

Dynamic Risk Profiler
Profiling Investor Attitude to Risk
White Paper

Version 2.0

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1. Introduction

This white paper sets out the methodology behind Dynamic Risk Profiler; Distribution Technology's new proprietary profiling mechanism for assessing an investor's attitude to risk. The methodology is built on well-established behavioural finance principles as well as original research commissioned by DT.

2. Intellectual property

DT owns and is responsible for the methodology set out in this paper, the intellectual property rights in relation to Dynamic Risk Profiler and all related materials.

3. Why risk profiling is important

Accurately risk-profiling investors is the single biggest issue currently facing investment advisers and financial institutions. The consequences of not doing it or getting it wrong can be severe for both investor and adviser. In the UK, endowment mis-selling is a clear example of individuals being sold products that did not fit their risk profile. The benefits of getting it right however are also significant; from the client's perspective there is the opportunity to avoid unwanted investment experiences which are either too risky, or indeed what the Sandler Review¹ called "reckless conservatism" where many UK consumers adopt 'low risk' investment strategies at the expense of significant opportunity costs.

Additionally, the degree of risk an investor is willing to take on is the single most important driver of return within an asset allocation framework, so even the best asset model will fail to deliver the right result if the investor's attitude to risk is not well understood.

With a valid framework for assessing attitude to risk there is the opportunity to build longer-lasting and meaningful relationships with clients where both parties share a clear understanding of what is appropriate for the client and what is not.

4. Why risk profiling is difficult

Accurately assessing client specific risk is not straightforward. The FSA² carried out research in 2004 to assess what consumers thought 'risk' meant. Their study found that the term 'investment risk' had at least five different meanings to consumers and indeed some felt that "the impact of risk was not something that would affect them".

Our analysis has identified eight different characteristics to be considered when profiling attitude to risk which includes issues such as risk sensitivity, desire for profit and tolerance for ambiguity; but also financial awareness and investment experience as excellent predictors of an individual's likely attitude. Clearly with these wide-ranging issues, helping investors articulate and understand their attitude to risk is not a simple task.

¹ "Medium and Long-Term Retail Savings in the UK", Sandler Review, July 2002

² "Consumer understanding of financial risk" FSA Consumer Research 33, November 2004

5. Our approach

To assist advisers and their organisations, Distribution Technology's risk profiling methodology distinguishes attitude to risk from two other important concepts; Risk Capacity and Value at Risk. These are best dealt with through separate analysis and provide two further variables for the client or the adviser to consider when developing an investment strategy. Within our approach understanding the client's attitude to risk refers to assessing the client's degree of discomfort (or aversion) to the potential for losing money or for a volatile investment experience.

Assessing the client's Risk Capacity requires the adviser to calculate how much risk a client can realistically take (usually measured by a given probability) and still achieve what they want to achieve with their money. This should be a separate quantitative exercise and is a function of the client's current wealth, their time horizon and the size and duration of any goal they wish to achieve e.g. income in retirement, pay off mortgage, school fees etc.

Helping the client understand their Value at Risk in the context of the potential returns they might get is also important. Investment literature is conclusive that the variation in returns associated with different investments is driven over the long term, primarily by asset allocation. Analysing asset allocation as a measure of the underlying or systematic risk to which a clients' portfolio is exposed is a very useful way of helping them understand a significant proportion of the strategic risk they face.

6. Psychometrics

In order to understand a client's attitude to risk Distribution Technology utilises a psychometric approach. Psychometrics are internationally recognised as the most effective means of reliably measuring an individual's knowledge, abilities, attitudes, and personality traits. The field is primarily concerned with the study of differences between individuals and involves the construction of accurate and reliable tests and questionnaires for measurement of these differences. A reliable test is one where if the same questions are asked of a sufficiently large group from the same population, the same distribution of answers will be created.

In the UK, a number of questionnaires are currently in use to assess investor attitude to risk. These vary in length from simple assessments asking one or two questions to comprehensive psychometric profiling offered by specialists with 30 or 40 questions. Whilst recognising that the accuracy of categorisation is likely to increase when more questions are asked³, many institutions challenged by the need for an efficient fact finding process are not comfortable asking a comprehensive set of profiling questions consisting of over 20 questions as this can reduce the efficiency of the fact find.

