



Psychometric risk profiling

A key step in establishing investment suitability

A psychometric investment risk questionnaire is important to help identify the amount of risk that an investor is prepared to take. It can, however, only ever be a starting point for a discussion with an investor about his or her personal circumstances, financial goals and views about investment risk.

Investment risks

Psychometric risk profiling gives a profile of investors' attitudes towards common investment risks such as:

- capital loss;
- not meeting a desired investment objective e.g. repaying a mortgage;
- not keeping pace with inflation;
- depletion of capital by drawing a desired level of income;
- investment volatility;
- lack of liquidity;
- counter-party failure;

- lack of diversification; and
- under-performance due to overly conservative investment choices.

It follows that the score from a psychometric risk questionnaire does not say anything about which of the above risks most concerns the investor, nor anything directly about the personal circumstances of the investor.

The risk profile from the questionnaire provides a starting point for an informed discussion about the nature of risk and the investment return which might be achieved by taking it.

About eValue

eValue is a market leading financial planning tool set enabling advisers and consumers to understand the risk reward trade-off around their investments and financial goals. eValue tools use the fully comprehensive functionality of the eValue modelling engine to provide forecasts and cash flow planning. Our easy to use tools cover all aspects of pensions, investments, lifetime cash flow planning, income drawdown and tax optimisation.

The risk profile provides unique insights into the investor's feelings about investment risk in general and throws a light on the psychological make-up of the individual. For example, is he or she a worrier or someone who enjoys a bit of excitement in life?

The risk profile does not provide any information about the investor's view about the different types of risk, as listed previously, nor about personal circumstances or motivations for investment.

However, it provides an excellent starting point for a discussion about life and financial goals, the nature of investment risk and the trade-off between risk and reward.

The questionnaire is trialled with many hundreds of investors and statistically tested to determine its

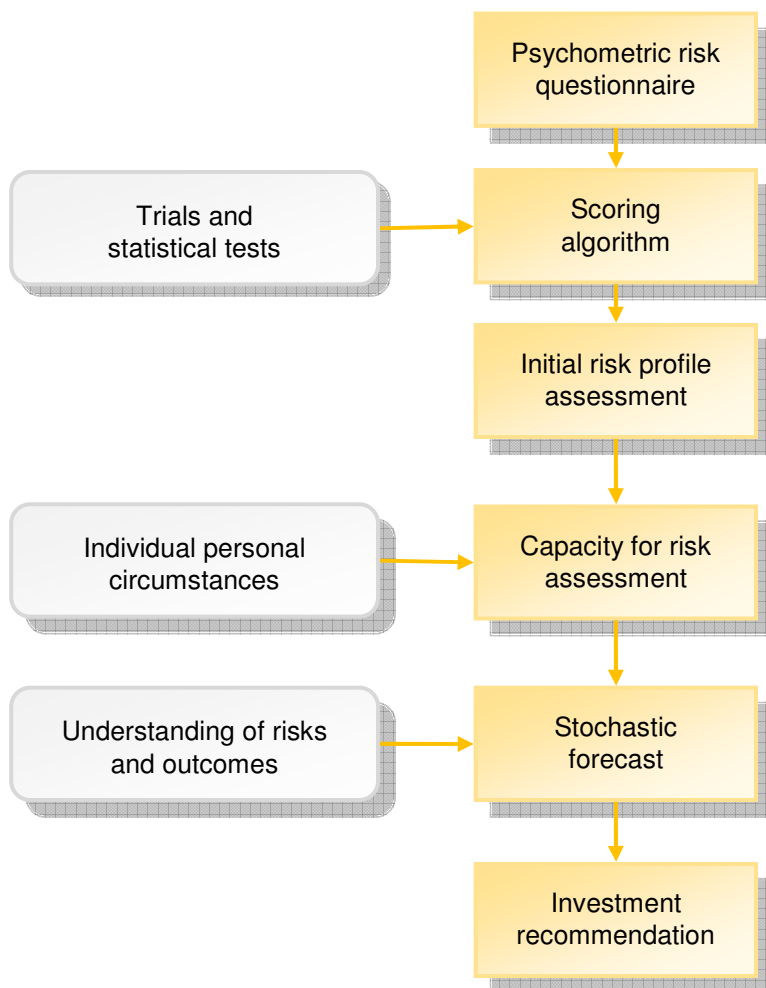
validity, reliability and accuracy. This is normally expressed as a probability - around 95% for a well-constructed questionnaire.

A probability of this degree indicates that the questionnaire is measuring investment risk as intended. It also indicates that the investor would be highly likely to be allocated to the same risk profile if the questionnaire were repeated.

Nonetheless, testing a questionnaire with many hundreds of investors cannot provide insight into the personal circumstances of a specific individual investor.

Establishing suitability

How a psychometric risk questionnaire might be used in an advice process



Want more information?

