Considering client risk capacity

Tony Vidler | Strictly Business | 02 October 2012

As advisers embed new processes and systems in a more prescriptive world, we are increasingly seeing some concepts that were formerly considered "best practice" being re-assessed.

Much has been written recently about determining a client's tolerance for risk, which is quite appropriate as advisers re-consider their methodologies and systems that justify the suitability of their recommendations. A simple risk profile questionnaire which categorises a consumer into (say) one of four boxes and associated strategies is increasingly questioned as to its appropriateness.

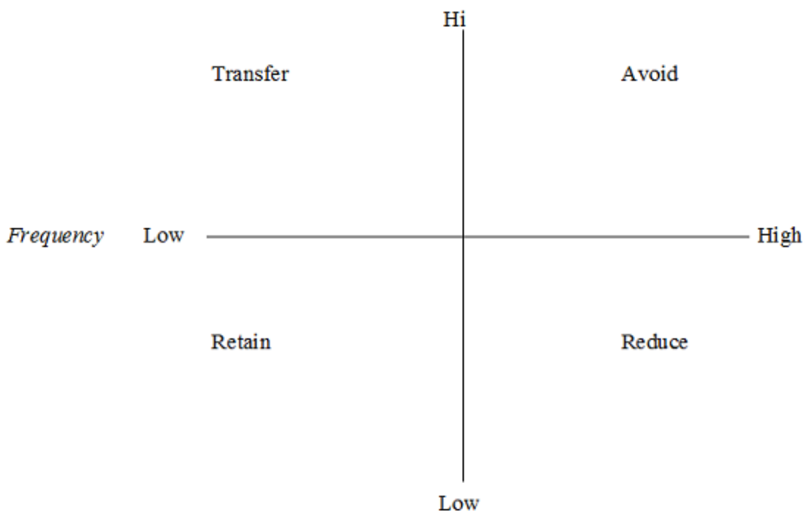
It is not necessarily appropriate any longer to assess risk in simple terms of the client's tolerance for volatility of returns. Such testing can really only determine their anticipated behaviour in response to fluctuating portfolio values. In itself this is helpful, but it doesn't necessarily test the key issue - a client's *capacity* for absorbing different risk events.

If we step back and consider risk in a much broader sense than has traditionally been considered in the investment world, we might think of it in the context that risk management experts do. In their world, risk is the possibility of an adverse, or unwanted, outcome - but the measurement of that risk can best be determined by considering two key indicators:

1. Likely frequency of the occurrence
2. Likely severity of the occurrence

If we place *frequency* on the vertical axis and measure the likely occurrence of different events on a range from extremely low to very high, and place *severity* on a horizontal axis using the same measurement scale, the result is a graph that provides us with the opportunity to place weight upon different events.

Assessing risk



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Appropriate risk management strategies then become readily apparent. To use two extremes as examples:

a. if an event was of very high severity (i.e. a catastrophe!), and of very high likely frequency (i.e. very likely to happen), common sense suggests that a good strategy is simply not to go there. Or, from a risk management perspective, we might say the strategy is to avoid the risk.

b. if an event was of relatively low severity (virtually no pain at all, really!), and unlikely to happen very often, it is reasonable to simply retain the risk as it is relatively inconsequential in reality.

As a method of engaging in a frank discussion with a client to reveal their true *capacity* for different types of risks and for different scenarios, a simple diagram can be far more effective than a detailed questionnaire. The key element you really want to uncover is the client's capacity for change. Determining their possible tolerance and attitude to the adverse outcomes is only marginally helpful. After all, most of us have had many clients with risk profiles that indicated they had a reasonably high tolerance for volatility - and portfolios have been designed accordingly. Yet some years later, when an adverse event happened, we have found that the client didn't actually have the *capacity* to cope.

There is little doubt in my mind that risk profiling is a useful and necessary step in the process of advising clients. Risk profiling that is focused solely on assessing likely reactions to volatility are limited in use, however. It may be useful to consider complementing that with a broader conversation, in diagrammatic form, to examine the client's *capacity* for foreseeable events on an ongoing basis.

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by Paul Resnik 06:36PM 2nd Oct '12

Unillateral planning defies common sense. Collaborative planning protects planner and client.

A stool without at least three legs is likely to collapse under pressure and at best bruise the sitter. Equally a plan that fails to take account of an individual's risk tolerance, the third limb of the planning process, is likely to tilt and fall. A plan hoisted on a client by a planner who knows whats 'best' for a client is just a ticking time bomb. It not only ignores common sense and experience but flouts regulation.

The preferred outcome of the advisory process is that the investment recommended suits the investor's goals and also takes into account the investor's risk capacity and risk tolerance.
This process is a blend of art and science. The science lies in the tools the adviser uses. The art lies in the adviser's ability to use the tools effectively, to work collaboratively with clients to understand their needs, to assist in resolving mismatches by explaining alternatives, and to guide the decision-making process.
When assessing risk acquired, the projection capabilities of good planning software are used to determine the return required to achieve goals. There will be a level of risk associated with that return - and this is the risk required. The portfolio selection is based on this.
The science lies in the financial planning software. The art lies in explaining the relevant issues to the client, eliciting the right information, resolving conflicts, and determining expected returns for portfolios and the capital market assumptions upon which they are based.
Risk capacity is the extent to which an individual's financial plan can withstand the impact of unexpected events. For a goal as important as income in retirement, for instance, a 50 per cent chance of success is unlikely to be acceptable, which means that trade-offs will be required. In a comprehensive scenario, risk capacity is measured by the excess over 50 per cent of the likelihood of achieving goals.

Clearly, unexpected negative outcomes might derail the client's plan and this means the plan must be stress-tested. All forms of stress testing are driven by assumptions: capital market assumptions for investment returns, life expectancy for longevity and so on. If we do a poor job on these assumptions, any stress test will be compromised.
With risk capacity, the science is in the calculations, the art lies in explaining the concept to the client.
Risk tolerance is how an individual feels about taking risk. Where is their emotional balance between a favourable outcome versus risking an unfavourable outcome? A plan will have little value if a client, feeling overwhelmed by fear during a severe market correction, withdraws from equity markets. When and how will they re-invest? Half way through the next boom or when the investment news is more favourable? It is inhuman to ignore the risks an individuals life plan may be subjected to in ignoring their risk tolerance in the planning process.
Psychometrics is the scientific discipline used to assess characteristics such as risk tolerance. With risk tolerance, the science is in the questionnaire and scoring algorithms.
The art is in the discussion between adviser and client - explaining the risk tolerance report, resolving inconsistencies, arriving at a final assessment, obtaining acceptance of the assessment.
Risk tolerance is more likely to be consistent between planning sessions than risk required and risk capacity. That consistency makes it a useful foundation for both planning and investment decisions. Decisions made collaboratively by both planner and client. This fundamental legal prophylactic is wasted in unilateral planning

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by Glen Reid 10:47AM 3rd Oct '12

Risk tolerance etc.....

Tony

Thank you for your comments to simplify and demystify this subject, keep it up, we need more common sense then ever before in the industry.

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by Alan Milton 09:24AM 4th Oct '12

risk tolerance etc

Whilst I agree that to protect him/herself the adviser must have high regard for the risk tolerance profile of the client, isn't it also true that somtimes the adviser's view of what the client needs to do to meet their stated investment goals is not what the client is prepared to accept? How does the adviser stand if he/she says to the client " if that's the level of risk you are prepared to accept, that's your decision but my personal and professional view is that this is unlikely to achieve your objectives".

Or am I, long retired, being naive?

Subject

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