What is risk?
Technically-speaking, risk means that there could be a number of different possible outcomes associated with a particular action or activity and we do not know beforehand which one will occur. Think about tossing a coin, for example.
In more everyday terms, people often think of risk as being the prospect of an undesirable outcome, such as making a financial loss. Another way of putting that could be the chance of not meeting your goals or objectives.
Risk exists in a number of different situations, but our concern here is with financial risk. By financial risk we mean the volatility associated with the prices on and returns from investments.

What is financial risk tolerance?
Some individuals are more able to tolerate financial risk than others. Researchers have argued that financial risk tolerance can be broken down into two parts:
1) Ability to take risk (or “risk capacity”)
2) Willingness to take risk (or “risk attitude”)
An individual’s ability to take risk relates to their financial circumstances and their investment goals. Generally speaking, the higher the individual’s level of wealth and income, relative to any liabilities they have, and the longer their investment horizon, the more able they will be to take financial risk and the greater their risk capacity.
Risk attitude, on the other hand, has more to do with the individual’s psychology than with their financial circumstances. Some individuals will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues. The risk profiler questionnaire attempts to measure risk attitude.
Aspects of financial risk attitude

Financial risk attitude is a complex construct and comprises a number of interrelated aspects. The risk attitude profiling questionnaire is designed to capture several aspects of risk attitude:

1) **Financial knowledge** – Generally-speaking, individuals who are more knowledgeable about finance and investment are more willing to accept investment risk.

2) **Comfort with risk** – Some individuals have psychological traits that allow them to take risk. These individuals typically see risk as involving a ‘thrill’ or ‘opportunity’ rather than as ‘danger’ or a ‘loss’.

3) **Investment choice** – Risk attitude can also be gauged in preferences for different types of investments, e.g. the relative safety of a bank account versus the potential risk of stocks and shares.

4) **Regret** – is the negative emotion that arises from making a decision that is, after the fact, wrong.

Scoring the questionnaire

Each question is answered on a five-point scale ranging from Strongly Agree through to Strongly Disagree. In the questionnaire there is a broad balance of normal questions where agreement indicates an inclination to take risk and ‘reverse’ questions where agreement indicates aversion to risk. The overall risk score is compiled by equally weighting the answers to the various questions, having regard to whether they are normal or reverse questions.

We adjust the raw scores from the questionnaire so that the average respondent gets a normalised score of 50. The score categories are shown in the following table, while the normalised scores from the pilot study are shown in the chart.

<table>
<thead>
<tr>
<th>Investor Category</th>
<th>Normalised Score Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Cautious</td>
<td>0 – 25</td>
</tr>
<tr>
<td>Cautious</td>
<td>26 – 35</td>
</tr>
<tr>
<td>Moderately Cautious</td>
<td>36 – 42</td>
</tr>
<tr>
<td>Balanced</td>
<td>43 – 56</td>
</tr>
<tr>
<td>Moderately Adventurous</td>
<td>57 – 67</td>
</tr>
<tr>
<td>Adventurous</td>
<td>68 – 78</td>
</tr>
<tr>
<td>Very Adventurous</td>
<td>79 – 100</td>
</tr>
</tbody>
</table>
Description of investor risk attitude categories

Category 1 – Very Cautious Investors
[Normalised score 0-25]

Very Cautious investors typically have very low levels of knowledge of financial matters and very limited interest in keeping up to date with financial issues. They are unlikely to have experience of investment beyond bank and building society accounts.

In general, Very Cautious investors prefer knowing that their capital is safe rather than seeking high returns. They are not comfortable with the thought of investing in the stockmarket and would rather keep their money in the bank.

Very Cautious investors usually avoid anything that looks like a gamble. They can take a long time to make up their mind on financial matters and will usually suffer from severe regret when their decisions turn out badly.

Category 2 – Cautious Investors
[Normalised score 26-35]

Cautious investors typically have low levels of knowledge about financial matters and limited interest in keeping up to date with financial issues. They may have some limited experience of investment products, but will be more familiar with bank and building society accounts than other types of investments.

