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JOURNAL REPORTS: WEALTH MANAGEMENT

Your Tolerance for Investment Risk Is Probably Not What You Think

Questions financial advisers ask clients to get at the answer actually measure something completely different—often leading to misguided investment strategies

Questions advisers tend to ask take all sorts of different concepts—regret, fear and overconfidence—and lump them all together under this vague concept called risk. ILLUSTRATION: C.J. BURTON FOR THE WALL STREET JOURNAL

By Meir Statman

Sept. 10, 2017 10:16 p.m. ET

Anybody who has ever been to a financial adviser knows the drill. The adviser begins by asking you to fill out a questionnaire, aimed at getting at a key measure: your appetite for risk. By knowing how much risk you're able to tolerate, the adviser knows how much you're willing to lose to get where you want to go.

The adviser can then construct a portfolio that reflects your risk tolerance.

Pretty simple, no? If only.

The truth is that the questions advisers ask often don't measure what they purport to. Instead, they take all sorts of different concepts—such as regret, fear and overconfidence—and they lump them all together under this vague concept called risk. Each of those things is worth understanding and examining on its own. But to call them risk ends up distorting more than clarifying, and leaves investors with portfolios that may be disturbingly inappropriate for their goals.

For instance, people who are labeled as having a high tolerance for risk may really be reflecting dangerous overconfidence. You don't want them owning portfolios of risky stocks because they have a mistaken sense of their ability to pick winners. Conversely, investors who are considered to have a low tolerance for risk could actually be excessively afraid of daily ups and downs. Instead of having them forgo the returns from stocks, better to teach them to overcome the fear, rather than let the effects of fear bleed into their investment decisions.

To get a better sense of what risk questionnaires actually measure—and how advisers and investors could refine those questions—here's a closer look at some typical questions.

Risk vs. fear and exuberance

Imagine a steep stock-market decline, as happened during the 2008-09 financial crisis when the S&P 500 index plunged more than 40% in six months. How would you react?

I would sell all of my stock investments.

I would sell some of my stock investments.

I would make no changes to my stock investments.

I would increase my stock investments.

This is a typical question posed to investors, supposedly to gauge their tolerance for a market decline. But what do the answers tell us? Not what we typically believe.

For starters, consider that everybody finds it difficult to foresee future emotions. Today, the fear induced by the stock-market crash of the recession is fading, while the fear induced by the dot-com crash of 2000 and the crash of 1987 are long gone.

Rather, how people feel about a big decline depends almost entirely on what has been happening in the market recently. So asking people how they would feel if the market falls 40% is likely to elicit an answer "I am afraid" in the wake of a big decline, and elicit "I am not afraid" when the market has been moving up. Asking people today how they felt in March 2009 is likely to elicit a response indicating less fear than they actually felt in 2009.

In other words, the answer tells you very little.

But while the question doesn't reveal anything about an investor's tolerance for risk, it does hint at another important measure: an investor's current feelings of fear or exuberance. To get at those feelings, advisers might ask clients to estimate stock-market returns in the coming *12 months*, and their perception of stock-market risk during the same period. Investors who say the returns would be high and risk low are likely infected by exuberance. Investors who say that returns will be low and risk high are likely afflicted by fear.

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That's an important measure for advisers and investors to know. Investors who are asked about their risk tolerance following high past returns are likely to overestimate it, swayed by exuberance. Investors who are asked following low past returns are likely to underestimate it, swayed by fear.

As a result, once advisers get answers to the question, they need to push back. In 2009 they should have said, "I know you are afraid. So am I. It is a natural feeling in times like today. You believe that future returns will be low and risk high, so you want to sell your stocks. But I also know that feelings can be exaggerated. More likely than not, the economy will recover and the stock market as well, as happened post-2000 and post-1987. You are better off leaving your portfolio alone, even if fear compels you otherwise."

Advisers also need to push back in the other direction in periods of exuberance. "I know that you feel good about the stock market and believe that returns will be high and risk low. But I know that feelings can be exaggerated. It isn't wise to increase your stock allocation beyond prudent levels, because sometimes declines follow increases, and you are not in a financial position to withstand a decline if you want adequate retirement income."

Fear increases risk aversion even among financial professionals, leading to high risk aversion in financial busts and low risk aversion in financial booms. In an experiment, financial professionals asked to read a story about a financial bust became more fearful than those asked to read a story about a financial boom, and fear led them to reduce risky investments.

Confusing regret and risk

Suppose that five years ago you bought shares in a highly regarded company. The same year the company experienced a severe decline in sales due to poor management. The price of the shares dropped drastically and you sold at a substantial loss. The company has been restructured under new management, and most experts now expect the shares to produce better than average returns. Given your bad past experience with this company, would you buy shares now?

