STEP RIGHT UP

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THRILLS GALORE!

DO YOU DARE?

DISCOVER HOW MUCH RISK YOUR CLIENTS ARE WILLING TO SHOULDER. PSST! IT'S HARDER THAN YOU THINK

BY KIMBERLY LANKFORD

If nothing else, the recent gyrations in the stock market have taught us that of all the information advisers collect about their clients, probably the most important concerns their tolerance for risk. "Everything starts with risk and return," says Michael Thompson, a market strategist at RiskMetrics Group, a New York firm that provides financial-risk-assessment software. "What advisers need to do at the outset is establish with an investor how much risk he's willing to take, because at the end of the day that will determine what return is reasonable."

I n fact, it's almost impossible to overstate the importance of accurately assessing your clients' propensity for risk. If you underestimate clients' risk tolerance, their portfolios could be too conservative and they may never reach their goals. If you overestimate their risk tolerance, not only could the clients miss their goals but they could sue you for placing them in unsuitable investments—an outcome that has become increasingly common since the dot-com bubble burst. Using a good risk-assessment tool can become a form of liability protection.

"If a proper suitability analysis or asset-allocation model is done initially, many problems could be avoided. It's the key issue I use in evaluating cases," says Jacob Zamansky, a principal at the law firm of Zamansky & Associates in New York who represents investors in suitability cases against their advisers and brokers. "We don't need amateur hour here. The analysis has to be by a real professional who's trained and has asset-allocation models available, rather than someone just creating a form."

But the problem is many risk-assessment tools are exactly that: amateur. Even though the practice standards published by the Certified Financial Planner Board of Standards, the Association for Investment Management and Research, and the Investment Management Consultants Association all emphasize the importance of assessing your clients' risk tolerance, none explain how you should go about making that assessment. A hodgepodge of techniques exist, but most are inadequate, leaving the bulk of the analysis to the adviser. For this reason, risk assessment has been called the Achilles' heel of the financial-planning business.

"My interest in risk assessment came about because I was frustrated with the current state of the finance literature," says Andrew Lo, a finance professor and director of the Massachusetts Institute of Technology's Laboratory for Financial Engineering. "But I'm part of the problem as well. The kind of work I've done in the past has been technical, focusing on the quantitative aspects of the financial markets and ignoring what I now see as a more important set of issues: the more human part of the market. Human behavior and risk preferences present a challenging set of issues, and we haven't had a good set of analytics to quantify these things."

Consider the tools most advisers have been using. "In the early days you had a lot of homemade questionnaires, and

you had an awful lot of questions about risk taking in a context other than financial matters," says Michael Roszkowski, director of institutional research at La Salle University in Philadelphia and a specialist in developing psychological tests. "There's some correlation between the different aspects of risk taking, but the correlation is not very high. It's not improbable to find a bungee jumper who's conservative in his investments or someone who's aggressive in his investments but would never bungee jump."

Having clients pick their risk tolerance on a scale of one to 10 is also unreliable because people don't usually do a good job of gauging their own tolerance for risk, especially if they have little investing experience. "One thing we've learned from psychological research: If you've never experienced a certain event, far too often you'll assume the probability of it happening is zero," says Lo.

Granted, asking investors how much money they'd be comfortable losing is a step in the right direction, says Lo,

RISK TOLERANCE,

like intelligence and personality, is a psychological trait—that is, one that generally remains the same over time

because the question at least raises the possibility of loss. But asking about loss in a vacuum is unrealistic, he points out. Nobody wants to lose money, but most people become more tolerant when they understand the risk-return trade-off.

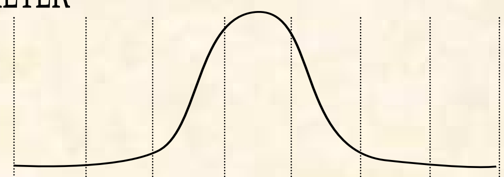
"The problem with questions like 'How much money are you willing to lose?' is they're generic," says Christopher Jones, executive vice president of financial research and strategy at Financial Engines in Palo Alto, Calif. "They're not personalized. When you ask somebody what he or she would do if the market went down 15 percent—buy, hold, or sell—the answer is, 'It depends.' " Is the market decline concentrated in a particular sector? What's happening to other people? What sort of securities is the client holding? "If someone's holding low-risk investments, he's going to feel differently than if he's in Yahoo," says Jones. "To help people make good decisions about risk, you have to put things into their personal context. You have to describe the trade-offs in terms of their specific circumstances."

