

An Evaluation of the Risk-Taking Characteristics of Affluent Households

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IDENTIFYING THE NUANCES of wealth accumulation at the household level has been the subject of research and discussion for nearly 100 years. Atwood (1926), for example, attempted to understand the attitudes and behaviors of the affluent of his day, concluding that the truly wealthy act differently than others and engage in behavior that those without wealth sometimes interpret as being arrogant or odd (for example, having a rather mundane lifestyle). According to Schervish and Havens (2001), this "fascination with and opinion about the

Executive Summary

- The purpose of this study was to test whether affluent households differ in the frequency of engaging in certain financial risk-taking tasks and to evaluate the association between net worth and performance of risk-taking tasks.
- Data from two survey samples showed that affluent respondents reported more frequently taking above-average investment risk, understanding risk levels, and understanding the risk and return characteristics of investments.

Less affluent respondents reported taking fewer financial risks.

- Results also showed that net worth was associated with conceptualizing and understanding risk and return trade-offs.
- Under both FINRA and SEC rules and guidelines, financial planners are required to evaluate their clients' risk tolerance profiles prior to making recommendations. The results from this study suggest that this requirement may be more important than previously thought.

millionaire has never gone out of style" (page 76). Klontz, Seay, Sullivan, and Canale (2014) noted the following: high wealth-holding individuals and households act differently than others. The affluent are less likely to avoid money issues or overvalue assets, income, and wealth. They also exhibit higher levels of financial knowledge and more planning behavior to increase wealth.

Nearly 20 years earlier, Stanley and Danko (1996) uncovered similar attitudes and behaviors. In their well-known book, *The Millionaire Next Door*, Stanley and Danko reported the results of a series of surveys designed to document the types and frequencies of tasks engaged in by wealthy households. They created a now widely used formula to estimate how much wealth someone

should have in relation to their age and income.¹ Ultimately, what emerged from their work was evidence documenting what wealthy households do on a regular basis, in terms of personal finance tasks.

Based on the work of Stanley and Danko (1996), Klontz et al. (2014), and others, financial planners now know that it is not always possible to gauge a person's financial situation simply by viewing what a person exhibits to the world (for example, their home, car, or clothing). According to Stanley and Danko, those who live frugally are more likely to also be wealthy. The affluent among the population tend to spend less than they earn and save aggressively. Those who under accumulate wealth are more likely to signal their social

status by spending on cars, clothing, vacations, and luxury items and services. As noted by Ameriks, Caplin, and Leahy (2003), those with less wealth often fail to control their spending through pre-planning activities, limiting wealth accumulation.

Much of the analytical work devoted to evaluating differences between those who have accumulated large sums of wealth and others has focused on attitudes, traits, cognition, and planning behavior as explanatory variables (e.g., Ameriks et al. 2003). Fewer studies have focused on the similarities and differences among households in terms of the engagement of risk-taking tasks.

Some evidence suggests that there may be differences in the risk attitudes and behaviors of those who report possessing high levels of wealth compared to others. Again, the work of Stanley and Danko (1996) provides some insight on this topic. They documented that the affluent are willing to take risks if the returns are reasonable and the rewards outweigh possible losses. According to Stanley and Danko, the affluent tend to be willing to invest in riskier assets, such as equities and private businesses. They are not, however, gamblers or speculators. Rather than taking a long-shot bet on an investment, Stanley and Danko argued that the affluent prefer, in general, to diversify their investments across higher-return assets. They also tend to avoid holding large positions in cash and other lower-return investments.

These insights are now considered to be foundational concepts within the personal finance community (Bosch-Domènech and Silvestre 2006; and Carroll 2000). Yet, whether there are, in fact, associations between frequently engaging in certain risk-taking tasks and having a high net worth has not been verified in the literature. This study was undertaken to help fill this gap in the literature.

The primary purpose of this study was to reevaluate the risk-taking task domains originally presented by Stanley and Danko (1996) in order to determine whether the affluent behave differently than others in the frequency of performing certain financial risk-taking tasks.

Literature Review

The relationship between engagement in risk-taking behavior and wealth accumulation is a complex one that starts with the concept of risk tolerance. Risk tolerance is generally defined as a person's willingness to accept the possibility of a loss in pursuit of a gain (Nobre and Grable 2015). The engagement in risk-taking behavior is thought to be positive (Rollison and Scherman 2002). Additionally, Finke and Huston (2003) hypothesized that financial risk tolerance and wealth are positively associated. People who described themselves as being more willing to take financial risk generally did engage in more risky investment behavior, and they often reported greater levels of wealth accumulation. It is important to note, however, that the relationship is not perfectly linear. Hallahan, Faff, and McKenzie (2004) found that the affluent are not always willing to accept more risk in all situations.

Finke and Huston (2003) used the 1998 wave of the Survey of Consumer Finances to examine how financial risk tolerance impacted levels of financial assets owned by a household and net worth. They found that net worth was more than two times greater among those who were willing to accept higher risk, compared to others who were not willing to accept any risk. Among those who reported having below-average risk tolerance, the difference was more than three-and-a-half times greater. Those with a moderate level of risk tolerance also reported having a significantly lower average net worth and financial asset ownership in

comparison with those in the highest risk-tolerance group.

Hallahan et al. (2004) presented two perspectives on the relationship between wealth and risk-taking behavior. The first was that affluent investors could afford to take more risk because they could withstand higher levels of losses. This is akin to saying that affluent households have a greater risk capacity (Yao 2011). The second was that affluent investors were more conservative with their money perhaps because they had more to lose, whereas the less affluent had less to lose and perhaps viewed risky investments as an opportunity similar to buying a lottery ticket.

Guiso and Paiella (2008) used the Bank of Italy Survey of Household Income and Wealth to investigate the relationship between risk aversion (the inverse of risk tolerance) and wealth. They found that risk tolerance was both positively associated with risk-taking and wealth, but that risk tolerance increased at a proportionately slower rate than wealth. In a similar study, Carroll (2000) found that, in general, portfolios of affluent households were more heavily invested in higher-risk assets such as stocks and mutual funds.

Over time, portfolios of the affluent have become more varied. Evidence of a shift in portfolio risk was documented in the U.S. Federal Reserve's Survey of Financial Characteristics of Consumers between 1962 and 1995. Data from the surveys indicated a decrease in stock ownership and an increase in mutual fund ownership among affluent households.

Today, those who are affluent are more likely to be involved in entrepreneurial activities, such as starting and running their own businesses. For these business owners, much of their income and net worth is derived from and concentrated in their business. As a result, their investment portfolios are risky in that their wealth is concentrated in one investment and not well diversified.