



**SYNTONIQ**

# Investor Risk Profiling

## A Behavioural Approach

Alain Samson, PhD  
Prasad Ramani, CFA, FRM

[www.syntoniq.com](http://www.syntoniq.com)

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## Overview

Investing wisely is a cornerstone of financial success, and a crucial aspect of this is understanding an investor's risk appetite. Risk profiles can help financial professionals identify the types of investments that are most suitable for them, better manage their investment portfolio performance expectations, and avoid unnecessary losses in order to achieve their financial goals. Whilst traditional risk assessments used by financial advisers have focused on objective indicators of risk capacity along with simple subjective self-assessments, the goal of emerging approaches is to assess investors' risk profile in a more behavioural and comprehensive manner.

An individual's behaviour in relation to risky outcomes is determined by a range of interconnected characteristics, including risk preferences and associated behavioural biases, such as loss aversion and overconfidence. A psychological approach to risk has to take into account situational and enduring factors that shape risk attitudes and behaviours. In our view, 'behaviouralizing' risk tolerance requires us to

1. allow for important behavioural aspects of risk tolerance, such as loss aversion, as well as other psychological factors, such as overconfidence;
2. use a combination of psychometric and behaviourally meaningful methodologies that best predict investment decisions, such as questions asking people to make trade-offs, scenarios to gauge their behavioural reaction, or real-life trading behaviour;
3. take a more holistic approach by ensuring an understanding of risk psychology in a wider context that includes behavioural risk drivers, as well as risk capacity and need;
4. consider the dynamic nature of risk psychology by accounting for the more situational nature of risk tolerance, such as risk composure.

This paper will discuss these dimensions and their interconnections underlying risk evaluation approaches. We first outline variables related to risk that a more comprehensive behavioural assessment should cover. We then show how risk assessment approaches can use goals-based and wealth maximization risk suitability tools for portfolio construction. We also discuss the impact of assessments on client communication and suggest technical solutions to various challenges. We conclude by offering arguments that make a business case for the use of behaviourally-informed risk assessment tools.

## Drivers of Risk Attitudes and Behaviours

The psychology of risk is complex and dynamic. A person's general willingness to take risks or avoid risks is itself the product of numerous factors, including not only their background, but also risk perception, knowledge, and experience, as well as biases, such as overconfidence.

### Risk Perception

Risk perception is the process by which investors assess the likelihood, severity and potential impact of uncertain events. It involves the cognitive and emotional evaluation of particular situations or objects. Factors that can influence risk perception include personal characteristics and the context in which it is presented. For example, equities are likely to be evaluated as riskier during an economic downturn and by a person with lower levels of investment knowledge. Investors who perceive low levels of risk are likely to be more adaptable in the face of market volatility.<sup>1</sup> Risk perception is usually evaluated in a client's discussion with their financial adviser or by asking investors how they feel about financial risks (e.g., "How risky is the stock market?").<sup>2</sup>



Risk perception is typically considered as one of the underlying variables for risk tolerance, a person's willingness to accept risks in pursuit of a goal. This willingness is considered more proximate to actual behaviour. Thus, risk perception tends to be excluded from investor risk profiles in favor of more central risk preferences.

## Overconfidence

A psychological factor that is easily overlooked even in behavioural risk assessments is overconfidence. Optimism and confidence are among the most useful traits for mental wellbeing and financial engagement, but frequently lead to problems in decision-making. In investor psychology, optimism may lead individuals to perceive the stock market as less risky than it really is. In addition to unrealistic optimism, overconfidence can be seen in a miscalibration of probabilities, illusions of control, and the better-than-average effect. The latter type is evident when people hold an inflated view of their own competencies.<sup>3</sup> This bias leads investors to overestimate their investment skills when facing new decisions and, retrospectively, inflates the value of past successes. Overconfident individuals are prone to exaggerate the subjective probability of a particular outcome and, due to an illusion of control, believe they can affect it to a greater degree than they actually can.<sup>4</sup> Excessive confidence can lead to greater risk-taking, overtrading or overinvesting, lack of diversification, as well as greater belief in one's ability to time markets.

