Assessing Client Risk: A Two-Dimensional Approach

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The concept of investment risk is getting plenty of attention lately. The losses from plummeting dot-com companies, coupled with the uncertainty of future interest-rate hikes, raise client questions: Should clients worry about the recent drop in stock prices? Do you think we are in, or are about to go into, a bear market?

We struggle with gauging the amount of risk in the current market environment while trying to keep an eye on how our clients react to and perceive uncertainty. Though the questions sound the same, the risk level appropriate for individual clients may vary widely. It would clearly make our work easier if there was one standardized number that measures an individual's ability to tolerate or accept risk. Unfortunately, no one measure can capture all the components of risk tolerance. In fact, risk encompasses two dimensions. The first dimension is the client's (financial) ability or capacity to assume risk; the second is the client's (emotional) attitude toward risk or willingness to tolerate it. Taken together, ability and willingness to bear risk have an impact on the long-run satisfaction and commitment clients have to investment planning.

The use of a framework in which to conceptualize the two risk dimensions helps to identify the risk components for each dimension. In the first (financial) dimension, I look at the following risk-tolerance-related factors in clients' situations:

1. Client age
2. Time horizon
3. Income and spending
4. Liquidity needs
5. Available assets
6. Unique needs or circumstances

The client's age implies a time horizon, but projecting the actual time horizon requires some assumptions regarding life expectancy. To get a handle on this information, I ask clients about their own health issues and whether their

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parents are still living--and, if not, at what age they died and what was the cause. Consider, for example, the client that plans to retire at age 65, but because of health risks and family history, you believe that life expectancy may be shortened. Thus, there would be fewer years of spending down assets and, therefore, a higher risk-taking capacity than someone who may have a longer expected spending horizon. Generally, the longer the accumulation period relative to the withdrawal period, the greater the capacity for risk. The shorter the accumulation period and the longer the withdrawal period, the less capacity for risk.

Next, I try to assess client consumption. For instance, consider the client who spends 75% of an $80,000 annual income and the client who spends 120% of a $250,000 annual income. The client with a lower consumption, independent of the absolute income level, has the capacity to bear greater risk. I try to keep in mind that clients prefer to maintain a steady consumption level throughout life. (Economists refer to this as "life-cycle spending.") People prefer to spread their consumption of goods and services evenly over their lives to the extent that this is possible, and in particular, people prefer that consumption not fall sharply when they retire.

Even so, consumption is a moving target, and it is helpful to remember that risk is a dynamic concept. Like tactical allocators, planners must respond to changing conditions. When greater cash flow is required, overall portfolio risk should be reduced. As cash-flow needs fall, greater risk can be assumed again. For instance, many clients feel more able to bear risk after they've paid off college expenses for their children. Also, the greater the number of dependents in the household, the less capacity for risk generally. In application, this may mean setting up target ranges for stocks, bonds, and cash that allow for adjustments that accommodate changing risk capacity. Normally I use a spread of 20% to 30% in stocks and bonds and 5% to 10% in cash, depending upon current and projected liquidity needs. For example, the range for a specific client may look like this: stocks 50% to 70%, bonds 30% to 50%, cash 0% to 5%.

When income is the principal source of consumption, the planner must also consider factors that would cause the income stream to change, such as disability, job loss, and economic events that may affect the industry the income is derived from. The more variable the income stream (real-estate sales, poor work history, illness, family problems), the less capacity for risk.

In this context, I also consider the presence or absence of insurance policies in the risk-tolerance equation. Does the client have disability, life, and long-term care coverage in force? Is the coverage adequate? If so, the client has a greater financial capacity to take risk and absorb negative consequences.

In general, the higher the probability that client liquidity needs may increase, the lower the risk capacity. It will require all of a planner's judgment to determine or anticipate circumstances where clients may require lump sum amounts or suddenly have to take on serious ongoing expenses. I look for any special circumstances, like children with disabilities, major health concerns of the primary income earner, aging parents who may require paid care but are without resources to pay for it, any "unique" (i.e., costly, dangerous) hobbies or interests and any special attitudes or beliefs that influence a person's willingness to take on risk. These are not always obvious. As time goes on, I've found that experience with a wide range of client circumstances allows me to relate similar client situations and generalize to other client circumstances.

Next, I consider asset level. Paradoxically, the lower the level of assets, the lower the risk capacity. When assets are perceived to be inadequate, the inclination is often to accept greater risk to "make up" for limited savings. This is the wrong approach. The best planning for clients with insufficient funds is to help them save more and lower the risk in their investments until their resources are less limited.

The financial or procedural dimension of risk can have a significant impact on the emotional or personal dimension. When clients are helped to sort out the financial elements of their risk capacity, they become more confidant that their real needs will be met by the investment plan. These more-objective factors in the risk-tolerance equation can be used to educate the client about risk, which can result in attitude changes toward it. Client confidence in the process increases the likelihood of remaining disciplined and staying the course during the inevitable changing tides of the market.

In the personal dimension, there appears to be some confusion between how planners view risk and the way their clients define it. Among professionals, willingness to assume risk is generally thought to rely on some assessment of the "level of uncertainty of return" a client will emotionally tolerate. However, behavioral research on decision-making indicates that people exhibit loss aversion instead of risk aversion. In situations where the probability of loss is very large, people exhibit risk-seeking (rather than risk-averse) behavior. Those losses are so painful that individuals will gamble (increase uncertainty) to avoid the realization of a loss. More generally, the research indicates that losses feel worse than a proportionate amount of gains feel good. Therefore, to assess willingness to assume risk, it may be more meaningful to talk to clients in terms of probability of loss or downside risk, instead of the more traditional risk measures like standard deviation of returns or volatility.

Behaviorists now believe that two things get in the way of rational decision-making: emotions (which represent a lack of control over our environment) and cognition or beliefs that lead to failures in understanding. People tend to be very sensitive to changes in the level of their assets and relatively insensitive to absolute value. Clients react more to short-term fluctuations in asset value and seem indifferent to terminal or long-run wealth. Obviously, this would influence client willingness to tolerate shifts in asset value that we professionals may view as less meaningful when considering client long-run objectives. We can help assuage client fears by educating them in how markets behave, and by providing them with historical data on both long-run market averages and year-to-year changes in value.

When the assessment process is completed, we might find that clients are willing to assume more risk than they are able. Behaviorists have identified the phenomena of overconfidence, in which people exhibit more confidence in the validity of their conclusion than is justified by their past success rate. Some clients will inevitably conclude that aggressive-growth stocks always double in value every three months, based on their most recent experiences. Not fully understanding or believing the statistical changes of a large loss, they may insist on holding concentrated portfolios of currently hot sectors, in an effort to beat the market or make up for lack of prior savings. However, generally, I find that clients are more risk averse than they may initially appear. In either case, asking clients how they feel about risk will not elicit the best answer and will do little to determine the appropriate portfolio for their unique financial and emotional circumstances.

Armed with data from a client's situation, planners can educate and inform clients about the nature of risk. If they then add an understanding of the other dimension of risk tolerance--the emotional and cognitive issues that influence a client's willingness to accept risk--planners can provide clarification and guide their clients to a portfolio that works for them.

Questions and comments about this article should be directed to site manager Jerry Kerns.