DECISION BRIEF

# Client Risk Assessment: Capacity, Tolerance, and Need

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| **Scope** | This *brief* describes the three-dimension framework Rain Dog uses to judge how much investment risk is appropriate for a household: risk capacity, risk tolerance, and risk need. It covers the whole-household wealth-allocation accounting that informs these dimensions, the qualitative intake used to elicit them, how conflicts among them are reconciled, and how the result is recorded in the client's *Investment Policy Statement*. |
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## 1. Summary

Most advisors reduce a client's risk profile to a single "risk tolerance" number produced by a questionnaire, and then map that number to a model portfolio. Rain Dog takes a different approach. A household's suitability for investment risk is not one thing but three, and they sometimes conflict within the same household: how much loss the household can financially absorb, how much volatility the household can emotionally live with, and how much market risk the household's goals actually require.

**Decision.** Rain Dog assesses three distinct dimensions for each household: *risk capacity* (the financial ability to bear loss), *risk tolerance* (the behavioral and emotional ability to stay invested through loss), and *risk need* (the market risk the plan requires to fund the household's goals). Each is assessed through structured qualitative inquiry across the household's entire balance sheet, then reconciled where the three conflict and recorded in a client-signed *Investment Policy Statement*. Rain Dog does not use a numeric risk score for the client or for the portfolio.

## 2. Scope & Application

This *brief* describes the definitions of risk capacity, risk tolerance, and risk need; the whole-household wealth-allocation accounting that informs capacity and tolerance; the qualitative, intake-based elicitation of each dimension; the reconciliation of conflicts among the three; and the recording of the result in the *Investment Policy Statement*, which is reviewed at least annually.

## 3. Assessment Model & Methodology

### 3.1 The three dimensions

Rain Dog assesses risk along three independent dimensions:

- **Risk capacity—the financial ability to bear loss.** The household's objective capacity to absorb a decline without compromising its standard of living or its goals. It is built from the planning horizon (intended work runway, health and family longevity, and the maximum planning age the client chooses), liquidity needs, and quantitative capacity (investable assets, income, home equity, insurance, business value, cash reserves, expected inheritance amounts, debt, and other household-specific factors).
- **Risk tolerance—the behavioral and emotional ability to stay invested.** The household's capacity to hold a position through a loss without abandoning the plan. It is inferred across several behavioral elements: willingness to take risk, preference for safety versus return, financial knowledge, investing experience, how the client perceives risk, and composure under past market conditions.
- **Risk need—the market risk the plan requires.** The real return the household's goals require, and therefore the portfolio risk needed to fund them. It is computed in the Investment Forecast Model from the household's goals and spending, not gathered from the client directly.

**A note on terminology.** Rain Dog uses *risk capacity* as a common-language synonym for what some frameworks call risk-taking ability, and *risk tolerance* as the umbrella term for behavioral and emotional dimensions. This usage matches how these terms are generally used in practice and how clients understand them; it does not necessarily match formal usages of those terms.

### 3.2 The wealth-allocation framework as the whole-household instrument

Rain Dog uses a wealth-allocation framework of three buckets (safety, stability, and superabundance) as the structured means of accounting for a household's entire set of resources, not just its securities. This is the instrument that produces the capacity picture and structures the tolerance conversation.

- ***Safety* accounts for the resources most securities-only assessments ignore.** A mostly-paid-off home with substantial home equity, life insurance, several more years of intended work, and cash in the bank all belong here. These are the resources that establish a household's financial ability to take risk, and the framework makes them visible.
- ***Stability* structures the tolerance conversation.** Once safety is accounted for, Rain Dog and the client can examine what the stability portion actually needs to do, and whether an overly conservative posture there is undermining needed growth. The client may still choose caution, but the framework turns that into a reasoned choice against a visible backdrop rather than a reflex.
- ***Superabundance* sizes higher-risk exposure against total resources.** A concentrated stock position, a private investment, or any high-convexity bet is sized here against the household's total resources. When a client holds, for example, 15% of net worth in a single concentrated position while the household's profile suggests that a 5% total in superabundance would be more suitable, the framework gives a structured, independent basis for the conversation about trimming it.

The framework never produces a specific answer. It produces structure for reasoning about what makes sense given the household's total resources and risk preferences, including financial-adjacent resources such as how much longer the client intends to work and whether the client owns a business, together with the client's general tolerance for risk.

### 3.3 Elicitation

The three dimensions are elicited through Rain Dog's client intake and the conversations around it. *Capacity* is drawn from health and longevity, the chosen planning age, employment plans, income continuation, the relationship of spending to assets, reserves, business ownership, and debt. *Tolerance* is drawn from open questions about what financial risk means to the client, proudest moments and biggest regrets in prior investing, positive and negative experiences with specific asset types, what is keeping the client up at night, and the client's ranked standard-of-living and investment-strategy priorities. *Need* is drawn from Rain Dog's financial planning.

**Composure by inference.** Of the behavioral elements, composure, how a client behaves in an actual loss, is inferred from the client's account of past experiences and regrets rather than asked as a separate scored question. This is deliberate: Rain Dog believes that the qualitative narrative of what a client actually did, and what they wish they had done, provide a more reliable read than a hypothetical self-report.

The assessment is conducted at the household level, and the two members of a couple often answer the same question differently. Those differences are treated as information about the household, not as a discrepancy to be averaged away.

