

# Investment risk and financial advice

A guide to using Vanguard's risk profiling tool as a starting point to discovering a client's true risk profile.

**For investment professionals only – not for retail investors. The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.**



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# What is 'risk'?

Your clients' perception of 'risk' and what the investment industry portrays as 'risk' can differ radically. This can lead to challenges for advisers if they rely solely on quantitative measures of risk, such as 'volatility' for example.

Experience in markets where fee-based advice models are well established, suggests that advisers should consider taking a more comprehensive approach to educating their clients about the nature of investment risk, as well as understanding their clients' true and complete risk profile.

## 'Risk' is not a single number

Technically-speaking, 'risk' means the possibility of a number of different outcomes resulting from a given action. For example, before you flip the coin you know the result could be heads, tails or land on its edge. After you toss the coin, one of the three outcomes will occur.

Investment academics usually identify risk as the volatility associated with the prices and/or returns of investments. However, we believe this approach is much too narrow for financial advisers to use in their practice. This is because clients do not think in terms of narrow mathematical terms. Indeed, clients often think of risk as the prospect of an undesirable outcome, such as a financial loss or not meeting an investment objective.

## Risks your clients face

### **Inflation**

Inflation is like a stealth tax eating away at the value of money. Clients may not see a smaller cash balance in their accounts, but they will definitely lose buying power. In other words, the amount that they can purchase with each pound in their pockets slowly erodes over time.

Investors need to understand that some savings vehicles fail to pay a return that beats inflation, especially after tax is deducted. So even if they reinvest every penny of interest, the real purchasing power of their savings could fall.

### **Shortfall**

This means the risk of failing to meet a long-term investment goal. This could occur if an investor didn't take on enough risk to get the potentially higher rewards. On the other hand, they could also be exposed to shortfall risk if they invest in too many high-risk assets causing their portfolio to lose value at the wrong time.

The relationship between risks and rewards needs careful explanation to ensure that investors understand how you are structuring their portfolios through time. The myriad of risks that can affect a client's investment portfolio can be daunting. But shortfall risk together with inflation risk highlight the need to invest to meet long-term goals.

### **Economic/political**

Economic and political factors play an important role in the performance of investment markets. Economic factors include economic growth, inflation, employment, interest rates and business sentiment. Political risk includes changes in government, political uncertainty and international conflicts.

A key feature of these risks is the apparent inability of even the most skilled economists and political scientists to predict them. You, as the adviser, have a key role in explaining that these risks are unpredictable and in structuring portfolios in such a way as to help manage the impact these risks can have.

### **Broad market**

Individual markets, whether equities, bonds or even cash, are exposed to a variety of factors that can lead whole markets, or even most markets, to decline together. We have seen this over the last decade, most markedly during the recent global financial crisis.

## Asset-based risks

There are also a number of potential risks associated with individual assets or asset classes that investors need to consider.

<b>Country</b>	The risk that domestic events – such as political upheaval, financial troubles, or natural disasters – will weaken a country’s financial markets.
<b>Credit</b>	The possibility that a bond issuer will fail to repay interest and capital on time. Funds that invest in bonds are exposed to credit risk.
<b>Currency</b>	The risk that changes in currency exchange rates cause the value of an investment to decline.
<b>Interest</b>	The possibility that the prices of bonds will fall if interest rates rise.
<b>Liquidity</b>	The chance that an investment will be difficult to buy or sell.
<b>Manager</b>	The chance that an investment will underperform due to poor investment decisions by the investment manager.
<b>Sector</b>	The risk that a particular sector within a market, such as the oil and gas sector, or the travel sector, may decline in value. For example, if oil prices surge, the oil and gas sector might rise, but the travel sector might fall due to rising fuel costs.
<b>Volatility</b>	Different types of investments fluctuate in value over time. This is referred to as volatility and is often used by the investment industry to assess the potential risk associated with an investment.
<b>Security</b>	The risk that a specific share, bond or fund you’ve invested in performs badly.

