

Risky Business

Understanding and managing the four primary aspects of risk will help you give better advice, build stronger relationships with clients and secure your practice. Now is an opportune time to be featuring this conversation in your client induction and review processes.

Advisers talk to clients all the time about risk issues, and compliance departments dedicate an enormous percentage of their time on the risk-related aspects of advice. But even with all the ostensible focus on risk, many advisors do not handle it well. It may be because they themselves are not clear.

Risk has four primary aspects:

- ❖ Risk required - the risk associated with the return required to achieve the client's goals, a financial projection.
- ❖ Risk perceived - the risk perceived by the client in the course of action being considered, how risky the action feels to the client.
- ❖ Risk capacity - the risk that the client can afford to take, a financial characteristic.
- ❖ Risk tolerance - the risk normally chosen by the client, a personality characteristic.

RISK REQUIRED

How can risk be required? Well, it's not actually a risk that's required but rather a return that's required. Taking a client's circumstances, resources and goals as inputs, advisers can use their planning software to determine the return required to achieve goals ... and there will be a level of risk associated with that return, hence a risk required.

Of course, the first time the inputs are fed through the software the return required might be impossibly high, e.g. inflation plus 20%, in which case some reality checking and goal reviews will be needed to bring the return required down to a level that is at least feasible.

Generally, given the fall in investment values, the risk required will have increased unless goals have been reduced, delayed or abandoned.

RISK PERCEPTION

Let's take a look at an example of risk perception. A few of my peer group have bought motor scooters just to get around, for short trips. They don't see this as carrying a risk, yet statistics show that people over 50 who ride a motor scooter are likely to have an accident. But most of the people who buy them are not aware of the statistics, so their perception is of a much lower risk.

Some of the people who bought sub-prime investments—the ones with AAA ratings—didn't realize they were taking a risk. We now know that the ratings of those investments may have been problematic, but the investors saw and put their faith in the AAA rating, bought the investment and didn't perceive the risk as being as high as it was.

In the current climate, clients may see more risk in investment markets than prior to the Global Financial Crisis - clearly an opportunity for re-education.

Generally, what someone does in a risky situation (financial or other) will, in simple terms, be determined by risk perception, risk tolerance and risk capacity. Whether someone will or will not do something will depend on the risk they perceive, their emotional risk preference, and the worst case outcome they could 'survive'.

Clients cannot give their informed consent to any strategy where the risks are not clear. Advisers must ensure that clients' risk perceptions are soundly based and that the (downside) risk has been explained in terms the client understands, and be able to prove this subsequently, should proof be necessary.

RISK CAPACITY

Risk capacity has to do with whether, for a given level of risk, the individual's financial situation can withstand the impact of a worst case outcome.

Imagine that your mother decides she'd really like to learn to ride a skateboard, so she goes out and buys one. You try to talk her out of it, because while she may have the appropriate risk tolerance for it - after all, she was the one who decided to try it - she doesn't have the appropriate risk capacity because she could easily break a hip or something equally incapacitating. So you give the skateboard to your 8-year-old son and suggest that he use it. He doesn't want to try it because he knows that his friends have had accidents and he doesn't want to get hurt. This is just the opposite situation. He has the risk capacity - he's not likely to break anything and even if he does, he'll recover quite easily. But he obviously doesn't have the tolerance, the psychological inclination, for this type of risk.

A client's risk required may be achievable through a portfolio that could fall by 30% and such a fall may be consistent with her risk tolerance, so far so good; but an evaluation of her risk capacity shows she can lose no more than 10% without putting her important goals at risk. Risk capacity is an absolute measure and overrides the other two. Resolving such a mismatch is discussed under Trade Off Decisions below.

A reduction in a client's net worth arising from the Global Financial Crisis will have decreased that client's risk capacity.

Advisors are readily able to evaluate risk capacity by analysing the client's financial circumstances; however, the measure of risk tolerance is more nuanced.

RISK TOLERANCE

Risk tolerance is psychological. It expresses how an individual feels emotionally about taking risk. Where does the person strike the balance between getting a favourable outcome versus an unfavourable outcome?

For example, have you ever been a passenger in a car when the driver seems to be going either too fast or too slow? The speed obviously feels right to the driver, but you're uncomfortable. Either you're anxious that there will be an accident, or you're antsy, wondering why he or she is just creeping along. (Now if the creeping driver is your sixteen-year-old son, all of a sudden the speed seems just fine...but that's another story altogether.) Many factors determine a person's driving behaviour, but a key element is the person's tolerance for risk. The fast driver has a higher risk tolerance than you, the worried passenger - and the slow driver's risk tolerance is lower than yours.

Risk tolerance evaluation may be readily converted to an indicative growth and defensive asset mix which can be used to illustrate potential downside volatility.

While risk tolerance is a stable attribute it is not set in concrete. Analysis suggests it decreases with age, though slowly, and personality traits are known to be affected by (major) life events, good or bad.

