

# FINANCIAL PLANNING RESEARCH JOURNAL

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Journal of the  
Financial Planning  
Association  
of Australia

The Time Diversification Puzzle: A Survey

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Investment Risk Profiling: Lessons  
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## Aims and objectives

With an ever more complex financial system, an increasing emphasis on self-funded retirement for Australians, the increasing size of Australia's managed funds pool, and persistent evidence of financial illiteracy, the importance of financial planning is clear. The financial planning profession lacked an academic platform for discourse on the issues of individual personal financial planning and wealth management, where issues of practice and policy can be debated with rigour, independence and evidence. Prior to the Financial Planning Research Journal (FPRJ), no journals fitted into this niche to provide a forum for dissemination of research in the specific area of personal finance and investments in the Australian context.

The context of personal finance and investments for Australia is different from the rest of the developed economies because of the presence of mandatory superannuation, a large managed funds pool and a strong social security system. Because of these factors international journals in the area of personal finance and/or investments may not suit an Australian audience. In addition, the rapid developments in regulatory and professional standards within the context of personal finance suggests there should be some interest in, and need for, independent, peer reviewed research in this area.

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## From the editors

We are pleased to present Volume 2, Issue 2 of the Financial Planning Research Journal, the journal of the Financial Planning Association of Australia.

“In this world nothing can be said to be certain, except death and taxes.” Benjamin Franklin

In the case of financial planning/financial services perhaps the above quote should be extended to “death, taxes and uncertainty”. The last few months have certainly seen a lot of uncertainty with market volatility, consumer/investor/business confidence hit, regulatory uncertainty over superannuation and professional standards, concerns over consumer outcomes from financial services with calls for more government intervention, and further discussion of low cost options for more Australians to access financial advice, including through digital advice platforms among other models of advice. Indeed, there has also been much interest regarding international developments and the potential impact on financial markets of ongoing conflict, humanitarian issues, the US presidential election and movement within the European Union.

For stakeholders of financial planning, there are, as always, many complex issues to explore and to contribute towards. This FPRJ has a role to play in exploring theoretical and policy issues relating to the financial planning industry. This issue of FPRJ tackles a number of these issues with investment diversification, risk profiling, licensee structures, financial literacy and demand for financial planning graduates examined.

We once again thank the Financial Planning Association of Australia and Griffith University for providing a platform for the dissemination and debate of research in this area. The first two editions of the journal were well received and we hope to build on this with this and future editions of the FPRJ, and in doing so foster lively, evidence based debate in the discipline.

This issue contains five articles on a range of topics. The first article in this issue by Robert Bianchi, Michael Drew and Adam Walk regarding one of the most enduring puzzles of modern finance, time diversification. The paper provides a comprehensive review of the major streams of thought and analysis in the time diversification literature and argues that a more realistic analysis using defensible assumptions is likely to lead to better prescriptions for improved retirement investing.

The second paper in this edition is by Katherine Hunt and discusses the application of psychology literature in developing an empirical risk profiling system. The paper provides a theoretical foundation for considering the risk profiling system by applying the literature from self-control, optimism, financial literacy, and risk tolerance, to a risk profiling system. Dr Hunt invites readers to contribute to further stages of this research which will focus on the development and testing of a risk profiling system based on the theory within this paper.

The legitimacy of the current ‘Authorised Representative’ model is the subject of the third paper by Angelique McInnes and Abdullahi Ahmeda which applies Suchman’s legitimacy theoretical framework to the current authorised representative licensing model to not only advance financial

planning theory, but raise further questions for future empirical research, which should provide policymakers data required to make evidence-based decisions around licensing advisers.

The fourth paper by Levon Blue is regarding the role of culture and context in financial literacy education with a Community instead of for a Community. The findings may offer insights for financial educators and/or planners participating in financial literacy education and engaging with Aboriginal clients.

The final paper in this edition is by Dianne Johnson, Mark Brimble and Ric Zanetti and explores industry demand for financial planning graduates. The paper details results of a survey of 191 financial planning practices on their expectations and plans for new entrants in the five years (to 2019).

Finally, we would like to thank the FPRJ production team for their efforts in getting the issue completed. Without the efforts of Dianne Johnson, Joy Lin, Sian Jones and Alicia Stokes, this edition of the FPRJ simply would not have been produced.

We hope you enjoy the third issue of the Financial Planning Research Journal.

*Dr Rakesh Gupta and Professor Mark Brimble*

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## THE TIME DIVERSIFICATION PUZZLE: A SURVEY

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### ABSTRACT

Since Samuelson's (1969) theoretical proof that risk and time are unrelated, a half century of debate and controversy has ensued, leaving time diversification as one of the most enduring puzzles of modern finance. The most conspicuous aspect of the debate is the questionable assumptions that underlie much of the analysis. Thus we are left with an unsatisfying debate conducted in a paradigm where terminal wealth is usually a function only of returns, and where time-weighted measures are assumed to adequately evaluate performance. This paper reviews the major streams in the time diversification literature and argues that more realistic analysis using defensible assumptions is likely to lead to better prescriptions for improved retirement investing.

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## 1.0 Introduction

The time diversification puzzle is concerned with the relationship between investment risk and investment horizon. Beyond this there appears little else upon which the protagonists agree. In the literature we see a multitude of theoretical priors, schools of thought, quantitative methods, and conceptions of risk and yet we have no resolution to the debate. Why is it that a subject that has attracted some of the most fertile minds in economics remains so elusive? In this paper, we argue that at least part of the problem is that the debate is conducted on the wrong terms. In particular, we argue that there is too narrow a focus on returns as the sole determinant of terminal wealth. Realistic accumulation models are also a function of contributions and salary growth so without correcting the basis upon which the debate is conducted, we argue that it will remain abstract and of limited practical value.

When thinking about investment risk, we anchor our work in Markowitz (1952), who considered the problem of portfolio choice under uncertainty<sup>1</sup>. As with much ground-breaking research, Markowitz's (1952) modern portfolio theory was a caricature of a more complex problem. In particular, Markowitz (1952) considered portfolio choice in a single period setting, allowing him to remove time-variation from the problem of portfolio selection.

Naturally, the financial economics literature evolved and scholars began to consider the portfolio selection problem in a multi-period setting like that encountered with practical investment problems. Chief among these scholars was another Nobel Prize winner – Paul A. Samuelson – who considered the problem in a multi-period setting using expected utility theory. Samuelson's (1969) work is of particular interest for two reasons. Firstly, he was amongst the first to bring the genius of Markowitz's (1952) work into a multi-period setting which by itself is remarkable<sup>2</sup>. Secondly, and particularly germane to this paper, Samuelson (1969) initiates the time diversification debate by considering whether the concept of diversification works with time, in the same way as it does amongst assets or securities (cf. Markowitz, 1952). In order to study the existence of time diversification, Samuelson (1969) selects the classical expected utility theory as his framework of choice. Expected utility theory is thus the point of departure for the time diversification debate, and all other competing streams or schools of thought tend to emerge at least in part as a reaction to Samuelson's (1969) work.