An investor's level of confidence tells us whether their expectations regarding risks and returns are realistic or potentially inflated due to overconfidence. Research with student participants has shown that overconfidence and risk perception are associated with risk-taking behaviours.<sup>5</sup> The same has been found among finance professionals in a study that measured both miscalibration of probabilities and better-than-average effects as indicators of overconfidence. Results showed a positive relationship between overconfidence and risk taking, such as allocations made to risky assets.<sup>6</sup> While overconfidence can be measured as a trait, it can also be induced temporarily. This is evident in research that asked male participants to recall a situation in which they had power over one or more individuals in order to create an illusion of control. Participants who were subjected to this overconfidence manipulation chose hypothetical lotteries over certain payoffs about 50% more often than individuals in a control group.

In practice, we recommend using an overconfidence measure that is multi-dimensional, including people's perceived accuracy of their own judgments, the perceived likelihood of desirable future outcomes happening to them versus other people, as well as their confidence about uncertain events that are outside of their control.

Data we collected<sup>7</sup> on a representative sample of working-age individuals shows the important role played by such an overconfidence measure in relation to risk tolerance. When we analyzed the data, we found the usual relationships between risk tolerance and demographic characteristics: Being male, younger, more educated and high earning were all associated with greater willingness to take risks. Controlling for the effect of all other variables we measured, we found that a person's risk-taking score, expressed as a percentile, is about 10 points higher for a person with high (top tertile) overconfidence than one with moderate (middle tertile) overconfidence.

The relationship between overconfidence and risk preferences suggests that risk tolerance may need to be adjusted in light of confidence levels. The aim is to answer one key question: how *realistic* are this investor's risk preferences? While risk capacity (discussed later) sheds light on the same



question from an objective point of view, overconfident (and conversely also *underconfident*) risk tolerance implies a subjective bias.

## Financial Engagement

Another important driver of risk preferences is financial engagement, which includes a person's financial knowledge and involvement in financial matters.

Financial literacy reflects a person's level of numeracy and understanding of basic financial concepts, such as compound interest and diversification. Research has shown that a good understanding of finance is associated with higher levels of net worth. This relationship holds even after other determinants of wealth are statistically accounted for.<sup>8</sup> It appears to occur because financial knowledge helps people make better decisions, such as increasing their participation in the stock market or choosing mutual funds with lower fees.<sup>9</sup> Financial education stimulates financial planning<sup>10</sup> and ultimately higher saving levels, both for retirement and in general.<sup>11</sup>

The positive outcomes of financial knowledge have also been investigated longitudinally,<sup>12</sup> showing causal effects of financial knowledge on outcomes that make up financial well-being. Researchers found that financial literacy predicts a person's future satisfaction with their own financial situation and confidence in their ability to face financial shocks. It could also predict planning for retirement. The effect of financial literacy on financial well-being occurs after controlling for demographic variables, such as age and income, and traits, such as cognitive ability and risk aversion.

While financial knowledge leads to positive outcomes, a lack of financial knowledge has been linked to negative consequences in the domain of borrowing. Research shows that education and financial literacy explains high-cost borrowing better than economic circumstances, such as low income, having been hit by shocks, or being unbanked.<sup>13</sup> Similarly, borrowers who take out high-cost mortgages usually display lower levels of financial literacy.<sup>14</sup>

Households with low financial literacy are also more likely to hold portfolios with low diversification, which can negatively affect wealth.<sup>15</sup> By the same token, a lack of financial knowledge can affect levels of risk taken in investments. One study found that financial literacy is positively associated with investment in risky assets.<sup>16</sup> This effect persisted even when risk aversion and other variables were included in the statistical model. In addition, investors' confidence in their own financial skills further increased the likelihood of holding risky stocks and bonds. Similar results were obtained in a study on older adults, which showed overconfidence in financial knowledge more specifically was positively associated with financial risk tolerance.<sup>17</sup>

Financial engagement is a multi-faceted trait that reflects the interrelation between knowledge, motivations, and behaviours. It can be measured by objectively assessing a person's financial knowledge, asking about a person's subjective interest in financial matters, or evaluating the extent of actual financial management or planning behaviour.

Research on financial decisions and outcomes highlights the importance of knowing individuals' financial engagement in holistic risk assessments. Understanding an investor's level of financial engagement can help evaluate their financial situation in the context of broader knowledge, experience and skills.





