WHITE PAPER

TrueProfile

The Adviser Who Knows the Client Best, Wins

Why regulators, advisers and clients are demanding science-based profiling

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Separated at Birth: Client profiling and portfolio optimization

There are two pillars of financial advice: The ability to understand a client in all of their complexity, and the ability to construct a suitable portfolio and plan to meet their needs—both must comply with regulation. Each pillar is essential but only one, portfolio management, has benefitted from modern mathematics and computing techniques. When done well, portfolio optimization is robust but it cannot reach its full potential without the benefit of a deep understanding of the client. For practitioners, it is as if client profiling and portfolio optimization were separated at birth. Portfolio construction techniques have received significant investment of time and technology and now are largely fit for their purpose. In contrast, client profiling is fragile and has changed little over the years despite increasingly complex client preferences and priorities. Our industry would find it hard to claim a deeper client understanding today than decades ago. Fewer face-to-face interactions resulting from fee compression and competitive realities will further constrain our goal of understanding the client. So now what?

Re-united: The science of understanding clients as an input to custom portfolios

In order to move our industry forward, client profiling methods should employ the same rigor and meet the same standards that portfolio management does today. Now is the time to invest more into investigating our day-to-day methods because when we do, we will find that things are changing for the better as a result of innovation.

The core philosophy that will bring profiling up to modern standards is simple:

- **Show, don't tell** – Use gamification to let clients naturally reveal their preferences regarding risk vs. return, today vs. tomorrow, and certain vs. ambiguous, rather than relying on stated preferences alone.

ABOUT CAPITAL PREFERENCES

We reveal client preferences from their decisions, so advisers can act with confidence. By examining how clients make tradeoffs between risk vs. return, today vs. tomorrow and themselves vs. others, we gain a precise measure of their preferences and can customize their financial plans with confidence.

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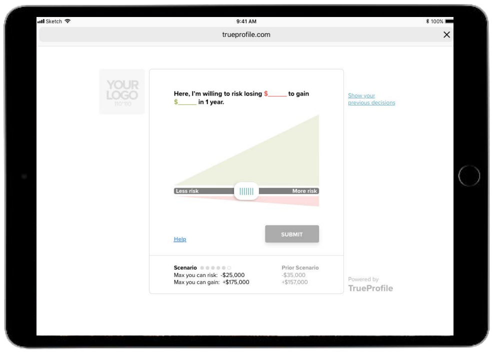

Revealed Preferences

- **Lever economic science and mathematics** – Use quantitative and verifiable assessments of a client's goals, constraints and preferences that have clear economic interpretations and direct implications for portfolio construction and financial planning.
- **Adopt technologies from the frontier of economic research** – Use the most scientifically advanced decision games that can be administered efficiently to clients in order to scale an advisory practice, make digital financial services successful, and address looming compliance and regulatory concerns.

Old Techniques

Below, we describe the status quo of client profiling and its failures. We then introduce methodological advances that address these failures and will shape the future of digital and face-to-face advice. New methodologies must have relevant and precise mathematical underpinnings and produce repeatable outcomes that are easily retested and recalculated with statistical confidence—just like the science of asset management.

Client Profiling: What data is needed?

To explain the limitations of current profiling practice, we begin with a definition of what it means to understand a client, followed by a description of the methods currently in use by advisers.

Profiling methods vary but their thrust is to understand and measure a client's:

- **Goals (risk requirements)** – a client's primary intentions for their financial assets.
- **Preferences (risk tolerance)** – real world, financial choices a client would make if they truly understood the available options and had time to thoroughly consider them.
- **Constraints (risk/loss capacity)** – a client's capacity to pursue various goals, driven by age, income, assets, tax policy, and other considerations.

Old Client Profiling Methods: In dire need of an overhaul

Historically, advisers have used investor interviews and/or risk tolerance questionnaires to assess client goals and to profile their preferences and constraints.

A fundamental limitation of these methods is their reliance on stated preferences. **They make the assumption that people can accurately state their own preferences and priorities.** Economic research makes clear, however, that many investors face enormous difficulty articulating their preferences for risk or otherwise. As a result, financial advisers who use these unscientific methods often work with poorly defined and unverifiable information. The resulting advice may therefore be badly misaligned and hard to validate as compliant or suitable.

As an industry whose business processes have serious impact on financial well-being, our profiling assessments should be grounded in precise measurements, not just words, with a consistent scoring methodology and statistical confidence in the results we gather from the client. Without scientific confidence in the assessment results of client preferences and priorities, the credibility of the advice process and claims of "customization" are inherently weak.

Additionally, both investor interviews and risk tolerance questionnaires don't work well in a digital age, where more and more consumers will be acquired and served online. The results these methods produce are imprecise, incomplete, and infrequent.

