Amid all the new rules, regulations, checks and balances levelled at financial advisers, the biggest barrier to quality advice could be staring the industry right in the face, Matthew Smith writes.

Risk profiling is not being talked about enough considering investment risk is on everyone's mind, and advisers are still struggling to properly understand their clients. In a recent Australian Securities and Investments Commission shadow shopping report, one finding stands out above all others: in 15 of the 16 examples where an adviser's investigation of the client's personal circumstances was categorised as poor, the overall quality of advice was also rated as poor.

From this, the regulator surmises that the likelihood of an adviser providing high-quality financial advice is severely reduced if he or she does not adequately determine the client's personal circumstances.

Sounds simple enough but this rather innocuous statement touches on an issue that the financial planning industry has ducked and weaved for the best past of the past decade.

The process whereby advisers attempt to categorise people based on their willingness and capacity to take on risk as the basis for investment advice has barely changed over the course of the past 10 years. It's not that risk profiling doesn't have a place as part of the financial planning process – quite the contrary.

Risk profiling is intertwined in the discovery every financial planner embarks upon to assess a client's needs. Every adviser will

STAGNANT STATE OF RISK PROFILING

ILLUSTRATION SAM BENNETT

Kay Aarons, Strategic Finance Solutions: Advisers are unwilling to challenge clients.

have access to a risk-profiling tool of some sort, whether it is provided by the licensee, part of the planning software they use, or offered by an external firm that specialises in the area.

But in the absence of guidance from regulators and professional bodies, the process of risk profiling seems to accommodate both the categories product providers use to measure market volatility, and the interests of large dealer groups seeking to avoid liability should clients lose money.

So says Kay Aarons, a licence holder and principal planner with Strategic Financial Solutions – a five-planner group based in Melbourne. Enough clients have come to Aarons over the years with poorly assessed risk profiles showing her something is amiss on the risk-profiling front.

She had a 70-year-old client who came to her recently who was considered by another planner to have a high appetite for risk based on answering "yes" to the question of whether that person had borrowed money to invest before.

"Turns out this person once had an overdraft loan to start a business years ago," Aarons says. "The problem is some advisers are unwilling to challenge clients or make judgments on what is being spat out of their systems."

Other clients that she sees may have an arbitrary 60-40 or 70-30 allocation to shares and fixed income that bear no direct correlation to any personal risk profile.

Aarons uses the psychometrics-based FinaMetrica risk-profiling tool, but she says she in no way holds herself out as an advocate of this evaluation method.

Psychometrics is an approach to testing that utilises a blend of psychology and statistics to come up with questions that can be used to test for reliability and validity of attitudes and assumptions in people.

She says FinaMetrica is a vast improvement on the seven-question survey that previously served as industry best practice before psychometrics became more widely used by the industry about 10 years ago.

However, a psychometric questionnaire doesn't provide all the answers. "I think the problem is a lot of advisers are conservative when it comes to challenging their clients," Aarons says.

"I don't mean conservative in terms of risk and volatility, I mean in terms of questioning conventional thinking."

It's been a long time since the peak industry body, the Financial Planning Association of Australia, has weighed in on the issue.

The last policy position on the topic of risk tolerance and risk profiling published by the FPA was in 2003.

Deen Sanders, FPA's chief professional officer, acknowledges this document remains the association's view on the practice.

The paper outlines that, while risk profiling is accepted to be a common industry practice, the process itself may not be effective in achieving the goals it sets out for itself.

The paper then goes further, stating that any attempt to pigeonhole clients based on their tolerance and appetite for risk could be contrary to the concept of tailoring customised advice.

Sanders agrees that many advisers do not properly understand people's needs and objectives. He also believes, though, that prescribing a method of risk profiling is not the answer.

"The job of a planner is to have the tough conversations and challenge [clients] ... prescribing a way to have those conversations will just lead to the lowest common denominator approach," Sanders says.

ASIC outlines a broader principle of risk tolerance in policy statement 175, while the Corporations Act 2001 also addresses the topic broadly in s945A(1)b by stating advisers should consider a client's individual circumstances.

So with little direction from professional standards and regulators, advisers and their licence holders are generally beholden to standards set by complaint resolutions and by within clauses of professional indemnity insurance contracts, Aarons believes.

The Financial Ombudsman in its winter 2011 circular published a note outlining the areas the service would look at in a dispute

