

The Elephant in the Room

Advisors start discussing their real jobs: managing risk

Finance is the business of risk. At the heart of every financial product and strategy is a set of risk tradeoffs that guide investor choices. Responsibility for risk management has traditionally been on the shoulders of portfolio managers. That responsibility is now increasingly on the shoulders of advisors as well, as they seek to give advice about how all the moving parts in the financial lives of their clients—and particularly of high-net-worth clients—should work together.

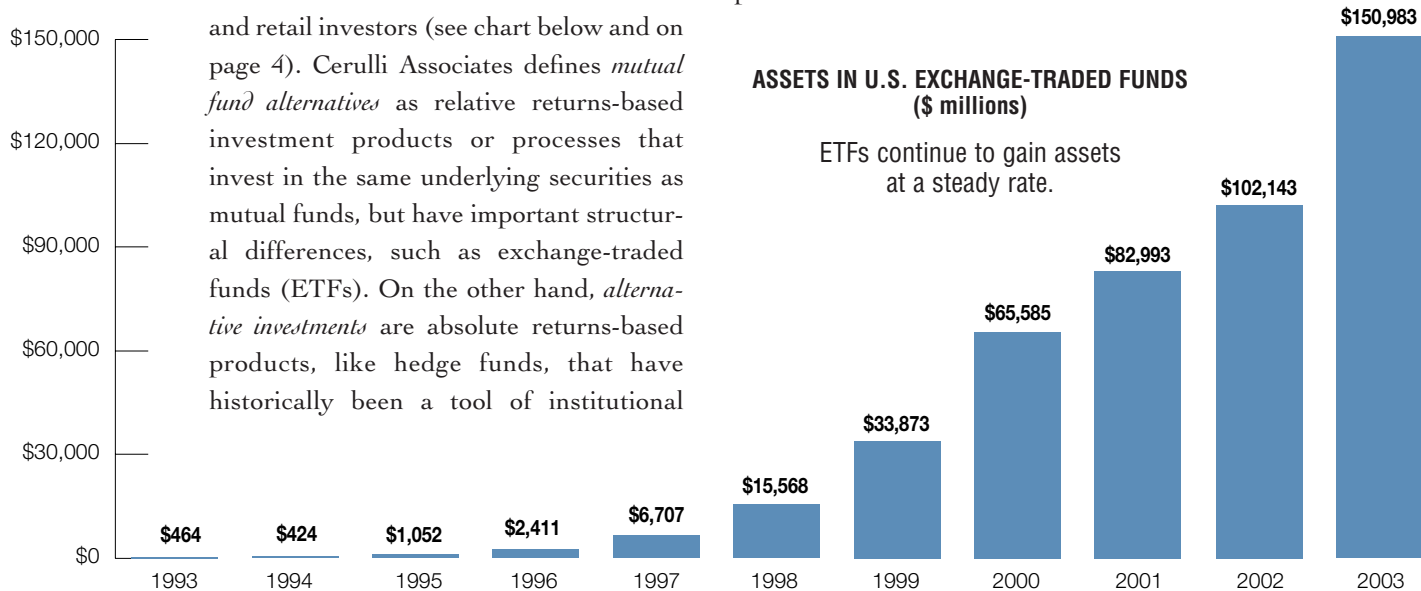
Yet the practice of risk assessment has been called the Achilles' heel of financial planning. The most successful holistic advice providers will be those advisors who understand, communicate, and use those risk concepts effectively.

