

# Risk profile questionnaires:

## Inappropriate questions lead to inappropriate advice

### A client's risk profile may determine the appropriateness or suitability of the recommended product and for that reason it is important to understand the meaning of risk profile in the context of the Financial Advisory and Intermediary Services Act, 2002 (FAIS Act) and its subordinate measures.

The questions in these risk profiling questionnaires should be sound and the application of the outcome from the questionnaires instrumental to appropriate advice.<sup>1</sup> If a client's risk profile determines the suitability of the product, it means that if the risk profile questionnaire is sound, it will lead to sound advice. However, if the risk profile questionnaire is fundamentally flawed, it will lead to fundamentally flawed and inappropriate advice. But, there is much more to this subject than it may appear.

#### The meaning of risk profile

The term risk profile has not been defined in the Act and therefore the normal meaning of the words must be used in its application under the FAIS Act. *Risk* means the possibility of something bad happening or a situation that could be dangerous. To risk something is to do something even though the result could be unpleasant.<sup>2</sup> *Profile* is a description of something that gives useful or important information.<sup>3</sup> A person's profile may also be defined as a *character sketch*.

#### The application of risk profile

Although a client's risk profile is particularly relevant to investments, a client's risk profile must be determined, irrespective of the financial product concerned.<sup>4</sup> There are two primary

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reasons for this requirement. Firstly, it is a specific requirement in terms of the General Code of Conduct with none of the products specifically excluded. Secondly, the normal meaning of risk profile can apply to all the financial products. Although there is a specific reference to risk profile in the General Code of Conduct, the obligation of providers to establish a client's risk profile has also been noted by the FAIS Ombud, in an article for FA News:<sup>5</sup>

*"When considering a complaint, the Ombud has to conduct an investigation. He will look at all avenues of non-compliance or wilful negligent conduct on the part of the FSP or representative."*

Pillai, the FAIS Ombud, specifically stated that *"this may include failure to give appropriate advice which may be manifested by the failure to do a risk profile."*

#### Historic risk profiling questionnaires have been fundamentally flawed

This article challenges one of the most widely used instruments in the financial planning industry, namely risk profile questionnaires. It aims to demonstrate why the application of historical questionnaires is fundamentally flawed and therefore inappropriate under FAIS.

#### Markowitz's Modern portfolio theory (MPT)

The essence of this theory is summarised by Dr. Jan Hofmeyr, founder of The Customer Equity Company and consultant to 70 countries worldwide. He wrote that Markowitz's Ph.D thesis (1952) laid the foundation for the definition of risk, widely used in the investment industry: *"Risk is the extent to which the price of an asset varies more than the average price of a class of assets. In ordinary language, using shares as an example: the more volatile the price of a share, (relative to any group of shares), the more risky it is (again relative to that group)."* The Markowitz thesis illustrated

how to maximise return for a given level of risk. In other words, if an investor can tell the adviser how much risk he/she is willing to accept, the adviser will be able to find a number of shares whose expected return is as big as possible for that amount of risk.<sup>6</sup>

#### Practical flaws in Markowitz's views on risk from a FAIS perspective

The majority of South African risk profile questionnaires are designed around Markowitz's theory, suggesting that the investor should first decide on the amount of risk<sup>7</sup> that the investor can tolerate. It is this point that is fundamentally flawed in practice for a number of reasons. The first is that, according to its normal meaning, the definition of risk is a situation that could have a bad result.<sup>8</sup> For the majority of clients this would simply be the risk of losing money.

"Risk" is defined as "chance of bad consequences or bearing any contingent loss" or "expose to chance of injury or loss".<sup>9</sup> It also means "hazard" or "with him to bear any loss".<sup>10</sup> It is clear that the definition of risk according to Markowitz, is quite different when compared to the ordinary meaning of the word. It is an accepted legal principle that when dealing with the interpretation of words in terms of statutory law, the normal meaning of the word should be used. Such legal principles aside, the likelihood of misunderstanding between an adviser using Markowitz's definition of risk and a client using the normal meaning of the word increases the chances of an adviser being accused of malpractice by a client.

