

Rethinking Risk

Risk Versus Early Retirement

DAVID B. LOEPER, CIMA
CHAIRMAN/CEO

What Is Your Maximum Tolerance for Risk?

For years financial advisors have been trying to help their clients answer this question in a consistent and meaningful way. More recently, “cyber advice” websites and other “experts” have deployed risk questionnaires and algorithms that supposedly probe your psyche to help discover the answer to this all-important question.

I don't mean to offend anyone, but we are being pretty stupid if we believe we will ever find a logical answer to this question. Before you tear up this paper (or close your browser window), take a step back and think about what we are asking investors to identify for us. We are asking them how much money they can tolerate losing. We are asking them how much uncertainty they are “comfortable” experiencing. We are asking them how much pain they can endure.

Now, maybe my perspective on this is somewhat backwards, but this sounds like the type of question that can only be answered one way—as little as possible. In fact, this is often the first answer we get from investors. Investors are telling us that, like everything else unpleasant, the risk of financial pain is something they prefer to avoid. To me, asking this question is like asking someone how much they are willing to bleed, how badly they are willing to be burned, or how hungry they are willing to be. If something is unpleasant, our survival instinct tells us to avoid it. Losing money is unpleasant. It is something we want to experience as little of as possible. This is the case with investment risk, just as every other unpleasant experience.

What is even more ironic, however, is that once we supposedly identify an investor's tolerance for risk, we then endeavor to position them TO EXPERIENCE IT! This is like identifying that a person can “tolerate” a second-degree burn and then proceeding to place their hand in a fire long enough to achieve it. Oh, by the way, in your attempt to achieve a second-degree burn there is a 33% chance that you will achieve a third-degree burn...so don't try this at home.

The investment industry has generally ignored this reality. A theory in one of my favorite books says, “Logical contradictions do not exist, so if you perceive a contradiction, check your premises.” The industry has perceived the contradiction but has not yet been willing to check their premises. Instead they have sought to blame other factors. It couldn't possibly be that our premise is flawed...could it?

“It isn't that investors don't have a maximum tolerance for risk, but instead how we are measuring and communicating risk to them that is the problem,” proclaim the experts. The solution...come up with new risk measures other than the original ones—beta and standard deviation—that started us out on this folly. Mathematicians proceeded to design maximum loss (or draw down), semi-variance or other mathematical means of measuring unpleasant investment experiences. Still, we have wondered why investors seem equally averse to these “improved” risk measures.

Having failed with new mathematical risk measures, the experts chimed in with the statement that, “Many investors don't like mathematics so we have to bring in psychologists to learn how investors feel about risk.” The psychologists proceeded to design questions for which there is but one answer (as little as possible). Still, they gladly accepted their psychological consulting fees. After all, their task assigned by the “experts” wasn't to determine whether or not it is irrational to ask investors how much unpleasantness they want. They did their job by designing questions that indeed identify that investors don't like unpleasant experiences. Imagine that!

Perhaps now that we have revealed the human genome, we will simply ask investors for a specimen so we can uncover their “risk tolerance gene” so that we can position them in the ideal portfolio to make sure they experience the worst they can bear.

Investment risk is not something we have a maximum tolerance for and then endeavor to experience. Risk is something that we begrudgingly accept because the consequences of not accepting it are more painful than the investment risk we accept. It is like going to the dentist. I've not met anyone that goes to the dentist more frequently than needed because they can "tolerate" the pain or discomfort. We go to the dentist, begrudgingly, because if we don't the consequences are far more painful. Why on earth do we believe that investment risk is the lone unpleasant experience that humans seek or tolerate, instead of avoid?

I'll tell you why...because if we accept this premise, we can "optimize their potential return." Never mind whether or not this actually helps the investor increase the likelihood of achieving their goals. In many cases it has the exact opposite effect. But, the Nobel Prize committee must have had a weak moment because they took something based on an irrational premise and none-the-less bestowed their coveted award. Maybe they understood it as much as most investors do...which is not at all, because we don't have a magical hidden tolerance for risk just waiting to be discovered.

Does it make sense to take more risk than is needed because you can tolerate it? Nobel Prize-winning works were based on the premise that investors will "optimize their potential return for the risk they can tolerate." Or, in other words, we will go to the dentist weekly because for some of us, the pain is bearable and our teeth will be whiter.

This sure does sell well though. It sells because it is sophisticated. It sounds impressive. At first blush, it even sounds like it may be rational. "My job is to optimize your investment return for the risk you can tolerate" or "There is a trade-off between risk and return" both sound like they make a lot of sense...until you learn how it is implemented. Now, I'm not saying that there isn't a trade-off between risk and return, just like I wouldn't argue that my teeth wouldn't be whiter if I went to the dentist weekly. But, is it rational to say that because there IS a trade-off between risk and return, we must therefore identify our tolerance for something we want to avoid, and whether or not it is necessary, position ourselves at a point for the maximum pain we can bear? This is the premise of the risk versus return trade-off.

We have evidence that this is irrational. Investors often respond to the maximum risk tolerance question by answering with a question of how much risk should they accept? They perceive the answer to the question as obvious (as little as possible) and therefore either the question is irrational or they are hoping to get some real advice about something that makes perfect sense to them; that is, they will accept as much risk as makes the most sense to them based on what they wish to achieve.

How can you argue with that logic? I'll take as much investment risk as needed provided it isn't more than necessary. Or, I'll take as little as possible so long as that it still permits me to avoid consequences that I would consider more painful. Or, I'll go to the dentist every six months because if I don't the pain of rotting teeth is worse than the semi-annual visit.

Risk Versus Early Retirement?

What investors are seeking is some common sense. We've had little to offer. It isn't a question of risk versus return. It is a question of risk versus early retirement, or risk versus spending more, or risk versus my children's education. That is what investors are seeking advice about. Instead, we choose to ignore their goals and abstract the trade-off to a meaningless return number. It is harder to do this correctly. No formula can help. The value of advice under this model isn't based on selling theoretical sophistication of other models. It is based on understanding what is important to the investor and what goals are more painful than investment risk if they are not achieved. It is what our industry is supposed to stand for. It is what we are about.