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Risky Business
By Mitch Anthony

Imagine this risk tolerance discussion:

"Before we begin to put together an investment plan that is suited to your needs, I need to have you answer a couple of questions:

1. How much money can you handle losing before you start throwing up and selling your children's electronics on eBay?
A. 0%-10%
B. 11%-30%
C. 31%-50%
2. Which statement best describes you?
A. I watch CNBC 12 hours a day.
B. I have my advisor's number on speed dial but only call on 100-point dips or greater.
C. When the market is down, I take out home equity loans and invest more.

I have made no secret over the years of my lack of regard for the client assessment instrument known as the "risk tolerance questionnaire." I find the methodology laughable––but, alas, my barbs and criticisms seem only to fall to the floor with a thud. I continue to see the same lame assessments being administered as indicators of what a client can handle in turbulent times.

If the recent subprime and CDO crises teach us anything, it's that, by and large, this industry has been unsuccessful in accurately assessing an individual's degree of risk tolerance. In fact, if advisors were given a quiz on their own clients' real risk tolerance, they'd likely flunk it. For example, have you by any chance observed in this decade of dizzying down markets that a high percentage of the clients who indicated that they had moderate-to-high thresholds for risk sounded awfully conservative in their yearly review meetings?

Have you ever suspected that it might be silly and maybe even naïve for us to expect another human being to accurately predict how he or she will react when faced with a crisis? For example, if an advisor were to ask his client, "You just found out that your wife has run off with your best friend, what would you do?"

1. Vow to never again trust ANYONE
2. Suddenly realize how much you miss him
3. Fill out the profile at eHarmony.com

We're asking clients to look at a traumatic event they may have not yet experienced and to predict their emotional response. Well, if we're convinced that this is a sound methodology, I think it is time to take the process to the next level. Wise teachers have warned me that it is far too easy to curse the darkness––it is better to be a light in that darkness. So, into the dark room of risk assessment I bring my tricky, inextinguishable birthday candle.

Here is a more penetrating risk tolerance profile that I call the TMA ("Take My Assets"—which are also my initials) Risk Tolerance Questionnaire. I'm hoping you can implement this tool in your practice ASAP (before the next big dip causes your phone to ring off the hook).

The TMA Risk Tolerance Questionnaire
1. You are on a cruise and you suddenly enter choppy seas with 12-foot waves. What would you do?
A. Try to lie down and wait it out.
B. Order three martinis and four nausea pills.
C. Tell the captain, “Strap me to the mast. I’m going through it!”
2. You are walking at night in a big city when a mugger jumps out of an alley and demands your wallet and watch. What would you do?
A. Hand over your wallet and beg, “Please, don’t hurt me.”
B. Run as fast as you can into the street, screaming for help.
C. Pull out a Bruce Lee move and beat the snot out of him.
3. You are working in your ship shop and you accidentally slice deep into your finger exposing the bone. What would you do?
A. Call 911.
B. Wrap it tightly and drive to the emergency room.
C. Use your “Rambo-style” auto-surgical procedure and sew it up.
4. You open your mail to discover your spouse has maxed out five different credit cards. What would you do?
A. Call a credit counselor and a lawyer.
B. Have a tête-à-tête with your spouse about it and put together a budget for paying the debts off.
C. Take your spouse out to dinner (on your AMEX card) and congratulate him or her for realizing how short life is.
4. When playing Texas Hold ’Em, you tend to:
A. Play tightly, and play only the best hands.
B. Check and call a lot.
C. Raise and bluff.

Operation Toleration

Clearly what we are attempting to discover in risk tolerance is what a client will “tolerate.” Well, it quite depends on the topic at hand. In the case of alcohol, an individual’s tolerance grows, and so he or she drinks more. In the case of whining children, however, my personal threshold for tolerance has shrunk considerably over the years, and so my last child gets much less audience for outbursts than my firstborn.

In discussing how much tolerance a client has for risk, we need to decide first if risk is a stimulant or an annoyance—or both. It sort of depends on the personality we’re dealing with, doesn’t it? And equally important is an individual’s personal history with risk.

The Real Risk

Maybe the biggest risk is in believing that these risk tolerance questionnaires unearth anything other than whimsical answers revealing only how an individual felt at the time. Based on those slight indicators, you create an investment plan, your clients sign off on it and then they call you in a panic, brew silently or switch advisors when the low-end realities come into play. Now, that’s risky business. How can we do better?

By accepting the reality that two or three risk assessment questions will provide false indications or transitory indications at best, I suspect that safer, more credible inquiries can be discovered in a client’s personal history or his personal financial philosophy. How much risk an individual will tolerate hinges more on past experience than on predicting a future response. The following are issues I believe to be germane to the risk tolerance discussion:
1. The clients’ personal experiences (both positive and negative) in the arena of investments. What happened, how did it happen, whom do they blame or credit, and what conclusions did they draw from these experiences?
2. Their personal philosophy on financial matters. What guidelines do they follow regarding financial and investment matters? Do they have guidelines, or do others make these for the client? What are their boundaries regarding debt, assuming risk and trusting others? In short, what is their “fiscalosophy?”

In the interest of space constraints, I will offer some suggestions in this article on item one (their experiences). I will deal more extensively with item two (financial philosophy) in my next column.

Speaking From Experience

1. What positive experiences have you had with investments, and how did they come about?
2. What disappointing experiences have you had, and how did they happen?
3. What kinds of investment concepts are you simply not interested in?
4. What guidelines or rules do you attempt to follow regarding managing your money and investments, and how did you learn these guidelines?
5. What sort of experiences have you had with other financial professionals?
6. What are your expectations of a financial advisor?
7. What are your hesitations about working with a financial advisor?

I would venture to guess that you will obtain a much clearer portrait of a client's tolerance for various investment suggestions through this type of inquiry than you ever will through the instruments applied universally in this industry. Furthermore, I suspect that your clients' stories will indicate much more about how they might behave, given a set of future circumstances, than a pencil mark designating "conservative," "moderate" or "aggressive" would ever hope to tell us.

An advisor came to me the other day and told a story that affirms my suspicions:

"My partner and I were getting ready to sit down with a prospect who had a considerable amount of money. My partner had put together a plan for allocation that was moderate in risk but included some exposure to the technology sector. This fellow's risk indication had come in as moderate, and so we thought this would fly. At the last minute, just before we were to show him our suggestions, I decided to do what you recommended, and dig into a little of his investing history. I asked him what his 'best and worst' investing experiences had been. He talked, with vivid emotion, about being badly burned, and concluded with firm resolve, 'I'll never put another penny in tech.'"

Oops.

This advisor found out the real risk in dealing with a client's risk level—not knowing the story of how the client came about his or her opinions and tolerances.

The other risk would be using a test for risk that simply doesn't work.

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