

PARAMETERS

OPINION

Ticking time bombs 1999 – 2004

By Geoff Davey, CEO & Co-Founder, FinaMetrica Limited (www.risk-profiling.com)

In 1999, with the bull market roaring, a client's risk tolerance was typically given scant regard by licensees and advisers. But the ensuing bear market, the rise of consumerism and the increased focus on professional standards have since emphasised that advisers must both assess their clients' risk tolerance and have regard to those assessments when formulating advice. The problem is that typical industry practice relies on risk tolerance questionnaires that do not produce an adequate test of risk tolerance. Mismanagement of clients' risk tolerance is still the financial advising industry's Achilles heel. Many client files contain ticking time bombs that could destroy the reputations and businesses of both licensees and advisers.

In a 1999 white paper, "Financial Advisers' Assessment of Clients' Risk Tolerance"¹, I stated that "Financial advisers have both a Corporate and Common Law obligation to form a view of their client's risk tolerance and to take that view into account when giving advice. Yet industry standard practices are such that this obligation cannot be effectively discharged."

This statement is still true today.

There has been some improvement over the intervening five years. For example, the FPA, in a series of position statements, has stressed that advisers must assess their clients' risk tolerance and have regard to that assessment when formulating advice. In 1999, this was a minority view but is now generally accepted.

Additionally, in its most recent position statement (Oct 2003), the FPA condemned 'portfolio-picking' questionnaires².

However, common industry practices are still ineffective because the typical questionnaire simply does not provide an adequate test of risk tolerance. Whatever then follows is fatally flawed.

Risk Tolerance Assessment Requirements

There are two basic purposes for a risk tolerance test – know-the-client and gap-analysis.

For the 'know-the-client', an adviser needs a quantified assessment of the client's attitudes, values and behaviours with regard to financial risk. The assessment must be meaningful to the client (that is, a comprehensive summary in plain English) so that the client can sign-off on it as representing their instructions to the adviser about the level of risk they would normally choose to take. The assessment should consider financial risk generally, not just investment risk (unless the advice is always to be confined to investment advice.)

For the gap-analysis, the assessment must be made in such a way as to allow meaningful comparison between the client's risk tolerance, and the risk inherent in strategic alternatives. The process of personal financial planning relies upon obtaining the client's properly informed commitment to a set of

trade-offs between conflicting alternatives. Properly informed trade-off decisions can only be made when the elements of the trade-off have been separated, and can be clearly understood and compared. A key trade-off decision for the client is between comfort with financial risk and the financial risk required to achieve goals. The financial risk associated with the return required to achieve a client's goals often exceeds the level of risk with which that client is comfortable. Identifying the existence of any such 'gap' and helping the client resolve it through properly informed trade-off decisions is an essential step in obtaining the client's properly informed commitment.

Importantly, if in order to achieve these goals, the client decides to take more risk than the client would normally choose, the adviser's methodology must make this decision clear, so that the client can sign-off on it.

Scientific Risk Tolerance Assessment

The literature³ recognises two risk-related constructs: risk tolerance (sometimes referred to as risk attitude) and risk capacity.

Risk tolerance (i.e. how much risk I choose to take) is a psychological attribute of the individual. Risk capacity (i.e. how much risk I can afford to take) is a financial attribute of the individual's circumstances.

Risk tolerance affects how psychologically receptive an individual is to decisions involving risk, and the degree of anxiety experienced in situations where risk is evident. Risk capacity is the amount of money an individual could afford to lose without putting the achievement of (financial) goals at risk. It represents an absolute, downside constraint on strategy selection. An individual should not embark on a course of action where the worst case scenario involves the possibility, no matter how remote, of a loss greater than his or her risk capacity.

Risk tolerance and risk capacity both have important, but distinct, roles to play in the financial planning process. Here, however, we are concerned with risk tolerance.

Risk tolerance is best defined as the extent to which an individual chooses to risk experiencing an

unfavourable outcome in the pursuit of a favourable outcome⁴.

