

Measurement of Client Risk Tolerance:

How Improving Methodology
Could Offer Advisors a
Significant Competitive Advantage



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Hopefully the worst of the COVID-19 pandemic is behind us, but looking ahead, there is no doubt that it accelerated pre-existing trends related to financial advice technology and the expectations of individual investors for the advice fees that they pay. On top of the pandemic pressures, the ongoing introduction of new and more demanding regulation like “Regulation Best Interest” in the United States, “Client Focused Reforms” in Canada and the “Royal Banking Commission” in Australia have layered on a greater burden of proof for advisors to demonstrate that the advice they deliver is in the client’s interest, not theirs.

Against this backdrop, we are compelled to rethink what it means to assess a client’s risk profile and align it to products and portfolios that are in the client’s best interest. Can new processes provide a strong competitive advantage that meets or exceeds new regulatory requirements and, more importantly, leads to better investor outcomes?

Why We Care About Risk

For advisors, the stewardship of people’s money already comes with a heavy responsibility and increasing compliance costs. At the same time product-related fees are declining, and client expectations are increasing. COVID took away the traditional face-to-face meetings where advisors relied on connecting emotionally to build relationships and get to really “know the client.” Advisors became another digital channel but still needed to demonstrate the value they bring to the client if they want to retain them for the long run.

The good news is that interest in investing is getting stronger, and financial advisors are reaping some of the benefit. Fifty percent of independent advisory firms in the US added more clients in 2020 than in previous years according to an annual survey of registered advisory firms by Charles Schwab & Co., and many reported younger and more tech savvy new clients.¹ Many individuals are seeking help because times are uncertain. We have seen increased volatility over the last two years, amplified by a market crash and amazingly fast recovery, massive job layoffs and the following wave of stimulus checks, an employment rebound and continued resilience, rising inflation, and most recently regional bank failures in the U.S.

While uncertainty has led some to seek trusted advice, others have decided to go it alone. Finder², a global financial information intermediary, released a study indicating that over 3 million Canadians (10.1%) were planning to stop using a financial advisor in 2021, with another 15% seriously considering this action, driven primarily by Millennials and Gen Z jumping on the “do-it-yourself” train to deal with an unprecedented five times increase in savings rates from pre-pandemic levels. These younger investors, who are often not targeted by advisors compensated based on assets under management, found themselves with growing investment accounts driven by unexpected equity gains, and no significant experience to temper their feelings of invincibility.

¹ <https://www.aboutschwab.com/schwab-independent-advisor-outlook-study-2021>

² <https://www.finder.com/ca/financial-advisor-report>

Although 2020 was a roller coaster for the markets, the COVID crash was actually brief. Markets dropped 30% in 30 days but recovered over half of that in the next 30 days. People hardly had time to react before markets continued their march upward to end the year with double-digit gains. It's not surprising that 2020 left more folks excited than scared. But the tables turned again in 2022, as inflation roared, the U.S. stock market shed 20%, and U.S. bonds, normally a safe haven, also dropped over 10% as the Federal Reserve hiked rates ever higher. 2023 through March has seen stock and bonds again on an upward trajectory, but still well below 2021 highs.

³ Browning, C. and Finke, M. "Cognitive ability and the stock reallocations of retirees during the Great Recession." *Journal of Consumer Affairs*, 49(2), 356-375 (2015). doi: 10.1111/joca.12065/

While our current bout of volatility is still playing out, we can reflect on the financial crisis of 2008, which saw markets drop over 5 months and take 4 years to return to previous highs. During that time about 57% of U.S. households reduced their equity holdings beyond what could be explained by market returns, according to the *Journal of Consumer Affairs* research paper "Cognitive ability and the stock reallocations of retirees during the Great Recession."³ The study found that about 10% of households had more than a 65% reduction of equity holdings, 15% of the participants had between a 30% and 65% reduction, and another 15% had between a 15% and 30% reduction. These decisions to lower equity holdings after a steep market decline likely solidified their market losses, with those investors missing out while the market began its multi-year recovery in March 2009.

Several factors may have led to this costly behavior: Clients may not have had access to good advice, the assessments of client risk tolerance may have been overestimated, or the risk levels of the portfolios may have been simply too high. Regardless of the cause, the effect was a massive loss of hundreds of billions of dollars by retail investors.

