Smarting Up Onboarding

Synopsis: ***The Andes Wealth instrument goes beyond traditional risk tolerance measurements to provide a deeper look at a client's investment preferences, and facilitate a deeper conversation about the right portfolio recommendation.***

Takeaways: ***Advisors can quickly learn about their prospects' mental biases, and the prospects actually select the portfolio they prefer—making the process more defensible. There are illustrations of different efficient frontiers over different time frames, and clearly illustrated downside risk***

It's been a few years since I wrote about Andes Wealth (*https://andeswealth.com/*), which I view as a client onboarding tool that combines client profiling with risk tolerance assessment and risk management. It is a risk tolerance instrument that also drives an impressively sophisticated conversation about investing between advisors and prospects.

Since my last article, Andes has been winning industry awards from the Money Management Institute, ThinkAdvisor (the actual award, not the worthless 'finalist' credential) and Family Wealth Report.

It's not hard to see why. Unlike some of the popular risk tolerance instruments on the market (Nitrogen in particular) Andes doesn't dumb down the conversation into: *hey, you're a 27 based on your answers to a series of questions that don't reflect any recognizable potential investment outcomes over the next six months, and hey, your portfolio is a 61. Let me help you get those closer together.*

Andes allows advisors to effectively 'smart up' the process, by getting to know what they're dealing with in a prospect fairly quickly, and facilitating an adult investment conversation that helps prospects recognize your sophistication.

Andes Wealth is not a marketing tool, but it drives conversations that help a prospect see your investment expertise.

Perhaps most importantly, it is not a marketing tool. Advisors can use Andes to close a higher percentage of prospects through that investment conversation. But the key difference is that the Andes portfolio decision-making process is defensible in court as an actual assessment of what the client wants, needs and can tolerate in difficult markets.

To see the difference, imagine that we experience a severe bear market and a client decides to take legal action claiming that the portfolio the advisor recommended was unsuitable because, well, he lost money.

There are two ways the cross-examination might go:

"Mr. Advisor, *you did an assessment of the suitability of the portfolio you recommended to my client, is that correct?"*

"It is."

"Can you tell the Court how you arrived at that assessment?"

"I used a very popular tool that currently has nearly a 50% market share in our industry. It listed your client as a 27 on a scale of 1-100, and I invested accordingly."

"Very interesting, Mr. Advisor. Would you look at this screenshot of the popular tool's website? Do you notice that it says that it is a very effective marketing tool?"

"I do. In fact, we've been using it for years, and I attribute a big part of our growth to having adopted its marketing methodology. It's been terrific at helping us close prospects into clients."

"Indeed. So you're telling the court and esteemed members of the jury that, when you determined how to invest my client's life savings and ensure his family's future financial security, you relied (let me read this screenshot again) on a ***marketing*** *tool?"*

Or the conversation could go in a different direction:

"Mr. advisor, you did an assessment of the suitability of the portfolio you recommended to my client, is that correct?"

"It is."

"Can you tell the Court how you arrived at that assessment?"

over shorter time horizons.

And, together, we looked at the maximum drawdown during periods of significant historical market volatility, to make sure he was aware of the short-term losses that sometimes occur in markets like we've just experienced, and

The assessment tools are two to three questions long, but they are built on academic research to help advisors understand the prospect's investment personality.

"I used the Andes Wealth instrument to show your client several proposed portfolios, which listed the upside and downside parameters of expected returns over different time periods based on the tenets of Modern Portfolio Theory to an 80% confidence range. Your client, himself, selected the portfolio that we ultimately implemented.

But before investing in that portfolio, I followed up with several client profile instruments to further clarify your client's loss aversion, investment sophistication and investment personality.

I also used the Andes instrument to determine your client's risk capacity, to make sure we understood the full picture before any investment decisions were made.

And in that initial conversation, I showed your client several different models of how the efficient frontier actually manifested over different time periods, to help him understand some of the concepts of how we invest for maximum portfolio efficiency and the potential for variability in returns willing to experience them in return for the upside potential of that particular portfolio.

I believe my attorney plans to introduce the investment policy statement that your client signed off on that documents these decisions that we arrived at mutually in those early discussions."

(silence.)

