Capital Preferences

Understanding Our Insights for Advisers

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Our Insights

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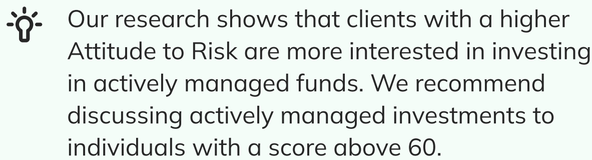
Attitude to Risk

A measure of your client's comfort with fluctuations in investment returns.

Tailoring advice to Attitude to Risk.

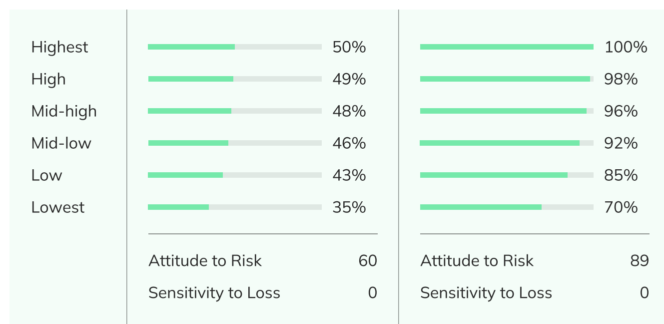
A client's Attitude to Risk is an important factor in determining her Risk Comfort score. By considering each of your clients' unique Attitude to Risk scores, you can help them find portfolios that balance their desire for returns with their tolerance for market fluctuations.



Our research shows that clients with a higher Attitude to Risk are more interested in investing in actively managed funds. We recommend discussing actively managed investments to individuals with a score above 60.

Identifying Attitude to Risk in client decisions.

A client's Attitude to Risk can be approximated by observing her decisions with the slider. The farther to the right the position of the slider is, the more risk she is willing to take. If there is a wide range in their decisions, the mid-point can be an approximation of her Attitude to Risk, and this could be an indication of an increased Sensitivity to Loss.



What's behind the Attitude to Risk score?

Our scores are always backed by science. We measure Attitude to Risk through the Constant Absolute Risk Aversion (CARA) utility framework.

CARA helps us to understand how individuals make decisions about taking risks with their money. It is a two-part utility function that helps us to identify several common behaviours and is used to find the point where someone's utility (read: satisfaction) will be highest. The two parameters called alpha (α) and rho (ρ) make up our Sensitivity to Loss and Attitude to Risk scores respectively.

By using mathematics to understand each of your clients' unique preferences, we can precisely measure how satisfied your clients will be with each investment option and find the right investment portfolio for them.

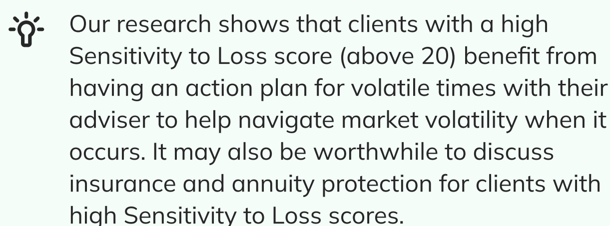
To learn more about our science, you can check out our white paper: New Ground in Financial Risk Tolerance.

Sensitivity to Loss

Nobody likes losing money, but Sensitivity to Loss is a measure of your client's increased levels of pain associated with losses.

Tailoring advice to Sensitivity to Loss.

A client's Sensitivity to Loss is an important factor in determining her Risk Comfort score and establishing a servicing plan. By considering each of your clients' unique Sensitivity to Loss scores, we can help them find portfolios that balance their long-term financial goals, while keeping them comfortable through short-term market volatility.



Our research shows that clients with a high Sensitivity to Loss score (above 20) benefit from having an action plan for volatile times with their adviser to help navigate market volatility when it occurs. It may also be worthwhile to discuss insurance and annuity protection for clients with high Sensitivity to Loss scores.

Identifying Sensitivity to Loss in client decisions.

A client's Sensitivity to Loss can be approximated by observing her decisions with the slider. We reveal this by noting the degree to which the client reduces the risk she is comfortable with as the opportunity decreases. It is normal for clients to somewhat reduce the risk they take as the opportunity decreases, but in cases where clients significantly reduce their risk-taking as the opportunity decreases, we can observe which clients are loss-averse.

