

The Risk of Not Understanding Risk

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Why is it some people will gleefully abseil off a 50 metre cliff face when others wouldn't be caught within 5 metres of the edge?

This difference in individuals relates to confidence and attitude to risk – something that is not easily measured. If you were to attempt measurement, it would take the form of a continuum, comparing one person to another. This same continuum applies to measuring an individual's attitude to investment risk. Establishing a client's risk profile is one of the most critical issues a financial planner must address. Why?

- Get the risk profile wrong for a conservative client and place them into investments with a high percentage in equities will result in much discomfort. It may also cause them to exit their investments at the worst possible time
- Place a more aggressive client in conservative investments like cash or fixed interest (NB some fixed interest is very high risk) and they will not be satisfied with the returns.

Both scenarios will result in unhappy clients.

Overriding all this, get it wrong and the client may not achieve their goals.

Attitude to risk is not well understood. Whereas the client's definition of risk relates to loss of money, Financial Planners use it to refer to investment market volatility.

In the past it has been all too easy to accept a demographic profile, or some other intuitive method, as the basis for determining how much is invested in income vs growth assets. Its been "oh you are in your 60's and therefore you must have a conservative portfolio". Yet they could be comfortable and/or need a significantly higher weighting in growth assets of property and equities to meet their goals. Further, it is just as conceivable that a 20 something individual could be extremely conservative.

Using a series of questions, psychometric risk profiling attempts to scientifically predict how the individual will react to normal market forces and it measures:

- Risk Tolerance – how well you will weather market ups and downs. Traditionally this has not been done well.

Currently most risk profiling looks at Risk Capacity which is how much you can take and still meet your goals. Typically in the past, it is this one step which has been used, ignoring the other. It is a number and is relatively easily calculated once an individual's total financial history and goals and objectives have been established.

It is not sufficient to look at just one of the steps. Both the risk tolerance and risk capacity must be meshed to provide a total solution for the client.

Using one of my clients as an example – a 45 year old who wants to retire aged 60 on a given income. Risk profiling results indicated she was medium risk investor meaning she could accept, a weighting towards growth assets within the comfort band (see illustration). However, to do so meant there was a gap and because of that she would not achieve her desired goals.

What to do?

Together we discussed the implications of both scenarios to determine the best path for her. Basically the two options were:

- Change her desired retirement goals – retiring later or taking less annual income from the investment portfolio
- OR
- Accept there will be times of market volatility that may make her feel uncomfortable.

She decided meeting her goals was more important and so accepted a higher weighting in growth assets.

What is heartening is that she is a person who took the time have a comprehensive financial plan completed. Because of this plan and the psychometric risk profile testing, a crucial gap was identified and a solution agreed which was based on a better understanding of her risk tolerance. It is also fortuitous that she chose to work with an advisory practice with the tools available to uncover potential pitfalls that may have thwarted her achieving her goals.