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The Promise of a Good Night's Sleep

A new look at risk profile methodology.

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WEALTH POINT
Psychometrics is the science of test design. Unfortunately, its use in financial services is presently quite rare, especially psychometrically designed risk attitude questionnaires. But one company, FinaMetrica, offers a scientifically validated technique for assessing risk tolerance. You can read about FinaMetrica's process at www.risk-profiling.com.

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Prudent investment management requires a balance between a client's risk profile and portfolio volatility — both must be determined to establish an appropriate investment policy. But certain aspects of a client's total "risk profile" are confusing and can lead to faulty conclusions, potentially undermining your client relationship.

It's important to understand that a client's risk profile is really comprised of two aspects: the client's risk attitude and his risk capacity. Risk attitude is the true measure of a client's personal comfort with risk — it is a measurement of the individual's willingness to risk a less favorable outcome in the attempt to achieve a more favorable one (the "risk/return trade-off"). Risk capacity, on the other hand, is about the client's ability to sustain a less favorable outcome without derailing his original goals and objectives. Risk capacity is affected by factors such as time horizon (allowing the client time to recover from an adverse return) and total wealth (allowing the client to go through a decline in account value and still maintain desired spending).

The problem that we face is that risk attitude and risk capacity are separate constraints. In other words, the appropriate amount of risk is generally the lesser of the two, not some kind of composite score. For example, assume that a client's risk capacity indicates that he could sustain a 25-percent market decline without any impact on his goals. This might indicate a portfolio policy in the range of 60 to 80 percent in equities. However, if this client's risk attitude measure indicates that any decline in excess of 10 percent would make him feel panicked and suicidal, then the above equity policy is clearly not appropriate. Nor is a "mid-way" portfolio even appropriate (as implied by a scoring system that combines attitude and capacity into a single composite score used to "pick" a portfolio policy). Instead, the client should be invested with a portfolio policy that addresses the very low risk attitude — that is the necessary reality for this client. To do otherwise would risk the client's peace of mind and create a potential loss for you, as well: the client's business during a market downturn.

Many current risk profiling systems combine risk attitude and capacity together into a single composite score, often called the "risk profile score" or "risk tolerance score." However, as indicated above, combining these elements into a single score can be hazardous. In fact, if you ask almost any client to describe her risk tolerance, she will likely provide an answer that clearly indicates she is talking about risk attitude only, and not risk capacity. Risk tolerance is a term that should only be used interchangeably with risk attitude, and not with the entire risk profile that addresses both attitude and capacity.

So how should we address a client's full risk profile? There are two keys: First, we must obtain a true measure of risk attitude, which means the test should not only exclude items which address risk capacity, the test should also be valid and reliable and scientifically designed. Secondly, as wealth managers that integrate financial planning with investment management, we must take a client through the financial planning process to determine true goals and objectives, and not settle for a rough estimate of "risk capacity." By applying Monte Carlo analysis to the client's specific needs and desires, we can truly determine what portfolio policy will provide the highest probability

of achieving our clients' goals — and not settle for some rough numerical questionnaire-based estimate of "risk capacity," where time horizon is often the predominant (and often the only) factor, that fails to take into account the nuances of each particular client.

Once we know what is necessary to maximize the probability of success, we can determine what the appropriate investment policy should be, using risk attitude as a constraint. Alternatively, under the constraint of risk attitude, we might discuss with the client how he may need to adjust his goals (retire later, spend less, save more, etc.) because they cannot be achieved given his attitude toward risk. Through this methodology, you can provide the best value for your clients and ensure that their portfolio is consistent with their goals and objectives. Ultimately your clients should be able to sleep well every night, and they will have you to thank for this.