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Should you be penalized for being prudent with clients' portfolios?

Sometimes it's suitable for your clients' investments to be less risky than their maximum risk tolerance

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(Published by Investment Executive | October 16, 2020)

If your client, Mary, has a 100% medium risk profile and her portfolio is a blend of medium and low-risk investments, does that make her account unsuitable? Word has it that the regulators' answer might be yes.

For as long as know-your-client (KYC) forms have existed, advisors have had to complete the risk area with the answer to a single question: What is the client's "risk tolerance"? The definition of risk tolerance is "the client's willingness to accept risk." That means clients assess for themselves how much investment risk they can tolerate.

The client-focused reforms (CFRs) expand the concept of a client's "risk profile" and explain that advisors need to consider, along with risk tolerance, "risk capacity," which is defined as "a client's ability to endure potential financial loss". While this expanded definition of a client's risk profile is an improvement, regulators or dealers who suggest the risk rating of every investment in Mary's account must match her stated risk profile may have lost sight of the context of a client's risk profile.

Risk is not the goal of a client; it is a by-product of the pursuit of a client's goals and objectives. Risk, in this context, is volatility (standard deviation), so the KYC exercise is to determine the degree of volatility (downward, of course) that your client is willing to take.

Using the above example, if Mary's objective is an average annual growth rate of 6% and you exceed that goal year over year with low- and medium-risk investments, shouldn't we be applauding you rather than admonishing you for not precisely matching every one of Mary's investments to her risk profile?

If you explained to Mary that your plan is to keep her risk level at no higher than 100% medium while still attaining her objectives, wouldn't Mary be happier taking on less risk? Or should you switch Mary's holdings into higher-volatility funds? In essence, that would be like saying to Mary: "I have not given you the full measure of volatility that you said you are willing to accept. How about we change to a more volatile portfolio?"

Can I suggest that we treat clients' risk profiles more like the way we treat the speed limit? We should never exceed it, but sometimes it makes sense to drive a bit slower due to conditions. When we do drive slower, we don't need to change the road signs. Of course, if Mary's portfolio is significantly under her stated risk tolerance and she is not meeting her objectives, that is a different matter. We don't drive 50 km/hr on a highway where the speed limit is 100 km/hr, but it may be reasonable to go 90 km/hr in some circumstances. We should not be penalized for being prudent with clients.

In my view, the key is to not hold advisors to perfectly matching a client's risk profile to the risk rating of each and every investment in her portfolio — as long as the investments are not over the client's indicated risk profile.

My advice is to continue your dialogue with clients so they understand your approach. As long as there are notes in your client's file or investment policy statement, I suggest that driving slower than the speed limit is appropriate in some circumstances, particularly when the market is showing some volatility and your judgment — given the client's circumstances — is to play it a bit safer.

Of course, if there is a significant difference in your clients' risk ratings and your investment choices due to market volatility, it would be prudent to have conversations with them to determine if any of your clients' KYC risk profiles should be changed, given current circumstances.

All this is to say the addition of risk capacity to the KYC process is a good thing — but the balancing of a client's risk profile and their objectives should not be lost in translation.

I want to thank Howard Mix for reaching out to me suggesting this important topic.