



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



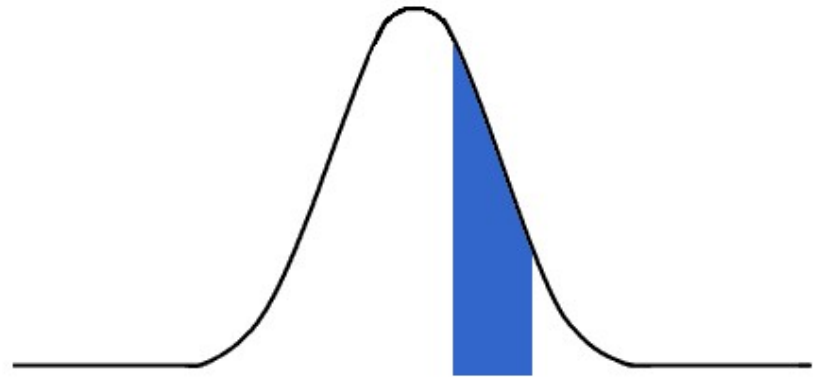


“Risk tolerance is only stable when considered as a personality trait, which can be measured effectively using holistic psychometric scales.”

Greg Davies PhD

Head of Behavioural Finance,
Barclays Wealth

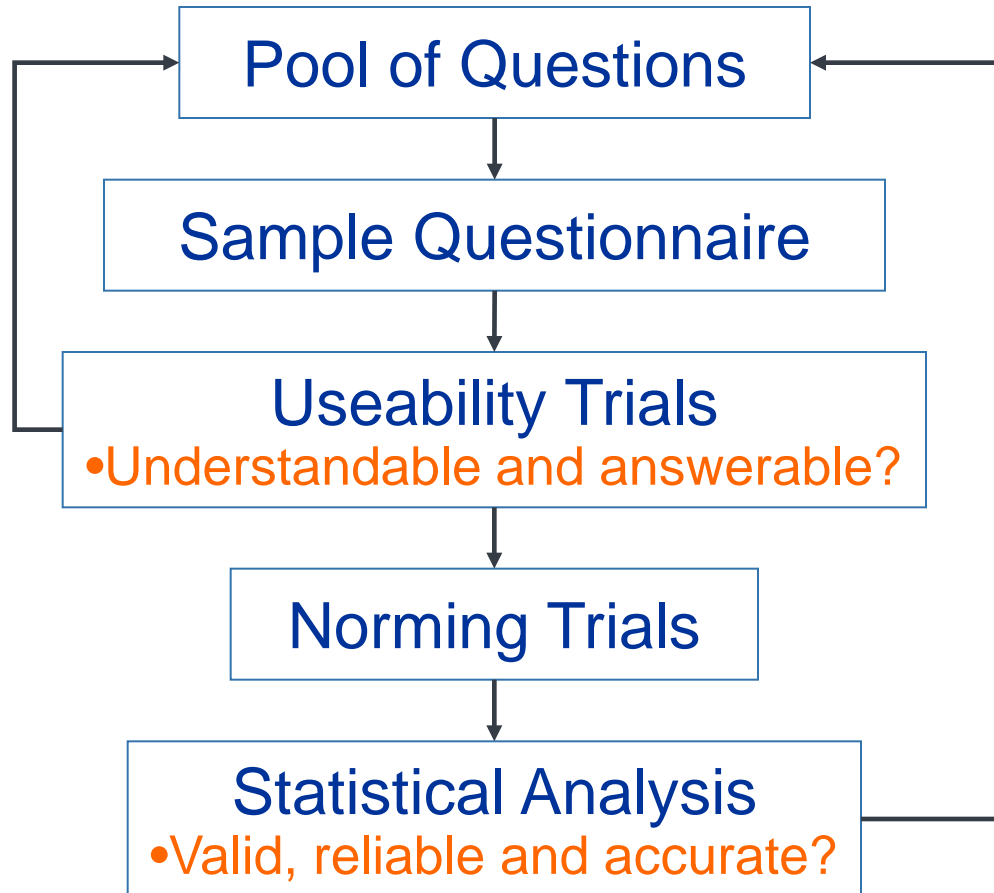
Saïd Business School,
Oxford University



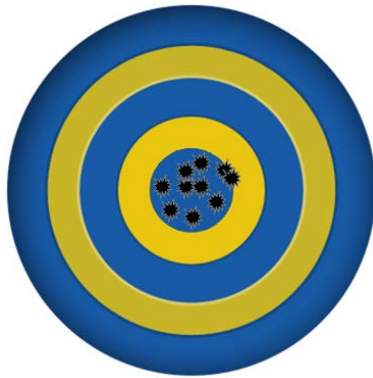
Risk Group	1	2	3	4	5	6	7
Score Range	Less than 25	25-34	35-44	45-54	55-64	65-74	75 or more