The process of developing a psychometric risk questionnaire is described in a further eValue factsheet available at www.evaluefe.com

Psychometric risk questionnaires Fact sheet

An integral part of giving advice is taking into account the risk profile of the individual and their financial goals. Advisers need to have in their armoury a robust method of identifying the risk tolerance of their clients to ensure the best possible advice can be given. A psychometric risk questionnaire can give a starting point for discussions about the risk and reward that clients are prepared to take, as well as providing an excellent tool for discrete research. The eValue FE questionnaire has been validated by experts in occupational psychology and psychometric statistics.

Frequently asked questions

How does the risk questionnaire link to the efficient asset classes?	How should the risk questionnaire be used?
The nature of the questionnaire is based on the number of portfolio, however, the risk score also works for the overall portfolio. The questionnaire is designed to be used for the questionnaire to assess the risk level of the client.	The risk questionnaire is a key part of the process. Once received, the questionnaire is analysed and the results are used to determine the risk level of the client.
How is the number of questions determined?	What is the purpose of the questionnaire?
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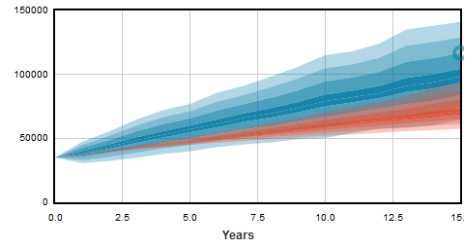
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This is only an example of how the process might work but all the elements need to be in place:

- an understanding of the attitudes of the investor towards risk;
- an understanding of the investor's capacity for risk, based on knowledge of the investor's personal circumstances, experience and goals; and
- a discussion about the different types of investment risk and how the potential outcomes might affect realisation of the investor's goals.

The education of the investor and the alignment of the investor's expectations with the investment recommendation are the final and possibly the most crucial steps in the advice process. All too frequently it is an unwelcome surprise – for example short term capital loss which leads to complaints from investors. The difficulty is explaining all the different types of risk and the potential reward for taking them.

Here stochastic modelling can play an important role by illustrating many of the risks and showing how they might be managed. Stochastic modelling can also help the investor understand what needs to be done to stand a good chance of achieving investment goals. By setting investor expectations at realistic levels, this approach can make a major contribution to reducing complaints.



How are the results calculated?

	Selected risk <input checked="" type="checkbox"/>	Cash comparison <input checked="" type="checkbox"/>
High return	£141,000	£93,600
Mid return	£98,300	£70,500
Low return	£64,600	£57,500
Chance of beating cash	87%	

Audit trail

Having identified an investor's risk profile it is important to establish an audit trail of the risk assessment. This can be done by providing the investor with a report documenting the entire process.

Although not directly covered by the FSA in its thematic review, this would probably have done a lot to reduce the FSA's concerns about advisers making recommendations solely on the basis of the output from a psychometric investment risk questionnaire.



Best practice

eValue offers all the best practice elements that an adviser needs to ensure that investment recommendations can be made which are suitable to a customer's risk profile. These are summarised in the table below.

FSA good practice recommendation	eValue risk profiler
Capacity for risk	✓ Additional questions are included after the psychometric questionnaire to assess capacity for risk. These can be configured to meet advisers' requirements.
Clearly worded and easily understandable questions	✓ All questions are trialled with target investors before being used in questionnaires to ensure that they are easily understood and unambiguous.
Information on investment objectives	✓ eValue incorporates the term of the investment in the assessment of an investor's risk profile and goals can be set to see potential outcomes.
Clear descriptions of risk	✓ eValue communicates investment risk in multiple ways through: clear wording, visuals that communicate short term volatility and forecasts of potential longer term outcomes.
Sensitivity to answers to individual questions	✓ Questions are trialled and answers tested for consistency with additional questions incorporated to reduce the sensitivity to the answer given to any one question.
Regular management information on the results of risk profiling tool	✓ The eValue psychometric risk questionnaire includes demographic information so that management information on the distribution of risk profiles is continuously available online in aggregate and by individual firm or adviser
Regular updates of customer risk profiles	✓ A record of customer risk profiles is maintained and changes recorded over time.
Avoidance of wide risk bands that include customers with very different risk profiles in same risk band	✓ The position of a customer's risk profile in the risk band is shown and the probability of the customer being in an adjacent risk band given.
Customer engagement and understanding	✓ eValue offers alongside its psychometric risk questionnaire some quick and simple stochastic forecasting tools which can illustrate potential outcomes from investment solutions matching different risk profiles. The whole risk assessment process is captured in a customer report.
Investment recommendation consistent with customer's risk profile	✓ Stochastic modelling allows investment recommendations to be matched precisely to risk profiles with a clear definition of the boundaries for each risk profile.
Guidance on the use of risk profiling tools	✓ Extensive information on the methodology used to construct a psychometric risk questionnaire is available together with a guidance note on how it should be used.