Knowing your clients' risk tolerance is key to a meaningful and rewarding ongoing relationship

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"The service of personal financial planning is provided by a personal financial planner to assist clients with their personal financial planning (ISO 22222 – Personal Financial Planning). Personal financial planning is a process designed to enable consumers to achieve their personal financial goals." By starting from this definition, which asserts a consumer focus, it is possible to deal more effectively with many financial planning issues particularly accountability and ongoing adviser remuneration.

Making clients accountable

All consumers do some form of personal financial planning all the time - when they open and use a bank account, purchase and pay insurances, choose and stay in a job, contribute to their retirement savings, etc. Their underlying objectives are often to better manage their current financial affairs and create a basis for income in the future. In their mind, there is no starting point such as a written financial plan.

However, at some point in time, people do need and may seek the services of a professional to document and help crystallise what they should do. If the person (now a client) 'owns' the ongoing journey and the planner 'merely' provides a service, then client ownership of the recommendation is easy to justify.

Accountability is then simply understood and managed from this perspective. If consumers are always performing financial planning, provided it can be demonstrated that planners act to ensure their clients are able to make properly informed decisions, then clients are responsible for the outcome of those decisions. Amongst other things this has important implications for liability management and settlement of disputes. Planners experienced with previous market declines will tell you that properly informed clients are not only easier to manage but they also become excellent referees.

Risks in traditional risk profiling

There are only two things that most financial services players agree on: losing money makes clients unhappy and that everyone, industry insiders and clients alike, gets upset when their expectations are not met.

If you make personal assessments of a client's financial risk tolerance you should be aware that early FinaMetrica research identified that financial planners, even with clients that they know well, assessed their clients' risk tolerance inaccurately. One in six assessments was wrong by two standard deviations or more. There was no pattern of difference, some were overestimated others underestimated. On the other hand, when you use a 'portfolio picker' questionnaire to recommend portfolios, you probably have only a limited understanding of your client's underlying financial risk tolerance. If you have clients who are a couple, you probably have neither an explicable nor a defensible method to account for each person's separate risk tolerance.

In both cases, you are unlikely to have a clear acknowledgment from them about the risk they have taken on in accepting your recommendations. In both cases, you will be taking the liability for the financial risk, not the client. A scientific risk tolerance assessment's report, on the other hand, can be structured as an instruction to you from your client on the amount of risk they are prepared to take.

What's in a real long term plan?

A real long-term financial plan identifies the clients' goals and aspirations and maps them against their resources. The critical tradeoffs between risks needed to achieve those goals, along with the spending and financial risk taken on, will need to be illustrated to (and be seen by) the client in order to form the core of the ongoing client relationship. It is only with this that there will be a solid basis for both client ownership of the plan and an ongoing service relationship. Both planner and client then have a clear understanding of their role and their accountability. Without an accountable plan, there is only transactional advice, from which there is no meaningful or sustainable basis for either an ongoing service or a recurring fee. With an accountable plan there is a natural segue to dealing with the rich complexity of changing personal circumstances, needs, investment markets, legislation and economic conditions.

The critical issue is the full recognition of the clients' individual needs, circumstances and aspirations. This is generally part of the 'know your client' obligations. Recommendations can consequently be easily seen to be matched to the requirements of the clients. Personal circumstances to be addressed include:

- Recognition of the client's (and any partner's) needs that have a financial dimension.
- Recognition of the client's (and any partner's) longevity.
- Projections of net assets and outgoing expenditure to at least 15 years beyond the client's (and any partner's) life expectancy.
- Recognition of the client's (and any partner's) financial risk tolerance and how any differences in financial risk tolerance between partners is resolved.
- Recognition of how risk tolerance is accounted for in the plan.
- Description of how the asset allocation recommendation was arrived at.
- Illustration of possible volatility in the recommended portfolio.
- Quantification of the range of possible portfolio outcomes.
- Recognition of the client's (and any partner's) risk capacity, and
- Meaningful identification of how the manager recommendations were arrived at.

Clearly, a 'living' financial plan needs to be regularly monitored for changes in client circumstances, economic conditions, government legislation and the broad range of issues that impact upon the client's financial wellbeing. Justification for ongoing financial planning fees clearly follows.

Consequently, a properly structured plan will do much to share responsibility with the client for the decision-making. In addition, there will be an obvious pathway for the client to take ownership of the recommendations based on their 'properly informed commitment' to the plan.

Time to act

It is never too late to bring in clients to review their circumstances and re-assess their needs including helping them understand their financial risk tolerance(s) and how it affects their financial plan.

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