Role of products in the risk equation

Industry innovation in financial engineering and technology has rendered mutual fund alternatives and alternative investments more accessible to advisors and retail investors (see chart below and on page 4). Cerulli Associates defines *mutual fund alternatives* as relative returns-based investment products or processes that invest in the same underlying securities as mutual funds, but have important structural differences, such as exchange-traded funds (ETFs). On the other hand, *alternative investments* are absolute returns-based products, like hedge funds, that have historically been a tool of institutional

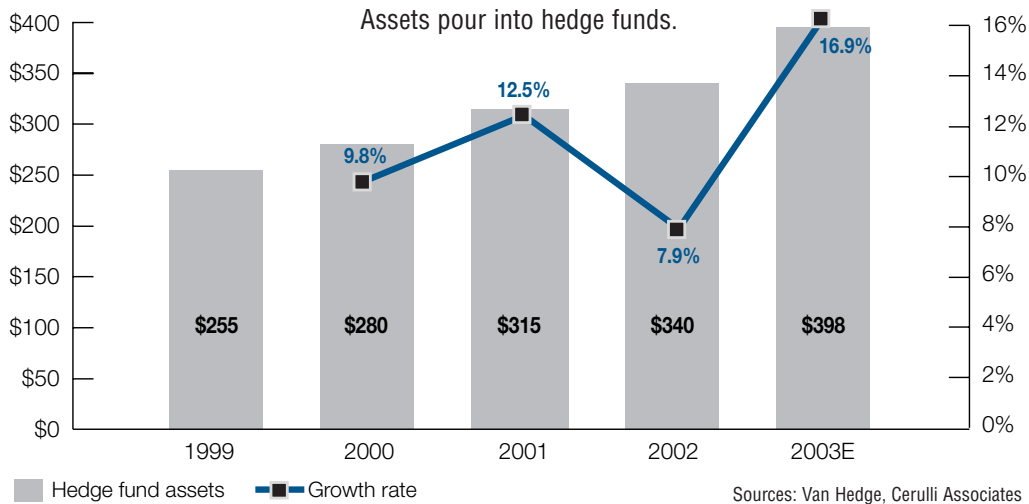
investors. These alternatives have brought risk concepts to the center stage of U.S. distribution in at least two ways.

First, as firms such as Smith Barney and Merrill Lynch build retail platforms to give their clients direct access to nonproprietary hedge fund vehicles, the suitability of relative versus absolute returns for that client portfolio has become part of the discussion between broker and investor. Many of the big firms, such as American Express, are also expanding or consolidating their own fund of fund vehicles into dedicated business units. Regulators have repeatedly warned practitioners about the importance of training brokers themselves about risks associated with unregistered vehicles and vehicles that may be less transparent and liquid than other types. Vendors such as Morningstar have begun to support broker training and clearer discussions with clients by supplementing traditionally spotty data with hedge fund indices that track performance and risk.



Sources: ICI, Cerulli Associates

U.S. HEDGE FUND ASSETS (\$ billions)



Second, the use of hedge fund strategies in open-end “hedged” mutual funds and ETFs has also put discussions of risk in the spotlight. ETFs can be used as a shorting tool, and there now exist a number of market-neutral and long/short hedged mutual funds, several of which were just introduced in 2003.

Communicating risk

It is more important than ever for advisors to ensure that they and their clients have an understanding of general types of risk, how market risk in particular interacts with different products, and how the prod-

ucts together create a unique risk mosaic.

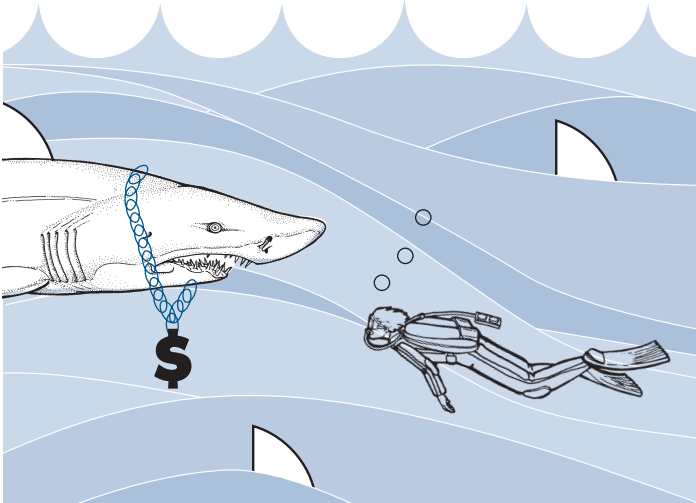
The million-dollar task, however, is to find out what kind of risk mosaic corresponds to the client’s risk tolerance. Documenting a client’s risk tolerance good liability protection for the firm: creating a portfolio without having an idea about risk tolerance is like driving an 18-wheeler on a tightrope.

