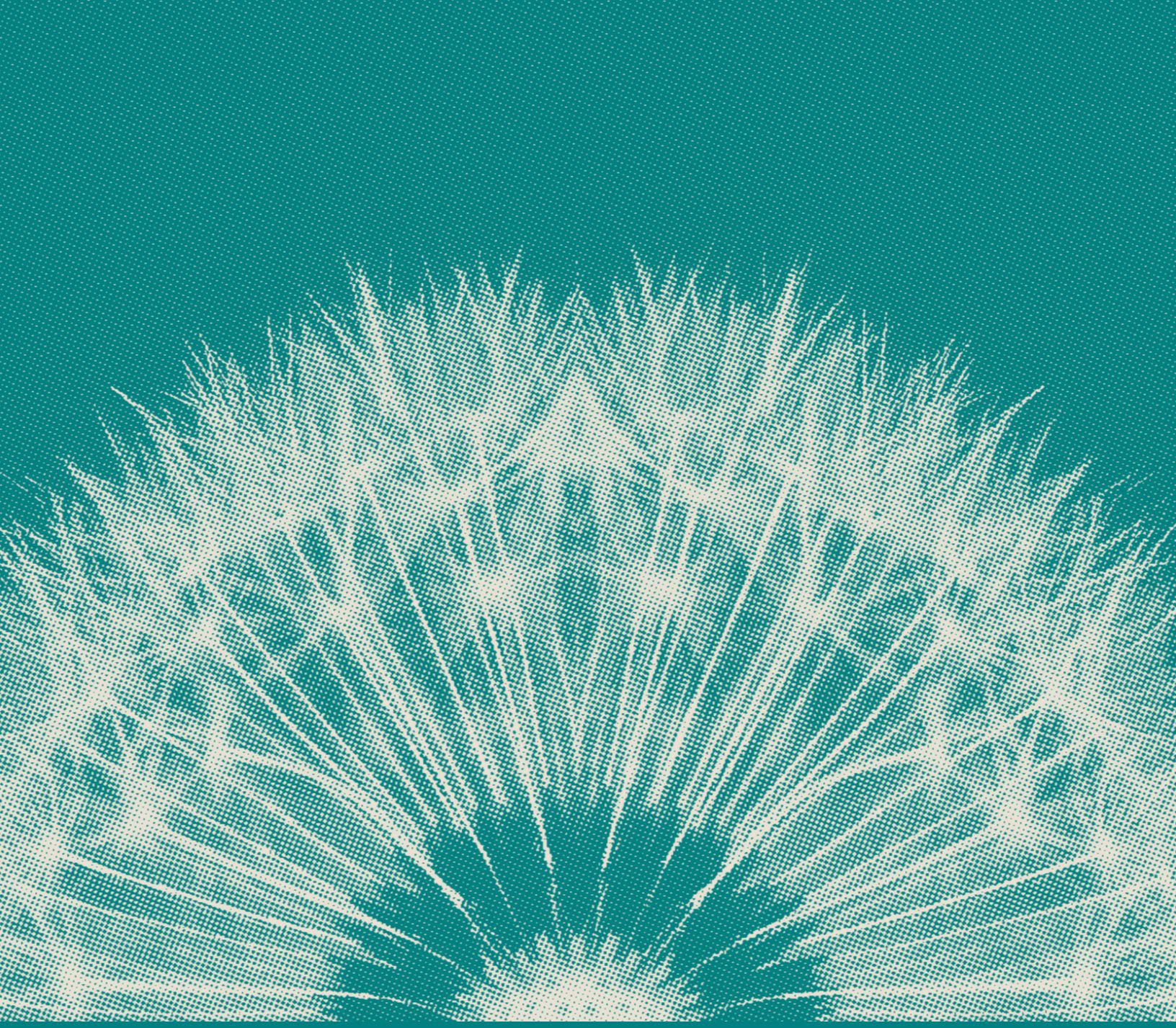


Nitrogen

Using Risk to Manage Client Expectations

NITROGEN WHITE PAPER

Using Risk to Manage Client Expectations

With vast amounts of information available, the advent of client-centric technology and increased transparency in the industry, it is a great time to be a client of a financial advisor. Today's clients are more in tune with the ebb and flow of the market and the holdings in their portfolios. Along with these positive changes come challenges to overcome in the way we do things as an industry, particularly when it comes to managing client expectations.

It is often the case that when the markets are up, clients want to know why they are not making more money, yet when the markets pull back, clients ask why they are not more diversified or protected against losses. The issue arises from the way that advisors typically set portfolio return expectations with their clients. Our industry typically focuses on the performance of a portfolio based on the average — a tactic that all but guarantees failure — leading to countless hours of phone calls and meetings with worried or unhappy clients that could have been avoided simply by setting better expectations up front.

