



BEST PRACTICE CASE STUDY

The State of Client Understanding

RISK PROFILING WITH REVEALED PREFERENCES



*The State of
Client Understanding*

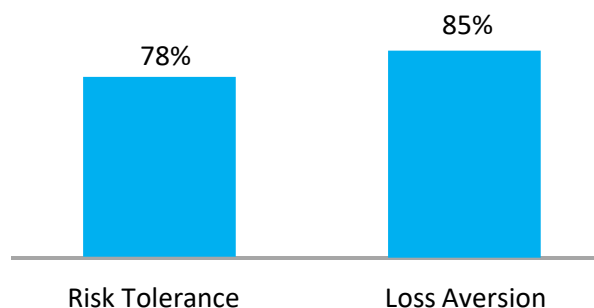
THE PROBLEM WITH STATED PREFERENCES FOR CLIENT PROFILING



A majority of advisers rely on stated preferences for risk profiling...

...but these approaches have problems.

Percentage of Advisors Relying Solely on Stated Preferences



Problems with Stated Preferences



Imprecise: rely on ambiguous language with no underlying mathematical theory supporting their scoring methods or definition of risk



Incomplete: often one-dimensional, focused purely on risk, and provide neither statistical confidence in reliability, nor quantitative guidance on how risk preferences translate into portfolio allocation



Infrequent: designed to be a one-time process that does not allow for easy client re-profiling and monitoring of change

What are Stated Preferences?

Stated Preferences describes any method for understanding someone's preferences that relies on the person to accurately articulate what their preferences are. Common stated preferences methods include dialogue, surveys and questionnaires.

A leap forward with Revealed Preferences

“Advice professionals have been frustrated with the shortcomings in sales-based risk profiling sheets that meet compliance but struggle with the truth. TrueProfile has lifted this veil and enabled clients to have genuine input and control such that the adviser is able to design and discuss real risk/return tension.

Ian Knox
Co-Founder and Chairman
PARAGEM



Paragem offers its affiliated advisory firms a revealed preferences toolset called TrueProfile, which uses decision games to reveal clients' true risk preferences and behaviors.

Why we like it:

The revealed preferences method shows what clients do, providing a point of comparison to what they say. That lets advisors engage clients on “say-do” gaps, often the source of important client insights and educational dialogue.

Advisors can isolate client loss aversion (as distinct from risk tolerance), so they can identify and engage those clients who are likely to make rash decisions in volatile markets.

Advisors have more informed views of suitability, since they can see with mathematical precision how well each of their model portfolios “fit” a client’s investment comfort zone.

Advisors are much more likely to re-profile clients and track important changes in risk preferences, since the decision games are much quicker for clients than risk tolerance questionnaires.

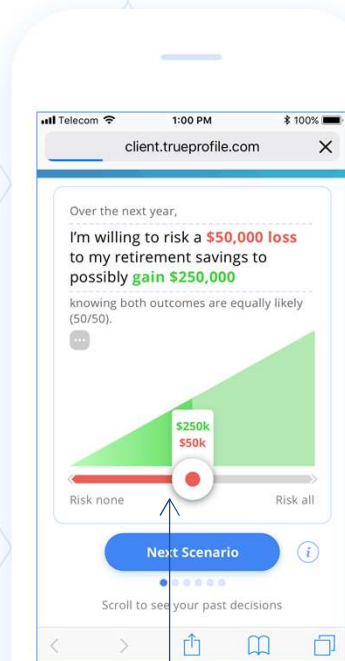
HOW REVEALED PREFERENCES WORKS



A client's decisions under different sets of conditions reveals their preferences

1

Clients face six simple investment decision scenarios on their device.



