The Use of Risk Profiling Questionnaires in South Africa

during the financial planning process.

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Introduction

In the first quarter 2009 FSB Bulletin, an excerpt from Advocate Ken Silke on Finance News Laws, *FSPs should warn clients of financial risks,* was published. In the article Adv Silke refers to the fact that FSP's are required to give advice on financial products which are appropriate to a client's risk profile and needs according to the FAIS General Code of Conduct. He argues that since the words "risk profile" are not defined in the FAIS act it should be given a broader interpretation, to include the numerous risks that a client could be exposed to.

What is the situation in South Africa?

Most financial planners in SA today use some form of risk profiling questionnaire. In many instances a relatively simple questionnaire, probably provided by a product provider is used. The client will complete it quickly, in many instances with the planners "assistance", since there is a perception that financial planners will be fine in terms of FAIS, once they can show that the client has completed and signed the questionnaire.

In most instances the completion of the risk questionnaire is linked to the selection of one of five investment portfolios ranging from conservative to aggressive, according to which the client's entire investment is invested.

I'm of the opinion that most financial planners don't necessarily determine the risk tolerance of clients. Most of them use what I'll label an "asset allocator questionnaire" which asks a mix of questions about the client's investment experience, situation, time horizon etc to select one of four or five investor profiles, for each of which there is a model portfolio. There is no output from this process other than the asset allocation recommendation. It sometimes adds a brief description of the characteristics of the recommended strategy and the type of individual it is thought to suit.

Understanding Risk Tolerance

Risk tolerance is one of those concepts on which each person has a slightly different understanding. When asked to describe risk tolerance, you may get answers such as:

"It's the level of volatility an investor can tolerate."

"It is where someone feels comfortable on the risk/return spectrum."

Different terms such as risk tolerance, risk attitude, risk capacity and risk appetite are used to describe risk related concepts, not necessarily with the same meaning.

To avoid confusion it is necessary to understand what is meant by risk tolerance. Some commentators use terminology such as risk attitude (how much risk the client ***choose*** to take) and risk capacity (how much risk the client can ***afford*** to take; how much money can the client ***afford*** to lose without putting the achievement of financial goals at risk). For others, risk tolerance is a combination of risk attitude and risk capacity.

For the financial planner it is important to distinguish between and understand both the clients' risk attitude (a **psychological** attribute) and risk capacity (a **financial** attribute). In this document "risk tolerance" is used to mean the psychological attribute.
Since risk tolerance affects how individuals make decisions, the following definition probably best describe the fact that the client has to decide between alternative courses of action:
"risk tolerance can be defined as the extent to which a person chooses to risk experiencing a less favourable outcome in the pursuit of a more favourable outcome."

What has research taught us about risk tolerance

- Males are more risk tolerant than females.
- Risk tolerance decreases with age.
- Risk tolerance correlates positively with income, wealth and education and negatively with marriage and number of dependants.
- Test/re-test studies over periods of 30 to 120 days produced strong correlations between the first and second tests. It provides strong evidence of the stability of risk tolerance. The risk tolerance of clients therefore does not necessarily change as we move between bull and bear markets. However, the client's perception of risk, risk capacity and/or financial goals may change. Personality traits do change, but usually only slowly over time.
- Financial planners are not particularly good judges when estimating their client's level of risk tolerance. One could not rely solely on a financial planner's judgment to establish a client's level of risk tolerance. The use of a valid test is therefore advisable.

Problems associated with traditional Risk Tolerance questionnaires

Many risk tolerance questionnaires deal with financial aspects that do not form part of the construct of risk tolerance. This can be ascribed to the use of "asset allocation calculator" questionnaires that are often thought of and incorrectly described as testing for risk tolerance.

Validity of questions

Although time horizons (client's age, stage of life, when money will be needed) are all relevant in the financial planning process, it is not relevant in a risk tolerance context. For example " I plan to make withdrawals from the investment within the next 5 years" has nothing to do with risk tolerance. The question has more to do with financial goals and planning than risk tolerance.

Questions requiring explanation

With many questionnaires the client will need the help of the planner to complete. Once this happens the results are influenced and the objectivity of the results compromised.

Over reliance on investment issues

In most instances questionnaires rely heavily on questions focused on investment issues. Financial planning is not just about investment advice but financial issues in general and risk tolerance is relevant to all financial decisions.

Why are my clients' unhappy even after they've completed a risk questionnaire?

Although risk tolerance questionnaires used within South Africa are mostly "asset allocation calculators" it is important that financial planners should understand the value of a proper risk tolerance questionnaire and where it fits into the financial planning process.

A questionnaire that only leads to some asset allocation in isolation are bound to lead to unhappy clients. It is also important to distinguish between those clients who are unhappy with their investment return but not the advice, and those who are unhappy with both returns and advice.

The first group will include the clients' with an **informed commitment** to a plan that include proper consideration of risk tolerance, which is **but one of three** risk related inputs into portfolio recommendation. The other two being the risk taken to achieve one's goals **(risk required**) and the risk one can accept without changing one's goals (**risk capacity**).

Those clients' that are unhappy with both advice and returns will be those where the financial planner did not get the full commitment from the client since there was no proper assessment of all of the risks involved.

The following example illustrates the principle.

When deciding on which portfolio best suits the client's needs, the client together with his/her financial planner, must take into account the three risk related parameters: the client's risk required, risk capacity and risk tolerance.

The financial planner calculates that the client needs a very aggressive portfolio to achieve the client's life ambitions. However by questioning and analysis the financial planner discovers that the client cannot afford to lose more than 20% of his/her investment assets without having their life style and ambitions markedly changed, which means a conservative portfolio. After doing a risk tolerance assessment the financial planner discovers that the client has a low to medium risk tolerance which, all else being equal, would lead to a moderate portfolio.

Clearly there are potentially three different asset allocations leading to three distinctly different outcomes here:

- Is any one of them right for the client?
- Which allocation will cause the client the greatest and the least anxiety?

- Are there alternatives?
- What is the right way to proceed, recognising the substantial differences in long term outcomes?
- How should the client make those decisions?

The client need to make the decision because he/she is ultimately the one who has to live with the consequences. The client must give their informed commitment to the asset allocation which is to be implemented. Exploring the trade-offs is usually a powerful educational experience about risk and return. **The financial planners role in this process is to suggest alternatives, to illustrate outcomes, to recommend but not to decide**.

The process is commonly called **Gap Analysis** and is usually resolved by a combination of:

- Increasing the resources through earning more and/or spending less, and converting personal use assets to investment assets.
- Easing the goals through delaying, reducing and/or discarding.
- Taking somewhat more risk than would be the client's preference (but not to the stage that in a downturn they might panic and sell.)

The process is at odds with much of standard industry practice where "asset allocator calculators" questionnaires are used to decide on the best portfolio fit. However, a short cut runs a high risk that there will be a poor match between the needs of investor and the portfolio recommended. This is bound to result in a greater risk of client unhappiness, higher levels of product churn and the greater likelihood of both informal and formal dissatisfaction and complaints.

Financial Planners will therefore need to investigate and take all aspects of risk into consideration and not blindly use the "risk profiling/asset allocator calculator" questionnaires currently found in South Africa.

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