For professional advisers only

INCOME DRAWDOWN
Risk profiling questionnaire factsheet

Our Income Planning Tool provides access to the Capacity for Loss and Attitude to Risk questionnaires, which are based on the A2Risk Attitude to Risk Profile Questionnaire. This factsheet outlines the questionnaires and explains the role they can play as part of an income drawdown advice process.

The following text is reproduced from the A2Risk Attitude to Risk Profile Questionnaire by Alistair Byrne and David Blake.

INTRODUCTION TO RISK PROFILING QUESTIONS

The questions are intended for use with clients currently requiring income from their pension fund and who have decided to investigate the possibility of doing so by drawing that income directly from their pension fund rather than buying an annuity immediately.

The questionnaires are intended as part of an overall risk assessment risk process to help you and your client decide on an appropriate investment strategy and regular income level. You can use the answers as a basis for discussion between you and your client.

The questionnaires look at tolerance for investment risk – i.e. how much uncertainty your client is prepared to accept in the returns from his investment.

Risk tolerance can be split into:

Capacity for loss – which is related to the client's personal circumstances, and depends on time horizon, income, wealth and spending requirements

Attitude to risk – which is related to the client's psychology

You and your client should also discuss how much risk they need to take in order to meet their investment objectives.

CAPACITY FOR LOSS

This questionnaire comprises six statements related to capacity to take risk with investments that are intended to provide retirement income.

The client should indicate the extent to which he or she agrees or disagrees with each statement, using the five-point scale (strongly agree – strongly disagree).

The six questions collect information about the client's:

- Investment time horizon – a longer horizon supports the client's capacity to take risk
- Sources of income other than the pension fund – having other sources of income supports the client's capacity to take risk
- Available assets other than the pension fund – having substantial other assets supports the client's capacity to take risk
- Ability and willingness to work to generate income – being able and willing to work in future supports the client's capacity to take risk
- Financial support available from family members – the ability to rely on family members to provide financial support supports the client's capacity to take risk
- Ability to reduce spending if required – being able to reduce spending if income falls supports the client's capacity to take risk.

Investments

The report summarises the factors that support the client's capacity to take risk, and the factors that weaken the client's capacity to take risk, and helps inform the client's decision about how much regular income to take from their pension plan.

You should discuss the report with your client. Each factor should be considered. While a greater number of supportive factors would tend to indicate greater capacity to take risk, care should be taken to identify whether any single factor dominates the client's situation. The discussion with the client should be documented.

Where a client appears to have limited capacity for risk, income drawdown may not be suitable.

ATTITUDE TO RISK

The attitude to risk questionnaire is a psychometric questionnaire designed to assess the client's comfort with taking investment risk. The questionnaire comprises twelve statements related to willingness to take investment risk. All of the statements have been tested for relevance and clarity.

The client should indicate the extent to which he or she agrees or disagrees with each statement, using the five-point scale (strongly agree – strongly disagree).

The statements cover the client's comfort with risk, knowledge and experience of investment, investment preferences, and proneness to regret. Following psychometric practice there is a mix of statements that indicate risk tolerance, and reverse statements that indicate discomfort with risk.

SCORING THE QUESTIONNAIRE

The questionnaire scores are based on a norm group comprising a sample of 800 adults statistically representative of the British population aged 55 years and above. The survey work was done online by the market research company YouGov in October 2013.

Each client's score is based on the answers they have given and calculated with reference to the norm group. A score of 50 indicates willingness to take risk in line with the average of the norm group. Scores range from 0 to 100, with high scores indicating higher willingness to take risk.

The scores are mapped to the following categories, and within our Income Planning Tool this becomes the default investment choice assumed for the next stage of the process, the client-specific stochastic risk analysis.

Investor Category	Lower score	Upper score
Risk Averse	0	48
Risk Rating 1	49	50
Risk Rating 2	51	53
Risk Rating 3	54	57
Risk Rating 4	58	62
Risk Rating 5	63	66
Risk Rating 6	67	100

Each category has a description based on the typical answers of clients who are allocated to that category. The allocated category should be discussed with your client, and adjustments can be made if the discussion suggests the category is not the best fit for your client. This discussion should be documented, and you should discuss the revised stochastic risk analysis corresponding with the new investment choice with your client. The outputs from the risk analysis may well lead you and your client to conclude that he can take more or less investment risk than suggested by the questionnaire.