2

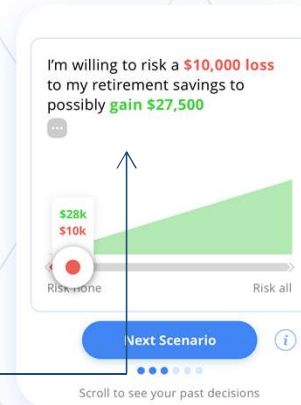
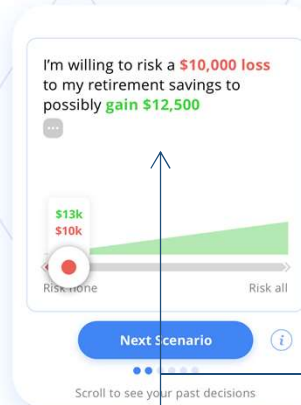
In each scenario, clients move a slider to choose the point they prefer.

4

A calculation engine then uses economic theory and mathematics to make precise estimates of client risk preferences and "best fit" portfolio.

3

As scenario conditions change, revealed preferences captures how client decisions change.

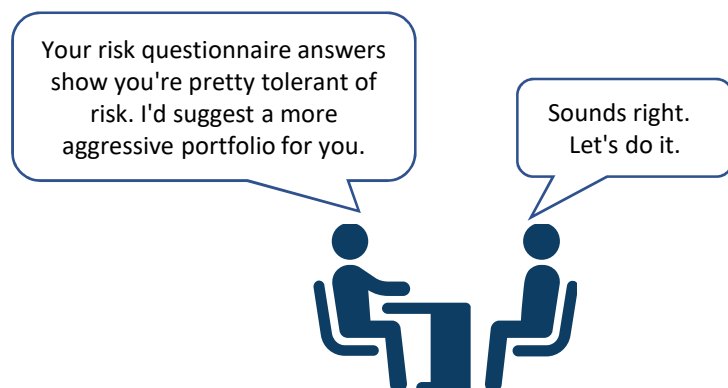


APPLICATION: GETTING AHEAD OF LOSS AVERSION



BEFORE (with Stated Preferences)

The risk tolerance questionnaire often profiled clients as highly risk tolerant...

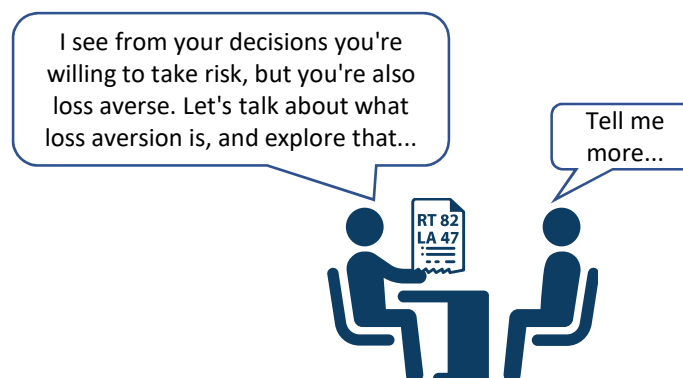


...but many of those clients made rash decisions when markets got bumpy.



AFTER (with Revealed Preferences)

The revealed preferences tool shows advisors a client's loss aversion separate from risk tolerance...



...allowing the advisor to invest loss averse clients more suitably and pre-emptively engage them when markets dip.



APPLICATION: ENGAGING CLIENTS IN MORE EDUCATIONAL CONVERSATIONS



With knowledge of the client's revealed preferences, advisors can identify and prioritize educational topics to explore with the client.

