Risk Tolerance: Your Duty To Care

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PRESENTATION OVERVIEW

I. What is Risk Tolerance?

II. Why Does It Matter?

III. Fiduciary Best Practices
What is Risk Tolerance?

“The extent to which an individual is willing to risk experiencing a less favorable outcome in the pursuit of a more favorable outcome”.

ISO 22222 Personal Financial Planning Standards
What Risk Tolerance is...

- A psychological trait that differentiates people
- Helps define “who we are”
- Some people enjoy taking risk while others despise it
- It is domain specific: ex. physical vs investment
- It is relatively stable over time and does not fluctuate with markets
What Risk Tolerance is NOT

- Risk tolerance is NOT the ability to take risk
  - Risk Required
  - Risk Capacity

- Risk tolerance is NOT a mental state
  - Risk Perception
“Risk tolerance is only stable when considered as a personality trait, which can be measured effectively using holistic psychometric scales.”

Greg Davies PhD
Head of Behavioural Finance, Barclays Wealth
Said Business School, Oxford University

<table>
<thead>
<tr>
<th>Risk Group</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score Range</td>
<td>Less than 25</td>
<td>25-34</td>
<td>35-44</td>
<td>45-54</td>
<td>55-64</td>
<td>65-74</td>
<td>75 or more</td>
</tr>
<tr>
<td>% No in Group</td>
<td>1%</td>
<td>6%</td>
<td>24%</td>
<td>38%</td>
<td>24%</td>
<td>6%</td>
<td>1%</td>
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Source: Risk Tolerance: Essential, Behavioural and Misunderstood, November 2013
Psychometric Test Development

- Pool of Questions
- Sample Questionnaire
- Useability Trials
  - Understandable and answerable?
- Norming Trials
- Statistical Analysis
  - Valid, reliable and accurate?
Validity and Reliability

Valid and Reliable
Valid not Reliable
Reliable not Valid
Neither Valid nor Reliable
Why Risk Tolerance Matters
Legal Liabilities

FINRA Arbitration Cases Filed 1999 - 2010

<table>
<thead>
<tr>
<th>Year</th>
<th>Cases</th>
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</thead>
<tbody>
<tr>
<td>1999</td>
<td>5,608</td>
</tr>
<tr>
<td>2000 – Internet Bubble</td>
<td>5,558</td>
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<tr>
<td>2001</td>
<td>6,915</td>
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<tr>
<td>2002</td>
<td>7,704</td>
</tr>
<tr>
<td>2003</td>
<td>8,945</td>
</tr>
<tr>
<td>2004</td>
<td>8,201</td>
</tr>
<tr>
<td>2005</td>
<td>6,074</td>
</tr>
<tr>
<td>2006</td>
<td>4,614</td>
</tr>
<tr>
<td>2007 – Subprime Crisis</td>
<td>3,238</td>
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<tr>
<td>2008</td>
<td>4,982</td>
</tr>
<tr>
<td>2009</td>
<td>7,137</td>
</tr>
<tr>
<td>2010</td>
<td>5,680</td>
</tr>
</tbody>
</table>

The bulk of these were due to “too much risk”
“My advisor should have known the strategy was too risky for me. I didn’t understand the risks. They weren’t explained properly. If I had understood, I wouldn’t have taken the advice..”
Why Risk Tolerance Matters
Compliance

FINRA Suitability Rule 2111

- Risk tolerance added to the explicit list of factors advisors must obtain and analyze when making investment recommendations to customers

- Became effective July 9, 2012
Regulatory, competitive, and professional pressures are driving a more fiduciary future.

Unethical & Unskilled

US Regulation

UK Regulation

Source: Blaine Aikin, CEO, fi360
AICPA PFP Conference Jan, 2014
9 of 11 risk profiling tools “not fit for purpose”

Half unsuitable advice cases involved risk profiling failures

“Bad” questions and “ineffective scoring” cited as major reasons

Advisers didn’t understand the tools they were using
Poor Practice

- A firm relied solely on the use of a tool that assessed a customer’s attitude to risk
- Clear that the results from the tool were the primary influence in making an investment selection
- Very little information gathered to assess suitability other than that needed by the tool
- Lack of appropriate consideration of other customer needs and circumstances
The 5 Proofs
A Simple Self-Administered Suitability Test

- Prove you know your client: their situation, needs and aspirations
- Prove you identified mismatches and looked at the alternative strategies
- Prove you know the product(s) recommended
- Prove you explained the risks in the plan and the product(s) recommended
- Prove you received your client’s properly informed consent to the risk in the plan and the product(s) recommended
1-2-3 of Risk Profiling

1. Assess risk required, risk capacity and risk tolerance.

2. Identify mismatches and assist with trade-off decisions.

3. Confirm risks are understood and obtain your client’s properly informed consent.
Risk Tolerance to % Growth Assets
Enter the risk tolerance score to see the Comfort/Discomfort ranges for the % of Growth Assets in

Enter Name: Susan
Enter Risk Tolerance Score: 59

Enter Current Portfolio: 90% Growth Assets
Enter Target Portfolio: 70% Growth Assets

Susan 59

Current Portfolio vs Target Portfolio

% Growth Assets

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Fiduciary Best Practices
Gap Analysis - Couples
Risk Tolerance vs Risk Required

Risk Tolerance to % Growth Assets
Enter the risk tolerance score to see the Comfort/Discomfort ranges for the % of Growth Assets in

Enter Name
Susan
Enter Spouse’s Name
Bill
Enter Risk Tolerance Score
59
45
Enter Current Portfolio
90%
Growth Assets
Enter Target Portfolio
70%
Growth Assets

- - - - Current Portfolio  - - - - Target Portfolio

Susan 59
Bill 45

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%
% Growth Assets
Fiduciary Best Practices
Due Diligence

- Have the validity and reliability of the RTQ been established through test/retest studies?
- Is there a technical manual for the test?
- What is the questionnaire’s track record?
- Are there academic or independent studies to confirm the stability of test results, particularly across market cycles?
Fiduciary Best Practices

Employee Retirement Income Security Act (ERISA)

The Employee Retirement Income Security Act (ERISA) requires plan fiduciaries, when selecting and monitoring service providers and plan investments, to act prudently and solely in the interest of the plan's participants and beneficiaries.

Source: http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html
Fiduciary Best Practices

Are you acting prudently and in plan participants’ best interest if…?

- Plan participants looked to previous years’ performance, and neglected to consider longer-term results
- Plan participants chose previous years’ best performer and ignored fees
- Plan participants forced to “pick-a-portfolio” without regard for assessing risk tolerance

Source: http://www.aicpaconferencematerials.com/personalfinancialplanning/?select=session&sessionID=16
Assessing Risk Tolerance

What’s your risk tolerance?

Uh?
Contact

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10% Discount for fi360

Free 30 day trial:
http://riskprofiling.com/Trial