RISK PROFILING THROUGH A BEHAVIORAL FINANCE LENS

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INTRODUCTION

The challenge of Risk tolerance assessments

- Typical risk tolerance assessments using questionnaires are unreliable.
  - The typical questionnaire explains 15% of the variation in risky assets between investors.
  - The primary issue is the design of the questionnaires, which focus on socioeconomic variables and hypothetical scenarios.
  - The typical investor does not understand their own risk tolerances
- What investment professionals need to consider are the lifetime experiences of investors, financial decisions made in the past by the investor, and the influence of family, friends and advisors.
- Practitioners can enhance their understanding of client preferences and better inform their recommendations of investment strategies and products by better understanding the psychological temperament of the individual investor.

BOTTOM LINE

The importance of understanding how investors make decisions

- Most sophisticated financial advisors use behavioral finance principles, and
- Less experienced and quantitatively-oriented advisors are challenged by clients’ behaviors.

BEHAVIORAL FINANCE

What is behavioral finance?

Behavioral finance helps us understand and explain investor behavior, both individually and collectively.

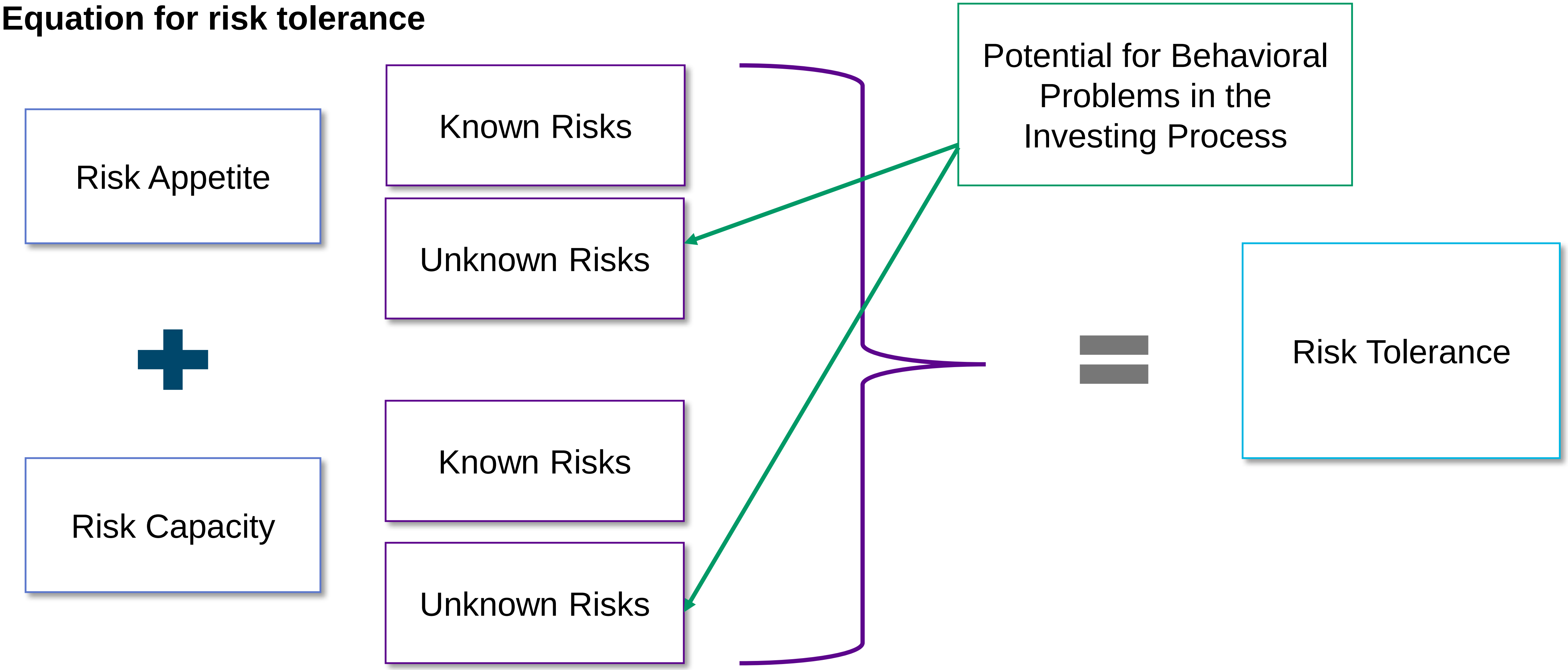
- It helps explain how people make decisions.
- It helps explain how investors *should* behave from how the *actually* behave

Behaviors may be classified as:

- **Cognitive - reflect h*ow people think***
    - ***Recency bias –*** *Extrapolating a pattern from recent events when none really exist*
    - ***Confirmation bias –*** Putting more weight on opinions that agree with you
- **Emotional – reflect h*ow people feel***
    - ***Loss-aversion Bias*** – Not being able to sell a security that has lost money on the hopes it will rebound
    - **Overconfidence Bias** – Feeling that one has better skills or an edge over other investors

ASSESSING RISK TOLERANCE

Equation for risk tolerance



RISK TOLERANCE AND BIASES

Exhibit 1. Risk Tolerance and Types of Biases

	Behavioral investment types (BIT)			
	Conservative	Moderate	Growth	Aggressive
Risk tolerance	Low	Medium	High	Very high
Bias types	Primarily emotional	Primarily cognitive	Primarily cognitive	Primarily emotional
Biases	Endowment Loss aversion Status quo Anchoring Mental accounting	Regret Hindsight Framing Cognitive dissonance Recency	Conservatism Availability Confirmation Representativeness Self attribution	Overconfidence Self control Affinity Illusion of control Outcome

TAKEAWAYS

Working with behaviorally-biased clients

Understanding how investors make investment decisions is no longer a “nice-to-have” skill. In this new era of volatile markets, financial advisers must be able to diagnose irrational behaviors and advise their clients accordingly.

Behavioral finance attempts to understand and explain actual investor behavior rather than theorize about investor behavior.

In the behavioral context, tensions exist between the willingness to take risk (risk appetite) and the ability to take risk (risk capacity) as they are defined in terms of known and unknown risks.

Advisers can use behavioral investor types to help make rapid yet insightful assessments of what type of investor they are dealing with before recommending an investment plan.

With a better understanding of behavioral finance vis-à-vis risk taking, practitioners can enhance their understanding of client preferences and develop better-informed recommendations of investment strategies and products.