## Risk and your service promise

Explaining the various risks to clients helps them to gain a better understanding of the risk they take by investing. For the adviser, it can also help detach the service ‘promise’ they make to their client from the actual performance of the investments

they recommend. After all, advisers do not have any control over the performance of markets and making performance promises, actual or implicit, runs the risk of leading to disappointment for the client and disaffection with the adviser.

See the next section for a fuller description of this process.

# Adviser as 'alpha'

The data shows that picking investments that consistently outperform the broad market has historically been very difficult. This can lead to disaffection on the part of clients when investment results are not what they feel they have been promised, even if you didn't explicitly promise them anything.

The experience of successful fee-based advice practices in the UK and abroad suggests advisers may be better served by changing their performance benchmark from the market's return to the returns that investors might achieve without your help.

A financial adviser has a greater probability of adding value, i.e. 'alpha', through relationship-oriented services, such as providing wealth management, financial planning and acting as their clients' behavioural coach, than by attempting to outperform the market.



## Financial advice and RDR

With the end of commission, the financial advice market will complete its ongoing shift from transaction-oriented sales to fee-based advice.

From the client's perspective, fee-based advice largely removes concerns about potential conflicts of interest in an adviser's recommendations. From the adviser's perspective, fee-based compensation can promote stronger client relationships and more reliable income streams. The adviser can spend more time with clients, knowing that compensation does not depend on whether or not a transaction occurs.

## What do we mean by the 'adviser as alpha'?

For some clients, paying fees whether or not a transaction occurs may seem like money for nothing. The confusion can grow if the adviser bases their value proposition on an ability to deliver 'better' returns for the client. But better returns relative to what? For many advisers and clients, the answer would be 'better than the market'. However, a more pragmatic answer for both parties might be 'better than investors would likely do if they didn't work with a professional adviser.'

In this framework, advisers demonstrate their 'alpha' by their ability to effectively act as a wealth manager, financial planner and behavioural coach – providing discipline and logic to clients who are often undisciplined and emotional – than by efforts to beat the market.

## Professional stewardship and investor behaviour

Rather than investment capabilities, the adviser as alpha model relies on the experience and stewardship that the adviser can provide. Left alone, investors often make choices that impair their returns and jeopardise their ability to fund their long-term objectives. Many are influenced by market performance. This is often evident in market cash flows mirroring what appears to be an emotional response – fear or greed – rather than a rational one. Investors also can be moved to act by fund advertisements that feature recent outperformance – as if the investor could somehow inherit those historical returns despite disclaimers stating that past performance is no guarantee of future returns.

Historical studies of mutual fund cash flows show that after protracted periods of relative outperformance in one area of the market, sizeable cash flows tend to follow. This performance-chasing behaviour can seriously harm a client's long-term returns. The adviser as alpha target, then, might be to improve upon this return shortfall by means that don't depend on market outperformance: asset allocation, rebalancing, tax-efficient investment strategies and cash-flow management. It can also mean, where appropriate, coaching clients to change nothing at all if the client's asset allocation model remains in line with their risk profile and investment goals.

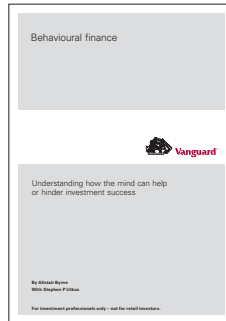
## The Financial Services Authority guidance

But just as risk is not a single number, so too is a client's risk profile not a single number or psychological dimension that can be easily measured. The FSA recognised this and issued new guidance on assessing client suitability. The next section explores the FSA's guidance on assessing investment suitability.

For more information on building a robust and systematic investment advice process, please see our guide: *Building a robust investment advice process*.



For an insight into destructive investment behaviour, with practical guidance on how advisers can act as a behavioural coach, please see our guide: *Behavioural finance*



To gain some insight into how to define a compelling client promise – one that is not tied to investment performance and that clients explicitly understand and are willing to pay you to keep – see our guide *Making a compelling client promise*.



