

## Risk Profiling

### Has the financial advice industry got it right?

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Over the past seven years I have looked at many financial advice businesses both large and small and I have been very active in giving expert opinions in litigation involving financial advice. So the point is that I have seen many forms of risk profiling and there appear to be three broad methods.

One is the pure psychometric method that is offered by FinaMetrica. The other more common method is a simpler set of questions where the answers are weighted and equated with an asset allocation. The less common method is where the adviser explains the source of risk, return and volatility and relates those to a series of model portfolios and asks the client to choose.

All of these methods assume that the process of risk profiling is linked to the psychology of the client and their emotional reaction to market volatility. There are two problems with this. The first is that the outcome of these methods will reflect the recent experience of the client. When markets have been strong most clients will produce a risk profile result that will indicate they are very tolerant to volatility. However, if we profile them again in two years time after they have lost money, we may get a different result reflecting that they are not tolerant to market volatility. The second problem is that financial advisers are not psychologists and I question the wisdom of expecting us to link a person's psychological profile with an asset allocation. Or even the relevance of this.

Why are we doing this?

In Regulatory Guide 175.104 (d) and (e), ASIC tell us that we need to account for a client's:

- “(d) tolerance of the risk of capital loss, especially where this is a significant possibility if the advice is followed;
- (e) tolerance of the risk that the advice (if followed) will not produce the expected benefits;”

We seem to have interpreted ASIC's use of the word, “tolerance” as meaning emotional tolerance and that is why we have gone down this path of trying to link a psychological profile to asset allocation. I interpret the word “tolerance” in the contextual sense to mean financial tolerance and this means that we need to ask the question, “how would the financial capacity of the client be affected if they suffered capital loss or the expected benefits were not delivered?” To me, ASIC is asking us to do a simple sensitivity analysis to test how the probability of different outcomes would affect the financial capacity of the client.

When you really think about it, the logical way to plan for a client is to follow this process.

1. What are the finite financial resources that are available?
2. What is the time period for investment?
3. What is the measurable objective?
4. What asset allocation has the highest probability of achieving the objective?

That's it. Of course you would give the client an expectation of the volatility experience that they can expect and if they were not happy with this, they could either adjust their financial resources or the time period or their objective and we could then apply a different asset allocation with a different volatility outcome.

You would also conduct a sensitivity analysis to look at the client's position if the outcome achieved the maximum or minimum of the standard deviation of the portfolio (thus satisfying RG175.104(d) and (e)).

In some of the legal work that I have done, I have looked at a lot of the more common simpler questionnaires used for risk profiling and compared the outcome with what is known about the client. In some cases the risk profile outcome had been ignored by the adviser and in some cases it conflicted with known facts about the client. What has become clear is that some advisers place more value on completing these questionnaires so that they can demonstrate that they are compliant rather than engaging them as a serious tool to assist in formulating advice. I can only conclude from this observation that some advisers place little value on the outcome of these risk profiling questionnaires.

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