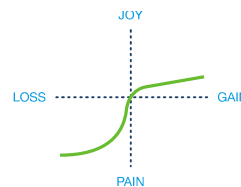
Educational Conversations Enabled by Revealed Preferences

Explore Say-Do Gaps



Compare what clients tell you about risk attitudes and what their revealed preferences demonstrate; explore discrepancies

Educate About Loss Aversion



Discuss and educate clients on loss aversion; create a pre-emptive comms plan for when markets get volatile

Discuss Risk-Taking Barriers



Identify risk-taking thresholds and ceilings; discuss with clients why these might exist

Probe Inconsistent Preferences



Spot preference inconsistencies; explore how clients interpreted the scenarios; see if there are basic comprehension or cognitive decline issues

IMPACT FOR ADVISORS



"True Profile turns the traditional – and never rigorous in any case – risk profiling questionnaire on its head. Having a simple-to-use tool, but with a robust scientific and mathematic basis, means a significantly better understanding of a client's risk tolerance and loss aversion. Even better than that, True Profile doesn't provide the answer, or the box. But it does provide the foundation for having a much deeper and more engaging discussion with clients about their investments, their asset allocation, and their behavioural biases."

Peter Gersch
Owner, Woodward Nhill Financial Planning
Melbourne, Australia

"True Profile has given me the tools by way of the report to be able to, with certainty, have those deeper conversations with my clients or prospective clients as to where they truly sit and more importantly, why. Someone may say they are happy to take risk, but the TrueProfile activity proves it or allows you to show them why they aren't if their answers aren't aligned, in a detailed and precise way. Clients have told me that they have peace of mind knowing that I do understand them and can convert what they feel into words, as to where they are comfortable with investing."

Louise Parker, CFP
Founder, Financial Lifestyle Managers
Emerald, Victoria, Australia

IMPLEMENTATION TIPS



1. Familiarize yourself with the underlying science—revealed preferences is grounded in behavioural economics and decision science. Advisors who understand the economic theory behind it will be better positioned to discuss results with clients. See www.TrueProfile.com/the-science resources.
2. Trial thoroughly before going live with clients—revealed preferences is like a new-in-kind medical diagnostic. Test it on yourself and your team, with multiple client personas in mind, so you can get a feel for how different decisions lead to different outcomes. Tap into resources provided by TrueProfile to develop your “bedside manner” when using revealed preferences.
3. Get comfortable with clients’ results challenging their self-perception—a reasonable portion of your clients will come into the activity believing themselves to be a particular sort of investor. However, the decisions many of those clients make will reveal them to be different than they imagined. Practice engaging these kinds of clients with open-ended questions that get to what the client was thinking as they made different decisions—a very effective way for you to help clients self-discover.
4. Segment clients by loss aversion—revealed preferences will show that some of your clients with high risk tolerance are also loss averse. Establish a pre-emptive engagement strategy for these clients when markets get choppy, as these clients are prone to rash decision making at these moments.

APPENDIX

- HEAD-TO-HEAD: STATED VS. REVEALED PREFERENCES
- BEHIND THE SCENES: THE MATH OF RISK PREFERENCES
- APPLICATION: ENGAGE CLIENTS IN MORE EDUCATIONAL CONVERSATIONS
- APPLICATION: PRE-EMPT BAD CLIENT DECISIONS IN VOLATILE MARKETS
- APPLICATION: MAP CLIENTS TO BEST-FIT PORTFOLIOS WITH PRECISION
- ABOUT CAPITAL PREFERENCES AND TRUEPROFILE™

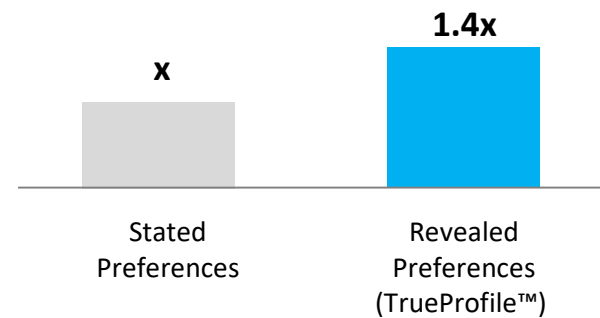
HEAD-TO-HEAD: STATED VS. REVEALED PREFERENCES