This paper Explore how to use risk to properly manage client expectations, leading to:

Greater Efficiency
Reduce the number of 'talk me off the ledge' phone calls every time there is a bump in the market.

Increased Productivity
Accomplish in one meeting what usually takes three or four.

Higher Levels of Client Trust
Your current clients will stick with you and prospects will jump aboard.

Starting the conversation about performance by talking about risk is the simplest and most effective method to set client expectations in a way that will provide payback in terms of time, effort and goodwill.

An Appetite for Risk

The first step to properly managing client expectations is to accurately assess the amount of risk that the client is comfortable taking. Every investor has a certain amount of risk that he or she can handle, and it is important to identify this up front.

This is a crucial step in the client onboarding process because typical investing patterns of individuals look something like this:

> When the market is up: we feel positive and excited, so we buy.
> When the market is down: we feel negative and fearful, so we sell.

We know that this model of behavior, buying high and selling low, is logically the wrong approach to take with investing — but we see it over and over again. The issue is that it is difficult for people to ignore fear. The goal is to build a framework that allows human behavior to thrive in the context of how much risk clients are taking with their money.

The strategy is not to beat human nature or time the markets. If your clients actually invest within the bounds of how much risk they can handle and stay invested for the long run, they will not only do better for themselves, but your client-advisor relationship will also improve.

CASE STUDY

Risk Preference for the Unlucky Investor

Let's take a look at two examples of investors with the worst timing imaginable.

INVESTOR A put all of his money into the market at its peak in 2007 with the S&P at over 1500. He is invested outside of his risk preference, thus he became fearful and sold at the very bottom of the market in 2009, with the S&P under 700. This investor lost over 45% of his money.

INVESTOR B also put all of her money into the market at its peak in 2007. This investor, however, is invested within her risk preference, thus she did not make an irrational, fear-driven decision to sell at the bottom of the market. As of early 2015, with the S&P over 2000, this investor now has a gain of over 33% on her money.

In these examples, two people invest with the same timing, yet one was invested outside of his risk preference and paid the price.

Pinpointing Risk Preference

Most advisors currently use some method of measuring the risk that a client can handle. Advisors typically measure risk by:

> Administering a purely mathematical, quantitative and objective risk questionnaire (preferred method).
> Administering a risk questionnaire based on psychological or qualitative testing.
> Basing the client's risk tolerance on their age and time horizon.

The quantitative and objective approach to risk — or risk preference — is built upon a mathematical foundation; decades' worth of behavioral economic studies culminating in prospect theory, the leading economic theory of risk-

DEFINITION OF RISK PREFERENCE

How far a client's portfolio can fall, within a fixed period of time, before he or she capitulates and makes a poor investing decision.

reward decision-making that won the Nobel Prize in Economics. With a quantitative risk questionnaire, clients answer a series of questions that determine when they prefer risk and when they prefer certainty. The questions focus on the actual dollar amounts that the client has to invest. Thus, clients are able to accurately capture their Risk NumberTM, the quantitative measure of risk, based on their real investments rather than abstractions.

The strategy is not to beat human nature or time the markets. If your clients actually invest within the bounds of how much risk they can handle and stay invested for the long run, they will not only do better for themselves, but your client-advisor relationship will also improve.

The problem with most psychological or qualitative risk questionnaires is that they are inherently subjective. At some point in the process, someone must weight the various answers to come up with a qualitative score — the client's estimated risk tolerance.

Questions that ask if clients get a thrill out of investing, how they feel after making financial decisions or that ask them to self-identify their risk aversion can provide insight into how clients feel at the time the test was administered — but test questions are all eventually given subjective weights to make up a score. Risk tolerance is generally still anchored to the client's age, and simply moving them slightly up or down the risk spectrum compared to others in their age band makes it a more subjective and ambiguous measure of risk than actual risk preference.

TABLE 1. Distribution of Risk Number vs. Age

Risk Category	Risk Number	Age 20-29	Age 30-39	Age 40-49	Age 50-59	Age 60-69	Age 70+
Conservative	0 to 9	0.5%	0.1%	0.3%	0.8%	0.7%	0.9%
	10 to 19	0.4%	0.2%	0.4%	0.6%	0.9%	1.1%
Moderately Conservative	20 to 29	6.6%	3.9%	3.9%	7.2%	12.3%	17.1%
	30 to 39	12.8%	7.5%	10.6%	15.8%	23.4%	27.9%
Moderate	40 to 49	17.3%	14.6%	18.3%	22.2%	25.2%	22.1%
	50 to 59	15.3%	14.8%	17.0%	17.6%	15.1%	13.3%
Moderatley Aggressive	60 to 69	10.5%	10.6%	13.4%	11.1%	7.4%	5.5%
	70 to 79	11.1%	13.2%	9.6%	7.1%	5.7%	2.8%
Aggressive	80 to 89	12.5%	17.0%	12.4%	8.7%	4.9%	3.9%
	90 to 99	13.0%	18.0%	14.1%	9.0%	4.4%	5.4%

Table 1 shows the percentage of clients in each age band with a given Risk Number. The highlighted area represents the typical risk profile given to clients based on their age. Every client outside of the highlighted area is invested outside of his or her risk preference. Data is analyzed from nearly 10,000 responses to a quantitative risk questionnaire.

