Transcript


Episode 1.20 – The risky business of risk assessment

*Michael Gillemette* - They should care about this topic because assessing client risk directly influences the client's portfolio allocation, which then directly affects whether they can meet their goals. And the whole point of hiring a comprehensive financial advisor is to make sure that they can help the client reach those financial goals in retirement.

*Ben Jones* - Welcome to Better Conversations, Better Outcomes presented by BMO Global Asset Management. I'm Ben Jones.

*Matt Smith* - And I'm Matt Smith. In each episode, we'll explore topics relevant to today's trusted advisors; interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

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*Ben Jones* - When you are managing and investing someone else's money, one of the important things that you must always keep in mind is the concept of risk. While you as an advisor may have an opinion about how much risk your client's should take, your clients' attitudes towards risk are probably of more critical importance. Today, Matt is talking with Michael Gillemette about risk tolerance.

*Michael Gillemette* - So, I'm an assistant professor in personal financial planning at the University of Missouri. I teach courses over investments, risk, and insurance and I have multiple publications in the area of risk tolerance assessment looking at questions that best capture portfolio allocation preference and recent investment changes, and it's been published - multiple publications in the *Journal of Financial Planning*. And I've talked to FPA groups across the country on this concept of assessing client risk preferences over a variety of different topics.

*Matt Smith* - Before we dug into the details of risk tolerance, I wanted to talk with Michael first why this topic is an important one for advisors. Why should an advisor care about this topic?
Yeah, so they should care about this topic because the assessing client risk directly influences the client's portfolio allocation, which then directly affects whether they can meet their goals. And the whole point of hiring a comprehensive financial advisor is to make sure that they can help the client reach those financial goals in retirement. So, that from a 40,000 foot view is one of the reasons, again, I touched on the fiduciary standard and how it -- from the Department of Labor standpoint, that this is something that's important from -- every client's plan should be individualized and with that individualization, the advisor has a fiduciary standard to capture a client's risk preferences. So, that's another. From a legal standpoint it is important to do it as well and then it's also important because from a behavioral standpoint, realizing if as my client ages that they may prefer greater certainty, which then puts the onus on shifting to things like TIPS or annuities, specifically maybe longevity insurance that I think is a great product, a deferred annuity that pays out at 80 or 85. So, I think all of these things factor into why this is such an important topic for advisors to think about in the beginning of the financial planning process and also throughout the process as they're monitoring their client's plan.

Matt Smith - What do you suggest to financial advisors is a practical way to determine their client's risk tolerance?

Michael Gillemette - Yeah, so I think the first thing to think about is really to back up and talk to the client about the investment philosophy and your investment process first and foremost. So, before jumping into giving them a questionnaire which, as well get into, is part of the fiduciary standard now, I think it's important that they understand that the investment process is holistic, that no portfolio is an island. And what I mean by that is that the client's got stocks, bonds, real estate, they've got their Social Security, they've also got their human capital future earnings, and all of these things together are helping them to ultimately achieve their financial goals in the future. So, it's – I think sometimes that gets lost in terms of client risk assessment where the advisor may jump right in to just giving them a questionnaire right off the bat without first explained the holistic process, without first giving them a written investment policy statement. And why these things are important from a risk tolerance standpoint is that, if you talk to a client say, holistically, about a portfolio. The research shows they're much less likely to freak out by thinking of the portfolio and all these different aspects. Like I said, the stocks, bonds, human capital, real estate, Social Security, as opposed to if you just focus on, say, the stock portion or the bond portion, which is what everybody's thinking about when you look at these and other things. So, I think that's one aspect of it and I think the other aspect of that would be the written IPS. So, that is important because the research shows if you sit down with the client and have them realize that the riskier investments like stocks, bonds, are for the long-term goals, they're more likely to stick with that advisor during a downturn.

Matt Smith - I'd like your thoughts on what is the purpose of a risk tolerance assessment? Is it to inform the individual's asset allocation so they only take the amount of risk they can handle, or is it something else? Is it a tool for advisors to use to manage their client's reactions down the road to, let's say, a market event.

