Calculated risk

Risk assessment and profiling the consumer's attitude is today perhaps the most essential part of the 'know your customer' process as intermediaries are under pressure to show the client understands their own risk profile and the potential threats to their investments. Gareth Vorster investigates how financial advisers handle that process and the support tools now on offer

Given the number of mis-selling cases peppering the financial advice industry in recent years, financial services experts believe the solution to securing confident client risk assessments lies in advisers taking a 'back to basics' approach of understanding risk and working closely with clients. But increased emphasis on the creation and development of risk profiling tools is likely to be key in driving up standards and confidence in the near future.

Aside from even at looking the tools available to intermediaries, Jim Clancy of Clancy's Financial Planning, believes getting his clients to understand the term 'risk' is still the most crucial part of the risk profiling process.

In particular, Clancy points to property as an example of how differences in risk assessment have to be clarified. While the general public perceives property as a solid investment, most advisers understand investing in property alone is a high risk strategy because of its lack of liquidity and periods when the property might stand empty resulting in no income flow.

"It is most important to ensure that a pound given to an adviser to invest today is worth the pound that is given back to them at age 75," says Clancy.

Advisers are aware there are many factors which alter the risk of an investment; interest rates, inflation, politics, currency/exchange rates, liquidity in markets, confidence and general sentiment; investment philosophy and the capabilities/skills of the fund manager can all influence the relative performance of investments and intermediaries understand how investment values could change.

Ben Goss, managing director at Distribution Technology, understands the key to risk profiling

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inevitably relates to the consumer knowledge as he notes the FSA carried out some research last year to assess what consumers thought 'risk' meant and discovered the term 'investment risk' had at least five different meanings which can also be interpreted in different ways by consumers.

More specifically, the study suggested some groups of consumers felt "the impact of risk was not something that would affect them".

Yet Goss points out: "This lack of understanding is important for advisers as it is not safe to assume that clients will behave as a 'rational investor' making trade-offs around the risk and return options they face. This is principally because consumers are far more focused on avoiding losses than making gains."

CLIENT CONTACT

Tim Page, certified financial planner at Page Russell, stresses the importance of working closely with a client, as he believes the lack of explanation to client is part of the reason so many mis-selling claims are made. Page says it is a crucial part of an adviser's job to ensure that they conduct a sufficient risk assessment on a client each year which accommodates changing markets, conditions and even alterations in a client's profile. In recent years, advisers such as Page have felt it necessary to reduce the number of clients they advise to ensure they can manage the expectations of their clients.

"Some advisers will boast 5,000 clients, but this is a number for which it is impossible to provide a sufficient service. Therefore, all an adviser really has is 5,000 names for business and not clients, as it is impossible to provide an ethical service."

Page believes the creation of more efficient support tools – acting as a 'crutch' support rather than as the only source of risk profiling used by the intermediary – will in the future lead to re-engagement within the industry.

He believes people are always going to be disappointed about their expectations of investment should they not achieve their maximum potential, instead blaming the marketing of such investments which has put high expectations on making money. But much of the problem still seems to be consumers are not prepared "to see investments grow over the long term," says Page.

Goss argues the recent claims of mis-selling in the precipice bonds market, for example, is a clear example of the wrong products being sold to the wrong people. At the same time, this has triggered huge adviser interest for technology-based risk profiling services and the development of tools such as the Dynamic Planner risk profiler, created by Distribution, as a result.

Goss warns, however, distributors and advice firms to guard against those risk-profiling solutions, which simply assume that client risk level of 'x' means products with risk level 'x' are appropriate. At the same time, however, product risk is very difficult to gauge," points out Goss, and, there are a number of types of risk that investors face when could affect investments.

HELP IS AT HAND

Both Clancy and Page champion the development of the relatively-new risk assessment tool 'Risk Profiling System' by Australian software provider FinaMetrica, which conducts psychometric test on clients to match up to various profiling data.

Clancy believes FinaMetrica is a great tool for intermediaries to help explain risk assessment to a client in the simplest terms.

"Using the Risk Profiler and the questionnaire together with the historic 10-year return to date for the specific portfolio gives the client a greater understanding of their own positions," says Clancy.

"For example, data can show over a 120-month rolling period, the expected returns over bank deposits and can use graphs to indicate the actual returns made against the expectations of certain portfolios by also highlighting historic volatility and analyses the length and depth of any fall," he adds.

More importantly, Clancy argues the system helps to point out to clients there is no right and wrong answer to any investment selection. But using such tools on an annual basis allows them to adjust portfolios accordingly, showing the client what could happen if they deviate from their portfolio, and in doing so allows them to assess the tolerance of risk.

Page Russell has recently selected the FinaMetric online risk profiler, after trawling various other systems including 1st Software's risk profiler developed by The Silent Partner, the Morningstar system linked to the Transact wrap account; as well as tools offered through the Standard Life and Winterthur extranets.

Page says the FinaMetrica tool creates confidence between the client and the adviser and is a tool that provides structured detail, which is a strong defense against mis-selling in court.

"While the 1st Software profiler looks very impressive and contains a psychometric test with a sufficient amount of questions to be valid, we are suspicious of a 'free' feature where there is no explanation of how it works 'under the hood' and where there appears to be no way of linking the risk profile results to an asset allocation," says Page.

Morningstar, Standard Life and Winterthur were rejected as approprirate systems as Page feels, in his opinion, they appear to be typical of many US-derived asset allocation systems, which have too small a number of questions for the results to be valid.

Like Clancy, Page says FinaMetrica provides a great deal of information to explain how their system works, while its questionnaire has 25 questions, which is more than enough for it to be seen as scientifically valid.

Another new entrant to the market is decisionsdecisions which provides investment analysis tools to both individual investors and their advisers through a web interface.

Iain Horn, managing director at decisionsdecisions, says future developments will largely focus on making the whole advice process more straightforward and holistic with the support of risk assessment tools which integrate more comfortably into back office administration systems.

Moreover, the FSA's 'treating customers fairly' regime is likely to be key to the evolution of risk assessment advice – especially in allowing them to understand complex investment vehicles such as with-profits or other structured investment products.

Horn points at forthcoming changes being made to legislation with A-Day a prime example of circumstances where risk assessments may need to be reconsidered, and which are helping to generate new tools designed to help intermediaries with new advice models, such as lifetime limit calculators.

With the prospect of new markets, developing, greater retirement flexibility and the emergence of new products including alternatively secured pensions and new investment vehicles which could include residential property and other tangible assets, advisers will need to monitor their clients carefully in future.