Questions Investors Should Ask Themselves

How strongly do you agree with the following statements? Your answers offer a window into your investing attitudes and have important implications for your investing strategies.

I HAVE LESS money than I need. I find it difficult to pay my bills. I am financially worse off than my parents were at the same age.

People who agree strongly aren't necessarily poor, but they ***lag behind their aspirations.*** *This motivates them to accept risk and possibly losses for a chance to reach their aspirations.*

I FEEL BAD if another alternative has done better than the one I have chosen.

People who agree strongly have a ***high propensity for regret.*** *One prophylactic is to keep yourself ignorant of how alternatives have done.*

SUCCESS IN CHOOSING investments with above-average returns depends on skill more than on luck, and I have the skills to choose such investments.

People who strongly agree are likely ***overconfident in their skills*** *at choosing winning investments, motivating them to hold undiversified portfolios and trade often.*

IT'S MORE LIKELY that stock- market returns will be low and risk high in the coming 12 months than returns high and risk low.

People who think it's more likely that returns will be low and risk high are probably ***excessively fearful,*** *motivating them to invest too little in stocks. People who think returns will be high and risk low are probably* ***excessively exuberant,*** *motivating them to invest too much in stocks.*

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Again, this question is typically presented as about risk attitudes, interpreting a "no" answer as bolstering a conclusion that a client is highly risk-averse and therefore should be assigned a low-risk portfolio.

The problem is that this is not really a question about risk attitudes. Instead, it's more about regret. Attitudes toward risk and regret are both important, but they are different. Indeed, the correlation between the two attitudes is close to zero.

Regret is a painful emotion, and pride, its opposite, is pleasurable, but both are effective teachers. We recall our choices and their outcomes, and learn to repeat choices that brought pride and avoid choices that inflicted regret.

Regret and pride guide us rightly, however, only when there is a strong connection between choice and outcome. They guide us wrongly when luck weakens that connection. Luck predominates in investment outcomes, yet we are regularly blind to its role. Good outcomes bring pride even when choices are foolish, and bad outcomes inflict regret even when choices are wise.

So this is an important question for financial advisers to ask—but not to learn about their clients' appetite for risk. Rather, it tells us about their susceptibility to regret and pride. For one thing, that susceptibility can inflict misery on advisers, expressed in their common lament, "When a stock goes up, the client says, 'I bought it.' When a stock goes down, the client says, 'My adviser sold it to me.' "

What's more, because regret is so painful, advisers might recommend overly conservative investments to regret-averse clients, because those investments aren't likely to inflict large losses and accompanying regret, even when a proper assessment of risk attitudes would call for riskier investments that offer good chances for substantial gains.

Advisers should diagnose pride-seeking and especially regret-aversion in their clients, perhaps asking them more directly whether they agree with the statement: “Whenever I make a choice, I feel the pain of regret if another alternative has done better than the alternative I have chosen.” Advisers should then proceed to reduce clients' susceptibility to pride and regret by educating them about the dominant role of luck in the link between investment choices and outcomes, rather than recommend low-risk investments to regret-averse clients.

Confidence and overconfidence

How much confidence do you have in your ability to make good financial decisions?

The risk questionnaire asking this question considers people who profess high confidence as willing to accept high risk, bolstering recommendations for high-risk portfolios.

There is indeed a relation between confidence and risk tolerance: High confidence generally corresponds to high risk tolerance. But advisers should pause before recommending high-risk portfolios to confident clients, because confidence can easily turn into overconfidence.

Overconfident investors perceive risk as lower than less-confident investors, biasing upward the measure of their risk tolerance. Advisers therefore need to adjust downward their assessment of the risk tolerance of overconfident investors, and perhaps tamp down their overconfidence as well. Even if overconfidence is unrelated to risk tolerance, it still matters to financial advisers as they guide investors toward fitting portfolios. Investors who are overconfident in their investment-picking skills are likely to resist advice to buy diversified portfolios and hold them rather than trade.

(As an interesting aside, men tend to be more overconfident than women, and the young tend to be more confident than older people.)

Perhaps a better question diagnosing overconfidence asks: *Some people believe that they can pick investments that would earn higher-than-average returns. Other people believe that they are unable to do so. Please indicate your belief.*

The real risk of foreign investments

Foreign investments involve risks that are in addition to those of U.S. investments, including political and economic risks, as well as the risk of currency fluctuations. These risks may be magnified in emerging markets.