# The FSA and profiling client risk

The FSA has studied the way client risk tolerance has traditionally been profiled by the industry and found it wanting. As a result, it issued new guidance consultation in January 2011: *Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*. Any consideration of risk or risk profiling must take careful account of the FSA's findings and guidance. The guidance provides sobering reading for any adviser that has come to rely on single-dimension measurements of risk profiles.

## The consultation key findings

The following summary should not be considered as a substitute for reading the full guidance paper which can be found on the FSA website.

<b>Failure to collect and properly account for all the information relevant to assessing the risk a customer is willing and able to take</b>	<ul style="list-style-type: none"> <li>■ Many firms fail to take account of a client's capacity for loss.</li> <li>■ Many risk questionnaires rely on poor questions, scoring and interpretations.</li> <li>■ Failure to identify customers that are unwilling to accept any risk of capital.</li> </ul>
<b>Relying on risk-profiling and asset-allocation tools</b>	<ul style="list-style-type: none"> <li>■ Failure to identify limitations and flaws in tools.</li> <li>■ Need to mitigate limitations through suitability assessments and full 'know your customer' processes.</li> </ul>
<b>Poor descriptions of attitudes to risk</b>	<ul style="list-style-type: none"> <li>■ Many descriptions not fit for purpose.</li> <li>■ Overly vague.</li> <li>■ Do not effectively explain or differentiate risk levels.</li> </ul>
<b>Failure to select suitable investments for the customer</b>	<ul style="list-style-type: none"> <li>■ Failure to match asset allocation and/or investments to a 'correctly assessed' client risk profile.</li> <li>■ Failure to take account of all aspects of a client's objectives and financial situation.</li> </ul>
<b>Inappropriate focus on the risk a customer is willing to take</b>	<ul style="list-style-type: none"> <li>■ Failure to take account of client needs, objectives and circumstances outside of 'willingness'.</li> <li>■ Failure to recognise that suitability is about more than a client's attitude to risk.</li> </ul>
<b>Understanding products and underlying assets</b>	<ul style="list-style-type: none"> <li>■ Failure to understand the nature of the risks associated with assets selected for clients.</li> </ul>
<b>Responsibilities when using tools</b>	<ul style="list-style-type: none"> <li>■ Suggestion that firms do not appear to understand the tools they use.</li> <li>■ Firms remain responsible for assessing suitability, even when using tools.</li> <li>■ Tool providers need to provide clear supporting information to firms that will use the tools to help firms use them as designed.</li> </ul>

The FSA's timely findings and guidance has informed every step of the development of our tool for measuring investor risk profiles and the process we advocate for using it. We've written this guide, in part, to help advisers address the FSA's concerns.

You will also find some helpful checklists and tools at the end of this guide, designed to help you structure your approach to applying the regulator's guidance in your business.

# Clients' 'true' risk profile and asset allocation

In the past, some advisers might have stopped with a client's 'willingness' to take risk as measured by an 'attitude to risk' tool, and proceeded directly to selecting investments. However, in light of RDR and increasing regulator scrutiny, the results of such a tool should only provide a *starting point* for a conversation about investment risk, not an ending. It should not be thought of as a substitute for a suitability test

But what is the most appropriate way to develop a client's risk profile, especially in light of the FSA guidance?

## Starting conversations

Asking your client to complete a risk profiling questionnaire should mark the beginning of a conversation with them about risk. You can use the generalised output to move the conversation onto deep and critical issues in the 'know your client' process. Only by having a thorough and carefully structured conversation, as part of a systematic approach to investment advice, can advisers understand a given client's true investment risk profile.

Our experience in other fee-based advice markets suggests that this is where advisers can add real value for clients.

## 'Willingness' is just the beginning

A client's 'willingness' to take risk, as measured by a questionnaire for example, is only a small part of a client's full and true risk profile.



Three key components comprise an individual's true risk profile:

- Psychological willingness to take risk, sometimes called 'risk attitude'
- Financial ability to take risk, or 'risk capacity'
- Need to take risk, including the need to accept risk to meet an objective, avoid falling short of a goal or having wealth eroded by inflation.