However, research confirms¹ that risk tolerance neither collapses in bear markets nor soars in bull markets. Of course, we have all witnessed cyclic client behaviour patterns - clients seek risk in bull markets and avoid risk in bear markets. But what we are talking about here is changes in client behaviour.

As noted above, risk tolerance is not the sole determinant of client behaviour; other factors, notably risk perceived, also play a role. All the evidence points to risk tolerance being stable and risk perceived being the determining variable; risks are underestimated in bull markets and overestimated in bear markets.

These four aspects - risk tolerance, risk capacity, risk perception and risk required - all come into play when advisors sit down with clients to do financial planning and all are important. What is absolutely essential, however, is that advisors (1) recognize how these aspects are distinct and (2) ensure that there is no confusion between them when it comes to the client's decision-making.

RISK QUESTIONNAIRES

Most advisors today use some form of 'risk questionnaire'. It may be one provided in their planning software, by a product supplier or as a required element from a compliance department. Typically, the client completes it quickly, often with the advisor's 'assistance'. Then one of two things occur: either the adviser moves on to the 'real' portfolio design process, ignoring the "I have to do this for compliance purposes only" recommendation or, even worse, the risk questionnaire itself is used to select an investment portfolio directly. This type of profiling is known as a *portfolio picker strategy*; questions are asked about goals, experience, risk capacity, risk tolerance

etc., to select one of five or six investor 'styles' e.g. "A Prudent investor who values security of capital ...", each of which has its own model portfolio/asset allocation. The whole planning process reduced to an intellectually empty and legally indefensible quiz!

The designer of a portfolio picker starts with the model portfolios/asset allocations and works backwards to a questionnaire and scoring algorithm - a very arbitrary process. A recent empirical studyⁱⁱ of 131 such questionnaires showed alarming results. When all questions in the questionnaires were answered in the most conservative way, the percentage of assets recommended for stocks ranged from 0 to 70. When answered in the most risky way, the percentage of assets recommended for stocks ranged from 50 to 100.

One consequence of the industry's reliance on portfolio pickers is that advisers have a poor understanding of their clients' risk tolerance. Statistical studies typically show correlations of .4 or less between advisers' estimates and measured risk tolerances. Correlations of this order give errors of two or more standard deviations for one in six cases. This means that advisers would be more accurate if they made no attempt to assess clients' risk tolerance and simply assumed all clients were average!ⁱⁱⁱ

These unsatisfactory results can be attributed to two main causes.

- ❖ The selection of an appropriate model portfolio/asset allocation will be a function of a number of variables - goals, resources, time frame, risk capacity, risk tolerance and so on. Usually there will be some conflict between these goals; for example, the client cannot realize all their goals from the resources available, in the desired time frame within their risk tolerance or risk capacity. In a portfolio picker these conflicts are 'solved' through 'averaging' by the scoring algorithm which reflects the test designer's values not the client's. Critical trade-off decisions are made completely unseen by adviser or client.
- ❖ There is no rigour to the process by which questions are selected and scored. Whether the questions actually measure what they purport to measure is anyone's guess. Woe betide an adviser having to defend advice based on these questions.

While it might be convenient to arrive at a model portfolio/asset allocation in a single step, it is the very opposite of professionalism and a complete negation of the adviser's duty of care.

The better option is to rigorously measure the critical variables separately, and then incorporate these measurements into the planning process in a manner that allows trade-off decisions to be made out in the open, visible to both client and adviser.

MEASURING RISK TOLERANCE

Risk tolerance is the most challenging variable to measure and, generally, advisers do it very poorly and, consequently, have a poor understanding of their clients' risk tolerance.

Fortunately there is a scientific discipline, psychometrics, for testing attributes such as risk tolerance^{iv}. Psychometrics, a blend of psychology and statistics, provides a discipline for developing a valid and reliable test and standards against which the bona fides of a test can be evaluated. In psychometric terms, a valid test is one that measures what it purports to measure and a reliable test measures consistently with known accuracy.

Unfortunately, advisers and the financial services industry have had little, if any, exposure to psychometrics and are largely unaware of its benefits.

A psychometric risk tolerance test will provide an accurate assessment of a client's risk tolerance - with a small known margin of error on a known scale - and a plain English report that will be meaningful to both client and adviser.

Psychometric testing is complicated. But the complexity resides in the development of the questionnaire and the report, not in its use with clients.

TRADE-OFF DECISIONS

The process of personal financial planning invariably involves helping our client manage one or more conflicting

alternatives through trade-off decisions that best meet their present and future wants and needs in their current and anticipated circumstances.

Effective trade-off decisions can only be made when the elements of the trade-off have been separated, and can be clearly understood and compared.

A simple example illustrates a typical financial planning trade-off situation. In deciding on what portfolio best suits his needs and to which he can make a properly informed commitment, Bob, with his advisor's assistance, needs to take into account and resolve conflicts between competing risk-related parameters.

