The Disconnect Between Risk Tolerance Questionnaire and Portfolio Decision

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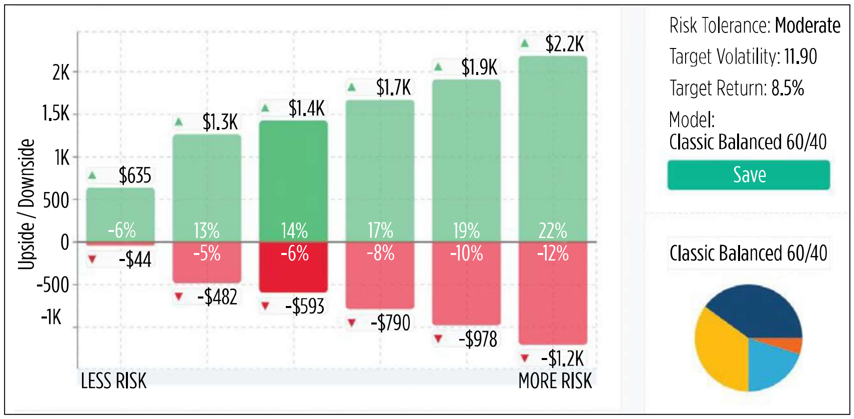
Constructing an investment portfolio that matches the client's risk tolerance is a fundamental task for financial advisors, but not necessarily an easy one. Many advisors still use a traditional Risk Tolerance Questionnaire, which does not provide a direct linkage to the portfolio decision.



Some questionnaires simply ask the client, "what is your risk tolerance?" And the client will choose high, medium, or low. This self-described risk tolerance tends to be unreliable and unstable.

Other questionnaires ask a series of questions to get the risk tolerance. For example, one of our RIA clients uses a questionnaire that includes questions like: "how would your best friend describe you as a risk taker?", and "how comfortable are you investing in the stock market?"

Results from such questionnaires tend to be relatively stable, but there is still a disconnect between these questions and the portfolio decision. For example, how do you prove that the balanced portfolio is the best fit for a client instead of the growth portfolio? More importantly, how would client know that they could lose money when investing in a diversified equity portfolio, and how much?

There needs to be a more direct approach that is transparent and defensible.

Many firms use model portfolios to standardize their investment practices, and the most direct approach is to ask the client to pick a model in the model set based on the upside/downside tradeoff that the client is most comfortable with (see chart). It is like going to a café that offers salad, soup, sandwich, and hamburger, and you pick one based on your appetite.

This way, the result maps directly to a model, and the client explicitly acknowledges the downside they are willing to accept.

"This makes perfect sense," one might say, "but if this is so intuitive and direct, why haven't other vendors done it already?" We wondered about that too. As far as we know, our patent pending Risk Tolerance Test is the first and the only one that allows advisory firms to plug in their models.

What if a firm have multiple model sets? Many firms have a basic model set for entry level clients and a different set for higher net worth clients. In this case, the Risk Tolerance Test should reflect the intended model set for each client.

Once the client has a portfolio that matches their risk tolerance, we should monitor it on an on-going basis to make sure it continues to be a good fit. This is where things get tricky.

When we talk about the investment risk, the first question is "what time frame?" Each time frame, from 1-month to 30-year, offers an important perspective of the overall risk picture. During extreme market conditions, the short-term risk will spike. Does it mean that the risk is now misaligned, and the client portfolio needs to be adjusted? No.

It is important to acknowledge the higher risk in the short term to validate the client's concerns, and then emphasize how the risk is still aligned over, say, 3-year time frame. These rich perspectives cannot be captured by a single number.

Combining the Risk Tolerance Test and real-time risk monitoring, financial advisors can better fulfill their fiduciary duty and tell their long-term story. ■

Helen Yang, CFA, is the founder and CEO of Andes Wealth Technologies, and a winner of 2011 Harry Markowitz Award.

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