About the Head-to-Head Test

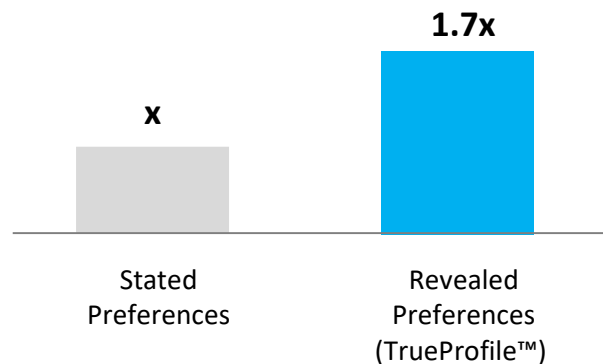
A top 5 US-based wealth management firm tested revealed preferences (TrueProfile™) against its existing risk tolerance questionnaire.

- 355 clients participated as test subjects
- All subjects went thru both methods
- Subjects were asked which experience they preferred at the end

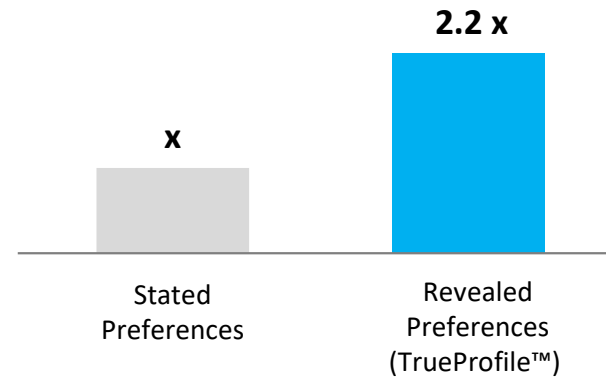
*Q: Which method would you **trust more to provide an accurate assessment** of your comfort with investment risk?*



*Q: Which method did you find **more enjoyable** in assessing your comfort with investment risk?*



*Q: Which method **helped you better understand** your comfort with investment risk?*



BEHIND THE SCENES: THE MATH OF RISK PREFERENCES



*The revealed preferences
method calculates mathematical
risk parameters...*

Client Risk Parameters



out of 100

Risk Tolerance

Measures the client's willingness to put money at risk for potential gains.



out of 100

Loss Aversion

Measures how intensely the client feels pain from investment losses; distinct from risk tolerance.



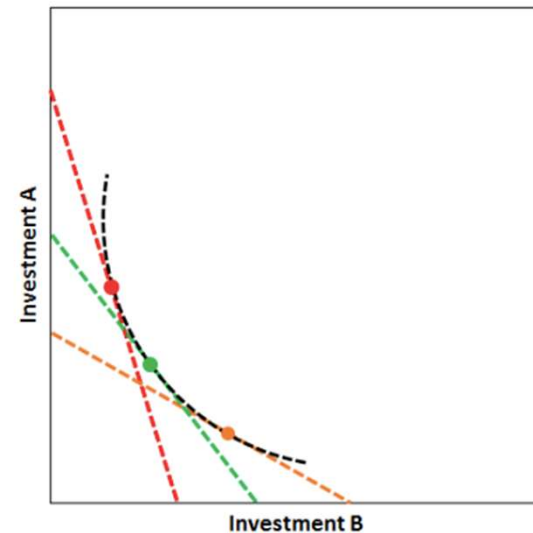
out of 100

Decision Consistency

Measures internal consistency across the client's decisions; primarily for compliance purposes and to help detect cognitive decline.