**Ability** to take risk relates to financial circumstances and investment goals.

Generally speaking, the higher the level of wealth relative to liabilities, and the longer the investment horizon, then the greater the ability to take risk. The financial planning process should consider all of these issues carefully.

**Willingness**, or 'risk attitude', on the other hand, relates to psychology, rather than to financial circumstances. Some individuals find the prospect of investment volatility and the chance of losses distressing. Others are more relaxed about those issues. Financial advisers should try to fully understand the psychological willingness of each client to take risk. This is what risk profiling questionnaires focus on.

**The need** to take risk is the third component of a true client risk profile. Willingness and ability need to be evaluated in the context of an individual's need to take risk to achieve a goal. If they have a very low risk profile with a very demanding investment objective, something will have to give.

## Contradictions in the risk profile

Clients' psychological willingness to take risk can sometimes clash with their financial ability to do so. For example, if someone has a high risk tolerance, but has a finely balanced financial situation. When such a conflict exists, financial advisers need to take time to counsel the client and explain the consequences of the mismatch. You'll need to explain the consequences of low or negative returns to more aggressive investors with less liquid wealth.

Ultimately, a client might insist on an investment strategy that matches their risk attitude and the adviser may need to accept this. But having had the conversation, the client/adviser decision will at least be in the context of a thorough review of the investor's risk capacity, attitude and need.



## The investment objectives and the client risk profile

People can sometimes have different risk profiles with different pools of assets. They might be willing to take on considerable risk with assets they earmark for a particular goal, but not with others. The simplest way to think of this is to think of the £5 some people spend each week on lottery tickets. They're willing to take the highest risk possible with that £5, but not with the money they set aside for their children's education.

While this kind of separation might not make sense from a purely financial theory point of view, many investors rely on separate 'mental accounts' when thinking about their investments. For more information on 'mental accounting' please see our guide: *Behavioural Finance – Understanding how the mind can help or hinder investment success*.

## Different risk profiles in couples

Sometimes couples that deal with their investments together have conflicting risk attitudes. In this case, you'll need to explain the consequences of different strategies and approaches. It may be possible to negotiate a compromise position after explaining the issues, but in some cases the views of one spouse will prevail.

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Later in this guide you'll find a section on having this conversation with your clients, including a helpful checklist and other practical tools.

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# Starting conversations by measuring 'willingness'

Having established that a client's 'willingness' to take risk is just the beginning of a client conversation about risk, we can focus on how to best measure that willingness.

You can measure risk attitude in a variety of ways, each with its own advantages and disadvantages. Best practice suggests using a structured interview or a questionnaire to help draw out the issues.

## Measuring willingness – the Vanguard approach

Risk attitude is a complex area and as a result risk profiling is not an exact science. Nonetheless, a well-designed risk profiling tool can still make an important contribution to the financial planning process.

Vanguard's online risk attitude profiling tool for UK advisers is based on the Byrne-Blake Attitude to Risk Questionnaire. The Byrne-Blake approach to risk profiling builds on established psychometric principles and represents best practice from the science of measuring an individual's willingness to take risk.

The questionnaire has been designed for ease of use by a variety of different client types. It avoids questions that present complex investment scenarios, require mathematical calculations or use concepts such as percentages. We also sought to avoid vague questions, or those that deal with issues that people outside the industry might not know anything about.

## How the tool works

The tool uses a series of short statements followed by a scale where the individual can indicate whether they agree or not with a statement. The scale, known as a Likert Scale, typically includes:

- Strongly Agree
- Agree
- No Strong Opinion
- Disagree
- Strongly Disagree

The questionnaire has 12 questions, making it relatively fast and easy to complete. It typically takes less than six minutes. The tool uses a five-point scale as more choices could make the questions too complicated.

## Writing the questions

Byrne and Blake identified the various components that make up an individual's risk attitude and wrote questions to address each component. Following best practice, each question contains only one question or statement and avoids subjective words like 'frequency' whenever possible.

## Testing the questions for suitability

All of the questions have passed suitability screening by a test group. 141 individuals completed the initial online test.