IF YOU UNDERESTIMATE CLIENTS'

risk tolerance, their portfolios could be too conservative and they may never reach their goals. If you overestimate their risk tolerance, they could sue you for placing them in unsuitable investments

The way a question is framed also makes a big difference, says Terrance Odean, an assistant professor at the Haas School of Business at the University of California, Berkeley, who specializes in behavioral finance. People tend to answer similar questions differently, depending on whether you ask about potential losses or potential gains. If, for example, you asked what someone's reaction would be if 70 percent of his stocks increased in value, you'd probably get a different answer than if you asked what his reaction would be if 30 percent of his stocks lost money.

RISKOMETER



Risk Group ▶	1	2	3	4	5	6	7
Score Range ▶	0–24	25–34	35–44	45–54	55–64	65–74	75–100
% in Group ▶	1	6	24	38	24	6	1

SOURCE: ProQuest

Framing problems are particularly pronounced in a short test, which provides little opportunity to identify inconsistencies. "Financial advisers are looking for a five-item questionnaire that's 100 percent accurate, and that's a real problem," says Roszkowski. "I tell them what they're looking for is impossible. The longer the instrument, the more reliability. The shorter it is, the more variability from one session to the next." Suppose somebody is making a decision whether or not to hire you and makes the decision based on the answer to one question, says Roszkowski. "You'd say, 'But that doesn't capture the richness of my experience. You have to ask more than one question, more than five questions.' " The same holds true with risk-tolerance assessment.

To try to get a better understanding of their clients' attitudes toward risk, some advisers conduct lengthy face-to-face interviews on the topic. Although these discussions can be educational, no guidelines have been developed about what the advisers should do with the information gleaned from the discussions. Advisers who take this approach say they usually "go by feel"—comparing the answers from one client with those from other clients when deciding how much risk to build into their portfolios. Yet studies have found that advisers don't usually do a good job of assessing their clients' risk tolerance. "You are, after all, talking to relative strangers about intangibles," says Geoff Davey, a former adviser and now managing director at ProQuest, a risk-profiling firm in Sydney, Australia. When another Australian adviser, Andrew Macdonald, director and investment officer at Financial Management Services in Adelaide, used subjective assessments like those based on face-to-face interviews to determine the risk tolerance of his clients, he found that most of the clients ended up looking a lot like himself—suggesting a strong interviewer bias.

Even risk-assessment questionnaires that have numerical scores, like those developed by many broker-dealers, rarely explain where the number came from and what it means. "You do not know from one firm to the next what is supporting the assessment made by these questionnaires," says Thompson. "There are no hard-core numbers underlying their assumptions."

About 10 years ago, the American College in Bryn Mawr, Pa., set out to develop a different kind of risk-tolerance test. Taking its cue from academics who had concluded that risk tolerance, like intelligence and personality, is a psychological trait—that is, one that generally remains the same over time—the college tried to devise a test that would meet strict psychometric standards. "The standards for IQ tests also apply to risk tolerance," explains Roszkowski, who created the American College's test. In other words, one person's risk tolerance can only be measured relative to other people's; there's no discrete unit of measurement.

The American College's questionnaire had 57 questions, enough to make it reliable and valid—and none of the questions mentioned bungee jumping or other unrelated issues—but it also had some drawbacks. The test took about a half hour to complete, and the software was incompatible with many printers. In addition, advisers typically had to mail the answers to the American College to get their clients' results, and they often had to wait weeks to get a response. When the results were returned, there wasn't much guidance about how the information should be used to help clients select their investments.

