THE ADVISOR'S GUIDE TO

Fearless Investing

Here's to the advisors who empower the world to invest fearlessly. You're the real heroes, and that's why we believe the financial advisor is someone worth betting on deep into the future. Thank you—we couldn't have built this movement without you.

—Aaron Klein, CEO at Riskalyze.

CONTENTS

01

Investing is Broken

Warren Buffett probably said it best. “Stocks are the only thing consumers refuse to buy when they’re at their cheapest and only want to buy when they’re at their most expensive.” This is a model that can’t work, and statistically, it doesn’t. In a bear market, investors wonder why their portfolios aren’t performing at the same level as the S&P 500, or some other guy’s mutual fund, or even matching the pinpoint projection of their advisor.

Advisors can be a barrier against poor, emotional decision-making, but if their projections are based on market averages that haven’t happened in 25 years, it only reinforces the investor’s fears:

I’m taking too big of a loss. Sell.

When there’s a bull market, investors (again) wonder why their portfolios aren’t performing at the same level as the S&P 500, or some other guy’s mutual fund, or even matching the pinpoint projection of their advisor:

I’m not capitalizing on these gains. Buy.

Investors have a natural tendency to buy when things are good, sell when they get scared, miss the recovery, buy back in when the markets “feel safe again,” and repeat until broke! Why does this cycle get repeated?

Investing is broken.

Let’s fix it.

Stereotypes Don't Work

For decades, the industry has followed the same thought patterns: young people have time to make up for market losses, so they must have an aggressive risk tolerance; whereas, older investors need to preserve the wealth they've already built, so they must have a conservative risk tolerance. Everyone else? Dashes of both. Did you know that, in most cases, those assumptions are dead wrong?

The industry has used these antiquated terms like "aggressive" or "moderately conservative" to make investment recommendations. Not only are these terms subjective (moderate means something different to you than it does to me), they're based on stereotypes that don't hold water.

Every investor has a unique tolerance regarding risk and reward that is frequently independent of age. After combing through our risk assessment data, we found that 52% of 20-29-year-olds don't fit their "aggressive" stereotype. And stereotypes don't work any better for older folks. 53% of 70-79-year-olds didn't fit into their "conservative" stereotype, either. Imagine if smartphones only worked <50% of the time—would people still buy them?

What happens when more than half of all investors are invested incorrectly? They panic during market volatility. Some feel greedy and buy; others sell out of fear. Both reactions might negatively affect their long-term goals. This cycle repeats itself until they eventually change their investment strategy, fire their advisor, or both.

Stereotypes suck.

Let's talk about words like "moderate" and "aggressive." When building a house, you don't see contractors using blueprints referencing a "conservative" hallway leading to a "moderately aggressive" kitchen (if you do, you might want to find a new contractor!). They measure with feet and inches.

When it matters, we use numbers. So why don't we build investment roadmaps that way?

When an advisor stereotypes an investor, they're not seeing the investor as an individual with a unique appetite for risk. The result is that natural fluctuations spark panic and human nature takes over. If a young investor doesn't fit their "aggressive" portfolio, wild swings in that portfolio go against their instincts. It becomes an increasingly impossible task for an advisor to convince their client to "stick with it" and stay focused on their long-term goals.

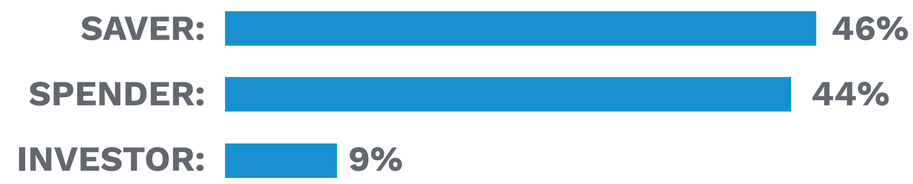
Let's start treating investors as the individuals they are. Let's empower fearless investing by getting a clearer image of risk tolerance and measuring it quantitatively.

Investors are Overwhelmed

There's no shortage of information out there—from the 24hr news cycle, to blogs, to Twitter, to financial analysts—everyone has an opinion about investments. More people are in tune with the ebb and flow of the market than ever before—yet fewer are investing, and market skepticism has never been higher.

