

Supporting Your Risk Profiling Due Diligence

Assessing a client's risk tolerance and capacity for loss is not only a regulatory requirement, it is an important aspect of delivering the best client outcome.

We recognise a lingering concern among advisers that many existing risk profiling tools on the market are not fit-for-purpose. Not only do they lack robust foundations, they often ask leading questions, have a flimsy approach to assessing risk capacity and conflate volatility and risk, thereby actively discouraging equity risk-taking in a way that is damaging to the long-term objective of most clients.

As a recognised leader in the application of empirical evidence to financial planning and decumulation, Timeline has applied its rigorous approach to the process of risk profiling based on extensive academic research. Our robust modelling based on 120-year asset class data enables us to look at investment risk from a unique vantage point that other existing risk profiling tools lack.

Furthermore, Timeline's technology captures detailed information about the end clients (including age, relationship status, income, expenditure and financial goals), enabling us to undertake a robust assessment of the likely impact of falls in asset value on the client's objectives and lifestyle, rather than through the misguided, abstract lens of 'volatility' that is typical of other risk profiling tools.

Using relevant questions that are clear, fair and not misleading, the Timeline Risk Profiler generates clear descriptions on how clients might view risk and loss. It puts this into context as to how an investment portfolio might then be appropriately structured. Advisers can download inputs and resulting output in an easy way for client reports.

The science behind Timeline risk assessment

As per FCA suitability requirements under COBS 9.2, the Timeline RiskProfiler looks at the following components of risk profile:

- Attitude to risk and volatility
- Knowledge and experience of investments
- Capacity for loss

This approach is guided by extensive academic evidence and regulatory requirements which are summarised below.

1. Regulatory Requirement

The regulatory obligation to place knowledge and experience, as well as capacity for loss at the centre of risk profiling is documented in COBS9.2.2R as follows:

1. A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:
 1. *(a) meets his investment objectives;*
 2. *(b) is such that he is able financially to bear any related investment risks consistent with his investment objectives; and*
 3. *(c) is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.*
2. The information regarding the investment objectives of a client must include, where relevant, information on the length of time for which he wishes to hold the investment, his preferences regarding risk taking, his risk profile, and the purposes of the investment.

3. The information regarding the financial situation of a client must include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and property, and his regular financial commitments.

1.2 Academic Underpinning: Literature Review

Below we summarise the key academic literature that supports Timeline's approach to risk profiling.

a. Risk tolerance is domain specific.

Research by Corter and Chen (2006) as well as Weber et al (2002) found evidence that risk-taking behaviour is a situation-specific behaviour, not a general personality trait. This conclusion was supported by the fact that investment risk tolerance, as measured by RTQ score, was not related to a measure of sensation seeking (Zuckerman, 1994). This is also consistent with the findings of Morse, 1998, showing no relationship of sensation seeking and investment risk preferences.

b. There is a strong direct relationship between investment knowledge/experience and risk tolerance.

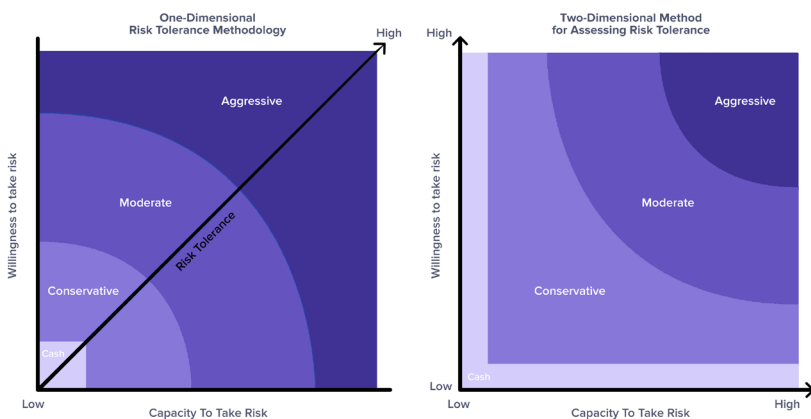
- There is a consensus among academic researchers that individuals who are more financially literate tend to be more tolerant of risk (Grable and Joo, 1999, 2004; Grable, 2000; Grable and Roszkowski, 2008; Gibson et al., 2013). Furthermore, Grable and Joo (1999) state that financial knowledge is the most important factor for predicting risk tolerance when compared to other factors such as demographics and socioeconomic characteristics.
- Corter and Chen (2006) found that investment experience proved to be an important predictor of risk tolerance, with more experienced investors showing more risk-tolerant attitudes, as well as more risky investment portfolios. The increased risk tolerance with increasing investment experience is consistent with Grable's (2000) results showing that risk tolerance increases with investment knowledge.

