The True Potential Centre for the Public Understanding of Finance

The Open University Business School

White Paper:
TOWARDS A COMMON UNDERSTANDING OF RISK

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Overview

Research shows that the UK public generally has a fairly basic understanding of the risks of saving and investing. This new research exposes the great variety of factors that affect people's perceptions of risk and their investment decisions. In an advisory process, some or all of these factors may be taken into account in the discussion between adviser and client. But what about the growing numbers of people who elect to make their own investment decisions? How can the industry and the regulator help ensure they make sound decisions, achieve the goals and outcomes they want, while steering clear of investment frauds and scams in their search for better returns at a time when savings interest rates remain historically low?

As the idea of 'self-service' investing gains ground and people have new financial freedoms, we need fresh thinking about how to encourage the average person to consider the financial risks they face, how to help them think about and describe their own attitude to risk, and how they can use this knowledge when they save and invest – particularly if they do not use professional advice.

This White Paper offers a blueprint for a Toolkit for the Ordinary Investor, which has four basic components:

1. What should I understand about the investment environment?

We know that the UK generally has low levels of understanding when it comes to investment risk, but there is no consensus about what people *should* understand. As a starting point for discussion, this research suggests six 'pillars of wisdom' that could help equip investors (particularly those completely new to investing) to understand the investment environment (see below).

4. What kind of investor am I?

Using case studies like the ones described in this White Paper to ask 'What kind of investor am I?' helps people think about the time they might invest in investing; the type of help or support they might be interested in; and the role of professionals in their decision making. This in turn can flag behavioural risks that people should be aware of, e.g. over-focusing on one thing such as past performance when taking investment decisions.

Generally understood	Investments go up and down and you may not get back the amount of money you invested at the start	Understand
	Inflation can reduce the real value of money saved in a savings account	
	What outcome are you looking for, and what time horizon are you thinking about?	
	Have you considered the impact of charges on your likely investment returns?	Ask
	Have you considered the rate of return in relation to inflation, how the investment returns are taxed, and the rate of income tax you pay?	
Less well understood	This is what your investment journey might look like over the next three to five years, and over the time until you reach your desired outcome	Visualise

2. What type of investment is right for me?

The research shows that we need an Attitude to Risk Questionnaire or tool designed specifically for DIY Investors, particularly those new to investing. It should (1) take account of individual circumstances, goals and objectives (2) help people think about the different dimensions of 'risk capacity' and (3) be consumer-centric and user-friendly. The same principles can be applied to existing Attitude to Risk Questionnaires to create more accessible and relevant tools for advisers and clients.

3. How might my emotions affect my decisions and what can I do to manage my emotions?

The investment journey can be an emotionally bumpy ride. Research suggests some simple strategies to help people manage their emotions, such as writing goals down to remind people about their reasons for saving, using if-then plans, and seeking emotional support (e.g. making investment decisions jointly with a partner or with your family).

To develop this blueprint into a practical, effective toolkit requires input not only from experts but also from the ordinary investors that it's aimed at. As the psychologist Paul Slovic concluded almost thirty years ago: *'Each side, expert and public, has something valid to contribute. Each side must respect the insights and intelligence of the other.'* [1]

Going forward, we plan to explore ways to put this research into action, in partnership with industry stakeholders.

[1] Slovic (1987) 'Perception of Risk.'
In: Science, New Series, Vol. 236, No. 4799, page 285.

What's the research about?

Previous research shows that, when it comes to saving and investing, the average UK consumer is generally unwilling to take risks with their money. In other words, they don't want to buy investments if there is any risk they may lose some of the original sum they invested, even if there is an opportunity for higher returns than, for example, putting the money in an ordinary savings account. While taking little or no financial risks with their money may be absolutely the right thing for some consumers, academics and industry commentators point to the risk of 'reckless conservatism' – the reluctance of many people to take investment risk which in turn may jeopardise their longer-term objectives (such as providing an income in retirement).[2]

At the same time, there is also evidence that, beyond a basic understanding of the risk-reward relationship and the idea of capital risk (the possibility that investors may lose some or all of their original capital and re-invested returns), the average consumer has a limited grasp about the financial risks actually involved in saving and investing.[3]

The research reported in this White Paper focused on four questions:

1. What do people understand by the term 'risk' in relation to saving and investing and what informs this understanding?
2. To what extent do existing risk profile tools reflect people's own understanding of risk?
3. Is there scope to improve risk profiling to provide a better indicator of people's attitude to risk?
4. Is it possible to develop a tool that consumers could use themselves? What would this look like?

52% of people would prefer to miss their savings goals than take investment risk, while only 12% would not.

Source: *How do savers think about and respond to risk?* Pensions Institute, Cass Business School, 2014

68% of people agree 'It is better to play safe with your savings, even if investing in higher risk investments could make you more money.'
18% disagree.

Source: *Attitudes to pensions: The 2009 survey.* DWP Research Report 701

[2] *How do savers think about and respond to risk? Evidence from a population survey and lessons for the investment industry.* Pensions Institute, Cass Business School, 2014.
[3] See, for example, *Consumer Understanding of Financial Risk,* FSA Consumer Research Report 33, 2004; and *Investment risk rating: Consumer attitudes towards risk,* Financial Services Consumer Panel, 2007.

What research did we carry out?

We conducted qualitative research using depth interviews. We use qualitative methods to get a detailed understanding of people's experiences, attitudes and perspectives; to answer questions about the 'what', 'how' or 'why'. Qualitative research is not intended to provide answers to 'how many' or 'how much' (which is the job of quantitative methods such as surveys), nor is it intended to be representative of a particular population (such as UK savers or investors).

We carried out depth interviews with three groups of people in September and October 2014:

1. Stakeholders, including representatives from consumer organisations and the financial services regulator.
2. The financial advice industry, including national and local advice providers and risk profiling experts.
3. Consumers who had bought or considered buying an investment.

In addition to the qualitative research, we reviewed relevant research and literature and analysed eleven Attitude To Risk Questionnaires to find out the types of questions they ask and the sorts of information they capture.

