Financial DNA®

Risk Tolerance: Born or Made? By Hugh Massie

With investors facing a possible fourth year running of negative share market returns, the subject of risk is becoming a more important issue. But asking a group of investors or even financial advisors to characterize 'risk' is unlikely to produce a definitive answer.

The term 'risk' means different things to different people, conjuring excitement in some and trepidation in others. An investment product with an extremely low 'risk profile' may feel extremely perilous to some investors, and vice versa. How does an advisor determine an investor's risk tolerance, and how much does a 'risk category' tell an advisor anyway?

Why, How, and What If?

The trouble with most risk profiles is that there is no context around the investor's risk profile score. A number on a scale does not tell you **why** the investor has that risk propensity. Is the investor very experienced? Are they willing to venture into unfamiliar areas? Will financial education make them more bold, or make them more guarded? Have they had positive or negative investment experiences? Unless these questions are addressed, any information a traditional risk profile may give will be left in a vacuum.

Inherent vs. evolved risk

There are two kinds of 'risk' that need to be understood by investors and their advisors – 'inherent' risk, which we are more or less born with, and 'evolved' risk, which comes about as a function of financial understanding and experience. When investors and their advisors understand the difference between these two kinds of risk, and know their own risk propensities, they are armed with valuable insights that can help them structure the investment strategy that is right for them.

Most risk profiles only measure an investor's evolved risk, which is influenced by education and experience. Asking an investor what percentage of their portfolio they are willing to invest in a single asset class, which is a common style of question in traditional risk profiling, is irrelevant for someone who may have years of experience in the asset class and is very comfortable with it.

To gain a robust picture of a client's investment propensities, both inherent **and** involved risk must be measured. Inherent risk – which affects not only the investor's financial decisions, but most decisions in life – is largely unchangeable. However, an investor's evolved risk is likely to become higher as they gain education and experience, but it does not measure many important areas of investment risk – how willing an investor is to take chances, commit to new products, or venture into areas that are new to them.

Financial services firm Financial DNA Resources has sought to expand the financial industry's definition of risk by assessing both forms of risk in their 'Financial DNA®' suite of appraisals, which are designed to be used by financial advisors to more effectively service their clients. By measuring a client's level of 'inherent' risk, Advisors are able to understand just how willing a client is to 'take a punt' on future outcomes, try investment strategies that are new to them, or commit to new or unproven products. In addition, Financial DNA Resources also measures the factors that make up a client's 'evolved' level of risk – their financial experiences, knowledge, fears and preferences.

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To illustrate the difference between inherent and evolved risk, Financial DNA Resources cite an example of two real investors who underwent the Financial DNA® process. The first investor, James[1], concentrates his investments exclusively in the share market, assessing only a few aspects of a company's balance sheet before investing in it. Chris, on the other hand, has a more diversified portfolio, with several blue-chip shares, some alternative assets including his own business, and several privately owned properties. Chris' method of research is significantly more rigorous than James', thoroughly scrutinizing each investment, and the people involved in it before committing to it.

Many risk profiles would classify James as a risk-taker and Chris as a conservative investor. However, through the Financial DNA® process, Financial DNA Resources discovered the opposite to be true of the two investors. James, the share investor, was found to have a very low inherent risk propensity. As a result, his share investing strategy is conservative, investing only in industrial and retail companies that he understands thoroughly. His focus is on long-term dividends – an 'income for life' – not share price or short-term speculation. Chris, on the other hand, had an extremely high inherent risk tolerance. Whilst his portfolio is more diversified than James's, in his asset of choice (property), he is willing to take significant risks, and is in fact bored by investments that do not involve a reasonable level of risk, innovation and challenge.

Risk or savvy?

The trouble with most risk profiles is that they focus on what an investor's behavior has been or would be in a given set of circumstances. What they don't take into account is the level of understanding or knowledge that investor has regarding those circumstances. In asking, 'how much would you be willing to borrow for an investment property?' most Australians would readily answer '100%' because of the country's obsession with property investment, and the willingness of Australian banks to loan the full purchase price of investment properties.

This doesn't necessarily mean that these respondents have a high inherent risk tolerance which can then be applied to any asset class. The individuals may simply be under-informed about the asset class, and are taking risks they don't know exist. Once educated more thoroughly about the investment, their response may be entirely different, but because investment knowledge rarely factors into most risk profiles, their risk profile results are skewed.

Financial DNA Resources assesses both aspects of risk in its Financial DNA® products, measuring not only inherent and evolved risk, but also investors' level of financial understanding and experience as well as many other aspects of their 'financial personality'. By understanding their knowledge gaps, Coddington argues, investors can determine which asset classes they are best suited to, enabling them to maximise their returns in that arena. For a financial advisor taking his or her client through the Financial DNA® process, the insight gained into the client enables the advisor to provide very tailored solutions, which are more likely to gain long-term commitment from the client, even during tough times, because they have been able to take the client's real needs and propensities into account.

About the Author:

Hugh Massie is the President of Financial DNA Resources. In his work as a Wealth Mentor, Hugh specializes in human behavioral discovery using the proprietary Financial DNA® Discovery Process to liberate and empower people, families and organizations internationally to implement committed wealth creation decisions aligned to the core of who they are. Hugh is the author of a book "Financial DNA® – Discover Your Unique Financial Personality for a Quality Life".

[1] Names have been changed to protect privacy.