Many psychological or qualitative questionnaires fall back onto the old stereotype of age — younger clients must be more aggressive and older clients must be more conservative. The problem with stereotypes is that they are often dead wrong. As our research shows in Table 1, many people in each age group are drastically underserved, with risk preferences far above or below that of other people their age. Our data show that 26% to 53% of clients fall outside of their stereotypical age-based risk tolerance. As you can see in the table, every client whose risk profile falls outside of the highlighted area is typically assigned the wrong allocation based on qualitative, psychological or other age-based risk profiling methods.

The Expectations Game

One of the biggest challenges that advisors face when working with their clients is properly setting and managing expectations for portfolio returns. When the markets are up and clients hear about the booming economy from the media, they are upset and want to know why they aren't beating the markets. Yet those same clients will call in when the markets are down to ask why they aren't more diversified and protected against losses.

The problem arises from the way we have trained ourselves as an industry to talk about expected returns. We talk about the expected performance of a portfolio based on average returns, while sweeping risk under the rug. We have chosen the one goal that we are practically guaranteed never to hit — and we use that amount to set expectations. Table 2 shows the mathematical chance of the portfolio attaining a rate of return close to the stated average. As you can see in the table, unless you are invested completely in bonds, it is unlikely for the returns on a portfolio to be within even 5% of its average.

TABLE 2. Chance of Nearing Average per Standard Deviation

	Bonds	Stocks	Stocks	Stocks	Stocks
Standard Deviation	$\sigma = 3$	$\sigma = 6$	$\sigma = 9$	$\sigma = 12$	$\sigma = 15$
Chance of Returns +/- 1% from mean	26.1%	13.2%	8.8%	6.6%	5.3%
Chance of Returns +/- 3% from mean	68.2%	38.3%	26.1%	19.7%	15.8%
Chance of Returns +/- 5% from mean	90.4%	59.5%	42.1%	32.3%	26.1%
Chance of underperforming mean	50%	50%	50%	50%	50%

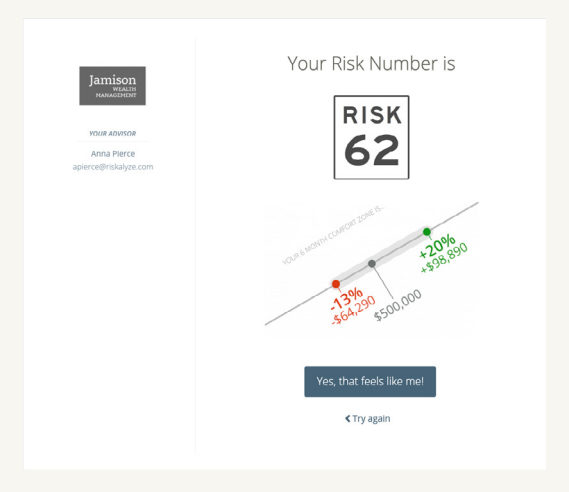
Table 2 shows the percent chance of being within a certain percentage of the stated average of a portfolio given the cumulative standard deviation of its hold- ings. Unless the portfolio is made up entirely of bonds, it is unlikely to come close to the average. Advisors are setting client expectations based on an amount that they will probably not come close to.

When an advisor says, "you can expect this portfolio to make about 8% per year, over the long run," the client only hears, "this portfo- lio will make 8% per year." Clients typically may not consider the underlying concepts of risk, variance and standard deviation that go along with the mean. We have to draw those lines for them, and will be much better off if we do.

Talking About Risk First

The best way to set client expectations is to begin the conversation by talking about risk. When you administer a quantitative risk questionnaire to find your client's Risk Number, the output is the range of returns on a portfolio that the client is comfortable with, as shown in Figure 1. This is an incredibly powerful tool, as the client tells you the range that they are comfortable with, not the other way around.

FIGURE 1. Example of a Risk Number and 95% Historical Range™



Take the example of a client who goes through the questionnaire and finds that they have a Risk Number of 62, meaning that they are comfortable risking 13% of their portfolio to have a chance at gaining 20%. The client has just told you their bounds for what they are comfortable with in terms of gains or losses.

The most powerful aspect of this approach is that you can build a portfolio and measure its risk on the same scale as the client's risk preference, as shown in Figure 2. You can build a portfolio that has a Risk NumberTM of 62, with a 95% probability of staying within the range of –13% and +20% based on the holdings in that portfolio.