MILLENNIALS: SAVERS, NOT INVESTORS

Millennials don't view themselves as investors. Here's how they describe their approach to finances:



SOURCE
2016 Fidelity Investments Millennial Money Study
George Petras, USA TODAY

According to a recent Fidelity study, less than 10% of millennials identify as investors; they prefer to save or spend instead.

Over the next 30 years, we're going to see the biggest transfer of wealth in history as Baby Boomers transfer nearly $30 trillion to their Generation X and millennial children. If those groups have no plans to invest, it affects market health for everyone when their parents' investments suddenly disappear.

Experienced investors face a different problem: *how do I know I'm on the right path?*

In either case, a financial advisor's words can be invaluable. Too often, however, investors remain confused.

Unsurprisingly, the old practice of throwing r-multiples and advanced statistics at investors until they're blue in the face doesn't actually make investors trust that advisors know best. Show us ten investors who have seen their standard deviation, and we'll show you ten very confused investors. Four out of three Americans are bad at math.

Handing clients a 30-page prospectus they'll never read doesn't promote the clarity investors need. The problem isn't too little information, the problem is that investors are overwhelmed.

Most industry products don't help. Fintech in the wealth management space isn't traditionally known for its effectiveness in client-facing contexts. It's tough to produce software that is powerful for the advisor, yet intuitive to their clients. Most tools err on the latter side, and the client suffers.

An advisor's role is turning complex data into a compelling roadmap. It's an uphill battle, but they'll never empower fearless investing any other way. If an advisor can't pull this off, it'll lead them to the same old outcome: investors have all of the data, yet are more confused than ever.

Bad Expectations Sabotage Us

An investor has an appointment with a financial advisor. They discuss plans for the next 5, 10, 20 years: buying a house, kids going to college, starting a business, etc. They have a conversation about investment options and the advisor recommends a portfolio that fits them best. Then, the following conversation ensues:

Investor: *What kind of performance can I expect out of my portfolio?*

Advisor: *Well, given your age and your time horizon to retirement, I believe this is the kind of portfolio that should help you toward your goals.*

Investor: *Sure—I figured that would be the case...I guess I'm just wondering how I'll know if we're on track. Where do you think we'll be at a year from now?*

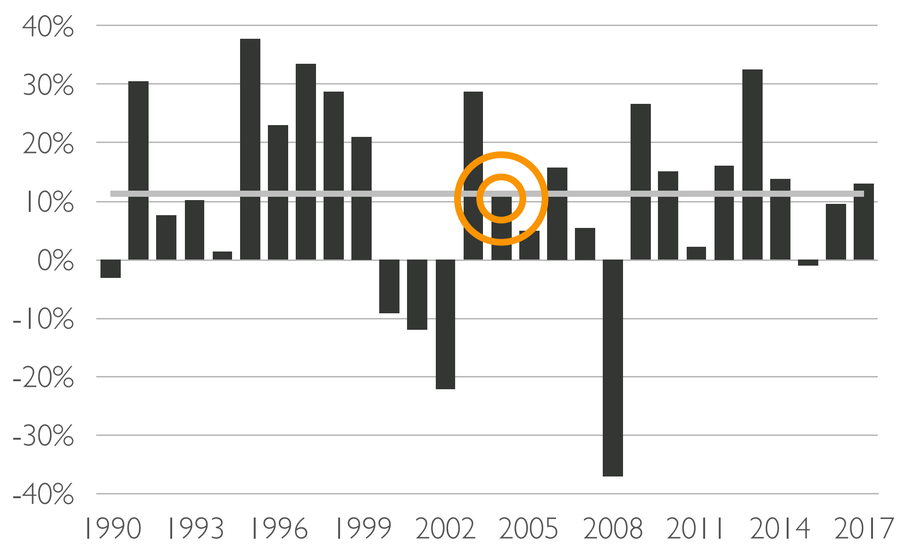
Advisor: *Well, I'm no prophet or shaman; I don't have a crystal ball. I can't predict where the market is going to be a year from now. That said, if we're thinking long term, I do think this portfolio is the right fit for you.*

Investor: *Wait a minute—I can't just sit back for thirty years in order to find out if we were right! I'm at least going to need an idea about what is considered "normal" year-over-year for this portfolio.*

Advisor: *I completely understand. I can't make any promises, but given our long-term perspective, this portfolio might make something like 8% year-over-year.*

The advisor's statement was technically accurate, but here's the problem: When the client looks back on this conversation, they won't remember much of it. In fact, there's only one thing they'll selectively remember: **8%**.

