FINANCIAL
LITERACY PROGRAM

BUILDING SOUND FINANCIAL MANAGEMENT SKILLS

Building a Diversified Portfolio

Risk Tolerance Profile

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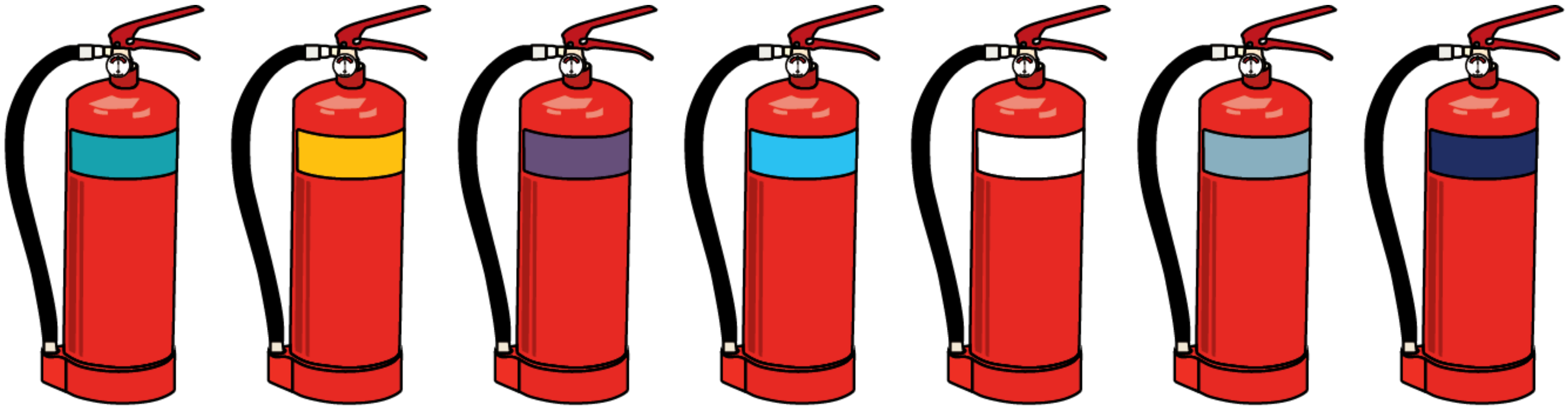
Types of Risk



- Market Risk
- Exchange Rate Risk
- Credit Risk
- Inflation Risk
- Interest Rate Risk
- Political Risk
- Country Risk

Types of Risk

In addition to the volatility associated with each asset class, there are a variety of other unavoidable risks which also exist, related more to being in the market in general and owning specific securities.

Some of the most common types of investor risks include:

- ***Market risk*** or beta risk is the primary risk investors take on when investing.
  - As the name implies, it is the risk inherent in being in the markets since there are external and uncontrollable variables that will impact all the securities that make up an asset class.
  - Therefore all securities will go up or down to some degree.
- ***Exchange rate risk*** is the risk that while investing in a foreign market or abroad, changes in the exchange rate cause the value of your investment in Canadian dollar terms to go up or down.
- ***Credit risk*** is the risk of loss due to a bond issuer not making interest payments on time or not paying back interest or principal in full.
- ***Inflation risk*** is the risk that an asset class or security won't maintain its purchasing power relative to rising prices in the overall economy.
- ***Interest rate risk*** is the risk that fixed income owners are exposed to when current interest rates change relative to the interest rate or yield being paid on the investment there are holding.
- ***Political risk*** is the risk that changes in a country's government or policies could cause instability and affect the value of securities either negatively or positively.
- ***Country risk*** is more encompassing than political risk because it also includes economic, social, and business risks that are unique to a specific country. Country risk will vary from country to country.

Who am I as an Investor?

Who am I as an Investor?

- In our financial education journey so far, we have been working towards building a solid understanding of investing concepts and principles.
- Now we are going to turn our focus inward and focus on self discovery, and personal risk assessments.
- Understanding risk is necessary in order to make informed decisions about what goes into your portfolios.
- And to understand risk, you have to understand who you are as an investor.

Modern Portfolio Theory

- In 1952, Harry Markowitz introduced the model of Modern Portfolio Theory (or MPT), a theory which earned him a Nobel prize for economics in 1990.
    - MPT attempts to account for how investors maximize a portfolio's expected return by diversifying the asset mix.
    - It is a theory where the calculations are based on expected returns (the mean) and the standard deviation (the variance) of the various portfolios.
- The most optimized portfolios – those combinations offering the highest return for the least risk – appear on a curve called the efficient frontier, the dividing line between efficient portfolios and inferior ones.

