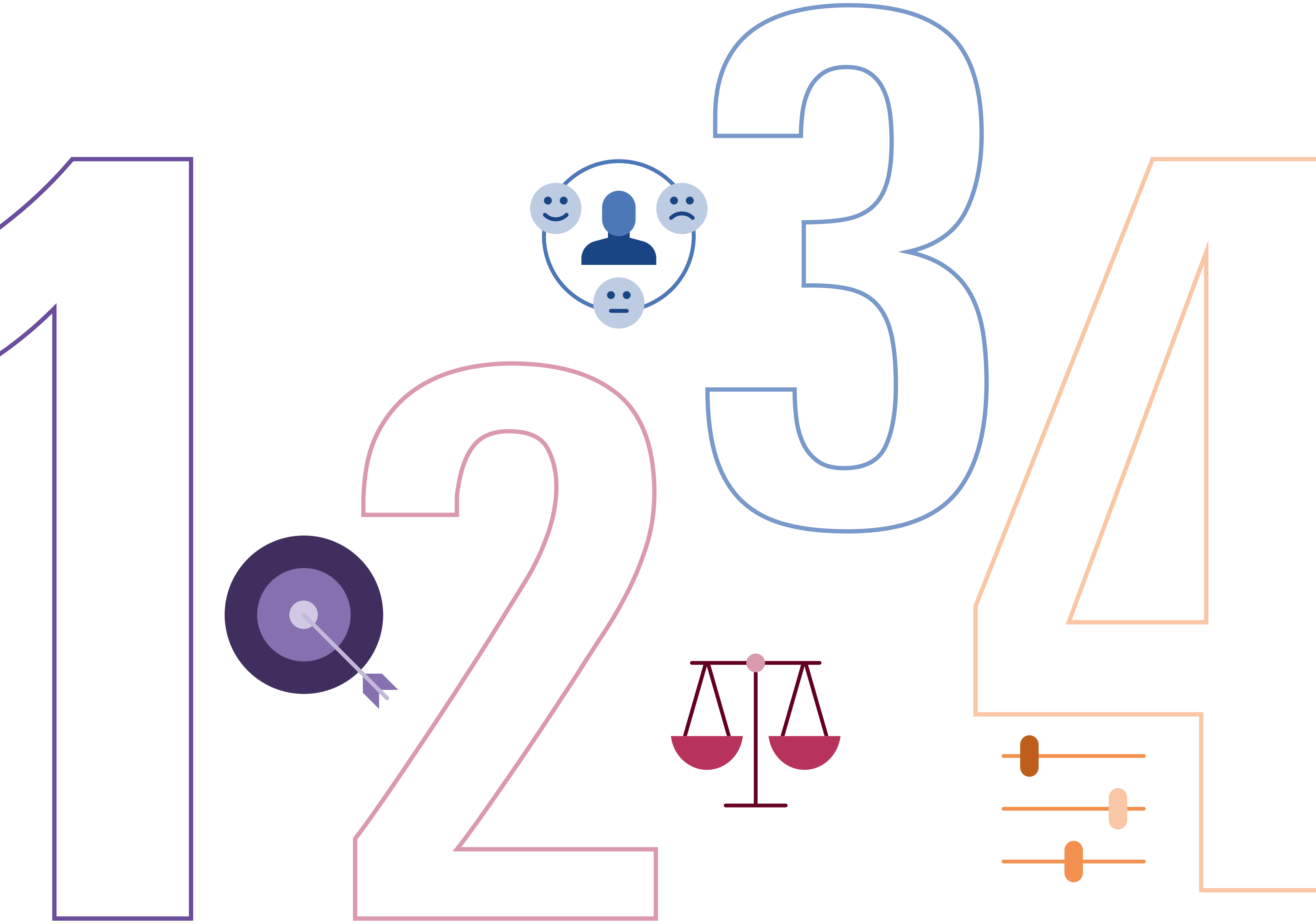
The 4-Step Guide to Creating Holistic Risk Profiles



Learn the process for evaluating your clients' risk profile featuring questions from Morningstar's best-in-class risk tolerance questionnaire.

[1] 1 E*Trade Advisor Services Report. (2019). Client Retention: Why Clients Leave and Five Ways to Encourage Them to Stay.

https://www.fa-mag.com/userfiles/ads_2019/ETRADE_May_2019/AI_Report_Client_Retention_ver2.pdf

Research from an E*TRADE report about client retention shows that more than 1 out of 5 clients leave their advisors within the first year. Among a variety of reasons why clients leave, there's one that stands out.[1]

Advisors don't understand their clients well enough.

Specifically, clients don't feel like their advisors have a good enough understanding of their willingness to take risks.

Every investment opportunity comes with risks, and no two clients will share the same risk preferences and experiences. To retain those clients and drive their financial success, advisors help each client complete a Risk Profile to help them make decisions that are in their best interests.

Where do you start? Let's start with what can be measured.

