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MANAGING RISK IN VOLATILE MARKETS: **THE ROLE OF FINANCIAL PERSONALITY**

The role of financial and emotional abilities to take risk across client life stages

What makes an investment selection suitable? Advisers and regulators agree that it's about matching the risk an investor is both willing and able to take with that actually being taken.

An investor's willingness is best represented by risk tolerance – a long-term, stable, psychological trait that requires a psychometric test to be measured reliably (as opposed to an adviser taking a subjective stab at it). Risk tolerance may too seldom be measured with adequate scientific reliability and validity, or with enough care to keep confounding variables from distorting a score, but no one seriously disputes what it's trying to do.

What about ability? Ability is primarily about financial circumstances. What is it that's being risked, considering the investor's overall picture? How reliant is someone on their investments to fund their lifestyle?

This calls for a quantified and dynamic measure of 'risk capacity' – an investor's ability to fund future financial commitments from their wealth, and therefore their ability to take risk with this wealth without jeopardising these commitments.

Risk capacity needs to account for an investor's circumstances not only right now, but also in the future. What future income, inheritances, expenditure, goals, or gifting plans lack in present-day certainty, they can make up for in potential significance.

We saw in the **first article** how an investor's suitable risk level – the right level of risk for them to take right now – is affected by expectations reflected in time horizons and the risks of events, markets, and longevity linked to client life stages. Each of these feeds into risk capacity.

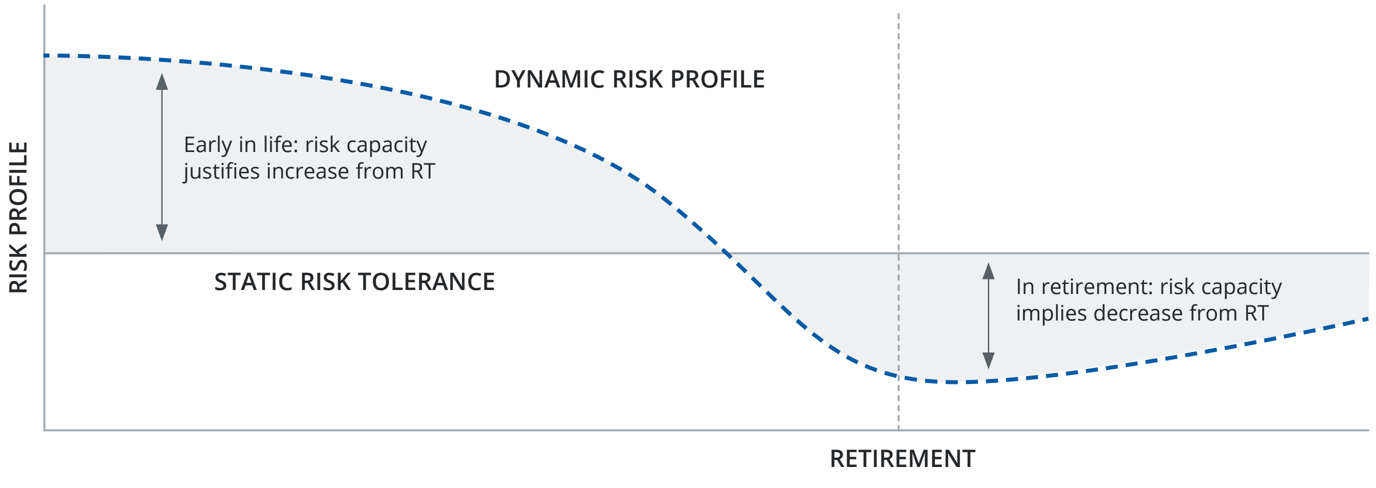
As the diagram below shows, risk capacity is often higher when younger. Despite no great accumulated wealth, younger people have high earnings expectations, and their expenditure is usually covered by income (so there is no immediate reliance on investments). Because of this, there is little controversy in younger clients investing at risk levels significantly higher than those suggested by their risk tolerance alone.

