



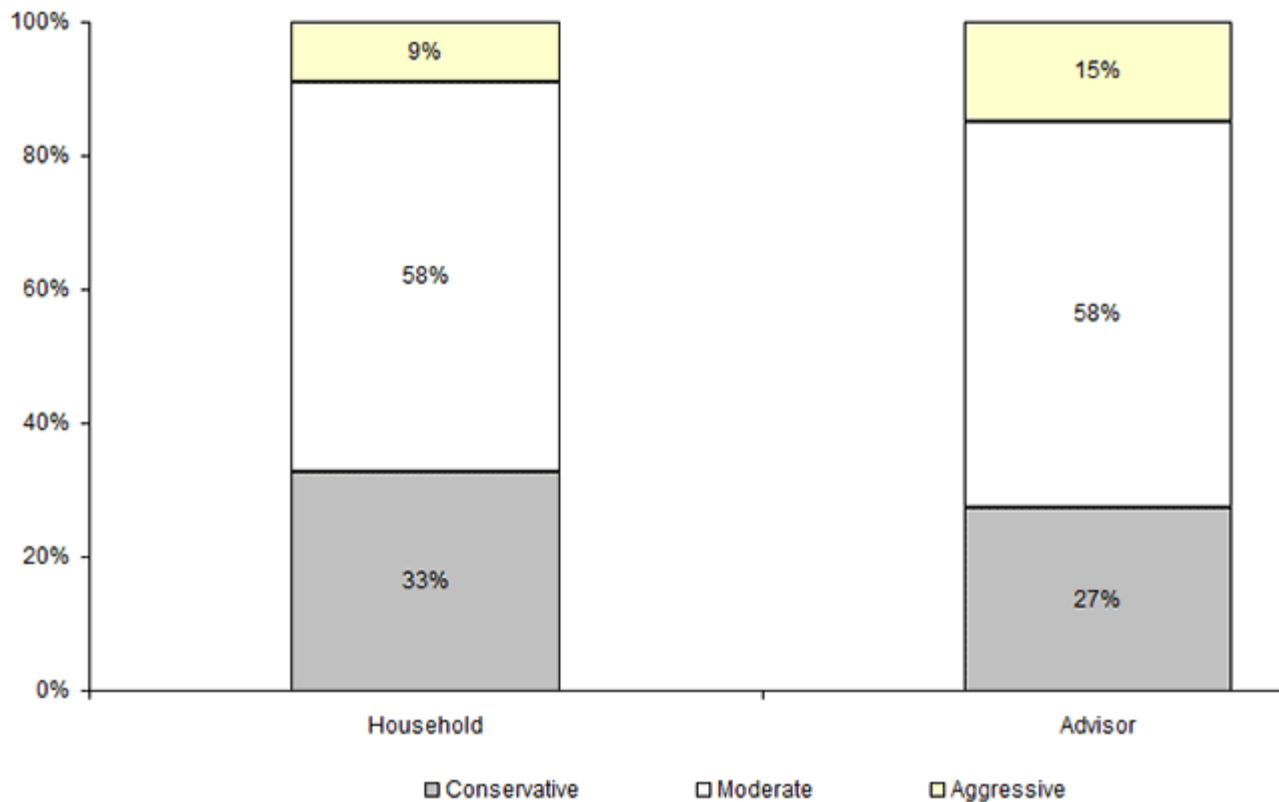
Hitting a Moving Target: Matching Portfolio Risk to Client Expectations

By Scott Smith
August 2, 2011

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Much of the angst faced by investors and advisors over the last several years was caused by mismatched perceptions regarding investors' appetite for portfolio risk. Advisors overestimated the amount of risk investors were comfortable being exposed to within portfolios. For example, based on advisor and investor surveys conducted by Cerulli over the past 18 months, only 9% of investor households classified themselves as aggressive investors, but advisors estimated that 15% of their clients were aggressive investors.

Exhibit 1: Household vs. Advisor Risk Assumptions, 2010



Advisors tend to overestimate the amount of risk to which investors are comfortable being exposed within portfolios.

Sources: Phoenix Marketing International, Cerulli Associates in partnership with Advisor Perspectives



Immediately after meeting a prospect and prior to any asset allocation decisions, advisors often place a risk-profiling questionnaire in front of the investor. Many contain as few as seven questions to determine the path of the relationship and see into the soul of the investor. How old are you? What do you expect of your portfolio if the market goes down for 10 years? For three years? For three months?