Michael Gillemette - Yeah, that's a great question. So, in a perfect world, absent of risk
tolerance, as you said it would be all about the client's objectives, time horizon. You could look at risk capacity, things like their human capital, how much -- their future earnings and things like that. Now, where it gets tricky is you -- everyone has different risk preferences, right. So -- and I think from that standpoint that if you assess the client's risk preferences and their averse, right. And you're in a situation where it looks like they don't want to take as much risk as it's going to take from the portfolio standpoint, risk standpoint to get them to meet their investment goals in retirement. Then the financial planner really, I think, only has one choice and that is to talk to the client about adjusting goals, whether it be retiring later, whether it be changing specific goals in retirement. Because I don't think if you have a client -- if they can't stomach the investment risk in the portfolio, you'd be doing them a disservice to override that just to help them reach their goals. And where that's going to go awry is when there is a downturn in the stock or bond market and what's going to happen is if you override their risk with things like objectives and that nature, then you're going to increase the likelihood that the client freaks out during the downturn and jumps to cash or fires the advisor - which means they're not going to be able to reach their goals anyway. Now, if you're on the opposite side of the coin and you have a client that is much more risk tolerant and he or she can meet their goals and objectives in retirement, and you're sitting there and looking at it and saying well, this client, they can meet all their objectives. We can also -- they can also from a preference standpoint can afford to take more risk in the portfolio. In that case, I say there's no need really to have -- take more risk in the portfolio if client can already meet their goals and objectives. Because that's the ultimate point of this in terms of making the client happy. So, hopefully that makes sense. So if they're risk -- basically, you never want to take more risk than the client's willing to stomach because everything could go wrong during a downturn and they could jump out and go to cash. And that being said, if things are good, if the objectives look like they can be met, then you also don't necessarily want to dial up the risk just to earn a little bit more -- if they can safely make it given your assumptions.

Ben Jones - Risk can be defined in many different ways, but for the purposes of this podcast, risk is going to be defined as the return patterns of a portfolio, movements up or down in the portfolio's value. Before you start talking to your client's about risk, it's beneficial for you and your client to get on the same page around your investment philosophies and the firm's practices. Now that you know the purpose of the risk tolerance assessment, let's talk about how the assessments happen.

Matt Smith - You usually do risk assessments in what's called a cold state, meaning there's little to no emotional attachment to the assessment because the questions are asked in somewhat of a hypothetical format. But then later life happens and the market is volatile, so it's important to have an understanding of how likely your clients are to stick with their answers from the risk assessment when faced with challenging times.

Michael Gillemette - So, when you look at research on time varying risk aversion, there's a lot of evidence to suggest that your younger clients -- those in their 20s, 30s, probably even early 40s -- you don't see a ton of variation over time with their risk preferences changing. Now, where you do see it change a lot -- and I'm working on a paper -- David Blanchett from Morningstar
and Michael Finke at the American College -- where for older clients you definitely see it shift when the market downturn and vice versa. They become risk tolerant when the market is up and there's many reasons for this. But, I would say especially for the older clients you want to be cognizant of the fact that if you give them the questionnaire when times are good, it's very likely they could be giving you rosier answers. Answers that make it seem like they're willing to take more risk than maybe they will be when the market declines. So, I think it's very important to realize when you're giving the questionnaires to clients -- especially your older clients because as we can go into -- in advanced age, individuals tend to prefer greater certainty and that means they have a greater preference for bonds and annuities more than they might have for stocks. In the study, it was really about age 50 plus where we found that they had much greater variation in their risk preferences and those variations in risk preferences moved along stock market. So, again, the clients became most risk averse during the global financial crisis, of course, when -- in late '08 and early 2009, and then their risk tolerance started to increase as the stock market started to increase. But, you didn't see that with the younger clients - the younger cohort.

**Matt Smith** - How does age affect an individual's ability to hold to that cold state assessment, or that unemotional risk tolerance assessment?