Any accurate measure of risk tolerance must adhere to psychometric standards. Psychometrics is the established scientific discipline for testing attributes such as risk tolerance. It provides standards against which a test questionnaire can be evaluated. Psychometric standards focus on validity and reliability – validity meaning that the questionnaire tests what it purports to test, and reliability meaning that it does so consistently with a known level of accuracy.

There are no short cuts in psychometrics⁵ – the right kind of work must be performed in development and testing, and in re-validating what is uncovered. The process is time-consuming and expensive. There is considerable statistical work involved which must be of a type suitable for this kind of assessment.

In short, while a risk tolerance test should be simple and straightforward for ease of use by clients, developing a risk tolerance test is not.

Typical Industry Questionnaires

The typical industry questionnaire is a derivative of the now-discredited ‘portfolio picker’. As previously mentioned, portfolio-picking questionnaires were denounced in the FPA’s October 2003 risk tolerance position statement.

This FPA reassessment of advisers’ risk tolerance assessment obligations was, for many, the catalyst to review their current practices. New questionnaires have been developed by networks and software suppliers. Though these may have had more thought put into them than in the past, they must still be fit-for-purpose. However, most of them are not. Through the use of inappropriate questions, the integrity of these tests is compromised and there are insufficient questions to ensure appropriate consistency and accuracy. There are too many ‘bad’ questions and too few ‘good’ questions.⁶

In brief, a ‘good’ question must meet a specific set of standards and this can only be determined by detailed analysis of the results of Usability and Norming trials. Usability trials focus on ease-of-understanding and ease-of-answering. Norming trials focus on the statistical attributes of the question with regard to its utility in producing a valid and reliable score.

‘Bad’ questions are those that fall short of the ‘good’ question standards. However, it is possible to do a quick sight-check of a questionnaire for ‘really bad’ questions – questions which are so obviously ‘bad’, it is not necessary to do the detailed analysis described above. In the typical industry questionnaire, two types of ‘really bad’ questions are common. The first type

is situational. Questions about age, stage of life, time horizon, financial needs, etc., while relevant as part of know-the-client, are not relevant to risk tolerance. The second type is those that require explanation by the adviser. If the adviser plays an active role in the completion of a questionnaire, the results will be influenced by the adviser and the objectivity of the test will be compromised. High-school-standard, plain English should be the order of the day. Financial terminology should be avoided if one aims for high understandability (even something as straightforward as the term ‘bonds’ will cause difficulties). Similarly, questions involving percentage rates of return are problematic, while questions involving means and standard deviations may as well be in another language (which, in reality, they are!)

By psychometric standards, the new questionnaires that have been developed by networks and software suppliers are both invalid (what is being tested is not risk tolerance) and unreliable (the scores will be subject to unacceptably high rates of error.) In psychometrics, valid and reliable are technical terms with quantifiable meaning. Testing a psychological attribute such as risk tolerance requires a special set of skills and disciplines, which are not usually found in financial services professionals or finance academics, despite the best intentions.

Not only is it clear from a theoretical perspective that typical industry questionnaires could not work, there is practical evidence from independent studies that they do not work.⁷

Role of the Courts and ASIC

Licensees and advisers evaluating whether their assessment processes are fit for the purposes to which they will be applied should remember that, in effect, the Courts and ASIC are peering over their shoulders.

The 2001 Paige case⁸ made it very clear that the Courts will not hesitate to ‘look under the bonnet’ at the tools advisers use in formulating advice. PS175 imposes a due-diligence obligation with regard to the tools that advisers use. Accordingly, licensees and advisers must ‘look under the bonnet’ at any questionnaire they use, or outsource that responsibility to a competent third party.

Ultimately, the Courts will decide acceptable practice. The Courts and ASIC can be expected to seek justification for any decision not to use the established scientific discipline.

In the past, consumers, the regulator and the Courts had a relatively unsophisticated understanding of financial advising and only those practices which were fraudulent or nearly so were likely to be punished.

In recent times, however, there has been a far greater focus on bad, as distinct from (borderline) fraudulent advice. Think of the Shadow Shopper survey⁹ and compare the recent FinWiz case and the Hartley Poynton case¹⁰ of a few years ago.