Just like that, bad expectations have been seeded and the advisor/client relationship is set up for failure. Sure, the market average might be 8%, but do you know how many times the market has hit its average in 25+ years? ONCE.



If returns are below the advisor's narrow target, investors aren't happy. When returns are above the target, they still might not be happy. Why? Because they ask questions like, *"Why is the market beating my portfolio?"* It's enough to drive great advisors insane.

If the portfolio didn't meet expectations, the investor assumes there must be something wrong and the portfolio needs to change. Hanging success or failure on a razor-thin margin is unfair, considering the standard fluctuation of the markets. Was an advisor wrong to capitulate and discuss returns? Not necessarily. Is there a better way?

Absolutely.

The Short Term Gets Ignored

Advisors have been trained that there are two things they should never discuss with their clients, and they're not religion and politics. We're talking about **risk** and **the short term**.

All of our research points to a simple truth: while investors should be focused on the long term, they react to risk in the short term, and emotional reactions to risk are the #1 killers of long-term financial goals and results.

Let's revisit a familiar conversation:

Investor: *Wait a minute—I can't just sit back for thirty years in order to find out if we were right! I'm at least going to need an idea about what is considered "normal" year-over-year for this portfolio.*

Advisor: *I completely understand. I can't make any promises, but given our long-term perspective, this portfolio might make something like 8% year-over-year.*

Déjà vu, right? Here's what happens next.

They shake hands, fill out the proper paperwork, and the client is officially invested! Fast forward to two months later: a merger between two companies the investor has never heard of causes a momentary shift and that 8% yearly portfolio is now -25% overnight.

An advisor can take the panicked phone calls and assure their client this fluctuation is temporary, but the damage has already been done. The client is scared, and their 8% promised return is out the window—through no fault of their own or their advisor.

While this is certainly a worst-case scenario, variations of it occur all the time for less severe losses. Downturns happen and are usually short-lived, but why the insistence on keeping clients in the dark on the short term? Sure, blips don't affect the bigger picture, but what happens now matters in the eye of the investor.

While "hanging in there" is the best way to ensure investing for the long haul, it's hard to go against human nature. Fear plays an important part in survival, and the trait carries over into all facets of life, including investing. Humans have greater motivation to minimize losses rather than earn gains.

Simply put: losses hurt worse than gains feel good. It's this ability to minimize risk to ourselves that makes us wonderful survivors—but less than ideal investors. Focusing on the long term is a good overall strategy, but it ignores the fact that all long-term investors are made one short-term decision at a time.

02

Why Have We Done it This Way?

Here's an interesting fact: railroad tracks in the United States are 56.5" wide. You might ask yourself:

"Huh, that's interesting. But why would they need to be that size?"

When they were extending the railroad across America, there were discrepancies in rail sizes. This meant that some trains coming from Chicago, for instance, couldn't use the tracks in San Francisco, and the trains coming from Atlanta couldn't use the rails in New York. It was a real mess. The railroad companies figured out that if they made the rails the width of the covered wagons they used to lay down the track, it would streamline the process and standardize the width—a real win-win. These covered wagons were 56.5" wide, which is why railroad tracks in the United States are 56.5" wide. And you may say:

"That is interesting. But...why are covered wagons that size?"

We associate covered wagons with the Wild West, but they actually have their origins in the Roman Empire. In the ancient world, wheels created deep ruts in the road and all carriages and wagons were designed to fit those ruts so the wheels wouldn't break. Ruts were about 56.5" wide, and building wagons to fit this width carried over into the conquered areas of the Empire and eventually into the New World. And you might ask:

"Wow, that's amazing. But...why were ruts in ancient roads in the Roman Empire that size?"

Well, Roman chariots were that wide, and they created those ruts in the road, which dictated the wagon size.

"But, why are Roman chariots, ruts in ancient city streets, Old World wagons, Old West wagons, and US Railroad tracks 56.5" wide?!"