Distribution Technology's methodology allows advisers or their organisations to understand the trade-offs between time spent and questionnaire reliability. We have developed three questionnaires with 5, 18 and 24 questions, so that this trade-off can be understood and an appropriate course of action taken.

Few, if any, psychometric questionnaires in this field have been benchmarked against the UK adult population. This is potentially a significant issue for users of these tools, as in order to ensure a reliable result the process needs to have been calibrated against a statistically sufficient number of individuals.

³ "The relationship between correlational and internal consistency notions of test reliability". Educational and Psychological Measurement, D.J. Krus & G.C. Helmstadter, 1987

Dynamic Risk Profiler was developed through a pilot of 200 respondents and full field survey using GfK NOP with 1,000 respondents representative of the adult population.

7. Defining attitude to risk

Distribution Technology commissioned The Psychometrics Centre, a leading psychometric research centre in the UK based at City University, to work with us to design a psychometrically reliable instrument to assess individuals' attitudes to investment risk.

Dynamic Risk Profiler (DRP) focuses on how an individual *feels* rather than *behaves* (emotions are only one factor in driving investor behaviour⁴) and looks at *savings* and *investments*, rather than other areas of general financial risk, which might cover financial protection, insurance or mortgages for example.

DRP's positioning is deliberately neutral with regard to '*when*' an individual feels these things e.g. 'when they are considering making an investment', 'when they are holding or considering selling an investment' etc. as behavioural finance literature is conclusive that the context in which an investment decision is made will have an effect on their attitude to risk.

Dynamic Risk Profiler is based on eight key characteristics of attitude to risk. These are set out in the table below and are based on an assessment of behavioural finance and psychological principles. Initially nine characteristics were selected for research, however at the pilot stage one was dropped as it did not show up statistically as being a useful identifier of attitude to risk.

8. Quantifying attitude to risk

Crucial to this exercise was to find non-numeric means of describing a particular investment experience and, ultimately, level of acceptable volatility. Many questionnaires will ask questions such as 'what is the maximum loss with which you feel comfortable?' However it is widely known, and our own research shows, that individuals find it hard, often impossible to define the level of risk with which they feel comfortable in hard currency or percentage terms.

Dynamic Risk Profiler therefore asks questions which describe an investment experience rather than asking for a quantitative response. Examples include; 'I get excited when I read about sudden changes in the financial markets', 'I like the excitement of investing in volatile foreign markets to potentially gain higher returns' or 'I prefer savings accounts to stock-market related investments'. Together these have enabled us to define an appropriate investment experience for each profile and these enable advisers and their institutions to put together acceptable investment strategies.

⁴ "Insights from Psychology and Psychometrics on Measuring Risk Tolerance", Michael J. Roszkowski.; Geoff Davey; and John E. Grable, 2005

Table 1 – Key characteristics of attitude to risk

Characteristic	Description	Type
Risk sensitivity	What is the preference for preservation of capital versus willingness to take on a “high-risk, high-gain” policy? How sensitive is the investor to fluctuations in an investment’s value?	Descriptor
Desire for Profit	Desire for profit and a high return on investments versus being satisfied with a small, steady profit return ⁵	Descriptor
Tolerance for ambiguity	Ability to tolerate ambiguous financial information and conflicting information about an investment ⁶	Descriptor
Outlook	To what degree does the individual weigh potential losses above potential gains when thinking about their investment future?	Descriptor
Horizon	Does the investor prefer to focus on the short or longer term horizon? This is different to available investment period and reflects their emotions rather than practical issues	Descriptor
Financial Awareness	Financial awareness through the news, experience and review of investments held	Predictor
Financial Experience	Perception of own financial experience and its strength or otherwise	Predictor
Suggestibility	Openness to suggestions and to influence by the media	Predictor

As can be seen in the above table, five out of the eight characteristics are descriptors of the investor’s attitude to risk. The remaining characteristics describe traits which have been shown to drive attitude to risk and are accurate predictors.

The next section of this paper sets out how these characteristics were used to develop the risk profiling questionnaire and attitude to risk scoring.