Who am I as an Investor?

- MPT makes a number of assumptions about the markets and an investor's preferences when evaluating the efficiency of a portfolio.
    - The core assumptions of the theory are that:
    - Investors attempt to maximize returns.
    - Investors are rational and avoid risk when possible.
    - Investors all have access to the same sources of investment information.
    - Investors share similar views on expected returns.
    - Taxes and brokerage commissions are not considered.
    - Investors are not large enough players in the market to influence the price.
    - Investors have unlimited access to borrow (and lend) money at the risk free rate.
- Now obviously, not all investors while share these same assumptions.
- It is equally important to acknowledge that investors are all human beings and that humans by nature are emotional creatures.
- Depending on the individual, certain investing decisions and behaviours will not necessarily be tied to maximizing returns.
- So, knowing no one investor is the same as the next, how do we attempt to reconcile the mathematics of investing with emotional human behaviour?

Approaches to Measuring Risk

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Approaches to Measuring Risk

- The risk profiling of an investor should take into consideration both the numerical information collected about a person's financial situation (i.e. investment dollars, time horizon, forecasted rates of return, etc.) and the attitudes, beliefs, and emotions a person is likely to experience around the management of their money and being in the markets.

- The two most common approaches that attempt to measure these 2 equal but distinct components of your money personality are:

  1. A structured paper-based or online series of questions that assign a numerical score to your responses – a quantitative risk assessment approach.

  2. A less formal open-ended conversation that seeks to draw out or confirm similar information – a qualitative risk assessment approach.

- Choosing to use one approach over the other, or a combination of the two, will depend on the amount time the investor devotes to the risk assessment, their preferred communication style, and the investor's general comfort level in disclosing certain types of information.

Investor Profile Analysis … a series of questions which are designed to help determine to an investor’s risk tolerance profile by looking at

1. GENERAL INFORMATION
2. TIME HORIZON
3. INVESTMENT OBJECTIVE
4. RISK TOLERANCE

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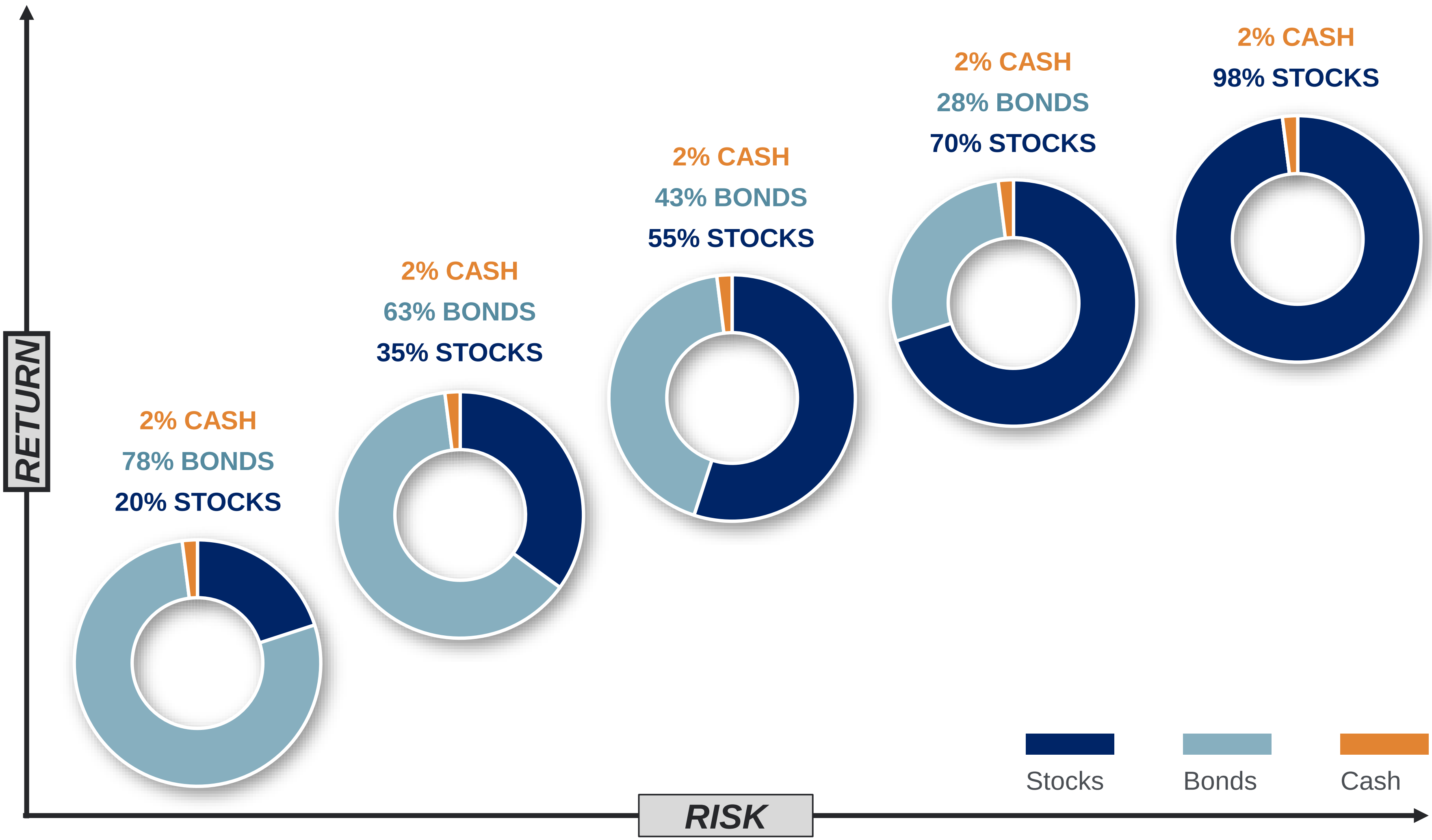
Quantitative Approaches: Surveys and Questionnaires