A literature review on time diversification without a discussion about expected utility theory, or any of the other major competing schools of thought, would (and should) be regarded as lacking. In order to synthesise the time diversification debate, we must conduct a critical survey of the literature. Fortunately, without too much effort, a process of taxonomy results in a number of distinct streams or schools of thought. Each of these competing schools tends to coalesce around an alternative theory to, or a common critique of, expected utility theory. The battle of ideas between these schools of thought has led to time diversification becoming one of finance's most enduring puzzles.

<sup>1</sup> Markowitz's contribution earned him a share in the 1990 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel.

<sup>2</sup> Others include Tobin (1965) and Merton (1969).

Following the literature more or less chronologically, we commence the formal review of the literature with the expected utility theory stream beginning with Samuelson (1969). In this seminal work, Samuelson (1969) isolates the relationship between risk and time by observing the optimal allocation to risk assets with horizon, based on three assumptions. While a number of proponents confirm the mathematical certainty of his findings, even more scholars – including some who are otherwise advocates of expected utility theory – call into question Samuelson's (1969) assumptions. In fact, it is Samuelson's (1969) three assumptions – which will be scrutinised throughout this paper – that provide later scholars the oxygen to keep the time diversification debate burning.

From the initial stream of work led by Samuelson (1969), the rise of the Black-Scholes-Merton Option Pricing Theory – another Nobel Prize winning idea – offered a convenient basis upon which Bodie (1991, 1995) could observe risk<sup>3</sup>. Bodie (1995) concluded that, because the price of a put option increased with investment horizon, so did risk. The option pricing theory approach of Bodie (1991, 1995) apparently emerged because of this unrelated breakthrough in economics, not as a result of a specific critique of Samuelson's (1969) work. Only later, did others highlight that Bodie's (1995) approach appeared to offer an objective measure of risk, in contrast to Samuelson's (1969) normative treatment<sup>4</sup>. After Bodie's (1991, 1995) early contribution, the option pricing theory school of thought tended to degenerate into semantic debates about whether Bodie (1995) was correctly identifying the price of insurance, and relating it properly to the investment horizon. After a burst of scholarship in the late 1990s, this stream in the time diversification literature has to some degree faded away. Perhaps the most substantial critique of Bodie's (1995) work was that it was conducted in a risk-only framework. In a sense, this is understandable given the relationship of interest in the time diversification debate is the one between risk and investment horizon. On the other hand, opponents questioned whether it is appropriate to separate risk from return, thereby overlooking one of investment's key trade-offs.

It is a generalisation that behavioural economists inevitably end up becoming amongst the most vocal opponents of any framework that tends to see economics as (hard) science, as opposed to social science. These two visions of economics mix like oil and water. Behavioural economists introduce the richness of humanity to economic problems, often in qualitative terms, whereas “scientists”, of whom Samuelson (1969) was most definitely one, prefer to take approaches characterised by theoretical formality and the rigour of mathematical reasoning, even if it means making simplistic assumptions about human behaviour. In these few sentences, we have briefly outlined both the behaviouralists' principal critique of Samuelson (1969) – the inappropriateness of his underlying assumptions – and our critique of the behavioural stream of literature – the lack of framework, and negative approach to the problem. From the authors' observation of the literature, the behaviouralists tend to avoid the formal frameworks of economics in analysing the

<sup>3</sup> Robert C. Merton and Myron S. Scholes shared the 1997 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel. Fischer Black died of cancer in 1995. Because the Prize in Economic Sciences is not awarded posthumously, Black is not formally recognised as a laureate although his contribution is beyond question.

<sup>4</sup> Recall, that to study risk by estimating the optimal allocation to risk assets, Samuelson (1969) first had to assume the investor's form of risk aversion.



question at hand. By way of analogy, behaviouralists could be described as the insurgents of the time diversification debate. They appear on the scene, they challenge the entrenched position with the insights of psychology, only to retreat without leaving a tangible alternative framework. From the literature review conducted in this paper, we will see that the influence of the behaviouralists is thus limited to providing critiques of the other streams of the literature. Notwithstanding its limitations, the behavioural stream in the literature does provide some compelling insights, particularly relating to the selection of risk measures for examination.

The final stream in the literature – what Booth (2004) describes as the “applied” stream – is defined more by what it's not, than what it is. While the applied stream is a somewhat nebulous confection of studies, there is the faint semblance of a unifying theme. Scholars who pursue this path tend to approach the problem of time diversification empirically, and without resting on a theoretical edifice as the more established streams tend to. Simulation techniques are also a common methodological choice as Booth (2004) suggests. Parallel to the time diversification debate, has emerged a rich literature on risk measures. Leaning on this literature, applied scholars tend to define risk in a certain way – for example, value-at-risk – and then proceed to estimate their selected risk measure over a number of horizons of different lengths. Scholars then draw conclusions about the presence or otherwise of time diversification by applying reasoning to these estimates. Naturally, it is possible to define risk in many ways and so the applied stream has tended to grow as new conceptions of risk emerge. As will become evident from this paper, some scholars have even developed measures purely for the purposes of analysing the time diversification question.

So, almost fifty years after the debate began, we continue to see studies emerge which seek to resolve the debate. As noted, several recent studies have even introduced particular measures whose sole purpose is to shed light on this debate. And yet the puzzle remains unresolved. It would thus be fair to say that there are a number of entrenched camps who are unable to agree on a common basis from which to advance the argument. This paper does not seek to induce the debate's antagonists to recant. Rather, by leveraging off aspects of each stream in the literature, and attempting to synthesise the debate, we set out to offer an alternative view of the relationship between risk and investment horizon. Thus, as has happened to the option pricing theory stream to some extent, sides in the debate are lost to time. This Kuhnian (1970) process reminds us of a famous quotation which, ironically enough, is attributed to Samuelson: “Funeral by funeral, theory advances (Wilson, 1998, p.52).”

This paper is about the relationship between investment risk and investment horizon, not about the objective merits of expected utility theory, or any of the other schools of thought we discuss. We accept there are other economic problems where any one of these frameworks might represent the superior framework within which to approach the given problem. Our interest here is whether the given framework – for example, expected utility theory – is the best approach to gleaning positive insights into the puzzle of time diversification. We posit that our critique should therefore be viewed narrowly through the lens of the purpose of this paper.

We agree with Kritzman (2000) that, as far as the debate thus far goes, everyone is right on their own terms. The entrenched camps do not seem to be budging from their position. But given the

magnitude of financial assets associated with long-horizon investing, and the continued shift to defined contribution style plans, we argue that scholars do not have the luxury of conducting semantic debates about abstract ideas. We argue that the first step is to locate the debate in reality but incorporating realistic accumulation models in analysis, and then to apply the flexible empirical approaches preferred by the applied stream in the literature. By doing this we believe that practitioners can apply insights from scholarly research to improve outcomes for their plan members.

Before we begin our detailed examination of the literature, we will first summarise the evolution of ideas that led to the time diversification debate as necessary context. The literature review thus commences with a discussion of the work of Markowitz (1952).

## 2.0 The time diversification puzzle

### 2.1 Markowitzian origins

The principle concern of the time diversification debate is the relationship between investment risk and the investor's horizon. But before we explore the subject in detail, we must first anchor the work in the field of finance. Fortunately, when it comes to investment – or, in formal terms, portfolio choice – we can rely on one of the most famous theories in all of finance: the pioneering work of Markowitz (1952).

