Lifeworks

# Going Beyond Risk Scores to Reinvent Retail Investing

BY ALEX MATHÉ-CATHALA

Lifeworks originates from the idea that **best practice is never good enough**. In this article, we highlight the flaws of risk scores and explain how we can do better for investors.

Risk surveys are a norm when it comes to investment advice. They may vary in content and length, but their common purpose is to distill an investor's complex profile into a single measure of how much risk their portfolio should assume. Inputs include age, wealth, income, investment horizon, and investor behavior. The resulting measure, either qualitative ("conservative," "aggressive") or quantitative ("6 out of 10"), is meant to be reductive enough so as to be interpreted by the person or the algorithm building the portfolio. It ultimately determines the target volatility constraint inputted in a portfolio optimizer function.

There is no denying that it is hard to design the perfect survey: from the impact of recent market performance to question order, many factors can negatively influence the quality of the final metric. **But is this delicate practice helping investors achieve their goals at all?** Can a single score summarize complex situations and allow for effective capital allocation? Should advisors rely on it? Should they use it at all? We answer those questions by the negative and suggest a better approach.

## Risk surveys focus on the wrong thing

**Risk surveys are a limited** – or even counterproductive – tool because their output is used to optimize for the wrong objective function. They focus on appetite for market risk, and try to qualify ("conservative," "aggressive") or quantify it ("your risk score is 1" or "your risk score is 10").

However, **investors only care about achieving their goals.** Investors do not fully understand, and often do not want to learn about, investment risk. They have valid reasons: they lack time, interest, or skills, or all the above. After all, division of labor has been around since even before the first primate erected on two feet, and clients should no more expect to break the back of their financial advisors' work than they expect to fit and stitch together leathers in place of their shoemakers. Yet, the way their money is invested today often depends on their answers to questions on their investment philosophy.

Take a look at some sample survey excerpts.

**Registered investment advisor in California:**

Which one of the following statements best describes your feelings about investment risk? I prefer:

- An aggressive mix of investments with emphasis on a higher degree of risk that may yield greater returns
- A balanced mix of investments, some with a low degree of risk and others with a higher degree of risk that may yield greater returns
- A mix of investments with emphasis on a low degree of risk and a smaller portion of others that have a higher degree of risk that may yield greater returns
- A conservative mix of investments with a low degree of risk, so I am less likely to lose my original investment

On a scale from 1-6, please select the level of risk and return you are most comfortable with:

- 1 (lowest risk and return)
- 2
- 3
- 4
- 5
- 6 (highest risk and return)

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A graduate of MIT with a Master's in Finance, Alex worked at Morgan Stanley, Rothschild, and other notable investment firms. Before joining Lifeworks, he was the Founder and CEO of Aimvest Technologies, a quantitative investment technology firm helping financial institutions and advisors manage risk for their clients. Aimvest was named one of the Top 15 MIT Startups to Watch in 2020 and acquired by Lifeworks in 2021.

When Alex and his team aren't developing algorithms to augment our investment offerings, they are preparing market insights and quantitative analyses that add value to our advisors and clients.

**One of the largest registered investment advisors in the world:**

Generally, I prefer investments with little or no fluctuation in value, and I'm willing to accept the lower return associated with these investments.

- Strongly disagree
- Disagree
- Somewhat agree
- Agree
- Strongly agree

**Wealthtech company helping investment advisors assess their clients' risk profiles:**

You invest $500,000. What would you prefer?

- Certain gain of 10% (you'd have $550,000)
- Take 50/50 risk. Heads, you lose 20% (you'd have $400,000); tails, you gain 150% (you'd have $1,250,000)

Isn't it unreasonable to assume that investors can easily answer these questions in a precise manner, without being influenced by their daily mood or something else around them at that time? Instead, wouldn't it be much easier for advisors to strive to find out what their clients seek to achieve and let them express it in meaningful terms, and then use that for a better tailored investment advice?

## Risk scores imply sub-optimal deterministic risk loading

Optimal risk loading through time cannot depend on time only!

**Under the current paradigm**, investment services providers cannot successfully optimize portfolios for financial goals. Indeed, age, wealth, income, behavioral patterns and other components inputted in the portfolio optimizer at the beginning of the investment period produce an output – an allocation strategy – which r**emains unchanged** until the end of the investment horizon, unless the client retakes a lengthy risk survey or their advisor chooses to reallocate assets based on a rule of thumb.

**Such practice fails to maximize probability of success.** The particular case of glide paths is worrisome: future risk levels are determined at the start of the project based on the initial risk score, implying that portfolio value evolution is not considered a relevant variable.

## Risk surveys blur the value of advisors

**Throwing investors into risk buckets** is a poor though common strategy which **prevents advisors from creating as much value as they could.** In addition, the advent of robo-advisors has been obviously challenging their added value to the retail investing value chain. Robos seamlessly integrate risk aversion surveys and diligently construct model portfolios, mimicking the services offered by traditional advisors.

But **advisors can foster the new revolution.** By restricting risk surveys to a compliance tool and shifting the paradigm away from risk scores, they will be able to help clients define their goals in meaningful terms and target them more accurately. Advisors will be at the center of a feedback loop where every input directly influences outcome distribution, and where they will leverage their most valuable asset, their relationship, to set their clients on the right track to achieve their goals.

Lifeworks started with a philosophy – that providing investment services is about exposing clients to a distribution of outcomes closely matching their goals. The current paradigm, arbitrarily mapping clients to a limited set of generic portfolios based on reductive risk scores, was far from being able to support our vision. We created our own model: risk surveys are replaced by collaborative efforts from both the client and the advisor. The mandate is defined in intuitive terms, the objective is quantifiable, capital is managed dynamically to maximize the chances of achieving the client's goal, and success or failure is verifiable. **Client's expectations are wisely managed, and their trust is earned through future validation.**