Consumer in-depth interviews: Who did we speak to?

We conducted 15 face-to-face interviews with 22 people. Seven interviews were with couples (who were joint financial decision-makers in their household), the rest were with the main financial decision-maker in the household. The interviews were conducted in London, Northampton and Birmingham. Most of the consumers we interviewed lived in couple households. They ranged in age from 29 to 72, but most were in their 50s and 60s. Apart from two couples who were fully retired, the people we interviewed were employed or self-employed. Several of them ran their own businesses. The consumer interviews divided about equally into those who had considered or bought an investment through a financial adviser, and those who had not consulted a financial adviser.

Personal saving and investing in Britain

Aside from personal current accounts in credit, the most common non-pension savings products held by households in Britain are savings accounts and Individual Savings Accounts (ISAs).[4] In the tax year 2012-2013, 78 per cent of the money saved into ISAs was in cash ISAs.[5] Only small proportions of households have any other types of non-pension investments where capital is at risk (Table 1).

Table 1: Percentage of households in Britain with formal financial assets (excluding private pensions), 2010/12

Savings accounts	58
ISAs (including PEPs)	48
National Savings certificates and bonds	22
UK shares	12
Insurance products[1]	7
Fixed term bonds	11
Employee shares and share options	6
Unit/investment trusts	5
Overseas shares	2
UK bonds/gilts	1

[1]Includes life insurance, Friendly Society or endowment policies (excluding mortgage-linked endowments). Excludes term insurance policies. Source: *Wealth in Great Britain Wave 3, 2010-2012. Chapter 5: Financial Wealth*, ONS, 2014

When it comes to pensions, 15 per cent of households in Britain have wealth in personal pensions; and 14% have wealth in current occupational defined contribution pensions.[6]

In the consumer interviews we conducted for this research, the sorts of investments held by our respondents were investment ISAs, investment funds, stocks and shares, property (second homes; buy-to-let), as well as personal pensions.

The consumers we interviewed were motivated to invest money for different reasons: to provide financial security for their own future; to help pay for their children's future (e.g. for higher education, to get on the property ladder); or simply to grow their money by making it 'work harder'.

In psychology, doing something because it leads to a separable outcome is called extrinsic motivation. The type of *extrinsic motivation* displayed by most of the consumers we interviewed was *identification*. Put simply, they identified with the personal importance of investing money and took responsibility for their behaviour.

[4] *Wealth in Great Britain Wave 3, 2010-2012. Chapter 5: Financial Wealth,* ONS, 2014
[5] *Individual Savings Account (ISA) Statistics,* HMRC, August 2014
[6] *Wealth in Great Britain Wave 3, 2010-2012. Chapter 6: Private Pension Wealth,* ONS, 2014

While identification is a strong extrinsic motivation to take action, a more powerful determinant of action is intrinsic motivation, which means doing something because it is inherently interesting or enjoyable. Among the consumers we interviewed, only a small number seemed intrinsically motivated to invest – and their motivation related to particular types of investment: one or two people were passionate about investing in residential property; and a few enjoyed 'playing the stock market'. Later in this White Paper we consider why it is important to understand individual's investment motivations.

What are we talking about when we talk about 'risk'?

Lanchester (2010) highlights the difference between risk as the mathematical calculation of probabilities (which is largely what risk means in the investment industry), and *uncertainty* (what he describes as *'the more profound unknowabilities of life and history')*[7] which is much closer to the way that we as individuals think about risk. It falls to the financial services sector to bridge these very different understandings to help people make investment decisions – in the form of regulated financial advice but also the information and guidance that it produces.

This is not a straightforward task, however. In personal investment, there are many different risks and uncertainties; it is this 'unknowability' that often deters people from investing. The most obvious is the performance of the investments that they decide to buy. Investors' emotions and behaviours also shape the outcome, for example how they feel about and respond to market events. Others are outside the investor's direct control, for example, how funds are managed and governed; government policies in relation to taxation, regulation, and its fiscal and monetary policies; and events that affect financial markets such as war, natural disasters and financial crises.

Formative research on risk perceptions in everyday life carried out by psychologist Paul Slovic shows that people's perceptions and attitudes to risk are determined by a variety of quantitative and qualitative characteristics that are not easily expressed in one statistic or a one-dimensional index.[8] Notably, people tend to be intolerant of risks that have certain characteristics – characteristics that we see in personal investments: the risks are perceived to be unknown, uncontrollable, not easily reduced, the risks have catastrophic (financial) potential, and there seems to be an inequitable distribution of risks and benefits.

Slovic concludes that our '*... basic conceptualization of risk is much richer than that of experts and reflects legitimate concerns that are typically omitted from expert risk assessments'.*[9]

This richness is reflected in the findings from our research, which shows that a whole range of factors come into play when we make investment decisions – of which attitude to risk is only one. As we go on to discuss in this White Paper, other crucial factors are the emotions and circumstances in which investment decisions are wrapped up, and people's motivations and behaviours in buying investments and what they do post-purchase. At present, these important factors receive relatively little attention compared to attitude to risk.

[7] J Lanchester (2010) *Whoops! Why everyone owes everyone and no-one can pay.* Allen Lane
[8] P Slovic (1987) 'Perception of Risk.' In: *Science,* New Series, Vol. 236, No. 4799, pp280-285.
[9] Slovic (1987) 'Perception of Risk.' In: *Science,* New Series, Vol. 236, No. 4799, page 285.

What do people understand about risk in relation to saving and investing?

In line with previous studies, the stakeholder and advice industry representatives we interviewed felt the UK public generally has a fairly basic understanding of the risks of saving and investing. But the research also shows that people's understanding of risk in relation to investing comprises two quite different components: (1) how they understand the investment environment and (2) how they think about 'attitude to risk'. So if we want to help people better understand risk in relation to investing, it is important to focus on both of these components, not just one or the other.

Understanding the investment environment

Although we have a large body of evidence about the UK's low levels of understanding when it comes to the risks of investing, there is no consensus about what people *should* understand when they think about buying an investment. This research highlights six 'pillars of wisdom' that could help equip investors (particularly those completely new to investing) to understand the investment environment (Table 2). It is not meant to be a definitive list, but it has the advantage of being evidence-based and is meant to provide a starting point for discussion.