Well, it turns out that 56.5" was the average width of two Roman war horses.

As humans, sometimes we can get into habits where we do certain things simply because it's the way we've always done them.

Why do we avoid conversations about risk? Why do we ignore the short term? Why do we stereotype investors?

Sometimes, it's just a two-horses'-asses kind of reason.

Let's Talk About Risk Tolerance

This broken investing cycle is a repetitive one—we stereotype investors based on bad data, investors sabotage themselves with bad expectations, we ignore the short term, and investors are too overwhelmed to know how to fix it. The key to breaking the cycle involves harnessing a four-letter word: risk. Why haven't we started the conversation with risk in the past? Because the industry doesn't have a track record of getting it right. But what is risk tolerance, really? Let's start with what it ISN'T:

The thrill you get from investing

If I'm collecting big returns, sure, investing does seem quite thrilling. But if interest rates rise or I lose a lot of money, I might find investing a lot less thrilling. This line of thinking is subjective and rooted in market sentiment, rather than a quantitative measure of risk tolerance.

Related to the car you drive

It's a laughable correlation that we've, unfortunately, seen firsthand. Similar to the first example, it assumes the car you drive must be a subconscious indicator of risk behavior. Love muscle cars? Surely you'll love this IPO! Reasonable sedans more your speed? Let's use cash and bonds to offset market volatility.

If this sounds silly, that's because it is.

Risk Questionnaires

If risk tolerance can't be determined with arbitrary questions or blindly guessed based on age, then the solution has to be more rigorous and objective. Many advisors use traditional risk questionnaires, but all too often these fall short. Asking multiple questions that tie into market sentiment and gains/losses with hypothetical dollar amounts won't get you better data—it'll just get you more bad data.

Revolutionizing Risk

Riskalyze came from a perfect storm of academia, investing, and technology—and an actual conversation between friends about risk:

"It's kind of crazy how ill-equipped the average investor is when it comes to addressing investment risk, isn't it?"

"If you think investors are ill-equipped, you should see what their advisors have to work with!"

(Hey, we didn't say we're fun at parties).
We knew there had to be a better way. Creating the world's first risk alignment platform is a two-sided coin, and the first innovation step was figuring out what those sides are. On the first side, we have concepts that didn't make it out of academia and into everyday use. We took Prospect Theory and built proprietary technology on top of it

to understand how to adjust a client's personal financial spectrum—understanding when they prefer risk and when they prefer certainty. An individual's aversion to risk is unique. Once that was done, we designed an algorithm that uses objective data and hypotheticals based on real dollar amounts and market performance to create a quantifiable measure of a client's risk tolerance: the Risk Number®. On the flip side, we need to match this measurement of risk tolerance with a portfolio. The inputs for this technology are largely market data. We effectively took daily pricing data for nearly a quarter-million securities—every U.S. stock, ETF, mutual fund, variable-annuity subaccount, SMA, third-party money manager, proprietary non-traded strategy—all kinds of different products. We take all the historical data, plus new data streaming into our systems nightly, and use that to understand trends over significant periods of time. If we don't have a long enough sample on a particular stock, we don't use "similar" stocks to cover the gaps—we keep the data honest, even if that means it's not there.

A return and a volatility model for each of those securities is completed every night and in real-time as the advisor builds the portfolio. There's also a cross-correlation analysis inside the portfolio and continuous evaluation of how the mix of securities within the portfolio actually corresponds to real risk. We roll all that data into a portfolio-wide Risk Number and 95% Probability Range.

Fast-forward 5 years: that conversation between friends was the impetus to create Riskalyze. Those friends? They're now co-founders. Our belief is that investors are sabotaging themselves, and advisors desperately want to help clients make the right decisions but lack the framework and context to do so. We've aimed to equip advisors with the technology to do that. With the right combination of professional guidance, backend technology, and risk assessment—we can empower the world to invest fearlessly.

Unlocking fearless investing, where investors and their advisors can set long-term goals and not succumb to emotional decision-making, occurs when we embrace the Third Wave of Advice. But first, let's see how the first two waves of advice turned out.

What is Prospect Theory?

Prospect Theory is an academic framework that won the Nobel Prize in Economics in 2002. It incorporates psychology into economic models and examines aversion to risk through a behavioral lens. Decades of academic research is empowering better decisions today.

