Equity Rate

ASSESSMENT GUIDE

Equity Rate indicates whether a person will experience too much or too little volatility based on their personal risk tolerance and life stage.

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Equity Rate

Assessment Guide

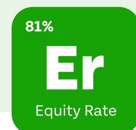
What is it?

Description: Equity Rate (Er) indicates the percentage of a client's total investable assets allocated toward equity investments.

CALCULATION

Equity Investments
÷ Total Investments + Cash

Equity Rate



Example: assume a client has a savings account with $20,000, a brokerage account with $25,000, an IRA with $150,000 and a 401k with $600,000. If the equity value of all these accounts was $620,000 their Equity Rate (Er) would be 78%.

Why is it important?

To grow net worth, there are three primary "levers" a client can pull: they can save more, reduce debt, or grow assets via investment returns.

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Unlike the first two, clients have little control over their investment return, but they can control how much risk they are willing to take with these investments.

With Elements, investment risk is measured by a client's exposure to equity investments. We can assume that a client with more exposure to equity investments is taking a greater risk. Further, including a client's personal cash into the total exposure calculation provides a more accurate view of a client investment risk profile.

How do I use it?

Use the process to assess whether a client's Equity Rate is appropriate or if they need to make improvements:

1. **Accuracy: ensure the accuracy of the Equity Rate inputs**
2. **Assessment: assess whether the given Equity Rate is appropriate.**
3. **Improvement: Identify areas of improvement**

Score Accuracy

Include Personal Cash: Because Equity Rate measures the total amount of risk a client is taking in their investable assets, Elements includes personal cash as an "investable asset." It would be inappropriate to isolate a measure of equity exposure just to the invested accounts and not to the full available investable assets.

> **Example:** A client has a 401(k) valued at $100,00 with an equity ratio of 80-20, and they also have $100,000 of personal cash in their bank account. Including the personal cash would make the Equity Rate 40%

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Score Assessment

Average Equity Rate scores depend on a variety of factors. Understanding the correlation between these factors and your clients' equity exposure will help you determine if the given Equity Rate is appropriate or not.

- **Investment Time Horizon:** Shorter = Lower Er
- **Risk Capacity:** Higher Capacity = Higher Er
- **Risk Tolerance:** Higher Tolerance = Higher Er

While a client's investment time horizon can be relatively easy to obtain, determining their risk capacity and risk tolerance proves to be more difficult. Volumes have been written on these two topics, and we will present very briefly a starting point for determining a client's risk tolerance and risk capacity.

Determining Risk Capacity

A client's risk capacity can be defined as their actual, functional ability to take on risk. While investment time horizon is the primary determinant of their risk capacity, these factors will also influence it:

- **Time Horizon:** Shorter = Lower RC
- **Age:** Older = Lower RC
- **Career Stage:** Early = Higher Rc
- **Current Liquidity:** High = Higher RC
- **Cash Flow:** Larger = Higher RC
- **Debt Levels:** Higher = Lower RC

Determining Risk Tolerance

A client's risk tolerance can be defined as how much risk they are comfortable taking. While their risk capacity may influence their risk

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tolerance, these should not be conflated.

While many services exist which aid advisors on determining a client's risk tolerance, you should consider the following as you identify their risk tolerance:

- **Sending the client a risk tolerance questionnaire.**
- **The client's past experiences with investing**
- **How the client feels about volatility**
- **Can the client stick with their investment plan?**
- **Are there recent life events that may influence their risk tolerance?**

Score Improvement

Much has been said about how to allocate a client's investment portfolio to ensure they take the right amount of risk. With the wide variety of solutions available, advisors will have different approaches to improving a client's investment risk profile.

Case Study

Let's look at the following example and apply the principles presented above. This case study assumes you've already ensured that you have a good estimate.

> **Example:** Given an Equity Rate of 63% and considering the following information, you begin your assessment of whether a client's Equity Rate is appropriate

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Age	41
Retirement Age	60
Career Stage	Mid-Career
Current Liquidity	$200,000
Cash Flow	High
Debt Level	$700,000 outstanding

Step 1 - Score Assessment: With a time horizon of about 20 years (client is 41 and wants to retire at age 60), the client has plenty of time to take more risk. Additionally, with a large net worth, a healthy amount of liquidity, and high cash flow, the client has the risk capacity to handle more investment risk. These factors should result in a higher Equity Rate.

However, after careful questioning you discover the client has had some very negative experiences investing in the past. This is causing them to dial back the amount of risk exposure they take.

Step 2 - Identify Improvements: First you'll look to the client's Total Term score to determine if they are on track and increasing their net worth at an appropriate level through savings contributions and debt reduction. If they need to take additional risk in their investments, you will engage in empathetic listening and find solutions that will incrementally improve their risk exposure.

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