Markowitz's (1952) seminal modern portfolio theory (MPT) was the first formal treatment of the benefits of portfolio diversification. The theory showed that, by constructing a portfolio of imperfectly correlated assets, it was possible to reduce portfolio risk for a given level of expected return. Formally, a portfolio,  $p$ , is said to be mean-variance efficient, or a superior portfolio, if it produces greater return for a given level of risk than any other portfolio,  $q$ , of the same assets, that is,

$$E(R_p) > E(R_q) \text{ where } \sigma_p^2 = \sigma_q^2 \quad [1]$$

or less risk for a given level of return,

$$\sigma_p^2 < \sigma_q^2 \text{ where } E(R_p) = E(R_q) \quad [2]$$

assuming the same assets. The two parameters for portfolio,  $p$ , of  $n$  assets are derived as follows:

$$E(R_p) = w'R \quad [3]$$

$$\sigma_p^2 = w'\Sigma w \quad [4]$$

where  $w'$  and  $w$  are, respectively, the row and column vectors of the portfolio weights of  $n$  assets,  $R$  is the vector of expected returns for  $n$  assets, and  $\Sigma$  is the matrix of variances and covariances between the  $n$  assets. The parameters for portfolio,  $q$ , are defined analogously.

While the MPT of Markowitz (1952) remains one of the iconic theories of finance, it is founded on a number of assumptions which have been critiqued extensively in the literature. Of these assumptions, the most relevant to this literature review is its single-period character. MPT's single-period assumption implies that the optimisation procedure need only be performed once because it

is based on single, static estimates of the optimisation's inputs – the variables in equations [3] and [4]. The single-period assumption implicitly relies on two important points: firstly, that the investor sees the life of the portfolio as one period; and, secondly, that the investor has in mind estimates of return and risk that characterise the performance of each asset for the entire period in question, along with a fixed covariance (or correlation) matrix that captures the co-movement between assets for the period.

In reality, investors view portfolio decisions as iterative. Realised returns and revised expectations necessitate a review of portfolio objectives, or the estimates used in constructing the portfolio (e.g. Grinold and Kahn, 1999). For example, further portfolio decisions may be required for the following reasons: the portfolio has failed to achieve the investment objective(s) set for it; it has achieved its objective(s) with too much risk; the investment objectives have changed; or, perhaps most importantly, expectations about the future performance of the underlying financial assets have changed. These kinds of examples give us a realistic idea of the context in which portfolio choice decisions takes place.

It is thus apparent that MPT's single-period assumption is seriously challenged by the realities of investing, with today's institutional setting being vastly more complex than that assumed by the basic MPT model, or by the time diversification debate. The critique of the single-period assumption is that it is too simplistic, and incompatible with the context in which real portfolio decisions are made. Multi-period approaches to the portfolio problem also have a relatively long history in the finance literature, and it is in a multi-period setting that this debate is squarely located (Tobin, 1965). Moreover, not only does the time diversification debate consider a multi-period problem, it is essentially about the relationship between multiple investment periods of different lengths – the “investment horizon” – and risk.

Beginning with Samuelson (1969), financial theorists considered whether it was possible to reduce portfolio risk by investing over successively longer periods<sup>5</sup>. Is it possible to reduce portfolio risk by spreading risk across  $t$  time periods, rather than  $n$  assets? Over time, the answering of this

<sup>5</sup> Some might be tempted to date the birth of the time diversification debate to Samuelson (1963). In this paper, Samuelson (1963) clarifies a mistaken interpretation of Bernoulli's Law of Large Numbers where it is thought that “an insurance company reduces its risk by increasing the number of ships it insures (p. 50).” In correcting this interpretation, Samuelson (1963) states that risk is not reduced by adding new risks (as in additional gambles, time periods, or ships insured), it is reduced by subdividing risks (as insurance companies and portfolio managers do). In clarifying one mistaken interpretation he appears to unwittingly introduce a dichotomy where we are choosing between adding a risk or subdividing a risk. While the problem Samuelson (1963) addressed was no doubt of interest, it has on occasion distracted scholars from the real dichotomy at the heart of the time diversification debate. For example, Oldenkamp and Vorst (1997), in an option pricing framework, compare the performance of a ten-year strategy to a one-year strategy repeated ten times. In Samuelson's (1963) terms, this is an example of subdividing risk. Oldenkamp and Vorst (1997) confidently state: “Thus, there are many scenarios in which the repeated one-year strategy outperforms the long-horizon strategy (p. 58).” We believe that Merrill and Thorley (1997) dispelled this misguided notion once and for all when, in critiquing Oldenkamp and Vorst (1997) directly, they note: “The objective in the time diversification debate is to compare risk at *different* (original emphasis) time horizons, not the same horizon (p. 62).” In the interests of complete clarity, we concur with Merrill and Thorley (1997) and see time diversification as a debate about the relative risk of horizons of different length. The comparative performance of strategies with the same horizon, but different reinvestment frequencies, would appear to be more relevant to something like the term structure literature.

question has become the time diversification puzzle, a debate that has been nourished by a focus on long-horizon investing born of the growth of private retirement savings.

Time diversification was first examined in an expected utility framework by Samuelson (1969) who found that the allocation to risky assets is independent of time, and only determined by risk tolerance. These conclusions were based on three assumptions:

- 1) the investor exhibits constant relative risk aversion;
- 2) returns follow a random walk<sup>6</sup>; and
- 3) wealth is a function only of returns.

Much of the subsequent research within the expected utility framework has considered variations to these assumptions, and the competing streams of research use these assumptions as a critique of the framework itself. Without overstating our case, these assumptions are absolutely central to any debate relating to time diversification.

Of Samuelson's three assumptions, the first and second have provided the motivation for much of the subsequent literature. As foreshadowed above, the time diversification literature can be neatly classified into four streams or schools of thought: (1) the expected utility theory stream; (2) the option pricing theory stream; (3) a behavioural finance stream; and, (4) an applied stream. The balance of this paper will outline, and discuss in detail, these separate streams in the time diversification literature which tend to dwell on Samuelson's (1969) first and second assumptions. But before we proceed to the literature review proper we will briefly discuss how Samuelson's (1969) three assumptions represent the battle ground of this debate.

## 2.2 Samuelson's first and second assumptions

As this paper will show, much of the time diversification debate has revolved around Samuelson's (1969) first two assumptions – that the investor exhibits constant relative risk aversion, and returns follow a random walk – with the debate taking place both within, and between, the four streams in the literature.

The classical approach requires the researcher to outline how they propose to isolate the relationship between risk and time, motivated by the literature. Predictably, the approach taken corresponds to the researcher's preferred paradigm, or their theoretical priors. For example, a proponent of the expected utility theory would typically estimate the allocation to risky assets that maximises expected utility, given a set of assumptions, and relate their results to investment horizon. Another approach might adopt a different framework, a different set of assumptions, and/or a different methodology. Studies therefore vary on a number of dimensions meaning it is difficult to isolate the essential relationship between risk and investment horizon because each difference in dimension introduces its own variation. We can therefore say that researchers have expended much more effort on adding to the debate – by considering a slightly different definition of risk, or a different set-up – than on synthesising or distilling the debate in search of generality. This

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<sup>6</sup> The idea that returns on financial assets are random or don't follow a predictable pattern.

willingness to re-visit the debate on different terms, and potentially arrive at a different conclusion, led Kritzman (2000) to make his memorable remark about the time diversification debate becoming a futile referendum on risk. Thus, what is needed is a study that distills the existing literature in search of durable truths. Armed with these truths – if, in fact, such truths exist – we are better positioned to bring them to bear on the essential economic activity motivating this paper: portfolio choice.

