Risk-Profiling Systems

Can you really get to know your client this way? BY DAVID J. DRUCKER

Risk-profiling systems — those software products that give us a feel for how much risk our clients can take — have always been around. And most advisors have tried a few here and there. But can you really understand your client by using these products?

Ask many advisors, especially veterans, and they'll tell you they've tried risk profiling but don't find it useful. Dave Diesslin of Diesslin & Associates in Fort Worth, Texas, says, "In 20-some years, we've been through a number of these systems. I think they're useful in understanding where a person is *now* in his perception of himself. Someone who's invested in real estate and had a [bad] experience will never [invest in real estate] again. Another client may be just the opposite... He's done extremely well, as during a boom market, and may take bigger risks than he should."

In other words, clients think they know the risk they can accept, but their self-assessment is shaped by the experiences they've had. Hence, many advisors believe the only way to truly determine a client's risk tolerance is to monitor his reaction to up- and down-markets over a period of time, since risk measurement systems may give false signals.

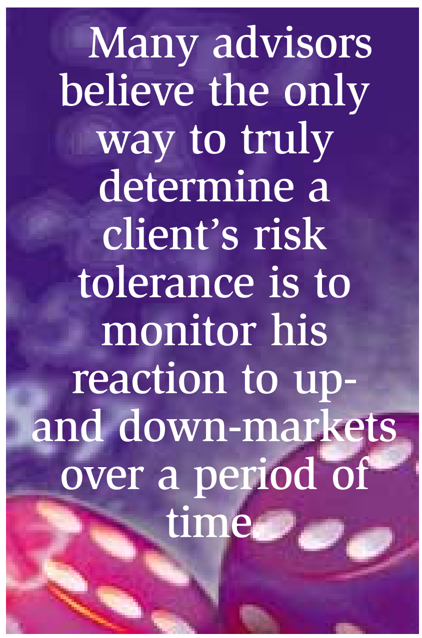
Which is why several risk-profiling vendors have refined their systems well beyond many of the earlier products that misled advisors to allocate their clients' assets inappropriately. FinaMetrica Risk Profiling System by FinaMetrica of Sydney, Australia, and Moneymax, the product of Dr. Kathleen Gurney of Financial Psychology in Sarasota, Fla., are now the systems of choice for those advisors returning to the use of these products. They differ markedly in their approaches, and either or both may be a valuable addition to your arsenal of tools.

To begin with, it's a good idea to clarify what is meant by "risk profiling." Although FinaMetrica (www.risk-profiling.com) describes its software with that terminology, Geoff Davey, a co-founder of the company, says, “The term ‘risk profiling’ is tricky because the term ‘risk profile’ is commonly used with two quite different meanings. Sometimes it is used to mean a profile of the client’s risk tolerance and other times it is used to mean the risk-return profile of a strategy being employed by the client. When we use it, we mean the former, but I believe it is commonly used more often to mean the latter. Our view is that the best solution is to avoid the term entirely and to talk instead about risk tolerance.”

FinaMetrica’s purpose, after your client completes its 25-item questionnaire, is to offer up a “pure” measure of risk tolerance. Davey acknowledges what all experienced planners know, namely, that the risk with which a client feels comfortable, or his pure risk tolerance, may be less than or greater than the level of investment risk he must take to achieve his long-term financial goals. So the purpose of FinaMetrica’s system is to clearly delineate a client’s risk vs. return measures, which is especially helpful if a client voluntarily takes more risk than he normally would for economic gain; that excess risk can be noted and even signed off on for the advisor’s protection.

Moneymax (www.financialpsychology.com), although thought of by many advisors as a risk-profiling system, is somewhat different from FinaMetrica. Says the Financial Psychology website, “Based on over 20 years of research, Moneymax can determine your client’s ‘financial personality’ and give you insight into their investment preferences.” Sounds similar, right? Yet, what Moneymax excels at is producing for the advisor a “client interaction strategy,” in the words of Mel Srybnik, Financial Psychology’s Chief Operating Officer.

To use Moneymax, the advisor purchases a Moneymax membership giving him a certain number of Moneymax profiles. Each profile consists of 28 questions clients can answer online, followed by a report to the advisor. The report categorizes the client into one of nine types, such as Entrepreneur, Optimist or Perfectionist.



Says Kathleen Gurney, Ph.D., Financial Psychology’s CEO, “[the clients’] trait scores go through a 27-step algorithm to predict the group the client is most closely identified with.” A Perfectionist, for example, is, “very thorough and particular in managing their money. They worry about making a mistake in investing their money and are careful to protect against a potential mistake or financial loss.”

Of course, this is just a synopsis. Each report describes the money management style of the client, including the kind of risk-taker he is. In addition, the report provides a detailed “money action plan” for the advisor to use with the client. For an Entrepreneur, the report might advise: “If a higher-risk strategy seems appropriate to meet your goals, ease into a higher-risk strategy slowly and consistently.”

