



Advisors, Clients, and the Global Financial Crisis

- Clients appear to have an unrealistic expectation that their advisor can protect them from the vagaries of the market.
- Incontrovertible evidence of the stability of risk tolerance, which disproves accepted wisdom. This may provide an opportunity for the wider advisory community, as explained in the report.

Survey Data: Clients

Based on our initial single-variable analysis, some interesting information has emerged. There can be no doubt that the global financial crisis has had been bad news for clients.

In Figure 1, clients affirm that they were affected by what happened to their investments.

Interestingly, in Figure 2, clients seem less surprised by what happened in markets than one might have been led to believe.

While the wording of the questions in Figures 2 and 3 differs, for 59 percent the effect on their investments was at least “considerably” outside their expectations, whereas only 33 percent believe the stock market is at least “considerably” more risky than they previously had thought. This suggests that clients were expecting their advisors to protect them from the vagaries of the stock market somehow. It is a reminder to advisors to be careful about how they describe their value offering to clients. Even so, no matter how careful advisors are, some clients will want to believe that their advisor offers special protection.

In Figure 4, we see, not surprisingly, clients’ ability to achieve their long-term goals has been affected.

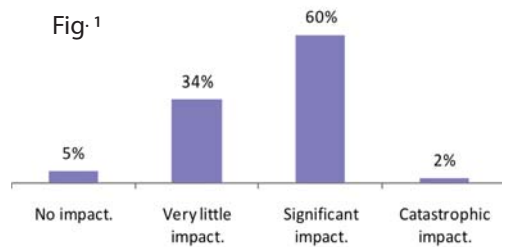
From December 2008 to July 2009, FinaMetrica surveyed advisors and their clients regarding the impact of the global financial crisis. FinaMetrica is the creator of a psychometrically based risk profiling software system (of the same name) that enables advisors to gain a more insightful understanding of their clients’ financial attitudes, values, motivations, preferences, and experiences. The software provides a statistically validated risk-tolerance measurement, enabling advisors to better manage clients’ investments.

The objective of the survey was to determine whether clients’ risk tolerance changed in the bear market. The survey began by asking about the extent to which the market declines were within clients’ and advisors’ ranges of expectations, and how the declines affected clients’ finances and their achievement of goals. Then we asked about clients’ and advisors’ current perceptions of market risk and the economic climate, clients’ investment intentions, and the impact of market declines on risk tolerance.

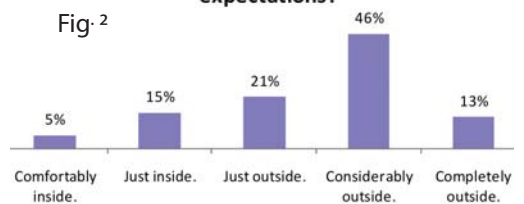
FinaMetrica subscribers were asked to participate by completing an advisor survey and by asking their clients to complete a client survey and to redo their FinaMetrica risk profiles.

The preliminary analysis confirms some accepted wisdom, but it also reveals some surprises, two of which are:

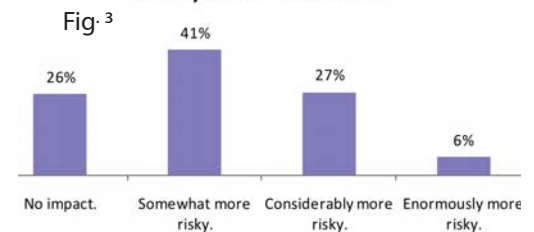
To what extent has the current share/stock market decline affected your current financial position?



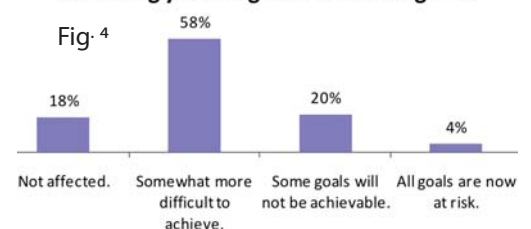
To what extent is the effect of the current share/stock market decline on your investments within your range of expectations?



To what extent has the current share/stock market decline affected your view of share/stock market risk?



To what extent has the current share market decline affected your expectation of achieving your long-term financial goals?



However, the picture could have been bleaker. Given the magnitude of the market's decline, the fact that 76 percent of clients described their long-term goals as only "somewhat more difficult" to achieve or "unaffected" reflects well on the quality of advice they received.

Perhaps this might explain the lack of panic evident in their intentions, as we see in the answers to the next two questions.

Figure 5: Fortunately for many clients, their fears about our economic future have not eventuated to date.

Figure 6: Perhaps the most interesting analysis will be of changes that occurred over the seven months in which the survey was conducted. Markets had already fallen substantially by the start of December 2008 and continued falling for the next three months, before turning around in March 2009. Comparisons between responses in December 2008 to February 2009 and responses in March to June 2009 could be very informative.

Survey Data: Advisors

Participating advisors typically had around 15 years of experience, and "overall" their clients were not yet retired. However, as Figure 7 shows, some advisors were quite surprised by the magnitude of the market decline.

Figure 8: Clearly, the answers here very closely match the clients' answers (see Fig 6), indicating that advisors were very much in tune with their clients' thinking. Again, the picture is quite positive overall, with 79 percent believing that goals will be no more than somewhat more difficult to achieve (versus 76 percent in the client surveys.)

Test/Retest Data

The analysis of test/re-test data provides the most convincing evidence of the stability of risk tolerance. The first test was done in the first half of 2007, and the second test was done after mid-2008. The longest period between test and re-test was 27 months, and the shortest was 13 months. The results are shown in Fig 9's scatter diagram. The

y-value for each point is the first test score, and the x-value is the second test score.