As the reliance on investments increases, and human capacity turns to human liability, risk capacity falls. When pension rules compelled annuity purchases, such falls could be quite dramatic in the run-up to retirement, as so much investment risk was wrapped up into one specific point in time.

Quantifying risk capacity to effectively combine it with risk tolerance allows calculation of a suitable risk level that accurately accounts for each client's life stage. It also reflects that investing is a journey full of ups, downs, and interactions, not a mere snapshot of an initial set of circumstances followed by some uneventful waiting. Importantly, it provides a means of seeing the calculation of a suitable risk level as a life-long resource-allocation problem, where human resources need to be considered alongside available investment resources.

However, ability doesn't stop there.

In addition to this *financial* ability to take risk, each investor also has an *emotional* ability to take risk: a *behavioural capacity* that determines how best to interact with investments to ensure ongoing comfort with the risk being taken.



It doesn't matter how good a plan is if the person it's written for doesn't stick to it, or feels sick doing so. Indeed, the theoretically 'perfect' portfolio could be the very spark for some distinctly imperfect behaviours.

Emotional ability is not about financial circumstances, but financial personality.

Behavioural capacity

Risk tolerance and risk capacity combined won't tell you how clients will react to likely behavioural triggers experienced during ownership of a portfolio.

These short-term behaviours should influence a suitable risk level only in limited circumstances (such as capping exposure to high-risk assets for the most anxious investors). But every interaction with market news (or with you as their adviser) creates the potential for clients' unique recipe of personality, financial education, and experience to affect how they act as an investor, and consequently the overall financial and emotional return they get from their investments.

The overriding point is to see that suitability is a system, not a checklist. The right level of risk for an investor to take, and the right way to take it, are determined by the interplay of psychological willingness, financial ability, and emotional ability. To see suitability as a system is to remember that each plan is written for and followed by a human, not a robot.

Investor management is often just as, if not more, important than *investment* management.

Investment-management solutions – baking behaviours in to the long-term risk level of a portfolio – are usually an unnecessarily costly way to provide an investor with comfort, relative to investor-management ones of tweaking decision-making and communication frameworks.

This is the context in which behavioural-based prescriptions need to be viewed. It throws up two key questions:

- How do we deal with individual personalities at scale?
- How do we ensure consistent advice in the face of changing circumstances and individual responses to them?

Prescriptions

These questions are best answered with examples.

To demonstrate the importance of behavioural capacity, we'll look at three investors – Kim, Sam, and Andy – each with identical risk tolerances and risk capacities. They differ on three key behavioural traits: *composure*, *confidence*, and *impulsivity*, taken from Oxford Risk's multi-dimensional assessment of financial personality.

Composure is an investor's tendency to emotional responses to the present state of their investment journey (and also external stimuli such as the news). It is a measure of an investor's comfort or anxiety with the ups and downs along the journey.

Confidence is how capable and comfortable an investor feels about their ability to make good financial decisions.

Impulsivity is an investor's propensity to act quickly and on emotional instinct when making decisions about investments and – often more importantly – spending.

There are, of course, plenty of key investing messages that apply irrespective of life stage, personality, or anything else. Regardless of clients' situation, a reliable rebalancing policy, taking a long-term view, paying attention to fees, and focussing on principles over the news are always going to be wise prescriptions to follow.

However, even here, accounting for personality has a key role to play, for the message sent is not always the message received. How something is communicated can matter just as much as what is communicated.

A lot of good management is a case of refinement rather than revolution. Subtle shifts in emphasis driven by individual relevance can have significant consequences. Behavioural-based prescriptions are more about foregrounding and backgrounding than they are about on and off.

For example, all clients should be reminded of core principles, but where repetition could be educative and engaging for a less-experienced client, it could be a turn-off for a more sophisticated one.

How might their different personalities affect how best to engage our example clients? Meet…

KIM:
NERVOUS, UNSURE, AND QUICK TO ACT

Defined by the unfortunately common behavioural timebomb of low composure, low confidence, and high impulsivity. The key for Kim is avoiding big mistakes, like cashing out entirely when markets fall and impulse and inexperience suggest that avoiding the markets altogether is the only way back to 'safety'.

