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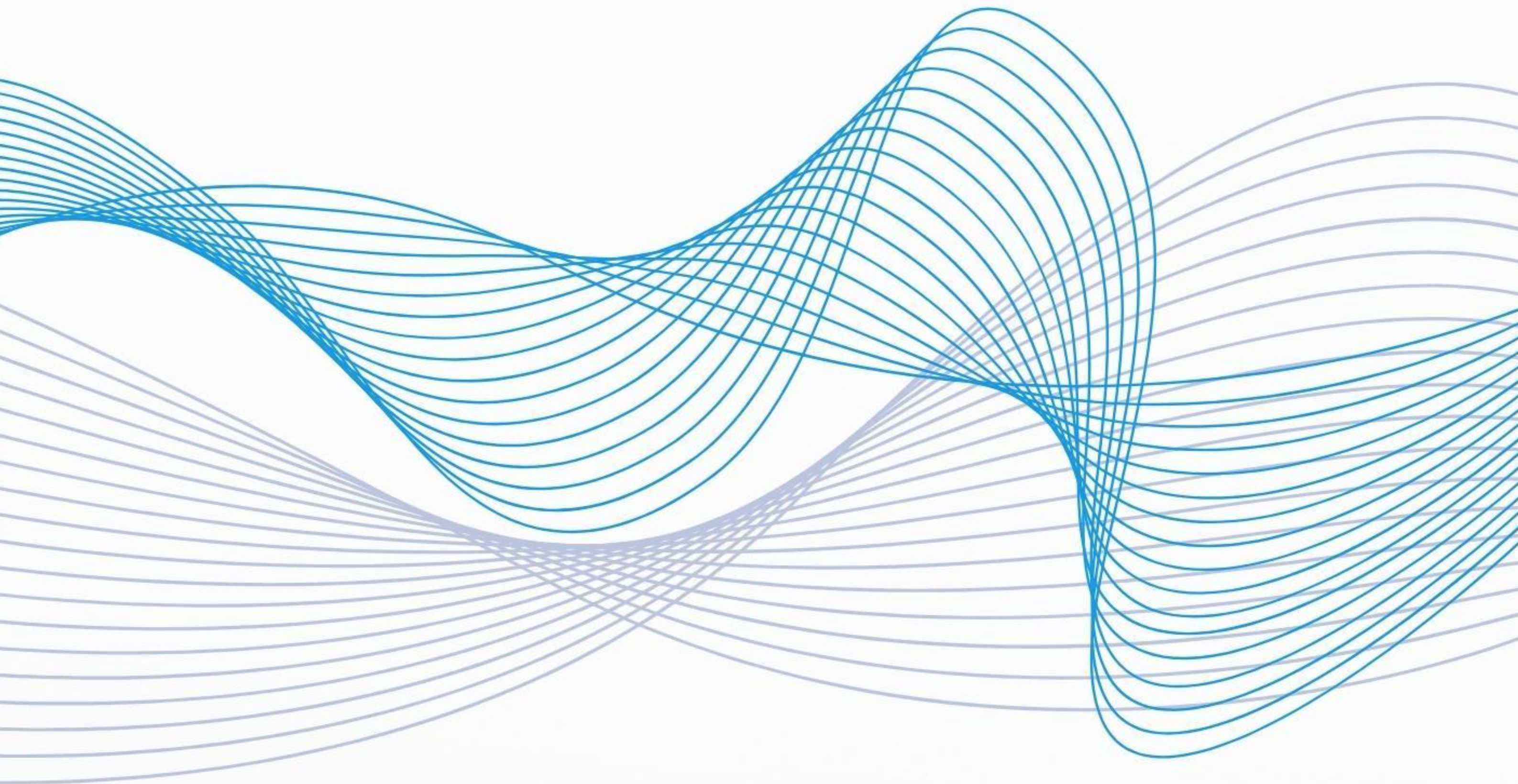

A FRAMEWORK FOR SUITABLE RISK TOLERANCE TEST FREQUENCY WITHIN THE ADVICE PROCESS

The suitable advice institute in conjunction with the Association of Registered Investment Advisers.