The stakeholders and industry representatives we interviewed felt that, at best, the general UK population understands the risk of making or losing money if they invest. The consumers we interviewed (who all had some investment experience) clearly grasped this basic idea: **investments can go up and down**. In addition, they understood their **capital was at risk**, with no guarantees they would get back the amount they originally invested. They also understood that the main risk of leaving their money in a savings account was the **impact of inflation** on the value of that money, tied up with the idea that your money isn't working for you if it's in a savings account.

> **'…it's depreciating in value… if you don't invest then you're sort of falling behind, you're not gaining anything, your money is not working for you.**
>
> (Consumer interview)

Table 2: Six 'pillars of wisdom' about the investment environment for would-be investors

Generally understood	Investments go up and down and you may not get back the amount of money you invested at the start	Understand
	Inflation can reduce the real value of money saved in a savings account	
	What outcome you are looking for, and what time horizon are you thinking about?	
	Have you considered the impact of charges on your likely investment returns?	Ask
	Have you considered the rate of return in relation to inflation, how the investment returns are taxed, and the rate of income tax you pay?	
Less well understood	This is what your investment journey might look like over the next three to five years, and over the time until you reach your desired outcome	Visualise

Inflation risk was regarded by stakeholders and advice industry interviewees as a really important benchmark, but one which the general public does not always fully appreciate, tied up with the fact that cash savings are tangible, accessible and feel 'no risk'.

> **'I can see the pounds, I've got the cheque, I know I've got it out now, I understand it feels like low risk and I've got £75,000.00 put in my bank account.'**
>
> (Advice Industry interview)

Finally, it was felt important for consumers to have a clear understanding of the outcome they wanted from their investment, and the time horizon over which they were looking. Is it a short-term investment to generate money for a house deposit? Or is a long-term investment to provide income in old age?

There were three more things that stakeholders and advice industry interviewees thought that consumers *should* know, but probably did not (and which did not come through strongly from the consumer interviews). The first was an understanding of the impact of charges on investment returns, which can impact quite significantly on the actual returns that a personal investor makes.

> **'The person selling you the fund should be able to say to you, right this fund is actually, of its type, very expensive. There's another one here that is very similar and it's much cheaper, they should be able to guide you like that and that never happens. So that's a discussion that consumers should definitely have.'**
>
> (Stakeholder interview)

But while making the costs of financial advice more transparent was a major focus of the Retail Distribution Review, research commissioned by the Financial Services Consumer Panel shows that it is not straightforward to work out the true costs of investing as many of the charges are deducted directly from the fund and remain hidden.[10]

The second thing that stakeholders and advice industry interviewees thought that consumers *should* know was having a sense of what's a good return? To work out the likely net return, this means taking into account the rate of inflation, the rate of income tax you pay, and the tax payable on an investment – as well as the charges. Stakeholders and advice industry respondents were concerned that people can have unrealistic expectations about the amount of risk they need to take for the returns they have in mind. This may make them vulnerable to investment frauds and scams.

Linked to this, stakeholders and advice industry respondents felt strongly that people considering an investment should be given some idea of what their investment journey might look like over the next three to five years, and over the time until they reach their desired outcome: for example, the fact that 'markets always wobble', what that might actually look like and how they might react when this inevitably happens.

Underpinning all of this, there were concerns (particularly among the financial advisers we interviewed who deal with clients on a daily basis) that adults in the UK do not have a good grasp of fundamental financial concepts such as inflation, tax, probabilities, how financial markets work, and how these concepts relate to an individual's own investments. Financial education in schools may go some way to address these concerns among future generations.

[10] Financial Services Consumer Panel, November 2014, *Investment costs – more than meets the eye*

How consumers think about Attitude to Risk

The Attitude to Risk Questionnaires used in the financial services industry aim to capture four key aspects of an individual's risk profile:

1. Willingness to take risk
2. Risk need, which is the *need to take risk* to achieve desired outcomes or goals
3. Risk capacity, which is someone's *financial ability* to take risk, and
4. Experience and expertise when it comes to financial matters.

So what does the interview data tell us about these four aspects of Attitude to Risk?

Willingness to take risk

The consumers we interviewed (all of whom had some investment experience) generally had a good sense of the risk they were prepared to take with their money. They described their attitude to risk in terms such as 'middle of the road', 'medium risk', 'cautious', 'risky'. This was a benchmark that they used when thinking about taking out new investments: in other words, asking themselves 'Is this investment more or less risky than what I've already got?' Life stage was a key factor that influenced people's willingness to take risk, so that having a young family or being close to retirement generally meant a more cautious attitude to risk. Past experience of investment losses also shaped people's willingness to take risk, and meant they tended to take a more cautious approach to investing. In most cases, investment losses had not deterred people from investing completely because they had also made gains.

Risk need

When it came to risk need (the need to take risk to achieve desired outcomes or goals), among the consumers we interviewed 'making money work' was a strong motivation to take some risk and invest rather than save. An appreciation of risk need was more strongly evident among consumers who had made an active choice to invest, as opposed to others where investment decisions were dictated by circumstances (e.g. bereavement, redundancy).

Some respondents decided to buy investments that were higher risk (compared to what they already had) in order to maximise their returns, either simply because they thought their money should be 'working harder' or with a specific purpose in mind. In one case, a respondent was thinking about a career change that would probably mean lower earnings, so he wanted to maximise the potential returns from his pension by taking more investment risk. Similarly, another respondent switched to higher risk investments with a view to using the money he made to invest in buy-to-let property in the future. In other cases, the purpose of the investment *constrained* the amount of risk that respondents were prepared to take – so that some respondents who were investing primarily for the benefit of their children tended to choose lower risk products, even though they planned to invest over a long time period.

Risk capacity

From the interview data we identify three dimensions to risk capacity (someone's financial ability to take risk). The first comes from the consumer perspective and is very much present-focused: it is a question of whether consumers feel they can **afford to invest money** from their current income or some other source. A professional couple in their 30s, for example, talked about only being able to invest money in recent years, because previously they couldn't afford to.