Managing low composure and high impulsivity could include:

Simple preset rules: Kim should avoid making important decisions in the moment. Preset rules allow actions to be taken in the present, based on decisions made in a calmer, cooler-headed past.

Investment to-do lists: To-do lists assuage the need to take action, especially in times of turmoil. Note: 'sell everything' is not on such a list.

Automatic investing: This lessens both the ongoing need to make decisions, and stops Kim focussing on a single investment amount resulting in unhelpful short-term performance checking.

Focussing on education: Use meetings and interim communications to educate Kim on principles, rather than comment on market news.

SAM:
CALM, CONFIDENT, AND QUICK TO ACT

Defined by high composure, high confidence, and high impulsivity. The key for Sam is avoiding overconfidence, and staying engaged at the right time.

Managing overconfidence could include:

Product selection: Using some less-liquid products can help put a brake on impulsivity as long as the investor understands what they are investing in and why.

Sticking to preset review times: Restricting decision-making to specific times helps with focus and reduces the chances of overconfident snap decisions.

Frequent, high-level communication: Stay in contact regularly, but keep communications brief, bringing up investment details only when necessary for making a decision.

ANDY:
UNENGAGED

Defined by medium composure, low confidence, and low impulsivity. The sort of investor whose default is apathy born of lack of both confidence and a sense of urgency. The key for Andy is to make investing feel more relevant, manageable, and urgent – to not sit on the side-lines for long periods.

This could include:

Avoiding day-to-day market news: Daily market news amplifies perceived complexity in an off-putting way, and it's almost never relevant to an individual investor.

Using shortlists, defaults and deadlines: These avoid actions being continually postponed. The default decision-making process should be a shortlist with a default option that Andy has to sign off on.

Using stories: Stories of particular investments can emphasise more engaging aspects or provide a hook for engaging with unfamiliar ones.

Agree on a phased investing plan: Andy doesn't want to, or won't, make frequent decisions. Instead, get him to agree once to a schedule of future investment, putting a portion of assets to work automatically every few months without him having to engage each time.

How does behavioural capacity fit into the system of suitability across client life stages?

Personality traits over time

Personality traits have an intricate relationship with the investment journey.

First, age. The importance of behavioural prescriptions can be tied to age, simply because the consequences of lessons learned or mistakes avoided have more time to compound.

Second, risk capacity. Risk capacity is a measure of the reliance on investments to fund a lifestyle. The more reliant one is, the more relevant managing behavioural effects becomes. The starkest expression of this is the move from accumulation to decumulation: reliance on investments leaps when someone starts withdrawing from them.

Consider impulsivity. Impulsivity related to spending in decumulation amplifies sequencing risk because there is less scope for flexing withdrawals to ride out downturns (and less capacity to recover from mistakes). Impulsivity related to making portfolio changes could also become a problem if someone is prone to over-trading and uses extra time in retirement to 'dabble' more frequently.

And as a topical example, an accurate measure of impulsivity should be a vital consideration in any pension transfer decision, but the personality of the investor is seldom considered directly.

Third, volatility. Market turmoil magnifies the importance of behavioural capacity, because both the reactions to events, and the consequences of making poor decisions because of them, are bigger.

The trick to dealing with turmoil is preparation. Panic is more easily prevented than cured, but it is often only when we're in need of a cure that we're inspired to act. Behavioural profiling can prompt preventative prescriptions, by gradually guiding clients away from storms before they hit.

Finally, other individual circumstances can also increase the importance of accounting for behavioural capacity.

For example, confidence in general is a positive, but overconfidence is not. Overconfidence is most dangerous in two situations. First, during especially busy times (e.g. juggling long hours and small children) when investment matters could fall through the cracks. And second, in preparing for major life events (marriage/divorce, starting a family, career changes, retirement, death) when advice is most needed.

We need solutions that are psychological, preventative, personal, perpetual, and planned for. Telling people how to behave is less effective than predicting how they're going to behave and planning appropriate preventative action.

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To find out more or to discuss any of the points raised in this white paper, contact your Account Manager on 0345 607 2013.