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BACKGROUND:

The Association of Registered Investment Advisers (ARIA) have commissioned this research paper into the frequency of risk tolerance testing for advised Indian investors.

This paper is authored by Paul Resnik and Stuart Erskine, in collaboration with ARIA. The objective is to help understand the appropriate frequency of risk tolerance in improving client and adviser outcomes within the suitable advice process.

The Association of Registered Investment Advisors (ARIA) Background:

ARIA was founded in January 2019 as a section 8 not-for-profit company to promote investor interest by elevating the standards of the investment advisory profession in India.

The Intent of ARIA is to:

1. Create a participative community forum of RIAs to meet at regular intervals and discuss matters of mutual interest.

2. Facilitate

    - Surveys/research to comprise industry-wide issues

    - Representation of the community interests to regulator and other stakeholders

    - Seminars, workshops, conferences, and other such events to elevate the standard of RIA practice in India

3. Work towards:

    - RIA Brand building

    - Creating and promoting ethical standards, corporate governance, and professional practices standards

    - Developing a fiduciary industry

    - Growing the RIA community by mentoring new aspirants and transitioning mutual fund distributors

ARIA and the authors have collaborated to help provide registered investment advisors and other intermediaries distributing and advising on financial products, a reference point regarding risk profiling frequency. The intention is to help adopt international best practices in the field of risk profiling frequency, as well as what constitutes a good risk tolerance test.

BACKGROUND OF THE AUTHORS:

Paul Resnik: Paul is an innovator in financial services which includes, founding investment platforms and fund supermarkets, cash-flow modelling technology, and global risk profiling technology: FinaMetrica. For over 30 years Paul has been at the forefront of improving the advice process for both clients and advisers. Paul's contribution to developing suitable advice particularly in assessing risk is probably unparalleled. Paul is Chief Ethics Officer of the Suitable Advice Institute.

Stuart Erskine: Stuart has an academic background with a Master's degree in Economics, specialising in Behavioural Economics. Stuart is the co-author of a number of papers with Paul Resnik in the area of financial risk and risk profiling. Stuart also co-authored the technical manual for FinaMetrica for a number of years which included extensive evaluation of the million-plus tests completed in many countries since 1998, including India. Stuart has developed a number of risk profiling tools and helped adviser firms improve the accuracy of their risk profiling process.

CONCLUSION/EXECUTIVE SUMMARY:

The findings contained herewith are based on publicly available data which will be referenced and risk tolerance test data, which for reasons of anonymity will be presented unattributed; The exploration of the optimal frequency of risk tolerance testing is best examined under extreme events to test and give insight into the stability of this personality trait.

As part of the research for this paper, the authors reviewed risk profiling data in light of the Global Financial Crisis (GFC) (2009) (sample size 2,408) (data provided by Finametrica) and The Pandemic 2020 (Sample size 25,843) to better understand the impact of major events have on the stability of risk tolerance.

The conclusion is that these events have impacted risk tolerance scores. The evaluation has been carried out using test scores prior to the events and then re-testing the same clients post the events.

Please note that the authors wish to highlight that while the events are both significant The Post Pandemic test data was collected early on in the pandemic before the current emerging financial crisis.

The authors conclude that the working assumption is generally true: risk appetite remains stable on average. However, for some clients, there is an impact to the risk tolerance score and sensitivity to major events. On a scale of 0-100 (with 0 being very low-risk tolerance and 100 being very high-risk tolerance and 50 being an average) a drop of more than 10 points becomes material, moving the client into another risk category.

The authors following their research recommend the following risk tolerance test frequency approach:

1. Client Onboarding; the adviser should undertake a risk tolerance test as part of the “know your client”.

2. Annual Review: At each annual review the adviser needs to explore the client's risk tolerance level and document it. Should advisers believe the clients’ risk tolerance level has changed significantly since the last client contact, then a risk tolerance test should be completed

3. Changing Client Circumstances: If client circumstances have **materially** changed eg as a consequence of health; divorce; marriage; wealth level; retirement; children; significant financial priorities and objectives - then a full risk tolerance test should be completed.