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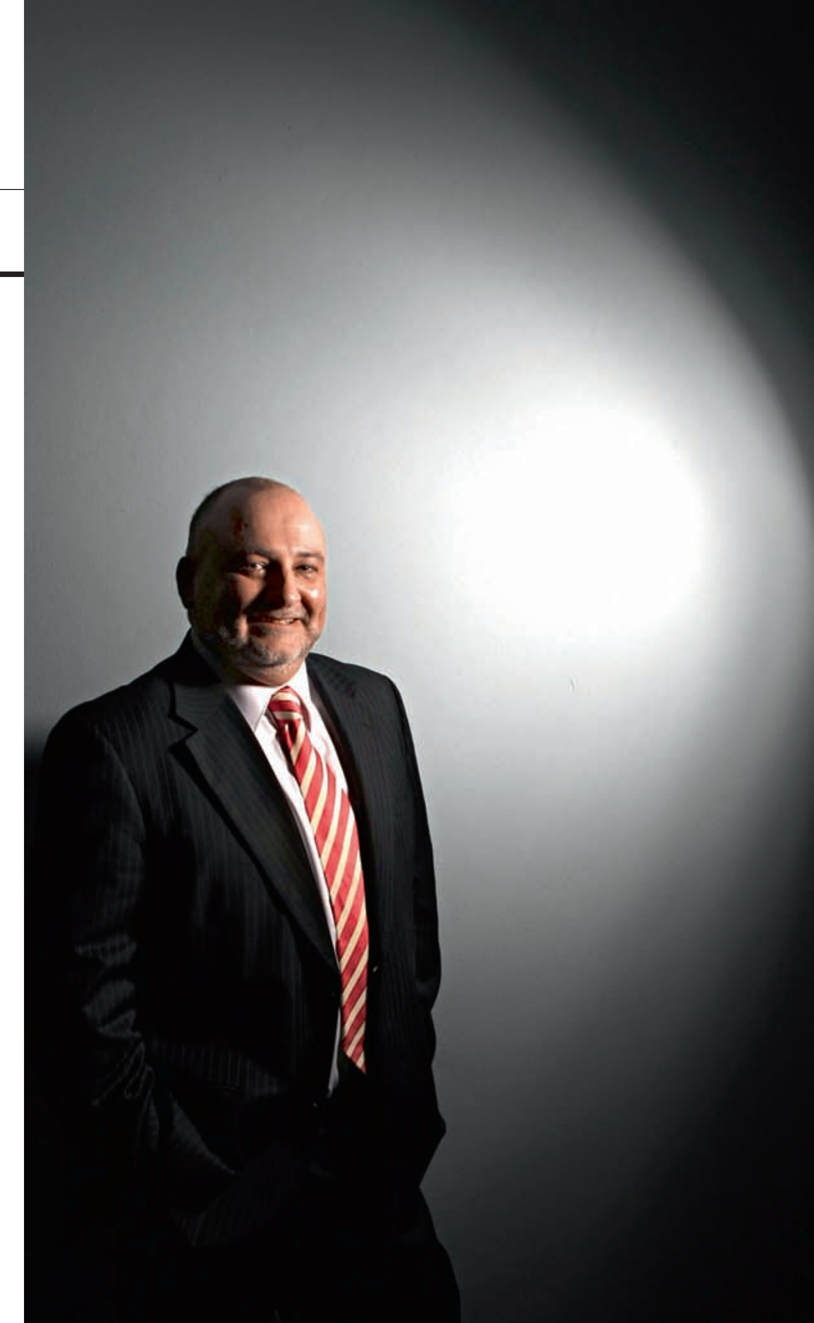


The job of a planner is to have the tough conversations and challenge [clients]...
Deen Sanders, FPA

with a financial services provider that related to risk tolerance. Among other points, it states that advisers should address both the client's attitude to risk and capacity for loss as well as address the inherent and specific limitations in the risk-profiling tool they use.

Hare today, tortoise tomorrow?

The concept of risk profiling is derived from modern portfolio theory, which assumes that investors are risk averse and, given the option, will only take on increased risk if they are compensated by higher expected returns.

Conversely, an investor who wants higher expected returns must accept more risk. So the theory goes, the exact trade-off will be the same for all investors, but different investors will evaluate the trade-off differently based on individual risk aversion characteristics. How different investors evaluate that trade-off is at the core of what risk profiling tries to achieve.

Psychometrics risk profiling is the closest thing the industry has to a standard – more than 500,000 investors have completed FinaMetrica's questionnaire. But there appears to be a fundamental disagreement in the industry over what lies at the core of an investor's approach to risk.

Proponents of psychometrics believe that people have a core risk tolerance – and while their approach to investing might change depending on the markets and conditions, behaviour is hard-wired and will remain consistent throughout someone's lifetime.

Paul Resnik, chief executive of FinaMetrica, describes this as the enduring personal trait. But many industry participants believe investors' attitudes to risk can change from one day to the next and accept there is no one method that stands out above all others.

"If you talked to me yesterday when I was stressed and hadn't eaten, my answers will be different than today when I am rested," says Rob Thomas, AXA general manager of technical, research and paraplanning.

While he says there is no foolproof way to prevent incorrect risk profiling at a dealer group level, culture and access to support services can help advisers to properly evaluate a client's risk characteristics.