In the near future, cases arising from the bear market will surface and advising practices will be under renewed scrutiny. Licensees and advisers can expect plaintiffs' lawyers to know that in 2004, not only was there an established scientific discipline for testing risk tolerance which was largely being ignored by the industry, but that there were also studies on the public record which demonstrated the inadequacies of the typical industry questionnaire.

Five years from now, when today's practices come before the Courts, a far more demanding set of standards can be expected to be applied than would be the case now.

What licensees and advisers should do – now

The aim must be to have properly informed commitment from all clients to the financial strategies being implemented. To do this, the advising process must have covered 'gap analysis'.

Risk tolerance is one side of the 'gap', hence licensees and advisers must ensure that they have an adequate risk tolerance assessment process. While adequate risk tolerance assessment is not sufficient for properly informed commitment, it is a necessary part of the process. Without it, no matter how well other aspects have been handled, properly informed commitment is unobtainable.

At the very least, licensees and advisers should seek certification from a competent third party that the risk tolerance test they're using meets psychometric standards. Relying on a test that is easily proven to be inadequate before the Courts will be fatal to a licensee's or adviser's defence that the client's properly informed commitment had been obtained.

The claims of risk tolerance test providers should not be accepted at face value – licensees and advisers must be able to point to a due diligence process supporting the test's credentials. Further, there must be a robust methodology for incorporating the test results into the planning process to facilitate 'know-the-client' and 'gap-analysis'. Once an adequate risk tolerance assessment process is in place, it should be used with all new clients in satisfying 'know-the-client' and as an input to 'gap analysis'. For existing clients, the next review should be used to (re-)do 'gap analysis' and obtain properly informed commitment to the current (or revised) strategy.

Only in this way can the value of an advising business be assured. In the light of the FinWiz case, prospective purchasers will be seeking such assurance when valuing advising businesses. ■

END NOTES

1. A copy of Financial Advisers Assessments of Clients' Risk Tolerance can be downloaded at www.risk-profiling.com/downloads/Time_bomb_1999.pdf
2. By the mid 1990s, the 'portfolio-picking' questionnaire was the most commonly used methodology for selecting an asset allocation to recommend to a client. 'Portfolio-pickers' asked from five to 30, but usually less than ten, questions about a variety of matters to do with the client and their situation: matters such as age, life stage, time horizon, investment experience, tax sensitivity, attitudes to risk and so on. Answers were scored on a segmented scale where each segment corresponded to asset allocation. Respondents would be told that, for example, "You are a Prudent investor who wants a balanced portfolio to work towards medium to long term financial goals ...". In retrospect, it may seem astounding that it could ever have been acceptable for the whole investment strategy selection process to be decided by how the client answered these few questions. But when first introduced, 'portfolio-picking' was an improvement on the free-for-all it replaced. It did result in an increased importance being placed on portfolio construction, risk tolerance was at least considered and there was some semblance of system where there had been none previously. 'Portfolio picking' became a recommended methodology in financial planning education. Virtually all of the large Australian dealer groups and planning software suppliers developed their own 'portfolio-picking' questionnaires. By the late 1990s, however, it had become obvious that 'portfolio-pickers' had serious short-comings. They did not produce a goals-based result, there being no consideration given to whether the recommended asset allocation when applied to available resources would achieve the client's stated goals. Nor did they deal adequately with risk tolerance. The limited risk tolerance information they collected was never isolated but rather merged with other information to obtain the recommended asset allocation. The first advance from 'portfolio-picking' came through modelling software that could project a strategy to see the extent to which it could be expected to achieve the client's goals. Initially, modelling was deterministic and, later, stochastic. However, there has not been a commensurate increase in the quality of risk tolerance measurement. Planning software packages often have "risk tolerance questionnaires". In some cases, these are no more than re-labelled 'portfolio-pickers'. In others, they are simplistically short or require a level of investment-risk understanding beyond the vast majority of clients. Quite a few advising firms and networks developed their own risk tolerance testing/coaching questionnaires and

processes, of varying degrees of sophistication and sensibility but all, to our knowledge, without employing a suitable methodology.

