Bloomsbury

June 2004

A risky business – FinaMetrica assess the facts

By Carolyn Corless

Of all the information that we collect about our clients, probably the most important relates to their attitude to risk.

It is vital that at an early stage in our process we determine with a client how much risk they are prepared to accept, since this will ultimately determine what rate of return it is reasonable for them to expect. We can then compare this against the rate of return required to meet their objectives. What a client needs, expects and is comfortable with are not always the same, so if the return required is unrealistically high for the acceptable risk, some form of risk/return trade-off will be needed – i.e. either to increase the level of risk in the portfolio, or adjust the objectives downwards.

The problem with assessing a client's attitude to risk is that it is very much a subjective matter. We have always striven to involve our clients in a structured analysis of their attitude to risk, but have been conscious that the available methods of determining a client's risk profile have been far from perfect.

We had been aware of academic research carried out in the field of psychometric risk profiling and knew that systems had been available in the US and Australia for some years. We were delighted, therefore, when we were invited to trial a UK version of the best known risk profiling system, FinaMetrica (formerly ProQuest). Based in Australia, FinaMetrica devised a risk profiling system which built on research carried out in the US and enlisted expertise from the Applied Psychology Unit of the University of New South Wales School of Psychology.

Why use psychometric risk profiling?

Academics studying risk assessment found that human behaviour played a vital role and that financial risk was generally viewed quite differently from other types of risk. For example, someone whose hobby is skydiving – and might therefore be viewed as a high risk taker – would not necessarily be comfortable with high levels of financial risk.

The phrasing of questions is also vital. Asking someone what their attitude to risk is "on a scale of 1 to 10" (unfortunately a method still used by far too many IFAs) is extremely unreliable since people generally are not very good at gauging their own tolerance for risk, especially if they are not experienced investors.

Human nature is such that we tend to answer similar questions differently, depending on the emphasis within the question. For example, if you ask someone how they would react if 70% of their portfolio increased in value, you will possibly get a different answer than if you asked how they would react if 30% of their portfolio went down in value.

The number of questions asked is also extremely important – the greater the number the more accurate the results, but ask too many and the profiling becomes too cumbersome. Too few, and you do not garner enough information to produce an accurate profile.

Many advisers would argue that they complete a process which is just as valid simply by talking to their clients and asking them questions about risk. The problem here is "Are they asking the right questions?" Advisers might argue that they "get a feel" for what risk profile their clients are by comparing answers from one client to those from another. However, academic research has found that this approach is intrinsically flawed and that advisers generally are not very good at assessing their *clients' attitudes to risk. In fact, studies have shown that in some cases clients 'end up' with a very similar risk profile to their adviser – suggesting a strong interviewer bias.*

Studies carried out by the American College, Bryn Mawr, Pa., concluded that risk tolerance, just like intelligence and personality, is a psychological trait, i.e. it will generally remain the same over time. They also found that, like IQ tests, one person's risk tolerance can only be measured relative to other people's – there is no discrete unit of measurement.

How does FinaMetrica's risk profiling system work?

FinaMetrica's questionnaire comprises 25 questions and generally takes less than 15 minutes to complete.

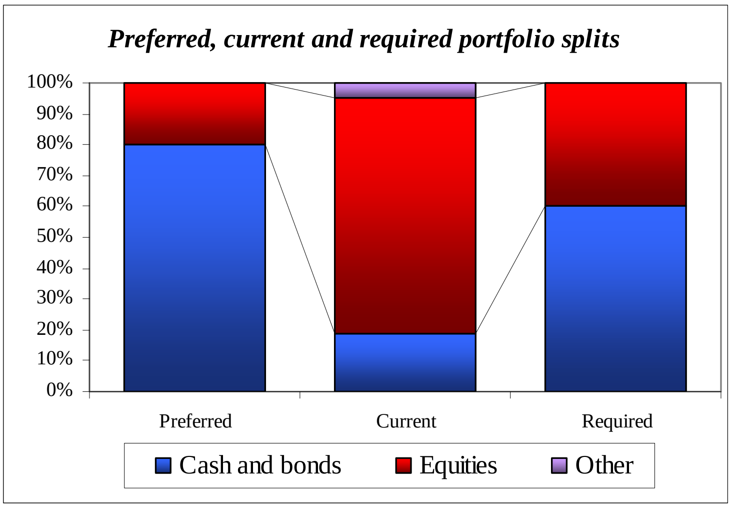
Clients can immediately see what their score is and how this compares with thousands of other completed profiles. Their score is illustrated on a bell curve graph divided into 7 bands. Most people fall into Risk Group 4 (scoring between 45 and 54) – only 1% of test takers have scored lower than 25 or higher than 75.

Bloomsbury's job is to analyse the results of the test. We will always discuss the test results with our clients, both to expand on the information provided by the test and to agree an appropriate asset allocation for the portfolio which takes account both of this and their goals.

Most clients will differ in some respects from the typical individual within their risk group, which will be highlighted by the answers they give to the questions. These answers enable us to determine the extent to which they are – or are not – a typical individual of their risk group, and if not, how that might affect the recommended asset allocation model. We can also determine from the test results what rate of return an individual expects to receive from their invested capital, and assess whether those expectations are reasonable. Crucially, we can also relate the test results to the rate of return the client needs to achieve their goals and discuss any mismatches.

Often a client and their partner may have quite widely differing test results. Again, we discuss this with them and agree an asset allocation with which both feel comfortable.

Having agreed the asset allocation, we can establish to what degree a client's existing asset allocation matches both their preferred and required asset allocations. The results can often be illuminating – with clients' existing portfolios often being far higher risk than they either want or need.



Bloomsbury has been very deeply involved in the trialling of FinaMetrica in the UK. Robert Lockie and Carolyn Corless have held detailed discussions with Geoff Davey, CEO of FinaMetrica, to provide input on how the UK version should be structured.

All of our existing clients have now completed the risk test and the results have been interesting and enlightening on both sides! We feel that having been through this process with our clients, we have a far more in depth understanding of their attitude to risk. The feedback we have received from our clients indicates they have found it a worthwhile exercise, which has given them a greater understanding as well! Where couples have had differing results, this has led to some interesting discussions – with one couple agreeing that the husband's score was so high it was probably best that he not make any financial decisions alone!

Having trialled FinaMetrica's risk profiling system for some months and seen the very obvious benefits it provides to both us and our clients, we are even more convinced than we were before the system was available that this is a vital tool for any serious planner or adviser who makes asset allocation and investment recommendations to their clients. If we underestimate a client's risk tolerance, their portfolios could be too conservative – with the end result that they either fail to achieve their goals, or have to take on much more risk at a later stage. If we overestimate, not only could clients fail to achieve their goals, but we also increase the risk of being accused of recommending unsuitable investments.

Informed decision making is key. We believe that by using psychometric risk profiling our clients are obtaining a better understanding of the choices they are making – and should consequently be much more comfortable with the results.

For further information on this subject please contact one of our Certified Financial Planner ™ licensees listed below.

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