

# FINANCIAL PLANNING AND MODELLING AN INDIVIDUAL'S ATTITUDE TO FINANCIAL RISK:

*Is everybody on the same page?*

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*Understanding and suitably modelling an individual's attitude to financial risk remains a challenge for financial planners. We provide a snapshot of the issues involved and highlight the need for regulators, educators and practitioners to foster a far more professional treatment of client risk attitude through better guidance or mandates. We propose a clearer standardisation of industry terminology, understanding and regulatory direction.*

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For well over a decade now, the Australian financial services industry has repeatedly been the focus of disgruntled investors, regulators and the financial media. These concerns are largely the result of an inordinate degree of inappropriate financial advice and a catalogue of events can be documented in this context. These events include: high-profile collapses of investment companies or schemes (such as Fincorp, Westpoint, Opes Prime, Storm Financial, Timbercorp and Great Southern); ASIC's 'shadow-shopping' investigations revealing a chronology of sub-standard financial advice (e.g. ASIC's Reports REP18 (2003), REP69 (2006), REP279 (2012), REP413 (2014)); regulatory changes designed to discourage inappropriate financial planning behaviour (e.g. the 2010 Future of Financial Advice (FOFA) reform measures; and the release of section 961B(1)'s 'best interest duty' and consultation papers into the training and assessment of financial advisers (e.g. ASIC's consultation papers CP153 (2011), CP212 (2013), CP215 (2013)). Recent comments by ASIC Chairman Greg Medcraft (Collett 2014) also highlight the ongoing concerns of the regulator regarding the state of financial advisory services in Australia: 'Australians want advice they can trust, it's absolutely appalling ... and it's heartbreaking to see people who have been advised to go into products that are completely inappropriate and they have no idea what they're invested in'.

A common thread through these events can be discerned, with poor advice and outcomes invariably occurring due to a failure to properly consider clients' attitude to financial risk. A casual observer might reasonably expect that since these events the modelling of client risk attitude would have been subject to significant remedial action across the industry, ensuring that this concept and method are now succinctly enunciated. Yet a review of current regulatory guidance suggests that a far less structured state of affairs persists. Oversimplified, naive techniques are in evidence and appropriate modelling of this attribute remains a challenge. The remainder of this paper provides a snapshot of the issues and we call for a clearer standardisation of industry terminology, understanding and regulatory direction.

## **The state of play: Disparate interpretation and guidance**

Although there appears to be a reasonable volume of guidance regarding the nature of financial risk, there is only limited direction on how best to model a client's attitude towards such risk. Moreover, the available guidance is characterised by disparate terminology and confounded interpretation. This can only serve to frustrate the client risk modelling process resulting in a 'Pandora's box' of practitioner and legal issues. We outline several of the problems below.

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## **Regulatory guidance**

There appears a paucity of guidance here. The *Corporations Act 2001* is the key legislative instrument used to regulate financial services in Australia and while it alludes to the foundations of good advice (such as through the section 961B-E best interests provisions), no detailed direction is provided. ASIC's guidance documents normally assist with interpreting the Corporations Act yet current guidance is either silent on the importance of understanding a client's attitude to financial risk or, at best, includes risk attitude in a checklist of potentially useful client information without further explication. As a case in point, Regulatory Guide 175 *Licensing: Financial products advisers – Conduct and disclosure* raises the importance of a client's risk 'appetite' and 'tolerance' yet does not elaborate on this anywhere within the substantial 110-page guidance document. Other pertinent regulatory guides are similarly devoid of guidance (notably RG36 and RG244).

Industry practice standards exist and they require advisers to consider a client's attitude to risk. For example, the Financial Planning Association's (FPA's) Code of Professional Practice (2013) includes Practice Standard PS4 with Rules 4.2 and 4.5 requiring consideration of 'the client's personal circumstances, including but not limited to the client's attitude to, or tolerance for risk'. Yet no guidance is provided as to how such attitude or tolerance is to be modelled. The FPA's publication *The Trade-off – Understanding investment risk* (2008) and ASIC's *Investing between the flags – A practical guide to investing* (2009) provide a sound introduction for investors to better understand sources or types of risk. Again, however, the modelling of client risk attitude is not broached beyond fairly rudimentary references to one's 'appetite for risk' and seeking an investment which allows one to 'sleep easy at night' (ASIC, p. 11).