**Michael Gillemette** - Everyone from age 20 on -- everyone experiences cognitive decline of some sort. Now, things like processing speed, word recall, those types of things. Now, where you start to see all different aspects of cognitive abilities start to decline is once people start to get into their 60s is really where you see this slope start to fall off and things start to go south. And there's other things that go along with that. So, when people are around that age group in research it's been shown that they prefer much greater certainty than their younger counterparts so you're seeing kind of two things. You're seeing as people age, greater decline in cognitive ability. And with that, a greater preference for certainty. And from a standpoint of this biologically, it kind of makes sense. If people are experiencing cognitive decline, then they should prefer greater certainty to protect themselves from making mistakes. So, that's one thing now. The certainty effect has some implications for portfolio allocations in that if the client is getting older and prefers greater certainty then, again, you should hopefully as an advisor be ratcheting up the allocation to bonds, treasury inflation protected securities, annuities as they get older knowing that this preference is coming whether the client wants to admit it or not. And there's also another study that's been really interesting that shows that along with this cognitive decline, older client's experience also a lower financial literacy score into their 60s, 70s, 80s. But unfortunately while their literacy declines in advanced age, their confidence does not decline in their financial decision making. So, it's kind of the perfect storm in that the client's even though they might be experiencing cognitive decline, they -- a lot of them don't realize it and are just as confident as before. Which then makes -- you're dealing essentially with an overconfident client. So, there's a lot going on there and some advisors down in Phoenix at the FPA Symposium were also mentioning to me -- and it was a great point -- that hey, it's not only the clients that may be experiencing this, but the older advisors may also be experiencing this. So, it's a great idea to have younger advisors in the office and succession plans in place and those types of things because it's not just the clients that are going to experience this, but
obviously the advisors themselves. And I thought that was an excellent point that they made.

*Matt Smith* - Are there other factors besides age that affect risk tolerance? For instance, are there generational patterns?

*Michael Gillemette* - There’s definitely generational effects. So, the research is showing that the Depression babies, those that grew up with the experience of the stock market crash of 1929 and lived through the Great Depression took on significantly less risk with their investment portfolio compared to say, the Baby Boomer generation. Now, there are generational effects -- we don't know really with the Millennials yet. I think it's too early to tell the effect that the Global Financial Crisis had on them. But there are generational effects and when it comes to things like men take more risk than women -- for example some studies have found that, but I question that because I think when you control for enough variables like income and net worth, those types of things, that you tend to see for most people it's -- tends to be consistent. But you do see some things like generational effects; aging effects are the two biggest ones.

*Ben Jones* - So, older clients, especially those that have lived through a challenging economic time are likelier to be more risk averse than their younger counterparts and that makes total sense because they're getting to an age where they'll need those funds available. Dealing with a couple is another challenging aspect of the risk assessment because you have to find the middle ground between two people who might have very different risk tolerances.

*Michael Gillemette* - When you’re dealing with two spouses or partners where there’s maybe drastic differences, say, in their risk tolerance assessment, say, when you do a questionnaire. I think a big aspect of it that advisors maybe tend to overlook is that asking both of the clients how often they look at their investments. So, there's a lot of research out there that suggests that the more frequently a client looks at their returns -- and that could be your actual portfolio return or also looking at things like -- watching CNBC every morning. But, the more frequently you do that, the less willing you are going to be to invest in stocks. So, to give you an example, there was a study done in the late 90s; when they showed clients monthly returns, then they had basically a 60% allocation into bonds with monthly returns. Then they showed the manual returns and it flipped to 70% allocation of stocks, 30% bonds. So, a massive shift going from, say, monthly to annual returns. So, I think when it comes to spousal risk preferences, one of the questions you should definitely be asking the clients is to be blunt, just how frequently -- and ask them separately -- but how frequently are each of them looking at things like returns on television, returns on their statements -- how frequently are they checking their brokerage accounts. That's going to give you an indication of really who you need to focus on to a greater extent into homing in on their risk preferences. And what I mean by that is if you have a client -- one's more risk averse and one's more risk tolerant, but the person who is risk averse isn't looking at their investment portfolio or looking at it very infrequently, say every year or so, but you've got the person who appears to be more risk tolerant looking at things every day, then I would be much more concerned with talking to that client and using that client’s risk preference assessment who is more myopic or short-term focused.
**Matt Smith** - So, it's important to be aware if you have a client, or one member of a couple, who is constantly watching financial news and checking their portfolio returns frequently. But really, you want to make both parties feel comfortable with the level of risk in their portfolio. Michael had other great pieces of advice during our conversation specifically about frequency of reporting investment returns and other ways to frame your investment decisions. What advice do you have for financial advisors who might have clients who are fixated on financial news?