Historically, academic studies focused on percentages as a reliable measure. Prospect Theory was different because it argued that people make choices based on two factors: A) their financial position, and B) what constitutes a "devastating" loss or an "acceptable" gain to them. Most often, people are more motivated to minimize losses. To accurately measure these factors, Prospect Theory proposed dollar amounts, not percentages. At Riskalyze, we took this framework and expanded it.

When individuals make choices based on their actual financial position, it presents real consequences for the decision maker. This is one of the ways in which our risk questionnaire has utilized and improved the theory most effectively: it's not just a dollar amount, it's an amount that is both specific and meaningful to the investor. This takes a scientific framework out of academia and into the real world.

Warren Buffett investing $100,000 of his fortune on a new tech stock would be modest, considering it's just a small portion of his overall wealth. A family investing their entire net worth of $100,000 in that same security means they are willing to risk a lot more. A $100,000 loss for someone like Warren Buffet would hardly be considered "devastating," and that's where risk tolerance plays a big role. This is what makes Prospect Theory a reliable framework for showing true risk tolerance.

Portfolio recommendations require quantitative measurements and as many questions as are practical in order to gauge inconsistencies. Generating hypotheticals based on portfolio percentage, instead of real dollar amounts, isn't relevant enough to be effective for investors.

Want a deeper dive into the numbers behind Riskalyze? You can view the academic paper that reviewed our methodology here.

03

The Third Wave of Advice

Wave 1
Focusing on Returns

It's the 1980's. Markets are booming. Investors are anxious to find the best broker, and brokers are hungry to onboard new investors. Commissions are high, and new reps flock to the profession continuously. With so many options, what incentive does an investor have to choose one broker over the other? It all came down to the broker's promises, of course.

"My mutual fund is way better than that guy's mutual fund. Trust me—you'll make way more money over here."

The first wave of advice died abruptly with the discovery of an unfortunate fact: his mutual fund actually wasn't better than that guy's mutual fund.

Wave 2
Long-term Goal Investing

Performance promises weren't a viable way to set expectations for investors. That sobering realization led the industry into the second wave of advice.

"Let me distract you by talking about your long-term goals."

Before we unpack the second wave, let's get something straight—of course it's wise to consider the long term. No decent advisor would undervalue the ultimate future of a client's financial health.

The issue here isn't that advisors focused on the long term; the issue is that advisors ignored the short term. Many advisors disregarded human nature altogether. This works about as well as your doctor saying, "If you exercise now, you'll thank yourself in 30 years." How often does that motivate you to go home and make the right decisions? (Short-term workout programs, on the other hand, have increased in popularity. They empower great decisions in baby steps, and ultimately can have a positive effect on long-term health).

The pendulum's overcorrection into the second wave caused many advisors to ignore returns completely. They began ignoring risk, ignoring human psychology, and focusing only on the long term. Staying far-sighted can actually be good advice—the problem is that humans are emotionally incapable of following it.

As we learned before: emotional, short-term decisions are the #1 killers of long-term financial goals.

Wave 3
The Fearless Investing Movement

The third wave of advice is about putting risk first. Advisors have woken up to the idea that the short term matters!

When advisors aren't afraid to talk about risk, investors aren't afraid to make the right decisions.

When advisors aren't afraid to talk about risk, investors aren't afraid to make the right decisions.

If you quantify risk alignment from the start, you're able to set clear expectations for investors. Knowing exactly how much risk is in their portfolio arms both the client and their advisor with the confidence to make informed decisions based on standards of predictability. Do these fluctuations fit within the guidelines of my risk profile? We can predict, with 95% probability, that they do. A clear understanding of how a portfolio can behave, in both directions, gives investors permission to "hang in there," even if markets are volatile.

The third wave of advice is catching on more quickly than we could've ever imagined. We're seeing it firsthand. When you quantify risk for an investor, you can empower anyone to invest fearlessly.

When you put a conversation about risk first:

No more stereotypes—a risk-tailored investment strategy that's a perfect fit.

No more overwhelmed investors—information is relevant and easy to understand.

No more ignoring the short term—use short-term decisions to make long-term investors.