Adding to the potential confusion, a disparate terminology is observed among the regulatory literature, including *risk profile*, *risk tolerance*, *risk capacity*, *risk appetite* and *risk attitude*. Some terms have been further partitioned. For example, ASIC's shadow shopping Report 279 refers to 'psychological' and 'situational' risk tolerances, with the former being intended to describe 'preferences and attitudes towards risk' and the latter being 'the technical or actual risk exposure that might eventuate' (Appendix 2). These definitions appear at odds with the literature. The 'psychological risk tolerance' seems a misnomer because by reflecting 'preferences and attitude' it will presumably also embrace factors *additional* to psychological (e.g. financial or other capacity 'constraint' factors that can influence attitude, such as wealth level and number of dependents). ASIC's 'situational risk tolerance' appears to confound terms and concepts in that 'tolerance' is a personal attribute or trait exhibited by an individual regarding a risk – it is not the risk *per se*.

## **Educational literature**

Compared with regulatory guidance, a review of tertiary educational literature generally reveals a more detailed discussion of client risk attitude yet overall it likely provides no clearer way forward. A diversity of definitions and explications of the concept suggests a financial planning environment conducive to problematic modelling techniques. A number of issues can be observed here. For brevity we simply outline the key points.

### **Financial risk vis-à-vis other risk domains?**

A person's propensity for risk-taking behaviour is multidimensional in nature and not necessarily correlated across such dimensions (Slovic 1964; Jackson et al. 1972; Rolison and Scherman 2003; Weber et al. 2002). Thus a person's views about *financial* risk-taking do not necessarily imply anything about other risk-taking domains (such as physical, ethical or social). Nevertheless, some financial risk tolerance questionnaires illustrated in the educational literature appear to incorporate risk domains *other than* financial/monetary into the measure. For example, one sample questionnaire includes the item 'I intensely dislike blind dates [True/False]'.

### **Attitude vis-à-vis tolerance, capacity, aversion or other attribute?**

Some financial planning texts align such terms as 'risk tolerance' with 'risk profile' and 'attitude towards risk' while other texts distinguish these terms and assign distinctly different meanings to them. Some discuss the financial 'risk capacity' features of clients (e.g. characteristics affecting one's ability to withstand financial shocks, such as wealth level, income and dependents) yet are silent as to the client's psychological predisposition (or personality trait) regarding financial risk. In other instances, the modelled attribute is actually a 'composite' of current beliefs/fears about the state of financial markets, psychological traits, emotional states and capacity features of a client. For example, one question asks 'Your investment suddenly goes down 15 per cent one month after you invest. Its fundamentals still look good. What would you do: Buy more ..., Hold on ... [or] Sell it ... ?' The response to such a test item will be influenced by (at least) the client's (i) motive for holding such a risky asset in the first place (ii) capacity to bear risk (iii) perception of recent market events and (iv) underlying personality trait regarding risk. Identifying what is actually being measured here is problematic.

In the finance (vis-à-vis financial planning) literature, detailed discussion of risk attitude or tolerance appears a rare thing and most tertiary finance/investment references use the term 'risk aversion' to help categorise investors and their choices about risk. Discussion is usually limited. For example, one text simply states that risk-averse investors 'do not like risk', perceive risk as 'undesirable' and thus have 'a negative attitude towards risk'. In the parlance of modern portfolio theory, individual investors exhibit their own particular level of risk aversion and this ultimately determines their preferred asset allocation as they seek to maximise expected utility. Risk aversion in this context would therefore encapsulate all factors pertinent to the individual's asset allocation and thus must presumably reflect the person's psychological as *well* as all other factors pertinent to his/her response to risk (such as financial capacity constraints). A detailed discussion of factors associated with 'risk-aversion' or other modelling issues is not a feature of such texts.

## **Research literature**

Numerous research studies have sought to better understand how individuals respond to financial risk. Unfortunately, as with the regulatory and educational literature, terms and constructs are invariably intertwined. For example, Shefrin (2002) considered the evidence at the time and concluded that 'people are not uniform in their tolerance to risk. It depends on the situation ... [and] ... on several factors, one being recent experience facing risk (pp. 27–8)'.