⁵ “The Disposition Effect to sell winners too early and ride losers too long. Journal of Finance”, H. Schefrin and M. Statman, 1985

⁶ “Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing”, H. Shefrin, 2000

9. Methodology

In creating the questionnaire a 5 point Likert scale (“strongly agree” to “strongly disagree”) including a mid-point was used and the following guidelines⁷ were adhered to:

- Relevance of statements
- Brevity of statement
- Easiness to understand
- Absence of ambiguity
- Exclusion of items whose agreement may be considered as socially desirable
- Avoidance of more than one statement in each item

9.1. Pilot

78 questions were initially selected for inclusion in the pilot. Each characteristic was initially equally represented and items were ordered in a way that no characteristic would appear to have too many statements too close together. Furthermore, positive and reverse items were alternated.

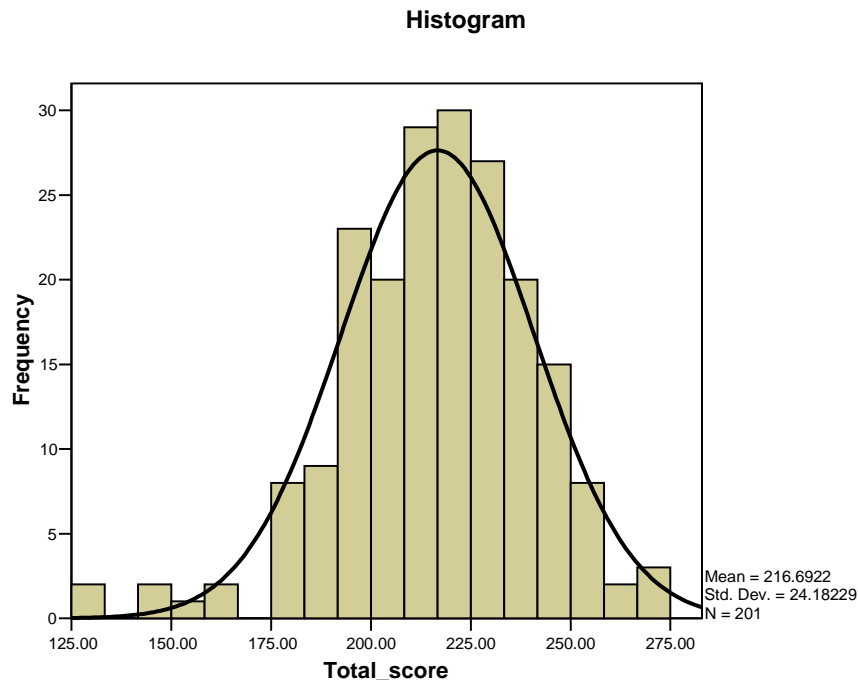
The pilot was completed using an Internet and a pen and paper version of the survey. 201 valid responses were collected within 6 days. 119 pen and paper respondents and 82 Internet respondents completed the survey. No significant differences between Internet and pen and paper responses were found. The distribution of the total score of all respondents for 78 items is depicted in Figure 1.

Additionally within the pilot, demographics with regards to variables known to affect risk tolerance were collated. These are:

- Age
- Gender
- Income
- Educational level
- Marital status
- Working status

⁷ “A handbook of test construction”, P. Kline, 1986

Figure 1: Histogram, mean and standard deviation of total score of 78 items from 201 pilot responses



The item total score for all 78 questions is normally distributed.

9.2. Pilot analysis

A proper analysis of the psychometric properties of the survey followed best-practice procedure for survey data analysis, in particular the following techniques were used:

- Item (question) facility analysis establishes whether the items differentiate between respondents or whether there is a floor/ceiling effect (that is if respondents opted for extreme responses)
- Discrimination analysis establishes whether the remaining questions have the ability to discriminate respondents on the dimension(s) of interest

Question means and standard deviation as well as kurtosis and skewness are used to establish whether an item has poor facility. The Z score for kurtosis and skewness is a further indicator for whether items deviate from normality. Z values exceeding +/- 2.32 give cause for concern⁸. An inspection of histograms for all 78 items assisted in finding items with floor/ ceiling effects as well as questions where the overwhelming majority of respondents choose one option.

