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RISK ATTITUDE PROFILING QUESTIONNAIRE FACTSHEET

Our Risk Attitude Profiling Questionnaire is based on the A2Risk Attitude to Risk Profile Questionnaire. This paper outlines the questionnaire and explains the role it can play as part of a financial planning process.

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

WHAT IS RISK?

Technically speaking, risk means that there could be a number of different possible outcomes associated with a particular action or activity and we do not know beforehand which one will occur. Think about tossing a coin, for example.

In more everyday terms, people often think of risk as being the prospect of an undesirable outcome, such as making a financial loss. Another way of putting that could be the chance of not meeting your goals or objectives.

Risk exists in a number of different situations, but our concern here is with investment risk. By investment risk we mean the volatility associated with the prices on and returns from investments.

WHAT IS FINANCIAL RISK TOLERANCE?

Some individuals are more able to tolerate financial risk than others. Researchers have argued that investment risk tolerance can be broken down into two parts:

1) Ability to take risk (or "risk capacity")

2) Willingness to take risk (or "risk attitude")

An individual's ability to take risk relates to their financial circumstances and their investment goals. Generally speaking, the higher the individual's level of wealth and income, relative to any liabilities they have, and the longer their investment horizon, the more able they will be to take investment risk, with the corresponding potential for losses, and the greater their risk capacity. Consideration of these issues should be a key part of the financial planning process.

Risk attitude, on the other hand, has more to do with the individual's psychology than with their financial circumstances. Some individuals will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues.

Individuals should also consider their need to take investment risk to meet their financial goals. Investors typically need to take risk to make higher returns. Investment goals may need to be reconsidered if the investor is unable or unwilling to take enough risk to earn the required returns.

The reconciliation of attitude to risk, risk capacity, and the need to take risk is a crucial part of the financial planning process.

MEASURING RISK TOLERANCE AND RISK ATTITUDE

The conventional view is that ability to take risk and willingness to take risk should be considered separately in the financial planning process. We have developed a profiling questionnaire that can be used in assessing investment risk attitude. Obviously, risk attitude is a complex area and, as a result, risk profiling is not an exact science. Nonetheless, a well-designed risk profiling tool can contribute significantly to the financial planning process.

The risk attitude profiling questionnaire is an online questionnaire designed according to the established principles of psychometrics, that is, the science of measuring individuals' attitudes.

The questionnaire consists of a series of short statements each of which is followed by a scale where the individual can indicate the extent to which he or she agrees with the statement. The scale, known as a Likert Scale, consists of:

- Strongly Agree
- Agree
- No Strong Opinion
- Disagree
- Strongly Disagree

The advantage of this approach is the statements are short and easy to read and can be answered relatively quickly.

All of the questions were tested in a pilot study. Questions that were not well understood or which caused other difficulties were eliminated. A norm group was created using responses from a sample of 2052 adults representative of the British population. The analysis was done online in December 2013 by the polling company YouGov. The norm analysis allows us to position any client's score relative to the attitude to risk of the wider British population. It is notable that the population as a whole is relatively risk averse when it comes to investment.

ASPECTS OF FINANCIAL RISK ATTITUDE

Financial risk attitude is a complex construct and comprises a number of interrelated aspects. The risk attitude profiling questionnaire is designed to capture several aspects of risk attitude:

1) **Investment knowledge** – Generally speaking, individuals who are more knowledgeable about investment are more willing to accept investment risk.

2) **Comfort with risk** – Some individuals have psychological traits that allow them to take risk. These individuals typically see risk as involving a 'thrill' or 'opportunity' rather than as 'danger' or a 'loss'.

3) **Investment choice** – Risk attitude can also be gauged in preferences for different types of investments, e.g. the relative safety of a bank account versus the potential risk of stocks and shares.

4) **Regret** – is the negative emotion that arises from making a decision that is, after the fact, wrong.

SCORING THE QUESTIONNAIRE

Each question is answered on a five-point scale ranging from Strongly Agree through to Strongly Disagree. In the questionnaire there is a broad balance of normal questions where agreement indicates an inclination to take risk and 'reverse' questions where agreement indicates aversion to risk. The overall risk score is compiled by equally weighting the answers to the various questions, having regard to whether they are normal or reverse questions.

We adjust the raw scores from the questionnaire so that the average respondent gets a normalised score of 50. The score categories are shown in the following table:

Investor Category	Normalised Score Range
Very Cautious	0 - 25
Cautious	26 - 33
Moderately Cautious	34 - 44
Balanced	45 - 56
Moderately Adventurous	57 - 67
Adventurous	68 - 79
Very Adventurous	80 – 100

DESCRIPTION OF INVESTOR RISK ATTITUDE CATEGORIES

Category 1 – Very Cautious Investors [Normalised score 0-25]

Very Cautious investors typically have very low levels of knowledge of investment matters and very limited interest in keeping up to date with investment issues. They are unlikely to have experience of investment, having only saved into bank accounts.

