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Risk Tool Smackdown: FinaMetrica vs. Riskalyze

By Bob Veres

Let's say about a year from now the S&P 500 were to drop 18% in one day, the result of a terrible Wall Street mishap. Over the subsequent three months, the index would give up just under 40% of its value.

Naturally, I'd worry about how planning clients will react. One client who I'm especially worried about is, well, me. Will I panic and retreat to money market funds? Will I stoically remain on course? Or will I cackle with excitement and urge my advisor to throw all the chips on the table at the bloody bottom of the wreckage?

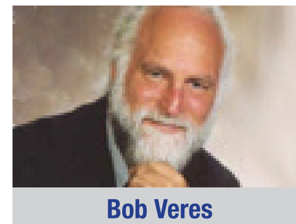
To find out — and also to evaluate the tools advisors are using to better understand their clients — I tested myself using two of the more popular risk tolerance instruments: Riskalyze and FinaMetrica.

You are more likely to have heard of FinaMetrica, which has been around since 1998, and has completed more than 520,000 risk profiles for more than 5,000 investment advisors in the U.S. and abroad. It was created by Geoff Davey, who previously spent more than a decade running one of the larger planning firms in the Australian market.

Riskalyze is the new kid on the block; it launched in 2011 as a consumer site, and became a tool for financial planners in 2012. Its founder, Aaron Klein, is a former executive with optionsXpress in Chicago. Klein declined to say how many advisors are using Riskalyze, except to say it is "thousands and thousands," many of them through affiliations with independent broker-dealers.

Taking The Tests

Both instruments are used by advisors to assess their clients' sensitivity to movements in their portfolios. There are two goals here: to create investment mixes with no more volatility than clients can stomach, and to let advisors show regulators (and, in a worst-case scenario, jurors) that they used the best tools available to create appropriate portfolios.



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I started with the FinaMetrica test's 25 questions.

I tell the survey that I consider myself to be a high risk-taker, which actually puts me near the middle of the range of answers. I also tell the system that I adapt very easily when things go wrong financially, which may be why I never considered abandoning stocks during the last downturn.

I am asked about whether I get a "thrill" from investing (no), and whether I would seek a job with more stability or higher income potential. How much could the total value of my investments go down before I begin to feel uncomfortable? (I choose 33%.) I choose a 70/30 mix portfolio, I say I'm easy to dislodge from a CD investment, and I really, really want my investments to retain their purchasing power against inflation. I prefer a fixed- to a variable-rate loan when interest rate movements are uncertain, and I have fairly complete insurance coverage.

Finally, I am asked what I think my score would be on a scale of 0 to 100. After a lot of deliberation, I choose 75.

I am wrong. The system gives me a score of 63. Even that is above average, though.

Out of the hundreds of thousands of people who have taken this test, 24% fall into this general category. The biggest red flag, it turns out, is that I overestimated my propensity for risk by an unusually high margin, which could be an issue when I invest.

Other observations about me that I could talk over with my advisor: I focused more on possible gains than possible losses in my financial decisions, I tend to adapt easily when things go wrong financially, and I have never invested for the thrill of it.

Different Questions

My Riskalyze experience was somewhat different. I am asked how much I have to invest (for a round number, I tell it $1 million), and how I would define a "devastating loss" ($333,000).

Then it stumps me. Over the next six months, Riskalyze asks me, would I prefer a certain gain of 10%, or a 50/50 chance of losing 25% or gaining 150%? Maybe I'm overthinking things, but where in the global opportunity set will I find investment choices like these? Are any advisors out there willing to guarantee me a 10% return? If the markets were truly offering these choices, I suppose I would take the gain.

From there, it drills down. What about a certain loss of 8% versus a 50/50 chance of losing 25% or gaining 150%? What about a certain gain of 1%, or the same chances of losing or gaining? A certain loss of 12%, or a 50/50 risk of losing 25% or gaining just 6%? A certain loss of 19% vs. losing 25% or gaining 6%?

I keep choosing the riskier option, but I'm continually troubled by the fact that the market itself would never offer me these actual choices.

In the end, Riskalyze scores me a 69 on a scale of 1 to 99. Over the next six months, I'm comfortable risking a 15% loss for a 23% gain in my investment portfolio.

Methodology & Marketing

According to both systems, I'll weather the market downturn. But how comfortable can advisors be that either test will stand up as evidence that they made every effort to make prudent recommendations?

Klein says that the research behind the Riskalyze process is based on the prospect theory posited by Nobel laureate Daniel Kahneman at Princeton. But is there anything in the literature that gives him those numbers that I was choosing from? "There is a lot of methodology behind it," he says. "But that's part of our secret sauce that we really don't disclose."

I asked Davey the same question, and he pointed me to a pile of literature on psychometric testing and the science of asking relevant questions to gain relevant data. FinaMetrica taps into a significant amount of research in the psychology community.

There appears to be one other difference between the two systems, which jumps out at you when you visit the Riskalyze website — which says, in rather large type: "How to Win a $2 Million Client in 10 Minutes." The difference is that Klein touts Riskalyze as a powerful marketing tool.

"We believe that you can use risk to win new business in a very effective way," he says. He tells the story of a prospect who came into a rep's office, took the test and was shown that his current portfolio was way above his tolerance number. "The blood drained out of the prospect's face, and he signed the [account transfer] form right there on the spot," Klein says.

Investment Choices

In addition to measuring client risk tolerance, Riskalyze evaluates investment choices. On top of the funds and ETFs already in the system, the latest iteration adds 130,000 variable annuity subaccounts — the investment recommendation of choice of many broker-dealer reps — and 10,000 separately managed accounts, which wirehouse brokers prefer.

The expected returns and projected standard deviations that are used to calculate these risk scores are taken from the performance of the individual fund, subaccount or SMA. If I were an advisor, though, I'd be very cautious about using any tool that projects future returns from past performance on any individual investment.

Bottom line: If I wanted to close a prospect, Riskalyze is hard to beat. In the hands of a great salesman, it can be used to make the prospect's current advisor seem incompetent, and win those $2 million accounts. But if I had to stand up in court and defend my process for selecting truly appropriate portfolios for my clients, I'd much rather have FinaMetrica in my corner.

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