THE PROFESSION

The new SEC compliance rules are in effect now, and you've already seen so many summaries of them than you probably want to hold a compliance manual burning party on the back lawn. But one area that isn't receiving much attention is the requirement that each client's portfolio must be aligned with his/her objectives, and that each client file must contain a plausible assessment of the client's tolerance for investment risk.

The problem, of course, is that risk tolerance is subjective and therefore hard to measure. In most cases, your files will contain either a note that you showed people a variety of portfolios and asked them to pick one, or you used a psychological assessment on risk-taking that has little to do with investments. Or, more often, neither; just notes of a conversation which (one hopes) didn't simply ask clients to define their tolerance on a scale of one to ten.

Geoff Davey, co-founder of FinaMetrica, a web-based risk assessment system, suggests that there may be plausible alternatives to this nonsense. A risk tolerance test, he says, has two basic purposes: compliance with the "know the client" guidelines and what is known as "gap analysis," which compares the client's risk tolerance with the risk inherent in strategic alternatives. In other words, clients may prefer to have all their money invested in the money markets, but they might need a real, after-inflation return of 5% a year to achieve their goals. Which approach should be considered the riskier? That's a trade-off decision for the client to make. But if the client decides to step out of his comfort zone and go for that 5% return, and then the markets go down, you'd better have information in the files that talk about why the decision was made, and with what supporting information.

A risk tolerance test questionnaire should also conform to ever-evolving psychometric standards--that is, to the standards established through the scientific discipline for testing subjective attributes. The focus, says Davey, is on validity and reliability--validity meaning that the questionnaire tests what it purports to test, and reliability meaning that it does so consistently and with a known level of accuracy. Look, Davey says, for certification from a competent third party that the test meets these standards. If you rely on a test that is easily proven to be inadequate in a court of law, your exposure is increased accordingly--and the SEC may be less than supportive as well.

In the past, when risk tolerance questionnaires tended to look suspiciously like sales tools for this or that product, you found what psychographic experts call "bad" questions. "In the typical industry questionnaire, there are two types of 'bad' questions," says Davey. "The first type is situational--questions about age, stage of life, time horizon, financial needs etc., while relevant as part of know-the client, are not relevant to risk tolerance." The second type of 'bad' question is anything that has to be explained by the advisor. "If the advisor plays an active role in completion of a questionnaire," says Davey, "the results will be influenced by the advisor, and the objectivity of the test will be compromised." He doesn't have to add how bad the advisor filling out the client's risk tolerance assessment might look to the SEC or in a court of law.

Yes, Davey has a substantial conflict of interest in suggesting that you look for a tool that meets psychometric standards and has third party validation, since FinaMetrica happens to meet those tests itself. (We, at this newsletter, haven't found another organization that does.) Meanwhile, the company web site (risk-profiling.com) takes an interesting approach to the risk tolerance process; instead of simply providing an instrument, it allows users (who pay a yearly access fee) access to the test over the web for their clients, push-of-a-key analysis of the results, plus risk and return guides and charts and a linking spreadsheet that allows you to download the data to your computer.

The point, as Davey explains it, is to take the concept of measuring a client's tolerance for investment risk and expand it into a comprehensive tool for building portfolios and providing effective client education about this esoteric topic. If you're going to have to put this stuff in your client files, you at least ought to get some savings of time and effort--and maybe a little more precision in the portfolio-building process--as well. ■