RETIREMENT INCOME INSTITUTE
Alliance for Lifetime Income

Who Should Read This Insight:
Consumers, financial professionals

Institute Research Agenda Topic:
Consumer behavior and decision making.

Definitions of **bolded key terms** are at the end of this article.

JULIE M. ANDERSON

MBA, MPP, is the founder and a principal of AG Strategy Group, a strategic consulting and writing services firm. Previously, she was the Chief Operating Officer and a Managing Director at Civitas Group, as well as an Associate Partner at IBM Global Business Services. Anderson has served as Acting Assistant Secretary and Deputy Assistant Secretary for Policy and Planning at the U.S. Department of Veterans Affairs. Anderson earned her Master of Business Administration from Duke University, has a Master of Public Policy from the University of Chicago, and is a graduate of Nebraska Wesleyan University in Lincoln, where she was named a Harry S. Truman Scholar.

Authors, Titles and Publication Dates of the Articles Addressed in the Insight

Kenneth Ryack, Michael Kraten, and Aamer Sheikh. 2016. "Incorporating Financial Risk Tolerance Research into the Financial Planning Process." https://www.researchgate.net/publication/317318118_Incorporating_Financial_Risk_Tolerance_Research_into_the_Financial_Planning_Process.

Kenneth Ryack, PhD, CFP, CPA, is Assistant Professor of Accounting at the Quinnipiac University School of Business, Hamden, Connecticut. Michael Kraten, PhD, CPA, is Associate Professor of Accountancy at the Providence College School of Business, Providence, Rhode Island. Aamer Sheikh, PhD, CPA, CrFA, CFC, CGMA, is Associate Professor of Accounting at the Quinnipiac University School of Business, Hamden, Connecticut.

Insight: HOW FINANCIAL PROFESSIONALS CAN INCORPORATE CLIENT RISK TOLERANCE INTO THE PLANNING PROCESS

IDEAS IN THE INSIGHT YOU CAN PUT INTO ACTION

Financial professionals need to be familiar with a client's risk tolerance level when designing a financial plan. The closer the financial plan matches the client's willingness to accept risk, the more likely it is that the client will put the plan into action and so build enough savings for retirement. There are nine factors that influence a person's risk tolerance; financial professionals can use those factors to better understand each client's willingness to accept financial risk.

PRINCIPAL INSIGHTS

Individuals take into consideration their own tolerance for financial risks when deciding how to invest. Therefore, when a **financial professional** works with a client to create a tailored financial plan, they should incorporate the client's particular **risk tolerance** level into that plan. The closer the financial plan matches the client's willingness to accept risk, the more likely it is that the client will put the plan into action and build enough savings for retirement. In their article, Kenneth Ryack, Michael Kraten, and Aamer Sheikh summarize previous research studies that examine the nine primary factors affecting risk tolerance in the financial planning process. They then organize those factors into a framework that could help guide financial professionals' discussions with their clients about acceptable risk tolerance levels.

Risk tolerance reflects an individual's willingness to accept uncertainty related to the outcome of a financial decision, and is a subjective measure. Usually, as a person's comfort level with uncertainty increases, so does their tolerance for financial risk, while an individual's risk tolerance influences their decisions about saving for retirement.

Research indicates that portfolios that include riskier assets tend to outperform portfolios made up of less-risky assets. Put another way, riskier investments *can*—but are not guaranteed to—generate more savings and thus a more secure retirement. The relationship between higher risk tolerance levels and higher **returns** on investments suggests that a financial professional could create a plan that adds more financial risk over time as the client's risk tolerance increases. But a financial professional must also account for the client's risk tolerance level and reflect it in their financial plan. If a financial professional recommends a financial plan with an investment portfolio that does not match the client's risk tolerance, the client could be discouraged from investing, and the plan would ultimately fail. If that occurs, failure could mean that the client will not have adequate retirement savings when they reach retirement age, and so might face **longevity risk**, or outliving their assets.

Previous research has shown that there are nine factors that could influence a person's

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financial risk tolerance. Financial professionals' ability to understand and apply these factors when advising a client can make it easier for the client to accept the financial planning process, and will produce better savings outcomes.

For instance, (1) *gender* plays a role, and women tend to show lower financial risk tolerance than men; men in opposite-sex married couples tend to exhibit higher levels of risk tolerance than women in those couples. (2) *Race/ethnicity* is another factor, and white Americans have a higher financial tolerance than Black or Hispanic Americans. Research into the effect of (3) *age* on financial risk tolerance has mixed results, with some studies indicating that older individuals have lower risk tolerance while others reveal the opposite effect.

Individuals with more (4) *education* tend to have higher levels of financial risk tolerance. Education usually means individuals are better able to understand and evaluate the link between risk and return, with educated clients more likely to proactively access and consult financial resources before making investment decisions.

In addition to educational level, the levels of (5) *wealth and income* also influence a person's financial risk tolerance levels, with a person's comfort level with financial uncertainty increasing along with their wealth and income. (6) *Self-employed* individuals generally have more financial risk tolerance, as does anyone with more (7) *financial knowledge* and experience. Another factor is (8) *marital status*: unmarried people tend to be more comfortable with higher levels of financial uncertainty.

Finally, the extensive research that looks at the relationship between financial risk tolerance and (9) *stock market expectations* and returns shows that tolerance could be variable with fluctuations in the stock market, but steady over time.

Ryack, Kraten, and Sheikh offer a framework that organizes the nine factors along two dimensions: foreseeability and manageability. These dimensions articulate the underlying factors of risk that most clients will be able to understand when talking with a financial professional. The authors expect financial professionals to use this framework to guide discussions with clients as they incorporate risk into financial plans. This framework will help a financial professional better understand a client's risk tolerance and its determinants, which can lead to a more appropriate financial plan, one that the client will actually follow.

Finally, financial professionals should consult regularly with their clients during periods of market uncertainty and reassure them that they would not be well served if they were to make drastic or impulsive changes to their investment portfolios.

To learn more, visit the Retirement Income Institute at
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KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

financial professional: *A qualified person who can help the consumer understand available options and make financial decisions to work toward stated financial goals.*

longevity risk: *The chance that a person might live longer than his income will last.*

return: *The change in the value of a portfolio over an evaluation period, including any distributions made from the portfolio during that period.*

risk tolerance: *The level of market risk a consumer is comfortable with.*

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