## 2.3 Samuelson's final assumption

Samuelson's (1969) final assumption – that wealth is a function only of returns – is the subject of remarkably little investigation in the time diversification literature. Most scholars are comfortable making Samuelson's (1969) final assumption theirs too. Why this is the case can only be conjectured, but it is thought to relate to the fact that an initial endowment model allows the researcher to ignore factors which both complicate their analysis, and are difficult to generalise in establishing a hypothetical investor. Unfortunately, in accepting this assumption scholars effectively divorce their research from the institutional setting in which long-horizon portfolio choice takes place. In today's world, we observe long-term savings generated by returns, contributions and the associated compounding. We are thus left with studies that are devoid of context; indeed, from a parallel universe.

Where scholars do pursue alternatives to the initial endowment accumulation model, they tend to consider their results in isolation. Thus, we see the results these models produce, but without the benchmark of the initial endowment model, we are none the wiser about how varying the accumulation model affects the relationship between risk and investment horizon. That the time diversification debate remains unresolved, and the marginal effect of alternative contributions is under-studied, is remarkable given that at this very point in time there are trillions of dollars of retirement savings being invested<sup>7</sup>. Without answers to these questions, we are left to wonder upon what basis these investment decisions are being made.

As we know, Samuelson's (1969) final assumption holds that wealth is only a function of returns. We also know that returns are, in turn, a function of the portfolio of assets held. Throughout much of the literature, asset allocation is a constant with stocks generally dominating portfolio composition. Given the central role of stocks to investing, this is not surprising. Furthermore, if we are to observe the essential relationship between risk and time, we would seek to limit additional sources of variation in the results and might therefore hold portfolio composition constant. However, since the time diversification debate began, approaches to asset allocation have evolved appreciably. The balanced fund design has been replaced by, or supplemented with, target date funds and a newer generation of dynamic fund designs. These newer fund designs – given they all have non-constant asset allocations – implicitly seek to expose the investor to risk at the appropriate time. These designs also implicitly acknowledge that there is an important difference between return- and wealth-based conceptions of performance. So, according to modern portfolio design principles, the timing, as well as the magnitude of returns, influences investment

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<sup>7</sup> Pensions & Investments (2012) estimates the total assets of the world's largest one thousand retirement plans at \$US6.7 trillion, as at 30 September 2011.

performance. Once again, we see that the terms upon which the debate is conducted are divorced from the prevailing institutional setting.

## 3.0 The time diversification literature

As we have noted, Samuelson's (1969) seminal work on time diversification was founded on three assumptions: (1) the investor exhibits constant relative risk aversion, (2) returns follow a random walk, and (3) wealth is a function only of returns. Of these three assumptions, the first and second have motivated almost all the subsequent time diversification literature. We consider these two assumptions together in one section because many previous studies in the literature discuss and vary both assumptions simultaneously.

In order to make this review easier to navigate we divide the literature into a number of streams which have emerged based on common critiques, or consistent theoretical or methodological foundations. Each stream is introduced in chronological order by the date of publication of the stream's foundational work. The exception to this rule is the most diverse stream in the literature – the applied stream – which is introduced last because it leans on elements of each of the other streams, and adopts diverse approaches to studying the time diversification phenomenon. Our discussion of Samuelson's (1969) final assumption follows separately.

## 3.1 Samuelson's first and second assumptions

### 3.1.1 Expected utility theory

The expected utility theory stream of the literature tends to observe risk indirectly. Rather than defining risk a particular way (e.g. standard deviation), then measuring it over various investment horizons, scholars within the expected utility framework typically solve for the optimal allocation to stocks for a given assumption set. In this way, it is possible to impute what happens to risk as horizon changes by observing the optimal allocation to risky assets for a variety of horizons. But in order to analyse risk in this way, Samuelson (1969), and his successors in this stream of literature, assign a risk aversion specification to their hypothetical investor via the selection of a utility function. The direction of the logic thus begins by defining the investor's risk tolerance and then works toward what this means for the relationship between risk and investment horizon. Such an approach therefore tends to be normative because it generalises how investors perceive risk first, and then observes the relationship of interest. This paper will show that the normativity of the expected utility framework, as well as its sensitivity to the specification of risk aversion, represent its key weaknesses.

We contend that the population of investors is highly heterogeneous, and not as amenable to generalisation as advocates of the expected utility framework would have us believe. The very existence of the field of behavioural finance is testament to the fact that much of classical economics assumes away the human aspects of what remains a social science. This critique is not new, and has been used in the literature to motivate both the option pricing framework and behavioural streams in the literature.

Samuelson (1969), in his multi-period generalisation of Markowitz (1952), found, assuming the investor exhibits constant relative risk aversion (CRRA), that "... the optimal portfolio decision is independent of wealth at each stage and independent of all consumption-saving decisions leading to a constant [risky asset weight]  $w^*$  (p. 244)." A page later, Merton (1969), in continuous time, confirmed Samuelson's constant weight finding in the presence of CRRA, and extended his analysis to consider a constant absolute risk aversion (CARA) assumption<sup>8</sup>. Merton (1969) found that, assuming CARA, the dollar value of wealth invested in the risky asset remains constant, so as wealth rises the proportion falls. While Merton (1969) admits this form of utility function is behaviourally less plausible, we see that very soon after the time diversification debate began we have evidence that Samuelson's (1969) findings are sensitive to his framework's assumptions.

Kritzman and Rich (1998) clearly show in their Exhibit 2 – reproduced herein as Figure 1 – that the allocation to risky assets is sensitive to how each of Samuelson's (1969) first two assumptions are specified. For example, for each of three asset return processes Kritzman and Rich (1998) consider, we can see that it is possible that the allocation to risky assets may be constant, increase with time, or decrease with time depending on the utility function specification. While we can't completely discard the expected utility framework as a means of analysing the time diversification debate, we are beginning to question how it is possible to rely on conclusions so sensitive to their underlying assumptions.

### Figure 1: The impact of preferences and return characteristics on time diversification

This figure reproduces Exhibit 2 (p. 68) from Kritzman and Rich (1998) that shows how the allocation to risky assets varies with utility function, risk aversion and the asset return process.