**Michael Gillemette** - Also, I think the first thing an advisor should do -- and this was, again, brought to my attention by some advisors that -- down in Phoenix at their FPA group -- is that you don't have to necessarily report returns quarterly. I think there's this inertia that takes place that you have a lot of advisors who, every quarter, send out the returns to the clients. Well, that right there is causing your clients to be myopic and I think if you can change that and report the returns annually, then that right there will go a long way in helping to shift the client's focus away from this more short-term investment philosophy to a more long-term philosophy. And some of the advisors I spoke with -- because there were some advisors who asked well what do you switch -- if you switch their statements from quarterly to annually, don't they freak out and aren't they curious why you're doing that. And very few of the advisors who I spoke with said that their clients really noticed if they switched from quarterly to annually reporting. And those that did, if the advisor talked to them about the fact that, look, you're investing for the long-term and thus we don't believe short-term returns matter and that's why we're reporting annually, then I think most clients will understand. Now, you obviously do not want to switch your reporting during a financial crisis because then it looks suspicious. But if you do this during a normal market period, then I don't think you're going to see much push back and I think it will go a long way to help reduce the myopia that your clients experience. Now, when it comes to CNBC and those types of things, that becomes a little bit more tricky. But at least I think you can educate the client on how that may not be the best behavior in terms of sticking to a long-term portfolio.

**Matt Smith** - What about showing total wealth rather than returns? Something like an on-track report. Does that have the same affect?

**Michael Gillemette** - No, I think that's great in terms of showing them things like that they're getting closer to reaching their financial goals. Like you said, maybe you could show them a net worth statement. Really, anything that takes their focus away from just the short-term returns to something that gets back to that long-term investment philosophy that you had in the investment policy statement I think is great. I mean the focus really has got to be on the goals in the investment meeting. And really, in speaking with advisors I think from a comprehensive financial planning standpoint, you really want to lead off the meetings with things like other services besides the investments that provide value in the relationship whether it be insurance, tax, financial counseling, education funding, and focusing on the goals. And really I think the last thing you want to do in the meeting, and de-emphasize, would be the portfolio performance if that makes sense.

**Matt Smith** - Are there any other framing effects that advisors should be aware of that we haven't talked about?
Michael Gillemette - Yeah, there's a really good one that I like that's referred to as the bucketing strategy and there's a lot of smart advisors that are using this strategy to help keep their clients in portfolios when the market goes south. So, the bucket strategy is really just -- and this conversation should happen again in the beginning before you even do the risk assessment when you're talking to them about your philosophy. In terms of having -- we have different buckets for different goals. So, you could have, say, the cash portion, a liquid asset portion of the portfolio is the client's short-term bucket, which may be zero to five years out. So, for any short-term needs the client is going to come across, we're going to take money from that short-term bucket to fund those needs. Then you've got to have this intermediate bucket that's looking at year 5 to year 15 and that could be our less risky assets like bonds for an example, to fund those shorter-term goals. And then finally we've got the risky bucket that's for 15 years out for things like retirement goals and those are going to be our -- for example -- our stocks. So, you break up these buckets and so when you have a market downturn, again you can point to your client and say, well, our bucket of stocks over here is not doing so well, but that bucket is for 15 years out. It places that long time horizon on that bucket. And you can point to your shorter-term buckets and say look, our bonds are doing well or our cash -- we've got enough cash to meet goals for several years down the road. So, you really don't need to worry about that long-term bucket of stocks because over the long run it should come back. So, I think that bucket strategy is a great way to use framing to help keep clients in portfolios for the long run.

Ben Jones - Those are some great recommendations. You don't necessarily have to report annually. You can think about switching from reporting returns to creating an on-track report and the bucketing strategy seems like a really effective way to talk to your clients about the relationship between their time frames and their needs.

Matt Smith - I think Michael's tips are really great, especially when it comes to not only understanding your clients and their risk tolerance, but also how to communicate with them about their portfolio. If you want to learn more, head over to bmogam.com/betterconversations. There you can find resources, links, and other episodes of Better conversations. Better outcomes.

Ben Jones - We'd love to hear your thoughts. You can join the conversation and let us know what topics you'd like to hear on future shows by e-mailing us at betterconversations@bmo.com. Thanks to Michael Gillemette for sharing his time and knowledge on the show. This episode was produced by the team at BMO, which includes Pat Bordak, Gayle Gibson, and Matt Perry. As well as the team at Freedom Podcasting, specifically Jonah Geil-Neufeld and Annie Fassler.

Ben Jones - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to bmogam.com/betterconversations.

Matt Smith - We hope you found something of value in today's episode, and if you did we
encourage you to subscribe to the show and leave us a rating and review on iTunes. And of course the greatest compliment of all is if you tell your friends and co-workers to tune in. Until next time, I'm Matt Smith.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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