The initial test group had the following characteristics:

- 65% male; 35% female
- Average age of 35 years
- Ages ranged from 19 to 70 years, with a standard deviation of 11 years

Questions with any of the following characteristics were culled from the question bank.

- Questions the test group found difficult or irrelevant.
- Questions that failed to accurately predict a given characteristic or differentiate among individuals (See for example, Grable and Lytton, 2003).
- Statistically 'outlier' questions that weren't closely correlated (less than 0.30) compared to the overall index score.

## 'Normalising' the questions

The final questionnaire needed to be long enough to produce reliable results, while short enough to be used in the financial planning process. A baseline or 'norm' was then established for the questionnaire in order to map respondents to broad risk categories.

To establish a norm group for the short questionnaire, Byrne and Blake commissioned market research firm YouGov to conduct an online survey with a sample representative of the British population. The results of this study allowed a comparison of each individual's response to the distribution of responses across the population. This allowed the testing of the reliability of a questionnaire using the pilot study.

Answers to questions are scored from 0-4, depending on whether the question uses standard or reverse wording. This means that the raw scores for the short questionnaire range from 0 to 48.

When reporting the test scores, the scores were normalised by subtracting the mean score and dividing by the standard deviation. In order to improve the clarity of the score, the reported scores were further adjusted so that an average response gets a score of 50 and the distribution of reported scores has a standard deviation of 10. This fits more readily with people's perceptions of where their score should fall on a scale of 0-100. The adjusted scores are then used to map individuals to broad risk attitude categories (see the following section for descriptions of these categories).

# Behavioural aspects of risk attitude

The complexities of measuring investment risk attitude require that the questionnaire address a number of interrelated factors. Vanguard's tool addresses four identified behavioural factors of risk.

## Knowledge

Individuals with more financial and investment knowledge are generally more willing to accept investment risk. Knowledgeable individuals often know that they will need to take at least some risk to generate higher returns. Short-term fluctuations in the values of investments need not matter for investors with longer-term horizons.

## Comfort with risk

Some individuals have psychological traits that allow them to accept taking risk. These individuals typically see risk as involving a 'thrill' or 'opportunity' rather than as a 'danger' or a 'loss'. Questions addressing risk comfort levels often involve individuals choosing among alternative courses of action relating to saving decisions, or simply stating their comfort level with risk.

## Investment choice

Preferences for different kinds of investments can also help to gauge risk attitude, for example, the safety of a bank account versus the risk/return potential of the stockmarket. However, questions of this nature need to avoid using financial jargon to ensure that clients truly understand the questions asked.

## Regret

This negative emotion arises from making the wrong decision. Individuals who are particularly prone to regret tend to try to make decisions that are less likely to cause it. For example, they might engage in regret avoidance.

The allocation of questions across the various categories:

<b>Risk attitude aspect</b>	<b>Number of questions in questionnaire</b>
Knowledge	2
Comfort with risk	3
Investment choice	6
Regret	1
Total	12

For a straightforward guide to some behavioural traits related to investing and risk, along with the consequences for advisers, see our guide: Behavioural finance – Understanding how the mind can help or hinder investment success. It's available free for professional investors on the Financial adviser section of our website Vanguard.co.uk.

## Scoring the questionnaire

The tool includes a variety of underlying algorithms and calculations to arrive at a generalised risk category with which to start a client conversation. Before moving on to the twelve questions that comprise the questionnaire, the tool pre-screens respondents to find out if they should even be considering investing at all, based on a 'no risk' attitude, or too short a time horizon.

### Pre-screening: saving vs. investing

Vanguard believes that anyone who is unwilling to take any risk with their capital should not consider investing in anything other than the safest savings vehicles. For that reason, our questionnaire asks:

Are you prepared to take the chance of losing some of your investment in seeking income or growth from your investment portfolio?

If a respondent answers "No" to this question, the tool stops there, defaulting to what is, in effect, a 'savings only' position. Advisers would need to make them aware of the full ramifications of their cautious attitude, in terms of the long-term value of their savings vs. the effect of inflation.

