RISKPRO

News, Insights, and Disruptive Thinking from RiskPro WealthTech Visionaries

Behind the SHIELD

IS YOUR RISK PROFILING PROCESS PUTTING YOUR FIRM AT RISK?

Historically, investor risk profiling begins with an investor completing a risk tolerance questionnaire and then getting a label like "conservative", or "aggressive". We created RiskPro® because we found weaknesses in the widely used process of risk profiling that has, and continues to create, challenges for financial institutions, advisers, and investors. We also felt it necessary to not just give you a closer look at this age-old problem, but to provide you details of our solution, especially in the wake of regulatory changes and market volatility.

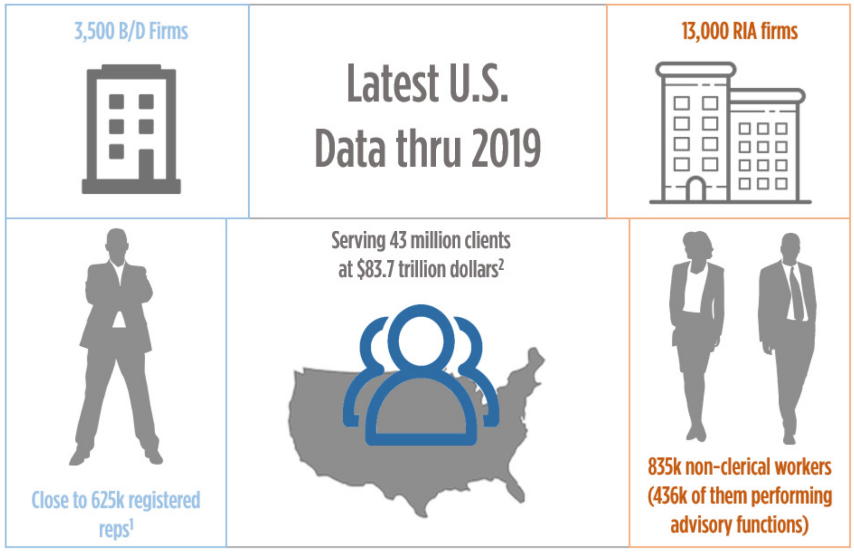
Here is some of what we know about the traditional, as well as digitized risk profiling processes in place, along with the possible trouble they can cause:

- Investors can often answer questions differently during positive versus challenging economic and/or market cycles.
- Questions asking an investor to "imagine" a possible future event are faulty, as trying to imagine a feeling about a hypothetical event is not the same as having the actual event experience and feeling the emotional consequences.
- Questionnaires tend to have a bias toward greater risk for the younger investor, or those with a longer time horizon (think conventional target-date investing).
- Scoring of the investor's risk profile typically results in ambiguous labels such as "Moderate", "Balanced", or "Aggressive".
- No clear path is set for the financial professional to identify a risk suitable portfolio, after the "labeling" of the investor takes place.

The last two bullet points are especially troubling as investors may have very different perceptions of the "label" assigned to them. Even more troubling is that there is not an accurate or common definition for risk used between broker/dealers (B/Ds), registered investment advisers (RIAs), insurance companies, banks, or custodians. Just stop to think about the large number of professionals and their teams that take part in the investment process for any single investment account, including but not limited to:

- registered representatives (RRs)
- investment adviser representatives (IARs)
- compliance officers
- client service and operations staff
- institutional strategists and mutual fund managers.

"With RiskPro's universal translation, ambiguity is gone forever and Perpetual Suitability™ is here to stay."



The hundreds of thousands of people working in the financial industry that work with the end-investor's assets without a common thread to define portfolio risk between them is rather unsettling. Without absolutes that define the risk of an investment portfolio that is universal for all involved, the amount of risk in one "moderate" portfolio versus another can obviously be very different. This ambiguity, in both identifying an investor's level of comfort with investment risk and in identifying the level of risk in a portfolio of securities, can easily lead to misunderstandings between advisors and their clients, relationship strain and possibly worse (arbitration or regulatory agency fines).

Firms relying on a psychometric type of risk profiling, to get into the investor's psyche, are still left with the same problem of ambiguous terminology or numbers that are not universal or based on mathematical market data. A financial professional estimating the risk of a portfolio to match a label or number based on investor psychology can leave the door wide open for miscommunication.

RiskPro®– The Universal Translator

At RiskPro, we acknowledge first, that risk profiling questionnaires are imperfect, no matter how robust they may be. We understand that it is not the actual questionnaire that really matters. In fact, if a firm working with us wants to keep and use their own questionnaire, it is never a problem to have our team use that questionnaire. We can do this, because RiskPro captures risk metrics from the answers, then calibrates each point to an average volatility (standard deviation, adjusted based on the 30-year volatility of the S&P) and a corresponding tolerance (maximum gain/loss for a forward looking 12-month period with an estimated 98 percent degree of statistical certainty).