> **'Before it was just about preservation, protection, now it's definitely more about maximising.'**
>
> (Consumer interview)

Another respondent decided to make a more risky investment because *'we're not going to feel this money'*. In other words, the fact that he had used disposable income to buy an investment would not impact on his family's current standard of living.

The second dimension was working out whether you have the financial building blocks in place to be able to **afford to take some risk** with the money you have. For example, do you have cash/ liquid savings equivalent to three months' income? Do you have protection against job loss or illness, through your employer or through insurance? With savings interest rates low, stakeholders and industry respondents were concerned that people feel they should be doing something to get a better return on their savings, but they may not be sure what to do and may or may not have enough money to take some risk.

If consumers decide they have money they can afford to invest, and they can afford to take some risk by investing that money, then the third dimension of risk capacity relates to **capacity for loss**. Guidance produced by the financial services regulator indicates that it would prefer investors to understand capacity for loss in an objective sense – pounds and pence and how that could materially affect their standard of living – not simply how they feel about it. In the consumer interviews, the idea of capacity for loss was something that some respondents were mindful of – although in a qualitative way, not really in any quantifiable form. Respondents near retirement for example, were conscious that they may well have to live off their private pension for a good many years. For others, sometimes the goals seemed too distant or vague ('children's future') for people to really be able to quantify their capacity for loss.

Experience and expertise

The consumer interviews highlighted the many different ways that people gain experience and expertise in investing. Interest could be sparked by talking to colleagues or relatives who were investors. Several respondents took their first steps in investment when nationalised industries were privatised or building societies demutualised. A sizeable number of the consumers we interviewed either ran their own business or had experience of helping run a family business. For the most part, these were the consumers who were more interested and engaged in investing. Others delegated investment decisions to a professional.

> **'… because we're a nation that sort of is hooked on debt, most people don't tend to have any significant amount of savings and so I think often people are drawn to investment for the wrong reasons and they're sort of hoping that they will be able to make those cash savings go a bit further but probably it should just be looking for a better rate on their cash savings, not looking for it to go up the risk scale there with what they've got.'**
>
> (Stakeholder interview)
>
> **In 2010/12, a quarter (25%) of households in Britain had negative net financial wealth**[11]

[11] *Wealth in Great Britain Wave 3, 2010-2012. Chapter 5: Financial Wealth,* ONS, 2014

How do financial firms assess people's attitude to risk?

Assessing a clients' attitude to risk is a crucial aspect of the advice process. Get it right, and the client has an investment product that matches their appetite for risk and is appropriate to achieve their investment goals. Get it wrong, and the client has an investment product that exposes them to too little or too much financial risk compared to their attitude to risk – even if it might achieve their desired investment goals. At worst, getting it wrong could result in significant consumer detriment and potentially a case of mis-selling.

The standard way used by financial firms nowadays to assess attitude to risk (and investment risk in particular) is a risk profiling tool, which is mainly used as part of an advisory process. In the course of the advisory process, advisers may also help clients understand the investment environment and some of the key concepts that are important in personal investing.

Risk profiling tools are mainly used as part of an advisory process that typically has the following steps:

- ✓ An initial fact find and discussion of risk and return
- ✓ Completion of the risk profiling tool
- ✓ An assessment of the customer's ability to cope with investment loss
- ✓ Discussion with the customer
- ✓ Suitability recommendation
- ✓ Written confirmation to the customer that covers the outcome from the risk profiling and any recommendation.

Specialist providers of risk profiling tools are a well-established part of the UK's financial services landscape and there are a range of risk profiling tools on the market that financial advice firms typically pay a license to use. Risk profiling tools also perform a regulatory compliance function: they help demonstrate to the regulator that an adviser has considered the client's attitude to risk in an appropriate way.

This research focused mainly on the Attitude to Risk Questionnaire. This is the customer-facing part of the risk profiling tool which is administered to the client using pen-and-paper or online. Behind the scenes, algorithms are used to score the client's answers to the questionnaire and to provide a risk profile for the client that can be used to help select an appropriate saving or investment product or products.

Attitude To Risk Questionnaires have been developed, tested on large numbers of clients and refined over time, with input from experts and academics. On the product side, savings and investments are labelled in ways that are designed to make it easier to match an individual to an appropriate product. For example, Morningstar's five risk profiles are Defensive, Cautious, Balanced, Growth, and Aggressive. The ATR Questionnaire produces five similarly-labelled risk profiles: Cautious, Moderately Cautious, Balanced, Moderately Adventurous, Adventurous.

Taking the temperature: views and experiences of Attitude to Risk Questionnaires

Concerns about advisers' use of risk profiling tools resulted in the financial services regulator publishing guidance on the matter in 2011, which highlighted examples of good and poor practice.[12] There were particular concerns about the assessment of clients 'capacity for loss' (i.e. their ability to absorb falls in the value of their investment); the use of subjective representations of risk in questionnaires, for example numeric scales or ill-defined terms; unclear question wording; and an over-reliance by advisers on the automated output of risk profiling tools, rather than using the output as the basis for discussion with the client. Several years on from the publication of the guidance, risk profiling continues to be a cause for concern for the regulator.[13]

In this research we interviewed advice providers who use proprietary risk profiling tools; others who use Attitude to Risk Questionnaires they devised themselves, which they use to determine asset allocation; and those that do not use risk profiling tools at all. Not surprisingly, the views of stakeholders and advice industry representatives were mixed, depending on their use and experience of risk profiling tools.

At best, Attitude to Risk Questionnaires were felt by stakeholders and industry representatives to be an enabling device, a tool to help advisers discuss risk with clients and get clients to consider their own risk profile in a structured, consistent way (especially for novice investors, or new-to-the-adviser investors). As such, these questionnaires can be part of an educative process for clients, and advisers benefit from the additional information and the audit trail they provide from a regulatory compliance perspective.

