

ADVICE INSIGHT

Risk profiling - whose needs does it serve?

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Conventional financial advice is heavily centered around personal risk profiles. Through risk profiling investors are put into broad categories based on their willingness to take on risk in order to achieve higher returns. The categories, being conservative, moderate or aggressive, serve as the anchor point around which their portfolio is then constructed. This logic has more to do with sourcing an investment product than understanding the client.

Confronted by the events of the credit crunch, many investors have found the risk profiling they completed with their advisers proved to be a rather inaccurate yardstick. Certainly, recent thinking around behavioural economics is challenging this conventional approach. Risk profiling assumes that peoples' risk profiles remain the same for many years – perhaps only changing towards conservatism as we age. The conventional wisdom also fails to appreciate that we attribute different risk positions to our need to be able to fund our grandchildren's education relative to say funding a world cruise.

To illustrate this point, take two hypothetical investors. Investor A and Investor B are invested in the same portfolio, they have the same risk profile, they both watched their investment drop by 30% when markets were at their lowest last year and they both found the experience deeply uncomfortable. What differentiates their reaction to the loss is the personal implication of that loss.

For Investor A, the loss implies delaying her purchase of a new car. For Investor B, the loss means that she can no longer afford to visit her new born grandchild overseas.

The two investors have the same investments with the same risk profile and the same mathematical outcome, yet they have completely different emotional outcomes. Understandably, Investor B was the one most likely to capitulate and she exited her portfolio late last year based on what can best be described as an emotional overload. As a result, when the market recovered this year she was not in a position to benefit

from it. So Investor B suffered a loss and then, as a result of her emotional and very human reaction, she was unable to recover from that loss financially. Most investors in Investor B's position (regardless of gender) would have done the same thing.

Risk profiling has proved to be a poor starting point for portfolio construction. A far better starting point is a deep understanding of each individual's unique needs. This deep understanding should provide the means to separate those needs, usually in the near term, which the investor does not want to jeopardise from those which they are more philosophical about.

NZ Funds' goal based advice process is based on a different approach - namely behavioural economics. A useful way to describe an investment portfolio from a behavioural point of view was developed by Meir Statman (1999) using a hierarchical view of an investor's needs. Statman proposed a behavioural portfolio with a pyramid structure where the investor's essential needs form the base, discretionary needs form the upper layers and aspirational needs form the apex.

Portfolios are then constructed to meet each of these groups of needs. For example, low risk investments such as bank deposits provide for essential and immediate needs, while distant and/or discretionary needs may be met from higher risk assets such as corporate debt, property, shares, currencies and commodities.

From the investor's perspective, seeing their assets allocated against a list of their needs creates a better chance of acceptance, connection and hopefully discipline, than one engineered around an ambiguous risk profile and amorphous strategic asset allocation.

In addition, rather than forcing an individual investor to 'become rational', an investment framework built and managed in this manner will accommodate their humanness and the effect emotions can have on the overall investment outcome.

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