The principle for most investors is not about how much risk or volatility they are willing to take on, it is how much money they can afford to lose. Unfortunately, very few investors are confronted with this real question. Without an understanding of the principle of what risk is, there is a strong argument that no client can make an informed investment decision.<sup>11</sup>



### Problematic applications of MPT for risk profiling under FAIS

Historically, financial advisers have been encouraged to use client risk profile questionnaires to categorise clients into different risk profile categories. After investigating a number of investment companies they identified at least eight different investor risk profiles, namely:

#### **Risk averse**

Risk averse means “expose to chance of loss opposed/disinclined”<sup>12</sup> or simply *opposed to loss*.

#### **Conservative**

Conservative means “tending to conserve/averse to rapid changes/ seeking to preserve parts as far as possible/moderate/cautious/avoiding extremes”<sup>13</sup> or simply *cautious and seeking to preserve*.

#### **Careful**

Careful means “concerned for/taking care of/watchful/cautious”<sup>14</sup> or simply *cautious and seeking to preserve*.

#### **Moderately conservative**

Moderately means “avoiding extremes/ low/temperate in conduct or expression”<sup>15</sup> moderate/ cautious/avoiding extremes”<sup>16</sup> or simply *cautious and seeking to preserve*.

#### **Moderate**

Moderate means “avoiding extremes low temperate in conduct or expression”<sup>17</sup> or simply *cautious and seeking to preserve*.

#### **Moderately aggressive**

Moderately aggressive means avoiding extremes/low “offensive/disposed

to attack/forceful/self-assertive”<sup>18</sup> or simply *cautious and seeking to preserve*.<sup>19</sup>

#### **Assertive**

Assertive means “tending to give effect to oneself/insist on one’s rights or opinion/declare”<sup>20</sup> or simply *having one’s own way*.

#### **Aggressive**

Aggressive means “offensive/disposed to attack/forceful/self-assertive”<sup>21</sup> Contrary to the definition of the word, providers seem to agree that *there is only one kind of aggressive investor and that is one that has just lost money*. Unfortunately the aggression is then aimed at the adviser.

The current risk profiling practice encourages providers to give clients a risk profile questionnaire to complete. Based on the profile that emerges, without explaining the meaning of the profile to the client, the adviser proposes investment portfolios that match the above subjective profiles. The portfolios so selected normally consist of specific fixed asset allocation frameworks, ranging from 0% to 100% of investment capital invested in equities, depending on where the investor is “risk averse” or “aggressive”. However, at no point is any reference made to the investment objective or pricing of any of the asset classes. This tool effectively makes financial planners responsible for initial asset allocation<sup>22</sup> without considering the appropriate investment objective. From a FAIS point of view, this is where the biggest conflict occurs as the point

of departure should be the client’s investment objective<sup>23</sup> and not the risk profile. The investment objective is the primary goal, whereas the risk profile is subject to the investment objective selected. To add injury to insult, providers who use traditional risk profiling questionnaires also become responsible for tactical asset allocation<sup>24</sup> and/or ongoing market timing.

During discussions with astute investment providers<sup>25</sup> and debates with asset managers<sup>26</sup> since 2003, it became clear that the reference to a “client’s risk profile” as referred to by the General Code of Conduct<sup>27</sup> is misinterpreted by most financial services providers. As a result, the use of most current industry-designed risk profile questionnaires will continue to be instrumental to inappropriate advice, which by definition is non-compliant under FAIS.<sup>28</sup>

Research and motivation in this article should show that most risk profile questionnaires are instrumental to herd-behaviour and promote asset allocation by financial advisers who are in most cases not qualified to do so in terms of the Act’s fit and proper requirements.<sup>29</sup> Arguably, very few providers are actually capable of doing asset allocation as an investment manager.

### Survey on the success/failure of risk profile questionnaires

In most cases investors do not understand the impact of their answers because when equity markets do well, they generally feel more “aggressive” and when markets do badly, they feel more “conservative”. These perceptions are conveyed in the traditional risk profile questionnaires. A simple questionnaire was designed in this regard and 74 financial planners were selected to complete these questionnaires during a number of presentations in April and May 2004. The advisors were of different

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backgrounds and various years of experience in the industry.<sup>30</sup> They were merely asked to answer questions based on the behaviour of their clients over the years. The questions in the survey are exactly the same as the questions in the table (right). The outcome of the survey is illustrated in the table.