No in Group	1%	6%	24%	38%	24%	6%	1%

Source: Risk Tolerance: Essential, Behavioural and Misunderstood, November 2013

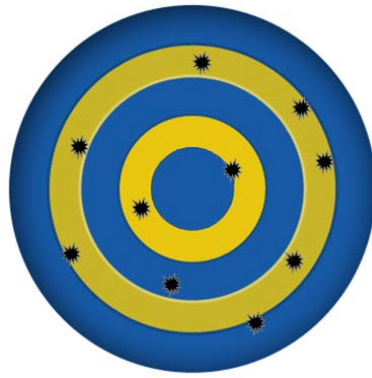
Psychometric Test Development



Validity and Reliability



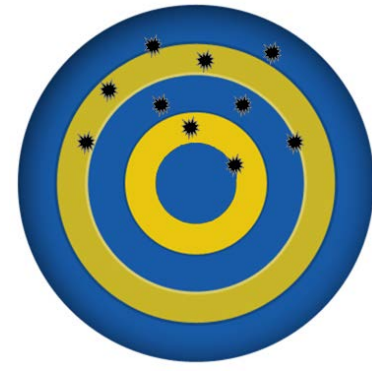
Valid and
Reliable



Valid not
Reliable



Reliable
not Valid



Neither Valid
nor Reliable

Why Risk Tolerance Matters

Legal Liabilities

FINRA Arbitration Cases Filed 1999 - 2010

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

The bulk of these were due to “**too much risk**”



