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The Risk Gap: Rethinking What It Means to Be a "Risk-Averse" Investor

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When investors hear the word "risk," they often think about losing money. But investment risk is broader than just market decline, as there are also risks of not earning enough, of inflation reducing purchasing power, and of reacting emotionally to short-term volatility.

We use the term "Risk Gap" to describe differences that have historically appeared in how women and men perceive, tolerate, and respond to all components of financial risk, as well as the implications those differences can have for long-term investing.

Of course, it would be inaccurate imply that *all* women are more risk-averse in investing than men, but some data does indicate that these tendencies may exist.

For example, one oft-cited study from 2012 titled "Strong Evidence for Gender Differences in Risk Taking" took 15 different datasets from thousands of participants to conclude that women systematically invest less in riskier assets and appear more financially risk-averse than men. Is this inherently a bad thing, though? Not necessarily.

CAUTION CAN BE A STRENGTH – AND A DRAWBACK

As we discussed at length when unpacking the concept of the Confidence Gap, while a lack of confidence can surface friction points when it comes to investing, overconfidence can lead to unnecessary activity and its own set of problems.

However, avoiding volatility altogether can mean accepting other risks. While a portfolio heavily concentrated in cash or very conservative investments may fluctuate less, it doesn't make it risk-free. Or put another way, the safest-feeling portfolio is not necessarily the one with the lowest risk to your financial plan. As mentioned above, market risk is one dimension, but there is also **inflation risk** (your money may buy less over time), **longevity risk** (your assets may need to support you for decades), and **shortfall risk** (your portfolio may simply not grow enough to fund your goals).

Time is also a critical factor, too.For someone investing for a goal 20 or 30 years away, short-term market volatility may matter less than insufficient long-term growth. Conversely, someone approaching a near-term withdrawal may need considerably less market exposure.

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RISK TOLERANCE IS ONLY ONE PIECE OF THE PUZZLE

When assessing how much risk you are willing to take, consider also that your own personal tolerance for risk needs to be considered alongside capacity and need.

If risk tolerance asks the question, "How much uncertainty can you emotionally tolerate?", risk capacity asks, "How much risk can your circumstances actually absorb?" And similarly, required risk asks, "How much investment growth does your plan need?"

Considering these thoughtfully will help you be better equipped to decide which risks are necessary for your goals, which risks are simply not worth taking, and how much volatility you (and your financial plan) can withstand.

A personalized portfolio should reflect both the math of the financial plan and the individual investor who must tolerate the ups and downs.

STEPS TO BEGIN CLOSING THE RISK GAP

Over the next few months, we'll explore in more depth specific ways to start closing the Risk Gap, as well as some of the myths and contradictions that accompany this topic. Along the way, we'll explore the role that behavioral finance can play, navigate the complexities of when couples have their own clashing risk tolerances, and much more. But for now, here are a few initial things to keep in mind as you consider your own relationship to risk.

1. Define risk in terms of your goals: Instead of asking whether an investment is "risky," ask what specific risk it creates, and what risk it may help address.

2. Know your time horizon: Money needed next year should usually be treated differently from money intended for decades from now.

3. Separate feelings from financial capacity: Addressing concern about volatility is important, but it should not be the main driver in determining the appropriate portfolio.

4. Create rules before markets become emotional: Decide in advance how you'll respond to volatility rather than making major decisions during periods of stress.

5. Stay involved: If someone else has traditionally handled investing in your household, start participating in conversations about asset allocation, risk, goals, and why the portfolio is structured the way it is.

Finally, and not too surprising, it is reassuring to keep in mind that most investors do not enjoy risk. A 2024 FINRA Investor Survey found that only 8% of investors said they were willing to take substantial investment risk, down from 12% in 2021, so discomfort with risk is hardly unique to women investors.

Understanding risk may not eliminate uncertainty, but it gives you context and perspective for deciding which uncertainties are worth accepting in pursuit of the future you want.

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