"WHEN I WAS DEVELOPING THE QUEStionnaire, we had to meet with the college's attorneys," says Roszkowski. "We were dealing with a product the attorneys thought could have some liability issues. They told us to provide only two things: a risk-tolerance score and a statement saying this score places the test taker within *x* percentile of the investing population. The attorneys didn't want us to go any further because they said at that point we'd be getting into investment advice and that's outside of our purview. It was up to the adviser to determine the next step." Although the test had some fans, it never really caught on with the majority of advisers.

In 1997, however, ProQuest set out to create an improved version of the test—and this one is generating plenty of interest among financial advisers. Davey had come across the original American College questionnaire the preceding year when he was studying risk-assessment tools for the Financial Planning Association of Australia. It was the first instance he'd seen of a psychometric test being used to measure financial-risk tolerance and he thought it had promise. He enlisted the help of the University of New South Wales School of Psychology's applied psychology unit to build on the American College's ideas. Together, they developed new questions and tested their clarity—to make sure the test takers understood the question without having to ask for help. They ended up decreasing the number of questions from 57 to 25 without jeopardizing reliability.

The test is now offered on-line at the ProQuest Website (www.risk-profiling.com), and the process takes less than 15 minutes. Clients can immediately see where their score falls in relation to 20,790 other completed profiles. They receive a score of between 0 and 100, graphed on a bell curve that's divided into seven bands, with most people falling into group four (scoring between 45 and 54). Only about 1 percent of the test takers score lower than 25 or higher than 75 (see "Riskometer," page 76).

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ProQuest test takers can also find out if any of their answers differ from most people with similar scores. For example, the questionnaire asks where they think their risk tolerance would fall on the bell curve. If they estimate that their score would be a 70, but it ends up being an 88, they’re notified of the discrepancy. A message is relayed that “most people underestimate their score, but only by a few points. Yours was a much bigger underestimate. When compared to others, you are significantly more risk tolerant than you thought you were.”

An adviser who registers with ProQuest can have his clients take the test. The client immediately sees the risk-tolerance score, but only advisers receive an analysis of how to incorporate the test results into a financial plan. By analyzing the 20,790 profiles and the historical performance of the portfolios the test takers preferred, ProQuest is able to link each score to an asset allocation that’s consistent with a person’s risk tolerance. For example, a score of 50 translates into a portfolio comprising 47 percent growth assets (defined as stock and real property), with the remaining assets in cash and fixed-income investments.

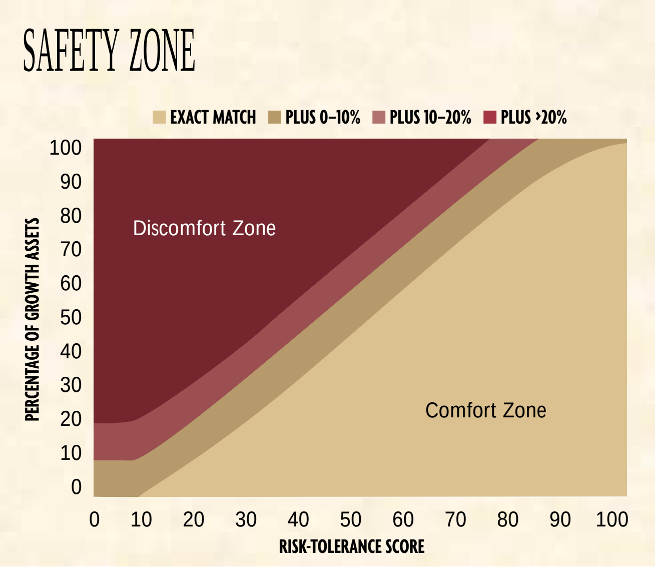
The popularity of the ProQuest product has been growing steadily among advisers. About 500 Australian advisers now use the test—including some of the country’s largest firms—and about 20 American advisory firms have been beta testing the product. Davey expects to make a big push to educate American advisers about the test over the next few months. The standard price for the service, which allows advisers to use the test on an unlimited number of clients, is $495 per year, but an adviser can start with a 30-day free trial, available at the Website.

The American College is also working on an on-line version of its test, which it hopes to have available by the end of the third quarter 2002. But unlike ProQuest, the American College will not offer a methodology for incorporating the test results into the planning process.