4. Major Economic Events: Good communication and connection is at the heart of the financial advisers’ relationship with their clients. Given that some clients may be less “Traited” and therefore sensitive to news about negative economic events, advisers should consider triaging clients according to risk tolerance level identifying clients at the lower risk tolerance levels ; with a view to contacting in the event of bad news to explore the clients’ risk tolerance level and document it. Should the adviser believe the clients’ risk tolerance level has changed significantly since the last client contact, then a risk tolerance test should be completed.

Impact of Major Financial Crisis on Risk Tolerance Scores:

The evidence emerging shows the impact for those affected by major financial events is greater for those clients with a lower risk tolerance; major (negative) financial events appear to reduce their level of risk tolerance.

The authors posit a theory that personality type may play an important part in the sensitivity of clients to news of financial crisis; currently, there is very little research in this area to confirm the validity of this theory that the "news" of financial crisis interacts with a client's personality more for those of a more nervous disposition (Neuroticism in The Big Five Personality Traits)[1] and that those with Neurotic personality type may have a greater propensity to lower risk.

The authors are developing a theory that personality type plays an important part in determining how sensitive and reactive clients are to (news of) financial crisis. Further, that clients with dominant Neuroticism personality trait (The Big Five Personality Traits)[1] may have a greater propensity to being lower risk tolerant with sensitivity to news of financial crisis; resulting in reducing their risk tolerance in the face of bad news of financial crisis.

The evidence suggests that at the lower end of the risk tolerance spectrum, around 2% of clients experience a meaningful drop in risk tolerance score post a crisis. This drop would put those clients into a new lower risk category; to a point whereby their original portfolio may no longer be appropriate for their "new" stated level of risk.

More broadly, at the lower end of the risk spectrum, 15% percent of people experience a drop in risk tolerance score but not necessarily to the point whereby their portfolio requires adjustments to their portfolio; but may require communication with the client to allay potential fear.

Warning: even if there is a material change to the risk tolerance score this does not mean that the client's portfolio will need to be adapted to reflect the change. Remember risk tolerance is only one factor, as advisers are aware other important factors come into play when giving suitable advice; risk capacity, risk required to meet objectives, time frame and other personal circumstances. It will therefore be dependent on the dominant factor.

WHY DO WE HAVE RISK PROFILING?

In an ideal world of perfect information, there would be no need for risk tolerance testing, a client would be able to articulate their risk score clearly. However, the world is imperfect, and the clients often have little financial knowledge or experience therefore need to be asked questions they know the answer to, in order to proximate their attitude to risk. It is not appropriate to rely on an adviser's professional judgment alone. Each assessment would be distinctive and therefore incomparable.

Paul Resnik, through his work, has assessed that most advisers score a higher risk tolerance than their clients; to avoid the adviser projecting their bias onto the client and influencing them to take more risk it is important to use a third-party tool.

Psychometrics is a social science; it is an art, not an exact science; it is the methodology that deals with the measurement of personality and attitudes including the application to testing (investment) risk tolerance.

Risk tolerance being a personality trait for how much risk one is willing to take in financial matters. The underlying assumptions to most risk profiling tools is that risk tolerance is normally distributed. The average person has average risk tolerance. Therefore, most tools are in effect concerned with identifying the exceptions (higher or lower) away from the average.

Defining Risk Tolerance, Risk Capacity, and Risk Required

Risk Tolerance: (financial) risk tolerance is often used as a catchall term for many risk-related concepts. "The specific meaning defined by Cordell (2001)[2] stated that financial risk tolerance is the maximum degree of uncertainty someone is willing to accept when making a financial decision that entails the possibility of a loss. This statement matches well with the International Organization for Standardization's (2006) definition that financial risk tolerance is the extent to which someone is willing to experience a less favorable outcome in the pursuit of an outcome with more favourable attributes.

When framed this way, financial risk tolerance is distinct from concepts such as risk preference, perception, capacity, need, or composure."[3]

RISK TERMS	DEFINITIONS
Risk aversion	The inverse of risk tolerance.
Risk capacity	An objective evaluation of an individual's financial ability to withstand a financial loss.
Risk composure	An individual's propensity to behave in a consistent manner; sometimes called risk appetite (Carr 2014).
Risk need	The amount of risk an individual needs to take to reach a financial objective; typically based on a predetermined required rate of return.
Risk Perception	A subjective evaluation, based on a cognitive appraisal, of the riskiness of a decision outcome.
Risk Preference	An individual's general feeling that one situation is better than another.
Risk Profile	An amalgamation of factors that help shape an individual's risk-taking behavior.
Financial Risk Tolerance	The willingness to engage in a risky behavior in which possible outcomes can be negative.