*...and a personalized utility function
describing how the client makes
risk/reward decisions.*

Client Utility Function



APPLICATION: ENGAGING CLIENTS IN MORE EDUCATIONAL CONVERSATIONS

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Discuss Risk Taking Barriers

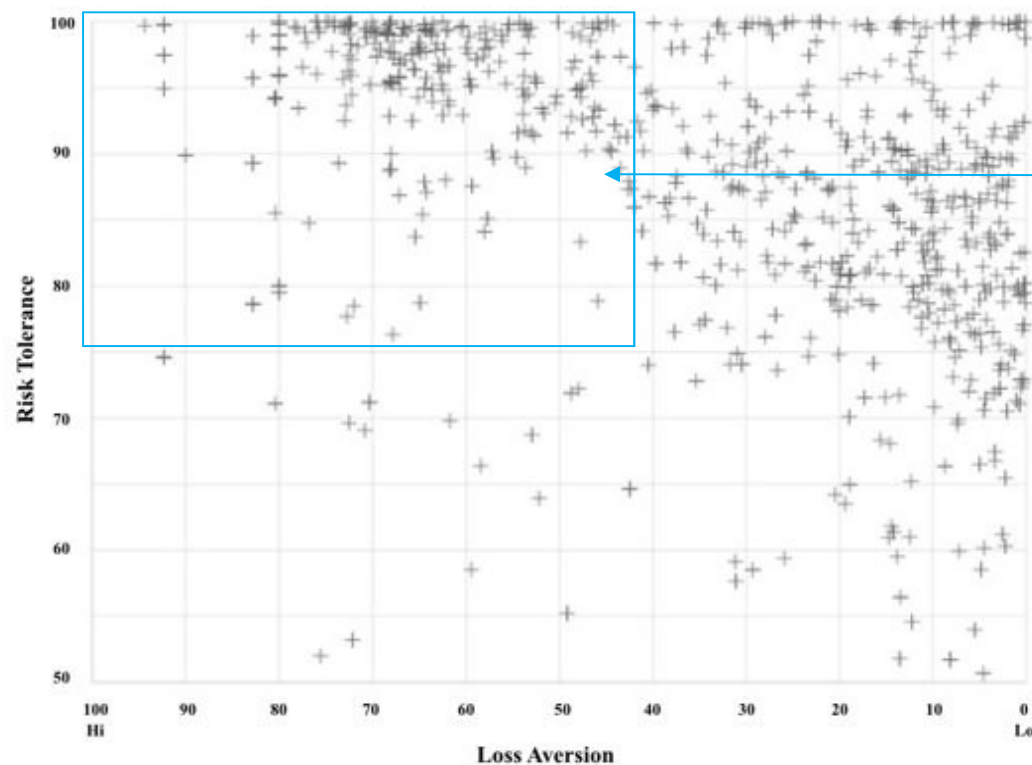
Identify risk-taking thresholds and ceilings; discuss with clients why these might exist

Decision Details

	Gain Chosen	Loss Chosen	%
Highest Reward	\$1,003,600	\$200,700	50%
High Reward	\$319,900	\$75,300	19%
Moderate Reward	\$260,900	\$74,600	19%
Moderate Reward	\$207,000	\$75,300	19%
Low Reward	\$150,500	\$75,300	19%
Lowest Reward	\$250,900	\$200,700	50%

