Risk Capacity

Risk capacity is a concept that is not universally ignored by the financial planning community, but it's close. Most consumers when they think of defining "investment risk" will think of risk tolerance.

What is risk tolerance?

"**Risk tolerance**" is someone's personal attitude about investment risk, e.g., how comfortable is someone with dramatic losses in their investment portfolio when the stock market goes negative.

For example, a person who doesn't like to lose more than 10% of their money at any given time in the stock market has a fairly low risk tolerance. On the other hand, someone who doesn't mind losing 35%+ at any given time in the stock market has a fairly high risk tolerance.

"**Risk capacity**" is defined differently than risk tolerance.

A classic definition of risk capacity is the amount of risk you need to take in order to reach your investment goals (either asset accumulation, income in retirement, or both). Risk capacity is supposed to be more of a facts and circumstance determination that takes emotion out of the equation.

The definition sounds simple enough, but when applying it, the definition seems incongruent (not compatible) to what happens in the real world.

Let's dig into this incongruency by looking at a simple example.

Assume you are 65-years old and you "need" to create $50,000 a year in income in retirement to live like you'd like to live. Assume you have $700,000 of investable assets as your only source to create that income stream and you would like your money NOT to run out until age 90.

What rate of return (ROR) do you need (net after taxes/expenses) to create $50,000 in income and not run out of money until age 90?

5.82% "net" (which is more like an 8% "gross" return if you factor in fees and taxes).

By the strict definition, the risk capacity would allow our example client to invest in whatever is needed to generate a 5.82% net ROR no matter how risky the investment is. (Keep in mind this is mainly a secular discussion about risk capacity. In the real world, you would use both risk capacity and risk tolerance to determine what investments to choose).

What's the problem?

The stock market can't and won't guarantee a 5.82% net ROR each year for 25 years. The chances are significant (almost certain) that one or more significant downturns in the stock market will occur during the 25-year retirement period. When these downturns occur will have a major determining impact on whether the example client will be able to withdraw $50,000 each year in retirement.

Risk capacity in the real world—let's look at a simple question keeping in mind the previous example that will get to the heart of understanding risk capacity.

-In your retirement years, would you rather be a little short on money more frequently or would you rather have huge income shortfalls on a less frequent basis?

Would you rather have 10 individual years where you were $5,000 short of your $50,000 spendable target or would you rather have 3 years where you were $16,666 short?

If you prefer more often but smaller shortfalls, then you have a lower capacity for risk than someone who is ok with fewer but more sizable shortfalls.

The income amount was the same ($50,000), but one person's risk capacity can be different than another's and because of this, a different investment mix to reach the $50,000 goal would be used.

A different view of risk capacity

A different way to define risk capacity is whether an investor is in a position to assume risk and if so, how much (will negative returns adversely affect the investment goals/objective).

Let's get back to our $50,000 a year income need example. There is very little wiggle room for error in the previous example. There is just enough money to generate a $50,000 a year income if if things go right. Therefore, the risk capacity should be fairly low and part of the discussion with the investor should be how they will cope should they have years with shortfalls in income.

Let's assume the same example, except the example client has $1 million in investable assets instead of $700,000.

How does this change the risk capacity question?

The need to generate a 5.82% annual net ROR is no longer there. The investments only need to return a net 2.23% ROR in order to generate a $50,000 annual income for 25 years before the account runs out of money.

That means that there is a lot of wiggle room with the investments. Or in other words, the investments could be riskier because if they don't work out as well as earlier planned for the investor with $700,000, there will still be ample assets to pay a $50,000 a year income stream.

Risk tolerance and risk capacity do NOT always align.

An investor might have a high risk tolerance (doesn't mind big losses in the stock market), but because of a limited amount of funds available to generate needed retirement income, there is a low risk capacity. In this circumstance, it would be wise to err on the side of caution and use more conservative investments.

Conversely, an investor might have a low risk tolerance (wants to avoid big losses in the stock market) but a high risk capacity due to an excess of assets needed to generate the needed retirement income. In this circumstance, you could argue that it would make sense to invest a little more aggressively.

The following is a smiple chart that can be used as a guide to determine if investors should consider rebalancing their asset mix depending on their risk capacity and risk tolerance.

		Risk Capacity	
		High	Low
Risk Tolerance	High	No Action Required*	Consider Reallocating to More Conservative
	Low	Consider Reallocating to More Aggressive	No Action Required*

***The no action required boxes are only accurate if investors have an investment mix that matches their risk tolerance and risk capacity**.

Unfortunately, the vast majority of investors do not have investments that match their risk tolerance/risk capacity which is why investment risk software is needed.

Software can be helpful in determining/fine tuning someone's risk tolerance/capacity and be used to help match up investments that are in line with the investor's personal risk score that was determined by the software.

How do you really determine risk capacity?

The only way to determine accurately someone's risk capacity is by asking a series of questions. Different firms (the few that look at risk capacity when making recommendations) will have different questions in their attempts to determine risk capacity.

The following questions are a few core questions that can be used to determine risk capacity.

1) What assets do you have to reach your financial goal(s)?