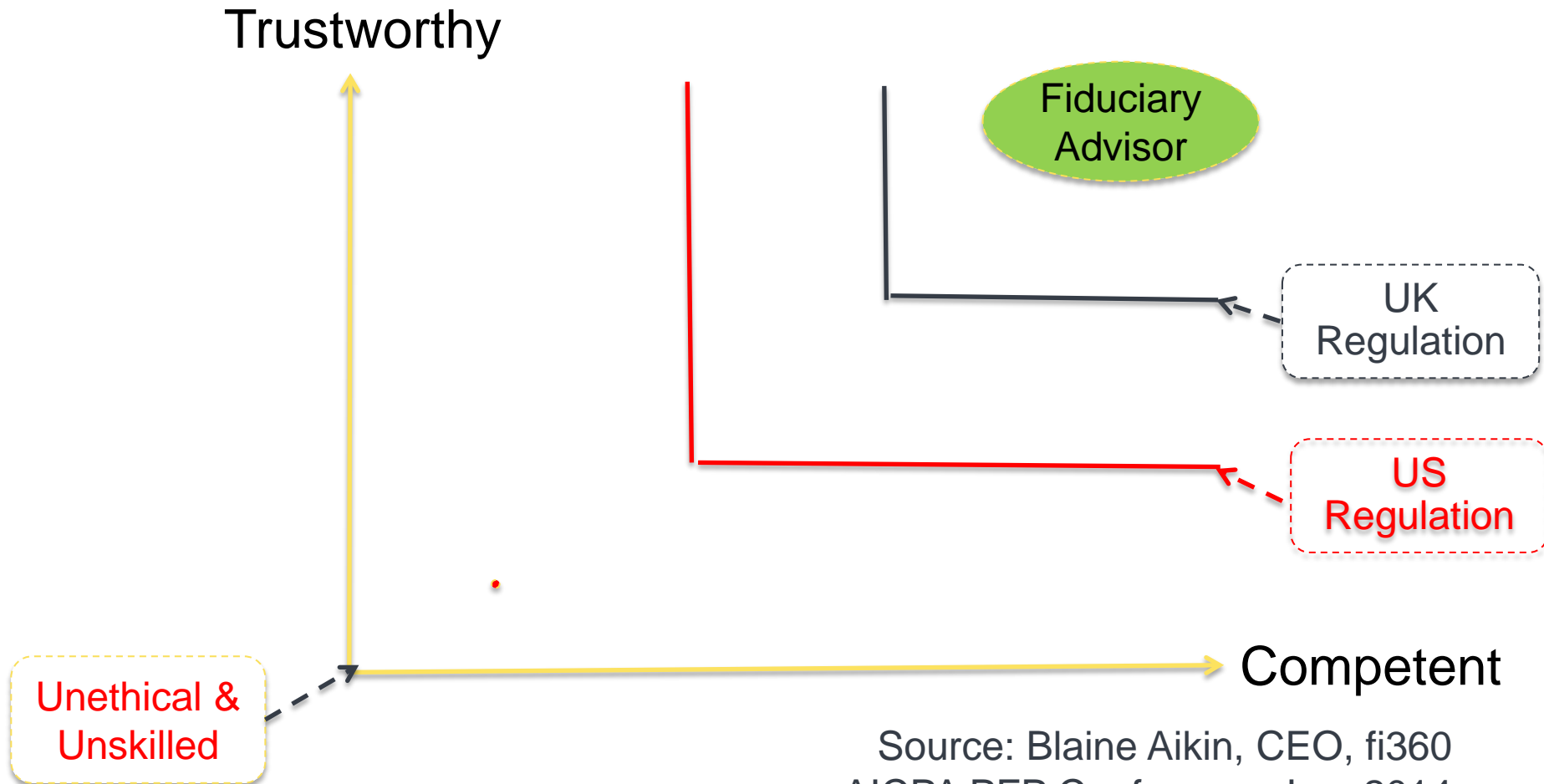
“My advisor should have known the strategy was too risky for me. I didn’t understand the risks. They weren’t explained properly. If I had understood, I wouldn’t have taken the advice..”

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

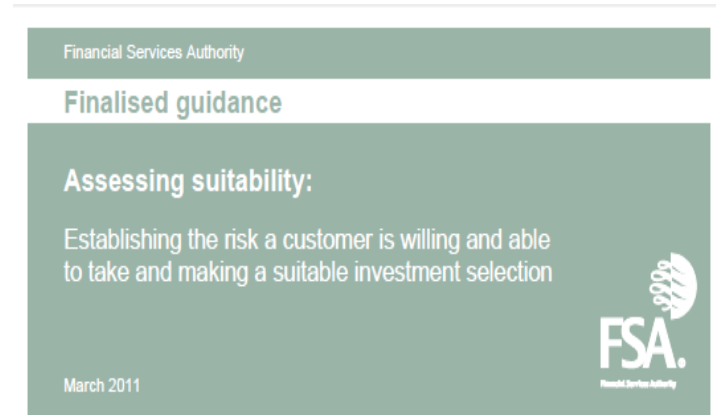
Regulatory, competitive, and professional pressures are driving a more fiduciary future



Source: Blaine Aikin, CEO, fi360
AICPA PFP Conference Jan, 2014

FSA Study

- 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



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3 Establishing the risk a customer is willing and able to take	9
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6 Summary of changes to final guidance as a result of consultation	29