Investors are not the only ones to lose out. On average, 20% of clients leave their advisor within the first year, according to a study by Spectrem Group.⁴ When asked why, the three top reasons were:

⁴ Report: "Client Retention: Why Clients Leave and Five Ways to Encourage Them to Stay." E*Trade Advisor Services (2019).

- ▶ Lack of good service and personal communications,
- ▶ Lack of understanding about the client's overall financial goals, and
- ▶ Poor understanding of the client's willingness to take risk.

About 31% of investors with \$1 million to \$5 million in assets said they left because the advisor didn't understand their risk tolerance. The Ombudsman Service for Banking and Investments in Canada has reported for several years running that, "the leading investment issue across products was suitability of the investment."⁵

⁵ OBSI's 2019 Annual Report

So, getting risk wrong can result in direct losses for retail investors as well as lost clients and legal and regulatory complaints for advisors. And now the regulatory bar is being raised again. So why is this so hard to get right?

Limitations of Traditional Risk Assessments

Peter Drucker said, “you can’t manage what you can’t measure.” Let’s face it, most compliance systems used in financial services today are built on administrative processes developed decades ago within the bounds of what could be measured at that time. The process typically looks something like this:

- ▶ Define a series of five or six bands that include profiles like very conservative, conservative, balanced, aggressive and very aggressive.
- ▶ Create a questionnaire that asks all the questions the regulator might want to see answered, then create a scoring model to assign investors into one of the bands.
- ▶ Assign risk levels to the product shelf. Usually, cash and money market funds go into the very conservative Band 1, fixed income into the conservative Band 2, balanced funds into Band 3, developed market equities in Band 4, and other equities (country specific, sector specific, etc.) into the “very aggressive” Band 5.
- ▶ Because investment products come in many flavors, use a rolling standard deviation as a measure of the product’s risk and the band it belongs in.
- ▶ When firms have relatively sophisticated systems (not everyone does), all the investments can be combined and measured based on the same rolling basis for the aggregate portfolio, allowing advisors to demonstrate the value of diversification (i.e., the client can own some products that are Band 4 or 5 and some that are Band 1 or 2 and arrive at a balanced portfolio overall).
- ▶ The suitability process then dictates, if the investor is determined to be “balanced” they get sold products from the balanced group, or that their portfolio volatility should stay in the range appropriate for balanced (Band 3).

Although this seems administratively simple, we know categorizing tens of thousands of unique products is far from easy, and there are ongoing and unending changes in investors’ risk levels and product risk levels. Telling an investor, “You are ‘balanced’ along with 100 million other Americans” is far from personalized and possibly not in the client’s best interest.

Many advisors consider risk profiling questionnaires a compliance requirement, but one that offers no insights and no value to the advisory relationship — it is another form that must be filled in. Many advisors trust their own judgment and frankly put little or no stock in the questionnaires they are obliged to use. If asked, advisors will often say that they do not work, and an investor’s profile changes in a market crash regardless, so a client might be aggressive as markets climb but revert to conservative after a market drop.

And while clients are feeling stressed from a market downturn, investment products may also be recategorized. For example, in a period of growth and stability, many balanced funds or portfolios might be categorized as moderate risk. Then a crash happens, such as in 2008, and those same investment vehicles may suddenly be deemed appropriate only for “aggressive investors” because the standard

deviation increased dramatically. In such a scenario, advisors might be obliged to move clients out of newly reclassified “aggressive” investments into something more “moderate,” crystallizing losses and setting them up to miss out on the inevitable recovery.

So traditional systems are basically a bulk categorization of investors and products into a limited number of groups. Depending on the tools and processes used, the measures of both risk tolerance and the risk classification of the products are themselves potentially unstable, adding to the confusion and costs incurred by consumers, advisors, and firms during market crashes. Better a blunt instrument than no instrument at all, but in a world where consumers can see personalized and targeted ads in their browser moments after any search, why should investors expect to be treated like another cog in the wheels of the advisors and institutions managing their accumulated wealth?

Improving Risk Profiles

In imagining a better solution, let’s first debunk a common belief in investing, that a client’s risk tolerance changes as the markets rise and fall. Risk tolerance is an individual’s willingness to take risk to achieve better financial returns. It is a psychological measure and is best determined and monitored over time with a psychometric tool.