In Figure 9, we see a small overall decline by, on average, 2.9 points. This is less than one-third of the standard deviation of 10 points, and so would not have a significant practical impact. Also, note that some clients' risk tolerance scores have increased. However, there is an overall reduction, and it is worth considering possible explanations.

Major life events can cause permanent psychological change. For some clients, the crisis might have been a catastrophic life event, and their scores might have decreased dramatically; these scores would bring the average down.

Also, there might have effectively been a change in how some of the questions asked in the questionnaire were understood. The perceived riskiness of the answer options given for questions related to stock market investment is likely to have increased—with the result that the client would now choose a lower option, which would lead to a lower score.

Or there might be something else entirely. We are hopeful that our academic researchers will be able to analyze risk tolerance scores, answers to specific questions in our risk tolerance test, and the demographic data we gather with each test.

This finding of stable risk tolerance will pose some challenges for the wider advisory community, where

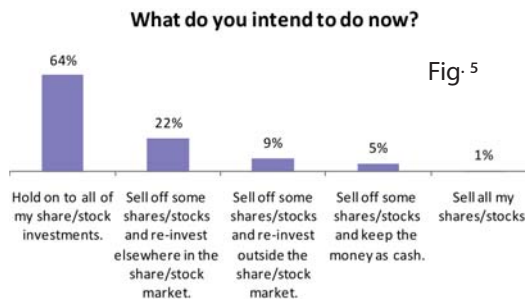


Fig. 5

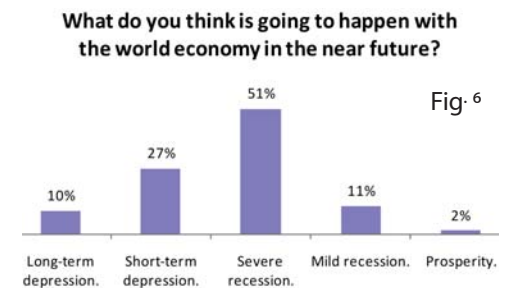


Fig. 6

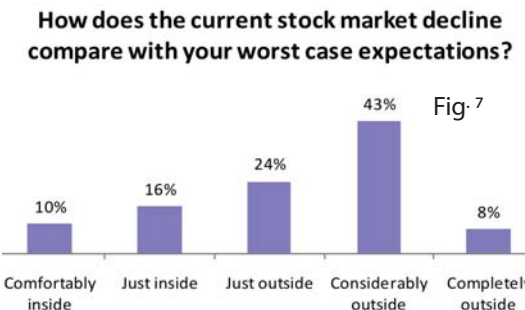


Fig. 7

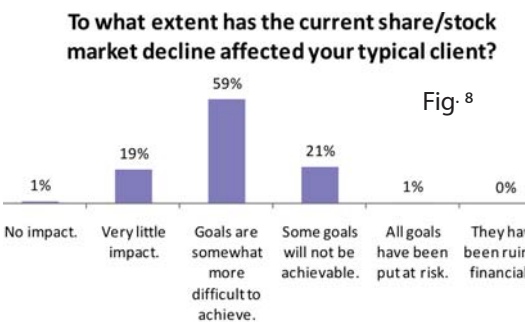


Fig. 8

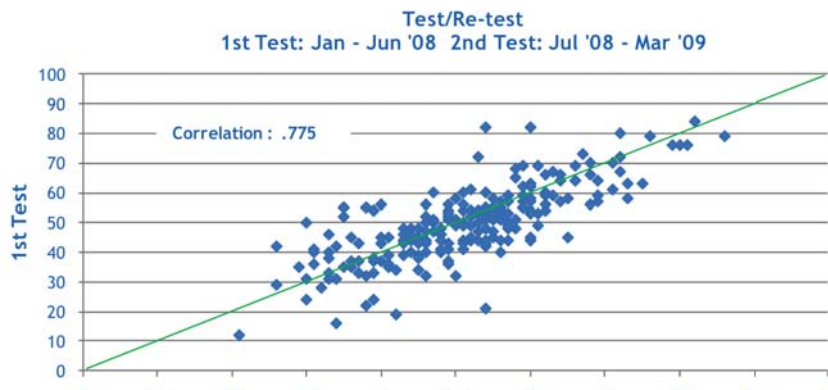


Fig. 9

the accepted wisdom is that risk tolerance collapses in a bear market. However, it also might provide an opportunity. There is no argument that behavior changes in a bear market. But this is not because risk tolerance has collapsed; rather it is because of an increase in perceived risk, as per Figure 3.

It is quite likely that of the six percent of clients who are now perceiving markets to be “enormously more risky” (Figure 3), some are, in fact, significantly over-estimating the risk (just as, two years ago, many significantly underestimated the risk). These clients have “frozen” or become unreasonably “gun-shy.” While the actual number of such clients may be small for a particular advisor, even one anxious client will be of concern.

If, as our research indicates, client

anxiety is a function of a misperception of risk, then the advisor can address that issue and help the client to understand what’s going on by re-educating him about risk. This helps the client move forward, which is a benefit to the client and a significant value-add by the advisor.

Conclusion

To our knowledge, this is a unique survey. We readily acknowledge that the very occurrence of the global financial crisis, which presented a once-in-a-lifetime research opportunity, made it a difficult time for advisors to be asking more of clients. We thank the advisors and their clients who participated. We very much appreciate their efforts.

The preliminary analysis discussed above certainly provides interesting

and valuable insights. We look forward to more discoveries as our academic research panel works on the data.

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Geoff Davey, co-founder of FinaMetrica, has an international reputation for expertise in risk tolerance and its role in the financial planning process. A pioneer of financial planning in his native Australia, Davey has been a part of the financial services industry for 37 years. He can be reached via FinaMetrica’s information portal, www.riskprofiling.com.