Utility Specification	Absolute Risk Aversion	Relative Risk Aversion	Impact of Time on Equity Allocation		
			Random Walk	Mean Reversion	Mean Aversion
Log Utility = $\ln(\text{Wealth})$	Decreasing	Constant	Hold Constant	Hold Constant	Hold Constant
Square Root Utility = $(\text{Wealth})^{1/2}$	Decreasing	Constant	Hold Constant	Increase	Decrease
Power Utility = $-1/\text{Wealth}$	Decreasing	Constant	Hold Constant	Increase	Decrease
Quadratic Utility = $25 \times \text{Wealth} + 0.1 \times \text{Wealth}^2$	Increasing	Increasing	Decrease	Decrease	Decrease
Combination Utility = $1/\text{Wealth} + \ln(\text{Wealth})$	Decreasing	Decreasing	Increase	Decrease	Increase

<sup>8</sup> Merton's (1969) paper literally begins on the next page of the same edition of the Review of Economics and Statistics. Merton (1969) notes that Samuelson's (1969) work is more general with respect to the probability distributions it can handle.



Even the most prolific scholars within this stream of the literature – like Samuelson (1963, 1969, 1971, 1989, 1990, 1994) and Kritzman (1994, 2000) – concede that their general findings against time diversification may not hold with alternative utility specifications<sup>9</sup>. Samuelson (1989), for example, states that if the logarithm of wealth less some subsistence level of consumption is the expected value to be maximised, then a lower allocation to stocks with age can be justified. Samuelson (1989) states:

“Suppose, though, human nature is such that we are each most anxious not to fall below a ‘subsistence’ level of terminal wealth [original emphasis] – so that  $\log(W - S)$  and not  $\log W$  is the utility whose Expected Value we seek to maximize. In that case [the] contention is correct that older people will put less into risky stocks when they have fewer years to go before the terminal date of retiring or bequeathing (p. 11).”

Similarly, Kritzman (1994) conditions his findings in favour of Samuelson’s (1969) original conclusion by highlighting five “valid reasons why you might still condition your risk posture on your investment horizon (p. 17).” One of these reasons is the potential for an investor to have a discontinuous utility function<sup>10</sup>. Kritzman (1994) explains:

“Consider, for example, a situation in which you require a minimum level of wealth to maintain a certain standard of living. Your lifestyle might change drastically if you penetrate this threshold, but further reductions in wealth are less meaningful. You might be more likely to penetrate the threshold given a risky investment over a short horizon than you would be if you invested in the same risky asset over the long run (p. 17).”

Milevsky (1999) tests just such a discontinuous utility function motivated by the fact that it “has been extolled as conforming to observed investor behavior (p. 271).” Milevsky (1999) supports Samuelson’s (1969) results, finding that the optimal allocation to risky assets is independent of time. He also finds that, notwithstanding a constant allocation to risky assets, risk – defined as the probability of earning a cumulative rate of return less than that of the risk-free asset – declines exponentially with investment horizon. Milevsky (1999), thus, differentiates between the risky asset allocation and risk in a way not generally seen in this stream of the literature.

Apart from the aforementioned studies, the expected utility stream of the literature contains numerous other studies which attempt to study time diversification by estimating the optimal allocation to risky assets that maximises expected utility, given some set of assumptions (e.g. Bodie *et al.*, 1992; Levy and Spector, 1996; Levy, 1996; Jagannathan and Kocherlakota, 1996; Van Eaton and Conover, 1998; Hansson and Persson, 2000; Strong and Taylor, 2001; Gollier, 2002; Karlsson,

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<sup>9</sup> Note that both authors also published other joint work in the time diversification literature, for example, Merton and Samuelson (1974) and Kritzman and Rich (1998), respectively.

<sup>10</sup> Kritzman and Rich (1998) reiterate this point regarding a discontinuous utility function and give three practical situations consistent with a sudden drop in utility if a threshold is penetrated: “A decline in the value of pension assets will cause a net pension liability to appear on a company’s balance sheet; A covenant on a loan agreement will be breached if assets fall below a specified value; Your spouse will abandon you if your net worth falls by a certain amount (p. 70).”



2006)<sup>11</sup>. What we have shown here is that the central players in this stream in the literature admit that the time diversification debate hinges on the form of risk aversion exhibited by the investor. If the specification changes, as Kritzman and Rich (1998) show us, then so does the relationship between risk and time.

Other streams in the time diversification literature generally motivate their resort to an alternative framework with a critique of the Samuelson (1969) approach. The option pricing protagonists contrast their framework with Samuelson (1969) by highlighting its objectivity and independence from particular models of risk aversion or utility. Fisher and Statman (1999), as representatives of the behavioural stream of the literature, critique the assumptions underlying expected utility theory noting that Samuelson (1969) implies that investors accurately assess the probability of loss, a fact not supported by the behavioural literature. Critiques of expected utility theory even pre-date the time diversification debate itself. For example, in criticising results from a similar framework to that of Samuelson (1969), Roy (1952) comments that “in calling in a utility function to our aid, an appearance of generality is achieved at a cost of a loss of practical significance and applicability in our results. A man who seeks advice about his actions will not be grateful for the suggestion that he maximize expected utility (p. 433).”

As shown in the earlier discussion of Kritzman and Rich (1998), it is common in the expected utility theory literature for authors to vary both of Samuelson's (1969) first and second assumptions simultaneously. This is the principal reason why they are considered together in this paper. For example, Kritzman and Rich (1998) in a matrix, reproduced herein as Figure 1, outline what happens to the optimal allocation to stocks for fifteen separate combinations of utility function – log utility, square root utility, power utility, quadratic utility, and combination utility – and asset return process – random walk, mean reversion, and mean aversion. Once again we see that the verdict on time diversification, from within its foundational paradigm, is highly sensitive to the model specification. Take, for example, the power utility function assumption from Figure 1. Depending on one's view of the asset return process, there are three possible relationships between time and risk.

Another relevant study from the expected utility theory stream of the literature is that of Strangeland and Turtle (1999). It represents another example – like Samuelson (1989) and Kritzman (1994) – where the proponents of expected utility realise that the time diversification puzzle may require alternative, or complementary, approaches to be resolved in any general way<sup>12</sup>. Strangeland and Turtle (1999) state that the presence of time diversification “depends critically on a number of important and highly context-dependent factors (p. 1).” They go on to cite relative risk aversion and the risky asset return process as two, out of a total of six, factors that may affect portfolio choice<sup>13</sup>.

<sup>11</sup> Other studies examine optimal allocations from a purely mean-variance perspective including Levy and Gunthorpe (1993), Gunthorpe and Levy (1994), Booth (2004), Mukherji (2008) and Panyagometh (2011). Recent research by Ayres and Nalebuff (2013) compares the performance of a range of investment strategies, including leveraged ones, in what they describe as the “Merton-Samuelson” tradition.

<sup>12</sup> Resolving the time diversification debate for certain specific circumstances is not beyond any of the major approaches taken in the literature. A lack of generality is why time diversification remains a puzzle.

<sup>13</sup> The complete set of factors Strangeland and Turtle (1999) identify are: (1) relative risk aversion; (2) risky asset return process; (3) ability to change work habits; (4) frequency of required withdrawal for the investor's portfolio; (5) existence of non-tradable assets (e.g. human capital); and, (6) changes in investment knowledge over the investor's life.

