Risk assessment

Risk assessment lies at the heart of the wealth management process. But just why is it important?

If you do not know what to expect from your investments and you do not know what impact risk could have on your financial security and, you do not know how your manager is going to deal with risk, your expectations of risk and return and, possibly your financial security, could be compromised.

The risk assessment process should be designed to interact with the client and deal with a wide range of issues that will surface throughout the client's portfolio lifetime.

Your advisor needs to educate you about the basics of investment, about their investment discipline, about how they will run your money and how they will go about managing the key investment risks.

They need to assess your attitudes to these risks and explain to you the effects of these attitudes on the ability of your portfolio to meet your needs, risk preferences and financial objectives.

This first risk assessment should only be a preliminary assessment and should only be used to develop the investment planning and portfolio management report. After the client has read this report and has met to go over this report, the risk assessment needs to be confirmed and reinforced.

A copy of your risk assessment should be given to you.

Education, three stage process

Education lies at the heart of managing client expectations. Most investor concerns over markets and performance are related to insufficient education and information at outset.

Education starts at the client's first meeting, is developed in the initial investment planning report, supported by education material and reinforced at each investment planning review. The client should not be forced to learn through events and mistakes. Changes to preferences may still occur, but risk profiling should limit the magnitude of such change.

Education, basic examples

- Your advisor needs to explain the benefits and risks of equity investment over time. This must include the short term risks, the natural ups and downs of equities and the importance of taking a long term view.

- The advisor must explain that stock markets do not always go up and that you must be prepared to experience long periods of poor performance and periods of significant falls.

- Has your advisor explained the initial risks of investment, especially during high market valuations and how they manage this risk?

- There have been instances when equities have failed to produce real returns for investors over periods as long as 20 to 25 years. Equities can be detrimental to your long term financial security if bought at the wrong time.

- Your advisor needs to explain the importance of cash and fixed interest investments within the portfolio and the consequences of either holding too much or too little.

- Have they explained the risks of inflation and what inflation is?

- Has your advisor explained to you their core investment disciplines? How will their investment discipline affect the management of your portfolio over time?

An organisation's global and specific market strategy and investment style (growth/value, large cap, mid cap, small cap) will pose performance risks to the investor. The investor should be educated about the organisation's allocation approach, the risk and the risk/return benefits over time. Only then can the investor assess his or her attitude towards these risks and select a profile which will either limit the performance risk or neutralise it.

Performance risks do not just involve return factors, but also risk factors. Where an investment style is characterised by higher volatility than the market, the client's attitude to this risk needs to be assessed.

Complexity, the dilemma

One of the biggest problems with investment is the need to deliver complex issues simply and to provide access to more detailed and complex perspectives. The advisor should provide you with access to more detailed information about investment and their particular investment approach.

Risk Assessment Rules

1. Any aspect of portfolio structure that may impact on the portfolio's ability to meet an investor's financial security needs to be communicated to the client and their attitude towards it assessed by the client.

2. The investor needs to be educated about these risks and, he or she needs to be able to assess whether the recommended structure adequately meets their needs and preferences. They should also be provided with options that provide real alternatives to the recommended portfolio.

3. Any aspect of portfolio structure that has been specifically designed to deal with a risk to financial security also needs to be assessed for the same reasons discussed above.

4. Any aspect of investment strategy and asset allocation that may conflict with the investor's risk and performance preferences also needs to be assessed at outset.

5. The investor needs to be educated about the advisor's investment style, the recommended portfolio and any options that the client has to change to a more aggressive or more conservative portfolio.

The only way an advisor can effectively assess risk aversion is by educating the client over the basics of the risks and factors affecting the risks.

An investor enters a wealth and asset management relationship with expectations. If these expectations are not carefully managed and assessed by the advisor there will be conflicts later on in the relationship.

It is therefore extremely important that investors seek advisors with a focus on education, communication and risk assessment.

The Investment Universe

The risk profile should relate the client's investment and risk universe to that of the asset or wealth manager.

Even if a wealth manager follows an aggressive investment style, invests in smaller companies, emerging markets and has big global allocation, a risk profile would allow a conservative investor to be allocated a more conservative portfolio with more defensive larger companies and a higher domestic allocation.

Now the ability of an asset management company to adjust their portfolio structure to suit your risk preferences depends very much on their investment style and their investment planning disciplines. Investment planning disciplines are the rules that define the relationships between the manager's investment style and strategy to the varying risk preferences and financial needs of the investor.

Investment planning disciplines are discussed in greater depth in the technical documents in the Technical section of this website.

Companies which have a narrow allocation focus and limited investment planning disciplines can only deal with investors where the client risk profile is a close match to their own investment style and where the client's financial needs over time is relatively simple.

Because a risk profile integrates the investor's and the organisation's risk return universe into the one risk/return management process, both advisor and client know where each other is coming from and portfolios can be run consistently with both risk preferences and financial needs in mind.

Advisors using standard industry portfolio construction software may not have the ability to adjust the structure of your portfolio to suit your risk preferences.

It is very much in the individual's interest to have a portfolio which matches their needs, risk aversions and performance risk preferences.

Risk profiling

The risk assessment should provide the wealth manager with a risk profile. A risk profile is a record of the individual's answers to the risk assessment questionnaire.

It is important because it is this profile which should be used to both select the recommended portfolio, asset allocation and security selection and adjust this asset allocation and security selection to suit the investor's own preferences.