While these questions serve as interesting conversation starters, they don't help an advisor truly understand an investor's preferences or ability to comprehend or absorb market volatility. Yet across much of the industry, this is the extent of an advisor's inquiry into the subject. Just by answering these seven questions, an investor's needs and wants are supposed to become clear.

What exactly is an advisor trying to determine in the risk profiling process? In most cases, an investor has a goal in mind (most likely retirement), and an advisor will take all the investor's known variables (age, income, current assets) into account to construct a portfolio that will target the highest expected return given an appropriate risk level, as determined by a risk profiling questionnaire. Rarely is the amount of risk going into a client's portfolio discussed or even mentioned. Is the risk level the highest the investor could endure, the lowest that ensures baseline needs will be met or somewhere between the two?

Clarifying these questions is difficult. Advisors want to create a relationship of trust, and for the most part, investors are not that interested in the intricacies of how a portfolio works. Further exacerbating this condition are advisors' fears that clients may begin to question advising decisions or perceive lower value in the advising relationship as their understandings of portfolio dynamics increase.

This leaves a scenario in which investors' performance expectations are more likely to be set by water-cooler talk, snippets from television shows or online financial commentary than via a thorough conversation with an advisor. Even those investors who express interest in knowing more about their investments are likely to be shown a backward-looking hypothetical portfolio illustration with amazingly prescient investment selections exhibiting a best-case scenario.

Additionally, client risk appetite changed in reaction to recent market events. The number of investors who identify themselves as conservative, for example, has spiked since 2008. These shifts result in over-conservatism at the beginning of bull markets and over-aggression at market peaks. Despite their strategic plans, many advisors and investors react to short-term volatility, undermining their long-term planning and creating significant drag on portfolio performance. As a result of these reactions, mutual fund investors underperformed the market by 1.5% annually in the last decade, according to Morningstar.



Since the market benchmark replicates a buy-and-hold strategy, investors underperform when they dynamically shift allocations and move to cash. In many cases, investors (and their lawyers) blame portfolio losses on inaccurate profiling rather than on changes in an investor's risk appetite. However, behavioral factors, advisor investment management style and broker/dealer (B/D) controls all contribute to shifting tolerance. While an advisory relationship can add discipline to the investment process, flows in advisor-distributed funds (and subsequent client returns) indicate that advisory assets also suffer the negative impacts of attempted market timing.

Exhibit 2: Investor Returns vs. Fund Benchmarks, 2000-2009

3-Year Investor Return (Asset-Weighted)	Average 3-Year Total Return	5-Year Investor Return (Asset-Weighted)	Average 5-Year Total Return	10-Year Investor Return (Asset-Weighted)	Average 10-Year Total Return
-5.18%	-4.96%	0.64%	0.91%	0.22%	1.59%
-5.17%	-4.55%	3.27%	5.23%	2.64%	3.15%
-2.15%	-1.72%	1.57%	2.22%	3.36%	2.74%
2.36%	-1.68%	5.48%	3.03%	8.07%	8.55%
3.82%	4.13%	3.22%	3.89%	4.00%	5.33%
1.01%	2.50%	1.45%	3.02%	2.98%	4.57%
-2.71%	-2.14%	1.66%	2.38%	1.68%	3.18%