APPLICATION: PRE-EMPT BAD CLIENT DECISIONS IN VOLATILE MARKETS

Risk Tolerance and Loss Aversion in a Representative Client Population*



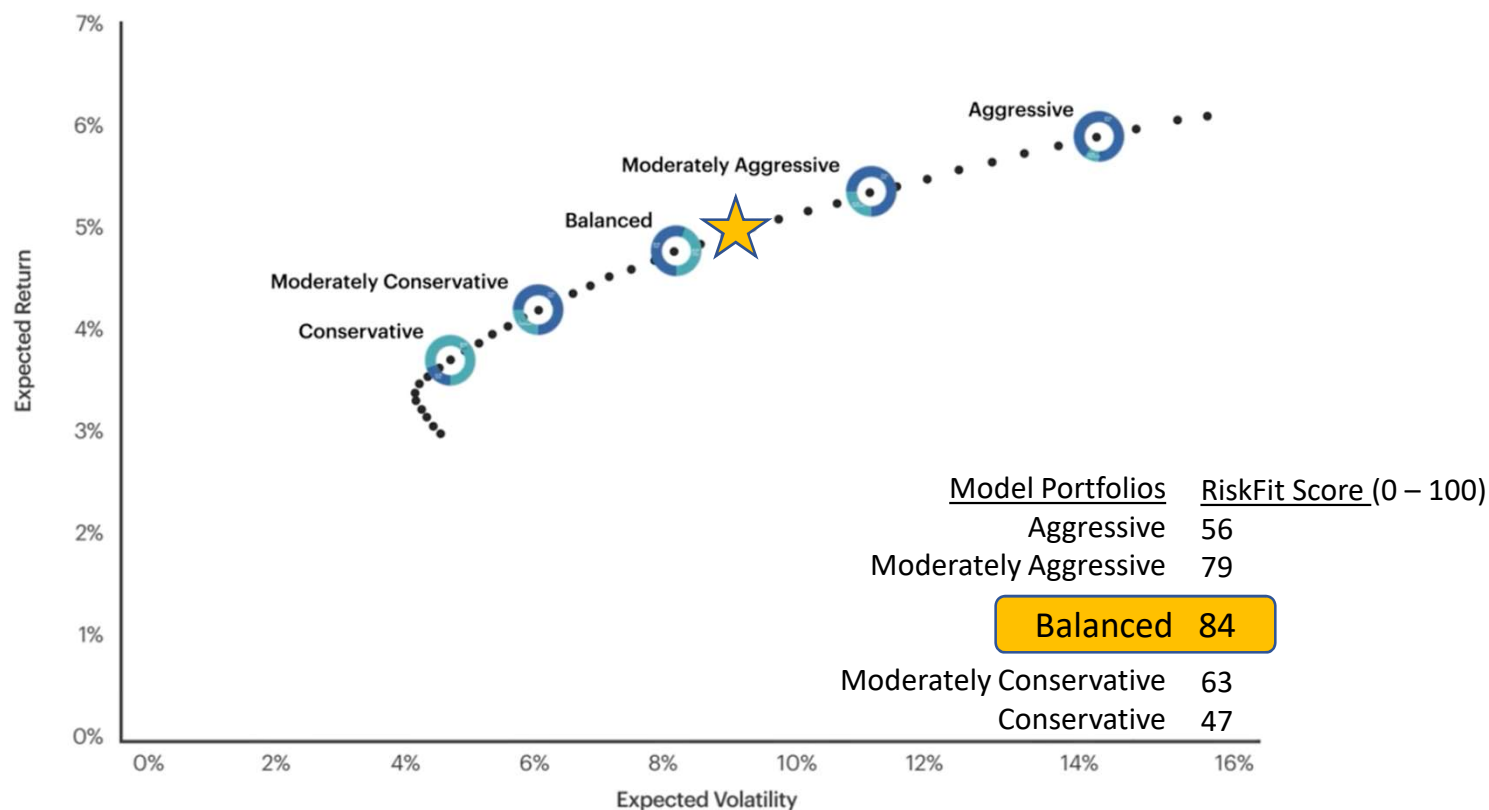
1. Risk tolerance and loss aversion are distinct, and there's wide variability from client to client.
2. Clients who are risk tolerant, but also loss averse, are the hidden danger in a client base.
3. They are often placed in aggressive portfolios, based on stated preferences.
4. But, when markets shake, their loss aversion causes them to feel greater pain and leads them to make rash decisions.
5. Revealed preferences equips advisers to detect these clients, invest them more appropriately, and pre-empt rash decisions.

*Source: S Choi, S. Kariv, W. Muller, D. Silverman. "[Who is \(More\) Rational?](#)" American Economic Review, June 2014.

APPLICATION: MAP CLIENTS TO BEST-FIT PORTFOLIOS WITH PRECISION



Mathematical risk preferences enables precise mapping of clients to best-fit investment allocations at the highest scientific standard.



