# RISK and Regret

## Did the financial crash alter investors' risk tolerance?

BY ED MCCARTHY

Your private clients stuck with equities even after the dot-com bubble burst. They held steady for the ensuing decade, even though the S&P 500 was essentially flat for the years 2000 through 2009. But the financial crash did them in. They rode the market down, but their risk tolerance diminished and they tired of volatility. Since the March 2009 bottom, they've simply been waiting until their portfolios had at least partially recovered, and now they're asking you to reduce their exposure to risky assets in favor of guaranteed returns.

Is this a scenario widely faced by advisers? Did the bear market significantly alter investors' risk tolerance and market behavior? Some advisers found that their Baby Boomer clients, particularly those who are retired or close to retirement, became more conservative. Among the advisers contacted for this article, however, many indicated that, although relatively few clients had the temerity to increase their exposure to risky assets during the pullback, most sat tight. Recent research has provided a more nuanced view of how investors have responded to recent turbulence and what this indicates about how risk tolerance may change over time and under different conditions.

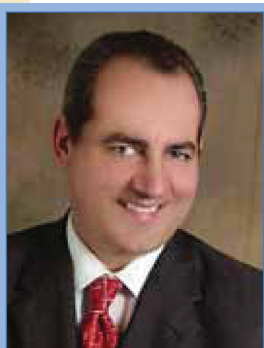
### THE MEASUREMENT DEBATE

Judging whether an investor's risk tolerance has changed requires the ability to measure that trait accurately at different times, and some advisers don't believe it can be done. Developers of risk tolerance questionnaires (RTQs) disagree. "My response has been that if you claim that you can't measure risk tolerance, then you can't measure any other personality characteristic," says Michael Roszkowski, director of institutional research at La Salle University in Philadelphia. "And that's not the case. The question has to do with how precise the measurement is that you are conducting."

Roszkowski points out that there is an unavoidable trade-off between a questionnaire's length and its value, assuming the questions are properly stated. Questionnaires that ask only a few questions lack precision. He cites an example of his work for a mutual fund company that wanted a five-question assessment with high measurement precision. Roszkowski told them this combination was impossible, but the company had him develop the questions anyway. A few years later, he learned that they stopped using it after discovering that changing the answer to a single question put the investor into a different risk category. "One of the things that comes out of psychometrics and is fairly well established is the principle that, other things being equal, the more questions you ask in trying to assess or measure a given construct, the better off you are," he says. "So, in other words, if you've got five questions addressing a given topic, the reliability of the measurement is going to be lower than if you've got 10 questions addressing that topic."

Michael Pompian, CFA, director of the private wealth consulting group at Hammond Associates in St. Louis, Missouri, and author of *Advising Ultra-Affluent Clients and Family Offices* and *Behavioral Finance and Wealth Management*: *How to Build Optimal Portfolios That Account*

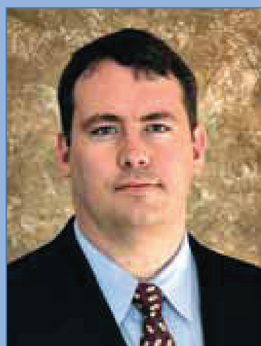
*for Investor Biases*, shares Roszkowski's doubts about the value of short-form RTQs. His firm gives each new client a formal survey that assesses risk tolerance but also asks about a much broader range of themes, including time horizons, liquidity needs, and other topics. That information is used to start developing the client's investment policy statement and portfolio design. "These standardized risk-tolerance questionnaires—which portfolio looks best to you, how much standard deviation are you willing to tolerate in any one year—are not broad enough to truly get at all the elements that are embedded in a portfolio, such as liquidity and so forth," he says. "There are other elements to a portfolio. So, I'm very skeptical about just sort of using a standard risk-tolerance questionnaire and spitting out a portfolio."



Michael Pompian, CFA

The decision not to use an RTQ isn't always based on skepticism, of course. Stephen Browne, CFA, chief investment officer with Paul Comstock Partners in Houston, Texas, says that although he has seen some reasonable questionnaires, his firm doesn't use one. "We're a small firm," he says. "Everybody in the firm works on every client, for the most part. So it's easier for us just to get to know the client and assess what their preferences are as we go through the relationship and present them options."