"Do you have any other questions?"

Investor types

Let's take a quick look at how all of these things happen prior to and in the first prospect meeting.

In some cases, before that initial meeting, the advisor will go to the Andes dashboard and auto-send the prospect a link to a series of mini-questionnaires. When I say 'mini,' I mean literally two or three questions each that get to the heart of the prospect's investing personality. Andes founder Helen Yang has co-authored academic research with Dr. Andrew Lo at MIT, who has published extensively on investor behavior and some of the biases we inherited literally from human brain development over millennia in the African savannah—which (as I suspect the reader knows) don't serve us well in the modern investing world.

There are loss aversion questions (does the prospect prefer a sure gain vs. a similar bet that carries some risk; and a sure loss vs. a similar bet?); two 'herding' questions that show whether the prospect is inclined to make decisions based on crowd behavior or by researching the choices; a couple of overconfidence questions (does the prospect think it was easy to predict the market tumble in early 2020; can he/she reliably pick investments that will beat the market?); a quick assessment of the prospect's financial sophistication and knowledge (three basic questions about diversification, compound interest and market risk); and finally the prospect is invited to select six words out of a total of 15 as a self-description. (I chose 'rational risk taker," 'independent thinker,' 'visual person,' 'logic-driven,' and 'adventurous,' and had trouble choosing between 'optimistic' and 'realistic.'

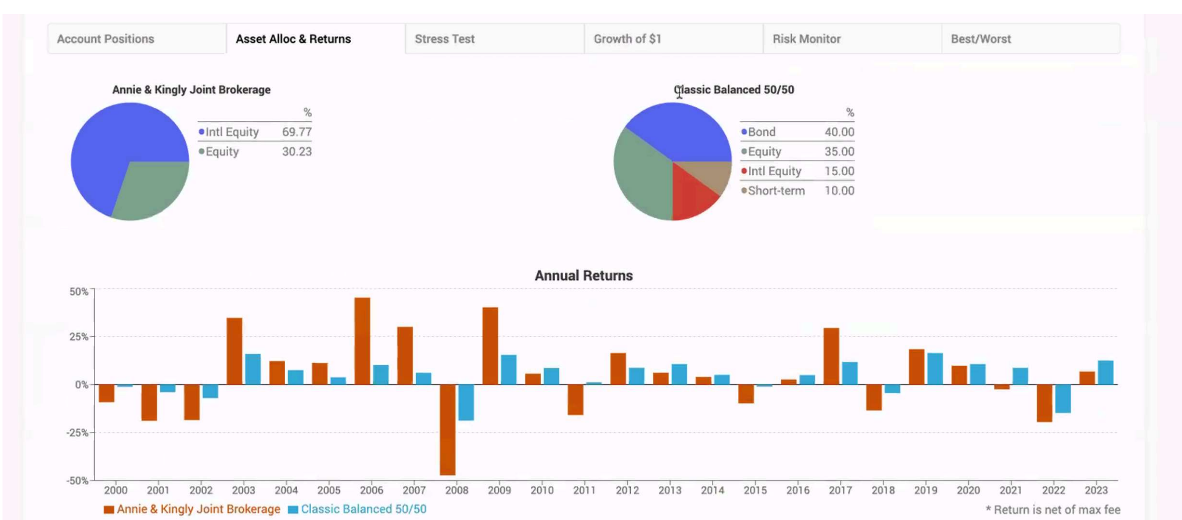
From this data, investors are categorized according to their investor type based on Dr. Lo's research. The types are: *passive investors* (35% of the investor population), *trend followers* (27%), *contrarians* (8%), *safety-seekers* (19%), *risk seekers* and *adaptive investors* (few, but they're out there) and people who don't fit neatly into any of these categories.

