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Rethinking Risk

Searching for a new way to assess risk tolerance.

BY MARIE SWIFT

For many clients, the years prior to 2007 were very good. Portfolio returns were pleasing and they didn't have to pay much attention to their investment strategies. Whatever their professed level of risk tolerance, they may not have perceived the true risk involved in investing in the stock market. Now that the market and clients' "fortunes" have dipped and they are experiencing significant losses in their portfolios (sometimes for the first time in their lives), they may suddenly wake up to what it means to be, for instance, a "moderately aggressive" risk taker.

Does risk tolerance change in a bear market? Geoff Davey, co-founder of FinaMetrica, provider of psychometrics-based risk tolerance questionnaires for advisor use with clients (www.riskprofiling.com), doesn't think so. Psychometrics is the discipline developed for psychological testing for everything from opinion polls and market surveys, through tests of IQ, personality, aptitude, ability, etc.

"Risk tolerance is a personality characteristic, generally unchangeable except in cases where the individual has experienced a major life event," Davey explains. "Risk tolerance is rooted in a person's psyche, describing the place where one strikes the balance between getting a return and experiencing a loss."

According to Davey, the risk tolerance questionnaires commonly used in the financial services industry have typically been developed by compliance, marketing or technical services personnel without regard to psychometric disciplines. "Many do not even test pure risk tolerance, let alone do so accurately," he explains. "As a result, advisors themselves, however experienced in their field, do not necessarily have the skills to accurately measure a client's tolerance for risk."

During the development trials for the FinaMetrica system, as a control to test for sample-bias, advisors were asked to estimate in advance the risk tolerance of clients who were invited to take the test. These same clients were also asked to estimate their own risk tolerance in advance. Both sets of estimates were then compared to actual test results.

"Clients' self-estimates were shown to be reasonably accurate. Estimates made by advisers were shown to be highly inaccurate," Davey says. "In one out of six cases, advisors had made gross errors of judgment. In fact, the advisors would have been more accurate if they had simply assumed that all clients had an average tolerance for risk. And these were experienced advisors dealing with established clients."

Questionable Capacity

Complicating measures of financial risk tolerance is the muddle that results when the issue of "risk capacity" is introduced into a questionnaire. Capacity is a purely financial consideration — how much one could afford to lose and still achieve the stated goals. Financial advisors are well equipped to determine risk capacity — run the numbers and you've got your answer. But, if a risk tolerance measurement instrument includes questions about both risk tolerance and risk capacity, the ultimate measure ends up being a blend of two different things. When the results of a mixed-up questionnaire are used to select an investment portfolio for a client, the selection is likely to be inappropriate as the choice wasn't specifically informed by a clean measure of the individual's risk tolerance.

In the current market environment, advisors are scrambling to address clients' concerns about losses. Many advisors have gotten requests from clients to move entirely into cash to stem losses. Does this mean that the client's risk tolerance has changed? Probably not. As an element of personality, risk tolerance tends to remain fixed in most circumstances.

"We don't think risk tolerance changes, but we're not sure — and we're going to find out," says Davey, whose firm is conducting a longitudinal study of risk tolerance. "What we do know is that clients' perception of risk changes and it is the perception of risk that drives clients' behavior change."

One way to think of the difference is this: risk tolerance is internal, like a barometer for risk; perceived risk is external, an assessment of the client's circumstances including market performance and estimates about the future.

For advisors, what is important to do regarding risk is:

• Use an accurate measurement tool to determine the client's tolerance for risk

• Educate the client about the meaning of his/her risk tolerance score

• Provide a thorough explanation of the perceived risks for the client (including risk capacity), making sure that the risks are understood and agreed to by the client

• Translate the client's risk tolerance and perceived risk into an appropriate investment strategy

• Communicate well the rationale that leads to the particular investment strategy

Some disgruntled investors are desperate to find someone to blame — and that person is often the advisor. Sometimes those clients take legal action. Unfortunately, there have been plenty of situations in which clients were simply duped. That's not what we're talking about here. Rather, we're concerned with the client who may say, "Yes, my advisor had me fill out a risk

profile, but I never realized that I could lose 40 percent of my invested assets with the portfolio strategy he recommended."

An advisor's responsibility to adequately inform clients about the nuances of risk is equally important in any market environment. Explanations and discussions about risk are part of the process that ultimately produces a successful client relationship. Gaining a solid understanding of a client's tolerance for risk as well as his or her objectives, time frame and risk capacity helps create the opportunity to keep that relationship going.

"These are certainly challenging times," says Andrew Samalin, AIF, principal of Samalin Investment Counsel in Mt. Kisco, N.Y. (www.sicounsel.com), "but the fundamentals of how we interact with clients haven't changed." Samalin begins his conversations with new clients with a simple, but non-traditional question. "I ask clients what they don't want to have happen with their investments." Their response to this question enhances the information provided from their risk tolerance questionnaire, and leads to good discussions.

Like many other advisors today, Samalin is double-checking the assumptions used to structure clients' investment portfolios. He is also talking to clients and reinforcing the messages he initially communicated. If a portfolio accurately integrated all of the client-driven elements — such as risk tolerance, risk capacity and cash flow needs — and the efficacy of the investment instruments (how well does it deliver on its "promise"), then he believes the client will understand the risk/return mechanism.

"Assuming the advisor is thorough about doing all those things," says Samalin, "then it all comes down to clear and honest communication. And having a good risk tolerance tool is a good starting point for both the initial and ongoing conversations." Samalin has been using the FinaMetrica risk profiling tool for a while, and is now encouraging clients to retake the assessment during financial reviews. "The market," he says, "has re-priced risk in ways not seen in generations." Client perceptions will follow that lead, and advisors should take notice.

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