When you begin the conversation by talking about risk, and the client tells you what they are comfortable with in terms of actual dollars, that client now has a real understanding of what is normal for their portfolio. The client implicitly agrees to be a long-term investor.

If the portfolio is down 4% and they know that it can be normal for the portfolio to be down 13%, the client will not call you with worries about their portfolio.

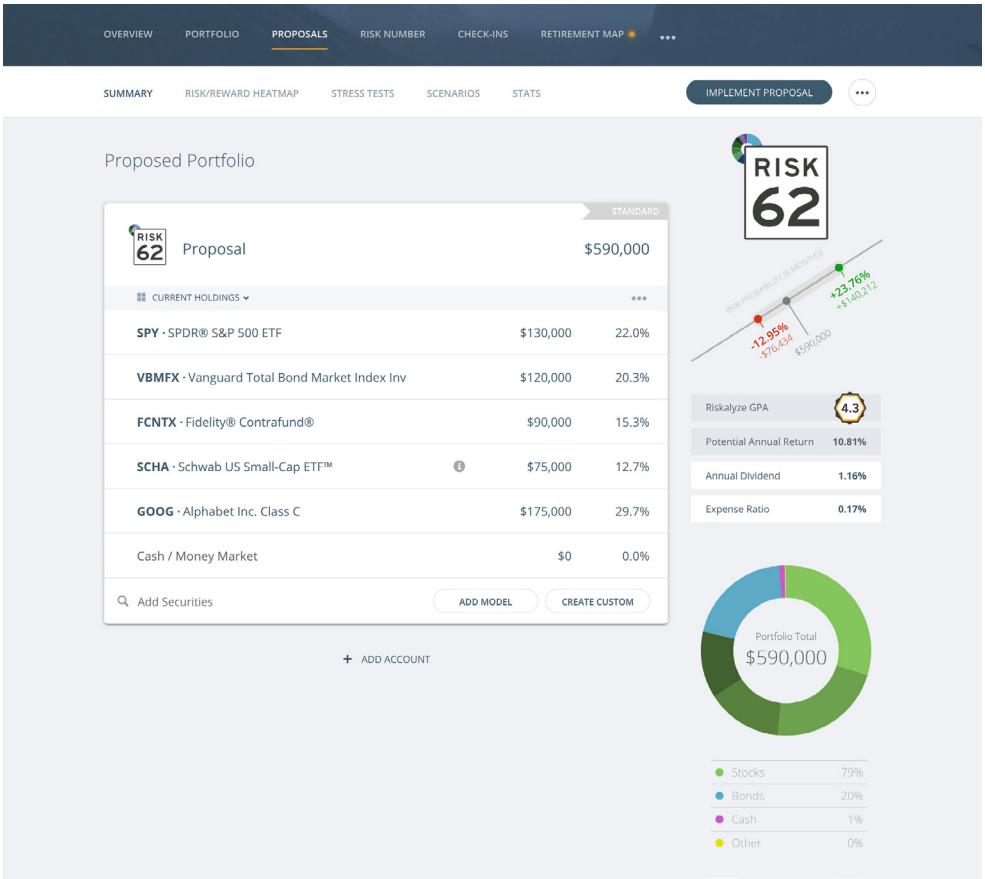


FIGURE 2. Example of Proposed Portfolio the Matches the Client's Risk Number

The True Return on Investment

When you approach setting client expectations with a range of returns based on the client's risk profile, you can conduct client meetings with greater efficiency and be more productive during those meetings and calls.

> *The client who understands that it can be normal for their portfolio to be down a few percentage points will not feel the need to call in with worries or complaints. Reduced calls can equate to hours or days of time saved every time there is a downturn in the market.*
>
> *When the client tells you the amount of risk that they are comfortable with in their portfolio and you can clearly show that the portfolio has that amount of risk, you can get done in one meeting what usually takes three or four.*

With all of the additional time from efficiencies and productivity gains, you can focus more time on managing investments, producing financial plans and building new relationships with clients.

The most significant ROI comes from the ease with which you are able to win new clients. Using the quantitative risk questionnaire and portfolio analysis to show prospective clients that they are invested wrong — and how you will help them invest right — turns risk into the best sales tool available to advisors.

Conclusion

When advisors start talking about risk rather than touting returns, they end up with happier clients.

Beginning your client onboarding process with a quantitative risk questionnaire enables you to craft a portfolio that fits the client and sets them up for long-term success. When you use risk to set client expectations it helps clients to gain a clearer picture of their portfolio and a better understanding of the potential downside risks.

Clients no longer feel the need to call in every time their portfolio drops, saving you hours or days every time there is a bump in the market.

The power of measuring risk preference and the risk in a portfolio on the same scale enables you to easily show prospective clients that they are invested wrong and prove to current clients that they are invested right.