## Risk Preferences and Loss Aversion

Economists typically look at individuals' decision-making through a lens of utility maximization—getting the greatest benefit at the smallest cost. Utility is determined by preferences, which becomes evident in the choices made by individuals between alternatives. Behavioural economists are particularly interested in risk, time, and social preferences.<sup>18</sup> Risk preferences show the extent to which individuals are willing to put up with losses in order to make a possible gain.

Risk preferences are an important concept in the field of finance and investing, as they help us determine suitable investments for a person based on their appetite for risk. An individual with a preference for a high-risk, high-return investment strategy may be willing to invest their savings in a high-risk stock, while someone with a preference for a low-risk, low-return strategy may prefer to keep their money in a low-risk savings product, such as a money market fund.

### Risk Tolerance

Risk preferences are a combination of different factors, particularly risk tolerance and risk composure. Risk tolerance is often viewed as the core of risk preferences, as it shows how much uncertainty an individual is willing to accept to achieve a desired outcome.<sup>19</sup> Put differently, it is a reflection of a person's willingness to risk a loss in pursuit of a potential gain. Imagine an individual were offered two choices with the same expected value, either to receive Rs. 10,000 for sure, or a 50% chance of either getting Rs. 20,000 or nothing, a risk-seeking person would be more likely to choose the gamble. A risk-averse person would tend to choose the certain payoff.

Risk tolerance can be measured both quantitatively and qualitatively. Quantitative approaches that are behavioural in nature often ask individuals to choose between two options with different risks and payoffs.<sup>20</sup> They may also involve portfolio allocation tasks, requiring people to split funds between assets with different risk levels. More qualitative assessments usually ask respondents for a self-assessment. This may involve rating their risk tolerance on a 10-point scale or assigning themselves to a label (e.g. "a real gambler", "a real risk avoider").<sup>21</sup>

In economics, risk tolerance has traditionally been understood through expected utility theory, which has been criticized by more recent behavioural approaches. These perspectives consider risky outcomes relative to a reference point (usually the status quo), instead of focusing on final wealth. Behavioural approaches also reveal that individuals are usually more willing to take risks to avoid losses than to make gains.

### Loss Aversion

Behavioural methodologies often measure individual's choices that involve hypothetical gambles. Consider the following decision problem:

1. Which of the following would you prefer,
  - A) a certain win of Rs. 25,000, versus
  - B) a 25% chance to win Rs. 100,000, and 75% chance to win nothing?
2. Which of the following would you prefer,
  - C) a certain loss of Rs. 75,000, versus



D) a 75% chance to lose Rs. 100,000, and 25% chance to lose nothing?

Work by Tversky and Kahneman<sup>22</sup> on prospect theory shows that responses are different if choices are framed as a gain (1.) or loss (2.). The majority of people faced with the first type of decision will opt for the riskless alternative A), while for the second decision people are more likely to choose the risky D). Humans appear to be loss averse.

According to prospect theory, people's bad feelings about a loss are about twice as strong as the pleasure they would feel about an equivalent gain. Loss aversion helps explain a myriad of biases, such as sticking to an existing state of affairs (status quo bias), overvaluing something that we own regardless of its objective value (endowment effect),<sup>23</sup> as well as continuing an endeavor even if it would be more beneficial to abandon it (sunk cost fallacy).<sup>24</sup>

In investing, loss aversion is also evident in the so-called disposition effect, the tendency for investors to sell a winning stock too early and hold on to a underperforming stock too long in the hope of avoiding a loss.<sup>25</sup> Since loss aversion is about the degree to which people react negatively to losing money, it has been identified as an important driver of risk tolerance.

Loss aversion can be quantified by measuring an individual's propensity to take risks in the face of possible losses relative to taking risks for possible gains. Loss aversion is also evident in rejections of small-stakes gambles with a positive expected value (e.g. a coin toss with a 50% chance to lose Rs. 800 and a 50% chance to win Rs. 1,000).<sup>26</sup> These approaches can be complemented with non-behavioural measures, such as psychometric ratings (e.g. "A potential failure scares me more than a potential success encourages me").<sup>27</sup>

Along with the previously discussed variables of overconfidence and financial engagement, loss aversion is a major driver of risk preferences. Due to its powerful emotional nature, loss aversion can also be considered a force that causes investors to stray away from previously made plans and act on impulse. Loss aversion thereby affects risk composure, which we will examine next.