This is a typical boilerplate on a risk questionnaire. And it couldn't be more misleading. Foreign investments regularly *reduce* the risk of diversified portfolios rather than increase it.

Before getting clients' preferences for venturing abroad, advisers should educate investors about global diversification rather than warning them about the risks.

That is, start with balanced information: “Over time, international markets and asset classes within those markets have not always moved in unison with the U.S. market. U.S. stocks have outperformed international stocks during some periods, and international stocks have outperformed U.S. stocks during other periods. Investing a portion of a portfolio in international stocks and bonds reduces risk.”

Then comes elicitation of preferences:

Which statement best reflects your view on international investing?

I am very comfortable with international investments.

I am comfortable with international investments.

I am somewhat comfortable with international investments.

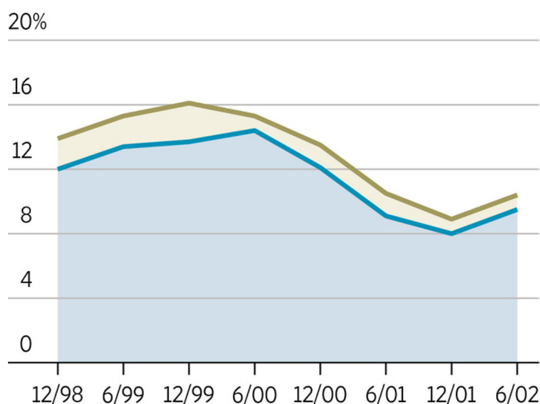
I am somewhat uneasy with international Investments.

Investor Overconfidence

On average, investors think they are above-average when it comes to their expectations for their portfolio returns vs. stock-market returns.

Six-month trailing averages

■ **Mean of estimates of own portfolio returns**
■ **Mean of estimates of stock-market returns**



Note: Data are from Gallup surveys. These questions were asked as a pair only during 1998-2002.

Source: Meir Statman, "Finance for Normal People: How Investors and Markets Behave"

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I am uneasy with international investments.

Investors can then choose to allocate to international stocks as little or as much as they prefer.

Don't forget aspirations

How strongly do you agree with this 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."

Attitudes about volatility are central in risk questionnaires. Investors who strongly agree with the above statement are deemed to have low risk tolerance, tilting adviser recommendations toward portfolios that are less volatile, and less likely to offer the opportunity for substantial gains.

Yet looking at risk like this in a volatility vacuum is, at best, misleading, and at worst, wildly off base.

That's partly because risk isn't just about the fear of volatility. Risk is also the risk of failing to meet our goals. In this context, an investor's appetite for risk could be very different than it would seem by just asking about whether they feel comfortable with volatility.

Say, for instance, a young woman answers the question above in a way that suggests she doesn't want much fluctuation in her portfolio. An adviser might conclude she has a low tolerance for risk, and so invests her portfolio in low-fluctuating securities such as money-market funds. But that portfolio is actually high risk when assessed by the likely large shortfalls from even modest aspirations for adequate retirement savings.

A somewhat better approach can be seen in this typical question: Would you want to make an investment where you have a 50-50 chance for a $3,639 loss or a $4,229 gain?

In this case, risk is about a person's willingness to lose money.

The problem, though, is that the stakes affect the answer. Many who would be willing to wager $10,000 on a 50-50 chance for a $3,639 loss or a $4,229 gain might not be willing to wager $100,000 or $1 million for proportionally higher gains and losses.

That's why it's better for investors to think about that question where there are substantial stakes, such as lifetime standard of living. Consider the following question:

Suppose that you are given an opportunity to replace your current investment portfolio with a new portfolio. The new portfolio has a 50-50 chance to increase your standard of living by 50% during your lifetime. However, the new portfolio also has a 50-50 chance to reduce your standard of living by X% during your lifetime. What is the maximum X% reduction in standard of living you are willing to accept?

I posed this question to people in 23 countries. On average, Americans are willing to accept a 12.6% reduction in their standard of living for a 50-50 chance at a 50% increase.

The lesson in all these questions is that advisers and investors can’t just think about their tolerance for risk in a vacuum, without thinking about their aspirations. Specifically, it’s the advisers’ responsibility to encourage clients to raise excessively low aspirations that will consign clients to poverty in retirement, and to accept fluctuations in value and even some losses for a chance to reach reasonable aspirations. At the same time, advisers should push back when aspirations for extravagance drive clients to speculative investments that expose them to large losses and poverty.

Risk, in other words, is the payment we make for a chance to reach our aspirations.

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Appeared in the September 11, 2017, print edition as 'What’s Your Tolerance for Investment Risk? Probably Not What You Think.'

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