FINDINGS:

The Authors findings are consistent with published papers: “Statistically, post-GFC risk tolerance scores are lower than their pre-GFC counterparts. However, the magnitude of this difference is economically small. When changes in financial risk tolerance are modelled, there is evidence of stability across the overall sample, with the mean individual change in tolerance quite small and not statistically significant. We confirm in the analysis of this change that the impact of the GFC on risk tolerance is small. However, there is some evidence that the drop in scores in absolute terms is larger in both tails of the distribution, implying larger relative drops for those with lower risk profiles.” [4][5]

Baumeister and Tice (1988)[6] introduced the term "traitedness" to describe the extent to which people exhibit a personality trait in their behaviour across different situations and contexts. They argue that people differ in how consistently they will exhibit a (personality) trait. Remember risk tolerance is a personality trait. Baumeister and Tice (1988) define a person as “Traited” when they exhibit stability in a personality trait. It is well established, in the psychology literature, that some individuals are more “traited” than others in consistently expressing or demonstrating that trait (Bem and Allen 1974)[7]. Individuals who are weakly “Traited”, tend be less predictable in their behaviour (LaHuis et al. 2017). [8]

Therefore, based on data available to the authors, their experience, and published papers the authors conclude that the optimal frequency for re-testing a client’s risk tolerance to capture any potential changes is at the **annual review.** This is in addition to re-testing at any material change in the clients' personal circumstances. Re-testing annually is particularly important for clients at the lower risk tolerance end of the spectrum. Indeed, segmenting clients by risk level may be useful to improve client outcomes when communicating in both terms of speed and approach. This furthers the authors’ opinion that at the heart of the issue is clients’ personality type. Clear communication with the client is likely to be key to stable client outcomes. Preventing client behaviours that in essence may be self-harming.

This is consistent with FinaMetrica Global Financial Crisis (GFC) Survey Report: “Major life events have been known to cause permanent psychological change. For some clients the (GFC) crisis might have been a catastrophic life event and their scores might have decreased dramatically, bringing the average down.” Geoff Davey October 2009.[9]

Major life events that **materially** impact (reduce) a client’s level of risk tolerance may be client specific too e.g. as a consequence of health changes; divorce; marriage; wealth level; retirement; children; changing significant financial priorities and objectives.

THE IMPORTANCE OF USING A GOOD RISK TOLERANCE TEST:

Due Diligence:

The objective of risk profiling to improve client outcomes is defeated if the risk tolerance test itself is not fit for purpose. Selecting the most appropriate tool is the responsibility of the adviser, or the adviser's employer. The authors have listed a link to the due diligence checklist which will help guide the adviser to select a reliable and effective tool. The authors have also set out below good and bad examples of an approach to risk tolerance.

Advisers with limited technical knowledge of risk and psychometrics can undertake due diligence to select good quality risk profiling tools. The starting point for due diligence is “ On reading the questions in the questionnaire: Do they make sense to you? Can you understand them? If not then there may be an issue; clients may struggle to interpret the questions, the report will likely be inaccurate and the final advice possibly flawed. Does the content and wording of the questionnaire appear valid in as much as the questions actually relate to financial risk tolerance? The questions should be related to the topic of financial risk, if not then the test may not be valid. Are there a variety of questions? Do they differ from each other? Is there any repetition? You need to see variety, not the same or similar question asked multiple times, otherwise the questionnaire will not be valid (know as Face Validity). Assessing the design provenance: has the questionnaire been designed by relevant field experts/academics (i.e. with financial sector and statistical experience)?Can those academics be referenced and verified?” For full due diligence check list, please see:

Risk Profiling Due Diligence Checklist

The U.K. regulator has a good perspective derived from consultation with the advice industry.

