Investment advice can be risky business

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Much has been said about flawed 'risk profile' and 'risk tolerance' questionnaires in the advice process. Despite the agreement as an industry about what is wrong, there is limited consensus around what the answer is.

What remains consistent, however, is Fais Ombud determinations that keep shining the spotlight on this important link in the advice process. Hot off the press in 2020 is a Fais Ombud determination (*Du Preez versus Ernest Venter*), going against the investment adviser, which mentions 'risk' 18 times.

More specifically, reference is made to the clear lack of a 'risk assessment', 'risk analysis' and failure to adequately assess the client's 'risk tolerance'. These are constructs that, while defined, likely have significant variation in perceptions of what the 'nuts and bolts' entail or how we should approach an assessment thereof. The warning remains that this elephant still lurks in the corner of our client meeting rooms (virtually or otherwise).

At Momentum Investments we define 'risk' as the likelihood of an investor not achieving their investment goal. With our outcome-based investing philosophy we help construct investment funds based on what an investor wants to achieve, how much the investor has to invest and when they need the money by. This forms a solid foundation for achieving investment goals.

We use behavioural science to understand investor behaviour and 'risk' is clearly a key component. This theoretical underpin can contribute significantly to unpacking this industry challenge and in giving more suitable investment advice. A good point of departure is 'risk preferences'. These are character traits of being attracted or repelled by risk and these risk preferences should be stable over time. This is a key concept.

When we ask people about so-called 'sensation-seeking' activities like gambling or provide them with hypothetical scenarios of gains and losses, we are not capturing a stable personality trait but something that is variable over time and which can depend on current financial circumstance or any number of other factors. When we tie an investment strategy to such a measurement, it is doomed from the outset as the potential for the investor to move out-of-sync with this strategy increases over time.

So, we can view 'risk tolerance' and 'risk preference' as being one and the same – both should be stable over time – and which is why a psychometric assessment of risk is a good approach. Psychometric tools capture personality traits that are stable, as oppose to most of the current assessment tools, which look at factors that can change over time. The variable elements that contribute to an investor's actual risk behaviour are explained by two further constructs. The first is 'risk perception' and involves the individual's assessment of inherent risk. The work of Daniel Kahneman and Amos Tversky showed conclusively that humans are predisposed to several cognitive errors in assessing risk.

For example, on experiencing or framing a situation as a loss, we are more willing to take a risk to eliminate this painful loss. Think of the 'double down' effect in casinos, where the gambler bets more money to try and make up for losses.

The second relates to 'risk propensity' which is where the situational element comes into play. From an investing perspective, the effect of prior outcomes (success or failure) is proposed to have a significant effect on investor decisions in respect of their subsequent willingness to take risk. This is clear in the role past investment performance (or lack thereof) plays in the decision to switch funds in search of greener pastures.

In summary, while investors may have stable preferences, ultimately the 'label' attached to the situation (risk perception) and our past experience of risk as profitable or otherwise (risk propensity) determines risk behaviour and therefore why decisions are often taken contrary to our stable risk preferences.

Understanding all three dimensions and the interplay involved here is key to providing more suitable and robust investment advice but will require the application of this understanding of investor risk behaviour in the client engagement and advice process.

The adviser will be responsible for accurately gauging the client's risk preference or risk tolerance (as a stable personality trait) and balancing this with the client's capacity to assume this level of risk as well as the risk necessary to achieve the investment objective.

With Momentum Investments, investing is personal and we strategically build outcome-based investing portfolios that are designed for easy matching to an investor's goals and stable risk preferences over time.

But the job is only half done here – understanding the client's subsequent risk behaviour as situational risk preferences and propensity ebb and flow with market movements is key to the investor reaching this personal investment goal.