

Risk Profiling Case Study

Jean is a 50 year old single professional planning for her retirement. Her risk tolerance score is 56 out of 100 and her current portfolio has a risky asset exposure of 57%. The balance of 43% is held in cash and term deposits.

Risk tolerance report for Jean

Under the heading, Your Risk Tolerance Score, the Risk Tolerance report

- Provides the client's score and a higher/lower % comment. Jean's score is 54, higher than 64% of all scores.
- Identifies the client's Risk Group. Jean's score is in Risk Group 4, and
- Reports on the accuracy of the client's self-impression. Jean over-estimated her score.

Personal Financial Risk Tolerance Report
Prepared Jean Sample AUS 2.0 from the questionnaire completed on 1 September 2012

Your Risk Tolerance Score
Your Risk Tolerance Score enables you to compare yourself to a representative sample of the adult population. **Your score is 54.** This is a slightly-higher-than-average score, **higher than 64% of all scores.**

When scores are graphed they form a bell-curve as shown below. To make the scores more meaningful, the 0 to 100 scale has been divided into seven Risk Groups. Your score places you in **Risk Group 4.**

In answer to the last question, **you estimated your score would be 60.** Most people underestimate their score by a few points. However, yours was an over-estimate. When compared to others you are somewhat less risk tolerant than you thought you were.

Your Risk Group
The description of Risk Group 4 which follows provides a summary of the typical attitudes, values, preferences and experiences of those in your group. It summarizes how those in your Risk Group typically answer the risk tolerance questionnaire. **Two** of your answers differed from this description. They are shown in italics below the relevant part and in the Summary section that follows. These differences fine-tune the description to you personally.

Making Financial Decisions
They think of "risk" as "uncertainty" and are prepared to take a medium degree of risk with their financial decisions (Q1 & 5). They have a reasonable amount of confidence in their ability to make good financial decisions and usually feel somewhat optimistic about their major decisions after they make them (Q12 & 7).
When faced with a major financial decision some are usually more concerned about the possible losses while others are usually more concerned about the possible gains (Q6). They would be slightly more likely to choose more job security with a small pay increase than less job security with a big pay increase (Q8).

Financial Disappointments
When things go wrong financially they are as likely to adapt somewhat uneasily as somewhat easily (Q3).

Financial Past
They have taken a small to medium degree of risk with their past financial decisions, more likely medium, and most have never borrowed money to make an investment (Q9 & 11). They have never invested a large sum of money in a risky investment mainly for the "thrill" of seeing whether it went up or down in value (Q4).

Continued over ...

Investments ... continued

It is somewhat more important that the value of their investments retains its purchasing power than that it does not fall (Q18). For most, a fall of 20% in the total value of their investments would make them feel uncomfortable but for others it would take a 35% fall (Q14). In recent years, for most there have been no changes in the risk of their personal investments but for those that have changed, the changes have been mostly towards lower risk (Q19). Over ten years they expect an investment portfolio to earn, on average, about two to two and a half times the rate from term deposits, more likely two times (Q21).

Given the portfolio choices below, they prefer Portfolios 3 or 4, more likely Portfolio 4 (Q16).

Portfolio	Expected Return	Risk
Portfolio 1	10%	Low
Portfolio 2	7%	Medium
Portfolio 3	10%	Medium
Portfolio 4	30%	High
Portfolio 5	20%	High
Portfolio 6	70%	Very High
Portfolio 7	100%	Very High

With these portfolio choices, you would choose Portfolio 4.

Borrowing
If they were borrowing a large sum of money at a time when it was not clear which way interest rates were going to move and when the fixed interest rate was 1% more than the variable rate, most would choose to have 50% of the loan at fixed interest but some would choose 75% or 100% (Q23).
You would choose to have only 25% at fixed interest.

Government Benefits and Tax Advantages
So long as there was only a small chance they could finish up worse off than if they had done nothing, they would take a risk in arranging their affairs to qualify for a government benefit or obtain a tax advantage (Q22).