Why is risk assessment so tough to accomplish? A person’s risk tolerance can only be measured relative to other peoples’ tolerance levels. This fact leads to thorny challenges.

For the past 20 years, the most common ways to assess a client’s risk tolerance have been through interviewing or through a standard questionnaire. There are a number of flaws with these methods. Behavioral finance professionals report that how questions are framed actually helps determine the answers. Advisors are likely to receive a different answer to a question about losing 30% of the value of a portfolio than one that asks about retaining 70% of the value of a portfolio.

Also, in economics as in politics, people have different conceptions about the meaning of labels such as “conservative.” And while interviewing can be useful for sheer face time with clients, that method has its

RISK IS EVERYWHERE



own pitfalls. Advisors have found that clients' tolerances begin to approximate their own personal tolerance levels, because interviewer bias is extremely difficult to avoid. Moreover, as tempting as it may be to employ shortcuts in risk assessments, generalizations are dangerous; studies show that there are no systematic patterns in risk levels as they relate to age or gender.

Perhaps the biggest difficulty is that investors regularly over- or underestimate their own risk tolerances, so that the very information advisors are trying to extract from them is faulty.

Best practices in risk assessment

Questionnaires can be quite effective when used to estimate how clients' tolerance compares with that of other people. By comparing how the client "scored" along the distribution curve of clients with how the client thinks he scored, the advisor can help the client figure out the extent to which he may be over- or underestimating his own risk tolerance. When the client has a clear idea about what he wants, he is able to give the advisor a clearer idea about what to deliver.

Advisors should discuss risk scenarios

in the context of clients' specific circumstances. To understand the context, it is necessary to add the ideas of time horizon and uncertainty to the discussion. Advisors should gauge clients' tolerance for uncertainty by discussing preferences for known results in an investment they already own, versus a higher rate of return that may involve more uncertainty. There are systems that now enable a real discussion about risk between advisor and investor in several ways (see box below).

The lesson here is that discussions about risk are separate from the actual financial requirements of the client. Tolerance for risk is a psychological trait that remains the same over time, but can fluctuate within certain margins in the short-term, depending on the economic environment and a host of other factors. Advisors should also remember that it is estimated that people feel loss twice as intensely as they experience a positive event.

Cerulli Associates believes that a focus on risk, already prevalent among wealth managers and their high-net-worth clients, will continue to spread across the universe of advisors and help lend credibility to the practice of financial planning. ♦

ASI

Advisor Software, Inc. (ASI) was founded in 1995 by the founder and former CEO of Barra, an industry leader in institutional risk models and risk management solutions. ASI launched with the objective of adapting and applying institutional-caliber analytics and portfolio management perspectives to the retail and advisory marketplace. ASI's solutions, focusing on the investment planning, portfolio construction, and rebalancing processes, provide investment advisors with the ability to identify, measure, monitor, and manage risk at several levels.

ASI's system applies a series of diagnostic tools to assess the risk and return characteristics of a client's current portfolio holdings, including sector exposures, style exposures, Monte Carlo asset simulation, efficient frontier, and value at risk. It also provides risk attribution analysis at the holdings level to allow the advisor to clearly communicate the source of risk within the portfolio. The software is also equipped with several risk assessment configuration options.

Once portfolios are established, the ASI application can monitor for risk drift at the portfolio level (*e.g.*, moderate to aggressive) or at the asset class level (*e.g.*, too much large-cap value), and trigger alerts to advisors so that they can take appropriate action. The advisor may rebalance to a target or model portfolio, or apply ASI's optimization technology to rebalance the portfolio. ASI provides both linear and quadratic optimization capabilities, which apply quantitative risk models to optimize a client's portfolio against a benchmark and within certain constraints and policies.