Not all questionnaires that claim to measure a client’s risk tolerance are created equal. Some questionnaires use what have been called “revealed preferences” and focus on risk aversion or the point at which an investor will become overly uncomfortable, using questions framed as gambles.

Other questionnaires take a psychometric approach. The science of psychometrics is the marriage of psychology and statistics, providing standards for evaluating tests and sorting good questionnaires from bad. Through psychometrics, we can determine if a test is good: namely, it must be both valid — measures what it purports to measure, and reliable — measures consistently over time with accuracy. A good psychometric test will employ a series of easy-to-understand questions that help determine how risk tolerant one client is relative to the rest of the population, with a high degree of reliability.

Academic research points to psychometrics as being a superior way to predict financial risk taking.⁶ Psychometric questionnaires have been shown to give greater insight into actual risk-taking behavior in the real world and greater test-retest stability. Said another way, a gambles-based methodology might help me understand what my client will do in Las Vegas, not what they will do when they invest.

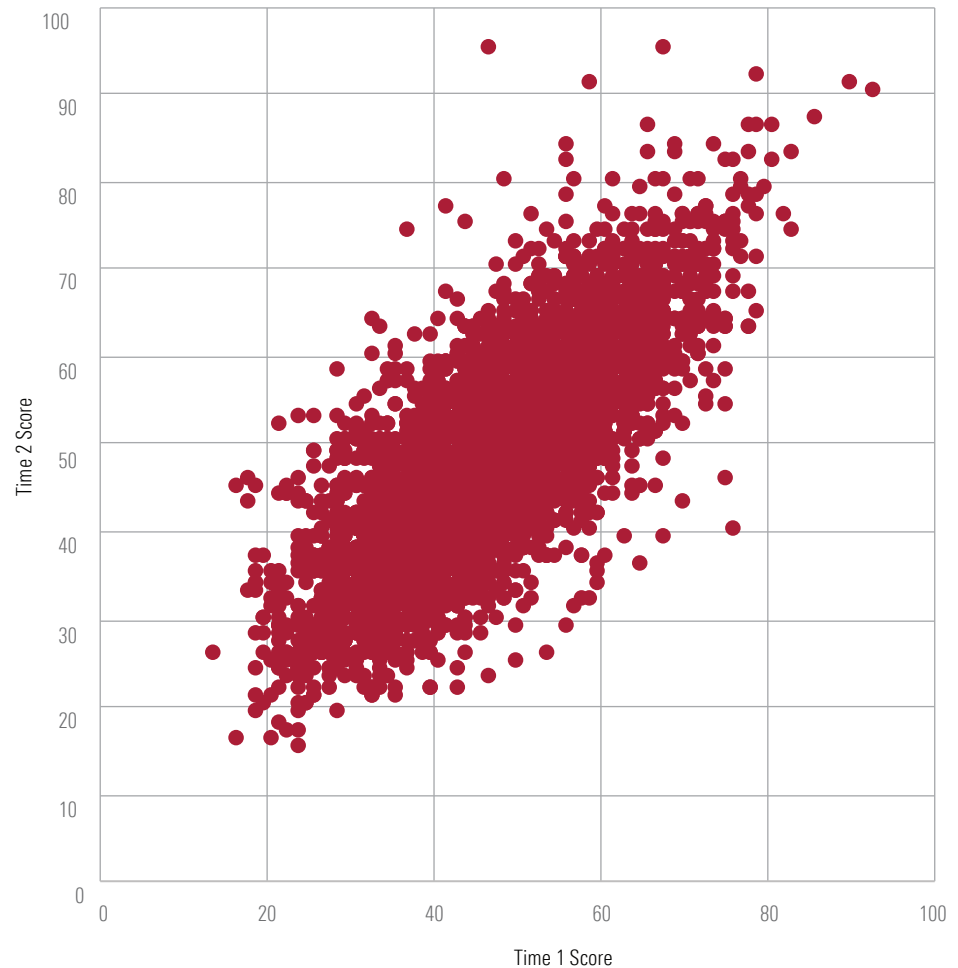
Repeated testing, where people take the same test multiple times, sometimes a year later and sometimes five years later, can indicate whether a trait is stable or inconsistent. A questionnaire that relies on this psychometric method — used by leading advisors in over 20 countries and taken by millions of respondents over two decades and multiple market crashes — is our recommended method.

