Are Risk Tolerance Questionnaires a Silly Waste of Time?

June 7, 2016

by Scott MacKillop

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

When a prospective client walks through the door, a financial advisor wants to know three things: their return objective, their time horizon and their tolerance for risk. Financial planning research has systematized the first two tasks. But the attempts to quantify risk tolerance have failed to produce positive outcomes for investors.

Calculating a return objective is straightforward. You learn how much the prospect has now and how much more they want in the future. You find out how much time they have to close the gap. You do some math and there you have it – a return objective. Of course, you may have to make a few assumptions and press the prospect for information they haven't thought much about, but the calculation itself is simple.

The same is true about the time horizon. You will have to make some assumptions about life expectancy and ask the prospect for information they may not be sure about, like remaining years in the work force. But once you have gone through this exercise, you emerge with a number. It may not turn out to be the right number – the prospect may die earlier than you assumed – but it is a concrete number derived from objective, measurable information.

How do you measure risk tolerance?

What about risk tolerance? How do you measure it? Can you calculate it using simple math? Can you calculate it at all? Can you even define it in a meaningful way? It is easy to see that there are really two very different varieties of risk tolerance: one is attitudinal and subjective, and the other is objective and measurable.

I'll look at the objective variety first. Let's say my goal was to have $2 million by the time I retire at age 65. Now I have arrived at my retirement date, and I have $3 million in my account – significantly more than I need. My goal should be to take as little risk as possible while maintaining the purchasing power of my assets. Objectively, I should have no tolerance for risk.

On the other hand, let's say my goal is to have $2 million when I retire in five years. But I only have $1 million today. Objectively, this means I should have a high risk tolerance. Few investments can generate the 14% to 15% annualized return I will need to reach my stated goal and they are all very risky. I have no choice. I need to take risk to reach my goal.

This objective type of risk tolerance determination has nothing to do with my internal feelings, attitudes or beliefs about risk. It is all driven by my goals and my time horizon.

Now let's talk about the attitudinal variety of risk tolerance. This is what risk tolerance questionnaires attempt to measure. They do this by asking questions designed to reveal our true predisposition toward, and probable level of comfort with, risk. Some of the questions are very direct in asking us how much risk we are comfortable with or how we rank ourselves along the spectrum of risk-takers. Other questions ask us to report how we would behave in the face of various scenarios, some of which involve investing and some of which don't.

Can we measure risk tolerance with a questionnaire?

Many of these questionnaires synthesize our answers into a risk score. These scores may label us as conservative, moderate, etc., or they may actually assign us a single number, like a 42 or a 78. Some are even designed so that these scores determine what investment strategy is appropriate for us. I am a 42 so I should have the 40/60 portfolio, and you are a 78 so you should have an 80/20 portfolio.

In other words, comfort with risk determines strategy.

Creators of these questionnaires would have us believe that our risk tolerance is like our heart or our brain. We all have one, and it can be identified and measured if only we have the right tool. The questionnaire, then, is like an MRI; it discerns our risk tolerance.

This view is inconsistent with risk tolerance. My experience, supported by behavioral finance research, indicates that a person's tolerance for risk is hard to capture and even harder to quantify precisely. With effort, you may get a general sense of a person's comfort with, and capacity for, risk-taking.

But I am not a 42, and you are not a 78.

The research also suggests that we are all notoriously bad at assessing our own risk tolerance. Trying to get a sense of how we would behave in the face of various adversities by asking us produces unreliable results. It is very hard for people to tell you with any accuracy how they would react in the face of a 20% market decline until they actually experience one.

Part of the problem is that risk tolerance is fluid and situational. A person may be conservative with their money, but enjoy ice climbing. We tend to be risk-averse when markets are declining and risk-seeking when markets are rising. We are more inclined to take risk when we are far from our financial goals and less inclined when we are close. Risk tolerance is not like a heart or a brain. It is highly dynamic. Today's bold adventurer is tomorrow's timid soul.

If we are not good at assessing our own tolerance for risk and that tolerance changes over time, what good is a questionnaire that produces a very precise risk score at one moment in time? Even if risk tolerance questionnaires did capture meaningful information, wouldn't you need to administer them to clients on a regular basis to get an accurate sense of the range of their risk tolerance? Such a practice might be useful, but is unlikely to gain widespread adoption.

Questioning the relevance of risk tolerance

A more controversial question is, “why is risk tolerance even relevant?” Why would you develop a strategy based on the client’s comfort level instead of their long-term goals? If a client has $700,000 today and wants to have $1 million in 10 years, what difference does their risk tolerance make? They need $300,000 and it’s our job to maximize their chances of getting it. Would we devise a strategy that gave them a smaller chance of reaching their goal simply because they had less tolerance for risk? If so, how do we justify that?

This raises another interesting question. What happens if a person with a low risk score is put into an aggressive portfolio? Let’s assume that risk tolerance questionnaires are actually measuring something meaningful. If I have a low tolerance for risk, and my advisor tells me I need to invest aggressively to achieve my goals, what should I do?

I badly want to achieve my goals, but what will happen to me if I blow past my tolerance for risk? Am I in danger of having a stroke? Will I experience blurred vision? I suppose I am in danger of being uncomfortable, but that may be a necessary side effect of achieving my goals.

Why can’t my advisor put me in the portfolio most appropriate for achieving my goals even if it stresses me out? One reason is that compliance departments are incorporating risk tolerance questionnaires into the suitability determination process. At some firms, it is difficult for an advisor to recommend a more aggressive portfolio to someone with a low risk score even if they need it to maximize the likelihood of reaching their goals. Does this make sense?

Say I have an 80-year-old client who lives very comfortably off the interest from a $5 million municipal bond portfolio. She completes a risk tolerance questionnaire and, not surprisingly, has a low tolerance for risk. She wants to invest $100,000 in an aggressive portfolio in order to provide a college fund for her granddaughter. Why should her low risk tolerance prevent it?

Sales people are also learning how risk tolerance questionnaires can be twisted to push investors into inappropriate products. They are now using these questionnaires to compare a prospect’s individual risk score to the risk level of their current portfolio in order to demonstrate that the prospect is invested improperly. Creating doubt and fear is an old tradition in our business, but risk tolerance questionnaires simply do not have the level of precision necessary to justify this practice.

Has science gone too far?

As in so many areas, we have lost sight of the true value of a useful tool and have allowed form to prevail over substance. A discovery questionnaire is a valuable tool for an advisor to use in soliciting information from a client. A good advisor can use the answers to stimulate further discussion and develop insights about the client, their goals and their attitudes about a variety of relevant topics.

But substituting a mechanical scoring system backed by questionable science for the judgment and experience of a trained advisor is a step backwards for our industry and ill serves our clients.

Scott MacKillop is CEO of First Ascent Asset Management, a Denver-based firm that provides investment management services to financial advisors and their clients. He is a 40-year veteran of the financial services industry. He can be reached at scott@firstascentam.com*.*