This context-dependency leads Strangeland and Turtle (1999) to conclude that "... there is little motivation to debate the general merit of time diversification for a *typical* (original emphasis) investor (unless we have a very clear understanding of a typical investor) (p. 1)." We can see that, like us, Strangeland and Turtle (1999) detect a fundamental incompatibility between the restrictive and deterministic nature of their framework on the one hand, and the heterogeneity of the hypothetical investor, and the inconclusive evidence on the process driving asset returns, on the other. But perhaps Strangeland and Turtle's (1999) most revealing comment puts their views beyond doubt. They state that "... the issue of time diversification *cannot* (original emphasis) be completely resolved by resorting to an expected utility framework (p. 2)."

Strong and Taylor (2001), attempting to correct for the restrictive assumptions of earlier studies, examine time diversification with what they describe as "realistic utility functions (p. 268)." Moreover, they claim to "not impose ... restrictions on the process followed by risky asset returns (p. 268)." We can see in Strong and Taylor's (2001) intent an implicit recognition of the critiques we make herein: that some of the utility function specifications adopted in the literature are more convenient than representative; and, the verdict on time diversification is, in part, a function of the assumption made regarding the process driving asset returns. At face value, therefore Strong and Taylor (2001) agree with the standard critiques, motivate their work with these critiques, and then set out to provide a corrective for the associated inadequacies. At first it appears that Strong and Taylor's (2001) approach may be sufficiently different to allow a resolution within the expected utility framework. For example, in contrast to Samuelson (1969), Strong and Taylor (2001) "provide support for the practitioner view that equity is a long-term investment," and that there "is evidence that equity represents a (significantly) more desirable investment over a ten-year investment horizon than over a one-month investment horizon (p. 297)." Notwithstanding this finding, we see more evidence of the weaknesses of expected utility theory. Once again, optimal allocations are not robust to "various levels of risk tolerance or various utility functions (p. 298)." Therefore, even "realistic utility functions (p. 268)" don't assist us in unravelling the time diversification puzzle. We, once again, find ourselves searching for an objective measure of risk which allows us to avoid the deterministic models of risk aversion integral to the expected utility stream of the literature.

One commonality between how the expected utility literature deals with the risk aversion specification and the asset return process is that both are approached from a deterministic perspective. Studies typically choose a risk aversion and asset return process assumptions motivated by the relevant literature, and then proceed to analyse that chosen set-up. Unfortunately however, as with utility functions, the views of scholars on the asset return processes driving financial data are mixed. Early research, for example, concluded that stock prices contain a predictable component over short horizons, contrary to Samuelson's (1969) random walk assumption (Bodie, 1976; Jaffe and Mandelker, 1976; Nelson, 1976; Fama and Schwert, 1977). Later studies reported evidence of negative serial correlation, or mean reversion, over longer horizons (Fama and French, 1988; Poterba and Summers, 1988; Lo and MacKinlay, 1988). While attempts have been made to explain mean reversion (e.g. Malliaropoulos and Priestley, 1999; Poterba and Summers, 1988; DeBondt and Thaler, 1987, 1989), no decisive argument has yet emerged. And to complicate matters further, a number of scholars find evidence against mean

reversion (e.g. Richardson and Stock, 1989; Kim *et al.*, 1991; McQueen, 1992; Miller *et al.*, 1994). Thus, we once again see that the time diversification debate is less about the question at hand – the relationship between risk and time horizon – and more about a second-order question relating to the assumptions behind the expected utility framework, in this latter case about what asset return process drives returns.

Whilst the expected utility stream of literature is perhaps the most voluminous and long-lived in the time diversification debate, there are three principal reasons why we believe it does not offer a solution to the puzzle. Firstly, there is no consensus regarding what utility function specification best represents the “average” investor, if such a generalisation were possible. The evidence from the literature in this respect is not convincing. Secondly, as Strong and Taylor (2001) suggest, estimates of the optimal allocation to risky assets are not robust to various levels of risk tolerance or various utility functions. Thus, any generality we seek to obtain can be rejected by providing a counter-example using an alternative risk aversion or utility specification (Rabin, 1952; Booth, 2004). Finally, we contend that expected utility theory is normative in that it imposes a utility function, or model of risk aversion, then proceeds to analyse the relationship between risk and time<sup>14</sup>. While this paper shows a lack of sympathy for the expected utility framework, the fragmented and contradictory findings of the literature to date certainly gives support to our contention that the time diversification debate is in need of synthesis.

### 3.1.2 Option pricing theory

Bodie (1991) was the first study to depart from the expected utility framework. In his paper, Bodie (1991) goes beyond “the Samuelson-Merton analysis” – which finds that investment horizon should not affect the optimal asset mix – to investigate “the implications of option pricing theory for investment policy of defined benefit pension plans (p. 57)<sup>15</sup>.” Other than a desire to test the time diversification question using a different paradigm, Bodie (1991) provides no motivation for this innovation. It is not until later – Merrill and Thorley (1996) to be precise – that advocates of option pricing theory offer it as an objective assessment of the relationship between risk and investment horizon. As shown in the last section, Samuelson (1969) and his successors, generally proxy risk by estimating the optimal allocations to risky assets over different horizons. So how does Bodie (1991) perceive risk? Using Black-Scholes-Merton Option Pricing Theory, he equates risk with the cost of insuring against shortfall risk. In so doing, Bodie (1991) makes a distinction between the probability of shortfall – which he deems a “faulty definition of risk (p. 60)” – and the cost of insurance against shortfall risk which he estimates with option pricing theory. Bodie’s (1991) basic conclusion is: “If the objective of pension asset management is to minimise the cost of providing guaranteed benefits, then the longer the time horizon, the *lower* (original emphasis) the proportion of assets that should be invested in stocks (p. 57).” This finding is both at odds with the findings of

<sup>14</sup> Thorley (1995) argues that “critics invoke mathematical models of risk aversion to argue that investors should not succumb to the time diversification ‘fallacy.’ The premise of [Thorley’s] paper is that these arguments are a misapplication of the positive economic paradigm (p. 73).”

<sup>15</sup> Bodie (1991) uses the general descriptor “Samuelson-Merton analysis” because of the multiple contributions each of these scholars has made to this debate. He cites in particular Merton (1971), Merton and Samuelson (1974), and Samuelson (1963, 1989) as examples.

Samuelson (1969) – who suggests that the allocation to risky assets is a function of risk tolerance not investment horizon – and conventional wisdom – which argues that higher allocations to risky assets can be justified at longer investment horizons.

Bodie's (1995) motivation is identical to his earlier work (see Bodie, 1991) in that he sets out to test the "familiar proposition (p. 18)" at the heart of the time diversification debate: that investing in stocks is less risky, the longer the horizon. He argues that, for this proposition to be true, the cost of insuring against underperforming the risk-free rate should fall as the investment horizon lengthens. The principal difference between the two works is that Bodie (1995) tests his findings for two types of asset return process: the random walk assumption as in Samuelson (1969); and, mean reversion. Bodie (1995) confirms the findings of Bodie (1991) that risk, measured using option pricing theory, increases rather than decreases with investment horizon. Thus, having adopted a different theoretical paradigm, Bodie (1991, 1995) produces results that contradict both conventional wisdom and the main findings of the expected utility theory stream of the literature discussed earlier<sup>16</sup>. In this sense, we see that the time diversification debate is developing *between* paradigms, as well as *within* paradigms. This matters to this paper because, if we are to advocate the importance of synthesis in relation to this puzzle, we must first show that a puzzle exists.