The upshot? We find that people’s risk tolerance does not dramatically change. Upon retesting, they usually scored very close to previous tests — including before, during and after the 2008 crash and the same with the Covid pandemic.

⁶ Grable, John and Hubble, Amy and Kruger, Michelle and Visbal, Melissa, Predicting Financial Risk Taking Behavior: A Comparison of Questionnaires (September 28, 2018). 2019 *Academic Research Colloquium for Financial Planning and Related Disciplines*.

Exhibit 1 is a scatterplot where we plot each investor's risk tolerance, scaled from 0 to 100, on two different occasions. People's scores are usually within one-standard (± 10) deviation of their prior score. So, someone with a relatively low risk tolerance might score a 20 one time and a 23 the next. Someone with a higher risk tolerance might score around 60 on test one, and then a 55 for the second test, but generally they are relatively small changes.

Exhibit 1. Scatterplot of Test/Retest Results

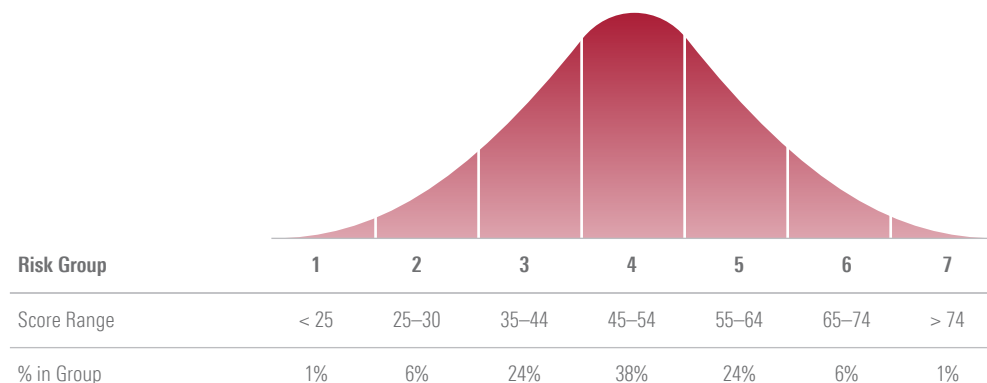


Source: Morningstar.

The reality is that even if good psychometric methods are more reliable than a revealed preferences test, most advisors do not use any form of validated test⁷. Home-grown risk profiling questionnaires often combine multiple factors into a single scoring algorithm, which effectively means it measures nothing. It also likely explains the erratic results which cause advisors to mistrust such questionnaires to begin with.

⁷ T3 2021 Advisor Software Survey

Exhibit 2. Normal Distribution of Respondents to a Psychometric Risk Test



Source: Morningstar.