Browne cites another reason why he believes an RTQ would be superfluous in his work. Most of his firm's clients are living off their portfolios, and their income needs drive the portfolio design. For example, if clients need a 4.5 percent withdrawal rate and have a 30-year life expectancy, they will need to own a substantial amount of equity to have any chance of maintaining that rate. Among wealthier clients with much lower withdrawal requirements, 1 percent or less in some cases, the client can choose from a wide range of risk exposures. "In that case, they could either be extremely aggressive or extremely conservative," says Browne. "We have one client with 90 percent of what we would just call risky assets and another one who's of similar size with only 30 percent in risky assets."



Stephen Browne, CFA

## FIXED OR VARIABLE?

Assuming that risk tolerance can be measured like other personal traits raises several critical questions: Does the risk tolerance of investors remain relatively constant over time? If it can change, what causes it to change? The question is not simply academic. If an investor's risk tolerance is positively correlated with investment performance, that information will be useful to an adviser trying to anticipate possible changes in behavior. When the markets are moving higher, some clients will complain if they underperform the results they're reading and hearing about because they will perceive their portfolios as being too conservative. In a down market, a rebalancing policy would indicate shifting funds into the category with weakest performance, but how many clients had the fortitude to do that in the spring of 2009?

That has been the experience of Susan Tannehill, chief investment officer for TIAA-CREF Trust Company and head of investments for wealth management in Charlotte, North Carolina. She recalls an episode that occurred in the late 1990s (she was with a different company at the time) when the market bubble popped and "the dot-coms died." During that bull market, clients criticized her and her team for being too conservative because they were not investing in all the new companies and IPOs reaching the markets. "Their risk appetite and their tolerance were unlimited," she says, "because they felt that that was an easy way to make money, and the propensity to take risks was very, very high."

Tannehill is noticing swings in risk tolerance after this latest down-up cycle, but this time, clients' reactions aren't uniform. She is seeing "a huge recalibration of risk in the marketplace" and believes several factors are behind the swings. The first is that the bear market forced Baby Boomers to pay attention to their retirement plan assets. This cohort is asking whether prior allocations were too risky and were reducing exposure to market risk. Other investors are going in the opposite direction. They were too nervous to invest when the markets were falling, but now they're convinced the rally will continue and don't want to miss out. "This last correction is being viewed by some as 'the second bus has come,' as we call it, to take advantage of a recovery and a better market,"

she says. "So I think the market is observing participants being more bifurcated. Some [are] looking to cash out, and some [are] looking to get back on the bus because they missed the big move."

## FORMAL STUDIES

FinaMetrica, a risk-profiling firm in Sydney, Australia, provides an RTQ for financial advisers to use with their clients. The firm analyzed risk-tolerance stability among 2,415 test-takers who had first tested between 1 July 2003 and 31 December 2007 and then had a subsequent retest after 31 July 2008. The longest period between test and retest was 71 months, and the shortest was nine months. Although the analysis showed an overall decline in risk tolerance, the decline was less than one-third of the standard deviation of 10 points, and some retesters' scores increased.[1]

These results confirmed the belief in risk-tolerance stability held by Geoff Davey, the firm's president, who notes that even though investors' risk tolerance remains stable, their perceptions of market risk can change in a given environment. Such changes in risk perception can and do influence an investor's behavior even though the underlying risk tolerance remains stable. In a separate survey conducted between December 2008 and July 2009, 445 FinaMetrica clients were surveyed about their perceptions of stock markets' declines and risk. Fifty-nine percent responded that the market decline was considerably (46 percent) or completely (13 percent) outside their expectations, and 33 percent believed the market was considerably (27 percent) or enormously (6 percent) more risky. "For about one-third of the people, their view on the market has changed significantly," says Davey. "Those people would have been taking risks they didn't understand, and so their behavior may now change."

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GEOFF DAVEY

Roszkowski says his research and other published studies have underscored the need to distinguish between absolute and relative changes in financial risk tolerance. Depending on environmental factors, a person's score can go up or down, but they move proportionately. "In other words, there was a change in the absolute score but not a change in the relative score, so people that were higher before are higher now, people that were lower before are lower now," he says. "It's a proportionate drop rather than just being a random drop. Yes, changes do occur in the absolute sense. Scores can go up and down depending on environmental factors. But, more or less, people are fairly stable when you look at them as a group and you look at their relative standing."