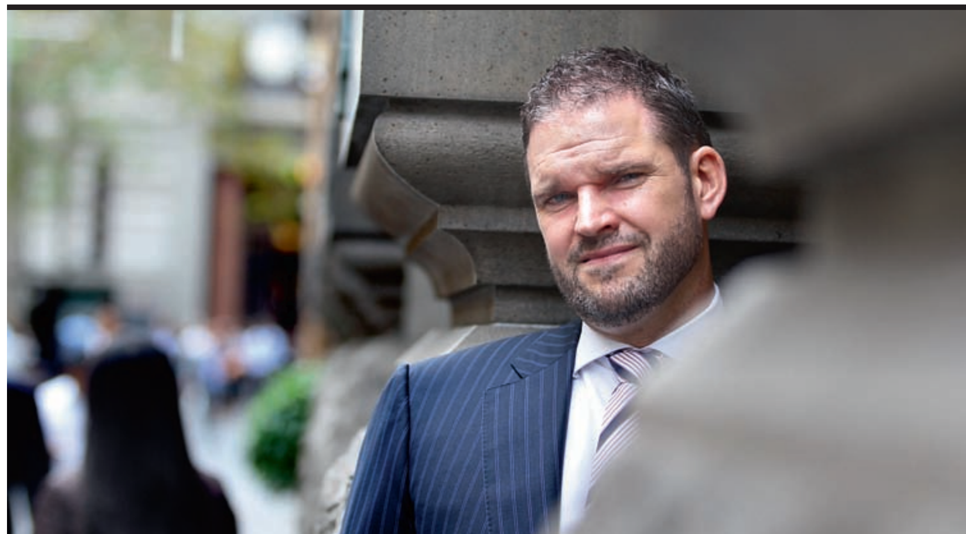
While AXA has developed its own set of questions for the purposes of risk profiling, Thomas says there are many components to a risk-profiling process, not just the questionnaire.

"It's more an art than a science," Thomas says. "At dealer groups there will be a standard questionnaire but beyond that, the difference is the internal culture. You can't regulate ethics or common sense."

Disregard for the principles of psychometric testing is not uncommon among industry participants.

According to Michael Kinens, IRESS's senior business development executive, it's common for dealer groups to formulate and substitute their own questions into the psychometrics test that is one of the tools in XPLAN's offering.

IRESS is the owner of technology provider, XPLAN, the financial



planning software with the largest user base in the country. "It's fairly clear, based on the way some dealer groups chose to customise the questions [in the risk-profiling tool], they have given no thought to what goes into the process of the psychometric assessment at all," Kinens says.

XPLAN provides a psychometric test as a standard feature on its risk-profiling tool but allows users to customise the test to suit their needs. Kinens says that by interchanging questions on a psychometrics questionnaire it undermines the test, which is road-tested to reduce variables in responses.

With no agreement on best industry practice, much of the industry is left with a watered-down risk-profiling method, which Aarons describes as a "tick a box" approach. She says this is used to serve a compliance or product purpose rather than for its intended purpose to help advisers better understand the needs of their clients.

In the United Kingdom, the Financial Services Authority is targeting risk profiling in an effort to improve the quality of advice of its financial advisers. In a recent guidance note on the topic, the overseas regulator stated that among other things, it is requiring clients to answer additional questions relating to their capacity for loss. Advisers will be required to test that capacity against their future income and cash-flow needs.

Specifically addressing loss in the context of risk profiling is important if the industry is to ever move towards prescribing a method of engagement, says George Lucas, managing director of Instreet, the investment consulting firm for financial advisers.

He says people generally have an "asymmetric" attitude towards risk tolerance in that they think significantly differently about risk when the value of their underlying assets are gaining than they do when the underlying assets move in the opposite direction.

Since the global financial crisis, planners have been more willing to have tough conversations with clients about loss, FPA's Sanders says. He agrees that clients' willingness to lose is less elastic than their willingness to share in the upside. Questions around how much a client is prepared to lose and "what if the value of your portfolio dropped by 20 per cent tomorrow?" have become a more prevalent part of planners' conversations with clients, he says.

Michael Kinens, IRESS: It's common for dealer groups to formulate and substitute their own questions in XPLAN's offering.

There are a number of providers of risk-profiling tools popping up in the UK offering consulting services and tools to advisers, FinaMetrica's Resnik says.

Resnik is one of the founders of the psychometric test in Australia and has recently found himself in high demand in the UK.

He has been over there for many months, speaking to auditoriums packed with financial advisers and holding court with regulators and professional bodies on his favourite topic.

By his own admission, however, Resnik would find it difficult to scrape together enough bodies to fill a row of seats in Australia, let alone fill rooms at convention centres as he is doing in the UK.

While he says risk tolerance in Australia is left up to the adviser, in the UK the process is prescribed and there is much more rigour around it.

For instance, Resnik says, an adviser in the UK wouldn't be able to have all its clients in one single wrap based on new risk tolerance standards, unless that adviser could prove all his or her clients had the same profile to risk.

Matching risk profiles with the right asset allocation is the next big challenge planners face, says Jonathan Ramsay, head of van Eyk's asset consulting business.

After several decades of blind faith in differentiating largely on the basis of equities versus bonds, Ramsay says the standard risk-profiling methodology has been found wanting.

He suggests the natural propensity for clients to question why they are being put into certain investment options over others following the losses they have faced during the global financial crisis will lead the industry down the path of better client engagement and client understanding. ⊠

Matching risk profiles is the next big challenge.

Jonathan Ramsay, van Eyk

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