Like our example client from earlier, the more assets you have to reach your goal, the more capacity for risk you have. The primary asset many people will have will be their personal residence. People who own a home will have a higher risk capacity than those who do not (those who rent). For people who have no or few assets to start with, the more important question 2) then becomes.

2) Are you fully employed, part-time, or unemployed?

If you have a secure job with a consistent paycheck, your capacity to take more risks with your investments is higher than those who worry about losing their job. Additionally, if you work on commissions that are not steady, this too may drive down your risk capacity.

If you are a professional (doctor, lawyer, etc.) it's likely that you have a higher income than someone who is a teacher or part-time worker. If you are retired, the issue then becomes one of consistent income from your assets/income sources (Social Security, pension, invested assets, or even a guaranteed income rider annuity).

3) What is your annual income?

Those with higher income typically have a higher risk capacity.

4) How much is your emergency fund?

Even if you have sufficient assets to reach your financial goals, things happen in life that can still derail reaching these goals. What could happen? You could be in a car crash, become disabled, have a major medical issue, your house could be severely damaged by an act of nature (fire, wind, water, etc.), or the bread winning spouse could die.

Those who have money set aside for an emergency (like losing a job) have a higher risk capacity. Also, those with a one month's emergency fund have a lower risk capacity than those who have a 3- or 6-month emergency fund.

For older clients, paying for long-term care (although this might be factored into your overall retirement budget) can be a big expense with the effect being a lower capacity for risk (because they can't afford to run out of money or they'll be stuck doing Medicaid planning instead of financial planning). If traditional LTC insurance is not affordable, then looking at single premium life products designed for LTC would be prudent.

Therefore, those who have proper insurance will have a higher risk capacity than those who don't. It is vital for everyone to have health insurance, auto, and home owner's insurance. Also, disability insurance is something that should be seriously considered and proper amounts of life insurance on one or both spouses is essential.

5) What are your future financial commitments?

This question is more important than ever. Having children is expensive (food, clothing, health costs, and potentially college expenses) and is a driving force behind this question. Having one child is expensive. Having two, three, or more is even more expensive and will drive down a person's risk capacity.

6) What is your time horizon?

This is the classic question that will be a big driver of your risk capacity. When do you need to access your funds? The longer you have to wait before accessing the money saved, the higher your risk capacity. In the past this has been an age question with the assumption that most people retire at age 65. People today retire both earlier and later than ever and therefore, asking how many years until retirement is a better question that is agnostic to age.

Refinement of risk capacity

When using investment risk software to determine someone's risk capacity, usually there are limits in the number of questions that can be asked. Practically speaking, people don't want to go answer 25+ questions in any kind of online questionnaire. Software can be a vital tool to determine one's risk capacity, but advisors should also discuss things with clients after the software is used to confirm their client's risk capacity or modify things as needed.

What could modify a person's risk capacity after using software?

1) Special needs children or caring (paying for) an elderly parent.

Today there seems to be more children with special needs than ever. In these situations, parents may have an ongoing financial commitment that last longer after the typical child would leave the home (18-23). Also, many children are helping pay for their elderly parent's care.

The more potential future financial commitments you have, the lower your risk capacity will be (you can't afford to sustain losses that will effect both your retirement goal as well as funding for other future non-retirement related issues).

2) Are you willing to work part-time in retirement if you fall short of your reaching your financial goals?

People who are willing to work in retirement (to make up any shortfalls) have a higher risk capacity than those who do not want to entertain working in retirement.

3) Are you capable of saving more if needed to reach your financial goals?

Some people will not have the ability to save any more money to reach their financial goals. If that's the case, their risk capacity will be lower than those who can allocate more toward savings.

4) Are you willing to spend less than budgeted in retirement?

For those who are willing to live on less in retirement without feeling like it substantially effects their enjoyment of life, the risk capacity would be higher than those are not willing to live on less.

Updating your risk capacity

2), 3), and 4) are questions that people may not know the answer to 5, 10, 15 years before retirement which is why having at least annual meetings with a financial or retirement planner is essential.

Retirement plans need to be monitored/tweaked as circumstances change. This is also why it makes sense for advisors who are using risk tolerance/capacity software to have their clients use it once a year and update their numbers. This will help the advisor better understand their client's current situation so he/she can make the necessary tweaks (or not) to the retirement plan.

Understanding risk capacity is not enough

This material and the questions provided focuses on risk capacity NOT risk tolerance.

As stated in the beginning of this material, most of the time, risk capacity is NOT often discussed with investors. Most of the time, investment risk tolerance is primarily, if not the only, the risk measurement discussed.

While it is true that risk tolerance will be the key component used to help investors determine how much risk they are comfortable with, only when you include risk capacity can an advisor truly have a full 360 view of an investor's situation. Once both are understood, appropriate recommendations can be made to help clients grow and protect their wealth leading up to and in retirement.

To conclude this material with some words to live by when determining how much risk to take when investing….

Investors should NEVER take more risk necessary to reach their investment goals!

The previous statement is true 100% all of the time. If you want to make sure you are using investments that have the least amount of risk to reach your investment goals, make sure the advisor giving you advice is using an investment risk software program that can not only determine your own unique risk score (combination of risk tolerance/risk capacity), but can also score investments and portfolios to make sure they match up with your personal risk score.