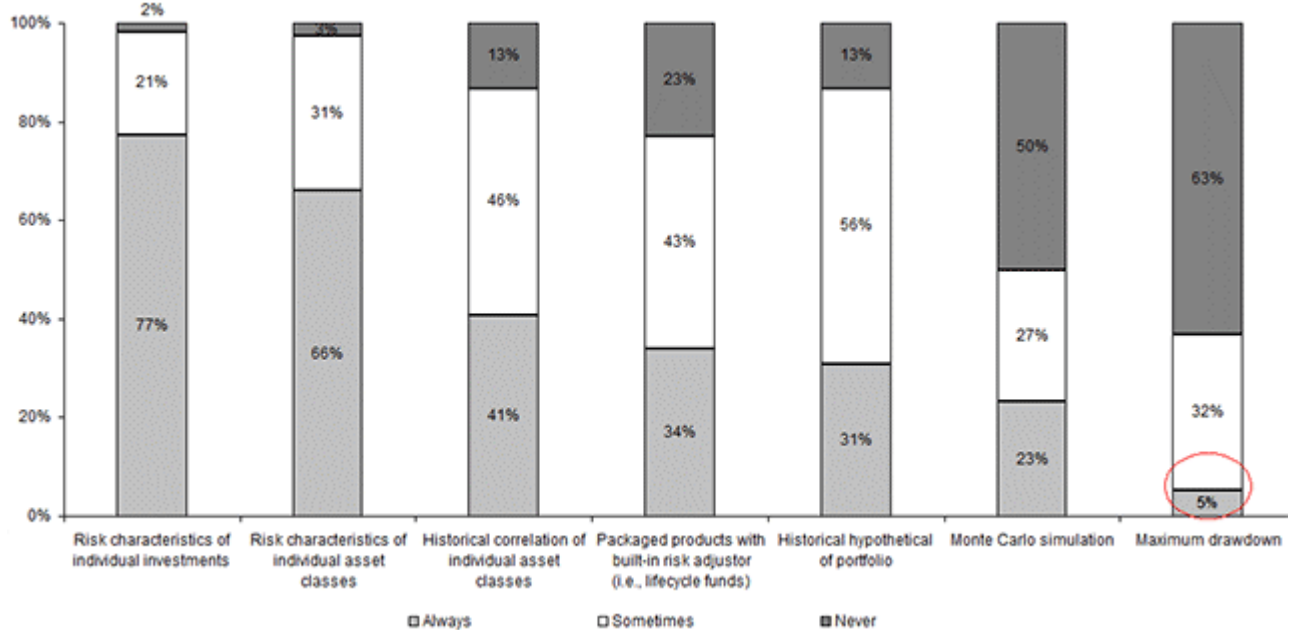
Behavioral and psychological factors have played a large role in the underperformance of investor portfolios versus market benchmarks over the last decade.

Source: Morningstar Direct, Cerulli Associates

Following the widespread market declines of the last decade, clients have somewhat unwittingly adjusted their perceptions of risk and forced advisors to focus on risk management procedures. Although risk tolerance assessments should guide investment decisions and clarify suitability concerns, this profiling method has proven insufficient. Advisors want to solidify a stable profile, but risk appetite is a moving target. Although the ability to tolerate risk is more easily quantified using a financial planning approach, changes in risk tolerance are more frequently impacted by clients' psychologically driven decision making. Exogenous factors, such as collective panic or exuberance, beget emotionally clouded actions, and clients require counseling and discipline to weather the tide.

Additionally, a reliance on financial modeling creates a false sense of precision. Advisors who use models based on previous probabilities to manage random outcomes end up underrating tail-risk events, assuming normal distributions and overlooking skews in investment returns. Advisors frequently use historical risk characteristics of individual securities and asset classes. But the use of limited time periods and datasets, which are subject to influence by external variables, leads to misleading results. Clients and advisors lack appreciation for the true distribution of model results. While advisors may think they are exhaustively identifying what-if scenarios, the worst-case situations they consider are limited to what has happened previously or even recently. The real risks for client assets are the improbable tail-risk events that defy general expectations.

Exhibit 3: Advisor Methods of Risk Assessment, 2010



Clients and advisors, alike, lack appreciation for the true outcomes of model variables.

Sources: Cerulli Associates, in partnerships with the College for Financial Planning, the Financial Planning Association, the Investment Management Consultants Association, Morningstar, and Advisor Perspectives

Improvements in risk profiling begin with better communication. Advisors typically overestimate investors' risk tolerance, placing too many households in aggressive portfolios and too few in conservatively invested portfolios. This simple inconsistency has a profound effect, but it can be quickly rectified with open communication. While initial communication can reveal constraints that present theoretical maximum risk levels for client portfolios, advisors must stress-test risk-and-return assumptions by realistically discussing a variety of scenarios, initiating dialogue on portfolio sensitivities and enabling the creation of contingency plans for periods of heightened market risk.

Though common risk-profiling questionnaires attempt to measure an investor's ability to take risks (as a factor of age and expected needs), they do not deeply examine an investor's willingness to do so. Risk tolerance consists of a willingness and ability to take risks. Advisors do their investors a disservice if they do not examine both sides of the equation to understand if there is a difference between the two. If that difference cannot be resolved, they must rely on the more conservative assessment when constructing client portfolios. Neglecting to understand the difference between an investor's risk capacity and preferences is fine during strong markets but leads to outsized client discomfort or attrition when markets fall.



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