## Risk Composure

Risk tolerance measures assume that risk preferences are stable and reflected in people's attitudes towards risk. While an individual's risk tolerance level may appear to be high, however, their true ability to take risks is often unknown until it's put to the test. Their risk preferences may not be revealed until risk composure is taken into account. It includes the ability to remain calm when faced with real or potential losses; it's evident in maintaining a stable emotional state and make rational decisions. In the context of risk preferences more generally, then, risk composure shows a person's propensity to behave *consistently* with respect to risk-taking.<sup>28</sup>

Risk composure has been referred to as simply the "tendency of an individual to take or avoid a risk."<sup>29</sup> Individuals with low risk composure are more likely to act in a biased manner and the construct is commonly defined as *actual* behaviour under risk conditions.<sup>30</sup> Hence, a risk composure measure is ideally based on a client's past real-life decisions ("In the past, when faced with investment losses, what did you do?").<sup>31</sup> For example, when faced with losses in a market downturn, low-composure investors may sell some or all of their investments, whereas high-composure investors may make no changes or even purchase more.<sup>32</sup>

While this approach is meaningful from a behavioural perspective, it does not constitute a methodology that can be consistently used across individuals with varying exposure to investing





situations. As a result, risk composure measures have to either be restricted to existing investors or rely on individuals' responses to hypothetical investment scenarios with real-life relevance. Questions may also tap into outside factors that affect the investor. In an assessment of risk composure, individuals can be asked how outside influences (e.g. people they know, publications, or the media) influence their financial decisions (e.g. investing in the stock market).<sup>33</sup>

Knowing an investor's risk composure can add a vital dynamic element to risk assessments.

## Reconciling Risk Drivers and Risk Preferences

Having collected all this information, how can advisers use behavioural and risk data to get a better understanding of investors? As mentioned previously, an investor's level of overconfidence may show whether their expectations about risks and returns are realistic or inflated. Similarly, understanding an investor's level of financial engagement can help evaluate their financial situation in the context of broader knowledge, experience, and skills. A lack of financial knowledge, for example, can lead to a lack of diversification, while greater knowledge may increase the investor's appreciation of risk to achieve financial objectives. Finally, risk composure tells us the extent to which risk preferences might translate into actual behaviour. Knowing the investor's overconfidence, financial engagement, and risk composure can add vital dimensions to the investor's overall risk profile.

Information about these key behavioural variables can produce two different kinds of insights. Firstly, it allows us to identify potential associations and blind spots that financial advisers can address in collaboration with their client. Given the client's financial knowledge, does their confidence appear well-founded? Could a high level of risk tolerance be due to overconfidence? Is there a gap between the level of risk the client says they can take versus what they might be able to handle, especially in a downturn? Secondly, behavioural insights about traits like overconfidence or risk composure can be used to calibrate how risk scores are used for portfolio construction. Compared to a client who has high risk tolerance and low overconfidence scores, asset allocations for a client with high scores on both dimensions may benefit from a less aggressive approach. The same would be true for clients with high risk tolerance and high risk composure versus high risk tolerance and low risk composure.

## Risk Capacity and Risk Need

Our discussion so far has focused on factors related to the psychological ability to take risks. However, it is only when the risk attitudes of investors of similar wealth are compared that we can observe true variation in subjective risk preferences.<sup>34</sup> In an ideal world, risk capacity, not risk tolerance, would be the main determinant of investment decisions. While it is important to know an individual's willingness to take risks, an assessment is not complete unless we also know their objective *financial ability* to take risks—their risk capacity. Having this information can show us the difference between the risk an investor says they would hypothetically be able to handle and what they are really able to handle.

Risk capacity refers to a person's ability to absorb or withstand potential losses based on available resources (especially financial ones) to manage and recover from risk.<sup>35</sup> The core of risk capacity is based on financial and temporal factors. Financial considerations include current assets and expected assets (income), liabilities, and expenses. This information provides a fuller picture of how much money an investor can actually deploy and on what kind of risk they can take without being



forced to take short-term investment decisions. The availability of financial resources determines an investor's ability to withstand a financial shock.

Temporal factors usually depend on an investor's stage of life, which influences their time horizon.<sup>36</sup> Financial life stages generally fall into one of three categories, wealth accumulation, preservation, and distribution. Both the need and ability to take risks change as an individual goes through different life stages.

