InvestmentNews
The Leading News Source for Financial Advisers

Different takes on risk assessment

January 29, 2012

When I boarded the Costa Concordia for a Mediterranean cruise in October 2009, I never considered the possibility of being on a sinking ship — much the way many investors never considered that a bear market could decimate their retirement nest egg.

Today, having seen cruise ships and stock markets sink, all of us are now more focused on risk.

But "risk" is vague. Do investors and their financial advisers understand the difference between risk tolerance and risk capacity?

Robert Kreitler of Kreitler Financial LLC in New Haven, Conn., isn't sure.

He thinks that most advisers and investors focus on risk tolerance, which defines the point at which a kick in your portfolio makes you cry, while ignoring risk capacity, which is the ability to sustain a loss and still achieve key objectives, such as retiring at 65 with sufficient income.

"Risk capacity is not a new concept; it just hasn't received the attention it deserves," Mr. Kreitler said. "The financial disaster of the past several years destroyed many financial plans because investors had portfolios that were too risky for their objectives."

Mr. Kreitler argues that once an adviser has defined how much capital a client requires to reach a must-achieve objective, such as a minimum level of retirement income to cover essential costs, that value should become the "critical path" used to determine risk capacity. (He said that the critical path is more important in the distribution phase than the accumulation phase.)

An individual whose portfolio's value is on or below the critical path should use only risk-free investments, Mr. Kreitler said.

Otherwise, the investor jeopardizes his ability to reach his essential goal. Once critical needs are covered, the investor can allocate surplus assets in a riskier manner to try to capture higher returns.

Mr. Kreitler defines a risk-free investment as one that is guaranteed by a third party to produce returns at a future date, protect against inflation or provide cash payments for a specific period of time, or for life.

Typical risk-free investment vehicles include government bonds, Treasury inflation-protected securities and guaranteed annuities.

Why should someone use an investment with a risk-free return when over the long term, riskier investments typically provide much higher returns?

The higher long-term returns aren't assured or guaranteed and the investor's objective, by definition, must be achieved, Mr. Kreitler said.

Another option is to reduce a retired client's critical needs by moving some expenses — such as entertainment, vacations or gifts — from the mandatory to the discretionary column, flattening the retiree's critical path and increasing his or her investment flexibility.

For vulnerable investors, Mr. Kreitler questions the appropriateness of applying Modern Portfolio Theory and using Monte Carlo models to structure portfolios in which outcomes are based on probabilities, not guarantees.

"Using riskless investments for some investors may require a major change in industry practice," he said. "Just ask the millions who shouldn't have owned risky portfolios in 2008 and now can't retire as planned."

Speaking of industry practices, website developer Peter Geismar thinks that most risk tolerance quizzes are useless.

Asking speculative questions — such as whether an investor could sleep at night if his or her portfolio value dropped 20% — increases skepticism and fear because investors don't really know the answer.

"Buyers know intuitively that it's all garbage in, garbage out," said Mr. Geismar, who spent much of his career designing customer interfaces for retail insurance and investment products. Consequently, if clients don't trust their answers, they may not trust the recommendations that you give them based on those answers, and they will be less likely to move forward in the decision process.

Devising what he thinks is a better solution inspired by behavioral-finance research, Mr. Geismar created a web-based tool that he calls Confident Choice, which streamlines the way that customers make decisions about complex products such as investments and insurance.

The tool (confident-choice.com) starts by asking questions about the respondent's current state to which the answers are known.

For example, a demonstration about choosing a Medigap policy asks about personal preferences, such as whether you would want to retain access to your doctors or if you are more concerned about saving money on health insurance premiums.

Using a proprietary analytic model, the tool matches answers to the preferences of consumers with similar characteristics. It then provides prospects with a description of what "people like you" chose and why that selection may make sense for the respondent, as well.

Mr. Geismar said that his model can lower the cost of sales, increase close rates and enhance customer relationships. It can be customized for a variety of products and services.

Mary Beth Franklin (mbfranklin@investmentnews.com) welcomes your comments and suggestions for column topics.