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RISK PROFILING

Get to know your inner investment self

To determine the level of risk you are happy with may require some profiling, but be aware of the limitations of some of the tools of this trade. Cathy Adams examines their usefulness

We might all like to think we're adventurous people, but when it comes to investing our hard-earned cash, it could be the exact opposite. Nobody wants to lie awake at night worrying about investments disappearing down a big black hole, but then nobody wants their money earning no interest under the mattress either. How do advisers, and investors going it alone, decide on a level of risk they are happy with? That's where risk profiling tools come in.

Risk profiling is familiar lingo among financial advisers, and it is standard practice for all advisers to use a risk tool to assess the level of risk the client is happy with. At their most basic level, risk profiles will give an answer that falls into three categories: cautious, balanced and adventurous. More sophisticated risk-profiling tools will use psychometric questionnaires – an example being the FinaMetrica test – comprising a number of questions, based on answers to questions about financial risk.

The tools focus on decision-making and processes, assessing how confident people are in making decisions, how much gut feeling is involved and how people feel after making financial decisions.

These kind of psychometric profiles are increasingly becoming the independent financial adviser's tool of choice to assess a client's attitude to risk. However, they are not a one-size-fits-all solution, as Jason Witcombe, chartered financial planner at Evolve Financial Planning, explains: 'The "cautious, balanced and adventurous" tests are worthless as they're so subjective. A number of advisers, including us, use psychometric risk-profiling questionnaires, but you can't expect to answer 20 questions and out comes a perfect risk profile.'

Other advisers employ different strategies. Julie Lord, financial planner at Bluefin Group, uses a 'three lens approach' to assessing risk.

'We look at their income and expenditure, their investment portfolio and return and their capacity for risk and loss. It then becomes a conversation about how the client can achieve their goals – it's about finding a balance between investment goal and investment risk.'

There's often a disparity between expectation and risk, though, and it's important for people to understand this. 'Most clients expect to get high returns for low risk,' adds Witcombe. 'People tend to feel more pain from decisions that went wrong than pleasure from decisions that went well. It's all about educating and coaching people about investment risk.'

While, as Lord and Witcombe highlight, they are a good starting point; risk profilers aren't infallible – as IFA Robin Wood from Parkhouse Financial Services attests. 'I once had an 83-year-old woman who answered a risk profiler's questions honestly and philosophically. She came out as an adventurous risk-taker,' he says in disbelief.

Earlier this year, the Financial Services Authority sounded a warning over the suitability of many risk-profiling tools, saying that many can lead to flawed results. Out of 11 risk-profiling tools, it found nine to have weaknesses that could lead to 'flawed outputs' – adding more weight to the argument that risk-profiling tools are just the first part of a long conversation about attitudes to risk.

Change is afoot, though, in the form of new 'emotional' risk profiles that focus on personality. Psychological Consultancy's Risk Compass, and Portfolio Metrix, a new risk profiler and discretionary management product, have sprung up on the market as a response to a 'lack of consistency' in the industry, according to Psychological Consultancy's managing director Geoff Trickey.

'Traditional risk profilers ask nothing substantive or emotional, or they assume prior knowledge of the client,' Trickey comments. 'Personality is very pertinent when taking risks. We consider five major aspects of personality, four of which have some input in risk taking.'

Clients who use the Risk Compass will come out as one of eight risk types. There are four pure types, like the points on a compass: north, south, east and west. Then in between the points there's a mixture of the two – north-east, south-east, south-west and north-west. These correlate to eight different risk 'types'.

Rather than asking traditional 'how would you feel if you lost 10 per cent of your wealth', the statements include 'I believe others have good intentions' and 'I trust what people say'. Clients then select how far they agree or disagree on a sliding scale. Using these answers, the risk compass 'distinguishes things about people that determines how they deal with risk',

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says Trickey.

He claims that 'risk' comes down to two key points: risk type – the deep-rooted personality trait determined *in utero*, and risk attitude – the more transient risk feeling, which can change with market sentiment.

So far, Columbus Wealth Management has taken up Trickey's Risk Compass, and he adds that they've seen most interest from hedge funds. That said, self-directed investors can also visit the site and do it for themselves by visiting www.psychological-consultancy.com, and paying £22.50.

In terms of fund platforms, few offer any kind of risk profiling. Interactive Investor, for example, gives a steer on the level of risk for various funds, but product director Rebecca O'Keeffe emphasises that it is 'ultimately up to the customer to know what risk they are happy to take and to deal accordingly'.

Hargreaves Lansdown offers a risk and reward guide, which explains the asset classes and how they interact, says Danny Cox, head of advice at the broker.

'Risk profiling tests don't give either the investor or the adviser a proper answer, and they don't advise how it got to whichever number gets spat out at the end. Risk profiling is all about the start of a conversation,' he says. 'We try and stay away from them, and just give investment ideas. It's potentially more harmful to provide one than to not provide one at all.'

However, Standard Life's platform Funds Zone and Fidelity FundsNetwork do give investors going it alone a form of risk profiling, although they are not as detailed as ones available through an IFA. Both platforms use a simple 10-step questionnaire to ascertain risk level, and then suggest investments based on this.

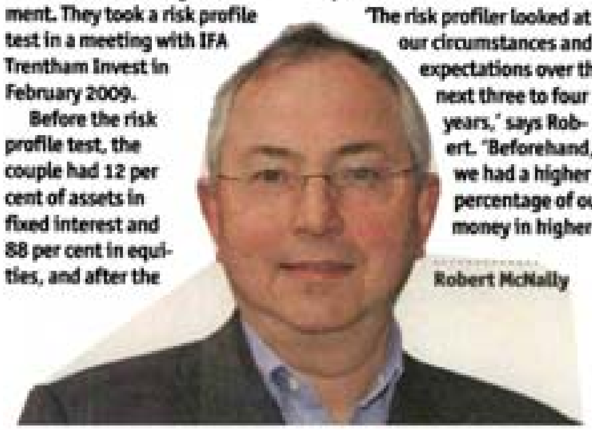
While risk profiles can point you in the right direction, they can't provide a perfect fit for each investor. 'None of us can predict the future – it's better to be comfortable with what your portfolio is doing, and find a mix that's right for you,' says Witcombe.

In practice Really useful profiler

Robert McNally and Fay Lau live in Surrey and are in their 50s. Their main investment goal was to grow their funds into a sole source of income to provide for them both through retirement. They took a risk profile test in a meeting with IFA Trentham Invest in February 2009.

Before the risk profile test, the couple had 12 per cent of assets in fixed interest and 88 per cent in equities, and after the risk profile test their asset allocation changed to 53 per cent in fixed interest and property, and 47 per cent in equities, reflecting their responses in the risk questionnaire.

'The risk profiler looked at our circumstances and expectations over the next three to four years,' says Robert. 'Beforehand, we had a higher percentage of our money in higher-risk assets as we thought that was suitable, but the risk profiler said we needed to be in lower-risk assets, and now our portfolio is more conservative. The profile was really useful for us because as you get older your circumstances change. Plus, at the moment, with the market volatility, we're happy to hold a slightly lower risk portfolio. A risk profile seems a good way to continually reassess our investment goals, and to give an independent view on our level of risk. Risk tools are quite refined, but it's been a useful tool for us.'



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