Where your client appears to have limited willingness to take risk (risk averse category), income drawdown may not be suitable. Where your client's responses are inconsistent with each other these are highlighted so that you can discuss them with your client.

DESCRIPTION OF INVESTOR RISK ATTITUDE CATEGORIES

Category 1 – Risk Averse (Normalised score 0-48)

Risk Averse investors are not comfortable investing in the stockmarket and look for safer investments, even if that means lower returns. They tend to take a long time to make investment decisions and prefer a stable income to seeking high returns.

In general, Risk Averse investors do not find investment matters easy to understand and have little investment experience. They tend to worry if their investments go down in value, and will not make higher risk investments if that means the chance of loss. They are concerned by the volatility of stockmarket investment, and associate risk with the idea of loss. They can be anxious about the investment decisions they have made, and are not interested in investment matters.

Overall, risk averse investors have below average willingness to take risk and may not find a drawdown approach suitable. They should consider buying an annuity.

Category 2 – Risk Rating 1 (Normalised Score 49-50)

Investors with a Risk Rating of 1 are not particularly comfortable investing in the stockmarket and look for safer investments, even if that means lower returns. They tend to take a long time to make investment decisions and typically prefer a stable income to seeking high returns.

In general, investors with a Risk Rating of 1 do not find investment matters particularly easy to understand and have relatively little investment experience. They tend to worry if their investments go down in value, and tend not to make higher risk investments if that means the chance of a loss. They are concerned by the volatility of stockmarket investment, and tend to associate risk with the idea of loss. They can sometimes be anxious about the investment decisions they have made, and are not particularly interested in investment matters.

Overall, Risk Rating 1 investors are prepared to accept the risk that income will reduce slightly in the pursuit of some upside in potential income.

Category 3 – Risk Rating 2 (Normalised Score 51-53)

Investors with a Risk Rating of 2 are not particularly comfortable investing in the stockmarket and look for safer investments even if that means lower returns. They do not take a particularly long time to make investment decisions and typically prefer a stable income to seeking high returns.

In general, investors with a Risk Rating of 2 may have some understanding of investment matters and have relatively little investment experience. They may worry to an extent if their investments go down in value, and tend not to make higher risk investments if that means the chance of loss. They are somewhat concerned by the volatility of stockmarket investment, and are inclined to associate risk with the idea of loss. They can sometimes be anxious about the investment decisions they have made, and are not particularly interested in investment matters.

Overall, Risk Rating 2 investors are prepared to accept the risk that income will reduce to an extent in the pursuit of some upside in potential income.

Category 4 – Risk Rating 3 (Normalised Score 54-57)

Investors with a Risk Rating of 3 are not particularly comfortable investing in the stockmarket and do not particularly look for safer investments even if that means lower returns. They do not take a particularly long time to make investment decisions and prefer a stable income to seeking high returns.

In general, investors with a Risk Rating of 3 may have some understanding of investment matters and have relatively little investment experience. They don't particularly worry about investment decisions they have made and do not particularly look for higher investment returns if that means the chance of loss. They are not particularly concerned by the volatility of stockmarket investment, and do not particularly associate risk with the idea of loss. They are not particularly anxious about the investment decisions they have made, and are not particularly interested in investment matters.

Overall, Risk Rating 3 investors are prepared to accept the risk that income will reduce moderately in the pursuit of some upside in potential income.

Category 5 – Risk Rating 4 (Normalised Score 58-62)

Investors with a Risk Rating of 4 are comfortable to an extent investing in the stockmarket and do not particularly look for safer investments even if that means lower returns. They do not take a particularly long time to make investment decisions and do not particularly value a stable income at the expense of high returns.

In general, investors with a Risk Rating of 4 find investment matters fairly easy to understand and have some experience of investment. They don't typically worry much if their investments fall in value. They may look for higher return investments even if that means the chance of a loss, and are not particularly concerned by the volatility of stockmarket investment. They do not particularly associate risk with the idea of loss, and tend not to be anxious about the investment decisions they have made, and are interested in investment matter to an extent.