The following examples of high versus low risk capacity illustrate the importance of these dimensions:

- Person A who is 35 years old and 32 years away from retirement versus Person B who is 60 years old and seven years away.
- Person C with an annual income of Rs. 15 Lacs and savings of Rs. 60 Lacs versus Person D with an annual income of Rs. 6 Lacs and savings of Rs. 10 Lacs.
- Person E who needs to grow assets from Rs. 20 Lacs to Rs. 50 Lacs in 10 years versus Person F who needs to grow from Rs. 25 Lacs to Rs. 40 Lacs in the same period of time.

Person E has more ambitious savings goals and has to increase their risk capacity to meet financial objectives. This is where risk *need* enters the scene, which is defined as "The amount of risk that a person should accept in his or her portfolio in order to meet a specific financial goal."<sup>37</sup>

We can expect a person's risk need to be reflected in their risk tolerance with respect to specific investment goals to some extent.<sup>38</sup> However, this may be entirely based on subjective evaluations. In addition, people's actions are not always consistent with achieving their goals or they may engage in risky behaviour in the pursuit of those goals.<sup>39</sup> Objective evaluations of risk need can help investors understand the amount of risk they need to take to reach a financial objective.

An assessment of an investor's risk need requires a determination of the following:

- Financial goal(s) to be met
- Amount required to achieve the goal(s)
- Target date (time horizon)

When investors work with financial advisers, it is also important to consider contingencies, particularly the consequences of failure. If there are grave consequences of not meeting a goal, a person's risk need may have to be lowered or constituent objectives and target dates adjusted.

## Risk Suitability Assessment

In the context of a larger risk assessment that involves risk tolerance, capacity, and need, a client's risk suitability can be assessed in terms of either goals-based investing or wealth maximization.<sup>40</sup> Goals-based investing tailors the portfolio to the client's specific financial objectives, ensuring that risk is aligned with these goals. Wealth maximization, on the other hand, focuses on optimizing returns while considering risk, often with a long-term perspective.

### Goals-Based Investing

The objective of goals-based investing is to align a client's portfolio with their specific financial goals and objectives. To achieve this, a risk assessment should consider the client's goals, such as



retirement, buying a home, or repaying a loan. The assessment should allow the user to set the goal, target value, current savings, target timeline, and criticality or priority for different goals. Portfolios can then be constructed to balance risk and return within the risk parameters that are suitable for each goal, including expected annual return and volatility. Portfolios can be customized for each goal, with varying levels of risk and asset allocation. For example, a long-term retirement goal may allow for a more aggressive allocation compared to a short to medium-term goal like buying a house.

## Wealth Maximization

A wealth maximization-based approach is for those who prefer to concentrate on capital growth overall. The focus is on achieving the highest possible returns given the client's risk tolerance. The assessment can determine the suitability of a client's desired annual return, given their risk tolerance and investment horizon. Users should be informed and asked to give their consent about the possibilities of short-term losses associated with their return expectations. This can be projected using historical data. Based on the assessment, portfolios can be constructed to optimize the risk-reward trade-off with an emphasis on growth.

The choice between goals-based investing and wealth maximization approaches depends on the client's individual financial situation and objectives. Financial advisers use the results of the risk assessment to guide the construction of portfolios that best serve their clients' needs and preferences.

## Client Communication

In the context of risk assessments, client communication needs to consider the importance of transparency, understanding, and actionability to ensure favorable results for both clients and advisers.

### Transparency

Behavioural risk assessments should ensure transparency between financial advisers and their clients. They can achieve this by clearly communicating the assessment process and outcomes to the client, thereby building client confidence in the results. In adviser–client relationships, transparency may be hampered when advisers do not share information with clients on a timely basis. Risk assessments can provide a technological solution to this problem by automatically generating and distributing (via email) reports to both advisers and clients. This encourages regular meetings that help strengthen the relationship, facilitate open communication, and build mutual trust. In addition, advisers do not have the option of either sharing or not sharing sensitive information like risk profiling. This also ensures that they are upfront with their clients about what they can and cannot do.