“Getting risk profiling right is a key issue for financial firms. Following research in 2010, the regulator concluded that 50 per cent of clients suffered misaligned risk profiles and strongly advised firms to understand the limitations of risk-profiling/asset allocation tools. Of 11 tools reviewed, the regulator found that nine had serious weaknesses and led to flawed outputs.” FT Adviser 25th January 2016

“Some firms unduly focus on the risk a customer is willing to take and fail to take sufficient account of the customer’s other needs, objectives and circumstances: for example failing to consider whether the customer would be better placed repaying debt, or failing to select an investment that meets a customer’s need for access or the term for which the customer wishes to invest. While attitude to risk is an important consideration, suitability is not just about making investment selections that reflect a customer’s attitude to risk” The UK Regulator is The Financial Conduct Authority (FCA) Assessing paper.[10]

The tool should not represent a black box to the adviser, they have a duty to understand the tools they use. So, any tool should come with the provision of technical support, training and an understandable technical manual. The manual should detail the academic research and independent testing and scrutiny; demonstrating the reliability (a Cronbach Alpha score of internal consistency of

above 0.5). Ultimately the question to ask yourself as an adviser is: “are you able to articulate and demonstrate an understanding of the tool?”

Example of Good Practice:

“A firm produced regular management information on the results of the risk-profiling tool used. It included information on how the results are distributed across the different risk categories and how this compares to what would be expected given the firm’s customer base. It also included information on the number of customers whose final risk categorisation is different to that indicated by the tool including information on the numbers that have moved by more than one category.” FCA Assessing Suitability.

So, there are circumstances in which the portfolio can be different from what the risk tolerance score suggests. For example, many clients may not be able to achieve their investment goals, so they have the option of changing the amount they invest, changing the time frame, or changing the risk level they are prepared to accept or combination of all of these factors.

Example of Poor Practice:

“A firm adopted a methodology in which the customer simply picked a number on a scale (of 1-10) where one end of the scale was described as low risk and the other described as high risk. This was a problem because the risk represented by each number was subjective. There was no certainty, in the absence of any other information, that the customer and the firm had the same interpretation of the level of risk a particular number represents.” FCA Assessing Suitability.

International Perspective on Risk Profiling:

The British Experience: The UK Regulator the FCA as published widely following consultation and research across the financial service sector regarding advisers assessing investment suitability for clients:

https://www.fca.org.uk/publication/finalised-guidance/fsa-fg11-05.pdf

The UK FCA Know Your Client (KYC) principle is appropriate internationally:

“You must obtain the necessary information from the client to be able to make a suitable recommendation. This includes:

- their financial situation
- their investment objectives
- information on a number of issues relating to risk, ie the client’s risk profile (attitude to investment), capacity for loss and knowledge and experience of investments”.[11]

The Indian experience: The authors have been provided with data from a risk profiling tool used by Indian based advisers. It is clear from this data that there is a marginally higher risk tolerance amongst India advisers’ clients. On a scale of 0-100 with (global) average risk tolerance of 50, India clients

average a score of 53. The explanation for this is the skewed population; the majority of those tested are younger males, with a higher education, which is a demographic tending towards higher risk tolerance.

Like many countries India is a patriarchal society. A recent survey suggests that "66% single women do not make their own financial decisions. When it came to married women, the number of women not making independent financial decisions increased to 69 per cent with the fathers being replaced by husbands or joint decision making. As women evolve in their life stages, they become less independent in taking money decisions." [12]

The Canadian experience (the Ontario Securities Commission): "[In short,] there are a wide variety of factors that go into the determination of a client's risk profile, selecting products that are suitable and that the client will 'stick with' in times of financial crisis. Based on the academic definitions, we have tried to illustrate the various factors, why they are important individually and how they relate."