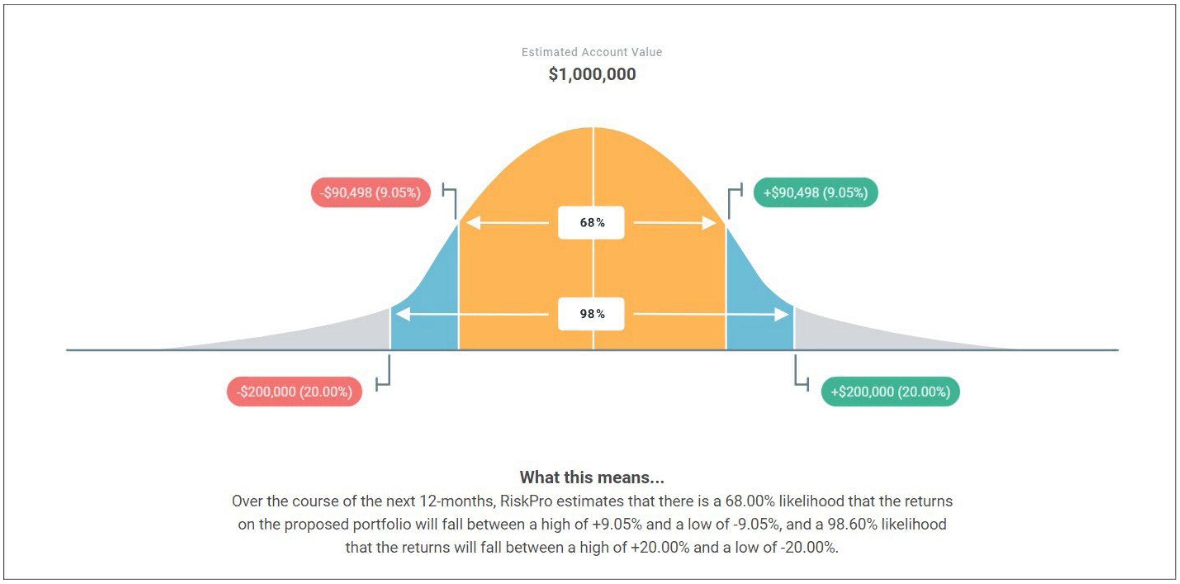
Once the risk profiling questionnaire is completed, rather than an arguable result based on assumptions, RiskPro displays an individualized Personal Risk Budget™ (PRB) which identifies the maximum gain or loss the investor is comfortable with, over a given 12-month period of time. Once a PRB has been established, it has a very specific meaning that RiskPro translates to precise metrics documented and exhibited in the software's user-friendly application. This translation then guides the financial professional to either manually construct a suitable investment portfolio or select a suitable model portfolio that matches perfectly with the investor's Personal Risk Budget.

The Danger of Miscommunication

When researching the risk profiling questionnaires and risk engines used by financial institutions, we uncovered a variety of misleading displays of uneven correlation between risk and reward. Although historically the stock market has been up significantly more than it is down, one of the major issues that could result in substantial danger to financial firms that believe they are "covered" from a compliance standpoint, is when a risk engine uses historic return data and extrapolates it over short periods of time.

Historic market return data may provide valuable perspective for both financial professionals and investors, however, extrapolating long term return data over relatively short periods of time may be highly misleading. In times when market volatility spikes, such as the global economic crisis of 2008 or more recently, the global pandemic that caused a 30% market drop in a very short period of time (February 20th to March 23, 2020), accounts may decline significantly more than investors expected.

RiskPro was developed with a "2008-type" market condition in mind. The RiskPro algorithm estimates the 30-year average volatility of a portfolio to determine the potential range of returns expected over a forward looking 12-month period. As previously stated, long term market data may provide a valuable perspective, however, since market direction is unknown over short periods of time and past performance is not indicative of future results – especially over the next 12 months – we use average volatility to determine portfolio risk and tolerance and then shift the mean to zero and convey to an investor an equal probability of either positive or negative returns (see our illustration below).



This approach is more effective in helping investors have realistic expectations for the expected range of returns in their portfolio.

Proven Math and Documented Methodology

The methodology used to calculate portfolio risk is critical and has the potential to create significant liability for advisers and the firms they represent if the math and process is faulty.