PROQUEST DOES NOT, OF COURSE, EXPECT ADVISERS to base their clients’ portfolios solely on the information it provides. Instead, advisers are expected to continue to come up with recommended portfolios based on the clients’ individual financial needs, then use the ProQuest scores to see how well that portfolio matches their risk tolerance. To that end, ProQuest indicates a “comfort zone” for each score, which is usually within 20 points of a perfect match (see “Safety Zone,” page 80). A client who scores a 50, Davey explains, is unlikely to perceive the difference in volatility between a well-constructed portfolio with 47 percent in growth assets and one with 57 percent in growth assets. But she will start to feel discomfort when the growth assets reach about 67 percent. Davey relates the concept to shirt sizes: "The sort of thing we're trying to avoid is where an adviser recommends an extra-large asset allocation to a client who has a small risk tolerance without either of them being aware of the discrepancy." For that reason ProQuest provides advisers with a link to a spreadsheet where they can plug in ready-made or customized portfolios to determine which one best fits the client's risk tolerance.

It's a concept that resonates with many advisers. "I'm not in front of arbitrators enough to know how they feel about risk profiles, but I'm more comfortable with an international tool than with something I created," says Paul Ewing, president of Prosperity Network in Overland Park, Kan., one of the American advisory firms that use ProQuest.

As scientific as ProQuest's process is, however, it still can't generate all the answers for advisers. Although the ProQuest approach has many converts, some advisers worry about the next step: what happens when there's a mismatch between the client's risk tolerance and the investment strategy needed to reach her financial goals. At times, says Odean, a client may agree to take on more risk to reach her goals but may not really understand what that means. "A lot of what's taken to be variation in attitudes toward risk is actually variation in expectations," he says. "In other words, when you see some people trading aggressively in the market, that often says less about what they feel about risk than what they think the market will do. Some people think it's more risky than it is; some think it's less risky."



SOURCE: ProQuest

"Risk-tolerance questionnaires and the reports that are generated from them are not effective when they're not illustrated right in front of the client," says Donald Trone, founder of the Center for Fiduciary Studies in Pittsburgh. "I believe the more effective process is to have a PC-based optimizer that's simple for the adviser to use and simple for the client to understand. Then you do the asset-allocation illustration right in front of the client and adjust it until you get the appropriate comfort level."

Craig Wainscott, director of knowledge capital at Frank Russell Co. in Tacoma, Wash., takes yet another approach. The only way for people to be able to express their risk tolerance, he believes, is to see what can happen to the portfolios under a variety of market scenarios. One way to do this is to show clients value-at-risk calculations—primarily in the form of Monte Carlo simulations—and make sure they're aware of the array of potential outcomes.

Jones also believes that this approach is more important than any psychological test. "When you consult with a pension fund, the board has to make a decision about the risk level of the portfolio," he says. "They don't have risk questionnaires. They have outcome-based investing. They look at the trade-offs between different risk levels along the frontier and the outcome." By using Monte Carlo simulations and other tools, Financial Engines tries to help people understand risk, says Jones. "If they make trade-offs today, what does it mean for their retirement income—the upside and downside? Rather than talking about standard deviation, we show them how much money they might lose if there's a one-in-20 bad market. That's a more relevant statistic."

Perhaps. But what may be even more relevant for clients, is that advisers are finally recognizing that the process of identifying risk tolerance must be a totally separate step from the financial-needs analysis, because what the client needs and what he's comfortable with are not always the same. Although advisers are still struggling to figure out what to do when the two assumptions don't match, the tools for making those decisions are improving. Using a test like ProQuest's, which identifies how well the recommended portfolio matches the client's risk tolerance, immediately shows advisers when they need to discuss making risk-return trade-offs. Combining that with value-at-risk tools helps illustrate to clients what those trade-offs might look like. No matter how the adviser finally decides to reconcile any gap, at least the client is getting a better understanding of the choices he's making—and should be much more comfortable with the results.

Kimberly Lankford is a financial writer whose articles have appeared in Kiplinger's Personal Finance *magazine, the* Boston Globe, *MorningstarAdvisor.com, and* Reader's Digest.