In general, cautious investors do not like to take risk with their investments. They would prefer to keep their money in the bank, but would be willing to invest in other types of investments if they were likely to be better for the longer term.

Cautious investors prefer certain outcomes to gambles. They can take a relatively long time to make up their mind on financial matters and can often suffer from regret when decisions turn out badly.

Category 3 – Moderately Cautious Investors
[Normalised score 36-42]

Moderately Cautious investors typically have low to moderate levels of knowledge about financial matters and quite limited interest in keeping up to date with financial issues. They may have some experience of investment products, but will be more familiar with bank and building society accounts than other types of investments.

In general, moderately cautious investors are uncomfortable taking risk with their investments, but would be willing to do so to a limited extent. They realise that risky investments are likely to be better for longer-term returns.

Moderately Cautious investors typically prefer certain outcomes to gambles. They can take a relatively long time to make up their mind on financial matters and may suffer from regret when decisions turn out badly.

Category 4 – Balanced Investors
[Normalised score 43-56]

Balanced investors typically have moderate levels of knowledge about financial matters and will pay some attention to keeping up to date with financial matters. They may have some experience of investment, including investing in products containing risky assets such as equities and bonds.

In general, balanced investors understand that they have to take investment risk in order to be able to meet their long-term goals. They are likely to be willing to take risk with at least part of their available assets.

Balanced investors will usually be prepared to give up a certain outcome for a gamble provided that the potential rewards from the gamble are high enough. They will usually be able to make up their minds on financial matters relatively quickly, but do still suffer from some feelings of regret when their decisions turn out badly.
Category 5 – Moderately Adventurous Investors  
[Normalised score 57–67]

Moderately Adventurous investors typically have moderate to high levels of financial knowledge and will usually keep up to date on financial issues. They will usually be fairly experienced investors, who have used a range on investment products in the past.

In general, Moderately Adventurous investors are willing to take on investment risk and understand that this is crucial in terms of generating long-term return. They are willing to take risk with a substantial proportion of their available assets.

Moderately Adventurous investors will usually take gambles where they see the potential rewards as being attractive. They will usually be able to make up their minds on financial matters quite quickly. While they can suffer from regret when their decisions turn out badly, they are usually able to accept that occasional poor outcomes are a necessary part of long-term investment.

Category 6 – Adventurous Investors  
[Normalised score 68–78]

Adventurous investors typically have high levels of financial knowledge and keep up to date on financial issues. They will usually be experienced investors, who have used a range on investment products in the past, and who may take an active approach to managing their investments.

In general, Adventurous investors are happy to take on investment risk and understand that this is crucial in terms of generating long-term return. They are willing to take risk with most of their available assets.

Adventurous investors will readily take gambles where they see the potential rewards as being attractive. They will usually be able to make up their minds on financial matters quickly. While they can suffer from regret when their decisions turn out badly, they are able to accept that occasional poor outcomes are a necessary part of long-term investment.

Category 7 – Very Adventurous Investors  
[Normalised score 79–100]

Very Adventurous investors typically have very high levels of financial knowledge and a keen interest in financial matters. They may be considered as ‘hobby investors’. They have substantial amounts of investment experience and will typically have been active in managing their investment arrangements.

In general, Very Adventurous investors are looking for the highest possible return on their capital and are willing to take considerable amounts of risk to achieve this. They are usually willing to take risk with all of their available assets.

Very Adventurous investors can easily be persuaded to take a gamble rather than a certain outcome and enjoy gambling as an activity. They have firm views on investment and will make up their minds on financial matters quickly. They do not suffer from regret to any great extent and can accept occasional poor outcomes without much difficulty.

Note: These profile descriptions are only illustrative. While they outline the common traits of individuals with the relevant risk profile scores, every individual is different and their scores will be built up from different combinations of responses to the questions in the risk attitude profiling questionnaire.
**Biographies**

The information reproduced in this leaflet and the risk attitude profiling questionnaires were researched and written by Alistair Byrne and David Blake. Alistair Byrne CFA is a Fellow of the Pensions Institute at Cass Business School in London and a Senior Lecturer in Finance at the University of Edinburgh. Dr David Blake is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School in London.

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