In late May and early June 2009, the Vanguard Center for Retirement Research surveyed 3,012 American investors whose demographics were weighted to match the U.S. population's general profile.[2] The respondents indicated a heightened risk perception about stock market investing, but that greater concern did not translate to a panic. Specifically, 49 percent agreed with the following statement: "Today, the stock market is a more dangerous place to invest retirement savings than it was in the past." But only 24 percent agreed that "The risks of the stock market are just not worth taking." This confidence translated into relatively few portfolio changes by respondents. Roughly 57 percent of the households that owned stocks made no changes to their stock holdings. Of these who made changes, 21 percent reduced stock holdings, 17 percent increased stock holdings, and 5 percent sold all stock investments. The report notes that among the 5 percent who sold all stocks, the overwhelming majority intended to invest in equities again in the future. John Ameriks, head of Vanguard Investment Counseling & Research, believes the findings emphasize the fact "that reactions of individual investors are perhaps not quite as dramatic or as widespread as one would infer from reading press accounts and paying attention to the news."

## REMAINING FLEXIBLE

The investment professionals interviewed for this article who use RTQs stress that the questionnaires are only one component in assessing the likelihood a client will stay the course during volatile markets. Behavioral biases, such as overconfidence and loss aversion, are also key factors. In late 2009, Hammond Associates revised its

1. FinaMetrica, "Global Financial Crisis Survey Report" (September 2009).

2. John Ameriks et al. "The Aftermath: Investor Attitudes in the Wake of the 2008–2009 Market Decline," Vanguard Center for Retirement Research (October 2009).

Donald Duncan, CFA

client survey to help identify clients' biases. The questionnaire addresses behavior directly by asking clients about their personal responses to the extreme market volatility experienced in March 2009 (see sidebar on this page). "Choices included 'cut risky assets in the portfolio,' 'added to risky assets,' or 'adhered to the investment policy statement and rebalanced,'" says Pompian. "We're really getting at what people actually did during that period, and it gives us insight into what the experience of these investors has been and how they might behave in the future." Donald Duncan, CFA, with D3 Financial Counselors in Downers Grove, Illinois, also does a "reality check" to determine how well clients' behavior matches up with their test assessments. "We always look at how the clients are invested before we do the financial plan," he says. "[Assume] a client's questionnaire said, 'I embrace risk. I want to get greater than 12 percent returns on my portfolio,' and then you see that their assets when they came to you were in CDs and bond funds and that type of thing. There's a disconnect. If people say 'I embrace volatility, but I'm invested in CDs,' they don't truly embrace volatility."

Duncan takes another step to avoid mismatches between stated risk tolerance and subsequent behavior by having clients set aside ample cash reserves so they can ride out volatile periods. This approach reduces clients' stressful reactions to market-news headlines and reduces the risk that clients will panic and bail out on their portfolio's longer-term allocation. In the spring of 2008, Duncan and his colleagues forecasted an oncoming recession and recommended that clients increase their cash reserves to cover two years' living expenses. In the summer of 2008, they increased the recommended amount to three years' expenses. This was a case of clients' stated risk tolerance taking "a back seat" to their financial plan, and it worked, according to Duncan: "Almost all of our clients are back to, if not above, where they were at that point in time."

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## BEHAVIORAL QUESTIONS FOR CLIENTS

**Below is an example of the client survey used by Hammond Associates to help identify clients' biases.**

**Assuming you had investment decision-making and/or investment committee responsibilities in 2008 and 2009 for a diversified portfolio of investments, what was your personal reaction to the extreme volatility that occurred at the time?**

- ☐ Cut risky assets in the portfolio as the market fell
- ☐ Added to risky assets in the portfolio as the market fell
- ☐ Adhered to an investment policy statement and rebalanced routinely
- ☐ Decided not to rebalance; waited to see what happened
- ☐ Other
- ☐ Not Applicable—I did not have investing responsibilities

**Like most investors, you have probably made an investment decision that went against you. In some cases, some investment decisions go particularly badly, which causes some investors to avoid certain investments in the future. Are there any in this category for you?**

- ☐ No
- ☐ Yes

If yes, please list these investments:

**Suppose you were presented with an investment opportunity that had both positive and negative characteristics. In deciding whether to move forward or not, what is your typical process?**

- ☐ I tend to focus on the positive aspects of the investment
- ☐ I tend to focus on the negative aspect of the investment