### Pre-screening: short, medium and long term

The length of an investment time horizon can change the types of investments an adviser should consider for a given client. For that reason, our tool takes this into account when scoring the questionnaire, or deciding if investing bonds and/or equities is even appropriate.

Our questionnaire then asks: How long do you intend to invest before you need your money?

- If a respondent answers less than three years to this question, the tool stops there, defaulting to what is, in effect, a 'savings only' position.
- If a respondent answers between three and ten years, the tool defaults to a 'medium term' (3-10 years) algorithm to score the questionnaire
- If a respondent answers more than ten years, the tool defaults to a 'long term' (10+ years) algorithm to score the questionnaire.



## Twelve risk profile questions

Each question uses a five-point scale ranging from Strongly Agree through to Strongly Disagree.

The questionnaire includes a blend of 'normal' questions, where agreement indicates an inclination to take risk and 'reverse' questions where agreement indicates aversion to risk. The profiling tool compiles the score by weighting the answers equally, taking account of whether they are 'normal' or 'reverse' questions.

Question response	Score for normal questions	Score for reverse questions
Strongly agree	4	0
Agree	3	1
No strong opinion	2	2
Disagree	1	3
Strongly disagree	0	4

## Risk profiling questions

- People who know me would describe me as a cautious person.
- I feel comfortable about investing in the stock market.
- I generally look for the safest type of investment, even if that means lower returns.
- Usually it takes me a long time to make up my mind on financial matters.
- I associate the word 'risk' with the idea of 'opportunity'.
- I prefer the safety of keeping my money in the bank.
- I find investment and other financial matters easy to understand.
- I am willing to take substantial financial risk to earn substantial returns.
- I have little experience of investing in stocks and shares.
- When it comes to investing, I'd rather be safe than sorry.
- I'd rather take my chances with high risk / high return investments than have to increase the amount I am saving.
- I am concerned by the uncertainty of stock market investment.

## Generating output

Based on time horizon indicated in the second question, and the Byrne-Blake proprietary algorithm, the score will be calculated to output a generalised risk profile broken into five labels. See descriptions on following page

- Low
- Low mid
- Mid
- Mid high
- High

## Sense checks

The scoring of the tool also includes sense checks along the way to account for contradictions in a respondent's answers.

For example, someone may answer nearly all of the questions in such a way that indicates high comfort with risk taking such that the tool puts them into the 'high' category. However, they've indicated that they strongly disagree with the statement: "I feel comfortable about investing in the stock market". The output would highlight this apparent contradiction so their financial adviser could delve further into the topic with them as part of the conversation that could lead to a full understanding of their true risk profile.

## Description of investor risk appetites

### Low risk

In general, low risk investors prefer knowing that their capital is safe and they're not comfortable investing in equities. They would rather keep their money in the bank. Low risk investors are unlikely to have much experience of investment beyond bank accounts. They will usually suffer from severe regret if their decisions turn out badly. Low risk investors with time horizons of ten years or more typically have portfolios with a majority of bonds and cash, with little exposure to equities or other higher risk investments. Low risk investors need to understand that their caution can mean that their investments may not keep pace with inflation, or that may fall short of their investment goal.

### Low-mid risk

In general, low-mid risk investors would prefer not to take risk with their investments, but they can be persuaded to do so to a limited extent. They would prefer to keep their money in the bank, but they may realise that other investments might be better over longer term. Low-mid risk investors may have some limited experience of investment products, but will be more familiar with bank accounts than other types of investments. Low-mid risk investors can often suffer regret when decisions turn out badly.

Low-mid risk investors with time horizons of ten or more years typically have portfolios with a majority of bonds and cash, but with some exposure to equities and other higher risk investments.

### Mid risk

In general, mid risk investors understand that they have to take investment risk to meet their long-term goals. They're often more willing to take risk with at least part of their available assets. Mid-risk investors may have some experience of investment, including investing in products containing higher risk assets such as equities and bonds. They can usually make up their minds on financial matters relatively quickly, but they still suffer from some feelings of regret when their decisions turn out badly. Mid risk investors with time horizons of ten years or more typically have portfolios with a mix of higher risk investments such as equities and lower risk investments such as bonds and cash.