A further relevant contribution of Bodie (1995) is a salient reminder that the investment decision which he examines – and which is the subject of this paper – exists within a broader lifetime planning context as discussed in Bodie, Merton and Samuelson (1992). In their paper, Bodie *et al.* (1992) considers whether the presence of labour flexibility affects consumption, saving, and portfolio investment decisions over the lifecycle. According to this broader context, where *total* wealth is the sum of financial capital and human capital, the investment decision is one of several interrelated factors bearing on lifetime financial planning. A worker's lifetime income profile – which, in present value terms, equals human capital – might thus bear on the investment decision.<sup>17</sup> Bodie (1995) – like Samuelson (1989) and Kritzman (1994) – conditions his findings regarding time diversification by referring to this more comprehensive set-up in Bodie *et al.* (1992). Bodie (1995) states that: "Asset allocation for individuals should be viewed in the broader context of deciding on an allocation of *total* (original emphasis) wealth between risk-free and risky assets (p. 20)." Within this broader context, Bodie (1995) finds a potential justification for a downward sloping allocation to risky assets through time (cf. Bodie *et al.*, 1992).

Merrill and Thorley (1996) favour Bodie's (1995) approach because they view it as an "objective way to evaluate the arguments for and against time diversification" that is "independent of any specific model of investor utility or risk aversion (p. 13)." We thus see the first sign of a formal critique of the expected utility framework motivating work within the option pricing stream of the literature. Despite their agreement with Bodie (1995) about option pricing theory's objective evaluation of risk, Merrill and Thorley (1996) use the same option pricing theory to consider two

<sup>16</sup> Bodie (1996) again examines the relationship between risk and investment horizon, this time in a defined benefit framework. Referring to Harlow (1991), he reiterates his critique of using the probability of shortfall as a risk measure noting that "it completely ignores how large the potential shortfall might be (p. 90)."

<sup>17</sup> This point – that lifetime income bears on the investment decision – and reliance on the work of Bodie *et al.* (1992) is common in the time diversification literature.

types of financially-engineered products – Protected Equity Notes and Self-Funding Market Collars – and find “that longer time horizons reduce the cost of risk elimination, and by implication, risk itself (p. 13).”<sup>18</sup> Once again, we see an example of a study that yields polar-opposite results to another study within the same theoretical paradigm.

While Merrill and Thorley (1996) muddy the findings of the option pricing theory stream of the literature, they make at least three other critical points about the debate. Firstly, in viewing the time diversification literature, Merrill and Thorley (1996) make a distinction between “practitioner-oriented empirical research” and the work of “financial theorists” (p. 13). The work of these financial theorists is in fact the literature that we are examining in this paper. The critique of the financial theoretical literature is that it tends to degenerate into a debate about the theoretical paradigm – e.g. what is the most defensible utility function – which necessarily leads to less focus on the essential relationship between risk and time horizon. Furthermore, many of Merrill and Thorley’s (1996) financial theorists, having outlined the “incontrovertible truth (Kritzman, 1994, p. 17)” and the “mathematical truth (Kritzman and Rich, 1998, p. 71)” gleaned from their theories, go on to provide a litany of reasons why their findings – and, this paper would argue, their theory – might prove unreliable. How are we to be convinced by an argument when the theoretical edifice upon which the argument is built is undermined by the theory’s principal proponents? At least, one would argue, the “practitioner-oriented empirical research” seeks to free itself as much as possible from the false comfort of theory. It is this “practitioner-oriented empirical” approach – or what Booth (2004) describes as the “applied” stream in the literature – that will be examined last in this paper.

Secondly, Merrill and Thorley (1996) rightly point out that differences of opinion are “often rooted in semantic issues about the meaning of risk (p. 13).” This statement is both a premonition of Kritzman’s (2000) comment about the time diversification debate being “a referendum on the meaning of risk (p. 50)”, as well as one of the motivations for separate work on this question (see Bianchi, Drew and Walk, 2014b). If we are to have a fair referendum on risk, are we not obliged to conduct it on common terms? Bianchi, Drew and Walk (2014a) argue that it is, and go on to compare a comprehensive array of risk measures from the literature using a consistent methodology.

Third, and finally, Merrill and Thorley (1996) hint at an important insight into the basis upon which performance ought to be evaluated. They indicate that returns-based measures of performance

<sup>18</sup> Dempsey et al. (1996), Zou (1997) and Oldenkamp and Vorst (1997) provide critiques of Merrill and Thorley (1996). Dempsey et al. (1996) highlight what they believe to be a false analogy in Merrill and Thorley’s (1996) interpretation of Bodie (1995). Zou (1997) suggests that Merrill and Thorley’s (1996) findings may say more about their methodological approach, than it does about time diversification. Oldenkamp and Vorst (1997) claim to “show that Merrill and Thorley’s (1996) conclusions are not as obvious as they claim” and “that their arguments do not resolve the time diversification debate (p. 57).” We note that Merrill and Thorley (1997) provide a qualitative response to Oldenkamp and Vorst’s (1997) critique of their work. They state, and we agree, that “the objective in the time diversification debate is to compare risk at *different* (original emphasis) time horizons, not the same horizon. The fact remains that it costs an investor less to insure against underperforming the risk-free rate at a long horizon compared to a short horizon (p. 62).” We make this point about the confusion between investment horizon and rebalancing frequency earlier when discussing the birth of the time diversification debate and Samuelson’s (1963) earlier work. Please refer to footnote 5.

may be the wrong basis for evaluation when they state: “Some critics of time diversification object to the use of annualised returns in measuring risk and return across different time horizons and suggest that dollar figures are more revealing. Thus, the argument for time diversification is even stronger when stated, perhaps mistakenly, in simple dollar terms (p. 17).” We argue that, far from being mistaken, wealth-relative terms are the only way to evaluate risk and return, particularly when we depart from the initial endowment model so popular in the literature (see Bianchi, Drew and Walk, 2014b).

As discussed earlier, Bodie (1995) found that “the cost of the insurance rises with [investment horizon]  $T$  (p. 20)” and, therefore, so does risk, suggesting that time diversification, as conventional wisdom conceives it, does not exist. Numerous scholars have lined up to critique Bodie’s (1991, 1995, 1996) findings, many doing so in a qualitative fashion. Ferguson and Leistikow (1996) question Bodie’s (1995) singular focus on risk instead noting that “if appropriate allocation proportions depend on reward in relation to risk, not just risk, then Bodie’s message for individuals is irrelevant (p. 68).” Taylor and Brown (1996) challenge Bodie’s (1995) analysis on three fronts. Firstly, they suggest that constant relative risk aversion might be a valid assumption over short horizons but may not be over long horizons. [As an aside, this critique would apply equally to Samuelson’s (1969) expected utility framework.] Secondly, Taylor and Brown (1996) argue that Bodie (1995) sets-up a “straw man that he knocks down with unrealistic assumptions (p. 69).” For example, they suggest that the worst-case scenario Bodie (1995) uses is extremely unlikely and is thus unrealistic. And finally, they highlight that Bodie’s (1995) argument fails when his assumption of a constant standard deviation in his application of the Black-Scholes-Merton option pricing model is replaced with a non-constant standard deviation. As the literature shows, very few measures of risk are constant with investment horizon.