- One of the first things an advisor will do when working with a client is determine the individual's risk profile as an investor.
- One key advantages of the quantitative approach is that the survey instrument can be used repeatedly over a wide and diverse pool of interviewees, helping to maintain a disciplined and consistent approach to understanding each client's investment goals and risk tolerance preferences.
- This information gathering is vital in understanding who the client is and making proper decisions on how to allocate investments across various asset classes and sub-asset classes.
- There are four general categories of questions typically asked in a risk profile questionnaire:
  1. **General Information:** gathers personal client data such as name, age, address, income, etc.
  2. **Timeframe:** encourages the client to think about the duration of their investment horizon.
  3. **Investment Objective:** asks the client about his or her investment goals (e.g. growth vs. income).
  4. **Risk Tolerance:** gathers information about the client's ability to take on risk and gauges their subjective reactions to volatility.

Matching Risk Profile to Asset Allocation

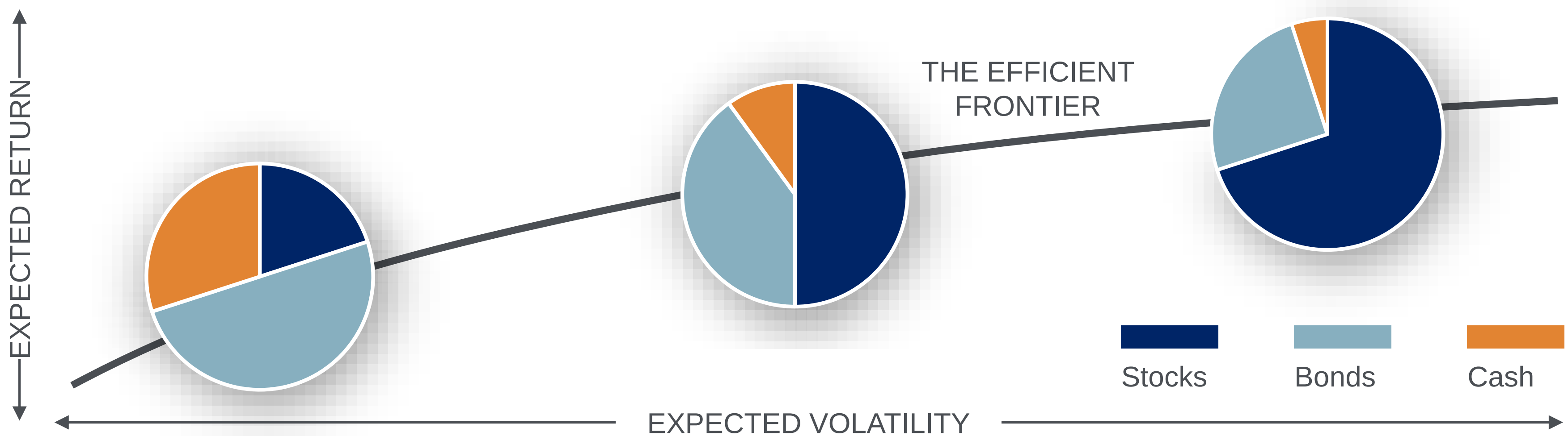


Matching Risk Profile to Asset Allocation

- So, what do we do after we have gathered the investor information using the quantitative and qualitative assessment techniques we've just learned about?
- The next step is to consider how the information is integrated with the predictions made about capital markets behavior and match the risk profile to the right asset allocation.
- An ***asset allocation profile*** is a tool that allows investors and advisors to have a conversation about investment needs and preferences, and set realistic expectations about capital market returns and the volatility of the underlying asset classes of stocks, bonds, and cash.
- Plotted along a continuum of escalating return and higher risk (left to right), or decreasing risk and lower return (right to left), asset allocation profiles show various portfolios of asset classes that are intended to achieve a desired investment objective.
- This means that responses from the various risk assessment tools can be grouped into clusters that correspond to distinct populations sharing similar characteristics about risk and return within the group, while being distinct from other groups.
- Generally speaking, there are a number of risk profiles that delineate boundaries between the most frequently sought after investment objectives that an investor might have (e.g. wealth preservation versus capital appreciation).

How do the Risk Tolerance Profiles of Investors Differ?

INCOME	BALANCED	GROWTH



Income (Conservative) investors generally…

- Seek wealth preservation
- Accept lower risk (less volatility)
- Hold more fixed income

Balanced investors generally…

- Seek wealth preservation and capital appreciation
- Accept moderate risk (medium volatility)
- Balance growth and income investments

Growth (Aggressive) investors generally…

- Seeks capital appreciation
- Accept higher risk (more volatility)
- Hold more equities

