Risk Scores: Putting the Horse Behind the Cart

EXECUTIVE SUMMARY

The understandable appeal of a single risk number which encapsulates all of the complexities of a client is indeed alluring. Alas, it is but a siren's song. We know that risk is too multi-faceted to be contained within a single number or cell on a spreadsheet. The goal of the risk score – understanding the client's risk tolerance – is not just laudable, it is an absolute necessity to make sure the client does not throw in the towel at the worst possible time. Unfortunately, in reality the risk score[1] ends up driving the entire process, even going so far as determining a key element: the asset allocation. To us here at Nebo Wealth, using a risk score to produce an asset allocation and then testing that portfolio, most of the time with flawed Monte Carlo simulations,[2] is akin to putting the horse behind the cart.[3] It makes it really difficult to get where you want to go.

Matt Kadnar
Sales Lead
Nebo Wealth

Martin Tarlie
Product Lead
Nebo Wealth

James Montier
Sr. Investment Strategist
Asset Allocation

The Disconnect Between the Plan and the Portfolio

Financial advisors spend a great deal of time working through clients' goals and objectives, often with the help of financial planning tools. The savings, spending, and legacy objectives produced by this process should be the focal point. Unfortunately, the standard process of converting a risk score to an asset allocation and then testing it via Monte Carlo simulation leaves the portfolio hopelessly disconnected from the very thing it's trying to fulfill: the financial plan. Even when the goals and objectives of the client change, the portfolio itself does not. Why? Because with this method the portfolio only changes if the risk score changes. Market goes up. Market goes down. Goals

1. See The Perils of Outsourcing Asset Allocation to a Risk Score (Montier, Kadnar and Tarlie 2024).

2. See Investing for Retirement II: Modeling Your Assets & Correcting the Flaws in Monte Carlos (Montier and Tarlie 2022).

and objectives change. Does not matter. The portfolio is tethered (chained really) to the risk score and disconnected from the client's financial plan that embodies those goals and objectives. Abraham Lincoln coined a good term for this: It's bass-ackward.[4] Further, it is a declaration by the advisor (whether intended or not) that the risk score, which represents the client's psychological risk aversion, is so well calibrated and so fundamentally immutable that all other considerations should be tossed aside. And that is emphatically wrong.

A Better Way

We propose an Investment Policy Process (IPP) that better balances the client's time horizon, risk tolerance, cash flows, legacy goals, and target return necessary to achieve the client's goals and objectives. The key is how we define risk in this process. In our framework, risk isn't volatility, but rather is "not having the financial resources you need, when you need them." We operationalize this concept of risk through an optimization designed to take all the elements of the IPP into consideration to minimize the client's risk of falling short of their goals. Or said in another way, our approach constructs portfolios to maximize the likelihood the client achieves their goals.

This IPP process is fundamentally different from the one centered on the risk score. It allows an advisor to better balance the long-term goals and objectives of a client with short-term risk aversion considerations, helping the advisor tease out the tension between these two critical objectives. The product of this process is a portfolio directly connected to the goals and objectives of the client and optimized to maximize the client's likelihood of achieving their goals.

> "...the result is a portfolio connected only to the risk score, negating much, if not all, of the great work done on the financial plan."

A defining characteristic of our approach is that if the goals and objectives change, the portfolio changes with them in a cohesive and flexible manner. The advisor no longer rebalances to a static portfolio. Rather, the IPP process takes into account the dynamic nature of both client circumstances and the market by re-optimizing to efficiently produce the perfect-fit portfolio for every phase of the client's financial journey.

3. We are using a play on the well-worn expression, "putting the cart before the horse." In our version, the horse is analogous to Asset Allocation in that it is placed first in the wealth management assembly line. The cart is the financial plan embodying the client's goals and objectives. Creating an asset allocation based on the client's goals and objectives and then testing the viability of the combined portfolio and plan, in our view, is a much more robust way to "manufacture" a portfolio specifically built to maximize the likelihood of achieving a client's financial goals.

4. From a letter written in 1847, Lincoln is credited with the earliest written instance of the term "bass-ackwards".

For clients, first and foremost, it is our belief that they will experience a better outcome. They will also understand why they are invested the way that they are. The focus is now on the plan rather than the vagaries of the market. This increases the advisor's confidence that they understand what they need to believe to recommend a portfolio for the client – both what they need to believe about the client and the markets. This is accomplished through a systematic and repeatable process that utilizes Nebo Wealth's open architecture platform. Further, the IPP provides documentation for both the client and regulator as to the assumptions used in creating the plan and the portfolio.

Putting the Horse in Front of the Cart

Nebo Wealth is a leap forward in goals-based investing allowing advisors to personalize portfolios for clients through an open-architecture investment platform that allows you to keep your investment identity or leverage Nebo Wealth's Investment Services. The use of risk scores to determine the asset allocation at the beginning of the client process prevents the advisor from building a portfolio directly aligned with the financial plan. The result is a portfolio connected only to the risk score negating much, if not all, of the great work done on the financial plan. The Nebo Wealth Investment Policy Process balances what the client needs or wants from their financial assets with a portfolio specifically optimized to achieve the financial planning goals. Clients should only take as much risk as they need to achieve their goals. This requires a dynamic process better suited to adapt to the client's dynamic life.

Nebo Wealth
53 State Street
33rd Floor
Boston, MA 02109

www.nebowealth.com