The higher the correlation between the score on an individual question and the total score on the overall item, the more discriminating the question. The conventional rule is to discard any item that correlates less than +0.2 (including any negative correlation)⁹. Both types of item analyses reduced the amount of items to 62 for reliability analysis.

⁸ "Organizational research methods: A guide for students and researchers", P. Brewerton & L. Millward, 2001

⁹ "Modern Psychometrics", J. Rust & S. Golombok, 1999

Reliability is the estimate of the accuracy of the questionnaire. The most useful means is to calculate Cronbach's coefficient alpha, or short alpha. This gives the average correlation between all items in the questionnaire. A minimum alpha of 0.7 is looked for when establishing the reliability.

From the original 78 items, the analysis determined 24 items for the survey. The alpha for the final 24 items selected for the survey was 0.84.

9.3. Survey

Moving from the pilot stage, the 24 question questionnaire was used to gather responses face to face from 1023 participants to assess their attitude to risk. The data was collected by GfK NOP and the sample characteristics were representative of the UK population as discussed above.

9.4. Questionnaires

From the field survey data the three questionnaires were then developed. The first contains all 24 questions while the other two use a subset of these. The questions were selected by assessing their correlation and explanatory power against an individual's overall risk score for the characteristics being measured in each questionnaire.

The following table sets out the explanatory power of each characteristic and shows how many questions are being asked against each characteristic in each questionnaire. The last line provides the alpha for each questionnaire.

Table 2: DRP length of final questionnaires and characteristics covered

Characteristic	'R' score	Questionnaire length		
		24	18	5
Financial experience	0.81	4	4	1
Financial awareness	0.72	4	4	1
Risk sensitivity	0.62	6	4	1
Suggestibility	0.50	1	1	1
Desire for profit	0.43	3	2	1
Horizon	0.35	2	2	0
Outlook	0.32	1	1	0
Tolerance for ambiguity	0.16	3	0	0
	Alpha	.74	.74	.63

All versions of the questionnaire are valid representations of customer attitudes however it is important to note that while the Alpha of the 24 and 18 question questionnaires demonstrates that the instruments are reliable, the 5 question version is not as robust.

The 18 question version is the 'best fit' in terms of providing the best analysis with the least number of questions. The 24 question version has added value questions which can provide the user with more feedback. The 5 question version provides more of a 'snap-shot' of the individual's risk profile but does measure the key characteristics which were shown to account for the majority of a respondent's risk score.