However, if a client risks a similar amount of her investment across each scenario, then we calculate that she has no additional Sensitivity to Loss.

What's behind the Sensitivity to Loss score?

Our scores are always backed by science. We measure Sensitivity to Loss through the Constant Absolute Risk Aversion (CARA) utility framework.

CARA helps us to understand how people make decisions about taking risks with their money. It is a two-part utility function that helps us to explain a client's decisions in the Risk Activity and is used to find the point where the client's utility (read: satisfaction) will be highest. The two parameters called alpha (α) and rho (ρ) make up our Sensitivity to Loss and Attitude to Risk scores respectively.

Prospect Theory tells us that people feel the pain of losses at higher rates than they feel satisfaction from gains of an equivalent amount. Our science goes beyond the research of Prospect Theory and measures the utility each individual receives in relation to perceived gains and losses.

By using mathematics to understand people's preferences, we can precisely measure how satisfied your clients will be with each investment option and find the right investment portfolio for them.

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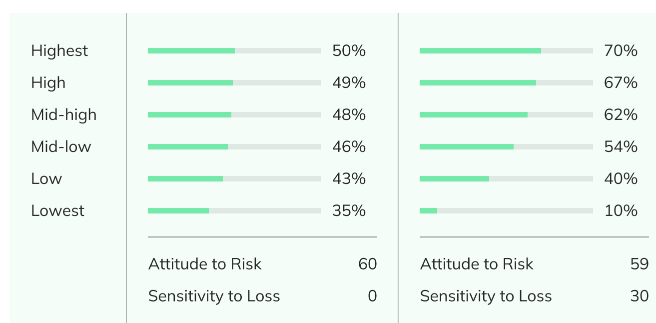


Risk Comfort

A measure of your client's comfort with the risk and reward in each model portfolio.

0% **100%**

COMPLETE MISALIGNMENT .... PERFECT ALIGNMENT

Tailoring advice to Risk Comfort.

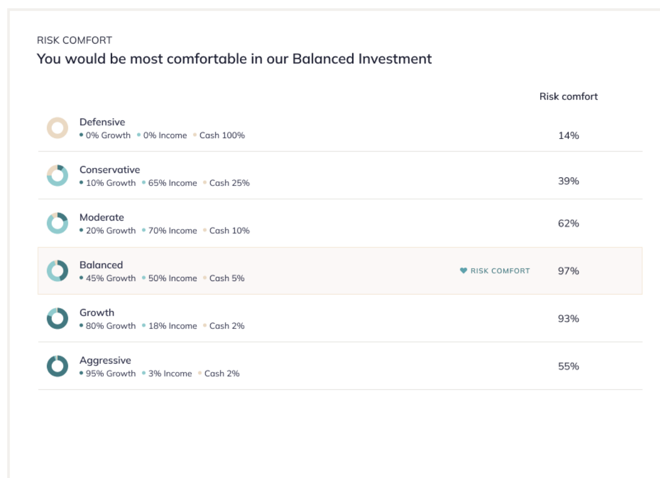
A client's Risk Comfort is one of the most important factors when selecting a portfolio. You can achieve the best long-term financial outcomes for your clients by balancing their Risk Comfort with their need for returns to achieve their goals and their capacity to take risk.

What information goes into a Risk Comfort score?

We use your expected return and expected volatility estimates to create your efficient frontier, and we overlay your clients' risk preferences to measure how comfortable they are in each model portfolio. Each client's risk preferences are made up of their Attitude to Risk and Sensitivity to Loss scores.

In the below example, the client has the highest Risk Comfort score (97%) in the Balanced Portfolio, with decreasing levels of comfort as the client takes more or less risk. Although the client has the highest Risk Comfort score in the Balanced Portfolio, her goals and constraints should also be considered when recommending a portfolio. We leave it up to your expertise as the client's adviser to discuss what portfolio makes the most sense.

How should you interpret the Risk Comfort score?



However, the scores reveal how comfortable the client would be across each investment option. For instance, in the above example, we see that the client would be more comfortable with the increased risk of the Growth Portfolio than the decreased return of the Moderately Conservative Portfolio.

In any case, the Risk Comfort score presents an opportunity for you to demonstrate to your clients that you deeply understand their risk preferences and help your clients understand why the portfolio they ultimately choose is right for them.