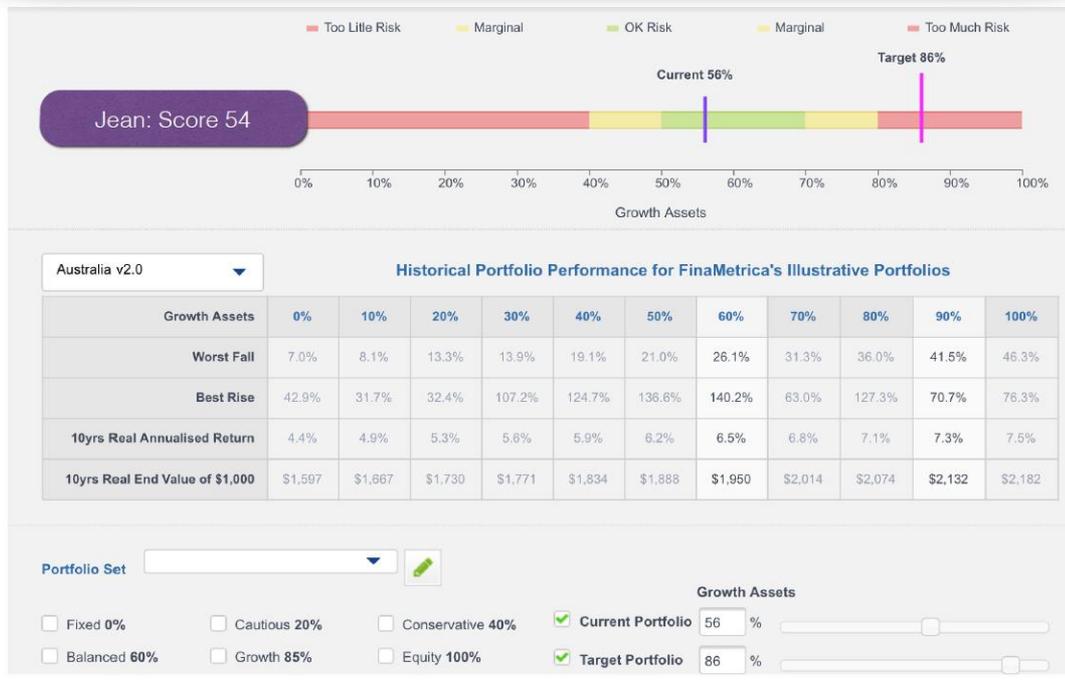
Summary

	1	2	3	4	5	6	7
	0-24	25-34	35-44	45-54	55-64	65-74	75-100
Risk Group							
Meaning of "Risk"							
Current Risk Rating (Q1)							
Confidence in Decisions (Q1)							
Feel Able to Decide (Q7)							
Losses or Gains (Q6)							
Job Security vs. Increase (Q8)							
Financial Disappointments							
Adaptability (Q3)							
Risk Taking (Q9)							
Borrow to Invest (Q11)							
Thrill Money (Q4)							
Financial Past							
Money Risk Taken (Q10)							
Overseas Investor (Q12)							
Risk Chances (Q13)							
Money Returns (Q14)							
Money Returns (Q15)							
Borrowing							
Fixed Variable Interest (Q23)							
Government Benefits and Tax Advantages							
Take Advantage (Q22)							

Jean has \$500,000 in super and plans to retire at 60. She believes she can save a further \$20,000 each year. To reach her goals, you advise her that she will need to be pretty fully exposed to equity markets and suggest a portfolio with 86% in shares, property and other growth or risky assets. To keep matters simple, we will assume that she can afford to live with the volatility of that portfolio. Hence, the target portfolio that's most likely to meet her needs in good times, and bad, is 86% growth asset exposed.

Jean's current portfolio, 56% growth (risky) assets, is comfortably within her preferred (green) risk zone, as the illustration below shows. But her target portfolio, with 86% growth assets, at this stage of the planning process, is well outside her natural preferences and is deeply in the red. So how to advise her?

Comparing Jean's asset allocation consistent with her risk tolerance with that needed to meet her needs.



History has shown that the higher exposure to growth assets in a portfolio the further it drops in a correction. And the greater a portfolio falls, the slower it generally is to recover. If we look at the history of the two portfolios we can see the following:

Comparison of the ten biggest falls between Jean's current and target portfolios

A 60% growth portfolio shows a drop of 25.5% and top to bottom and return of 33 months.

A 90% growth portfolio on the other hand shows a drop of 41.5% and top to bottom and return of 65 months.



Her adviser should walk Jean through the historical range of portfolio losses and recoveries. Jean should be challenged to think about how she might feel if somewhere in the future her then \$600,000 portfolio dropped to near \$450,000 over a 20-month period.

Alternatively, would she be significantly more anxious if her portfolio dropped to \$350,000 over a shorter 16-month period? Recovery timings are significantly different in each. The more growth-oriented portfolio took over four years to come back to its original nominal value, while the 60% growth asset exposed portfolio recovered in a more sprightly 13 months. How did she think she might respond over the 49 months while her portfolio clawed its way back to its original high? And of course it's worth pointing out that while these were the biggest drops for each of the two portfolios, they actually occurred more than 30 years apart. One was in response to the 1973 Oil Crisis. The other is the more recent GFC of 2008. Clearly asset mixes play a role in performance.

The numbers in this example are based on simple accumulation indexes. They are idealised. They don't take into account fees, taxes and other frictions.