FSA Study

Poor Practice

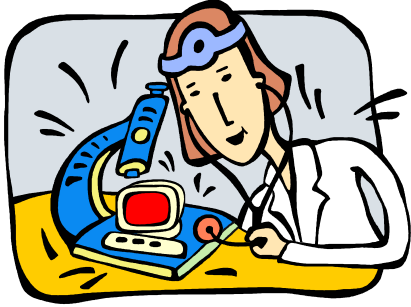
- A firm relied solely on the use of a tool that assessed a customer's attitude to risk
- Clear that the results from the tool were the primary influence in making an investment selection
- Very little information gathered to assess suitability other than that needed by the tool
- Lack of appropriate 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.

Fiduciary Best Practices Gap Analysis

Risk Tolerance vs Risk Required

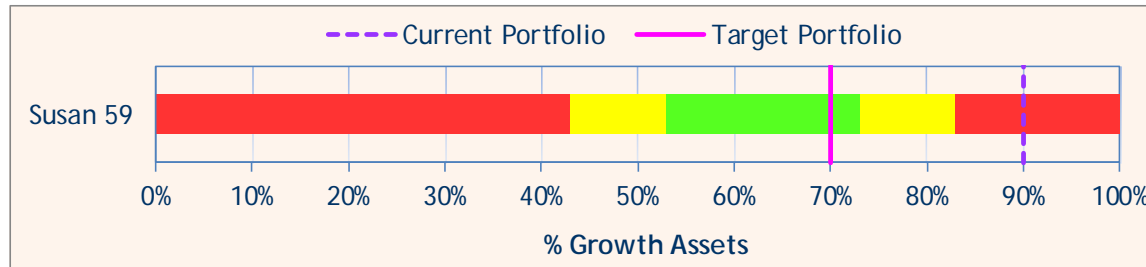
Risk Tolerance to % Growth Assets

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

Enter Name Enter Risk Tolerance Score

Enter Current Portfolio Growth Assets

Enter Target Portfolio Growth Assets



Fiduciary Best Practices Gap Analysis - Couples

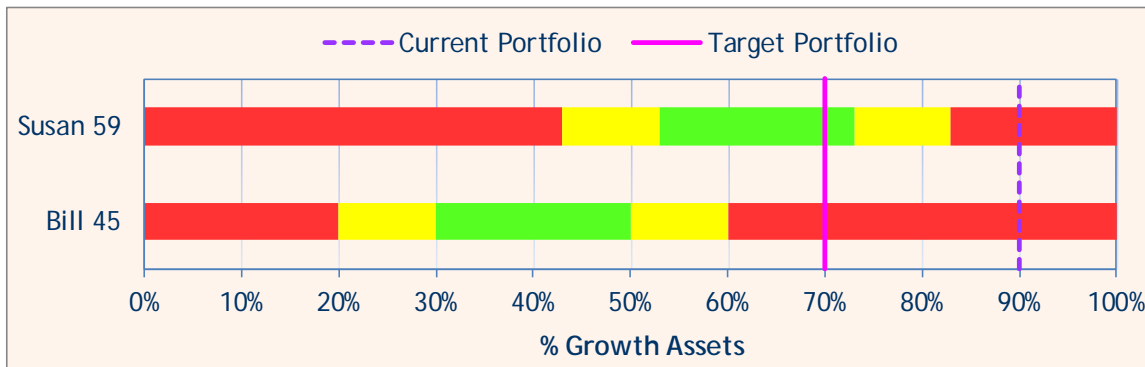
Risk Tolerance vs Risk Required

Risk Tolerance to % Growth Assets

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

Enter Name	<input type="text" value="Susan"/>	Enter Risk Tolerance Score	<input type="text" value="59"/>
Enter Spouse's Name	<input type="text" value="Bill"/>	Enter Risk Tolerance Score	<input type="text" value="45"/>

Enter Current Portfolio	<input type="text" value="90%"/>	Growth Assets
Enter Target Portfolio	<input type="text" value="70%"/>	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>Source

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>