How do the Risk Tolerance Profiles of Investors Differ?

The three most common risk tolerance or asset allocation profiles are **income** profiles, **balanced** profiles, and **growth** profiles.

1. Income – oriented investor profiles

- Also called ‘Conservative’ profiles, income-oriented profiles focus on wealth preservation.
- Income portfolios include mainly fixed income instruments or other lower volatility instruments, and typically include a small allocation to equities.
- This minimal exposure to growth assets is intended to help retain the real value of the portfolio after accounting for inflation.
- Income investors generally have some level of tolerance for loss over their investment horizon.
- And it is very common that income investors will require a reoccurring stream on cash flow to help pay for their expenses.

2. Balanced investor profiles

- Balanced investors look to strike a balance between capital appreciation and wealth preservation.
- The portfolio may include exposure to all asset classes and carries a moderate risk of loss over the investment horizon.

3. Growth – oriented investor profiles

- Growth profiles focus on long term capital appreciation, with a secondary focus on wealth preservation.
- The majority of the portfolio will typically be invested in a blend of growth assets and investors generally have a higher tolerance for risk over their investment horizon.

What Are the Benefits of Using a Risk Tolerance Profile?

NEW INVESTORS

- Develops a holistic view investor needs and expectations.
- Helps identify suitable strategic asset allocation models based on investor objectives and risk preferences.

EXISTING INVESTORS

- Helps to consistently align (and realign) existing asset mix and investment solutions to investor needs and expectations.
- Promotes periodic reassessment of the investor needs and expectations.

ALL INVESTORS

- Helps to clarify investor expectations to ensure there are fewer surprises.

What Are the Benefits of Using a Risk Tolerance Profile?

- Because communication is vital to any good investor-advisor relationship, the development of the risk tolerance profile is a valuable exercise for a number of reasons.
- For new investors, establishing a risk profile up front helps develop a holistic view of needs and expectations, and assists in identifying an appropriate asset allocation model to best align with the agreed upon risk tolerance levels.
  - This tool paves the way for investors and advisors to have more meaningful discussions around the tradeoffs between risk and returns, and helps to manage investor expectations around future investment performance.
- For existing investors, the risk profile supports open dialogue between the advisor and the client, promotes continuity between the asset mix, the investment solutions and the investor’s needs, and encourages the ongoing review of the portfolio.
- And regardless of whether you are new to investing or an existing investor, this is a tool which helps to clarify expectations to ensure there are fewer surprises down the road.

Thank you

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