Voice of Money

Risk Profile: Model Portfolio to Optimal Portfolio

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RISK PROFILE & MODEL PORTFOLIO

Over the years, financial planning has revolved around the suggestion of a model portfolio to clients, based on their risk profile. The client's risk profile is assessed from her responses to a set of questions. Accordingly, the client is categorised as very conservative, moderately conservative, moderately aggressive or very aggressive. The number of categories may be increased for finer grouping of clients. A model portfolio is pre-determined for each risk category. For instance, the model portfolio for a very conservative investor may be defined as 10% equity, 75% debt and 15% gold.

This traditional approach suffers from the following limitations:

- The client is assessed based on her responses to different market events. But the assessment is largely focused on one dimension – *psychological ability to take risk*.
- The *financial ability to take risk* is largely ignored. Thus, a person who has a high psychological ability to take risk may be suggested an aggressive portfolio, without considering the financial realities of the client, whose basic needs themselves may be unmet.
- The *knowledge ability* of the client too tends to be ignored. This violates a fundamental principle of financial planning viz. the client should be aware of the risk being taken.
- Most risk profilers do not assess the degree of reliability of the risk score.
- The client may not like the risk category into which she is grouped e.g. People may be conservative but may not like being called so!
- Linking the model portfolio to the risk category limits the scope to customise a portfolio to the individual client. Within a risk category, every client would have the same model portfolio, irrespective of inter se differences in their tolerance to risk.
- The asset allocation, in many cases, is limited to debt and equity – and in a few cases gold. Real estate is not a part of most model portfolios. Similarly, the asset allocation tends to ignore the speculative element in client portfolios.

3-D FRAMEWORK FOR OPTIMAL PORTFOLIO (3-D FOP)

3-D FOP assesses the risk profile of the client along 3 dimensions, viz.

- Psychological ability to take risk
- Financial ability to take risk
- Knowledge ability to take risk

Based on this, it proposes an optimal portfolio, which is customized for the individual.

PSYCHOLOGICAL ABILITY TO TAKE RISK

This is the one dimension that all current risk profilers seek to capture. Being subjective in nature, the client's responses to multiple scenarios from personal and professional life can be assessed. For instance:

- If you have won ₹50lakh in 'Kaun Banega Karodpati', will you choose to go for another question? A correct answer to the next question will take your prize money to ₹1crore. But, with a wrong answer, you will lose the entire ₹50lakh you have won so far.

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- Suppose, you are employed in a company, where your boss gives you two choices – (a) Continue in the same job with a 30% cut in salary (b) Leave the job immediately with compensation of 2 months' salary. What will you choose?
- As you are driving, the traffic signal changes to yellow. What will you do? (a) Accelerate, so that you cross the signal before it turns red (b) Decelerate, so that you stop at the signal, even if it is yellow.
- How much loss can you bear in your investment portfolio, before it starts disrupting your sleep?

Consistency in the answers across scenarios would be an indicater of the degree of reliability of the psychological risk assessment. If the reliability is low, the client can be prompted to repeat the exercise after a month.

The psychological ability to take risk would suggest an allocation to equity for the client.

FINANCIAL ABILITY TO TAKE RISK

The client's emergency funds requirement must be fully covered, before she starts considering investment in risky assets. Thereafter, the financial ability to take risk would be influenced by the following factors:

- Basic needs are covered for how many years?
- Ownership of home
- Ownership of car
- Borrowings & Repayment Commitment
- Number of earning members in family
- Number of dependents in family
- Life insurance coverage of the earning member
- Medical expense coverage through insurance or employer
- Stability of job / income in last 3 years
- Kind of employment viz. entrepreneur who is self-employed or part of Small and Medium Enterprise (SME); Established entrepreneur; Employee in unorganized sector; Employee in an established set up.

The financial ability to take risk may suggest an allocation to equity that is different from the one suggested by the psychological ability to take risk.

KNOWLEDGE ABILITY TO TAKE RISK

The client can be asked basic questions about financial markets and investments. For instance:

- Shares are a form of debt investment True / False
- What is the maximum possible loss with investment in shares? 0%, 25%, 50%, 100%?
- Investment in shares yield income in the form of interest True / False

The objective behind these questions is that if the knowledge ability is low, then the client's portfolio ought to be biased lower in terms of equity.

