Broken Confidence: New Directions in Risk Assessment

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Most of my recent clients come to me because their faith in their previous advisor was shaken. They realized in late 2008 or early 2009 that their portfolios were in significant trouble. Not only were they unprotected before our recent financial debacle, but when it happened their advisor didn't get enough of their money out of the market. My clients are looking for a new direction, one that provides better safeguards.

Though there are multiple ways to provide this, one new concept is comprehensive risk assessment (CRA). This concept refers to an investment firm's understanding a client's needs and risk tolerance better so disappointment is less likely to occur in the event of a significant downturn. It is being adapted by large financial institutions as a mechanism for retaining high net worth clients (HNWIs ; assets $25-30 million and above) when the market doesn't go as expected. Put simply, these firms don't want to lose clients. In a report entitled the "2009 World Wealth Report" compiled by Capgemini and Merrill Lynch, 25% of HNWIs withdrew assets or left their wealth management firm altogether in 2008.

The three essential elements of CRA include scenario analysis; the incorporation of behavioral and neuroscience into decision making, and utilizing wider diversification. The same principles also apply to those with less money and self directed investors.

The scenario analysis includes pictorial demonstrations that show the implication of dollar losses to the client in specific events both from the market and personal business such losing a job. This gives a better idea of the consequences of a significant loss to the client individually rather than in the abstract, the widely used earlier loss format.

The new field of decision making offers an opportunity to engage a client in understanding the latest neuro and behavioral science behind her or his own particular strengths and weaknesses in investment choices. A well worn example is that some investors are too conservative by nature while others are excessively risk seeking. Pointing out and working with these tendencies will, on average, produce a more balanced portfolio that is more likely to withstand the ups and downs of the market.

Lastly, diversification is emphasized. The idea of course, is that when one asset is down, another is up. Those that also held gold and bonds during the recent fiasco were more protected than those individuals without such diversification.

That this approach can have benefits is indicated by the quote below from the "2009 World Wealth Report." The World Wealth Report is based on statistically significant samples obtained through surveys of more than 1,350 advisors, more than 200 high net worth clients and more than 60 senior executives at wealth management firms.

"In the last two downturns, the portfolios of high net worth Individuals (HNWIs) who had gone through a comprehensive risk assessment fared better than those of HNWIs who did not. Research shows, for example, that during the 2000-02 technology bubble downturn the portfolio of a HNWI who completed a comprehensive risk assessment would have lost 6.1%, whereas a more conventional risk assessment for the same HNWI would have resulted in a 15.1% loss. Similarly, HNWIs who took advantage of a comprehensive risk assessment in 2008 suffered smaller losses than those HNWIs who did not."

Those with less money than HNWIs are not commonly treated to the perks of that status by their advisors. Still, they can track the CRA approach by regularly reading this column. This is because so many of my articles focus on the neuro and behavioral science behind decision making, a feature of CRA. I also emphasize wide portfolio diversification, another of its tenets. Though personal scenario analysis is impossible in a column, earlier articles directed toward age and risk tolerance go a long way toward encircling the subject.

The upshot here is that a person doesn't have to be rich to practice CRA, but she or he does have to be aware and interested in areas that could improve their portfolio's results going forward.