

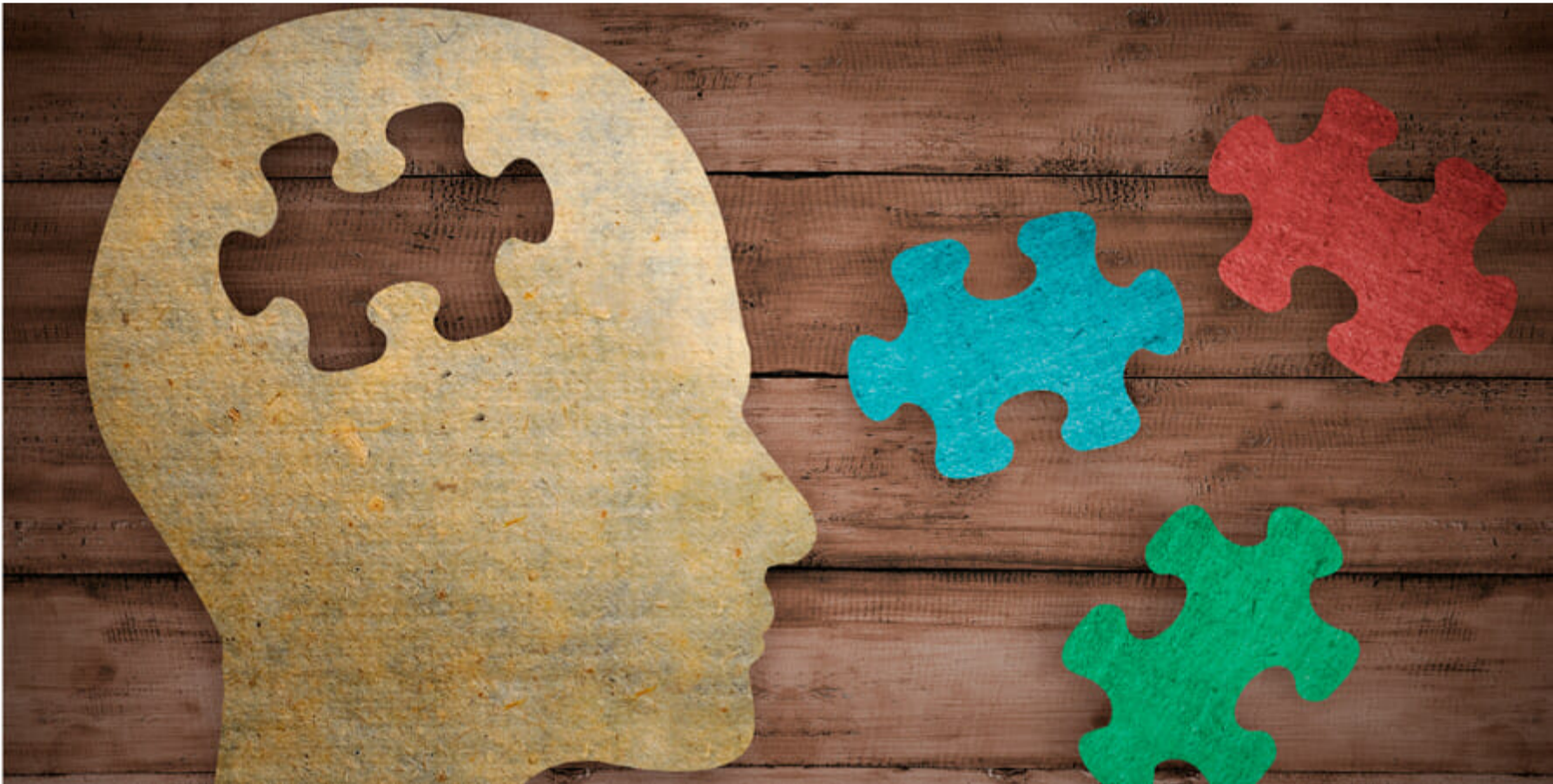
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For serious results, make risk profiling a game

 [Nour Azhar](#) July 18, 2017

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The respected academic argued that financial advisers and superannuation funds must replace their paternalistic attitudes towards clients with a more educational approach that is backed by scientific method in order to identify individuals' preferences, goals and constraints accurately.

"The current approach is, 'You don't understand the risks and I will do what I think is best for you', subject to regulations of course, but we need to move the discussion towards educating the clients. Some people cannot be educated but the majority can," Kariv said.

He presented his ideas during a visit to Sydney last week at industry events hosted by the local arm of the Investment Management Consultants Association and investor education group PortfolioConstruction Forum.

Common approach fundamentally flawed

Relying on surveys and individuals' stated preferences to understand their risk tolerance is a fundamentally flawed approach, Kariv said. He argued the industry must look at individuals' revealed preferences instead – through tested scientific methods backed by mathematics and economics – in order to obtain a more reliable picture of a client's true profile.

Kariv compared the current situation of financial advisers to a doctor trying to assess a patient's wellbeing without access to blood tests and X-rays.

"There is no way a financial adviser is able to construct a reliable client profile without this research," he asserted. "Conversation would not lead us anywhere. We need this technology that brings together all the research we have."

Playing games

The tool that underpins Kariv's work on revealing investor preferences is presented as a game. The game allows users to make choices that are plotted on a graph to indicate their preferences; for example, various 'coin-flip' choices are marked on the graph to determine risk aversion. The graph also shows how users' choices represent a preference for "more money now [or] more money later".

Kariv said the tool is based on research done by specialists in game theory – a popular topic of study in economics at the moment. The data collected with the tool reveals the preferences of the individual investor.

"What the algorithm does is [help shape] a portfolio that, with certain probability, would achieve the client's goals with minimum discomfort, [based on] their preferences – but the sad truth of life is that there will be discomfort."

Kariv said in developing and testing the methodology behind the tool, extensive data was collected from people across the spectrum of age, education and socioeconomic backgrounds, including PhD scholars, US Air Force fighter pilots, everyday Americans and even illiterate workers in the fields near Dar es Salaam in Tanzania.

The methodology has its foundations in applied mathematics, statistical inference and analysis, and practically applicable economics topics such as game theory. The resulting key outputs of the tool, based on the investors' choices, are called "revealed preferences".

This tool will allow financial and wealth advisers to use the revealed preferences and not rely on the flawed stated preferences, hence giving the adviser a robust and tested method to construct a portfolio that suits the investor's long-term goals, Kariv says.

Adoption by banks

PortfolioConstruction Forum director Graham Rich said Kariv's work has the potential to change the way portfolio construction and research are done, and the way advice and is delivered to clients.

"He is one of the world's leading behavioural economists and his tools, in my view, offer a paradigm shift in how to understand clients' goals, constraints and preferences," Rich said. "The advice and research community has an obligation and duty to check out this research."

Kariv said the Australian financial advice industry has a greater understanding of the need to change and is better equipped to move with time than the industry in the United States. One of the big four banks here has already adopted his research tool, he said, and soon it will unveil a portal directed at advisers. Also, he is in discussions with other financial institutions here in Australia and in the United States, and is about to embark on a pilot program with a major international bank in Malaysia.

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