The most common metric for determining portfolio risk is standard deviation, typically calculated using monthly observations over either a 3- or 5-year period. Until recently, we have seen an extended period of low volatility, leading many institutions to question whether this measurement was understating portfolio risk. In addition, when used in constructing and monitoring portfolio risk on an ongoing basis, this approach is slow to pick up changes in risk of individual securities and the portfolio itself. This is an issue that applies across the industry, and not just impactful for risk engines.

The RiskPro algorithm calculates the current volatility and relationship between securities to estimate the long-term average volatility of a portfolio. At RiskPro, we believe that the long-term average volatility is more predictive of the potential range of returns versus shorter time periods commonly used. At the same time, because RiskPro calculates current volatility, it picks up changes in the risk of each security relatively quickly and sends desktop alerts to advisers, OSJs, and firm compliance departments.

RiskPro's underlying mathematical algorithm that runs the engine has undergone significant due diligence, including analysis and review by an independent professor of mathematics at a leading university here in the U.S. The research found that using the RiskPro process to generate portfolio recommendations protected the investor's loss threshold approximately 98% of the time. In addition, when markets recently declined dramatically, bottoming on March 23rd, 2020, we did an extensive internal review with extremely positive results (see "RiskPro Proves Pandemic Proof")[3]. RiskPro calculates risk of securities, all individual models and may also be used to calculate the risk of multiple models combined as sleeves within unified managed accounts (UMAs). Additionally, the RiskPro API allows advisers to create and reallocate models or portfolios before synching directly with popular trading engines (Orion, FolioDynamix, acquired by Envestnet and coming soon, Envestnet).

Regulation Best Interest and Perpetual Suitability™

Under the Investment Adviser Act of 1940, Investment Adviser Representatives have always had the fiduciary responsibility to do what is in their client's best interest. Now under the SEC's Regulation Best Interest[4] (Reg BI), Registered Representatives of broker/dealers are subject to, among other things, the Care Obligation, which requires a standard that includes the investor's understanding of risk and reward, and how they are associated with a suitable investment recommendation.

For broker/dealers that agree to provide ongoing monitoring of client accounts, Reg BI includes the additional element that suitability needs to remain over time (a longstanding requirement for investment advisers). Further, under Reg BI, a "recommendation" includes not just a "buy" or "sell", but also a "hold". Therefore, not making a change in a portfolio is an implied "hold" recommendation, and any recommendation made must follow the guidelines of the Reg BI (also a longstanding requirement for investment advisers). This is very significant moving forward because if brokers and advisers are not performing a new risk tolerance evaluation when they review a client account, they are running the risk of violating suitability requirements. RiskPro solves for this conundrum by monitoring every client account daily and alerting the adviser, as well as the firm back office, of breaches in risk suitability. This automated surveillance and documentation system makes it simple for the adviser or broker to either reallocate investments, make a new recommendation, or update the client's Personal Risk Budget via email or in-person, to stay compliant and ensure ongoing suitability. In addition, RiskPro gives back offices and compliance teams the ability to set firm-specific risk rules for advisers or brokers and their client accounts. RiskPro also documents and generates reports for compliance departments to not only see and mitigate potential liability, but to also see trends among their advisers or brokers and client portfolios.

RiskPro does more than just surveil accounts; advisers can produce detailed proposals including comparisons of client assets held elsewhere to give them the ability to care holistically for their client's financial well-being while growing their business.

With RiskPro's universal translation, ambiguity is gone forever and Perpetual Suitability™ is here to stay.

[1] The Financial Industry Regulatory Authority (2020). "2020 FINRA Snapshot"

[2] Investment Adviser Association (2020), National Regulatory Services (2020). "2019 Evolution Revolution"

[3] Scalzo, Nick (2020). "RiskPro Proves Pandemic Proof" https://www.riskproadvisor.com/blog/riskpro-proves-pandemic-proof

[4] SEC Regulation Best Interest: The Broker-Dealer Standard of Conduct. Final Rule. (Sept. 2019) https://www.sec.gov/rules/final/2019/34-86031.pdf

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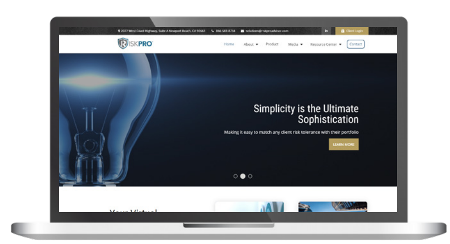

Disclsoure: RiskPro® is an investment risk profiling and portfolio construction software as a service platform developed by ProTools, LLC ("ProTools"). ProTools is a technology company headquartered in Newport Beach, CA. RiskPro is a risk analysis tool that provides information only and not intended to provide investment advice. For more information, visit us at www.riskproadvisor.com
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On the web:
www.riskproadvisor.com