Framing Portfolio Risk in a Consistent Manner

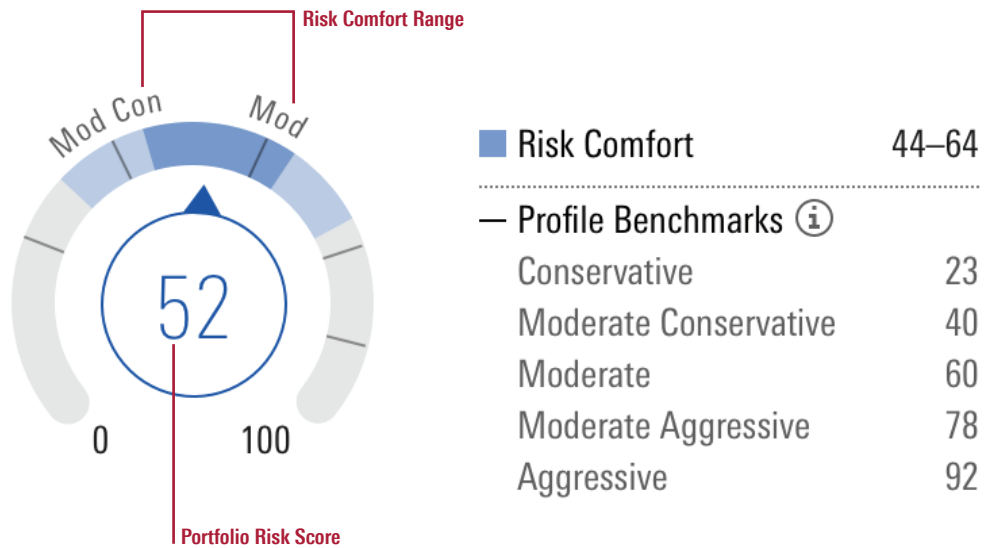
As outlined above, problems can occur when product risk is presented based on short-term volatility metrics. Most financial planners and advisors are working hard to educate and coach the client to think about the long term and achieving their goals and not to become enmeshed in the inevitable media noise during a market correction. For years, good advisors have used asset allocation models to explain risk and return trade offs and most investors understand that equities are more risky than fixed income solutions. This becomes more complex as the industry introduces alternative products that might look like an equity but behave like fixed income or the reverse. Then out comes a portfolio report showing massive changes in short term volatility implying the risk of their previous 60/40 portfolio has now doubled and is no longer appropriate. Unfortunately, the financial planning messages are often lost under the investment product reporting practices.

It is important that the industry develops approaches to fully disclose the short-term portfolio metrics but at the same time be able to frame portfolio risk in terms easily understood by the consumer, that reinforce good long-term behavior. If a client was invested in a well-structured 60/40 portfolio before, during and after the COVID crash, although the standard deviation of the portfolio changes so does the deviation of every 60/40 portfolio, including the most efficient, well-diversified 60/40 portfolio on earth. What advisors need are tools that foster dialogue and reassurance that clients remain invested in the portfolio they and their advisors have determined to be in their best interest. Morningstar's Risk Ecosystem uses a set of well-diversified Target Allocation Indexes to define what it means to be "Conservative," "Moderate" or "Aggressive," and our Portfolio Risk Score visuals depict the range of risk each type of portfolio may undertake over the longer run based on those indexes, allowing advisors to both acknowledge volatility's ups and downs over time, but also reinforce that, despite recently higher volatility, their moderate portfolio, for example, is still within an expected range for moderate portfolios and right for the client, provided they were profiled correctly.

A Personalized Comfort Band

Lastly, it is time for the industry to evolve beyond simplified bulk-banding of investors to personalized comfort bands. Technology exists to allow more reliable assessment of clients and more automated, stable and granular ranking of the risk of portfolios and constituent products.

Exhibit 3. Illustration of a Portfolio Risk Score, Profile Benchmarks and Personalized Comfort Range



Source: Morningstar.

In Exhibit 3, notice that the colored Risk Comfort Range extends from 34 to 47 (occupying a region associated with Moderate to Moderately Aggressive portfolio). The determination of the individual Risk Comfort Ranges is based on research that mapped client expectation of equity exposure against the overall risk tolerance score across several hundred thousand respondents.⁸

Not only is this more engaging for the investor, which will help with client messaging and retention, it will also allow a more appropriate determination of the products or portfolios on an advisor’s shelf and how they fit to that investor. For instance, if a client’s Risk Comfort Range crosses the frontier from one traditional bucket to another, the advisor can craft a portfolio that sits between the two traditional profiles, rather than force-fitting the client into one or the other.

⁸ Geoff Davey, 2015, “Getting Risk Right,” Investment Management Consultants Association, April.

Summary

Risk tolerance when done correctly can and should provide a demonstrably reliable understanding of the client's willingness to take risk, a psychological attribute that doesn't change every time the markets drop. It allows consistent, defensible advice when combined with a properly contextualized measure of the risk in a portfolio and a personalized "comfort range" for an investor.

With so much uncertainty in the markets, investors need a guiding hand, and we think understanding risk tolerance is critical. The technology is here to make distribution of questionnaires, generation of risk tolerance scores, personal comfort ranges and evaluation of the risk of individual portfolios eminently possible. This will make conversations with clients much easier and thoughtful, and more scientifically sound. Going forward, advisors will need a strong, proven, defensible methodology to measure risk and satisfy regulators. Choosing the right approach could also lead to much higher retention and a better connection with your clients.