IMPRECISE. Current methods rely on ambiguous language with no underlying mathematical theory supporting their scoring methods or definition of risk, making them:

- **Unreliable** – Results will vary, depending on the questions asked or even how standard questions are interpreted by investors, resulting in varying advice for that same client.
- **Difficult to interpret** – Questions like "On a scale from 1 to 5, how comfortable are you with uncertainty when investing?" are very difficult for investors to accurately answer.
- **Difficult to validate** – Without precise language and mathematical theory as a core underpinning, defending the suitability of the advice provided is problematic.

"*Principles and Effective Practices: Effective practices for customer profiling include: (abbreviated list)*

- *assessing both a customer's risk capacity and risk willingness.*
- *resolving contradictory or inconsistent responses in a customer profiling questionnaire.*
- *contacting customers periodically to determine if their profile has changed.*

FINRA's *Report on Digital Investment Advice,* March 2016

"*An FCA Study into suitability of investment portfolios found that "a third fell substantially short of our expected standards [and] a third need to make some improvements to meet our standards.*

FCA's *Wealth Management Firms and Private Banks: Suitability of Investment Portfolios,* December 2015 – TR15/12

"*A fiduciary is required to act in a manner "...based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor ...*

DOL's *Best Interest Standard of Care,* April 2016

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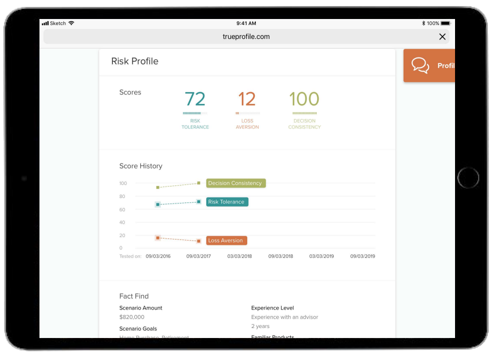

Rich Data Output with Portfolio Fit

INCOMPLETE. Current methods are one-dimensional, focused purely on risk, and do not:

- Provide the adviser with any degree of confidence regarding the reliability of the profile itself; the adviser can't be certain they captured the client's true preferences.
- Provide quantitative guidance on specifically how an investor's naturally occurring preferences might translate into a portfolio allocation.
- Offer quantitative guidance on other key dimensions of willingness to accept risk including, loss aversion, ambiguity aversion, goal priorities, and time preferences.

INFREQUENT. Most client profiling is designed to be a one-time process that does not allow for easy client engagement and monitoring of changes in client goals, preferences, and constraints.

Regulation: Know your client, do what is best, and charge a fair fee

Regulators are sending us a message: **"Deeper client understanding is the only sustainable answer to our industry's challenges."**

FINRA asks us to validate our client decision-making, and DOL asks us to prove our value, but concerns about understanding clients extend well beyond U.S. borders. One can only claim to customize a portfolio if there is client data to customize to. You can't claim to customize a portfolio based on one, unscientifically derived risk number.

New Hope in Decision Science: An Economic Fingerprint™ behavioral profile

Enter a 15-year body of research from Shachar Kariv, Chair of the Economics Department of University of California Berkeley, focused on reaching deeper levels of client understanding, in record time, through the structured analysis of clients' decisions, not their words. The result is what he calls an Economic Fingerprint™. Applying these methods to client profiling allows for a level of rigor, statistical confidence, and robustness that should give consumer financial services businesses new hope and new promise in their quest to add value. Founded on decision science and leveraging advanced computing power, gamification, and econometrics, these new and sophisticated methods are simple for the client. In them, we observe clients making actual decisions in a financial "wind tunnel". Tested across representative populations in major research panels and the subject of significant academic review, the output is rich data that enhances portfolio management and financial planning's value by giving this process verified answers to very important questions:

- How loss averse is this client?
- How risk tolerant?
- Does this client react negatively (become more risk averse) when facing uncertainty?
- What are this client's time preferences?
- How does this client make tradeoffs relative to their many goals?

Going Forward: The value is in the client data

The successful adviser and firm of the future will create value by fully understanding their clients. Rich data will help them balance their goals, preferences, and constraints with products and services that reflect who they truly are. In fact, knowing the client represents our single biggest opportunity, and new methods of client behavioral profiling will change our industry forever. Continually looking for shortcuts and putting clients on auto-pilot is not the right answer for the industry, its advisers, or clients. Knowing your client fully, and having the data to document this fact, is. **Simply put, those who know their client best will win.**

Where to go from here?

Next, we will examine those methods and their academic roots in decision science, economics, and gamification.