10. The full questionnaire

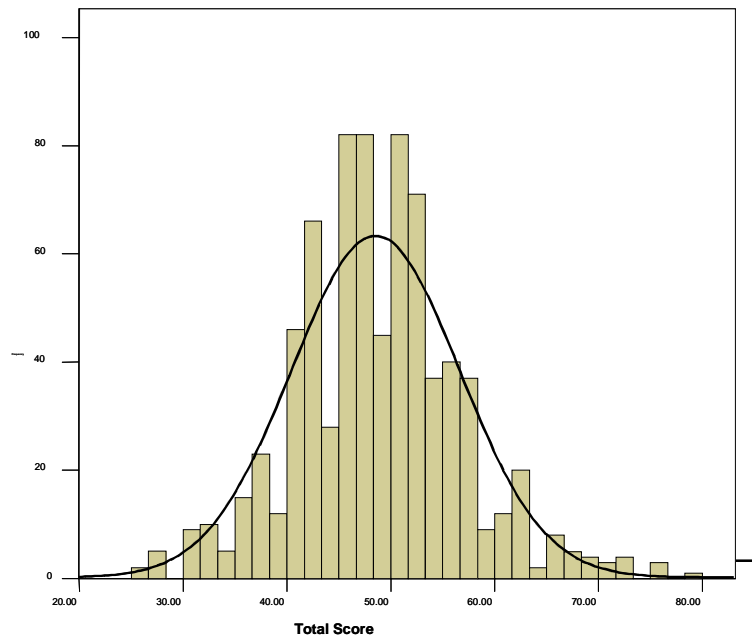
Table 3 – 24 question questionnaire

Item No.	Item
1	I get excited when I read about sudden changes in the financial markets
2	I believe in a "high risk, high gain" policy
3	I need to get a high return on my investments - a small steady profit is not acceptable
4	I do not like to keep up-to-date on financial matters
5	Conflicting information about an investment does not bother me as long as I think it is a good investment
6	I am comfortable with the idea of my investments falling and rising rapidly
7	I would describe my experience of investments as very limited
8	My knowledge of financial terms is very limited
9	Once I make an investment I hardly ever review it
10	I have sound financial experience to help me make an investment decision
11	I prefer having a long term financial plan
12	The thought of losing my money on an investment makes me nervous
13	I like the excitement of investing in volatile foreign markets to potentially gain higher returns
14	I try to make as much money as quickly as possible
15	Most of the time, I do not read the financial section in my newspaper
16	I am used to taking financial risk
17	Financial press is a major influence on my investment decisions
18	I prefer savings accounts to stock-market related investments
19	I would not like to invest in long term investments as I wish to respond to changes in my budgetary requirements quickly
20	I prefer not to stick to "tried & tested" investments
21	I am prepared to take risk in order to gain high returns
22	I do not think of accumulating huge wealth through investments
23	Had I been unlucky with investments in the past, I would make an investment again
24	I am uncomfortable with changes in the interest or profit I receive but I don't mind if the capital I invest goes up or down a little

11. The risk profiles

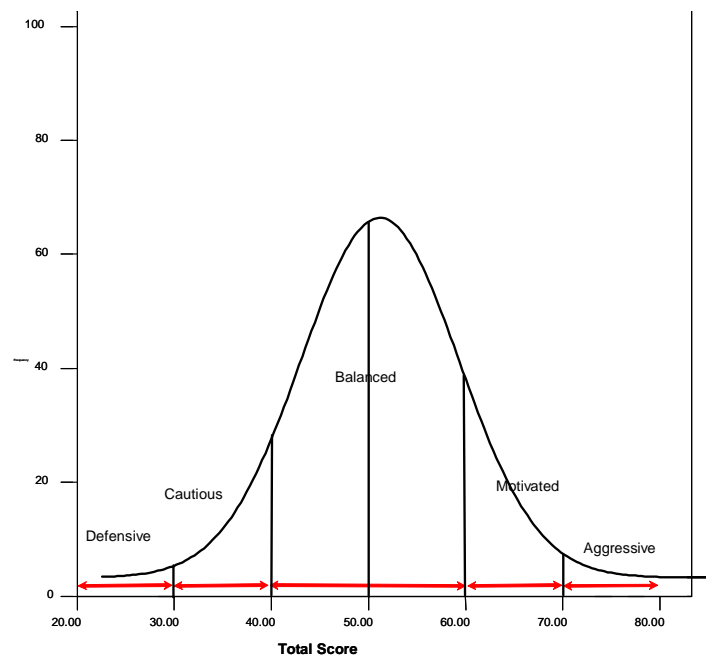
The results from the survey were scored on a continuum and are normally distributed as can be seen from the following diagram.

Figure 2: Histogram of responses to 24 items from 1,023 survey participants

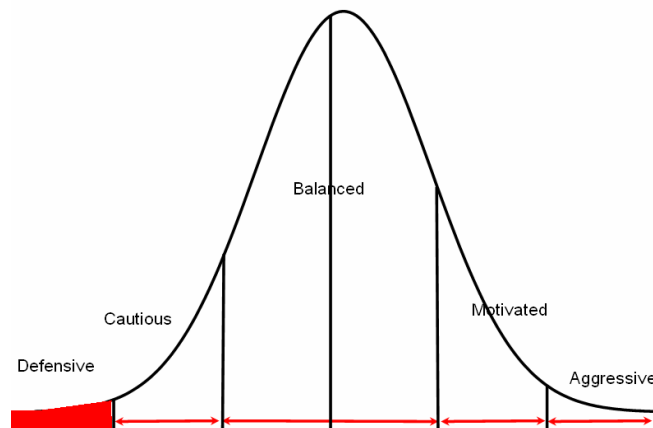


The population was divided into five risk profiles, reflecting the key distribution segments:

Figure 3: Key distribution segments



12. Profile 1 – Safety First Investors



12.1. Risk sensitivity

Safety First Investors are the most risk sensitive profile and capital preservation is likely to be this group's highest priority. Individuals in this group are likely to prefer savings accounts to stock-market related investments because of the security of capital, and they are also likely to be uncomfortable with changes in the interest or profit an investment generates. They are most likely to be seeking a small, steady return rather than anything greater and are very likely to become extremely nervous if they felt an investment could lose them any money at all.