Thus Shefrin's concept of tolerance embraces not only an underlying 'trait' but perhaps also a 'state' component.<sup>1</sup>

Grable et al. (2004) aligns tolerance to that of an attitude rather than purely a trait, coining a term 'risk tolerance attitude' whereby 'tolerance appears to be an elastic and changeable attitude ... [and] ... stock market price data does influence risk tolerance attitudes' (pp. 142, 145). A number of other studies have reported such associations between risk tolerance and market activity or mood/sentiment (e.g. Grable and Lytton 1999; Grable 2000; Yao et al. 2004; Pan and Statman 2010; Yao and Curl 2011). In contrast, others have reported risk tolerance to be a reasonably stable measure, not materially associated with short-term market movements, sentiment or mood, although likely subject to some moderation over longer time periods as a result of accumulated life experiences such as economic crises. Such studies include Yip (2000), Santacruz (2009), Roszkowski and Davey (2010), Hoffman et al. (2011), Malmendier and Nagel (2011), and Gerrans et al. (2015).

A confusing aspect of the research literature mirrors that of the educational literature: constructs are invariably derived from questionnaires and other test instruments whereby risk tolerance, risk capacity, risk perceptions and/or other attributes are often confounded to the extent that the test measure is open to question.<sup>2</sup> The importance of questionnaire design has been widely discussed in the finance literature (e.g. Yook and Everett 2003; Davey 2004; Roszkowski et al. 2005; Marinelli and Mazzoli 2010; Valentine 2013). The potential for unreliable questionnaire outcomes is well illustrated by Yook and Everett (2003) who investigated the consistency of responses to six different questionnaires that all purported to measure a person's financial risk tolerance yet the responses exhibited an average correlation of only 0.56 (p. 50). In another example, Marinelli and Mazzoli (2010) investigated different questionnaires devised by banks to assess client risk tolerance and concluded that 'depending on the bank questionnaire that is used ... the same client could be classified by a bank as risk averse and by another bank a risk seeker' (p. 2).

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A closer examination of the literature indicates that where 'financial risk tolerance' has indeed been modelled as an underlying personality trait and measured with a psychometric instrument (e.g. the studies by Santacruz 2009; Roszkowski and Davey 2010; Gerrans et al. 2015), the measure certainly displays a reasonable stability across changing externalities such as market sentiment.<sup>3</sup> While these metrics are typically associated statistically with various background factors (such as the investor's age, investment experience, wealth, dependents) the variation in tolerance 'explained' by these factors is never large and thus each person's tolerance appears mostly entrenched, as one would expect of a trait.<sup>4</sup> In contrast, study instruments that combine risk capacity, risk perception or other transient attributes will, almost by definition, report fluctuating measures that nonetheless simply reflect a changing stance towards risk due to changing personal circumstances, market mood, etc. (such as the study by Yao et al. 2004).

Understanding how best to model an individual's attitude to financial risk remains a work in progress and behavioural finance research has posed a number of pertinent, unresolved issues here. For example, the 'traitedness' of individuals has been considered in some studies — that is, some individuals might exhibit traits more consistently than others and, if so, measuring their risk tolerance is problematic without an accompanying test of traitedness (Roszkowski et al. 2009). More broadly, some research has even suggested investors might be *loss* averse rather than *risk* averse, or perhaps that these traits are manifested differently in different contexts such that an appropriate behaviour is something not readily predicted by simply gauging risk tolerance (for example, see prospect theory and associated matters discussed in Bodie (2014)).

## **Suggestions for moving forward**

### **Clearly distinguish client attributes that, in combination, determine each individual's ability to cope with financial risk**

Whether tolerance is strictly determined by a stable personality *trait* or influenced to some extent by transient *state* effects is unclear and this point remains an issue for further research. The key point, however, is that a *psychological* element likely exists and should be recognised and modelled separately. *Capacity* constraints are also important considerations that can limit or extend a person's appetite for risk and they too should be modelled separately — they are financial-related attributes peculiar to each person's circumstances (e.g. wealth level, number of dependents and time horizon) that help to identify how much financial risk a person could cope with. Further, each client will have a 'portfolio' of objectives and time horizons, thus tolerance and capacity analyses should be undertaken in the context of each objective/horizon. This 'micro level' approach should provide a much finer, cleaner assessment of how 'risky' each objective is, relative to pertinent tolerance and capacity constraints and it avoids a blanket appraisal of the client which can lead to erroneous 'portfolio-picker' styled outcomes.

