Have you noticed that clients who were willing to tolerate a lot of risk in 1999 turned risk averse in 2002? Have you noticed that clients who wanted their entire portfolios in dot-coms in 1999 wanted everything in Treasury bills in 2002? Of course you have, perhaps with a chuckle, perhaps with a frown, but surely with concern for both your clients and yourself. Accurate assessment of the risk tolerance of clients is crucial to building suitable portfolios and providing financial advice and it is a crucial part of advisor compliance with regulations, demonstrating that portfolios and investment advice indeed are suitable for each investor.

I observed the importance of an accurate assessment of the risk tolerance of clients and the challenge of shifting risk tolerance when I was retained by an advisor who was sued by a client. The client received a substantial inheritance in early 1987 and the advisor placed it in a diversified portfolio of stocks, based on an assessment of the client’s risk tolerance, financial conditions, and needs. The crash of 1987 frightened the client greatly and he demanded that the advisor sell all the stocks in his portfolio. The advisor explained once more the need to hold a diversified portfolio and keep a long-term perspective even when markets move violently day by day, but to no avail. The client wanted to be out of the market and the advisor reluctantly followed the client’s instructions. Then the client sued, saying that the portfolio never was suitable for him, and demanded compensation for his losses. I testified at the trial and the jury decided in favor of the advisor, but the cost to the advisor in both money and emotions was great.

Loewenstein et al. (2001) noted that virtually all current theories of choice in risky situations are based on cognition rather than on emotion. But they also noted a growing body of evidence showing that emotional reactions to risky situations often diverge from cognitive assessment of these risks. When such divergence occurs, emotion rather than cognition often drives behavior, as the earlier story of behavior in the wake of the 1987 crash illustrates.

You probably know that from your own experience as well, and not only in the arena of finance. Remember driver’s ed? Remember what you should do when you reach an icy patch? Don’t hit the brakes. Just steer gently to get out of the tailspin. Did you ever follow this advice? Neither did I. I was gripped by fear when I reached an icy patch and slammed on the brakes. The car spun out of control and only a miracle saved me from a serious accident.

Normal people occasionally are gripped by fear and fear can get in the way of wise behavior. Ironically, people with ventromedial prefrontal damage to their brains sometimes behave more wisely than normal people. The stroke or accident that causes ventromedial prefrontal brain damage deprives people of the emotional reactions of normal people, including fear. And the absence of fear sometimes helps people behave wisely. Damasio (1994), a professor of neurology, describes how one such brain-damaged man crossed an icy patch unperturbed, gently pulling away from a tailspin and driving ahead safely. The man remembered that not hitting the brakes was the appropriate behavior and his lack of fear allowed him to drive optimally.

Absence of fear helps people overcome icy patches on some financial roads as well. I invite you to play an investment game. I’ll toss a coin right before your eyes. If it comes out heads, I’ll pay you $1.50. If it comes out tails, you’ll pay me $1. We’ll play 20 rounds of this game. Before each round you can choose to participate, by placing a dollar on the table, or not to participate, by keeping the dollar in your pocket.
Some people by nature are more anxious than others, more fearful, and more risk-averse. But Loewenstein and his colleagues described a study that shows that frightened people have lower risk tolerance. Students were asked if they would agree to stand before the class in the following week and tell a joke. Those who told a joke would receive money. A flat joke can be very embarrassing so it is not surprising that some students who agree to tell a joke “chicken out” in fear when it is time to stand before the class. But students who are made to feel fear are more likely to chicken out. Half the students in the experiment were shown a fear-inducing film clip (two minutes from Kubrick’s The Shining) before making the decision whether to tell a joke or not. The other half of the students were not shown the film clip. It turned out that a greater proportion of those who were shown the fear-inducing film clip chickened out.

Risk questionnaires are a common advisor tool for gauging the risk tolerance of clients, but questionnaires rarely account for emotions. Consider a common question. Do you strongly agree, somewhat agree, or strongly disagree with the 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.” This question calls for a cognitive evaluation of the alternatives with no account of the emotional state of clients when they answer, whether in 1999 or 2002. Yet advisors know that recent movements in the market up or down affect clients’ answers and their measures of risk tolerance. Good risk questionnaires need to account for the effect of emotions.

The challenge facing advisors is the challenge of distinguishing situations where fear promotes wise behavior from situations where it stands in the way. The further challenge is to find tools that help clients go in the right direction even when fear stands in their way.

References