The four core components of a holistic risk profile are:

- Risk tolerance
- Risk composure
- Risk capacity
- Time horizon

HOLISTIC RISK PROFILE

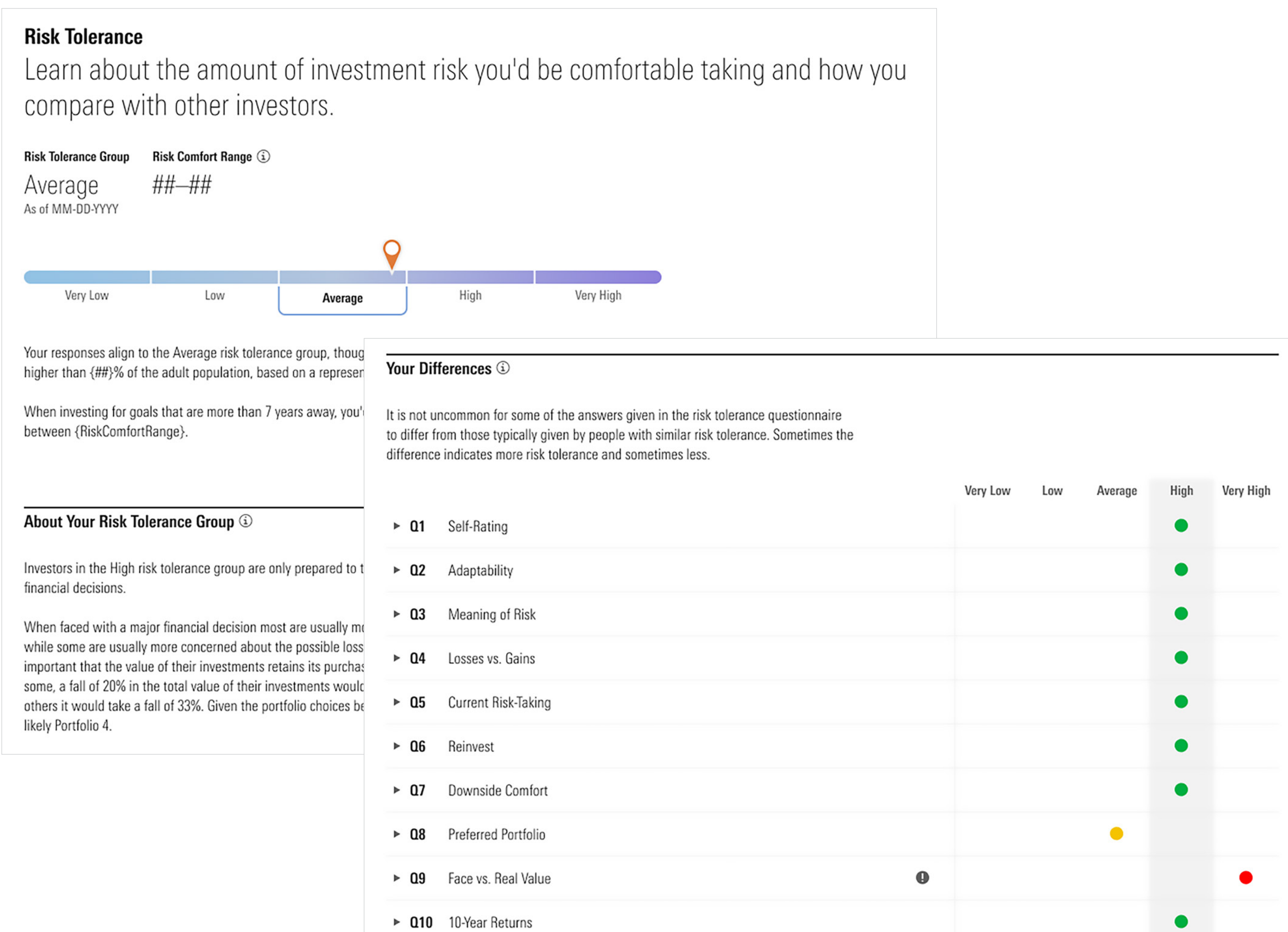
Morningstar has questions for advisors to ask during each of the four steps to create a holistic client risk profile based on emotional stamina, financial bandwidth, and comfort levels.

Step 1

Risk Tolerance: how much risk can your clients psychologically handle in a volatile market?
Every client has a limit on how much they are comfortable with losing if an investment performs poorly. This step has questions designed to get a clear picture of what that limit looks like.

Along with the Morningstar Risk Tolerance Questionnaire, below are some conversation starters to get a gauge of your clients' risk tolerance:

- How do you usually feel about your major financial decisions after you make them?
- Have you ever invested a large sum in a risky investment mainly for the "thrill" of seeing whether it went up or down in value?
- If you plan to place 25 percent of your investment funds into a single investment that's projected to earn twice the CD (certificate of deposit) rate, but you don't get protection against lost money, how much money are you comfortable with investing and possibly losing in the event of a downturn?