### **Rationalise terminology and promulgate consistency of terms and concepts**

Throughout this paper we have identified various terms, but we have mostly used the term 'attitude' to risk to encapsulate all factors of influence: psychological *and* non-psychological constraints. Our usage of the term was convenient for exposition purposes but ultimately we simply call for a standardisation of terminology, method and regulatory direction.

The term tolerance could be used to describe the client's suitable response to all factors i.e. reflect his/her psychological predisposition as *well* as financial constraint factors. Alternatively a narrower usage of the term could be more clearly encouraged, in a manner sympathetic to the body of work that already views tolerance as a personality trait and thus psychologically oriented.

Consistency is important and whatever the consensus view, the numerous other terms and concepts should be avoided so as to minimise potential ambiguity. For example, ASIC's Consultation Paper CP212 refers to 'risk profile/risk tolerance' (e.g. paras 60, 85) and risk 'appetite' (e.g. paras 43, 92) but ultimately we believe such terms should be discouraged. Similarly, misnomers such as 'psychological risk tolerance' and 'situational risk tolerance' (discussed earlier regarding ASIC's REP279) should be recast. The term 'risk profiling' might best be reserved to simply embrace the gamut of tasks associated with risk assessment e.g. assessing risk tolerance, capacity and prospective portfolio risk exposure.

### **Utilise psychometrically validated instruments where possible**

In the psychology discipline and other behavioural sciences, personality traits are an accepted phenomenon and psychometric tests can be acceptable if carefully constructed. The issue of questionnaire design has been broached earlier in this paper and care is required to isolate measures of trait from measures of capacity or perception etc. 'Composite' test inventories are problematic. Our suggestion therefore is to utilise widely recognised, psychometrically validated instruments when gauging a person's 'financial risk tolerance', not 'home-grown' instruments likely to lack validity.

### **Give more explicit recognition to financial risk tolerance and capacity in other less obvious realms of the financial planning process**

While more readily discussed in the investment context, a person's tolerance and capacity to cope with possible wealth diminution through an unfavourable event can be considered in other key financial planning contexts e.g. insurance planning and debt planning. For example, ASIC's Report 413 (REP413) documents a 'disconnect' between the advice in these non-investment contexts (e.g. insurance) and the client's ability to cope with possible losses and this provides one illustration of how explicit consideration of client risk tolerance or capacity in other contexts (and entrenching into regulation and procedure) could enhance the advisory process.

## Concluding remarks

Resolving the issues broached in this paper regarding client risk would help to diffuse one of the more persistent and vexing issues associated with personal financial advice. Regulators, educators and practitioners have the opportunity to foster a far more 'professional' treatment of client risk attitude via revisions to RG146 and through other guidance or mandates. This view seems reflected through ASIC's ongoing review of RG146's training and knowledge thresholds, with moves to provide a clearer and more stringent assessment regime than currently exists in the areas of ethics *and* knowledge (ASIC Consultation Paper CP212, 2013). Adviser understanding and expertise would be enhanced and the chance of unethical behaviour reduced by a stricter 'prescriptive' framework that precludes the type of error or abuse which currently occurs due to limited guidance.

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## Notes

1. Not unlike other personality-based responses. For example, anxiety can be modelled as a trait or state condition (Spielberger 1983).
2. We acknowledge that methods other than questionnaires can be used to assess attitude towards risk, such as simulation risk/return experiments and self-reported investment preferences. For more discussion see Shelbecker and Roszkowski (1993). Nevertheless, questionnaires appear to be the more common approach in both research and industry.
3. For example, the 25-item Financial Risk Tolerance Scale developed by FinaMetrica and featured in numerous studies (e.g. Faff et al. 2009). For more details of these tests, usability evaluation, norming tests and other information concerning the instrument, see the technical manual by Bright and Adams (2000) and [FinaMetrica](#).
4. For example, studies report multiple regression adjusted- $R^2$  of around 0.25 or less (e.g. Grable 2000; Faff et al. 2009; Gerrans et al. 2015).

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