

Let fear motivate, not greed

Client's changing risk tolerance a potential danger

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Financial Post

Monday, January 29, 2007

Greed or fear: Which one of these motivates you as a financial/investment advisor? Which one of these motivates your clients?

I recently met an advisor, Franco (not his real name), who, at 35 has a very successful practice. He has assets in excess of \$40-million under administration. What impressed me about him was not his considerable financial success, it was his attitude. Franco told me point blank, "I am motivated by fear, not greed."

I later learned what that meant. Although he had substantial assets under administration, not a single client of his invested on leverage (I use leverage and margin interchangeably, as they are both investing on borrowed money). In other words, Franco could double (triple, quadruple) his book using margin but, remarkably, he chose not to.



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Other advisors may have thought him foolish for leaving so much money on the table. Borrowing to invest is appropriate for many clients, and may even be appropriate for an advisor's entire client base. However, leverage or margin investing, while increasing your assets under administration, simultaneously increases the client's and advisor's risk.

Borrowing to invest introduces an additional layer of responsibility to the advisor's duties, particularly if the client has never before invested with borrowed money. The advisor must explain the concept of leverage in most basic of terms. Many advisors explain the benefits, among them tax benefits, that so often are expressed by clients to be a main objective.

However, without mention of the costs and the risks, clients may be lulled in to a false belief that this is free money. It must be explained to clients that interest is charged and that the money is exactly like any loan; it must be repaid, regardless of whether investments have appreciated or depreciated in value.

The client must understand the possibility of receiving a margin call, which will necessitate the deposit of additional cash or assets of equivalent value, or the sale of investments in the account, which may attract deferred sales or other charges. The magnification of risks in a down market must also be explained with concrete numbers. After explaining the risks of such investments, clients will be equipped with the information necessary to make an informed decision.

Let's go back to the concept of risk versus greed: An advisor motivated by greed may not consider whether such investment strategy is appropriate for the particular client. They roll out the concept, focusing only on the benefits, and not the risks or drawbacks. This is the difference between the duties of a salesperson and a professional advisor.

The advisor must explain the risks of any investment or strategy, and, among other things, cannot simply focus on the advantages to close the sale.

What about client's greed? A useful exercise for advisors is to determine whether their clients are motivated by greed or fear. A client motivated by greed might be more inclined to push advisors hard to purchase investments inconsistent with their personal objectives. When the market is hot, such clients insist that their risk tolerance increase accordingly.

To determine whether the client's risk tolerance has truly increased, or whether the client is merely being greedy, the advisor must simply ask the client what changes precipitated such an increase in risk tolerance.

"Red flag" answers that direct the advisor to conclude that the client is motivated by greed are: "My friends are making a killing on the market," or, "The market is burning hot and I want my share."

Answers that support a change in a client's risk tolerance are: "I received a nice bonus this year at work that I didn't expect and would like to see if it can grow it into something more substantial," or, "I have taken a course on investing and want to take on a bit of risk to realize more gains, understanding that I could lose the principal."

Courts and regulators are holding advisors to an extremely, and I believe, unreasonably, high standard. They suggest that a client's risk tolerance can only legitimately be changed on a "know your client" form if there is an explanation for such change-- something more than "but that is what the client wanted."

Judges and regulators insist that what is relevant is not what the client wanted, but your professional assessment of his risk tolerance and personal financial objectives. In other words, advisors may find themselves in a position where they must protect clients from their own greed.

This may be particularly difficult if the advisor himself tends to be motivated by greed.

Greedy clients are dangerous, as they will not hesitate to initiate legal proceedings against their advisor if they think this is the way to get their money back. Identify and manage greed, whether it is your own or that of your clients, to protect your own licence, livelihood and reputation.

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