At worst, respondents felt that Attitude to Risk Questionnaires (and risk profiling tools generally) are nothing more than a tick-box exercise that advisers feel they have to complete; or else advisers see themselves as technicians, who consider the output produced by risk profiling to be 'the answer'. In either case, there may be little discussion with clients about their risk profile and the extent to which this reflects their own views.

Drilling down, two key concerns were raised in the interviews with stakeholders and the advice industry about Attitude to Risk Questionnaires which can be summed up as: (1) words and meaning and (2) one-size-doesn't-fit-all.

Words and meaning

Words and meaning were the major concerns among stakeholders and industry representatives. Some Attitude to Risk Questions were felt to be vague, abstract and poorly worded – which means there is more scope for misunderstanding or misinterpretation by both clients and advisers.

'I think talking about it in terms of expected growth or worse case scenarios and putting figures on that has to be helpful, just because the alternative is to keep things very abstract and it just seems to me there's much more scope for things to go wrong when it's kept very abstract.'

(Stakeholder interview)

'I think the attitude to risk questionnaire is a key point at which you can do a bit of financial literacy work with the client, raise their awareness and help them understand … any time I hear [advisers] say sophisticated tool I just think no, no, no, no, that's no good, it's like a black box and you need the opposite of that, you need to be delving inside and talking to the client about those issues, not sort of wrapping it up in some sophisticated impossible to comprehend tool.'

(Advice Industry interview)

[12] *Finalised Guidance, Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection.* FSA, March 2011
[13] FCA: We still have concerns about risk profiling', Money Marketing, 14/05/14

In addition, some stakeholders and industry representatives were concerned that Attitude to Risk Questions come up with the 'what' (i.e. someone's attitude to investment risk) but not the 'why' (i.e. why this is an appropriate answer). For this reason, non-users or reluctant users of Attitude to Risk Questionnaires preferred there to be a discussion between an adviser and client.

> **'... one of the problems with the risk profiling tool is that really neither the advisor nor the client actually understands where the answers come from, all they've done is answer a series of questions, given them an answer and they have to believe the answer is right ... you get an answer nobody understands whether the answer is right or wrong, you just have to believe that is the right answer.'**
>
> **'It's all very well somebody compiled that risk questionnaire, it might be better going back to whoever has compiled that and say what do you actually mean by that question, you know, is there, how is this, when it gets fed into the system how does that then convert and associate with risk.'**
>
> (Advice Industry interviews)

Finally, some respondents questioned whether it was possible to ask about capacity for loss (a key aspect of someone's risk profile, as we saw above) in an objective way in an Attitude to Risk Questionnaire.

One size doesn't fit all

Among advice industry respondents in particular, there was some frustration that Attitude to Risk Questionnaires offer a pretty blunt tool for assessing someone's risk profile. This is because the same questions are generally asked regardless of the client's situation or their investment objectives, for example whether they are wanting to accumulate wealth or draw on the wealth they already have e.g. to provide an income in retirement.

Linked to this, some questions in Attitude to Risk Questionnaires may not apply to an individual, yet there is generally not an option in the question response codes for 'not applicable'. It is not entirely clear, therefore, how these questions can be answered or scored.

The consumer perspective

Not all the consumers we interviewed had experience of completing an Attitude to Risk Questionnaire, even though they all had some investment experience. In the interviews we tested a small number of Attitude to Risk Questions drawn from several different questionnaires. Our aim was simply to get people's views about whether these questions worked as *questions* e.g. could they understand the words and meaning of the questions, did the response codes make sense to them? The questions were chosen to represent different question types: hypothetical situations; questions that mentioned amounts of money; questions that required respondents to process quite a lot of information; or questions that asked respondents to make calculations.

Like the stakeholders and advice industry respondents, the consumers we interviewed had some issues about words that were used and what questions meant. But on the whole they found the questions relatively straightforward to understand and answer. For the most part, discussing the selected Attitude to Risk Questions in the interviews did not change consumer respondents views about risk in relation to investing. They already felt they had a good grasp of what they wanted from an investment in this respect – so the questions confirmed how they felt. However, several consumers reported that the questions helped clarify how they felt about risk – in particular, how much money they would be prepared to lose or could afford to lose. For one respondent, it made her think about the point at which she would start to feel uncomfortable 'if everything took a hit'.

We have to remember, though, that these were all consumers who had some experience of investment. People completely new to investing may find it more difficult to make sense of such questions in relation to understanding their own attitude to risk.

The other parts of the jigsaw: Emotion, motivations and behaviour

Whether we are conscious of them or not, a whole range of factors affect our understanding and perception of risk when we make investment decisions – of which attitude to risk is only one. Other crucial factors are the emotions and circumstances in which investment decisions are wrapped up, and our motivations and behaviours in buying investments and post-purchase. This research shows that these other factors deserve more attention.

Getting emotional: how emotions affect our perception of risk

We know from social psychology that any attitude has a spoken component (beliefs) but also unspoken components (feelings and emotions).[14] While Attitude To Risk Questionnaires touch upon the unspoken components of someone's attitude to risk, arguably a better understanding of the feelings and emotions that come into play in saving and investing, and how they affect people's decision-making, could improve the outcomes for individuals in both advised and non-advised purchases.

Conducted over the course of several years, a pioneering programme of research at The Open University, led by True Potential PUFin's Professor Mark Fenton-O'Creevy, has investigated the links between emotion and emotion regulation in the decisions of financial professionals (traders) and experienced private investors. This demonstrates that:

- Professional traders and private investors are often driven off-course by intense emotions
- They take risks to win back losses
- They feel lonely, with nobody to turn to.[15]

The research shows that, for professional traders, effective emotion regulation impacts positively on their trading outcomes. It's important to stress that effective emotion regulation *isn't* about suppressing or avoiding emotions. Rather, it's about managing emotions better.