- c. To be effective, capacity for loss should be scored separately, assessed robustly and applied as a mediating factor to risk tolerance

Kitces (2017) makes the case for why risk tolerance and risk capacity are two different dimensions of the client's overall risk profile, and must be assessed and 'scored' separately to properly recognize the constraining role that each can have on the appropriate investment policy statement.

Kitces proposed a 2-dimensional approach to risk profiling, noting that *'having a low willingness to take risk, and/or limited capacity to afford risk, should be viewed not just as a component of the risk score, but a constraint to the proper portfolio the investor agrees to in an Investment Policy Statement. Which means investors who have low tolerance or low capacity should remain in conservative portfolios And similarly, investors with "just" moderate tolerance or capacity should stay in moderate portfolios, and not drift up to aggressive just because their other score is high.'*

PORTFOLIO COMPARISON OF ONE VS TWO-DIMENSIONAL RISK TOLERANCE ASSESSMENTS



d. Responses to hypothetical questionnaires are poor predictors of actual behaviour.

Usherwood, 1999 suggests that one should not put too much weight on responses to hypothetical questions:

<https://pubmed.ncbi.nlm.nih.gov/1854520/>

This view is corroborated by Quantitative UX expert Nikki Anderson who makes a compelling case that people are generally poor at correctly predicting their own future behaviour. She suggests that past behaviour is a much stronger predictor of future behaviour.

e. Understanding a client risk tolerance can be useful in managing client behaviour and helping them to stick to their long term plan

Guillemette and Finke (2014) suggested that financial planners can be of great value by assisting their clients in developing a long-term strategy to deter them from selling low and buying high because their risk aversion varies in the short-term.

Commitment strategies can be used to influence households' saving and investment behaviour. Because those with more self-control have been shown to be more risk tolerant (Griesdorn et al., 2014), financial advisers may be able to help them become more comfortable taking risk by suggesting some commitment strategies. For example, they could suggest that their clients make a commitment to maintain a particular level of risk in their portfolios. As markets fluctuate, they may be less tempted to adjust their portfolio risk accordingly if they are committed to holding a portfolio with a particular amount of risk.

2. How Timeline applies academic evidence in practice to meet regulatory requirements

The Timeline Risk Profiler specifically addresses the regulatory requirements set out in COB9.2R by using a questionnaire to assess attitude to risk and volatility, as well as knowledge and experience of investments and we use a client's actual finances to assess capacity for loss.

The specific steps are as follows:

- **Attitude to volatility**

This aspect of the questionnaire is designed to assess how clients might cope with short-term volatility. It is based on the understanding that, while clients are investing for long-term returns, short-term volatility is what they have to contend with. Making investments can be a bit of a rollercoaster ride, with markets responding to world events in unpredictable ways. While over the long-term, riskier investment types (asset classes) tend to see higher returns than less risky ones, their values can fluctuate wildly, and so it is important to understand if the client might be uncomfortable at the level of volatility and potential loss their portfolio might experience, even if temporary.

- **Investment knowledge and experience**

One area that differentiates Timeline's approach from most risk profiling tools is that we place greater emphasis on a client's investment knowledge and past behaviour than hypotheticals.

Extensive academic research suggests that an investor's knowledge and experience is one of the most important factors. As shown in the review of risk tolerance research, there is a consensus that individuals who are more financially literate tend to be more tolerant of risk (Grable and Joo, 1999, 2004; Grable, 2000; Frijns et al., 2008; Grable and Roszkowski, 2008; Gibson et al., 2013). Furthermore, Grable and Joo (1999) state that financial knowledge is the most important factor for predicting risk tolerance when compared to other factors such as demographics and socioeconomic characteristics

- **Capacity for loss**

When it comes to deciding how best to invest your client's money, Timeline places a strong emphasis on the client's capacity for loss and uses this as a mediating factor for their willingness to accept risk.

According to FG11/05: 'By 'capacity for loss' we refer to the customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take.'

To meet this requirement, Timeline applies its 120 years of capital market data to assess how well the client can bear losses that may come from their investments and specifically measure how their standard of living might be impacted in the potential worst-case scenario.

We can be quite accurate with this by looking at how the scenario with the worst returns from the last 120 years of market history, including the Great Depression and World War II, would impact their overall finances. It takes into account the client's financial situation (including age, all current and future income sources, portfolio balance etc) as well as their objectives including expected retirement age, income required and other planned expenditure.

Furthermore, we benchmark their income in the worst-case scenario against the independent PLSA Retirement Living Standards and provide a clear indication of how their essential and lifestyle expenditures might be impacted by any portfolio loss in the worst case scenario.