### Understanding

Advisers should walk clients through the risk assessment process step by step with the use of scenarios, helping them comprehend the questions and factors that influence the outcomes. In the context of risk assessments, advisers should ensure that clients understand the concepts of risk tolerance, capacity, and need. The assessment allows advisers to help clients understand the trade-offs between risk and return, and in goals-based assessments also the implications of different risk levels on their financial goals. They can also help clients understand themselves better. Having a clarifying conversation about client goals enables both the client and the adviser to focus on what



truly matters to the client and to differentiate between 'real' needs and 'nice-to-have' wants. Prioritizing goals based on criticality is a simple and effective way to do that and further customize the discussion.

## Actionability

Based on the risk assessment results, advisers can make actionable recommendations that align with the client's risk tolerance, capacity, and need. Advisers are able to use assessment outcomes to create portfolios that reflect the client's risk profile, while helping them pursue their financial objectives, whether they are goals-based or wealth maximization oriented. Reports should include key discussion points. If all factors align, the green light to proceed with portfolio implementation can be given. If the risk need exceeds the client's risk tolerance, the adviser is cautioned to allocate only after discussion with the client. If the risk need exceeds investor's risk-taking ability, goal achievement should be flagged as problematic and the client encouraged to reevaluate goals. A final key discussion point should include information about the amount by which the investment needs to be increased or decreased given the total amount required and assuming that it is funded at maximum risk capacity.

Taken together, risk assessments can foster transparency in the adviser's communication with clients. They should ensure that clients understand the process and implications of their risk profiles. Reports should focus on actionability, which allows advisers to translate assessment results into concrete implications to help clients achieve their financial goals, whether these are based on wealth maximization or meeting specific financial objectives.

## Expectations

In case the wealth maximization goal is chosen, a risk assessment tool should enable clients to understand the immediate downside risks associated with making investments that aim to reach the expected return over the longer term. If goal achievement is chosen as the objective, the tool should enable the client to have an appropriate expectation about the probability of meeting their goal given their risk profile and risk capacity.

## Advanced Features

Financial risk assessment tools should be part of a robust framework, safeguarding both financial advisers and their clients while promoting ethical integrity and data security. This can be done with additional features that address information security, client repudiability, and the implementation of a red-flag system.

## Information Security

In order enhance information security, risk assessment tools should include IP address tracking capabilities. This is important for financial advisers and their clients, as it allows the adviser to verify the access is legitimate with the client before allowing sensitive transactions. In addition, IP address tracking can verify the client's identity and helps confirm if the client was the one who really filled out all the required information asked by the Risk profiler. Finally, the technology enables geographic login alerts. Advisers can set up alerts to be notified whenever there is an account login from a new IP location, so they can confirm with the client it is legitimate access. This is particularly useful for elderly clients or those with substantial assets. In summary, IP address tracking is an important tool



in a financial adviser's arsenal to verify client identity, ensure authorized access, and monitor accounts for anomalies.

## Client Repudiability

Client Repudiability is important because it protects clients from harm. Repudiable companies are more likely to engage in unethical practices, provide poor service, fail to deliver on promises or even commit fraud against clients. Repudiable companies may exploit clients for money, data, or other benefits without concern for their well-being. Their lack of integrity and responsibility makes them unsafe partners for clients. Avoiding repudiable companies helps clients steer clear of these risks. It also safeguards their financial and personal well-being.

For financial advisers, client repudiability refers to working with clients who exhibit characteristics that could jeopardize the adviser's business or reputation such as dishonesty or unethical behaviour. Unethical clients may lie about adviser interactions or fail to disclose important information. This could damage the adviser's reputation if discovered and may violate compliance standards. Some clients with unreasonable expectations about investment returns or financial outcomes can ultimately become dissatisfied and file complaints that hurt the adviser's reputation. They pose litigation risks.

These risks can be reduced with client consent and client non-repudiability. Once a risk profile is generated, clients should be asked whether they agree or disagree with the risk profile analysis. By getting the client to indicate their response, the risk assessment system ensures that both the adviser and client are on the same page, and that this agreement or disagreement is systematically captured.

## Red-Flag System

Risk assessment tools provide a systematic and digitized risk profiling system that can be offered on a periodic basis. As such, they should also include a tamper-proof fraud/input detection and audit trail. To prevent fraud, key input factors can be tracked over time and major differences highlighted. For example, input factors may include changes in various input values, such as annual growth percentages, goal values, or time horizons. Capabilities can become more sophisticated over time as user data and stakeholder feedback accumulates.