Bob's advisor shows him that he needs a very aggressive portfolio to achieve his life ambitions (risk required). However, by questioning and analysis she discovers that Bob could afford to lose no more than 10% of his investment assets without having his life ambitions markedly changed (risk capacity), which means a conservative portfolio. By assessment, the advisor discovers that Bob has a lowish risk tolerance which, all else being equal, would lead him to a moderate portfolio. Clearly there are three different asset allocations leading to three distinctly different lifestyle outcomes competing here, but:

- ❖ Is any one of them right for Bob?
- ❖ Which allocation causes Bob the greatest and the least anxiety?
- ❖ Are there alternatives?
- ❖ What is the right way to proceed, recognizing the substantial differences in long-term outcomes?
- ❖ How should Bob make those decisions?

In the end, Bob must make the decisions because he is ultimately the one who has to live with the consequences. He must give his properly informed commitment to the asset allocation that will be implemented. Exploring the trade-offs is usually a powerful educational experience about risk and return, where misconceptions about risk can be corrected. The advisor's role in this process is to suggest alternatives, illustrate outcomes, recommend - but not decide.

This process is commonly called Gap Analysis and is usually resolved by clients through a combination of:

- ❖ Increasing the resources being applied through earning more and/or spending less.
- ❖ Converting personal use assets to investment assets.
- ❖ Easing the goals through delaying, reducing and/or discarding.
- ❖ Taking somewhat more risk than would be their preference (but not to the stage that in a downturn they might panic and sell.)

Contrast this interactive and personal process with the portfolio picker's arbitrary one-step 'solution' described above.

As noted above, for clients who have suffered a decrease in net worth, risk capacity will have decreased (their ability to absorb losses is not what it was) and risk required will have increased (they are now restarting from a lower base), unless there has been an equivalent easing of goals.

Such changes call for previous trade-off decisions to be revisited.

Dealing with risk professionally will not only result in better advice but also will more quickly build the trust necessary for good client relationships. Clients don't have to be persuaded that risk is an important issue. The better that advisers can demonstrate that the four aspects of risk are being dealt with appropriately, the better the client relationships will be.

SECURING YOUR PRACTICE

Sloppy risk processes will make advisers vulnerable to claims by unhappy clients. It can be all too easy for a client who has lost money to say,

"The strategy was too risky for me. My adviser should have understood that. What's more I didn't understand the risks because they weren't explained properly. If they had been I would not have proceeded."

In such circumstances it can be very difficult to prove informed consent.

Nothing is more emotionally or financially damaging as defending a professional negligence claim. **The single most important element in reducing the likelihood of a claim and increasing your ability to defend one is a valid and reliable (psychometric) assessment of risk tolerance. Without that as a starting point all other steps are based on shaky ground.** And of course, good risk practices are not just important for liability reasons. A prospective purchaser is going to want to see a secure income stream and will discount the value of your practice if it is not based on good risk management processes.

SUMMARY

Advisers need to be aware that there are four distinct aspects of risk. Clients' awareness of risk varies. Risk required, risk capacity and risk tolerance must be separately assessed so that any gaps can be identified. Assessing risk tolerance can only be done validly and reliably by using a psychometric test.

Gaps between risk required, risk capacity and risk tolerance must be resolved through trade-off decisions in a manner that is clear to both client and adviser ... and these decisions must ultimately be the clients.

Explaining the risk in the strategies being pursued is the final step in obtaining the client's properly informed consent ... and their commitment to those strategies.

Now is an opportune time to be featuring the risk conversation outlined here in your client induction and review processes.

Geoff Davey
Cofounder
FinaMetrica
May 2009

ⁱ Risk Tolerance Revisited, FinaMetrica White Paper, April 2009, www.riskprofiling.com/Downloads/GD_RR.pdf.

ⁱⁱ A PhD dissertation, Variance in Risk Tolerance Measurement - Towards a Uniform Solution, Douglas F Rice, Golden Gate University (Unpublished).

ⁱⁱⁱ See

- Survey of Financial Risk Tolerance -Australian Technical Report, Elsayed, H & Martin,J (Unpublished) www.riskprofiling.com/Downloads/SOFRT_Report.pdf.
- Gender Stereotypes in Advisors' Clinical Judgments of Financial Risk Tolerance: Objects in the Mirror Are Closer than They Appear , Roszkowski, M.J and Grable, J., Journal of Behavioural Finance, Volume 6, Issue 4, February 2005 , pages 181 - 191.
- Estimating Risk Tolerance: The Degree of Accuracy and the Paramorphic Representations of the Estimate, Roszkowski M.J. and Grable J., Association for Financial Counseling and Planning Education (2005) www.riskprofiling.com/Downloads/EstimatingRiskTolerance.pdf.

^{iv} Insights on Measuring Risk Tolerance from Psychology and Psychometrics, Roszkowski, M.J, Davey G. and Grable, J., Journal of Financial Planning, April 2005.