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INVITED EDITORIAL COMMENT

The Myth of Risk Attitudes

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It is embarrassing and sad to occupy the slot that belonged to Peter Bernstein—but I suppose he would not have wished it to be vacant. Here it goes.

It is common ground in the industry that investors vary on a dimension of risk tolerance, and that the task of a financial advisor is to find a portfolio that fits a number: the investor's "attitude to risk." My purpose, here, is to suggest that there is no such thing.

The idea of risk preference originated in classic utility theory, where risk aversion is measured by the curvature of the utility function for wealth. Standard finance theory and the practices that build on it have adopted this unidimensional conception of risk. Psychology and behavioral economics suggest a more complex view—and I will argue that even those approaches neglect crucial aspects of the investor's makeup.

A central claim of prospect theory is that people are not consistently risk averse. Yes, they are much more sensitive to losses than to gains. But, they are also risk seeking, both in their attraction to long shots and in their willingness to gamble when faced with a near-certain loss. To complicate things further, we also know that people do not have a global view of their assets. They hold separate mental accounts (in Richard Thaler's felicitous phrase) and are much more willing to gamble from some of these accounts than from others. To understand an individual's complex attitudes toward risk, we must know both the size of the loss that may destabilize them, as well as the amount they are willing to put in play for a chance to achieve large gains.

Adding another tier of complexity, I propose that the temporal perspective, which is shared by both utility theory and its behavioral alternatives, may be too narrow for the purpose of wealth management. These theories are exclusively concerned with the moment of decision, not with the moment of truth when consequences are experienced. They tacitly assume that individuals correctly anticipate their reactions to possible outcomes and incorporate valid emotional predictions into their investment decisions. In fact, people are poor forecasters of their future emotions and future tastes—they need help in this task—and I believe that one of the responsibilities of financial advisors should be to provide that help.

Advisor and advisee share a common interest: both want the relationship not to end in disappointment, and both want to reduce the potential for regret and for abrupt reversals. Decisions about risk should build on these agreed objectives. An emphasis on regret avoidance suggests some unusual topics for the initial conversations between advisor and client. Does the client's history suggest a propensity for hindsight and regret (bad news for the advisor)? What are the benchmarks to which the portfolio will be compared when things go poorly—and when they go well? How impatient will the investor be in a downturn? These discussions should lead naturally to reasonable choices about risk. Explicit consideration of regret also serves as a vaccine—regret that is anticipated is more likely to be avoided.

Note: The ideas presented here were developed and implemented in a continuing collaboration with Andrew M. Rosenfield, Managing Partner, Guggenheim Investment Advisors.

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