## Regulatory Requirements for Risk Profiling

Following the recommendations provided within this report should help advisers meet regulatory requirements regarding risk assessments. As stipulated by the Securities and Exchange Board of India's regulations for Investment Advisers (2013),<sup>41</sup> risk profiling processes and tools need to ensure that necessary client information is obtained in addition to risk appetite (age, investment objectives including investment time and purpose, income details, existing investments/assets, as well as liabilities). In addition to assessing risk tolerance, advisers must also understand a client's capacity for absorbing loss and whether the client is willing to accept financial risks, while appropriately interpreting client responses to questions.

If tools are used for risk profiling, these need to be fit for purpose (with limitations identified and mitigated). Risk questionnaires have to be fair, clear, not misleading, and understandable by clients. Advisers need to communicate risk profiles to the client after the risk assessment is done and get their consent for the same. Finally, information provided by clients and their risk assessment has to



be updated periodically. A risk assessment tool needs to conform to these regulations before it can be considered acceptable.

## Risk Assessment Value and Impact

Assuming behavioural risk assessments conform to regulations, financial advisers who employ them in their work with clients can reap several benefits for both their clients and advisory practice.

***Empowering Clients with Self-Awareness.*** A comprehensive assessment delves into clients' financial mindset, providing them with insights into their own biases, preferences, and risk psychology. As result, clients gain self-awareness, as well as the ability to make informed investment decisions aligned with their psychological traits and goals.

***Equipping Advisers with Valuable Insights.*** Advisers receive detailed reports on their clients' risk psychology and financial aspirations, which provides the knowledge to offer tailored investment solutions. Armed with this data, advisers can tailor recommendations that resonate with individual clients.

***Growing Deeper Client Relationships.*** Client risk assessments foster communication and personalized recommendations,<sup>42</sup> which demonstrate the adviser's commitment to serving the client's best interests. This builds engagement and trust.<sup>43</sup>

***Increasing Client Conversion.*** Being invited to complete a risk assessment, taking the assessment, and discussing results with their adviser is a powerful tool to activate leads and engage prospects. The assessment's tailored approach enhances the adviser's value proposition.<sup>44</sup> Prospective clients are more likely to convert to clients when they see how a personalized approach can benefit their financial future.

***Strengthening Client Retention.*** Advisers can use assessment tools to continuously monitor and adjust portfolios based on client psychology and evolving goals. This helps maintain portfolio relevance. Clients who experience personalized service in the form of both customization and communication are more likely to stay with their advisers.<sup>45</sup>

***Gaining Compliance Benefits.*** Implementing risk assessment tools aligns with industry best practices and regulatory requirements. The Assessments should provide a robust "know your customer" (KYC) framework from a planning and advice perspective for understanding each client's unique financial psychology in relation to risk.<sup>46</sup> It provides a standardized, data-driven approach, which ultimately bolsters documentation and reporting, risk mitigation associated with client repudiability, as well as client protection.

## Conclusion

Traditional approaches to assessing an investor's risk profile are often overly simplistic or incomplete. This paper discussed the behavioural dimensions that should be considered in a more comprehensive risk assessment. Our main points included:





1. We can get a fuller picture of an investor's risk psychology if we consider not only risk tolerance, but also underlying behavioural factors, such as loss aversion, risk composure, and financial engagement.
2. This information not only helps advisers identify potential associations and blind spots in client decision-making, but also allows for more precise calibration of risk scores, influencing portfolio construction to better suit individual profiles.
3. Alongside risk preferences and underlying risk drivers, a full risk profile needs to consider risk capacity and risk need.
4. Risk assessments can further evaluate risk suitability based on either client goals or wealth maximization.
5. Risk assessment tools should ensure that transparency, understanding, actionability, and client expectation requirements are met in adviser–client communications.
6. They should also provide technological solutions to information security, client repudiability challenges, and fraud detection.
7. Behaviourally-informed risk assessments that meet these standards and regulatory requirements can become a compelling solution for financial advisers who wish to gain better insights for both their clients and their advisory practice, whilst also improving client communication, conversion, and retention.

Ultimately, behaviourally-informed risk assessments can empower both clients and financial advisers by driving positive outcomes through more personalized financial services.



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7th Floor, 701 / 702,  
Madhava Bldg, Bandra Kurla  
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