STIMULATE DISCUSSIONS WITH CLIENTS

But — going back to our premise that many advisors have tried and dismissed earlier risk-profiling systems — how are these products viewed and used in the advisor community?

Robbin Duren, an advisor with American Express Financial Advisors in Atlanta, says, “New clients often aren’t good at verbalizing how they feel about money. Moneymax reveals certain personality traits so I can advise them properly. Much of it is psychology — what’s going to be comfortable for the client.” One of Duren’s clients had tried managing his own money without success. Yet, when he hired an advisor, he was nervous that she wouldn’t understand him. “I had him go through the Moneymax exercise, and he was no longer nervous. He felt I’d taken the time to get to know him,” says Duren. Is Moneymax better than tools Duren has used in the past? “I’d tried some simple programs, but nothing as detailed as Moneymax. Those other programs were just good for documenting that I’d talked to the client about risk and investing. Otherwise, they were too simple and generic.”

Moneymax can be just as useful for existing clients, too, says John Howard of Resource Planning Group, also in Atlanta: “One of my long-standing clients had never fully bought into our investment strategy, but he liked and valued us as advisors. The client experimented with technical analysis and other tricks for a portion of his

portfolio that he retained control over. Finally, we tested him using Moneymax and he was very low on the self-deterministic scale, so that explained a lot in terms of our relationship. When someone scores high as a risk taker but low on self-determination, that means they want to take risk but can't really handle it." Howard explains the portion of the portfolio the client retained has been in cash for five or six years as the client has tried to figure out if there is a secret to investing that would reveal itself to him. Based on the client's Moneymax profile, Howard has moved the money he manages for the client predominantly towards fixed-income, which doesn't conflict with the client's life span and rate-of-return needs.

FinaMetrica users report similar successes. David Morganstern of CMC Advisers in Portland, Ore., values FinaMetrica's capability of pointing to an asset-allocation strategy that fits the client's "pure risk" measurement: "We use the score we get from FinaMetrica as one component of developing the client's asset allocation. FinaMetrica offers a portfolio allocation that we fine-tune with other factors we are aware of about the client like time horizons, retirement plans, need for cash vs. growth, pending large expenditures or whether they are in the midst of life transition."

> Each Moneymax report provides a detailed "money action plan" for the advisor to use with the client.

As Davey explains, "We would say that a client has a risk profile and that this is stable and has nothing to do with, for instance, time horizon. Others will say a client can have multiple risk profiles, that they change as his circumstances/situation/goals change, and that one's time horizon is very relevant. Both statements are correct if you take into account that 'risk profile' is used with a different meaning in each statement."

Says Sherwin Lesk, an advisor with Leonetti & Associates in Buffalo Grove, Ill.: "While we take note of the asset-allocation breakdown the client's FinaMetrica profile suggests, we find far more interesting and useful the process of analyzing the client's answers to the 25 questions. We pay particular attention to apparent inconsistencies. For example, one client indicated a willingness to only take on a small degree of risk and, when given the choice, picked a portfolio with only a modest exposure to stocks; yet he indicated that he wouldn't start to feel uncomfortable until the value of all his investments declined by 33 percent. We find discussions with our clients about these kinds of inconsistencies very valuable."

Of course, each vendor believes its own product is most useful to the advisor community. Says Davey of FinaMetrica, "We're the only people I know of who claim to have a 'pure' risk tolerance test. Moneymax does include risk tolerance as one of the traits it measures, but I think it's best thought of as a high-level communication aid in that it presents a broad, general picture of a client that could be useful as a conversation starter. But it doesn't ask enough risk tolerance questions to be considered an adequate test of risk tolerance." Says Gurney of Moneymax, "We don't see other products in the marketplace that help advisors get to the root of a client's behavior. We see risk questionnaires which are very analytical about numbers, but don't deal with attitudes and feelings."

Advisors will just have to decide for themselves which approach is right for them. R

Sample Questions from FinaMetrica

Suppose that five years ago you bought shares in a highly regarded company. That same year the company experienced a severe decline in sales due to poor management. The price of the shares dropped drastically and you sold at a substantial loss. The company has been restructured under new management and most experts now expect its shares to produce better-than-average returns. Given your past bad experience with this company, would you buy shares now?

1. Definitely not.
2. Probably not.
3. Not sure.
4. Probably.
5. Definitely.

Investments can go up and down in value and experts often say you should be prepared to weather a downturn. By how much could the total value of *all your investments* go down before you would begin to feel uncomfortable?

1. Any fall in value would make me feel uncomfortable.
2. 10%.
3. 20%.
4. 33%.
5. 50%.
6. More than 50%.

Source: FinaMetrica, Ltd.

David J. Drucker, MBA, CFP, a financial advisor since 1981, sold his practice 20 years later to write, speak, and consult with other advisors. His newest book — "Tools & Techniques of Practice Management" — was released by National Underwriters in December 2004 followed soon after by his other new book, "The One Thing...You Need to Know from Each of Industry's Most Influential Coaches, Consultants and Visionaries." Please visit www.daviddrucker.com for more information.