

You Will Be Using World's Best Practice in Your Clients' Financial Risk Tolerance Assessments

A client relies on their adviser to provide advice backed by specialist knowledge which is appropriate to them in their current, and reasonably foreseeable future circumstances. This requirement has its origins in the common law concept of duty of care and it is no co-incidence that the requirement has been enshrined in many legislative regimes.

The obligation to know your client is not new, it is certainly older than the financial services industry. What is new, however, is that we are starting to see the concept of the assessment of a client's risk tolerance as intrinsic to measuring the adviser's compliance with that obligation.

The concept of risk is nothing new in the financial planning context. Its importance has been recognised by the inclusion in ISO22222 (Personal Financial Planning – Requirements for Personal Financial Planners) of a requirement to obtain an assessment of a client's financial risk tolerance. It is the cornerstone of the adviser's basic obligation to determine their client's relevant personal circumstances.

The "know your client" rule has expanded beyond a static obligation to encompass the more dynamic concept of gap analysis which recognises an obligation to ensure a client provides properly informed commitment to critical strategic decisions throughout their investment timeline. Gap analysis recognises that the financial planning process often entails a trade off between a client's goals, resources and risk tolerance. In other words, the initial analysis often reveals a discrepancy between a client's financial goals and the resources available to achieve those goals. That "gap" can only be filled by one or more of the allocation of greater resources, the adoption of a greater level of risk than the client would otherwise be comfortable with and/or the reassessment of their goals. It is clear that in order to assist the client to resolve the discrepancy a robust risk tolerance assessment is an essential foundation. The profession and often regulators have come to identify risk assessment as a piece of the "know your client puzzle".

So Why is FinaMetrica Receiving Industry Accolades?

While there are a number of risk profiling "tools" currently available to, and being used in, the financial planning industry, FinaMetrica remains the only objectively verifiable psychometric risk assessment tool available in the personal financial planning arena. Developed and tested in Australia with the assistance of the University of New South Wales' Applied Psychology Unit, FinaMetrica is now being used by leading advisers in Australia and New Zealand and across, Asia, the UK and Europe.

It is now well accepted that Portfolio Pickers questionnaires are inaccurate and inappropriate because these recommendations do not give consideration to whether the client's goals will be achieved. In particular, the tools fail because they conflate the two critical goals, financial and psychological, into one score which invariably points to a portfolio.

It is still the case that many advisers rely on outdated and statistically unreliable methods of establishing a client's risk tolerance. In large part, this stems from a lack of understanding of the meaning of risk tolerance.

Risk tolerance is an individual psychological attribute, the measurement of which requires a targeted and scientifically reliable psychometric tool.

While many less sophisticated tools rely on an assessment by the client of their own risk profile or by the adviser on the basis of a series of subjective questions, or on a combination of the two, such systems misunderstand the complex psychological elements that combine to create a client's risk tolerance. It is much more than a function of risk, reward and demographic variables. Independent testing has comprehensively shown the lack of accuracy of those measures.

The established scientific discipline of psychometrics blends psychology and statistics to provide scientifically reliable tests which can be objectively verified as being both valid, that is providing a measure of what is purported to be measured, and also reliable which means that the tests measure consistently with a known level of accuracy.

Scientific studies evidence the fact that industry-standard risk questionnaires fail to produce useful results, largely as a function of the quality of the questions on which they are based.

FinaMetrica scores risk tolerance on a 0-100 scale with a mean of 50 and a standard deviation of 10. The resultant bell curve distribution moves out from the middle (mean) group with the two groups above and below the mean group being one standard deviation wide. This scoring methodology is consistent with accepted psychometric standards.

You should be comforted in the knowledge that you will be using FinaMetrica as a key input in the construction of your clients' financial plans.