TOWARDS AN OPTIMAL PORTFOLIO

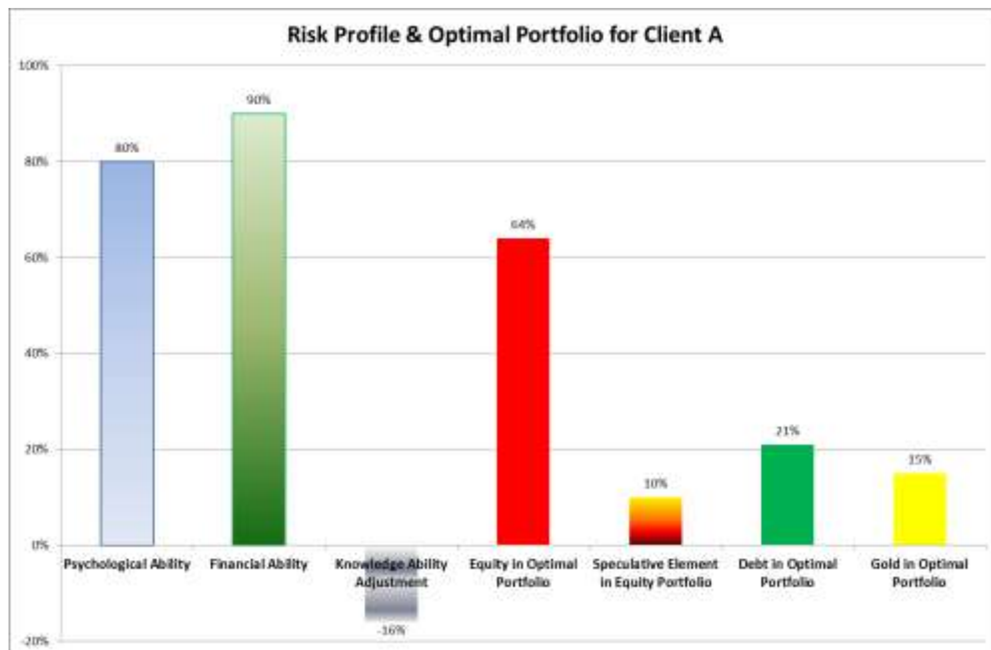
The allocation to equity in the client's portfolio should not exceed the minimum suggested by the first two dimensions viz. Psychological ability to take risk and Financial ability to take risk. Further, based on knowledge ability to take risk, the equity component may have to be reduced even further. On this principle, the Optimal Portfolio can be suggested as a mix of Equity, Debt and Gold.

Investment in one house that one intends to occupy should ideally not be viewed as investment. Additional investment in real estate can be suggested for investors with larger wealth corpuses who have met defined financial needs.

SPECULATIVE COMPONENT IN PORTFOLIO

It is normal for clients to feel excited about frequent trading in equity, transactions based on tips etc. It is the job of the financial planner to sensitise the client to the perspective that these are more in the nature of speculation. The optimal portfolio can include a suggestion on the maximum speculative component, within the equiy allocation. In general, the speculative component in the portfolio should not exceed 12%.

The image below explains figuratively, the position of Client A:



The image can be interpreted as follows:

- Psychological ability to take risk suggests an equity component of 80%
- Financial ability to take risk suggests an equity component of 90%
- The lower of the two is 80%
- Based on Knowledge Ability, the equity component needs to be reduced by 16%. Thus, based on 3-D FOP, the equity component in the optimal portfolio would be 80% *minus* 16% i.e. 64%.
- The speculative component in the portfolio should ideally not exceed 10%.
- The optimal portfolio would include 21% in debt and 15% in gold.
- Based on more complete information about the client's finances, real estate too can be added as an asset class. The real estate component would be carved out of the equity component, both being growth assets.

The 3-D FOP image can be a tool for the planner, while the client may be shown only the actual asset allocation suggested by 3-D FOP.

INDIVIDUAL OR FAMILY

The psychological ability and knowledge ability would be different for different members of the family. An approach can be to consider the average of the scores for the earning members in the family. Alternately, we can go by the score of the person who takes financial decisions in the family.

Financial ability clearly needs to be assessed at the family level.

CONCLUSION

The 3D-FOP, thus, can be the basis for customized advice to clients. It can be combined with the Financial Blood-Test Report (FBR) for a sound and path-breaking approach to financial planning.