No more bad expectations—investors are clear about what is "normal" for them.

04

Empowering the World to Invest Fearlessly

Putting risk first is the key to unlocking fearless investing—but is all risk the same? How do we reconcile risk tolerance with risk capacity? Fearless investing means having both the confidence and the ability to stick with a long-term strategy, armed with the right support and the right expectations. In order to do that, we've got to analyze the four types of investment risk.

How Much Risk Does the Investor Want?

This measure of risk is purely based on client preference, created from the client's responses in a risk assessment tool. Our definition of risk tolerance is this:

"How far can a portfolio fall, within a fixed period of time, before the investor will capitulate and make an emotionally-charged, poor investing decision?"

Unlike antiquated risk questionnaires, Riskalyze's assessments use Prospect Theory to ask as many questions as are reasonable (based on actual dollar amounts that are relevant to the investor) to make a valid determination. The result is a Risk Number that can be used as a guide and matched with a corresponding portfolio. Risk Number 45? The advisor has a portfolio designed with that Risk Number in mind.

How Much Risk Does the Investor Have in Their Portfolio?

What if an advisor is meeting with a prospect or client who has assets

invested elsewhere? To paint a comprehensive picture, the advisor should assess the risk of these outside investments as well.
In Riskalyze, advisors can sync outside portfolios with secure custodial credentials instantly, or import seamlessly through a user-friendly interface to see a portfolio's Risk Number.

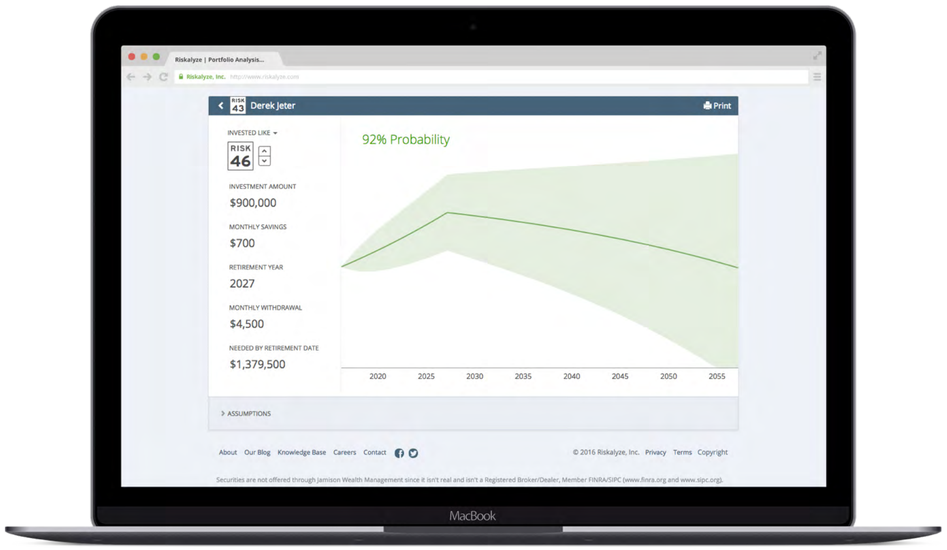
Quite often we hear that the advisor and their client see just how misaligned their portfolio is to their risk tolerance. No wonder investors are so anxious! The advisor can also offer further analysis with expense ratio visibility and comprehensive stress tests. These tools are helpful for investors who are curious to see how their current portfolio would have performed in the crash of 2008, the bull market of 2013, or an increase in interest rates.

How Much Risk Does the Investor Need to Reach Their Goals?

While it's important to align risk tolerance with portfolio risk, acting in the best interest of clients isn't quite that simple. What if an investor's risk tolerance and risk capacity aren't naturally compatible? This is where a great advisor steps in and can paint a more comprehensive picture.

Retirement isn't a one-size-fits-all goal, is it? Every now and then, you'll have a client with almost no risk tolerance (a Risk Number 21, let's say) but they want to retire early and live like royalty! At this point, you're forced to be the bearer of bad news; their best interest lies in investing more and taking on more risk. This is the point where you communicate something like, "there's no way we're getting from New York to California in one day if you're afraid to fly."