## Mid-high Risk

In general, mid-high risk investors are willing to take on investment risk and understand the nature of the long-term risk/return trade off. They're willing to take risk with most of their available assets. Mid-high risk investors are typically experienced investors, who have used a range of investment products in the past. Mid-high risk investors will usually be able to make up their minds on financial matters quite quickly. While they can suffer from regret when their decisions turn out badly, they can accept that occasional poor outcomes are a necessary part of long-term investment. Mid-high risk investors with time horizons of ten years or more typically have portfolios with a majority of higher risk investments such as equities, but that also contain bonds and cash.

## High Risk

In general, high risk investors want the highest possible return on their capital and are willing to take considerable amounts of risk to achieve this. They're usually willing to take risk with all of their available assets. High risk investors typically have substantial amounts of investment experience and will typically have been managing their own investments. High risk investors have firm investment views and will make up their minds on financial matters quickly. They do not suffer from regret to any great extent and can accept occasional poor outcomes without much difficulty. High risk investors with time horizons of ten years or more typically have portfolios made up primarily of higher risk investments such as equities, with little in bonds and cash.

**Note: These profile descriptions are only illustrative. While they outline the common traits of individuals with the relevant risk profile scores, every individual is different and their scores will be built up from different combinations of responses to the questions in the risk attitude profiling questionnaire. The results should support and enhance, not replace, the 'know your client' process. Financial advisers should use this to start a discussion about investment risk with the investor.**

## Tools and checklists

We have created a number of tools and checklists to help you assess risk with your clients, understand their true risk profile and help you to comply with the FSA requirements.

### Checklist: Establishing a client's 'willingness' for risk

Based on the FSA guidance, the process used to establish a client's willingness to take risk should:

- ✓ Help you to fully understand the client's capacity for loss
- ✓ Help you fully understand their capacity for risk
- ✓ Include clear and understandable questions
- ✓ Highlight conflicting responses
- ✓ Use differentiated and well described risk categories
- ✓ Include supporting charts of the variance of possibilities
- ✓ Have the ability to record alternative advice

### Checklist: Using third-party risk profiling tools

Again, with the FSA guidance in mind, your risk profiling tool should:

- ✓ Support regulation and reflect FSA guidance
- ✓ Describe its scope and any limitations
- ✓ Explain its provenance and structure
- ✓ Identify clients with 'no-risk' profiles
- ✓ Be written in client friendly language
- ✓ Include an audit trail facility
- ✓ Be simple and easy to use

### Checklist: Selecting investments

- ✓ Implement a robust investment process
- ✓ Research on investment fundamentals
- ✓ Match appropriate product to risk willingness, ability and need
- ✓ Measure risk using more than just volatility
- ✓ Consider graded funds to cover risk range
- ✓ Ensure funds have clear and descriptive (not potentially misleading, e.g. 'cautious') names
- ✓ Look for complete transparency of fund components

## Client tools

Visit the Practice management section of our Adviser website for a series of worksheets to use with your clients, including:

- ✓ Financial satisfaction survey
- ✓ Life goals profile
- ✓ Life transitions profile
- ✓ Simplified personal balance sheet
- ✓ Simplified personal cash flow statement
- ✓ Financial life history
- ✓ Life principles

Guidance for how to use these sheets can be found in our extensive guide *Building a robust investment advice process*.

We have also created a guide designed to help you discuss investment risk with your clients. It discusses investment risk and potential reward in a short, straightforward and client-friendly manner. You can download the guide from our website, or order printed copies from Adviser Support.



## References and further reading

For a good overview of financial risk tolerance, risk attitude and risk profiling, we recommend starting with Grable and Lytton (1999) and Roszkowski et al. (2005).

For an in-depth description of psychometric analysis and test design, we recommend Kline (1993) and Rust and Golombok (1989).

See below for full references

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