### 3.4 Reconciling conflicts

The three dimensions sometimes conflict within one household: low risk tolerance with moderate risk need or a high risk tolerance that exceeds risk capacity. Rain Dog draws on the green/yellow/red reconciliation logic of the CFA Institute's three-factor model to work through these combinations in a consistent way. The governing principles are:

- **Capacity is the upper bound.** Rain Dog will not recommend a portfolio whose risk exceeds the household's capacity to bear it, regardless of tolerance or stated preference. Where the risk need exceeds capacity, the goals or savings are revisited rather than the portfolio pushed past what the household can absorb.
- **Tolerance is never simply overridden.** A low tolerance is not ignored in favor of a higher capacity or need. Where tolerance is the binding constraint, Rain Dog may work with the client over time to reconcile it with the plan's realities, but does not paper over it.
- **The reconciliation is documented.** How a given mismatch was resolved, and why, is recorded in the *Investment Policy Statement*, so that the recommendation reflects a reasoned path through the three dimensions rather than a single number.

**Important:** As the advisor, Rain Dog advises, but the client decides. In some cases, a client may decide on an investment approach that is different from Rain Dog's recommendation. That is the client's right, and, after a thoughtful discussion of the implications, Rain Dog respects the client's right as the ultimate decision maker about their finances.

### 3.5 Recording the result

The assessment is recorded in the household's *Investment Policy Statement*, which names all three risk dimensions in these terms, states expected worst one-year and worst two-year ranges so the client is prepared for the fluctuations the plan entails, and characterizes the resulting plan (for example high growth, controlled growth, or income-focused). The client signs the *Investment Policy Statement* as their instruction to Rain Dog on how they wish their investments to be managed; Rain Dog does not finalize it until the client is fully comfortable with it. All three dimensions are revisited at each annual review, because capacity in particular changes as the plan progresses and goals evolve.

For clients who prioritize avoiding risk, Rain Dog's *Plan Score* can incorporate one or more risk measures, including maximum one-year drawdown, maximum two-year drawdown, expected lowest income year, expected income in worst-case scenario, expected end-of-life assets in worst-case scenario, chance of falling below the *Essential* income level, and so on. Many clients do not prioritize these kinds of risk measures, but they are available for clients that do.

## 4. Background & Research

### 4.1 Why three dimensions

A single risk-tolerance score conflates three things that are genuinely distinct and that regularly point in different directions. A household can have ample financial capacity and little emotional tolerance, or a strong need for return and limited capacity to pursue it. Reducing all of this to one number discards the tension that good advice should help resolve.

The deeper reason for a whole-household frame is that a household's ability to take risk lives across its entire balance sheet rather than only in its securities. A client's held away assets including a home, insurance, business ownership, rental properties, planned years to retirement, and willingness to work additional years all affect the viability of a financial plan.

### 4.2 Alternatives considered

- **A single risk-tolerance score.** Rejected as the primary instrument because that measures at most one of the three dimensions.
- **A numeric portfolio-risk score.** Rejected. A single portfolio risk number, whether client-facing or vendor-supplied, substitutes a figure for the reasoning and nuanced conversation that the three-dimension assessment is meant to make explicit.
- **A securities-only assessment.** Rejected. Assessing risk from the investment accounts alone ignores the home equity, insurance, employment runway, business, and other resources that determine a household's capacity, and misjudges the households Rain Dog serves.
- **Psychometric questionnaires.** Rejected. Rain Dog instead uses structured qualitative inquiry across the whole household combined with the structure of the Wealth Allocation Framework and joint creation with the client of an *Investment Policy Statement*. Rain Dog believes that understanding client's past behavior, the jointly-developed investment policy statement, and the related conversations provide a more suitable risk customization for a household than one or more numeric scores.

## 5. References

### 5.1 Related Documents

- Rain Dog Financial, *Investment Policy Statement* template.
- Rain Dog Financial, Client Intake form.
- Rain Dog Financial, spending-modeling *Decision Brief*, covering the Essential/Comfort/Luxury stratification and withdrawal guardrails.
- Rain Dog Financial, Plan Score *Decision Brief*, which may incorporate one or more client-specific risk criteria.

### 5.2 References

- CFA Institute, Investment Risk Profiling: A Guide for Financial Advisors (2020). The three-factor decomposition and green/yellow/red reconciliation logic from which Rain Dog draws.
- Ashvin B. Chhabra, wealth-allocation framework applied at the whole-household level.

## 6. Notes & Disclosures

Rain Dog Financial® is a trade name of Rain Dog LLC.

This brief is prepared first for Rain Dog's internal documentation purposes and second for compliance and record-keeping purposes. It is also shared with current and prospective clients to offer transparency into Rain Dog's methods and approach. It is informational and does not constitute individualized investment or tax advice. Investing involves risk, including possible loss of principal, and the worst-case ranges discussed with a client are estimates, not guarantees or limits on possible loss. The risk assessment reflects structured professional judgment applied to information the client provides; it is not a prediction of any outcome. All three dimensions are set with the client and reviewed at least annually.

Rain Dog does not provide tax-return preparation or legal advice; clients should consult their own advisors on their specific situation.

## Revision history

| Version | Date | Change | By |
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| 1.0 | 2026-07-19 | Initial draft. | SCM |