For a given set of financial needs over time, a given set of market and economic conditions and, a given investment style, there is a recommended portfolio for each investor which is personal to each investor. It is this structure that the risk profile will adjust, making it not only personal to the investor's financial needs, but risk and performance preferences.

A risk profile should do the following.

- Record the investor's aversion to significant stock market and economic risk and therefore determine the preferred low risk allocation relative to what the advisor would recommend. This risk aversion relates the amount allocated to low risk investments to the size and timing of an individual's financial needs and is not normally assessed. The profile would record a number say between 1 and 10.

- Record the investor's aversion to the initial risk of investment and therefore determine how much of the recommended stock market allocation is made from a cash position. This records the investor's aversion to the major initial risk of stock market investment as well as investment timing risks and, again is rarely assessed. For example the risk profile would record a yes or a no or, a 1 or a 2

- Record the investor's aversion to the risks of a manager's investment style. For those managers that are able to adjust portfolio structure in accordance with an investor's natural performance preferences this will mean either reducing or increasing international allocation and/or adjusting the strategy within markets towards that of the index. A risk profile may record say a number between 1 and 5.

- Record the investor's attitude towards taking a higher or lower level of risk than that taken by the manager within the stock market component of the portfolio, either increasing the aggressiveness of the strategy or reducing it and reducing the allocation to markets in general. Again this may record a number between 1 and 10.

- The profile would combine all the results, say 5, 1, 3 and 6 and these figures would be inputted into an investment planning and asset management system to select the portfolio, its allocation and the way in which it will be managed.

For many advisors, risk assessment and risk profiling starts and stops at the "know your client" form and the basic retail risk assessment questionnaire. Unfortunately, this limited retail risk assessment provides a very limited risk profile.

Additionally, for firms that deliver a fixed investment style and are unable to adjust their strategy and asset allocations for risk aversions and preferences would use the risk profile to determine whether or not a client is compatible for their services.

The results of the risk assessment should be reported in the client's initial investment planning and asset management report or at least be communicated formally.

How effective a risk profile is depends very much on an organisation's investment planning and investment disciplines as well as the sophistication of their wealth and asset management systems.

Why?

For each individual investor’s income and capital needs over time, there is a relationship between the allocation to larger companies, to dividend paying companies, to smaller companies, to defensive companies, to under valued companies, to global markets based on the way the advisor structures their portfolios.

The individual investor may be more conservative than the asset manager or more aggressive than the asset manager and their risk preferences will adjust the strategy of the portfolio.

Industry standard risk profiles

Industry standard risk profiles are those that are derived from industry standard risk assessments. You will find these at most banks and brokerages.

These risk assessments mainly assess your attitude to one investment risk, that of volatility.

While they do relate your basic financial needs to a portfolio structure, this portfolio structure is neither personalised to your financial needs nor are you capable of adjusting the recommended portfolio to suit your risk aversions and performance preferences.

Proper risk profiling should be used to adjust portfolio structure and strategy to one suitable to both financial needs and risk preferences.

Risk assessment process

Risk assessment is a continuous three stage process; the initial client meeting, the initial reporting stage and the annual investment planning reviews.

Initial client meeting

Clients should be taken though the risk assessment process at the initial meeting. They should be left with a copy of the assessment which should include the information used to conduct the assessment. Online assessment requires a more involved interaction of education and assessment than is currently offered by the market.

If the client data is already within the system, risk assessment can be an interactive process with illustrations of the risks and consequences of risk preferences.

Initial reporting stage

The initial report reinforces points discussed during the risk assessment process. It will state how the portfolio will be structured and managed and will assess the ability of assets to meet needs within the constraints set by the client's risk profile, assets and liabilities. If the client's assets are insufficient to meet needs over time the client may need to reassess their risk preferences or financial demands.

The report provides the client with concrete illustrations of the structure of the portfolio, the security provided by the portfolio over time, the initial investment strategy and an explanation of the function of each of the assets within the portfolio.

The report should state the allocation of the portfolio as it relates to risk aversion and current market conditions, the nature of the equity portfolio and its risk profile over time. Analysis of the equity portfolio will explain to the client the risks of the portfolio and what to expect from the portfolio over time as a consequence of management style and natural investment risk.

The follow up meeting to discuss and implement the report provides the client with an opportunity to question and the organisation to reinforce both message and fully establish the client risk profile on which the client's portfolio and financial needs will be managed.

It is here that the actual recommended portfolio is provided and the actual structure and risk of the portfolio detailed. It is here where the client is able to assess and accept of the risks and potential returns of the recommended portfolio as defined by the risk assessment.

Annual investment planning reviews

At each investment planning review client risk assessment is restated and related to portfolio structure, management, performance and market conditions. At each review the client learns more and more about an advisor's process and becomes more and more dependent on the advisor.

Risk assessment and education are key service components and represent an investment in the client, the client portfolio manager and the wealth management process.

Effective Risk Assessment

An effective risk assessment process should do the following.

- Educate the investor regarding risk and the effect of risk aversion on portfolio structure.
- Assess the investor's attitude to liability risks (risks to ability to meet financial security), volatility and performance risks.
- Provide clarity between the risk assessment and the effect of risk preference on portfolio structure.
- Provide a basis for consistent reassessment of risk aversion and continuing education.
- Provide a basis for constant communication of risk, risk preference and risk management relative to current stock market and economic conditions.

Importantly the risk assessment should neither perpetuate ignorance nor reinforce misunderstanding.