The real value of an advisor is the ability to take these life decisions and craft an investment strategy around them to achieve goals. This, by the way, is why Riskalyze offers Retirement Maps—a visual tool that acts as a quick, intuitive glance at the road to investment success. After all, a great advisor should be able to communicate an investor's probability of reaching their goals!



How Much Risk Should the Investor Take On?

This is the advisor's opportunity to be a hero, and where they demonstrate value time and time again. Your ability to align every factor above to propose the right portfolio is invaluable to your clients.

Once you've recommended the right investments, it's time to set better expectations. Advisors empower fearless investing by ditching the narrow targets of the past and adopting a model that includes a clear and realistic range. In order to better demonstrate how a portfolio may perform, Riskalyze invented the 95% Probability Range that assesses risk in six-month increments. We incorporated decades

of behavioral economics research and found that a one-year standard is just too long for a client to "hang in there" if they are in the midst of volatile markets and worried about their downside risk. These clients need a shorter timeframe than one year to keep them invested for the long term.

The advisor should be able to communicate something like this: "There are 5% of events that we can't quantify for you (things like black swans, 2008, Brexit, or Trump...) but 95% of the time, your investments are going to fall right within this range. Does this range look comfortable to you? Can we agree on this?"

At this point, with a clear and simple understanding of what's in their portfolio, the investor gives the advisor the most important gift: buy-in.

An advisor and investor now agree on how much risk they should take on. The advisor captured buy-in by making the fiduciary decision to align how much risk the client wants (risk tolerance), has (portfolio analysis), and needs (risk capacity). Keeping these variables in sync is the best way to show your prospects they're invested wrong and prove to your clients they're invested right. That's the power of risk.

Fearless Investing in Action

An investor named John sought out an advisor in 2013 when the markets were doing well. John called him and said, *"I've been a bit nervous. I like my current advisor, I know him well and golf with him often, but my portfolio has been bouncing around quite a bit. I've got $2M and I just feel like I have no margin for error."*

Naturally, the advisor sits up in his chair and gets pretty excited—until John starts to backpedal. *"But, on second thought, I do have an advisor I trust, and I've been making tons of money recently, so I'm not ready to make any changes right now."* (John is going to wait to lose his money before making changes, right?) He continues, *"Maybe I can just get to know you and if I need to diversify and use multiple advisors, someday, I'll be in touch!"*

The advisor got John to agree to a quick meeting to determine his Risk Number and see if it aligns well with his investment portfolio. John filled out the questionnaire using actual dollar amounts, answering questions that became more difficult by the end. Once he completed it, he discovered that his Risk Number is a 23—more on the cautious side. The advisor then imported John's current portfolio and discovered that John was invested like a 62! He's got a 13% downside risk over the next six months—it's no wonder he's nervous all the time. At that moment, John no longer wondered about how much he trusted the advisor he plays golf with. After all, there was no trick to it—John himself was the one who answered the risk questionnaire and discovered that he's a Risk Number 23. This advisor was only using information that John had provided.

The advisor noticed how bond-heavy John's portfolio was and felt a stress test should be the next step. He asked John, *"Do you want to see what would happen if interest rates went up by 1%?"* The portfolio jumped to an 81.

John's face went white as a sheet. At Riskalyze, we call that the *"ACAT form moment."* John signed the account transfer paperwork ten minutes into the meeting.

We see versions of that story happen week after week, and it's incredibly encouraging.

Riskalyze's co-founder and Chief Investment Officer is still a practicing financial advisor to this day. He's the first of over 20,000 advisors who have joined the fearless investing movement. *"With Riskalyze, my clients know what to expect, and I consistently deliver on their expectations time and time again,"* he says. *"It's the most amazing closing tool I've ever seen."*
—Mike McDaniel

Our company mission is empowering the world to invest fearlessly, and it's something we don't take lightly. Fearless investing is about having the right expectations that drive great long-term decisions in the face of short-term adversity. This third wave of advice is about having the guts to address a conversation about risk head-on. Short-term events are the number one killer of long-term financial goals—but they don't have to be.

Stop talking about returns. Start talking about risk.

Want some training on how to best supercharge your advice with Riskalyze? Attend Riskalyze 101!

Don't have Riskalyze quite yet? Schedule a personal tour to see how 20,000+ advisors use the Risk Number® to empower fearless investing.