### Problems with current risk profiling questionnaires

#### 1. Risk profiling questionnaires primarily show how investors feel at a specific time

The questionnaires do not help to determine investment objectives, but merely indicate how the investor feels about his/her money and risk at a specific time. They do not determine what investors are trying to achieve with their money. From a FAIS perspective the client's objective must be determined by the advisor and appropriate products must be recommended to suitably satisfy the clients needs, objectives and risk profile.<sup>31</sup>

To understand this obligation in terms of the Act, it is again necessary to refer to the normal meaning of the word *objective*, as it is not defined in the Act. The normal meaning of *objective* is "something sought or aimed at".<sup>32</sup> All the references in the Act pertaining to the advisor's obligation to determine the client's objective(s) indicate that the meaning of *objective* in terms of FAIS is that advisors must determine what is sought by the client financially or what he/she is aiming at.

In practice, after completion of the risk profile questionnaire, results are captured in a software computer programme that uses that information to suggest to the provider to which category the investor belongs and how much of the investor's money should be invested in equities and other asset classes. The problem is that this procedure may ignore the most basic principle of investing, which is buying the relevant assets at a good price. This procedure of asset allocation disregards whether

### Risk profiling survey

QUESTIONS	TRUE	FALSE	Spoilt	Total	% True
• Investors answer "aggressively" in strong equity markets	73	1		74	98.6
• Investors answer "conservatively" in "bad" equity markets	70	4		74	94.6
• These answers are based on investor perception/sentiment	73	1		74	98.6
• Perception/sentiment is Instrumental to emotional behaviour	74	0		74	100
• Risk profiling questionnaires measure people's emotional perceptions	66	7	1	74	89.2
• Risk profiling is currently the foundation of asset allocation	63	10	1	74	85.1
• Successful investing depends on objective facts, like value of assets not investor perceptions	71	3		74	95.9

equities are over-priced (expensive) and ready for a correction (prices should come down), or the other way around.

An "aggressive" investor would end up with most of the assets in his/her portfolio in equities, whereas a "conservative" investor with very little or no equities. In practice, this asset allocation, based on the risk questionnaire is normally implemented, regardless of the price of equities. Therefore the 'aggressive' investor could face a significant loss and as most "aggressive" investors cannot afford to lose money, they will become "conservative" investors.

As confirmed through the survey, the majority of investors are likely to be influenced by recent market conditions when answering the questionnaire. This in itself poses a risk. The current practice regarding risk questionnaires does not include testing whether the client's answers are objective or purely based on current market conditions or recent emotional experience. As an

adjective, objective (versus subjective) also means "exhibiting actual facts uncoloured by exhibitor's feelings or opinions"<sup>33</sup> and "belonging not to the consciousness or the perceiving or thinking subject but to what is presented to this external to the mind".<sup>34</sup> These definitions make it clear that objectives as referred to by the Act should not be confused with how investors feel about asset classes and the current market conditions. Studies of behavioural finance teach us that most investors are hugely influenced by emotional elements like fear,<sup>35</sup> greed and even events like family quarrels.

In most cases investors are inclined to answer the questionnaire based on how they feel about their money at that time, instead of focusing on fundamental, objective truths about their money, like attainable, realistic investment returns or how much money they can really afford to lose. These questions are based on asking investors what they want, which immediately triggers

emotional responses. Personal finance experts all agree that when building a sound financial plan, emotion is the one element that should never be the foundation of such a plan. As financial planners, it is necessary to ascertain what clients can afford to lose.<sup>36</sup>

## 2. Herd-behaviour

In most cases equities play the leading role in the asset allocation process as a result of historic returns. As investors tend to be bullish (they like equities) in a bull-market (a market where equity prices are increasing), they tend to answer the questions in a bullish fashion and end up with most of their money in equities when equities have already had their run. This leads to investors investing more money in equities at a point when equities are becoming over-priced. As the prices of equities are pushed up by these so-called aggressive investors, even more investors become excited by the spectacular returns and they also add their names to the list of

aggressive investors, leading to another round of investors buying expensive shares. This process is referred to as herd-behaviour.