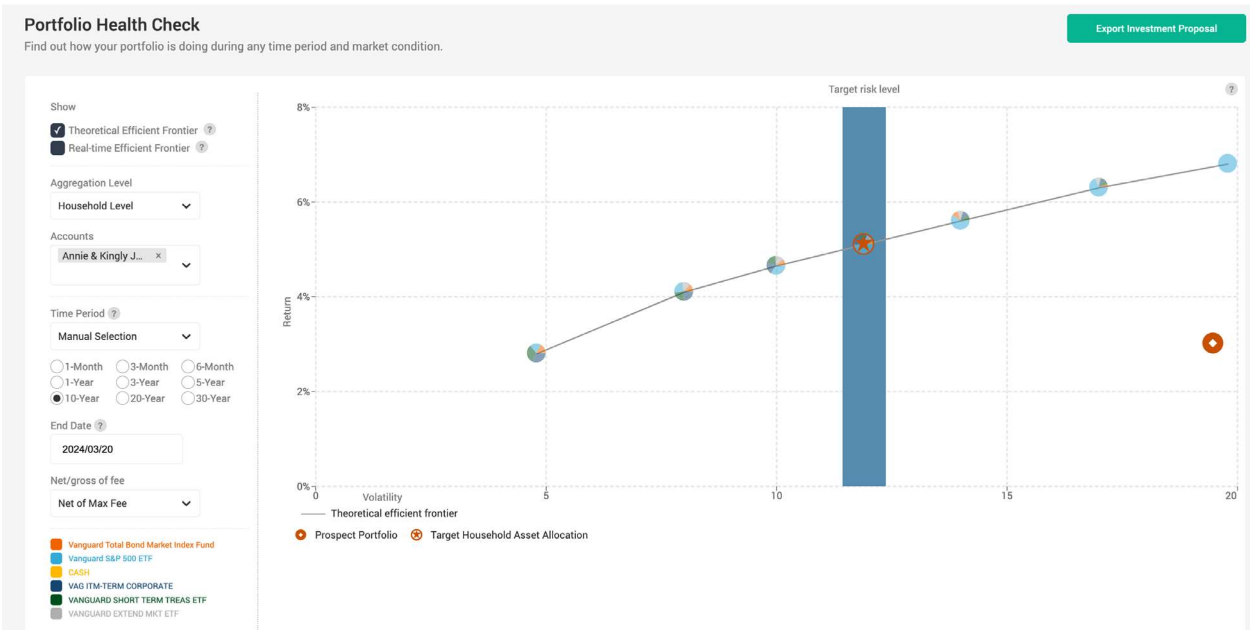
The process takes literally five minutes altogether, which undoubtedly results in a higher completion percentage. One interesting note is that, unlike many of the instruments in the fintech world, Andes will collect risk profiles of two members of a household, ensuring that one spouse's preference isn't drowned out by the other's. "We've found that this can be a big differentiator between Andes and Riskalyze,' says Yang. "With Riskalyze, there's one test and you're kind of stuck with that for the household; there's no way to merge the two or build hybrid results. We feel that it's important," she adds, "for the advisor to get a complete picture of the household."

Illustrating and closing

On to the first meeting. Earlier, in the brutal cross-examination above, we alluded to having the prospect select the portfolio. The prospect is shown the screen on this page, which illustrates the advisory firm's spectrum of model portfolios, with increasing risk asset weightings from left to right. The green bars represent the range of expected upsides over (in this illustration) a 1-year time period, and the red bars show the range of expected 1-year losses, out to that aforementioned 80% confidence range. Note that these returns are net of the advisor's fees and expense ratios, and they show the returns both in actual dollars and percentages. Advisors can easily show the prospect these same numbers over longer or shorter time periods to round out the conversation.

But those other risk tolerance marketing tools help 'close' the prospect, right? Andes does too, but in a more nuanced way. It offers several ways to compare an existing prospect portfolio with what the prospect selected a few moments ago. You can see one of them here; the screen shows the basic asset class breakdown of current and proposed, and the annual returns, year by year, over a selected time period. In this illustration, the proposed portfolio experiences far less downside risk, and also less upside during bull markets.





Another illustration shows where the prospect's existing portfolio would map out on the efficient frontier (it's that red dot on the right side of the image, above) compared with the proposed portfolio (in the middle of the blue bar)—which can facilitate a conversation about portfolio efficiency and how the only free lunch in investing is an asset mix that gets the highest expected return per unit of historical risk/volatility. Andes allows a quick look at this illustration over different time periods, and also demonstrates how the actual efficient frontier can twist and turn during different market environments—something that is not always evident even to advisors.

