

RISK ANALYSIS

POSITIVE	NEGATIVE
<u>S</u>	<u>W</u>
STRENGTHS	WEAKNESSES
<u>O</u>	THREATS

Risk Profiling
– beware of oversimplification and false precision



A well-designed Risk Profiling Tool (RPT) can be of major benefit to investment advisers and their clients. It brings objectivity and consistency to what is a crucial aspect of the advisory process. The UK's Financial Services Authority (FSA) has acknowledged their worth and both PIBA & IBA advocate their use.

In so far as the Consumer Protection Code (CPC) obliges advisers to align recommendations with the client's attitude to risk, using an RPT helps to be compliant. In due course advisers who lack a structured process with an RPT at its heart are likely to face higher PI insurance costs. {Disclosure: My firm has been offering its own RPT for two years.}

So what is there to be concerned about?

Essentially it is the temptation to regard the process as being far more scientific than it is. There is a range of potential drawbacks:

- a. The complexity of what is being measured should preclude spurious accuracy or certainty around outcomes;
- b. The questionnaires themselves may not be sound;
- c. Understanding of the questionnaire outputs;
- d. Insufficient attention to **capacity to bear risk**;
- e. Mechanistically relating outcomes to volatility-graduated funds or portfolios.

Complexity

The complexity of what is being measured is often under-appreciated: risk tolerance is a complex psychological concept with many factors. Risk Profiling is not like measuring height or weight – it has more in common with the measurement of IQ, if even less exact.

Outcomes **should be accepted as approximations**. In the real world where the client is often a couple, the adviser will be forced to use an approximation anyway.

A considerable body of academic work (much of it Australian) has studied the impact on risk tolerance of gender, age, education, income, and other variables. Perhaps not surprisingly to practitioners, gender has emerged as the most widely-accepted and significant variable affecting risk tolerance. The *Financial Services Review* will shortly publish a study entitled "Risk tolerance and demographic characteristics:

Preliminary Irish Evidence" (Lucey, B, C Larkin and M Mulholland) which corroborates the international findings that women are generally more risk averse and to a degree that is significant. The potential for distortion due to gender or other variables is another reason to favour the use of broader classifications rather than be seduced by the apparent precision of more finely graduated outcomes.

Soundness

It may come as a surprise to advisers to learn that those being used in the UK have been criticised by no less an observer than the FSA. In its March 2011 Guidance Note, "Assessing Suitability", the FSA stated that **9** out of **11** RPTs they examined had weaknesses which could lead to flawed outcomes. Specific concerns related to poor question and answer options and over-sensitive scoring. This document is required reading for advisers as it was compiled following a themed review by the FSA which found widespread inadequacies in the provision of investment advice.

One RPT in common use in the Irish market certainly appears to have a serious flaw: a client can give the answer "I could not accept that my investment may go down in value, even in the short term" and still be categorised as **Very Adventurous**.

A study by Yook & Everett (2003) found that the correlation of the outcomes of six Australian RPTs ranged from **0.3** to **0.8** with an average of 0.56. This degree of variability was disturbing and led to the conclusion that those RPTs did not provide a consistent picture of the same investor. It would be fascinating to have a selection of Irish people put through the various RPTs and see how the outcomes compared.

Another Australian study in this field (Callan & Johnson, 2002) contends that RPTs with a small number of questions should be avoided – they define 'small' as less than 10. Two of the RPTs which are in use in Ireland have 7 questions.

Understanding

In telling a client that they are categorised as 3 on a scale of 1–7 or were scored at 48/100 **what are we telling them?** It depends on the methodology used. A number of widely-used RPTs are based on the assumption that outcomes

are Normally Distributed, and the output metric is designed to position the client on the 'bell-curve' of responses from a large test population. Others attempt to position the client by reference to some representation of the risk spectrum.

If Irish peoples' actual risk tolerance is skewed towards risk aversion (as very many advisers believe) methodologies based on a Normal Distribution systematically over-state outcomes.

Most of the RPTs provide a set of descriptive statements which seek to reflect or corroborate the 'zone of comfort' of the client. RPTs which offer bare numeric outcomes without a form of narrative which is intelligible to the client are probably best avoided. A set of 'plain English' statements is far more powerful than numbers on scales.

Capacity to Bear Risk

Increasingly RPTs offered to advisers by product providers take the outcome and 'guide' straight into a multi-asset fund or a small portfolio of funds. Assuming the providers have assessed the risk of the proposed solution properly, isn't that 'problem solved'?

Absolutely not, particularly if capacity to bear risk has not been addressed. The CPC obliges advisers to take capacity to bear risk into account, though it places far greater emphasis on tolerance. Interestingly, the FSA places the primary emphasis on capacity to bear risk.

Mechanistically Relating Outcomes to Volatility-Graduated Funds or Portfolios

Advisers are going to become familiar in the coming months with the system of risk-rating devised by ESMA (European Securities and Markets Authority). This form of rating uses five-year historical volatility to position funds into one of 7 risk 'buckets' as follows:

Where the RPT uses a scale of 7 (as a number do) it may seem 'obvious' to align the outcomes with the ESMA graduations – this dialogue is already taking place. Alluring as this may appear, there is almost certainly no relationship here which should be relied upon. None of the RPTs in use in Ireland was built with ESMA in mind and any relationships would be accidental.

Think about this: those RPTs based on the Normal Distribution and purporting to cover the risk spectrum will have 50% of outcomes above

and below the average. The ESMA classification is massively skewed towards the low-risk end. Investments with volatility of >20% are not part of most retail product shelves, leaving categories **1-3** covering volatility of up to 5% with **4-6** covering **5%-20%**.

Continuing with the message that there is less science in all of this than people think, historical volatility is a useful reference point which should be used with care. The ESMA ratings may be useful for comparing the relative risk of investments but may not prove a very reliable guide to the absolute risk associated with a given investment. Apart from the huge skew in the ESMA classifications the fact that volatility can be so different from one period to another suggests that it is not a measure to be mechanically bolted onto anything.

Risk Profiling is a valuable tool which advisers should certainly be willing to embrace. However the methodology underpinning the RPT needs to be understood as do any limitations it may have. Any mechanical linkage with funds or portfolios simply on the basis of historical volatility is unwise.

Clearly some kind of model portfolios are a logical progression for advisers and historic volatility will be recognised in framing those models. Of more fundamental importance is an understanding of how the components are likely to interact. Apart from the mathematical outcomes (which software packages can compute) more advanced financial planners will want to understand how the portfolio would be likely to respond to different economic and market scenarios. This is something no portfolio analytics tool will impart.

In conclusion I came across the following quote from Paul Resnik and Geoff Davey who are the co-founders of **Finametrica** (probably the global leader in the area of psychometric investment risk profiling):

"The science lies in the tools the advisor uses. The art lies in the advisor's ability to use the tools effectively, to work collaboratively with clients to obtain an in-depth understanding of their needs, to assist clients in resolving mismatches by identifying and explaining alternatives, and to guide the decision-making process".

The quotation probably attributes a greater degree of science to the tools than is warranted, but the broad sentiments about the role of the adviser are very much shared.



1	2	3	4	5	6	7
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	Volatility Intervals	
Risk Class	equal or above	less than
1	0%	0.5%
2	0.5%	2%
3	2%	5%
4	5%	10%
5	10%	15%
6	15%	25%
7	25%	