REASSESSING RISK ASSESSMENTS

By Danielle Andrus

Danielle Andrus is editor of the Journal of Financial Planning. *She can be reached at dandrus@onefpa.org.*

Determining clients' optimum risk tolerance is often described as a combination of art and science. Regulators expect that financial planners are taking steps to analyze what their clients are comfortable with so that they can help them invest appropriately. However, there's disagreement about the best way to go about collecting and interpreting this information.

"When people use the word tolerance, they're not always meaning the same thing," noted Shawn Brayman, director of financial planning methodology at Morningstar. "There's my psychological willingness to take risk. There is whether I'm going to react badly in a downturn and have a knee jerk reaction. You've got all these moving parts, and a lot of people create tools that throw it all in like a stew and pretend that they can actually measure something."

However, Brayman pointed out, "anyone in the sciences knows that with a good test, you have to say, 'This is what I'm measuring. This is how I prove that I'm measuring it. This is how I prove it's reliable.'"

Morningstar data has found that clients' willingness to take risk doesn't vary materially over time,

Brayman said. "It's a stable trait of individuals. There are a lot of things around us that are not stable. Even if my willingness to take risk [doesn't change], my perception of what's going on in the market is going to change as the market and all these other unknowns come into play."

A lot of planners conflate willingness to take risk with perception of risk, he said. "They say, 'Oh, my client's risk tolerance changed when the market popped,' and the client's risk tolerance didn't change. What happened is the market popped."

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Brayman pointed out that even the experts disagree about the best way to combine factors like clients' prior investment experience and investment knowledge to determine their unique risk profile.

"We did some research, both survey-based and deep-dive interviews of guys like [Michael] Kitces and [Dave] Yeske, and ended up with the widest variety of opinions about what the right course of action," he said. "The truth of the matter is, that is a professional judgment. Some advisers would say, 'Experience doesn't matter; he's hiring mine.' Others would say, 'I don't put my clients on training wheels.'"

Planners' understanding of risk tolerance has wider implications for the relationship, too. Research from J.D. Power and published in *Barron's* shows that, on average, 29 percent of clients believe their adviser does not understand or respect their tolerance for risk. Only 32 percent of those clients say their adviser understands their goals and needs, and 26 percent say that their adviser is making recommendations in the client's best interest. By comparison, when clients feel their adviser does respect their risk tolerance, 90 percent say the adviser understands their goals and needs, and 85 percent trust that the recommendations the adviser makes are in the client's interest.

Turning to Tech?

Brayman worries that some advisers who eschew risk tolerance measurements "throw the baby out with the bath water" because they doubt the utility of the questionnaires they've seen and write off the approach entirely. Planners can use "the questionnaires that they get from [fund manufacturers] or little compliance check boxes where they ask the questions the regulator said they had to ask, but the adviser knows it's not measuring anything. So, they kind of say 'Oh, well, all of this is gobbledygook. Therefore, I'm going to just do it on my own because I can trust my judgment.'"

However, "there's a large body of knowledge in this space going back for many, many years," Brayman said. Risk tolerance assessment providers should be able to explain their methodology without hiding it in a black box, and advisers should be able to validate the methodology to satisfy regulators, he said. "How can you be a fiduciary and do the best for the client if you're buying a black box and you don't even know the principles under which it's coming up with an answer?"

Some planners may be disillusioned with fintech solutions for assessing risk tolerance. The 2021 T3/Inside Information Advisor Software Survey found that less than a third of advisers surveyed are using some kind of risk tolerance technology, down from

41 percent in 2020. The report found a diverse landscape of software providers for planners looking for a tech-based risk assessment tool.

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What Planners Are Doing

"After working as a CFP® [professional] for over 30 years, we utilize a combination of old and new techniques. The old, and still the best, assessment is conversation with the clients," according to Linda P. Erickson, CFP®, founding partner of Erickson Advisors. When working with couples, Erickson said she speaks with each partner "to see if they differ in their risk tolerance. We reassess, [and] we discuss the placement and relative risk of the placements every six months or one year."

Technology provides an opportunity to offer more sophisticated analysis of risk. "The new technique is, of course, using technology, such as Riskalyze, to put some numbers on the range of volatility in the current and proposed (if appropriate) portfolio construction. At least, the new technology tools can be used to take a deeper dive into the conversation," Erickson said.

Brad Lineberger, CFP®, president of Seaside Wealth Management, said that his firm used to use an "an old-fashioned written test, [but] technology has improved the game."

"The old-school approach that we took was a piece of paper and a pen, and it was a series of maybe 10 basic questions. It was more guesswork," he explained. "What made us realize that we needed to change was going through 2008, going through 2011, going through all of the market turbulence, and the people who said they're comfortable with risk oftentimes were the first ones who were nervous and wanting to sell at the most inappropriate time."

Lineberger started looking for a tech solution that could reframe risk in a way that helped clients see how market changes could impact them, ultimately settling on Riskalyze. "It can really demonstrate in not just percentage terms, but dollar terms. 'You say you're comfortable with the 12 percent and 14 percent decline? Here's what it looks like in dollar terms on your investment portfolio.' And that puts it in a whole new perspective when people could see the six-figure losses potentially. It helps them rethink it."

Reframing the inherent risk in a portfolio in terms of the impact it will have on the client helps them better understand it. For example, Lineberger had a client who felt that they could tolerate a 10 percent decline. Lineberger shared, "I'll never forget the comment that someone made several years ago. They said, 'Oh, my gosh, my account's down $100,000. That's more than I make in a year right now.' I said, 'Well, yeah, 10 percent on a million bucks is $100,000.' They were not comfortable with $100,000, but they were OK with 10 percent."

Lineberger noted that clients' perception of risk can be affected by how planners talk about market events.

"What we like to tell people is we're not going to reduce risk in reaction to what markets are doing, but we're going to reduce risk in reaction to life circumstances changing for our clients," he explained. "For example, we're getting closer to

retirement or we're in retirement, or we're changing jobs. If there are life changes that are happening—our spouse died, or maybe we have children and we want to start investing, or grandchildren and we want to start investing more aggressively on behalf of grandkids—those sorts of life changes, I think, warrant an adjustment to the risk profile."

A. Raymond Benton, CFP®, owner of Benton & Company and a registered rep with Lincoln Financial Advisors, takes a different approach. "We do not do 'risk assessments'—we simply assume that clients and prospects have a zero-tolerance for risk regardless of capacity or perception (the latter being generally false)—but most must nevertheless incur a bit in order to flourish (including many of which they are unaware). It is handled by a commitment to accompany them on their journey, the outcome of which is unknown. (And, it turns out, that is all they really want.)"

Brayman called the risk assessment problem an "evolutionary conundrum." His team talked to regulators in Australia, Canada, Singapore, the U.K., and the U.S. for a 2015 study. "We talked to everybody that would talk to us in the world, and the truth of the matter is the regulators don't know how to do it either. The best they can do is say, 'You should ask your client this, this, this, and this, so that at least you have some awareness of it,'" according to Brayman.

"You have financial planners who are supposed to care about long-term, informed consent—is the client on the right path?—and you have people selling products with compliance departments that are measuring short-term volatility, and . . . the two worlds don't necessarily meet in an elegant way," he said. "We're fighting a really tough war, where the media and a lot of other things are focused on short-term volatility, market movements, and trying to frame risk in that way." ■

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