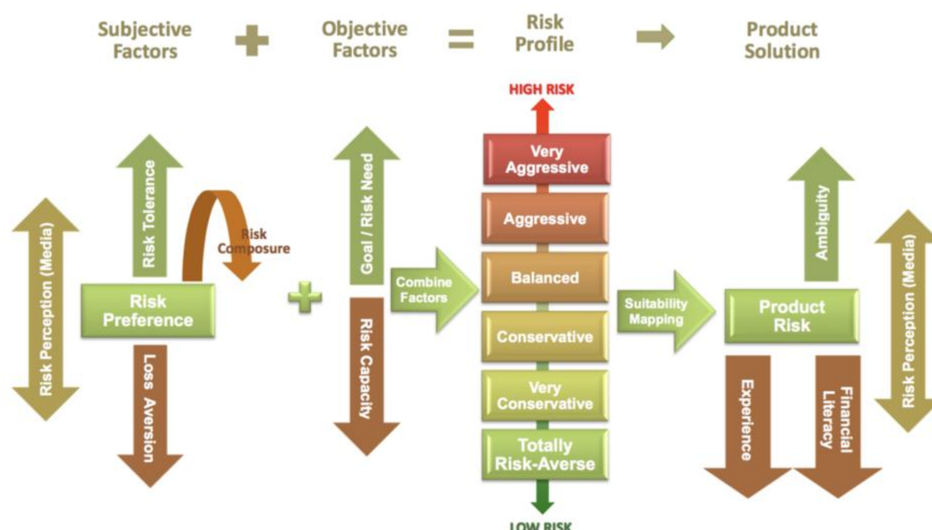

Figure 1: Visual Summary of Risk Concepts [13]

The Australian perspective: Paul Resnik (& FinaMetrica) developed five suitability proofs[14]; guidelines to ensure that customers' needs are at the centre of the advice process:

1. *Prove you know the client's circumstances, needs and aspirations*

Advisers need to have a thorough understanding of clients' circumstances, goals, risk tolerance and risk capacity. The client's goals include financial and lifestyle goals. Risk tolerance is an important factor that the adviser must assess and take into account. Where couples are involved, the adviser needs to know the risk tolerance of each person as the financial plan impacts them both. Effective risk profiling is a key contributor to confidence in advice.

2. *Prove you have explored alternative financial behaviours and strategies*

More often than not, clients can't achieve their goals with the resources that they have available. Here, advisers must explore alternatives with clients and the possibility of achieving goals through different means. The trade-off decisions themselves must be made by the client according to his or her values rather than by the adviser, who is there to guide the process.

3. *Prove you know the products and services being recommended to a client*

Once you have decided on an investment strategy, you must be able to prove that you know the products and services being recommended to clients as part of that. The clients should have their investment expectations appropriately framed by the adviser. Importantly, the adviser must explain product details to clients in a language they are likely to understand.

4. *Prove you have explained to the client the risks in the plan and the products through which the plan will be implemented*

The adviser must show they have explained to the client the risks in the financial plan as well as the risks associated with individual services, investments and products. Clients need a clear understanding of the expected performance of investments and, in particular, the downside risk on their portfolio.

5. *Prove you received the client's properly informed consent to accept those risks*

The adviser needs to demonstrate with evidence that the client has given their informed consent to the plan and that the risks have been fully explained and the client has accepted those risks.

Examples of Poor Risk Tolerance Questions in Practice:

"Questions used to assess the risk a customer is willing and able to take:

1. With the money you have to invest, would you select:

   (a) a product where there is very low risk of losing your money and the return is 5% pa on average; or

   (b) a product where you could lose up to 15% in a year and the return is 10% pa on average; or

   (c) to split your money between the two products?

This question is complex, assumes a high level of mathematical and financial ability, and assumes that all customers will be able to identify an accurate reflection of their preferences in the three options provided.

2. Placing some of my money in risky investments is something I like doing.

(a) Yes

(b) Sometimes

(c) No

This question assumes investment experience and fails to quantify the amount of risk or money involved.

3. When do you need to get back the money you invest, or start receiving an income from it?

(a) 1-4 years

(b) 5-10 years

(c) Over 10 years

This question asks two questions in one – the customer might need income from the investment immediately and capital return at a later date" FCA Assessing Suitability

EXPLORATION OF BIAS IN DECISION MAKING:

Knowledge of human behaviour, particularly bias in decision making is important for advisers to understand their clients:

We know humans are not rational, we are all emotional, and our personality type can influence our decision making.

Relating to financial matters, bias can be understood as decision-making that leads to sub-optimal outcomes. For example, present bias may lead to impulsive spending now, so that people don't save sufficiently for retirement; because they give little weight to future events.