ABOUT CAPITAL PREFERENCES AND TRUEPROFILE™



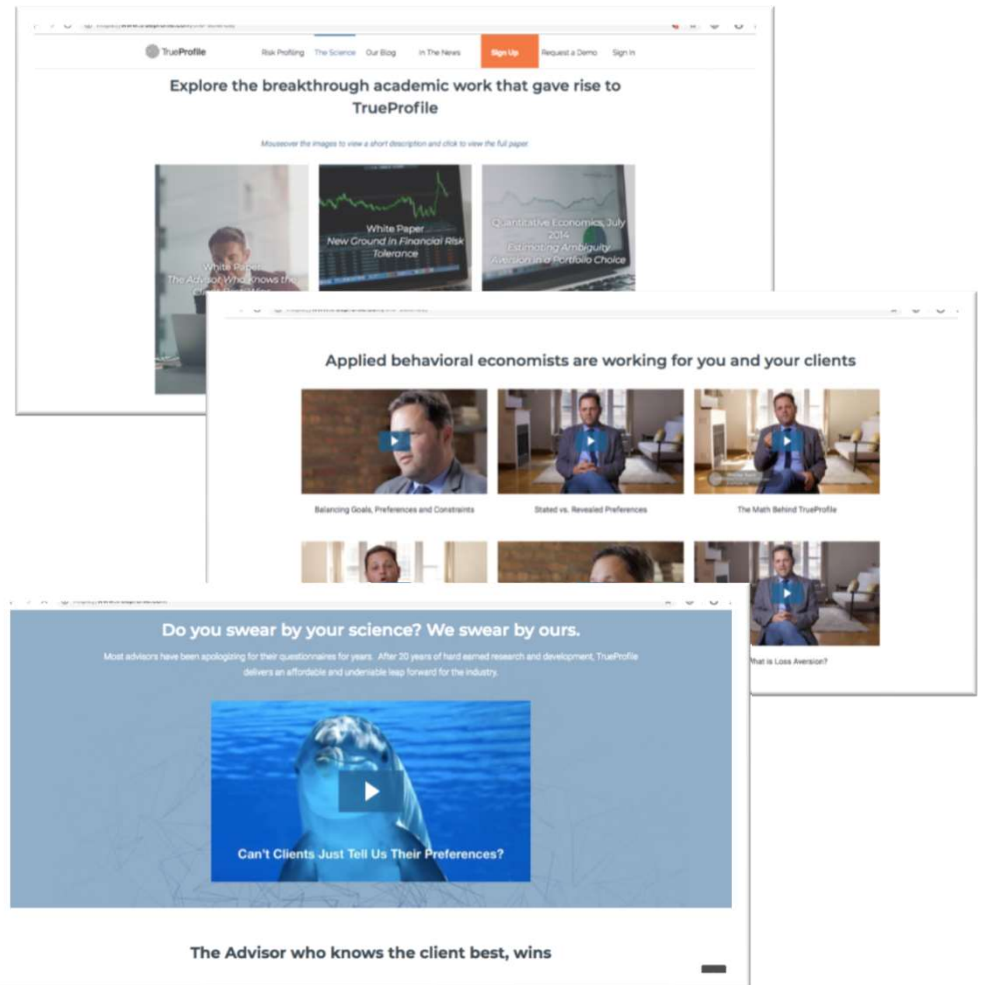
Shachar Kariv
Benjamin N. Ward Professor of
Economics @ UC, Berkeley
Co-Founder,
Capital Preferences LTD

About Capital Preferences

- Co-founded by UC, Berkeley-based decision scientist, Shachar Kariv
- Creator of TrueProfile, launched in 2018
- TrueProfile is based on Professor Kariv's groundbreaking work in revealed preferences
- TrueProfile is the only tool that reveals clients' risk tolerance and loss aversion as defined by economic science

Learn more about the science of revealed preferences and TrueProfile

<https://www.trueprofile.com/the-science/>



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