2.1 Here's how we calculate the risk score:

1. We calculate attitude to risk based on answers in the questionnaire.
2. We assess how reliable this 'risk attitude' score is based on your clients' previous experience and knowledge of investments. If a client has a tolerant attitude to risk, but they don't have the experience or knowledge to know for sure, the algorithm may cap the overall risk score, depending on how high the attitude to risk score is.
3. We check whether the risk score arrived at thus far is suitable for the client based on the personal historical worst-case scenario for their yearly spending power. In other words, their Capacity for Loss.

We define capacity for loss based on a client's definition of their 'Must Do' and 'Plan To' spending levels. If the client does not define personal levels, we use the research from the PLSA (Pension & Lifetime Savings Association) to ascertain what minimum level of yearly spending is necessary to pay for the essential things in life and whether the client achieves that.

When designing the questionnaire, we apply the following rules:

1. Questions should be open, not leading. This means we do not provide a statement for the responder to agree or disagree with, but provide open questions which have multiple potential answers. Leading questions can prejudice a responder to answer in a certain way, rather than letting their uninfluenced answer come out.
 - a. *For example, we ask: How much short-term volatility would you expect to have to accept to get high long-term results?*
 - None
 - Little
 - Some
 - A lot
 - Not sure

b. *Instead of: You would need to accept a lot of short-term volatility to get high long-term results*

Strongly agree

Agree

Neutral

Disagree

Strongly disagree

Garland¹ (1999) shows the effect on survey results of having no neutral or mid-point on a Likert scale. Participants in a survey were shown either a five point (with mid-point) or four point (no mid-point). This research provides some evidence that social desirability bias, arising from respondents' desires to please the interviewer or appear helpful or not be seen to give what they perceive to be a socially unacceptable answer, can be minimised by eliminating the midpoint ('neither... nor', uncertain etc.) category from Likert scales.

2. Responders should have the ability to answer 'Not sure' on relevant questions, so that they do not answer a question in a random way just so they can move onto the next question.
3. When asking for attitude, be as specific as possible. The more specific the question, the more accurate and less subjective an answer will be.

a. *For example, we ask: The chart below represents 4 investment portfolios in the last 10 years. Although past performance is no guarantee of future results, which portfolio best suits your desired level of risk and return?*

Portfolio A, [details of portfolio performance]

Portfolio B, [details of portfolio performance]

Portfolio C, [details of portfolio performance]

Portfolio D, [details of portfolio performance]

¹ Garland R (1999) The Mid-Point on a Rating Scale: Is it Desirable? Marketing Bulletin, 1991, 2, 66-70, Research Note 3 https://www.rangevoting.org/MB_V2_N3_Garland.pdf

b. *Instead of: I am willing to put a significant part of my wealth in high-risk investments.*

Strongly agree

Agree

Neutral

Disagree

Strongly disagree

- 4.** Understand the client's experience and knowledge of investment as a foundation for understanding their attitude to risk. A person's past behaviour is a better predictor of future behaviour than a hypothetical attitude to risk. Attitude informed by experience and knowledge is much more likely to be accurate than an uninformed attitude to risk. This is how we take 'composure' into account, as those with a lot of experience and knowledge will be more likely to stay the course in volatile market conditions than those without.

The results of the Timeline risk profiler provide a better understanding of risk and volatility. Historically, equities have performed consistently better over the long-term than other asset classes like bonds. It would be inaccurate to describe them as higher risk, therefore, but accurate to describe them as more volatile. That is why our 'Risk score' is labelled as 'Appropriate Investment Strategy', with a scale from 1, being the lowest return, most stable investments and 10 being the highest, most volatile returns. This allows the financial adviser to have a much healthier and more open discussion about risk with their client, which can lead to the implementation of a more appropriate investment strategy.

What we offer

User Profile	Retail and professional clients
Risk Tolerance	Yes
Capacity for Loss	Yes
Knowledge & Experience	Yes
Inconsistency Alert	No, however the adviser can see all answers to the questionnaire and assess themselves
Check of Client Understanding	Yes
Risk Rating Outcomes	Yes
No. Questions	18
No. Descriptors	10
Client Completion	Online
Mapped to models/ Mapped asset Allocation Models Provided	In development
Facility to map to your own models	In development
Branding	Yes, we offer white-label
Adviser Support	Yes
Standalone or part of a tool	Part of the tool (but we could separate)
Cost	Included in your Timeline subscription

Limitations

Our tool is designed to be used as part of client discussions.

Whilst the output may match clients' willingness to take risk and capacity for loss, it should not form the sole basis of your recommendations. If a client has a score of 1 out of 10 on the Appropriate Investment Strategy, a discussion on the appropriateness of any risk at all would be a good idea.

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