it's a way to measure clients' ability to handle volatility from an emotional point of view."

He adds that it's just one of the tools he uses to create an appropriate portfolio for a client. "I'd never set up a portfolio based just on risk tolerance because there are other issues to consider, such as risk capacity, and their goals and objectives."

Risk tolerance, Leonetti explains, relates to how much volatility people can live with before their emotions take over and cause them to make decisions they probably shouldn't. Risk capacity is the ability to handle a loss from a financial perspective.

Leonetti says his firm includes the FinaMetrica profile in the information packet it sends to prospective clients. If the prospects are a couple, he asks each person to complete a separate profile and not share the information with the other. They send back the profiles with the rest of the packet, and Leonetti writes up a report before the prospects come in for an introductory meeting.

"Risk tolerance tells me the volatility level they can live with emotionally, and that can translate into a certain portfolio structure," Leonetti says. "And that structure can be translated into a certain long-term average return."

The firm has its own separate questionnaire that asks prospects about their expectations for the return on investment. But those don't always jibe with the risk tolerance FinaMetrica results, Leonetti says. When that happens, he asks people if they're willing to live with the volatility that comes with their return expectations.

Then he incorporates risk capacity into the planning process. "People can take only so much risk to achieve what they want," Leonetti says.

He notes that someone's risk tolerance can change over time, and that his firm will give clients the FinaMetrica questionnaire again after a while. The frequency of retesting depends on the client, he says. Sophisticated clients might not change their risk tolerance much. But if the client was, say, somebody recently widowed and left a sizable sum of money, he or she might require a retest in a couple of years so Leonetti can see if the client has better acclimated to investing and handling the money.

Risks From Within

Some people dismiss risk tolerance questionnaires as something brokers use to cover their fannies when it comes to recommending products that meet the suitability standard for clients. Others believe they are fundamentally flawed.

Bert Whitehead, president of the fee-only planning firm Cambridge Connection Inc. in Franklin, Mich., and founder of the Alliance of Cambridge Advisors, is one of the non-believers.

"Risk tolerance is too difficult to measure since it is situation-biased, and there are no [risk profile] tests which have been evaluated professionally for reliability and validity," he says. "It is an abrogation of our responsibility as advisors to measure tolerance. Our job is to advise the client how much risk is appropriate in their situation."

That means being aware of other risks in the clients' lives. If they are doctors, for instance, they might have occupational risks to worry about. Or they might have highly leveraged real estate. Or they could face business risks (if they are self-employed, for example). "The more people who are dependent on you, the less risk you should take," Whitehead says.

Asking clients about these non-investment-related risks is key, he adds, because an investment portfolio should fit into their overall risk picture. "For example, an entrepreneur with high risk tolerance should generally not have high-risk investments, but rather a more stable, less risky investment portfolio to offset the risk of owning a small business."

Going Beyond Clients' Wishes

At Altfest Personal Wealth Management, clients are asked what kind of portfolio allocation they¹re comfortable with, says Lewis Altfest, the CEO, chief investment officer and principal advisor at the New York City-based firm. "However, we go beyond their own wishes through a system we developed called Total Portfolio Management, which makes an objective assessment of how much risk a client can afford to take," Altfest says.

The approach incorporates financial assets as well as the clients' human capital (their current and likely future salary); their real estate; the Social Security benefits they will likely receive in retirement; and the financial liabilities they face such as mortgages, credit card debt and fixed living costs.
"Using that information, we come out with an asset allocation they can afford to take," Altfest says. "As a practical matter, it tends to support and sometimes moderately alter preconceived client beliefs. In some cases, it questions client allocations entirely."

He gives an example of one client who wanted 90% in stocks when Altfest's analysis called for 20%. Ultimately, the client agreed to an allocation of 65% equities and 35% bonds.

"We're an active manager, and all decisions—unless it's something like private partnerships—are decisions we make," Altfest says. "The asset allocation decision is theirs."

He adds that letting clients select an asset allocation that fits their personality and correlates with the Total Portfolio Management system meant very few of his firm's clients bailed on their investments or requested allocation changes during the market crash in 2008. And that, Altfest says, is why it's vital to align a client's risk tolerance with their portfolios—no matter what system an advisor uses."Ideally, it's an approach that keeps people focused on keeping their assets in times of stress," he says.