12.2. Financial knowledge and awareness

Safety First Investors are unlikely to be particularly financially aware or keep up to date on financial matters and they are likely to have much less financial experience than average (or feel that they have). It is quite unlikely that they will have taken significant investment risks before. Where they have purchased an investment they are less likely to review it regularly and if they have had a bad experience in the past it is quite likely that their investment confidence will have been severely dented.

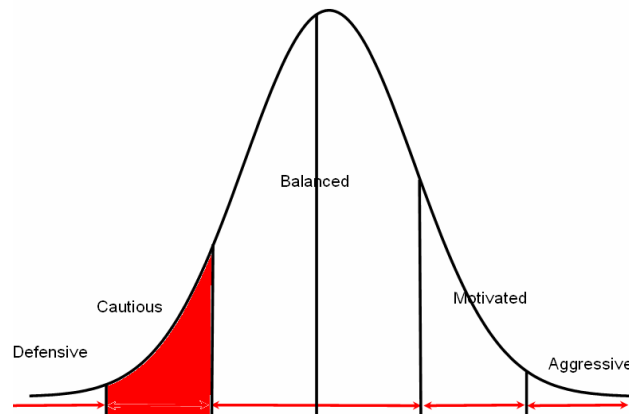
They prefer clear financial information and are likely to be concerned if they hear about conflicting information about an investment and their strong preference is to stick to 'tried and tested' investments.

12.3. Outlook

Safety First Investors will generally have a negative outlook on investments weighing the risks they face far more than the potential rewards. They will be focused on meeting short term goals and needs and are unlikely to be willing to operate with flexible investment time horizons.

Please note: This profile is a summary of feelings and characteristics that an individual with the appropriate DRP score is likely to display. All individuals are different and your client may have answered particular questions differently. It should not be assumed that all characteristics described here are applicable to each client. You should gain your client's acceptance that this profile is representative of them before developing an investment strategy.

13. Profile 2 – Cautious Investors



13.1. Risk sensitivity

Cautious Investors are likely to be risk sensitive individuals to whom capital preservation is a very high priority. They may potentially accept their return going up or down a little however they are likely to favour bank accounts or other guaranteed type savings vehicles over stock market related investments. They are more likely to be seeking a small, steady return rather than anything greater. They are very likely to become nervous if they felt an investment could lose them money.

Cautious Investors prefer clear financial information and are likely to be concerned if they hear conflicting information about an investment. Their strong preference is to stick to 'tried and tested' approaches and investments that they understand.

13.2. Financial knowledge and awareness

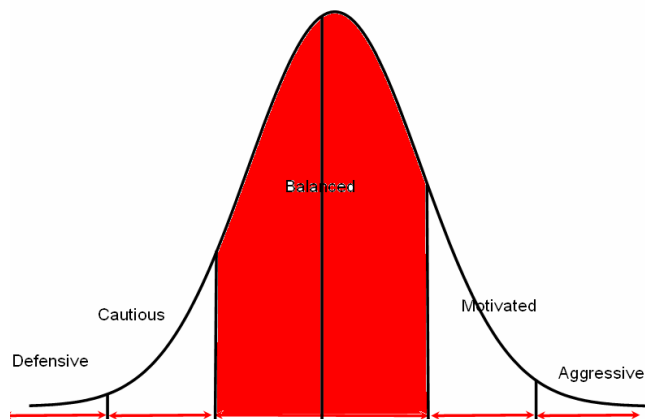
Cautious Investors are unlikely to be financially aware or to keep up to date on financial matters. They are likely to have little financial experience and are unlikely to have taken significant investment risks before. Where they have purchased an investment they are less likely to review it and if they have had a bad experience in the past their investment confidence is likely to be adversely affected.

