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Reframe 401k Participant Education To Stop Stressing Risk And Start Emphasizing Goals

Why do so many financial professionals still emphasize "risk tolerance" when the concept was debunked decades ago (see "Should 401k Plans Sponsor Ban Risk Tolerance Questionaires?" FiduciaryNews.com, August 13, 2013). In fact, the entire concept of "risk" has misled investors and their advisers for quite some time. (For a full treatment of this see the series of articles that begins with "7 Deadly Sins Every ERISA Fiduciary Must Avoid: The 2nd Deadly Sin- The Joy of 'Risk'," FiduciaryNews.com, August 16, 2011).

How did investors get hooked on "risk tolerance"?

This stemmed from advisors getting hooked on it first because advisers started using terms like 'risk-adjusted return'," says Scott Neal, President of D. Scott Neal, Inc. in Lexington/Louisville, Kentucky. "Very few investors have any idea what that means. Risk tolerance presents a simple metric that is easily scalable and looks good. It gives the advisor something to fall back on when the portfolio doesn't work as expected."

The problem only escalated during the first generation of computer-based asset allocation algorithms. Those enticing pie charts only whet the appetites of investors, and "risk tolerance" questionnaires seemed a logical systematic step towards performance bliss.

"In so many cases, a financial planning discussion is based on risk tolerance so the adviser in order to determine which 'cookie-cutter' portfolio can be used for the client," says Jordan Fandry, Financial Advisor at Manske Wealth Management in Houston, Texas. "When the main idea is to assign a title, or portfolio, to a client, the essence of financial planning and long-term goals may be overlooked by how the client feels about taking on risk. Unfortunately, the cookie-cutter portfolio based on risk tolerance is an industry norm that has investors hooked or fixated on risk tolerance."

As you now know, this turned out to be a little more complicated. Indeed, an over-reliance on those questionaires sometimes led to harmful investment decisions. For example, the 2006 Pension Protection Act promoted target date funds in part to wean retirement savers away from placing the bulk of their long-term investments in low-return stable income options.

"Risk tolerance can be dangerous when a client does not understand it's main purpose," says Brian Halbert, VP Retirement Services at Pensionmark in Austin, Texas. "Education is key."

Aye, there's the rub. How do you re-educate retirement savers to accept that "risk tolerance" is less important than they'd been led to believe? It starts by probably framing where risk ought to appear in the investment decision making process.

Show investors that while risk tolerance is an important component to investing, it is not the only component," says Tiffany Welka, financial advisor and accredited wealth management advisor at VFG Associates in Livonia, Michigan. "By showing investors a portfolio that aligns with their goals, their objectives, their morals, and their financial lifestyle, you can show the investor that risk tolerance is just a piece of the pie."

With the proper financial literacy syllabus, financial experts can help guide retirement savers toward realizing what they should most be concerned with: their Goal-Oriented Target (see "Goal-Oriented Target: How Leading Advisers and 401k Plan Sponsors are Using this New System to Replace Outdated Modern Portfolio Theory Risk Tools," FiduciaryNew.com, August 1, 2017).

"Risk will always be part of investing, but it should never be looked at alone," says Eric Phillips, Head of Financial Partnerships & Retirement Specialists at Human Interest in San Francisco, California. "What goals-based investing does is emphasize more than just risk. It helps create alignment between what a saver envisions for their future and how they invest. In contrast, focusing only on risk could potentially result in some people investing in asset classes that are not aligned with investing for their goals or carry a lot of risk."

The theme of 401k education programs and all retirement savings education efforts should be to have people understand what they're trying to achieve. There are plenty of real-world elements that make up a comfortable retirement. Savings and investments- and along with them risk and return- are only a means to an end. It is this end which professionals need to stress when speaking with savers.

"Retirement savers should first be able to identify what amount of money it takes to live," says Fandry. "Whatever amount of money covers food, bills, hobbies, etc. that allows them to live a comfortable life will be a critical step in identifying their goals. Their figure will help understand how to maximize savings goals and build out a meaningful financial plan complete with return objectives."

Identifying one's Goal-Oriented Target can only come once these fundamental building blocks have been identified and are in place. Too often, retirement investors have been taught to put the cart before the horse. In reality, it's most critical that they first specifically identify what a comfortable retirement means to them.

"After determining the amount of money needed to fund living standard and other more easily definable goals," says Neal, "one can back into return needed to generate the capital needed (i.e. the savings level plus return on savings) in order to fund those goals for a long-lived life."

There are many excellent tools to help you "back into" your return requirement. Here's one example of a retirement readiness calculator that contains all the essential elements a professional will want to go over.

"Your Goal-Oriented Target should be developed while working with someone that specializes in retirement planning," says Michael Foguth, founder of Foguth Financial Group in Brighton, Michigan.
"You could also use a calculator to reverse engineer the savings and growth to your income goal number. This is very simple when working with a financial professional that focuses on retirement planning but can be more difficult if you are going at it alone and without professional guidance."

It's fun to talk about "risk" and "return" because these are measurables and people are comfortable with the tangible world. But none of that touches upon what really matters. Worse, it can distract you from achieving what you want most.

"With respect to accumulating funds for retirement, the destination is much more important than the journey," says Robert R. Johnson, PhD, CFA, CAIA, Professor of Finance, Heider College of Business, Creighton University in Omaha, Nebraska. "That is, when one wants to accumulate sufficient funds for retirement, they may not enjoy the journey (the stock market has peaks and valleys), but the destination (a comfortable retirement) is the goal."

Isn't it everyone's desire not merely to tolerate risk, but to reduce it? There are reliable strategies to accomplish this desire. You just need the discipline to stick to them.

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