The Envestnet Risk Tolerance Questionnaire (RTQ) was developed by the PMC team to address a need to measure investors' attitudes toward risk and investment appropriateness in the Envestnet proposal workflow.

Background

At a high level, the ENV RTQ was designed to provide an objective assessment of the appropriate risk tolerance of the client, irrespective of what the advisor/client wants to invest in prior to completing the questionnaire. The construction of the questionnaire was thus motivated by this need to relate investor risk and prospective portfolio appropriateness with a client's attitudes and perceptions toward the risk and reward tradeoff when setting investment goals against an appropriate investment time horizon. The Envestnet RTQ is based on sound academic finance theory proposed by Ibbotson, Markowitz, and other experts who have studied risk tradeoffs versus idealized asset allocations and investment time horizons, given an appropriate set of asset classes with informed capital market assumptions.

Determining Risk Tolerance

There are two questions in the ENV RTQ that are central to determining risk tolerance. These are the first and last questions presented to the client, which serve as bookends to the flow of the ENV RTQ and attempt to measure the appropriate client inputs into the risk assessment. While each of these two questions is designed to assess the client's risk tolerance, they do so using different approaches. The first question in the ENV RTQ is a behavioral question, seeking to gauge the client's risk profile from a risk-return perspective. It is presented in dollars in order to gauge potential gain versus potential loss in a meaningful way for the client to measure. This question is assigned a material weight because it essentially captures the client's own perception of their risk tolerance in dollar terms. If a client believes they are risk averse, that sentiment should be given a fair amount of weight in the overall client risk profile assessment.

The last question is similar in magnitude toward measuring an investor's ability to take on investment risk. However, instead of behavioral-based assessment, this question probes the issue via an insurance and time horizon based "actuarial" lens. The answer to this question receives the most weight in the RTQ, and is arguably the most important. For example, if a client's answer is a less-than-three- year time horizon, that answer should have more bearing on the overall risk tolerance than any other answer on the RTQ: a three-year time horizon does not cover a full market cycle and the resulting portfolio therefore should not be subjected to potentially higher volatility. Shorter investment horizons also provide less certainty as to underlying asset appreciation based on what might be expected with longer term asset class capital market assumptions and economic growth. Through this question, the RTQ seeks to ensure that the suggested allocation is not overly aggressive if the client indicates their horizon is short.

Ideally, the answers to these two questions (#1 and #6) confirm each other.

The remaining four questions in the ENV RTQ are behavioral. Through each question's potential answers, these questions are designed to refine the risk tolerance implied by the answers to the first and last questions.

Understanding RTQ Results

ENV performed a significant amount of testing of combinations of answers to each question to ensure that a particular set of answers would yield an expected result when developing the scores given for each answer selected, and the weight of each question in the scope of the overall RTQ. The scores of both the primary questions and their underlying options were calibrated to produce appropriate outcomes that would be expected based on a normal distribution of investor risk tolerances and risk versus reward versus investment time horizon tradeoffs.

It should be noted that the RTQ assesses the amount of risk (in terms of an equity/fixed income asset allocation split) that may be appropriate for an investor, even if the result is not the level of equity/fixed risk the investor wants to assume. In other words, if the client's time horizon is 10+ years, the ENV RTQ suggests (appropriately, in our opinion) that the client is able to take on some equity risk. If they want to implement their strategy with a 100% fixed income portfolio there should not be an issue, so long as the advisor or client are willing to accept taking on a "capital preservation" risk profile (as opposed to a more aggressive risk profile, which would be more consistent with the results of the RTQ). However, Envestnet believes the opposite situation would be more difficult in terms of appropriateness, i.e. if the client's initial risk tolerance is determined to be conservative (based on the responses to the RTQ) with a shorter time horizon, and the client wants to pursue a more aggressive allocation in their actual portfolio.

In other words, if the client has a long-term horizon, an allocation with equities is appropriate, even if the client only initially desires to invest in long-term bonds based on some *a priori* self-assessment of risk tolerance. In fact, the extended investment time horizon of the client is an indication that they can indeed handle an allocation to equities, even if their initial inclination may have been to choose to invest more heavily in bonds.

It also works the other way, in that an advisor or client may want to invest in equities, but if they have a short-term horizon the RTQ will suggest a more conservative allocation to account for the fact that equities are riskier in the short run, in time spans that are less than the normal market cycles of five to ten years.

For More Information

Please contact your Envestnet representative and/or refer to the Envestnet Standard Risk Tolerance Questionnaire. RTQs with five- and seven-point risk scales are available, with and without scoring guidelines.