In general, Very Cautious investors prefer knowing that their capital is safe rather than seeking high returns. They are not comfortable with the thought of investing in the stockmarket and would rather keep their money in the bank.

Very Cautious investors can take a long time to make up their mind on investment matters and will usually suffer from severe regret when their investment decisions turn out badly.

Category 2 – Cautious Investors [Normalised score 26-33]

Cautious investors typically have low levels of knowledge about investment matters and limited interest in keeping up to date with investment issues. They may have some limited experience of investment products, but will be more familiar with bank accounts than riskier investments.

In general, cautious investors do not like to take risk with their investments. They would prefer to keep their money in the bank, but may be willing to invest in other types of investments if they are likely to be better for the longer term.

Cautious investors can take a relatively long time to make up their mind on investment matters and can often suffer from regret when investment decisions turn out badly.

Category 3 – Moderately Cautious Investors [Normalised score 34-44]

Moderately Cautious investors typically have low to moderate levels of knowledge about investment matters and quite limited interest in keeping up to date with investment issues. They may have some experience of investment products, but will be more familiar with bank accounts than riskier investments.

In general, moderately cautious investors are uncomfortable taking risk with their investments, but can be willing to do so to a limited extent. They realise that risky investments are likely to be better for longer-term returns.

Moderately Cautious investors can take a relatively long time to make up their mind on investment matters and may suffer from regret when investment decisions turn out badly.

Category 4 – Balanced Investors [Normalised score 45-56]

Balanced investors typically have moderate levels of knowledge about investment matters and will pay some attention to keeping up to date with investment matters. They may have some experience of investment, including investing in products containing riskier assets such as equities and bonds.

In general, balanced investors understand that they have to take investment risk in order to be able to meet their long-term goals. They are likely to be willing to take risk with part of their available assets.

Balanced investors will usually be able to make up their minds on investment matters relatively quickly, but do still suffer from some feelings of regret when their investment decisions turn out badly.

Category 5 – Moderately Adventurous Investors [Normalised score 57-67]

Moderately Adventurous investors typically have moderate to high levels of investment knowledge and will usually keep up to date on investment issues. They will usually be fairly experienced investors, who have used a range of investment products in the past.

In general, Moderately Adventurous investors are willing to take investment risk and understand that this is crucial in terms of generating long-term return. They are willing to take risk with a substantial proportion of their available assets.

Moderately Adventurous investors will usually be able to make up their minds on investment matters quite quickly. While they can suffer from regret when their investment decisions turn out badly, they are usually able to accept that occasional poor outcomes are a necessary part of long-term investment.

Category 6 — Adventurous Investors [Normalised score 68-79]

Adventurous investors typically have high levels of investment knowledge and keep up to date on investment issues. They will usually be experienced investors, who have used a range on investment products in the past, and who may take an active approach to managing their investments.

In general, Adventurous investors are happy to take investment risk and understand that this is crucial in terms of generating long-term return. They are willing to take risk with most of their available assets.

Adventurous investors will usually be able to make up their minds on investment matters quickly. While they can suffer from regret when their investment decisions turn out badly, they are able to accept that occasional poor outcomes are a necessary part of long-term investment.

Category 7 — Very Adventurous Investors [Normalised score 80-100]

Very Adventurous investors typically have very high levels of investment knowledge and a keen interest in investment matters. They have substantial amounts of investment experience and will typically have been active in managing their investment arrangements.

In general, Very Adventurous investors are looking for the highest possible return on their capital and are willing to take considerable amounts of risk to achieve this. They are usually willing to take risk with all of their available assets.

Very Adventurous investors often have firm views on investment and will make up their minds on investment matters quickly. They do not suffer from regret to any great extent and can accept occasional poor investment outcomes without much difficulty.

Note: These profile descriptions are only illustrative. While they outline the common traits of individuals with the relevant risk profile scores, every individual is different and their scores will be built up from different combinations of responses to the questions in the risk attitude profiling questionnaire.

ROBUSTNESS CHECKS

The risk profiling 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.

Best practice in using a risk profiling questionnaire

The questionnaire can play an important role in a well-designed financial planning process. Best practice includes:

- Explaining risk, risk attitude, risk capacity, and need to take risk to the client.
- Ensuring the client has an investment horizon of at least three years + and is prepared to contemplate at least some loss of capital. If these conditions are not met, a deposit-based strategy may be required. The client needs to understand the implication in terms of low returns and possible loss of inflation-adjusted purchasing power.
- Once the investor has completed the questionnaire, the adviser should review the score, the answers that comprise it, and any robustness checks that have been flagged.
- The adviser should discuss and agree the risk category with the investor. The category can be amended if the discussion suggests another category is more appropriate. A record of the discussion should be kept.
- The adviser then needs to discuss the investment implications of the risk category, outlining potentially suitable investment strategies.
- The investment discussion should consider capacity to absorb potential losses. A simulation model can be used to map out the range of possible outcomes from the strategies. Again, this needs to be discussed, agreed and documented.

BIOGRAPHIES

The information reproduced in this leaflet and the risk attitude 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.

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