Some of the simple but effective emotion regulation strategies used by professional traders that personal investors might find useful to help them manage the risks of investing are:

- Writing things down: have clear goals and a documented investment strategy and document any reasons for deviating from the strategy in advance.
- Use 'if-then' plans or intentions. Health psychology has shown that 'if-then' plans are effective at helping people achieve their goals.[16] Put simply, these plans or intentions state that if a certain situation occurs, then I will respond in a pre-specified way. For example, 'If my investment falls by 20% of its value, then I will review the situation after a week rather make any immediate decisions'.
- Seek emotional support. Our consumer interviews showed that making investment decisions jointly with a partner or one's family was one way that respondents mitigated the risks of investing.

For some of the consumers we interviewed for this research, the context of their investment decision was tied up with major life changes such as having a family, the death of a spouse, divorce and re-partnering – events which invoke strong emotions and which can add complexity to investment decision-making. Faced with making complex decisions in complex circumstances, the consumer interviews highlight some of the actions people take to try and mitigate the risks of the investing:

- Who you buy from: Some of the consumers we interviewed talked about investing with a trustworthy, reputable company that they know something about or only buying investments recommended by a professional or by someone they trusted (e.g. a relative working in the financial services industry). Convenience was another factor mentioned by respondents who had taken out investments with their own bank.
- Keep it simple: For the consumers we interviewed, this could mean investing in products that they felt aren't too complicated, like ISAs; or bringing their investments 'under one umbrella' so they were easier to monitor and review.
- Share the decision: Some of the consumers we interviewed had come to decisions jointly, e.g. with a partner or as a family (which may also offer the sort of emotional support that can aid decision-making, as we saw above).
- Do your own research: For example, DIY Investors might take notice of the funds that experts recommend, and select funds that several experts recommend.
- Triangulate: Some of the consumers we interviewed used more than one source of advice or guidance e.g. they talked to an adviser, but also talked to a well-informed relative or friend, and linked this to their own research.[17]

While investment experts may question the value of some of these strategies (e.g. buying from a big name provider), nonetheless these are the ways in which real-life 'ordinary' investors behave. Given new financial freedoms and responsibilities, this is how many other ordinary people might also behave who are new to investment.

[14] Secord PF and Backman CW (1964) *Social Psychology*. New York: McGraw-Hill
[15] See, for example, Fenton-O'Creevy, M, Soane, E, Nicholson, N and Willman, P (2011) *Thinking, feeling and deciding: the influence of emotions on the decision-making and performance of traders.*
[16] Gollwitzer, P. M. (1999). Implementation intentions: Strong effects of simple plans. *American Psychologist*, 54, 493-503
[17] Diversification – or in layman's terms not having 'all your eggs in one basket' – is another important way that investors can mitigate risk, and something that our consumer respondents were generally familiar with.

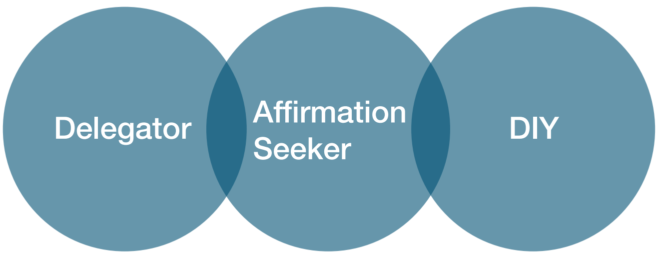
What kind of investor am I? Understanding motivations and behaviours

Alongside deeper emotional understanding, the interview data collected for this research also shows that it is worthwhile consumers asking themselves: What kind of investor am I?

Why is this useful? Because it captures something more about the behavioural and motivational side of people's investment decisions, which in turn helps build up a picture about the time they might invest in making, monitoring and reviewing investment decisions; the type of help or support they might be interested in; and the likely role of professionals in their investment decision making. How does this relate to people's understanding of risk? Because it can highlight some of the behavioural risks that might significantly impact on someone's investment outcomes, for example whether or not they are motivated to review their investments and make changes to ensure they are still on track to meet their investment objectives.

From the consumer interview data, we see there is a continuum from Delegators, through to Affirmation Seekers and DIY Investors. But context is important: people aren't necessarily one type of investor or another, they may move along the continuum depending on the particular circumstances around an investment decision.

What kind of investor am I?



Delegators

Delegators delegate the selection and decision-making to someone else, typically a professional adviser. They may do some of their own research, but probably not a lot. They monitor and review their investments perhaps once or twice a year, and the adviser is involved in this process as well. They identify with the personal importance of investing and they take responsibility and ownership for it, but they are doing it because it leads to a particular outcome, not because they have any great interest or get any particular enjoyment from investment – in psychology, they are what's called extrinsically motivated.

Case study: Delegators [18]

Jane is a woman in her 40s, recently widowed with teenage children. She describes herself as *'middle of the road'* when it comes to investment experience, with a decent understanding of the basics. She considers herself to be a cautious investor – particularly in her new role as the family's main breadwinner. Following her husband's death, the purpose of Jane's recent investment was to ensure she has an income in the future: as she described it, *'plain and simple necessity'*. She bought her investment though an adviser – *'the expert'* – who did all the research and recommended the investment that Jane went on to buy. Jane did however get a second opinion about the investment she was recommended, from a close relative who works in financial services.

[18] Respondents' names and some details have been changed

Affirmation Seekers

Like Delegators, Affirmation Seekers are extrinsically motivated. But unlike Delegators, they tend to do their own research and they are generally more engaged and proactive. Even so, they make their final choice of investment in collaboration with someone else – a professional adviser perhaps, or a trusted friend or relative. This is because they want affirmation or reassurance that they're doing the right thing, either because it's a fairly complex situation e.g. linked to divorce or a trust fund, because it's a large sum of money or because they're considering higher-risk investment.

Case study: Affirmation Seekers

Janet and John are a professional couple in their 30s, with a young family. Their overriding priority is to make sure they are financially secure in the future. They describe themselves as moderately experienced with a good sense of the financial products in the market. They are prepared to take some risk with their investments: *'we like to push the boundaries a bit …. It's only worth it if we do take a little bit of a chance'*

They keep a close eye on their financial situation, review their investments regularly, and take an interest in what's happening in the financial markets. When thinking about new investments, they do their own research, and are more interested in some things (property) than others ('*boring*' bonds).