Note that Andes, like the popular fintech competitors, provides a client and portfolio risk score. But instead of being a black box number that is presented with some mystery, the Andes risk score is simply calculated as five times the standard deviation of the portfolio over a 5-year time frame. For portfolios built with traditional asset classes, this maps neatly from 0 for an all-cash portfolio to roughly 100 for an all-equity portfolio. (Interestingly, this allows for greater-than-100 scores. For example, a bitcoin portfolio might score in the 400s. For further discussion, see: *https://www.advisorperspectives.com/articles/2022/02/18/how-risky-is-bitcoin*.)

The illustration of different efficient frontiers—where each year and, indeed, each decade produces very different return profiles—makes a point that Yang thinks gets lost in that mysterious risk number. "It shows that portfolio risk really can't be captured by a single number," she says, "because short-term and long-term risks can be very different. During market turmoil, the right message is that short-term risk may be high, but the longer-term is on track. Hence, investors should stay put if they have a sufficient investment time horizon."

There's a final test to whether the portfolio the prospect selected is appropriate or not: the client's risk capacity. Yang argues that most advisors get lost in a back-and-forth effort to determine risk capacity, but the real issue is not complicated.

"The traditional argument

says that if you are well-funded and already have more than you expect to need in retirement, then you can afford to take more risk," she says. "But at the same time, that well-funded person doesn't have to take as much risk. If you're currently underfunded, then you can't afford to lose money, but it's also true that you cannot afford not to take more risk. So the risk capacity discussion ends up being a wash."

Instead, Andes uses the client's time horizon to determine risk capacity. If the portfolio (or a bucketed portfolio that is allocated to, say college planning or the purchase of a vacation house) has a short time horizon before the money will be needed, then the risk capacity is low and the portfolio risk score should tend lower. If the time horizon is the client's expected lifespan, the the risk capacity will generally be much higher. "If you have a longer time horizon," Yang explains, "then you can afford to wait out the bear markets."

She adds that advisors might want to take into additional account things like the prospect's income stability. An artist or real estate agent with a feast-or-famine kind of job might need to dial back the portfolio volatility (and risk score).

IPS and monitoring

The output of this conversation is an investment policy statement. The document outlines the investment objectives, the results of the various risk tolerance assessments, the planning horizon that the new client provided to the advisor in that initial prospect meeting, the top holdings in the portfolio and the asset allocation in pie charts, range of outcomes over time, drawdowns during bear markets, and some legal disclosures that can be edited or modified. The client and advisor sign the document, and then the portfolio is implemented.

Andes Wealth will show clients where their current portfolios fall on the efficient frontier, which can generate a rich discussion.

Andes also offers, through integrations, a dashboard which shows all of these portfolio variables on an updated basis. Of particular interest is the ability to sort whether portfolios are out of tolerance from their initial allocations, and by how much. (Advisors can set their own tolerances' the default that comes out of the box is a 20% variance of any broad asset class.)

A firm's chief investment officer might consult this tolerance list and flag any portfolios where a staff advisor might have changed the allocation to something that is outside of the IPS, or whether the markets have conspired to stretch an allocation to a higher or lower percentage than the IPS specifies.

This is a fairly long article that describes processes which, collectively, will take less than an hour, depending on how long the advisor wants to drag out the initial investment conversation while also talking about financial planning issues, goals and pain points. It could easily be the middle 15 minutes of the initial prospect meeting; Andes allows advisors to cover the investment waterfront in minutes rather than hours, and have a richer, deeper investment conversation than might otherwise be possible.

The primary goal is to get to know the client's investment profile at a fairly deep level, engage in a meaningful conversation about investing and get the client's direct input on which portfolio will be optimal.

The secondary (but still important) goal is to leverage this conversation to maximizes the chances of closing the prospect.

And a third goal (definitely not unimportant) is to protect your firm with a defensible process for making portfolio recommendations.

Every advisor needs that defensibility, but in the real world demos that are taking place as you read this, the larger enterprises and broker-dealer firms seem especially interested in facilitating a sturdier initial *know-your-client* process that covers the bases—giving them, the advisor and the client a basis for sleeping at night no matter what the markets are doing. ■