


## RISK MANAGEMENT / COMPLIANCE

# But The Client Never Told Me ...

*A Misunderstanding of “Risk” is at the Heart of Most Advisor/Client Conflicts*

BY GREG RODGER, CFA®, AND WAYNE GILLESPIE, CIMA®

ne critical role of an asset consultant is to carefully manage clients' portfolio expectations, both positive and negative. To support this approach, we have incorporated our portfolio risk-management practices into a three-step portfolio process of proposal, management, and review. Specifically, while the proposal phase is focused upon understanding clients' investment objectives, risk tolerances, and constraints, and then incorporating these client attributes into a formal recommendation, the management phase is concerned with the implementation and ongoing management of the client portfolio. Finally, the review phase is a process through which clients' portfolio results are reviewed with them on a periodic basis and their investment objectives, risk tolerances, and constraints are reassessed. At each phase of this portfolio process, we incorporate a set of prudent, yet practical, portfolio risk-management activities that ensures that each client's portfolio truly is tailored to the client's unique needs and preferences. This article reviews the portfolio risk-management considerations for the first phase, proposal.

### Portfolio Risk Background

Historically, at least as Peter Bernstein suggests, risk and risk management have evolved through history, reflecting much of the temper and times of society, with the emphasis swinging from “gut” (the behavioral aspect) to measurement (quantitative) and then back to “gut.” As long as people sensed they had no control over their futures, chance explained the entire outcome of risk-taking. As each period unfolded (notably the Renaissance), Bernstein states that the human spirit for experimentation and exploration was unleashed, demonstrating that choice is a valid human activity and that risk is something to be taken as well as faced. Quantification became essential, leading to the laws of probability. In more modern times, uncertainty has replaced many of the neat concepts of probability and even has begun to attack the roots of the capital ideas of finance, namely mean-variance, the efficient market hypothesis, and the capital asset pricing model.<sup>1</sup>

But what happens when the theoretical “process” meets reality? When an investment advisor meets with a client or potential client to determine the most appropriate way to manage that client's portfolio, invariably the concept of risk will enter into the discussion, as well

it should. However, the focus on risk usually does not get the attention it deserves and, furthermore, what the investor understands as risk is different from what the advisor understands as risk. When this happens, the relationship is doomed.

There are many valid reasons why this misunderstanding takes place because risk is a concept that has generated much interest and attention for centuries from philosophers, scholars, and practitioners. As numerous books and articles continue to be written about how to identify, quantify, and manage risk (in its ever-evolving forms) it is obvious that a generally accepted and useful definition has not emerged. However, one of the most commonly used definitions in the investment industry is that of standard deviation, or variability of returns. Do you think the 70-year-old widow who is not sure if she has enough money to fund her remaining years shares that definition of risk? Not likely.

### What Is Risk to the Private Client?

Private investors each have their own interpretation of what risk means to them. This personal concept of risk (PCOR) has been formed in the investor's mind through life experiences and by innate personality. So to say that there exists an all-encompassing concept of risk and by extension an all-encompassing risk-management solution is preposterous. The most important job of an advisor is to have the client articulate his/her PCOR. Of course this is easier said than done. Typically individuals cannot articulate their PCOR because it is a complex and difficult concept that they likely have spent little time thinking about. Is it simply loss of capital, uncertainty, failure to achieve specific financial goals, or something entirely different? In some ways it is akin to the famous comment from U.S. Supreme Court Justice Potter Stewart, who in 1964 stated, "I can't define pornography, but I know it when I see it."<sup>2</sup> Private investors may not be able to define what risk means to them, but they certainly will know it after they experience it. Before investing, individuals might think they understand the types of "risks" they will be exposed to (especially after the risks have been explained by an experienced and knowledgeable advisor) and feel comfortable taking on those risks, but only once they experience a significant negative event can they truly understand whether or not they were prepared for it.

One of the problems with traditional and more technical definitions of risk, such as variability of returns, is that they are based on history and probabilities. We as investment professionals can talk all we want about how various types of investments have behaved in the past and from that assign probabilities to how they will behave in the future, but this really is nothing more than an educated guess. If we tell clients that with 95-percent confidence their portfolios will perform within a specific broad range of returns and on average they will experi-

ence X-percent gain per annum, the client typically remembers two things:

1. I should expect to see X-percent return *per year* in my portfolio.
2. The worst that will happen is the lower end of the range of returns.

The problem is that clients are unlikely to ever see exactly X-percent return in their portfolios in any given year (the returns could be significantly higher or lower) and they forget about the 5-percent probability that the actual returns achieved in any given year may be well outside of that range of returns. Both clients (and advisors) tend to think of "low probability" as equal to "no probability." This clearly is not the case and this fact should form part of discussions with clients. This is not about scaring clients away from certain types of investments but rather helping to prepare them for the journey that they are embarking upon.

No matter how sophisticated a forecasting model might be (including Monte Carlo simulations), it is impossible to predict all potential future events. Therefore, it is impossible to predict with absolute certainty how an investment portfolio might behave going forward. This is precisely where the danger lays: our inability to know all that is needed to be known to make an informed decision. Therefore decisions are made (and advice is given) based on imperfect information. Some will argue that this inability to predict the future with precision is well understood by clients and what clients really are looking for is guidance, not precision. This is a reasonable belief. However, the problem remains that if an advisor is unsuccessful in the attempt to have a client clearly articulate her PCOR, then is the guidance provided correct for that client?

