

PRACTICE NOTES

Risk required...what do you need to succeed?

The second in a three-part series on the three pillars of risk profiling
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Key Points:

- Risk required is goal-based and mathematical. It bridges the gap between where you currently are and where you want to be.
- Risk required is determined via a clear step-by-step process that calculates the risk a client **MUST** take to achieve their financial goal(s).
- Without risk required analysis, investment advice becomes opinion-based instead of goal-based.

Introduction

Client risk profiling is a multi-dimensional process comprising of three key components: risk capacity (ability), risk required (need) and risk tolerance (willingness). In this, the second of a three-part series, we focus on risk required. Understanding the nuanced difference between the three pillars of risk profiling is vital for know-how investing.

Definition

Risk required refers to the level of investment risk a client needs to take to achieve their financial goals and objectives within a specific time frame. It answers the question: “how much risk **MUST** I take to realistically achieve my goal(s)?” If you have a high goal but low savings, your ‘required’ risk might be high, even if your ‘tolerance’ is low. It is different from risk tolerance (how much risk you can emotionally handle) and risk capacity (how much risk you can afford to lose).



Risk required introduces objectivity into the advice process.

Every financial goal requires a certain return. For example, retiring comfortably, funding a child’s education or leaving a legacy. The core principle remains – the shorter the time horizon and the larger the goal relative to available capital, the higher the required return usually becomes. This is where mathematics meets reality. If you need a 10% annual return over 30 years to accumulate sufficient retirement funds, a conservative portfolio generating only 7% will not meet your requirements, regardless of how comfortable it feels. Risk required is particularly important because retirees are living longer, medical inflation remains high and clients often underestimate retirement capital needs.

Simple summary formula



Risk required

=

f (target capital/income - current resources + time available + return needed)

goal
size

-

current
assets

+

time
available

+

return
required

Step-by-step: determining risk required

- **Define** the financial goal clearly.

EXAMPLE

A 55-year-old investor with savings of R4 million wants to retire at 65. The investor wants to earn a monthly income/pension of R40 000 in today's value. Inflation assumption: 5% and a life expectancy of 85 years.

The objective is clear:

- Need: R40 000/month in today's value.
- Retirement in 10 years.
- Inflation assumption: 5%.
- Expected to live another 20 years in retirement.

- **Calculate** the future income requirement.

We inflate this income for 10 years at 5%. This gives the required monthly income at retirement.

- $PV = R40\,000$.
- $i = 5\%$.
- $n = 10$ years.
- $FV =$ calculate income required at retirement.

Required monthly income at retirement

$\approx R65\,000$ per month

[or around R780 000 per year]

- **Convert** the income need into the capital requirement.

Calculate how much capital is needed at retirement to sustain the above income IN retirement. The investor needs this income for:

- 20 years – growing at 10%.
- Increasing with inflation annually.
- We therefore calculate the present value of an inflation-linked annuity using the real (resultant) rate of return*.
- $PMT = 65\,000$.
- $r = 4.76\%$.
- $n = 20$ years.
- $PV =$ calculate capital required at retirement.

$$^*r = \frac{1.10}{1.05} - 1 = 4.76\%$$

Required retirement capital at 65 years of age **$\approx R10$ million.**

- **Determine** your existing capital position [ability] at retirement.

The R4 million savings includes all the discretionary and non-discretionary savings. If this grows at 10% p.a. for 10 years, you will have approximately R10.8 million at date of retirement.

- $PV = R4\,000\,000$.
- $i = 10\%$.
- $n = 10$.
- **$FV = R10\,800\,000$.**

- **Calculate** the funding surplus or shortfall

Required capital	R10 000 000
Projected capital	R10 800 000
Surplus	 R800 000

In this example, based on the current analysis and various assumptions, the client is on track and should achieve a surplus at retirement.

- **Match** the required return to a suitable investment portfolio.

The client experienced a projected **capital surplus at retirement** because he diligently continued to invest in growth assets – a typical balanced and/or equity portfolio with a relatively high allocation to equities of 65% or more. The client also ensured his investments were diversified between asset classes and asset managers.

The client is still 10 years from retirement, hence the need to continue investing in growth assets such as local and global equities. Including growth assets can improve long-term inflation-beating returns while also enhancing tax efficiency. Equity investments are often taxed as capital gains rather than as income. Annual capital gains exclusions can further assist in reducing overall tax exposure. The aim is to ensure that the client's retirement objective 'remains on track', allowing the portfolio to grow sufficiently to combat inflation and support long-term income needs.



You always need growth assets.



Inflation continues after retirement.

Inflation risk (high medical costs), **longevity risk** (you may be fortunate enough to live another 20 years plus in retirement) and the fact that your compulsory annuity is taxed at your **marginal tax rate**, will mean that you need to continue investing in growth assets IN retirement. Your financial position when you eventually retire, may allow you to reduce risk required. For example, it may allow you to reduce your growth assets/equities from 65% to say 30%, but you would still need equity exposure.

Financial planning – the big gap / mismatch

The **gap analysis** between a **capital surplus** or **capital shortfall** is one of the most important parts of financial/retirement planning and allows corrective action years before retirement. The risk required is not about what the client wants emotionally or what they prefer. When there is a shortfall, the planner must endeavor to reduce the gap through one or more corrective actions. On the other hand, if the goals are already achievable, excessive risk may no longer be necessary.



Gap management is an ongoing process, not a once-off calculation.

The most challenging scenario for a financial planner is to deal with a situation where a client has a capital shortfall and is simultaneously conservative i.e. has a low tolerance for risk/panics during volatility. The scenario may result in an unrealistic return need – risk required – but can be managed by the adviser exploring corrective options. For example:

- Developing greater risk tolerance through education and gradual exposure; and/or
- Finding alternative strategies like **increasing** savings rates, **extending** working years or **lowering** the client's goals to something more realistic.

In the case of a surplus the challenge is to protect accumulated wealth. It is imperative for the client to know – and understand – what needs to be done to reduce the risk of potentially falling into a shortfall. Hence, the importance of reviewing a client's plan on a regular basis remains key.



Summary

To recap, risk required is important because it:

- Connects investment risk to financial goals.
- Determines the minimum return needed.
- Prevents unrealistic expectations; and
- Identifies future shortfalls early.

The important principle is that risk required should never be assessed in isolation. Rather, it must be considered together with risk capacity (as discussed in part 1 of this series) and risk tolerance. Thus, the most suitable financial plan is one where:

- The client's goals are achievable ✓
- The required risk is realistic ✓
- The client can financially and emotionally remain invested through market volatility. ✓

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