How to Deal with Clients Who Avoid Risk When They Shouldn't

by Dr. Vicki Bogan

Do you have clients who are not taking risks? Are their portfolios either too conservative or not diversified enough? Extremely risk averse investors often avoid risk by not investing or by trying to transfer risk through an annuity or other type of insurance product. Not taking an adequate amount of risk can significantly hurt an investor in the long run. For an example, consider the fifty-year period from 1966 through 2015. If you had invested in U.S. Treasury bills, you would have earned a 4.92% (geometric) average rate of return per year. If you had invested in longer-term Treasury bonds, you would have earned a 6.71% average rate of return per year. However, if you had invested in mutual funds that held shares in the largest American companies (such as an S&P 500 Index fund), your would have earned a 9.61% average rate of return per year.[1] As you can see, taking risks can enable investors to maximize the amount of return on each investment dollar. Understanding, retaining, and controlling risk is vital for savvy investors to be able to create an optimal portfolio.

Economists, though, generally assume an individual's level of risk aversion is time-invariant (or does not change). While there is some recent academic research to suggest that risk aversion levels can be altered by significant events (e.g., experiencing an economic recession or depression – Malmendier & Tate, 2011) or significant trauma (e.g., experiencing combat – Bogan et al., 2013), most people do not change with regard to their appetite for risk. As a result, there is limited "wiggle room" for financial advisors to shift a client's risk aversion level. Nonetheless, that does not mean advisors should not encourage some risk taking. With the tremendous volatility plaguing our financial markets today, it can be quite difficult to encourage investors (particularly risk averse ones) to take on additional risk. Yet, that is often exactly what they should do, and good financial advisors should work to encourage clients to take *appropriate* risk – risks that are in the best interest of the client.

For an advisor, two of the most powerful levers that can be used to encourage risk taking are: focusing clients on their time horizon and linking risk taking with the client's financial goals.

[1] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html. (Past performance is not indicative of future results. For illustrative purposes only.)

Focus on Investment Horizon

It is important to communicate to risk averse clients that a longer investment horizon will give them the opportunity to take advantage of the 'magic' of compounding interest and may help them minimize big **realized** losses during downturns. Investors that have a long investment horizon (35-40 years before retirement) have the time to ride out the ups and downs of the market. They most likely do not have to worry about having to cash out of their positions (selling their stock or other financial securities) when the value is low. They will probably be able to wait and sell assets at a more optimal time – when their assets will have a higher value. Consequently, investors with long investment horizons should consider investing in the higher risk, higher yielding sectors, provided it is consistent with their risk tolerance and investment objectives (for example, 70% equities, 15% bonds, and 15% money market instruments).

Linking Risks with Goals

If clients can see how taking risks could be necessary to help achieve their goals, it can facilitate them taking on an *appropriate* level of risk. Your clients may believe that risk taking is essential when investing to finance a child's college education or to finance retirement goals. However, risk is also an important consideration for wealth building over their lifetime. With respect to wealth building, about 30% of American households receive a wealth transfer in the form of an inheritance, and these transfers account for close to 40% of their net worth.[2] Yet, bequests received are not generally something that an individual can control. Thus, households should focus on the other critical elements of wealth accumulation – elements that they can control:

i) The number of years an individual/household has been consistently investing.
ii) The proportion of funds (on average) allocated to higher return (higher risk) investments such as stocks.[3]

Whether wealth building or paying for college, the strategy of consistently investing in higher risk investments over a long time horizon can be a sound formula to help meet most long-term financial goals. The specific financial goals of your clients determine the level of funds required and this will drive the proportion of their portfolio that needs to be invested in risky assets.

Key Take-Aways

An individual's fundamental risk preferences do not often change. As a result, advisors must nudge clients to take the appropriate amount of risk for their specific situation and

[2] Wolff, E.N. & Gittleman, M. (2011). "Inheritances and the Distribution of Wealth" (U.S. Bureau of Labor Statistics Working Paper)

[3] *www.hussmanfunds.com*

investment temperament. The key is to link risk taking with financial goals and focus on longer time horizons to encourage clients to take 'smart', calculated risks – risks that have a higher probability of improving the investor's portfolio performance. If someone is having trouble sleeping at night because they are invested in stocks, then you should probably steer them toward lower risk investments. However, you can still recommend options to create a less volatile portfolio, which has the opportunity to offer upside potential. It is critical to strike the best possible balance between the clients' need for return and their comfort level with risk.

References

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