

# A View on Risk Profiling



The 2009 Report of the Financial Services Ombudsman shows a large increase in the number of complaints relating to investment (from 711 to 1371). Some of the work we do in this area suggests that the peak of such claims may not yet have been reached. Complaints against intermediaries rose sharply from 259 to 630 and it is fair to assume that a significant number of these relate to investment.

Any broker who has ever faced even a hint of an allegation of mis-selling will have quickly sought out their fact-finding documentation. Having the documentation is a given – the next question is how would your assessment of risk stand up under examination?

The fact that you have asked a number of risk-probing questions of a client and have a signed document recording a conclusion should stand you in good stead. However we live in very different times and what was satisfactory a few years ago could look quite inadequate now. Some of the questionnaires being used look very simplistic in the context of the totally changed emphasis on (and understanding of) risk.

Even where the questionnaire is fairly comprehensive, the basis on which the answers translate into a risk rating can present difficulty –for example, a questionnaire made available to brokers by a leading life company can produce quite a high risk rating despite the client having given an answer that they could not tolerate any fall in the value of their capital.

Our ongoing interest in this area acquired a particular focus when a (broker) client asked us to review the questionnaire they were using: having been underwhelmed by those we had seen, we decided to devise our own. In doing so we drew on the best questionnaires we could find internationally. Our questionnaire is available free of charge on [www.clarus.ie](http://www.clarus.ie).

Because it is available on-line your client will be able to take his/her time to review it and do a trial run(s) before finalising it with you. It also enables the husband and wife to 'debate' the

**Paul McCarville**  
is a principal in  
**Clarus Investment**  
**Solutions**  
...an independent  
investment  
consulting firm



answers in the privacy of their own home rather than squabble in your office!

A key part of our process is the validation (or otherwise) provided by the statements attached to the outcomes. By way of example, the outcome "Growth" is presented in panel below.

The person may well be stimulated through disagreement with one or more of the validation statements to re-do the exercise. Similarly, a bar chart provided as part of the output may highlight one or more answers which are out of step with the rest and worthy of re-examination – this is more likely to be picked up by you the broker than the actual client(s).

People have asked us why we opted for four narrative descriptions (Ultra Conservative/ Cautious/ Balanced/ Growth) rather than the more widely-used numeric rating (typically a number on a scale). While there is an intuitive appeal to the finer graduation provided by a scale from 1-7 or 1-10, we believe that it conveys a somewhat spurious accuracy. We are convinced that a client's risk attitude will be better defined by reference to a set of clear statements than a number off a scale.

From a practical standpoint we believe that having 7 or 10 sets of validation statements would seriously diminish their usefulness. Again, in practice, are brokers going to devise 7 or 10 different portfolios suited to each client 'bracket' ?

There is also some suggestion that members of the Financial Regulator's staff may be questioning the use of funds which have a higher risk ranking than 'the number' attributed to the client. While in the context of a portfolio such an approach would make no sense, using the narrative /broader categorisation leaves the question less likely to be asked.

Clearly, a proper assessment of risk tolerance is crucial and a more refined process can only be of benefit in framing advice. It is also likely to better satisfy the Financial Regulator - the providers of your PI insurance should sleep better too!

## **Growth**

Not risk averse  
Experienced, with a good understanding of markets  
Willing to tolerate significant fluctuations in value  
Can live with prolonged or permanent impairment of capital  
No problem with complexity  
A long term investor – no access required for 7 years+  
Willing to own non-income-producing assets  
Comfortable with new investments/providers