Your Risk Questionnaire May Not Be a Sound Basis to Form an Investment Objective

Is your risk tolerance questionnaire adversely affecting your portfolio performance?

I wanted to discuss the answer to this question and inform you of the purpose for the risk tolerance questionnaire that your advisor has you complete. Many, if not all, people believe the questionnaire is a feel good mechanism designed specifically to guide the investor to ultimate success. They believe that by answering certain questions, they will fall into a certain category, and it is this category that will determine which route their advisor takes with their investments. While a feel good idea, this could not be further from the truth.

The risk tolerance questionnaire is not really for you, but rather to protect the advisor from potential lawsuits. It was created by lawyers in an effort to protect their clients (the advisors) from investors who claimed they were capable of investing in equities, but in reality weren't and could sue the advisor for suitability misappropriation. So the questionnaire is used as a tool to demonstrate to the investor which category they fall into based on their answers, thus removing liability from the advisor.

Now that you know the real purpose of the questionnaire, I'd like to explain why, even in its flawed intention, it hinders the investor even further. The questionnaire tends to focus on risk-related returns rather than needs-basis returns, or the genuine requirement out of the investment portfolio. It doesn't actually focus on your needs and objectives; it focuses on risk as the dominant factor in terms of principal invested. There is an illusion that the questionnaire is intended to design an appropriate strategy for the investor. In reality, its sole determination is to help protect an advisor in legal recourse if a client should suspect improper management of the investments.

Not only is the risk tolerance questionnaire ineffective in helping the client, but it actually works to prevent them from ever getting to the point that really matters. It determines that the "perceived riskier" investments are indeed riskier while the "perceived conservative" investments are safer. Experience has taught us that this isn't always the case. As risk tends to diminish over time, the more conservative investment can be potentially riskier for the individual as it doesn't actually help the investor to meet the necessary long term goals.

The questionnaire also dominates risk only in terms of principal, whereas for people planning for a 30-year, two-person retirement, the erosion of purchasing power is a far greater risk than is loss of principal. Thus, it does not help the client form a strategy that will be helpful in real terms.

Moreover, the questionnaire confuses the distinction between risk and volatility. In the real world, the more volatile your results, the more faith you are going to need to stick with your strategy. It's easy to stick with a plan when all your investments are going up, but more difficult when a falling market starts to gash your portfolio, especially when the trend continues for many months. Further, as the market goes higher, risk tolerance goes up, but as the market goes down risk, tolerance goes down with it. People are often willing to take more risk as long as the market is going up.

Risk tolerance is dynamic, and there is no static questionnaire that can effectively address it. So, the next time you complete one of these "feel good" assessments, please keep this in mind. While your answers will indeed help to form your investment strategy, it may not be the one that's in your best interest based on your future needs.