Upon completion of the risk profile, the Risk Tolerance report displays the assessment results.

Step 2

Risk composure: have your clients previously handled volatile situations well?
Risk composure measures how well your clients can regulate their emotions in both good and bad situations while keeping a clear head to make data-backed investment decisions.

As you speak with your client to understand their long-term goals and the resources available to reach them, be thinking beyond their financial traits. Ask them about their history with large purchases, their family life, how they currently allocate their income, and the types of regular expenses they have.

These kinds of questions can tell you more about who they'll be in a risky situation because you get a sense of them as a person. Different lifestyles, ages, and other info about your clients' daily lives may all impact their risk composure.

After you've spoken with your client, ask yourself these questions to understand their risk composure:

- Is your client impulsive or careful? Do they jump into investment fads because they're afraid of missing out on the chance to get rich quick?
- Do they appear anxious about making decisions or not knowing an answer? Do they panic and contemplate selling off their portfolio because they feel trapped without enough information to do anything else?
- Does your client have any prior investing knowledge or experience that can help you assess their risk composure?

Risk composure helps you understand how well clients will stick to the plan during periods of instability.

Step 3

Risk capacity: do your clients have the means to take risks?
Willing doesn't always mean able. Risk capacity focuses on client's financial circumstances, including income and other cash flow needs. A client might have a big risk appetite, but they might not be able to afford to invest in high-risk activities.

Take time to ask yourself these questions of your client:

- Is your client confident in their job security, or do they want to preserve a financial cash cushion?
- Do they have emergency savings funds, and if so, how much?
- What, if any, debt payments need to be taken into account, such as a mortgage or car loan?
- What sources of guaranteed retirement income will be available to them?
- If the worst-case scenario happens with their investments, are they able to maintain an acceptable standard of living that covers necessary expenses in the long term?

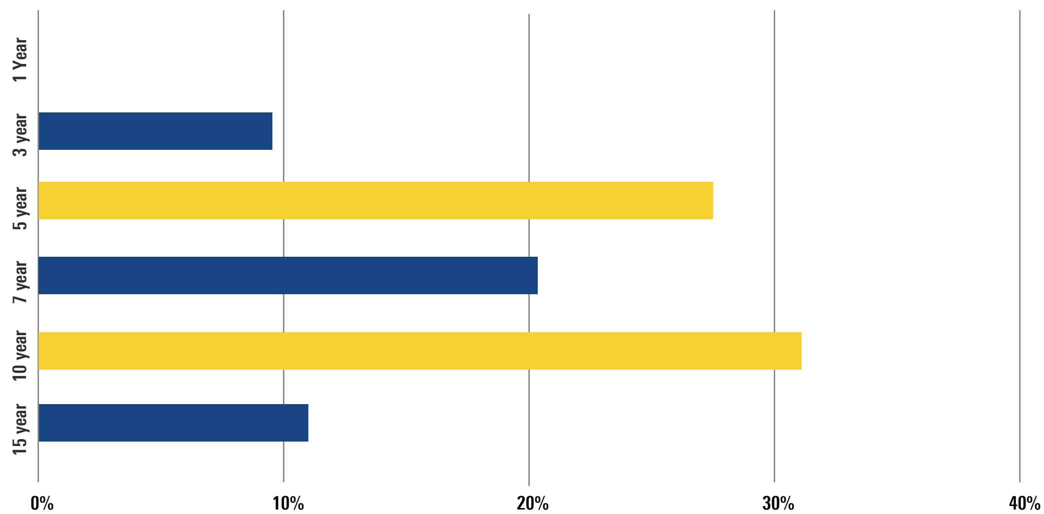
Step 4

Time horizon: can your clients withstand the recovery time for a possible bad investment outcome?

Even the most aggressive investor client is bound by time and impacted by a time horizon, or how long a portfolio can remain untouched while pursuing investment opportunities. Time horizons may constrain how much risk investors take on. A lengthier time horizon gives investors more room to pursue aggressive portfolios, as long as they are comfortable doing so.

With a near-term time horizon, following a less risky path is more critical because investors have less time to wait out a market downturn before needing to make a withdrawal. If clients must pull out money during a market dip, they lock in their losses and miss out on the market recovery.

A Morningstar survey found that advisors hold varied opinions on how long a client needs to hold a portfolio without withdrawals so that time horizon is not a concern.



How long can your clients withstand a downturn period without making withdrawals that make an impact on their long-term investments?

As you continue building your client relationships, remember that risk profiling is only one piece of the puzzle. Turning this reliable data into an actionable effort will help you achieve regulatory compliance while maintaining strong, long-term client connections that benefit both of you.

Advisor Workstation's Investment Planning experience and risk profiling capabilities provide advisors with reliable, defensible and actionable data to help them keep their clients invested for the long term.

Get a demo today.

Visit: www.morningstar.com/products/risk