Furthermore, dare we even get into the concept of risk tolerance? While this topic will be left for another day, it bears some mention here because it is so intertwined with PCOR. Advisors often are faced not only with uncertain or conflicting responses from clients around risk; they also are obligated to then categorize each client within some parameters. Put much too simply, clients are seen as either having the willingness to incur risk but perhaps not the financial ability, or having the financial ability but not the willingness. David Cordell, finance professor at the American College, outlines the following four components of risk tolerance<sup>3</sup> that should be evaluated independently:

- risk propensity—the client's real-life decisions in financial situations
- risk attitude—the characteristic most often used synonymously with tolerance, whereas in reality it simply refers to the client's willingness to incur monetary risk
- risk capacity—the client's financial ability to incur risk
- risk knowledge—the client's relative understanding of risk and the risk/return tradeoff

Obviously, these components often are influenced

## >> "BUT THE CLIENT NEVER TOLD ME" CONTINUED

by each other, and this just serves to complicate matters even further.

Let's try a simple example.

Think of an individual named Walter who cannot swim but needs to get to the other side of a river and has hired a river expert named Mary to assist him. Mary claims to have tremendous knowledge of the river and in fact studies reports on the river from various experts on a regular basis. Walter asks Mary if it would be possible to walk through the river to the other side, but for whatever reason neglects to tell her that he cannot swim.

Armed with a wealth of data and charts, Mary sits Walter down and tells him that this easily can be done and now is the perfect time. It's the perfect time because the current typically is at its weakest, the river at its lowest, and the temperature at its warmest at this time of year. Mary goes on to say that based on detailed analysis she knows that the river is one-mile wide, has an average depth of four feet, and a standard deviation of two feet. All of this seems to make perfect sense to Walter, who has no reason to question any of the data provided to him by someone who is a river *expert*. "The current is slow, the temperature is warm, and the river is four-feet deep, give or take a bit," thinks Walter. With that, a confident Walter takes off his shoes, steps into the river, and begins his one-mile crossing. All is well for the first minute or two until Walter reaches an area of the river that is seven-feet deep. The six-foot tall Walter sinks quickly. Mary sees what is happening and jumps in to try to help. In a panic Walter fights her off. Just before he goes under for the final time, Mary asks, "Why didn't you tell me you can't swim?" and Walter replied: "You never asked. Besides I didn't think it was important since you told me the river was only four-feet deep."

So, how could this have been avoided? Clearly Walter should have told Mary he could not swim. Just as clearly, Mary did not have all the facts before sending her client into the river because she did not ask the right questions. Was that the client's mistake or the expert's? One thing is for certain: Mary won't benefit from any future business or referrals from Walter.

### How Should Advisors Help Clients Manage These Risks?

Often as advisors we are anxious to get the assets in the door and invested. While we have the client complete a questionnaire that provides us with the know your client (KYC) information and some insight into what type of investment portfolio may be most suitable, usually some of the most important information is not collected and only rises to the surface when it is too late.

No matter how comprehensive your company's questionnaire or profiling tool might be, nothing replaces an in-depth interactive conversation about experiences,

expectations, needs, desires, and market realities. If you have a profiling tool at your disposal, use it. But don't just give it to clients or prospects and ask them to complete it. View this as a great opportunity to engage each individual in one of the most important of discussions. Walk your client through the questionnaire and discuss each question and answer. This is your opportunity to lay the foundation for a successful long-term relationship.

An advisor never should accept the responsibility bestowed by comments such as, "You're the expert, just do what you think is best." This type of comment is irresponsible (but somewhat understandable) on the client's part and would be even more irresponsible on the part of the advisor if the advisor agreed to it. Also, advisors should not overlook the fact that they possess their own biases. Resist the urge to guide clients into certain answers. Provide them with facts and engage them in discussions to help them make decisions, but the answers must be their own.

Helping a client stay the course during unsettled markets is one of the most important roles of an advisor. Your ability to do this is directly related to how accurately you have understood the client's personal concept of risk, how well the portfolio is aligned with this reality, and how effectively you have prepared the client for the inevitable gyrations of the markets. If the advisor confidently can demonstrate to the investor that the stated goals and objectives have not been put at risk by the short-term market movements and events are similar to what was discussed at the outset, then there is a good chance that the client will stick with the longer-term plan. If the investor has not been sufficiently prepared for such events, or the portfolio has not been structured appropriately, then, much like Walter, the investor will have a drowning feeling and may fight off the advisor's attempts to help the client through the uncomfortable periods. **M**

*Greg Rodger, CFA®, is president and chief investment officer at Graeden Hall Asset Management in Toronto, ON. He earned a B.A. in economics from the University of Toronto. Contact him at [grodger@graedenhall.com](mailto:grodger@graedenhall.com).*

*Wayne Gillespie, CIMA®, is chief operating officer and chief risk management officer at Graeden Hall Asset Management in Toronto, ON. He earned a B.A. in economics from York University. Contact him at [wgillespie@graedenhall.com](mailto:wgillespie@graedenhall.com).*

### Endnotes

1. Peter L. Bernstein, *Capital Ideas Evolving* (Hoboken, NJ: John Wiley & Sons, Inc. 2007).
2. Justice Potter Stewart in *Jacobellis v. Ohio* 378 US 184 (1964).
3. David M. Cordell, RiskPACK: How to Evaluate Risk Tolerance. *Journal of Financial Planning* (June 2001): 36-40.