Individuals do not necessarily act rationally and consider all available information in the decision-making process because they are influenced by behavioural biases.

In understanding consumer decision-making, the comparison of observed behaviour is typically made against standards of rational or optimal behaviour. A behavioural decision-making bias is defined as a choice which deviates from these standards of optimality.

People can be thought of as engaging in two types of thinking when making a choice between, say, different investment opportunities. System 1 "intuitive" thinking is fast, automatic, relatively uncontrolled, associative and inflexible. System 2 thinking ("reasoning") is slow, deliberate, controlled and flexible. Whilst consumers do use both types of thinking, it is normally type 1 thinking which governs much decision-making. Thinking, fast and slow Daniel Kahneman.

There is much literature on covering decision making and bias; it is important for advisers to have awareness of some natural human biases as risk profiling and the advice process exists to improve client decision making and improve outcomes; in effect to overcome bias.

Example of Relevant Bias:

Loss Aversion: People tend to strongly prefer avoiding losses than obtaining gains. The implications of loss-aversion are clients over-represent safe investments and under-represent risky investments in their portfolios, in relation to objective relative performance of these items. The avoidance of short-term stock-market losses contributes to this phenomenon.

Bandwagon Effect. This is a form of herd instinct, describes gaining comfort in something because many other people do (or believe) the same - individual decision making is influenced by the crowd. It's why financial bubbles exist.

Availability: The availability heuristic demonstrates how ease of recall can make a phenomenon seem more likely to occur. Additionally, an easier to imagine scenario is perceived to have a higher chance of happening than one that is harder to imagine

Anchoring Bias: The tendency to rely too heavily on a past reference or one piece of information when making a decision.

Risk Composure: This describes how a client will actually behave when faced with financial loss. The likelihood that in a perceived crisis, individuals will have a tendency to behave emotionally which is fundamentally different to their rational self eg selling or buying. Risk composure describes how an individual will actually behave when faced with a financial loss. Often reflecting on the clients past behaviour during a previous market downturn can be one of the best predictors of the true tolerance for risk.

Disposition Effect: Individuals want to sell an asset that has increased in value and resist selling an asset that has declined in value, often hanging on too long.

Overconfidence Bias: occurs when a client's subjective confidence in their own judgements is greater than the objective accuracy of those judgments. An overconfident decision-maker may both overestimate the accuracy of their judgements and view the accuracy of their judgements as greater than that of others; it can lead to bad investment choices resulting from failure to recognize informational disadvantages, an under-reaction to new information, over-investment in speculative markets and excessive trading volumes (especially in bull markets).

Framing bias: Presenting a problem, information or a situation affects the ultimate outcome or final decision of a client.

Suggested reading:

Cognitive Biases as an integral part of behavioral finance

Cognitive Biases that can lead to investment mistakes

Cognitive Biases in Behavioral Finance

The Importance of Pulling the Strands of Behavioural Bias of Adviser and Client Together:

The use of tools an a repeatable process help reduce bias, for example in the absence of a risk profiling tool the adviser, who on average will have a higher appetite for investment risk than the client, may inadvertently influence the client ending up in a situation where the client is taking more risk than they ideally want.

For the same reason couples should complete risk profiling separately and then the results compared and discussed, rather than one influencing another at the outset.[15]

RECOMMENDED RISK TOLERANCE TEST FREQUENCY APPROACH:

1. Client Onboarding; the adviser should undertake thorough risk tolerance test as part of the “know your client”

2. Annual Review: At each annual review the adviser needs to explore the clients’ risk tolerance level and document it.

3. Changing Client Circumstances: If client circumstances have **materially** changed eg as a consequence of health; divorce; marriage; wealth level; retirement; children; significant financial priorities and objectives - then a risk tolerance test should be completed.

4. Major Economic Events: Good communication and connection is at the heart of the financial advisers’ relationship with their clients. Given that some clients may be less “Traited” and therefore sensitive to news about negative economic events. Advisers should consider triaging clients according to risk tolerance level identifying clients at the lower risk tolerant clients; with a view to contacting in the event of bad news to explore the clients’ risk tolerance level and document it. Should the adviser believe the clients’ risk tolerance level has changed significantly since the last client contact, then a risk tolerance test should be completed.

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