

Factors that every financial advisor must consider when doing a client's risk profile

There has been much debate about risk profiling and its relevance – or lack thereof – in determining an appropriate investment solution for customers.

Risk Profiling is a process of finding the optimal level of investment risk for your client considering the risk required, risk capacity and risk tolerance, where:



- **Risk Required** is the risk associated with the return required to achieve the client's goals with the available financial resources,
- **Risk Capacity** is the level of financial risk the client can afford to take, and
- **Risk Tolerance** is the level of risk the client is comfortable with.

Each of these three risk aspects has an impact on the selection of an appropriate investment strategy.

Risk Required and Risk Capacity are financial characteristics calculated using a financial planning tool. Risk Tolerance is an analysis of the client's goals and the risks the client is willing to take to achieve his goal.

Risk Profiling requires each of these characteristics to be separately assessed so that they can be compared to one another. Risk Capacity and Risk Tolerance both act separately as constraints on what your client might otherwise do to achieve their goals (Risk Required). It is unusual for a client to be able to achieve their goals from the resources available within both their risk capacity and risk tolerance.

These aspects can often be in conflict and should be plotted against one another to find a best-fit solution for the customer.

'Sloppy' risk profiling makes advisors vulnerable to (legal) claims by unhappy clients. One of the most likely causes of an abrupt, unhappy ending to the advisor/client relationship is mismanaged risk.

Many tools are available to help measure an investor's risk tolerance, such as risk analysers. However, the focus should be less on the scorecard and more on the information gathered from the customer when seeking information. Take time to understand whether the customer likes to take risks or prefers to play it safe. Your focus should be on understanding how the customer thinks.

When seeking a solution that will best suit the client's circumstances, the following must be taken into consideration:

- **Objective**

Each investor has unique investment objectives that are affected by short- and long-term needs. The objective may be to create wealth to meet financial goals, protect savings from the eroding effects of inflation or to generate income.

- **Time frame**

It is important to know the "when" of the client's financial goals because investing for short-term goals differs from investing for long-term goals. Your investment strategy will therefore vary depending on how long the client looks to keep the money invested. Most goals fit into one of the three categories of —short-term, medium-term, and long-term.

- **Access to cash**

Find out if the client would need access to his/her investment funds in an emergency, and if his/her medical aid and gap cover would cover risk and medical expenses in the event of an accident or contracting a disease.

- **Age**

It is commonly accepted that clients who are older and retired have a lower risk appetite and risk profile compared to younger clients at the beginning of their careers. It is therefore important for you to ensure that the client's goals are realistically aligned to their age. If older clients wish to continue investing in high-risk products, then it is the duty of the advisor to clearly point out all of the risks and what the client may lose. Irrespective of age, the risk areas of a product should always be clearly set out to the client for the client to fully understand what he has to lose.

- **Income**

Clients who require income from their investment should be asked whether they currently earn an income. If they do, how long will they continue to earn an income and what increases do they expect? Do they anticipate their earnings will keep pace with inflation? Do they have a buffer in their budget to absorb any drop in real earnings? Do they anticipate any of their expenses to increase or decrease as they grow older?

Treating customers fairly should form an integral part of your business.

Outcome 2 of TCF stipulates that you, as a financial advisor, have a duty to make sure that the financial services rendered, and products recommended to the client are designed to meet the needs of the client. In light of this, the following questions must be answered:

- Do you understand your clients, their financial situation, and their financial needs?
- Do you understand what the products really do, and how these match the needs of your clients?

You, as the advisor, are responsible for gathering the necessary information about the client's circumstances and asking questions about aspirations and expectations, what the client wants to achieve and the anticipated outcome of the investment.

Outcome 3 of TCF requires the advisor to provide the client with clear information in order for the client to make an informed decision. Therefore, it is important that the risk profiling of the client is clearly documented, as well as the risks identified of the products recommended. The client must be able to see and understand how their Risk Required, Risk Capacity and Risk Tolerance aligns with the identified risks of the product. Only once this has been done, will the client be able to make an informed decision.