3. For example, Boone N. and L. Lubitz. "A Review of Difficult Investment Policy Issues" *Journal of Financial Planning*, May 2003.
4. This is the definition used in the draft ISO Standards for Personal Financial Planning.
5. An overview of what is required for psychometric risk tolerance testing is can be found in "Some guidelines for financial planners in measuring and advising clients about their levels of risk tolerance", Callan, V. J. & Johnson, M. *Journal of Personal Finance*, 1 (1), 2002.
6. What constitutes 'good' and 'bad' risk tolerance questions is discussed in detail in "Questioning the Questionnaire Method: Insights on Measuring Risk Tolerance from Psychology and Psychometrics", Roszkowski, M.J., Davey, G. and Grable J.E., a paper currently in pre-publication review by the US FPA's *Journal of Financial Planning*. A copy can be downloaded at http://www.risk-profiling.com/downloads/Insights_on_Measuring_Risk_Tolerance_Draft.pdf
7. Early evidence of the inadequacy of industry standard techniques was uncovered during development of the FinaMetrica system in a 1997 study by organisational psychologists, Chandler & Macleod Consultants. A copy can be downloaded at http://www.risk-profiling.com/downloads/SOFRT_Report.pdf. The accuracy of risk tolerance estimates by experienced advisers about their established clients was tested statistically. Estimates and actual scores correlated at only 0.36 – that is, one in six adviser estimates was wrong by two or more standard deviations. Put another way, advisers' estimates would have been more accurate if they had made no attempt to understand their clients' risk tolerance but had simply assumed all were average. This is not a criticism of advisers. Other studies involving managers and subordinates, doctors and patients, teachers and students, etc. have shown similar inaccuracies in assessing personal attributes.
Two recent US studies have also demonstrated the inadequacy of industry-standard questionnaires. The first – Yook, K.C. and R. Everett. "Assessing Risk Tolerance: Questioning the Questionnaire Method." *Journal of Financial Planning*, August 2003 – compared the results of using six different tests on a sample group and found very low correlations between the results. The second – Bouchey, P. "Questionnaire Quest" *Financial Planning*, July 2004 – reported on the unsatisfactory nature of the results of using a

typical industry-standard questionnaire. In both studies, the authors drew conclusions about the efficacy of questionnaires in general, not realising that the problems lay in the inadequacies of the actual questionnaires they were using. Roszkowski, Davey and Grable paper uses the shortcomings Yook and Everett (2003) as an introduction to a broad discussion of the relevant issues.

8. *Paige v FPI Limited & Anor* [2001] NSWSC 627 (27 July 2001).
9. The February 2003 ASIC research report, "Survey on the quality of financial planning advice", dealt with the results of a shadow shopping survey carried out by ASIC and the ACA. Half the plans were considered 'borderline' or worse quality including 17% considered 'poor' and 10% considered 'very poor'.
10. *Ali v Harley Poynton* confirmed that licencees are responsible for the behaviour of their representatives. And, amongst other things the recent *Financial Wisdom* case reaffirmed that licencees have a clear and unequivocal duty to ensure that those who represent them provide appropriate advice. In each case, the Courts award [over \$1 million in the *Hartley* case and reportedly over \$30 million in the class action against *Financial Wisdom*] included reparation for monies lost and opportunity costs. The latter was based on the Court's judgement of what was an appropriate portfolio for the client, based on their risk tolerance and personal circumstances and the performance they would have enjoyed had they been invested in that portfolio.

ABOUT THE AUTHOR

Geoff Davey is CEO and Co-Founder of risk profiling specialists FinaMetrica Limited (formerly ProQuest Limited). Geoff has been an invited speaker at US, UK and NZ conferences. He authored the Micro-Behavioural Finance chapter in the upcoming Bloomberg book "Investment Think Tank". Prior to FinaMetrica, Geoff was one of the pioneers of financial planning in Australia with the firm he founded in 1972 being amongst the first to offer a financial planning service. Geoff's email is geoff.davey@finametrica.com