Overall, Risk Rating 4 investors are prepared to accept the risk that income will reduce in the pursuit of some upside in potential income.

Category 6 – Risk Rating 5 (Normalised Score 63-66)

Investors with a Risk Rating of 5 are comfortable to an extent investing in the stockmarket and do not typically look for safer investments if that means lower returns. They do not take a particularly long time to make investment decisions and do not particularly value a stable income at the expense of high returns.

In general, investors with a Risk Rating of 5 find investment matters easy to understand and have experience of investment. They don't typically worry if their investments fall in value. They may look for higher return investments even if that means the chance of loss. They are not particularly concerned by the volatility of stockmarket investment, and do not associate risk with the idea of loss. They are not anxious about the investment decisions they have made, and are interested in investment matters.

Overall, Risk Rating 5 investors are prepared to accept the risk that income will reduce significantly in the pursuit of upside in potential income.

Category 7 – Risk Rating 6 (Normalised Score 67-100)

Investors with a Risk Rating of 6 are very comfortable investing in the stockmarket and do not typically look for safer investments if that means lower returns. They do not take a particularly long time to make investment decisions and do not value a stable income at the expense of high returns.

In general, investors with a Risk Rating of 6 find investment matters easy to understand and have experience of investment. They don't worry if their investments fall in value. They will seek higher return investments even if that means the chance of a loss. They are not concerned by the volatility of stockmarket investment, and do not associate risk with the idea of loss. They are not anxious about the investment decisions they have made, and are interested in investment matters.

Overall, Risk Rating 6 investors are prepared to accept the risk that income will reduce very significantly in the pursuit of upside in potential income.

ROBUSTNESS CHECKS

The attitude to risk questionnaire has been designed to be easy to understand and easy to use. Nonetheless, it is important to take care that each user has been able to complete the questionnaire without difficulty and been assigned an appropriate category. As a result, the questionnaire has a number of robustness checks.

It is reasonable for a client to select Neither Agree nor Disagree in relation to any or even all of the statements. This would tend to indicate a neutral view towards the risk issue being discussed. However, a client might also select that option if they were having difficulty understanding or responding to the question. Where a client makes six or more Neither agree nor disagree responses, the robustness check flags to the adviser that there may be a problem that needs discussed with the client.

Similarly, where a client has been assigned to a category that would imply a significant proportion of risky investments in the appropriate portfolio, but has made individual responses in the questionnaire indicating a preference for low risk investments or a discomfort with stockmarket investment, the robustness check flags this for discussion.

We do not expect many clients to be affected by these robustness checks, but they provide an important check and balance in the planning process.

Any discussions around the robustness checks should be documented by the adviser.

RECONCILING NEED, ABILITY AND WILLINGNESS TO TAKE RISK

The questionnaires provide an input into the determination of an investment approach which is suitable for your client.

As a starting point, you should consider your client's need to take risk in order to meet his or her financial objectives in relation to their ability and willingness to take this risk. Limited ability to take risk may constrain the ability to take enough risk to meet the objectives. In this case, the objectives should be reconsidered. Limited willingness to take risk can also act as a constraint on the investment risk taken with the portfolio. Alternatively, you may be able to counsel and educate your client so that he or she becomes more comfortable with risk.

The reconciliation of these factors is a crucial part of the financial planning process and should be carefully documented.

BIOGRAPHIES

The information reproduced in this leaflet and the profiling questionnaires were researched and written by Dr Alistair Byrne and Professor David Blake. Dr Alistair Byrne CFA is a Fellow of the Pensions Institute at Cass Business School in London and an Associate of the University of Edinburgh Business School. Professor David Blake is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School in London.

COPYRIGHT

Royal London
1 Thistle Street, Edinburgh EH2 1DG
royallondon.com

All literature about products that carry the Royal London brand is available in large print format on request to the Marketing Department at Royal London, St Andrew House, 1 Thistle Street, Edinburgh EH2 1DG.
All of our printed products are produced on stock which is from FSC® certified forests.

November 2014

5L22248/2