13.3. Outlook

Cautious Investors will generally have a negative outlook on investments weighing the risks they face far more than the potential rewards. They will be focused on meeting short term goals and needs and are unlikely to be willing to operate with flexible investment time horizons. They are not likely to be receptive to external suggestions.

Please note: This profile is a summary of feelings and characteristics that an individual with the appropriate DRP score is likely to display. All individuals are different and your client may have answered particular questions differently. It should not be assumed that all characteristics described here are applicable to each client. You should gain your client's acceptance that this profile is representative of them before developing an investment strategy.

14. Profile 3 – Balanced Investors



14.1. Risk sensitivity

Balanced Investors represent the largest investor group in the UK. They are likely to be interested in generating higher returns than more cautious groups however they are also trying to balance this with their natural risk aversion and caution. They are likely to accept that seeking higher returns requires taking more risk however the thought of losing money is still likely to make them nervous.

Whilst they will probably consider holding some investments that can fall and rise rapidly and may even be willing to look at foreign stock markets to gain potentially higher returns with a small proportion of their money there is still an underlying preference to avoid risky stock market investments and stick with 'tried and tested' approaches.

14.2. Financial awareness and knowledge

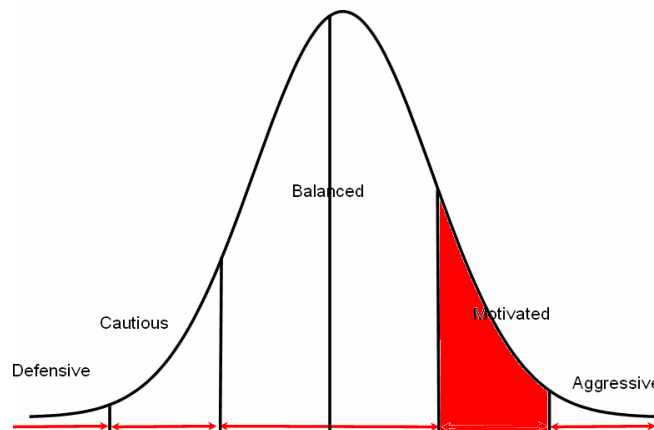
Balanced Investors are more likely to be financially aware than more cautious investors and may well read the financial press on a regular or semi-regular basis. They may still view their investment experience as limited however and are likely to be only moderately confident in relying on this experience to help make future decisions. Dealing with conflicting information about investments may be difficult for them and they are likely to have only a moderate ability to tolerate ambiguous information. Once an investment has been made they may well review it on a regular basis.

14.3. Outlook

Balanced Investors may well have a positive outlook on investment although this is likely to be tempered with their desire to manage risk. They probably give the same weight to the potential risks they face as the potential rewards. They may be open to suggestions on where to invest.

Please note: This profile is a summary of feelings and characteristics that an individual with the appropriate DRP score is likely to display. All individuals are different and your client may have answered particular questions differently. It should not be assumed that all characteristics described here are applicable to each client. You should gain your client's acceptance that this profile is representative of them before developing an investment strategy.

15. Profile 4 – Motivated Investors



15.1. Risk sensitivity

Motivated Investors are more likely to be driven by the desire for larger profits and are likely to be less risk sensitive. They are less likely to find small, steady returns acceptable and in seeking higher returns on their investment they are more likely to be comfortable with a “high-risk, high-gain” strategy and accept that investments can fall and rise rapidly. It is less likely that they will be unnerved by the thought of losing money on an investment and may well get excited by changes in markets. Motivated Investors are more likely to be interested in foreign or overseas investments in search of higher returns.