Janet and John's recent investments include a buy-to-let property where they used a mortgage adviser as a sounding board for their decision-making. John has also talked to a pension adviser about putting his pension savings into higher-risk investments to get a better return, because he's think of a career change that would probably involve a drop in their household income, at least in the short term.

DIY Investors

The big difference with DIY Investors is that they tend to invest because they are interested or because they enjoy it – in other words, they are intrinsically motivated. Their motivation can be quite specific, for example people with a passion for property or who are interested in the stock market. So they do their own research, they are likely to triangulate information from a number of sources, and they come to their own decision – and then they actively monitor what's happening and make changes. Unlike people who buy an investment from a financial adviser, DIY Investors of course have no redress for poor investment decisions they may make. There is also no guarantee that DIY Investors have the knowledge and expertise to make sound investment decisions.

Case study: DIY Investors

James is a single professional in his late 20s. Having saved in cash ISAs in the past, he *'decided to dabble'* in the stock market, influenced by conversations with his old boss: *'he used to go on about how he used to invest in things and how much money he used to make…'*

James bought a self-select stocks and shares ISA. He knew he wanted to be able to choose where he invested and to buy and sell shares fairly regularly. He did his own research into providers, before choosing one that doesn't charge an annual fee.

James thinks of himself as a fairly low-risk investor: *'… I stick towards the large equities, the UK Equities, FTSE listed businesses. I have dabbled in the AIM but I'd say 70% to 80% of my investments are very low risk, or I try to be low risk anyway.'* He checks the financial papers and a number of specialist websites every day to see what's happening in the business world, and monitors his own investments 2-3 times a week: *'You get quite excited when you read something on the news or something comes up'*.

Next steps towards a common understanding of risk

This research presents a strong case for the improvement of Attitude to Risk Questionnaires, to ensure they work better both within and outside the advisory process. But it also powerfully demonstrates the other factors - emotions, motivations and behaviours – that impact investment decisions and that we believe deserve more attention. What is needed, we suggest, is a toolkit for the ordinary investor, to help people get to grips with the sorts of things they should understand and the questions they should ask (of themselves and others). We explore these ideas in the following sections.

Attitude to Risk Questionnaires: next steps in the evolutionary process?

Overall, the message from the interview data is that, while Attitude to Risk Questionnaires (and risk profiling tools generally) can serve a useful purpose in an advisory process, they have limitations.

At the same time, it is anticipated that a growing number of people will elect to make their own investment decisions without financial advice, either on their own or with guidance. Unlike the clients of regulated financial advisers, these DIY Investors do not have to complete an Attitude to Risk Questionnaire. There are Attitude to Risk Questionnaires available online that DIY Investors can use if they wish – but these are typically the same questionnaires used in an advisory process, and this research raises important questions about their usability and validity as standalone tools.[19]

In other words, what we lack at the moment is a questionnaire or tool to capture attitude to risk that is designed *specifically* for the DIY Investor – and more particularly, for ordinary people who are new to investing who may be most vulnerable to making a bad investment decision.

From this research alone, it is not possible to suggest the specific questions that might be most effective at capturing and conveying someone's attitude to risk in a 'standalone' situation. This is something that the industry, working with the regulator, is best-placed to take forward. However, the rich insights from the consumers, stakeholders and advice industry interviews conducted for this research suggest three 'design principles' that might usefully be applied to any new questionnaire or tool for DIY Investors. The same principles can be applied to existing Attitude to Risk Questionnaires to create more accessible and relevant tools that can aid the adviser as well as the client.

Principle 1: The questionnaire takes some account of individual circumstances and objectives

We saw from the consumer interviews that people's attitude to risk and their approach to investment depended on circumstances, context and their investment objectives. Advisers were also concerned that 'one size didn't fit all' when it came to Attitude to Risk Questionnaires.

Attitude to Risk Questionnaires tailored to take some of this variation into account could therefore be more relevant and useful to consumers. One option might to have an Attitude to Risk Questionnaire with a core set of questions asked of everyone, plus supplementary questions tailored to individual needs and goals. Another option might be to have different Attitude to Risk Questionnaires to suit different needs and investment objectives, e.g. one for people who are at the stage of accumulating wealth, another for people who want to draw on their wealth. There are already some developments in this area: FinaMetrica for example has recently produced an Attitude to Risk Questionnaire tailored to small investors.

Principle 2: The questionnaire helps people think about the different dimensions of 'risk capacity'

The interview data clearly shows that, as far as consumers are concerned, there are three dimensions to 'risk capacity': (1) whether they can afford to invest any money in the first place (2) whether they can afford to take some risk with the money they can afford to invest and (3) the impact on their standard of living if their investment does not deliver the outcome they anticipated (in investment-speak, their capacity for loss). In the course of the advisory process, these three dimensions are typically discussed by an adviser and client. Some Attitude to Risk Questionnaires also try and assess people's capacity for loss.

It is important to encourage DIY Investors to consider all three of these dimensions – particularly as being able to afford to invest, and being able to afford to take some risk are things that should be 'knowable'. While mindful of not over-burdening consumers, the industry should consider whether there is value in having a separate questionnaire or tool that helps DIY Investors think about the multi-dimensional nature of risk capacity. Again, this could be tailored to take account of the individual's investment goals, their investment timeframe, and their circumstances – all things that impact particularly heavily on capacity for loss.

Principle 3: The questions are consumer-centric and user-friendly

Turning 'investment-speak' into language that ordinary consumers can understand is fundamental if people are to make sound investment decisions on their own. Across the different groups of people we interviewed (stakeholders, advice industry and consumers) there was also a view that visuals and graphics (such as infographics) could be used more effectively to convey information and aid consumer understanding.

[19] There is also a regulatory question about the information that is provided alongside online Attitude to Risk Questionnaires and whether, taken together, this information might constitute regulated financial advice.

One way to determine whether Attitude to Risk Questions work as questions is to simply ask:

- Can ordinary people understand the words used in a question?
- Does the question make sense to ordinary people?
- Do the industry and the consumer interpret the meaning of the question in the same way?
- Do the response codes match the question?
- Can ordinary people answer the question using the response codes provided?

