# Ideas @ Edelweiss Multi Strategy Funds – Risk Aversion

A client's risk aversion or conversely his risk tolerance is one of the most important characteristics in portfolio construction. And yet it is one of the least well understood parameters. Over the years, advisors and managers have attempted to quantify risk aversion through simplistic surveys or through complex numerical analysis but the exact measurement remains an art. In this month's Ideas @ Edelweiss Multi Strategy Funds we try and outline a framework to think about risk aversion.

Like an asset allocation exercise, risk aversion can be thought of having two components, a strategic and a tactical component. The strategic component of risk profiling is determined by an individual's intrinsic risk taking ability and the end use of the pool of capital. For example, all else being equal a young technology entrepreneur would be expected to have a higher risk tolerance rather than a retired widow. Ceterus paribus, funds earmarked for a child's college saving or a down payment on a home will have a lower risk tolerance than those with an open ended purpose. We believe that clients find it much easier to deal with the mental accounting of buckets and hence the end use of the pool of capital is more important than an individual's risk taking ability, although both are influential. This aspect of risk profiling is reasonably well understood.

The tactical component of risk profiling is often understood subconsciously or taught through narrative. It includes path dependent items like how long a client has been invested, how long they have been dealing with an advisor / portfolio manager, whether they have historically made or lost money, the quantum of money involved and broader market conditions. We have found that risk tolerance increases with length of investment, tenure of engagement, historical profit making track record and is inversely related to the sum of money involved. These can be difficult to quantify, but managers would do well to keep asking themselves if risk tolerance assessments are right or not and whether they can move in the direction of an optimal solution. To put it crudely, it is almost like a game of "Marco-Polo" where a blind folded child keeps asking his friends whether he is close to catching them or not by shouting Marco and hearing Polo in response.

We have found client risk profiling to be a very valuable tool when it comes to running funds and it is possible to generate meaningful returns by just exploiting common behavioral traits.