Decision Check

A flag to confirm that your client has a coherent understanding of risk trade-offs.

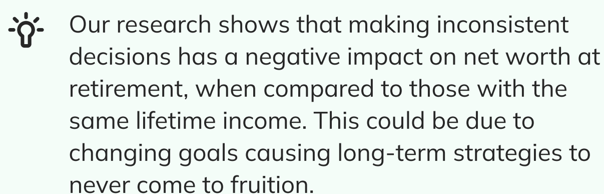
What if they fail the Decision Check?

A client's Decision Check shows us when we've accurately measured the client's preferences. If a client fails the Decision Check, she may need to be re-profiled to ensure she understood the activity. These clients may also benefit from additional coaching to help them find a level of risk that will be comfortable over the short and long term.

How can I recognise if my clients have inconsistent decisions?

We indicate inconsistent decisions with a flag on the client's profile screen. This means she did not have a coherent understanding of risk and reward in the Risk Activity.

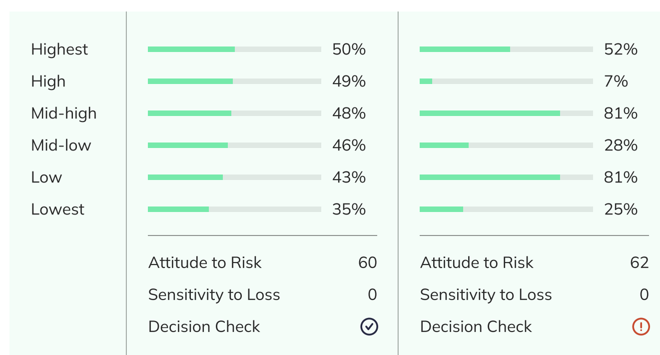
As shown below, an client with inconsistent decision making has no discernible pattern between the rounds, and this gives us low confidence that we have understood her risk preferences.



Our research shows that making inconsistent decisions has a negative impact on net worth at retirement, when compared to those with the same lifetime income. This could be due to changing goals causing long-term strategies to never come to fruition.

We also know that only 1% of investors have inconsistent decision making. Inconsistent decision patterns occur across all Attitude to Risk and Sensitivity to Loss combinations and income groups, meaning the only way to identify clients with inconsistent decision-making is to risk-profile them and see how they make decisions in the risk activity.

As an adviser, it is important to identify these clients early in the advice process and intervene as you see best. We recommend additional coaching and support throughout the advice process. You may also want to have an educative conversation about risk and reward and then re-profile the client to see if their decisions become more consistent.



Frequently Asked Questions

Why is the Risk activity trade-off over the next twelve months?

We know from our research that a client's risk preferences change over time. This happens naturally as clients age and as major life events occur, such as buying a home, starting a family, switching jobs, and so on.

However, individuals feel the pain of losses in the near term. The Risk activity is designed to understand each individual's unique risk preferences in the context of short-term investment outcomes, even if clients are not seeking to withdraw their money for a longer period of time.

This is because clients cannot express what their risk preferences will be five, ten, or twenty years down the road. They can only express how they feel about investment risk and return in the present moment.

We recommend re-profiling your clients' risk preferences annually to see how their Risk Comfort evolves so that you can continually personalise the advice you provide over time.

Why is the Risk activity trade-off an equally likely outcome?

The Risk activity is designed to be as simple for people to understand as possible and intuitive for clients across all levels of financial literacy and investing experience.

This is why the tradeoff is positioned as a 50/50 outcome, as clients have a high understanding of that probability.

Eliminating ambiguous distributions also means that their Attitude to Risk and Sensitivity to Loss are free of interpretation biases.

Why are there six decisions?

In the Risk activity, clients are presented with six decisions where they will make tradeoffs between risk and reward at varying levels of investment opportunity. You may be wondering why there are six decisions.

In short, six decisions are the minimum number of decisions our calculation engine requires for the results to be statistically significant. If clients were to complete fewer than six decisions, the statistical significance of the data would decrease, and client Attitude to Risk and Sensitivity to Loss scores will not be as accurate with six decisions.

If the Risk activity were to have more than six decisions, the results would be further validated, but the additional rounds of decisions are unnecessary and wouldn't change the results significantly enough to warrant additional rounds. It would also unnecessarily lengthen the client experience.

Example decision in the Risk activity