If the answer to any of those questions is 'No' then something may need to be changed to make it work better for ordinary consumers (as well as advisers). For example, it might mean adding a response code for 'not applicable to me'; or replacing scales that ask respondents to say how strongly they agree or disagree with a statement with yes/no response codes. Although on the face of it these changes appear simple, they may have implications for the way in which questions are scored and the risk profile calculated.

In the interviews with stakeholders and the advice industry, concerns about words and meaning flowed through to investor risk profiles and investment risk descriptions as well. Again, these concerns become magnified for people who elect to make investment decisions on their own. For example what does it mean if your risk profile is 'balanced' or 'cautious'? And how does this relate to a 'balanced' or 'cautious' portfolio? Does 'balanced' or 'cautious' mean the same thing across different products and providers or not?

Establishing a standard approach to risk profiles and descriptions might be one way to help advisers and consumers compare like-with-like. One stakeholder, for example, suggested creating a 'loss rating' system for investment funds, that would be produced by fund managers using a standard formula, as described below:

> **… as long as the formula was agreed by the industry and understood by people then it would be up to the fund managers to have to rate their funds and that would be a much easier way of consumers being able to say well actually that looks a little bit, you know, that bit there, that's a little bit out of my realms really, I think I'd rather go with this lot down here… I think it needs some new thinking, I think the old paths are just not working anymore.**
>
> (Stakeholder interview)

Better information: A bigger nut to crack?

While information disclosure is fundamental to consumer protection and competition, it is proving hard to strike a balance that works well for consumers, the industry and the regulator.

The stakeholders and advice industry representatives we interviewed raised concerns about the information that investment customers receive, including suitability reports that are produced by financial advisers for their clients and the information that comes with investment products. In a nutshell there's too much of it; customers don't always read or understand it; and as a result there is a real risk that important information about investments goes unnoticed or ignored.

'I think too little time is still spent thinking about, you know, how clients perceive information, how they interpret, how they assimilate it and how they translate it to their own minds.'

'… when I look at what we send out and we're obliged to provide sort of the fund key investor information as well as we also provide a factsheet and I'm sure that half our clients just use it to start their fires in the winter, you know. It's so off-putting for them and it's a massive challenge to work out how to provide the information but in a way that's digestible and useful for the client. And I still don't think that's been cracked.'

(Advice industry interviews)

The FCA (the UK financial services regulator) is carrying out work in 2014-15 to examine whether disclosures generally can be made simpler and work better for consumers.[20]

[20] *FCA Business Plan 2014/15*. London: FCA

Sound investment: A toolkit for ordinary investors?

Previous research finds that the UK public generally has a fairly basic understanding of the risks of saving and investing. Our research confirms this – but more importantly it exposes the great variety of factors that affect people's perceptions of risk and their investment decisions. In an advisory process, some or all of these factors may be taken into account in the discussion between adviser and client. But what about the growing numbers of people who elect to make their own investment decisions? How can the industry and the regulator ensure that ordinary people make sound decisions, and steer clear of investment frauds and scams in their search for better returns at a time when savings interest rates remain historically low?

No single tool or questionnaire can provide the answer. What is needed is a toolkit for the ordinary investor, to help people get to grips with the sorts of things they should understand and the questions they should ask (of themselves and others). The toolkit is not intended to replicate the advisory process, nor is it simply about giving people more information. Rather, it's about helping people make better use of the information and resources that are already available, by giving them some idea of the things they should think about in order to make sound investments. This research does, however, provide compelling evidence for a new Attitude to Risk Questionnaire or tool designed specifically around the needs of ordinary DIY Investors, as described above.

The evidence in this White Paper offers a blueprint for developing a toolkit for the ordinary investor, with four basic components:

What should I understand about the investment environment?

This research suggests six 'pillars of wisdom':

1. Investments go up and down and you may not get back the amount of money you invested at the start
2. Inflation can reduce the real value of money saved in a savings account
3. What outcome are you looking for, and what time horizon are you thinking about?
4. Have you considered the impact of charges on your likely investment returns?
5. Have you considered the rate of return in relation to inflation, how the investment returns are taxed, and the rate of income tax you pay?
6. What might your investment journey look like over the next three to five years, and over the time until you reach your desired outcome?

What type of investment is right for me?

This research presents compelling evidence for an Attitude to Risk Questionnaire or tool designed specifically around the needs of DIY Investors, particularly those new to investing. It should (1) take some account of individual circumstances and objectives (2) help people think about the different dimensions of 'risk capacity' and (3) be consumer-centric and user-friendly

How might my emotions affect my decisions and what can I do to manage my emotions?

The investment journey can be an emotionally bumpy ride. Research suggests some simple strategies to help people manage their emotions:

- Writing goals down
- If-then plans
- Emotional support

What kind of investor am I?

Using case studies like the ones described in this White Paper (e.g. as video clips) to ask 'What kind of investor am I?' helps people think about the time they might invest in investing; the type of help or support they might be interested in; and the role of professionals in their decision making. This in turn can flag behavioural risks for people to be aware of.

To develop this blueprint into a practical, effective toolkit that people actually use requires input not only from experts but also from the ordinary investors that it's aimed at. As the psychologist Paul Slovic concluded almost thirty years ago in relation to risk perception in everyday life: '… *risk communication and risk management efforts are destined to fail unless they are structured as a two-way process. Each side, expert and public, has something valid to contribute. Each side must respect the insights and intelligence of the other.'* [21]

Going forward, we plan to explore ways to put this research into action, in partnership with industry stakeholders.

[21] Slovic (1987) 'Perception of Risk.' In: *Science*, New Series, Vol. 236, No. 4799, page 285.

About True Potential PUFin

The True Potential Centre for the Public Understanding of Finance (True Potential PUFin) is based at The Open University Business School (OUBS). True Potential PUFin is a pioneering centre of excellence for research and teaching related to personal finance capability. It brings together academics with expertise in fields such as regulation, taxation, consumer attitudes, motivations and behaviours, and social marketing.

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