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Reassessing Investors' Risk Tolerance

Investment firms are reworking risk questionnaires to keep investors from losing money (and switching advisers)

By [Ben Levisohn](#)

Add risk tolerance questionnaires to the list of products that didn't work as advertised during the financial crisis. The ubiquitous surveys investors often fill out when they meet with advisers were supposed to provide a good sense of how much risk they could handle. By answering as few as seven questions, investors would learn whether they could stomach a lot of risk and load up on stocks, or whether they were better off sticking with a portfolio of mostly bonds. But the forms proved to be overly simplistic, and people couldn't handle the risk that tests said they could. Many sold at the worst possible moment—the bottom.

Now some advisers are developing questionnaires aimed at getting a more nuanced picture of a client's likely reaction to a wider range of real and perceived risks. A more accurate psychological reading, the reasoning goes, means investors will be more likely to stick with portfolio strategies—and advisers.

Where did the forms fall short? They measured an investor's tolerance of only one dimension of risk: willingness to chance a big loss in pursuit of a big gain. While investors may fit neatly into boxes labeled aggressive, moderate, or conservative, such categories ignore their response to short-term risk—that is, volatility—and their fear of the unknown. For instance, an investor might battle her fear of losing money until it overwhelms her, and then sell everything at the worst time. On the other hand, research has shown that investors feel regret when they miss an upward move and so finally break down and buy just as stocks peak.

"A HUGE MYTH"

Being aware of such tendencies may be especially important since the Dow Jones industrial average has breached 9000 and the Standard & Poor's 500-stock index is approaching 1000. "It's a huge myth that you have to take emotion out of investment decisions," says Denise Shull, president of New York consulting firm Trader Psyches, which coaches traders.

Widely available tests, including those from Charles Schwab ([SCHW](#)) and Vanguard, ask some questions based on behavioral finance, or how psychology affects investment decisions. Schwab asks investors to choose whether they are most concerned with losing or making money, or

whether they are equally concerned about both. Vanguard asks investors to agree or disagree with the following statement: "Generally, I prefer investments with little or no fluctuation in value, and I'm willing to accept the lower return associated with these investments." After a series of questions, the surveys then create an asset allocation—how much to put in stocks, bonds, and so on. Some academic research, however, suggests these types of tests may muddy the waters by taking information about, say, short-term risk tolerance and applying it to asset allocation, which should reflect long-term trade-offs. Vanguard says there's no muddying of the waters because tweaking the overall mix of bonds, stocks, and cash is the only way to take into account an investor's short-term behavior. Schwab notes that "all tools have limitations, but we've learned that some clients find the tool a helpful way to start thinking about risk."

Test results also can be skewed by the dollar amounts used in questions. One popular question asks the test taker to choose between a guaranteed \$10 and a 50-50 chance of \$30. At first glance, the question seems a reasonable attempt to gauge whether an investor prefers a safe return or a risky payoff. But make the amount \$10,000 vs. \$30,000, and the answer is likely to change from choosing the riskier \$30 to taking the guaranteed \$10,000, even though the odds remain the same as in the first set of figures. So the question is less a measure of risk tolerance and more a test of what an investor considers to be a lot of money.

Another example: Vanguard asks investors to choose among three portfolios that produce an ever-widening range of results at the end of one year for a \$10,000 portfolio. One produces a loss of \$164 or gain of \$593, another a loss of \$1,020 and a gain of \$1,921 and a third produces a loss of \$3,639 or a gain of \$4,229. To choose, some investors will run the odds, while others will simply look at the biggest gain or the biggest loss. (Vanguard also asks questions tied to an investor's actions in recent periods of market turmoil.) "Some questions run the risk of being more a test of numeracy than a test of psychological predisposition," says Greg Davies, head of behavioral finance for Barclays Wealth ([BCS](#)).

GAUGING THE TRADE-OFFS

That has led firms to create new versions of questionnaires. New York-based personality test developer Assessment Service, for example, has developed a more psychologically attuned survey it is marketing to financial advisers. Barclays Wealth, which caters to investors with at least \$10 million to invest, spent three years developing its questionnaire, which it recently launched in the U.S. Its 36-question survey tries to better fit specific investments to clients by gauging the trade-offs investors are willing to make for higher returns. It also measures five other factors, including sensitivity to short-term volatility, fear of unlikely but devastating events, and preference for managing one's money vs. delegating.

After coming up with a suggested asset allocation, Barclays recommends specific investments with return patterns suited to an investor's level of nerves. An anxious investor's portfolio would be full of funds less volatile than the market, perhaps gaining only 8% when the market is up 10% and losing 6% when the market is down 10%. An investor less troubled by market swings might be fine with funds that typically make 15% when the market's up 10% but that could lose 12% when the market falls 10%. And an investor who worries about rare but devastating financial events would want to avoid illiquid assets and carry more cash. Says Trader Psyches'

Shull: "When people know how to work with their emotions, they are more competitive in the market."

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