The result is that some investors are over-exposed to an asset class that is over-valued/expensive and more likely to decrease in value. Investment specialists agree that one should invest when the price offers good value for money. Buying an asset that is over-valued and expensive should not be recommended for investors who do not want to lose their money. "The value of any investment is, and always will be, a function of the price you pay for it."<sup>37</sup>

To advise a client to buy an asset that is too expensive is inappropriate, which by definition makes it non-compliant under FAIS. It is important to remember that this inappropriate result started with the traditional risk profile questionnaire. To add insult to injury, the results of the risk profile questionnaire are often used to indicate to the client how much of his/her portfolio should be allocated

to equities and as a result what return he or she could expect. This means that if the client is an aggressive investor, it implies that he or she should have more money invested in equities and therefore could expect a higher return than a conservative investor, who has less equities in his or her portfolio. If this so-called aggressive investor invests in equities at the top, the opposite will happen and chances are excellent that a client may complain over the short term.<sup>38</sup>

## Prediction

In view of the subjective nature of most current risk profile questionnaires, there will come a time where the FAIS Ombud's office is going to look beyond risk profile questionnaires to actual content to see if the questions and answers are instrumental to fundamentally flawed advice or not. It is long overdue for historic risk profiling questionnaires to be challenged.

## References

<sup>1</sup>See section 8(1)(c) of the General Code of Conduct

<sup>2</sup>See Oxford Advanced Learner's Dictionary: p.1264

<sup>3</sup>See Oxford Advanced Learner's Dictionary: p. 1160

<sup>4</sup>See section 8(1)(c) of the General Code of Conduct

<sup>5</sup>Pillai 2004: 43

<sup>6</sup>Hofmeyr 2002: 74

<sup>7</sup>Suggesting volatility in terms of Markowitz's theory

<sup>8</sup>Oxford University Press 2005: 1264

<sup>9</sup>McIntosh 1977: 716

<sup>10</sup>Sykes 1983: 900

<sup>11</sup>Swanepoel 2003: 23, 54 and 61

<sup>12</sup>Sykes 1983:60

<sup>13</sup>Sykes 1983: 200

<sup>14</sup>Sykes 1983: 139; My emphasis

<sup>15</sup>Sykes 1983: 650

<sup>16</sup>Refer to conservative above

<sup>17</sup>Sykes 1983: 650

<sup>18</sup>Sykes 1983:18

<sup>19</sup>My wording

<sup>20</sup>Sykes 1983: 51

<sup>21</sup>Sykes 1983: 18

<sup>22</sup>Deciding on the mix between equities, bonds, cash and property in the portfolio

<sup>23</sup>See section 8(1)(a) of the General Code of Conduct

<sup>24</sup>Switching of assets (equities, bonds, cash and property) from

one asset class to the other

<sup>25</sup>Gerrit Viljoen of Ultima Financial Advisors and FPI Financial Planner of the year 2003; PSG Konsult representatives 2003; FPI presentations (2004-2006); FNB Advisory Services (2006); Jan Richter, Johann Seyffert (FNB) Willem Theron, PW Moolman, Marius Kruger (PSG Konsult)

<sup>26</sup>Johan de Lange, Kevin Feather of Allan Gray; Ben Frazer and Ettienné Gouws of Momentum

<sup>27</sup>Section 8(1)(c)

<sup>28</sup>Swanepoel 2004: Cover 38

<sup>29</sup>Sections 8(1)(b) and 13(2)(a)

<sup>30</sup>Almost 50% of the questionnaires were completed by delegates of a Financial Planning Institute Business presentation held for the Institute's Pretoria Chapter on 13 May 2004. The balance of the questionnaires was completed during separate group presentations to advisers in Gauteng

<sup>31</sup>See section 8(1)(a) and (c) of the General Code of Conduct

<sup>32</sup>See Oxford University Press: 578

<sup>33</sup>Sykes 1983: 699

<sup>34</sup>Oxford University Press 2005: 578

<sup>35</sup>See Botha, Geach, Goodall Rossini 2004: 24 and 25

<sup>36</sup>See Botha, Geach, Goodall Rossini 2004: 25

<sup>37</sup>Graham 2003: 83

<sup>38</sup>See the FAIS Ombud determination in the Dr. Birken and Fidentia Financial Advisors CC case dated 8 December 2006 (Case number: FOC 2629/05 GP (1))