15.2. Financial awareness and knowledge

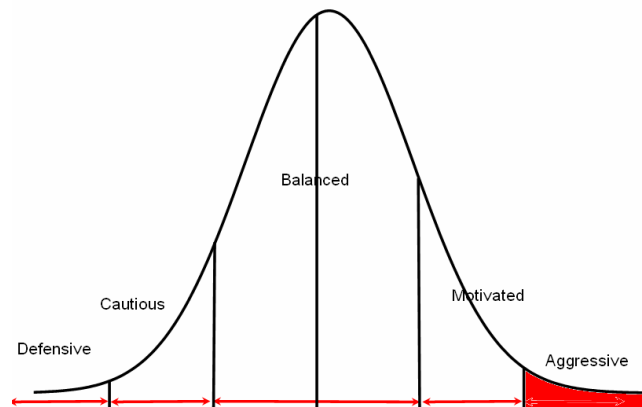
This investor profile is motivated to keep up to date on financial matters and is likely to read and be influenced by the financial press. They are more likely to be comfortable with conflicting and ambiguous information around their investment choices and once they have made an investment they are likely to review its performance. They generally feel themselves to be more experienced and may rely more on this experience to help them make an investment decision.

15.3. Outlook

Motivated Investors are likely to have a positive investment outlook and may well place a greater weight on potential gains than potential losses. If they have had a bad investment experience in the past this will not necessarily put them off investing again and indeed they are less likely to rely on tried and tested routes and are likely to be more open to suggestions on where to invest.

Please note: This profile is a summary of feelings and characteristics that an individual with the appropriate DRP score is likely to display. All individuals are different and your client may have answered particular questions differently. It should not be assumed that all characteristics described here are applicable to each client. You should gain your client’s acceptance that this profile is representative of them before developing an investment strategy.

16. Profile 5 – Acquisitive Investors



16.1. Risk sensitivity

Acquisitive Investors have a strong desire for profits and are likely to think about accumulating huge wealth. They are much more likely to seek high returns on their investments and will very likely want to try to make as much money as quickly as possible. As a result they are most likely to take risks to gain those returns and may well believe in a “high-risk, high-gain” strategy. They are likely to get excited by sudden changes in markets.

16.2. Financial awareness and knowledge

Acquisitive Investors are most likely to be financially aware and keep up to date on financial matters. They may well have a good knowledge of financial terms and are very likely to read the financial section in the newspaper. They are comfortable with ambiguous and conflicting information on investments.

As a group they are more likely to feel they have strong investment experience and to have taken risks before and may well be confident on relying on this experience to help them make future decisions.

16.3. Outlook

Acquisitive Investors are likely to be least sensitive to risk and are very likely to be comfortable with the idea that their investments can fall and rise rapidly. They are more likely to consider volatile foreign markets to pursue higher returns. If they have had a bad investment experience in the past this will not necessarily put them off investing again and indeed they are less likely to rely on tried and tested routes. They may be more willing than most to expand their investment timescales in order to run with an investment longer than anticipated and this may need to be watched as overconfidence can be an issue with this group. They are likely to be very open to suggestions on where to invest.

Please note: This profile is a summary of feelings and characteristics that an individual with the appropriate DRP score is likely to display. All individuals are different and your client may have answered particular questions differently. It should not be assumed that all characteristics described here are applicable to each client. You should gain your client’s acceptance that this profile is representative of them before developing an investment strategy.

17. Using Dynamic Risk Profiler in the advice process

Dynamic Risk Profiler benefits both the client and the adviser during the advice process. For the adviser; DRP delivers the opportunity to understand a client's attitude to risk in detail and make suitable investment strategy recommendations. For the client, DRP enables a better understanding of their attitude towards risk and together with the adviser, take responsibility for their financial decisions.

DRP should be adopted as a core element of the advice experience and integrated into the client fact-find. The risk profile output from DRP provides the opportunity for the adviser to enter into a discussion with their client(s) regarding their risk attitude and together reach an agreement on a final risk profile on which investment strategy recommendations are based. It should be remembered that all clients are different and the profiles are only summaries of how an individual with a particular risk profile might feel. Specific responses to questions may be different from the standard profile and these are worth discussing with the client. The discussion resulting from the output risk profile is as important as the DRP output itself, as discrepancies between this and the client's ideas can be smoothed out and agreed.

When integrated into Dynamic Planner, the advice experience then moves on to a quantitative assessment of the client's risk, the total underlying volatility acceptable within the portfolio and once this has been accepted appropriate products and funds can be identified and agreed.