Cohen, de Fontenay, Gould, Sirera and Bodie (1996) is a collection of four letters to the editor in response to Bodie (1995). Therefore, other than each responding to Bodie’s (1995) work, there is no common theme between the letters. Rather, they represent a heterogeneous selection of critiques. Cohen, for example, points out that “the reasonable cost of insurance declines as the horizon is extended and/or return expectations are increased (p. 72).” This assertion is supported by Dempsey *et al.* (1996). Gould, who is clearly a practitioner, hints at two points that are of particular interest in this paper: firstly, that “dollar savings (p. 73)” are the most important measure in pension finance problems; and, secondly, that achieving a retirement goal – which Gould expresses in dollar terms – might be a relevant way of conceiving a practical pension finance problem.<sup>19</sup>

Dempsey *et al.* (1996) attempt to synthesise the option pricing literature and clarify the debate. On the one hand, they see, on the basis of option pricing theory, an argument that risk rises with time (e.g. Bodie, 1995) and, on the other, “a conventional insurance premium (p. 57)” argument where risk falls. Dempsey *et al.* (1996) find that Bodie’s (1995) put option prices are correct, but that the price of a put option is a valid measure of riskiness “only in the case in which one may assume that the potential returns for holding the stock in relation to risk do not improve with the investment

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<sup>19</sup> Bierman (1997) and Booth (2004) also suggest that the achievement of investment goals might be important.

time horizon (p. 60).” Dempsey *et al.* (1996) conclude that the put option prices of Bodie (1995) “cannot be taken as representing a measure of market risk. The simple reason is that the price of a put option is indicative of *two* (original emphasis) features of the market: risk and the market’s reward for risk that an insurance writer on a stock can expect to achieve (p. 61).”

In conclusion, as Merrill and Thorley (1996) argue, a chief advantage of Bodie’s (1991, 1995) option pricing theory approach to investigating time diversification is that it measures risk objectively, in contrast to the more normative and contested expected utility theory stream of literature. Notwithstanding this advantage, the option pricing stream has been subjected to three specific critiques from both within the paradigm, and in competing paradigms. Firstly, Ferguson and Leistikow (1996) and Bierman (1997) argue that Bodie’s (1995) option pricing approach implicitly ignores reward-for-risk calculations in favour of risk-only ones. Bierman (1997) notes that: “We need to consider an interpretation of risk that includes good outcomes as well as the bad outcomes (p. 52).” In one sense, Bodie’s (1995) risk-only approach is defensible given that time diversification has always been about the relationship between risk and investment horizon. Bierman’s (1997) argument, on the other hand, has merit: if it wasn’t for the returns stocks offer, they wouldn’t be the financial asset *du jour*. The second critique might be appropriately described as a technical argument. As Taylor and Brown (1996) argue, when the constant standard deviation assumption of Bodie (1995) is relaxed, his findings collapse. Thus, in essence, the constant standard deviation assumption is to the Black-Scholes-Merton Option Pricing Theory, as the constant relative risk aversion assumption is to Samuelson’s (1969) expected utility theory. Each is a dubious assumption which proves lethal to its parent theory, and to our attempts to find a general relationship between risk and investment horizon. Third, is the claim by Kritzman and Rich (1998) that, “[u]nfortunately, the option angle of time diversification has resurrected a misguided discussion about the meaning of risk (p. 71).” So not only do we see the debate taking place *between* paradigms, as well as *within* paradigms, we see the recurring theme regarding the meaning of risk. In the option pricing paradigm we see further attempts to isolate the relationship between risk and time, once again from within an incomplete paradigm. The likes of Gould are the rare voices which seek to move the debate from return-only conceptions of risk to more comprehensive and realistic ones expressed in terms of wealth.

### 3.1.3 Behavioural finance

Until now we have reviewed the two most enduring streams in the time diversification literature: the expected utility theory stream and the option pricing theory stream. Both streams are characterised by strong theoretical foundations, rigorous analytical approaches, and numerous studies. With this third stream – the behavioural finance stream – a different sort of literature is presented. Apart from being relatively new, the behavioural finance literature has neither strong theoretical foundations (of the economic kind), nor any particular analytical approach. There are also few studies in the behavioural finance stream of the literature. Instead, the behavioural finance research applies the insights of psychology to financial decisions in order to better define how to study problems and interpret findings. In this sense, it offers no alternative analytical framework to compete with the two approaches highlighted thus far. Rather it tends to focus on identifying and enunciating deficiencies in the earlier literature. For example, behavioural economists have



critiqued the time diversification literature for not framing risk properly.

Olsen (1997) is one study that discusses risk and how it should be framed. In particular, Olsen (1997) points out that risk in pension funds management ought to be considered from the perspective of the plan member, the beneficiary, whose “risk might be related to the loss of a large amount of wealth (p. 62)” versus a manager whose “risk might be associated with a portfolio return below that of one’s colleagues (p. 62)”<sup>20</sup>. We again see here a distinction between wealth-denominated measures of risk – which Olsen (1997) sees as relevant for pension funds – and return-dominated measures of risk which are arguably more relevant to investment managers. This distinction is a persistent theme in this debate, and the research of scholars like Olsen (1997) provides motivation for the consideration of wealth-denominated measures of performance in empirical studies like Bianchi, Drew and Walk (2014a).

Olsen (1997) also describes risk as a “multiattribute phenomenon (p. 65)” where the principal risk attributes appear to be “the potential for a below-target return, the potential for a large loss, the investor’s feeling of control, and the level of knowledge about an investment (p. 65).” The essentially human dimension of these latter two attributes highlights both the contribution of behavioural economists, and the difficulties presented by the qualitative nature of behavioural finance research. On this basis, we will overlook these attributes. The first attribute – the potential for a below-target return – confirms the importance of targets to pension finance problems. Basu, Byrne and Drew (2011) take this point up in the design of their dynamic asset allocation strategy, and their reporting of comparative performance. The second attribute – the potential for a large loss – suggests once again that the magnitude of risk is important, which in turn focuses our attention on wealth-denominated measures of risk<sup>21</sup>. For example, it is a truism that two minus 25 per cent returns are equivalent *in percentage terms* no matter when they occur during a plan member’s accumulation phase. If however we compared the impact of equivalent negative returns at two different points in the accumulation phase – say, at age 30 and age 50 – the differences could be materially different *in wealth terms*. Because this paper focusses on the field of pension finance, we take seriously the perspective of plan members, and thus take seriously wealth-denominated performance measures.

Lastly, Olsen (1997) presents evidence that the relative importance of these attributes is a function of “idiosyncratic investor and asset characteristics (p. 65).” In one sense, these findings are not surprising. In another way, the idiosyncratic nature of the relative importance of the attributes represents a telling critique of the standard expected utility theory assumption of constant relative risk aversion. Olsen’s (1997) finding suggests that any attempt to generalise risk tolerance may be fraught, notwithstanding its convenience. Olsen (1997) thus lends support to the choice of using objective measures of risk over the normative framework in Samuelson (1969).

<sup>20</sup> In practice, both perspectives are – or at least should be – of interest to pension fund trustees. The plan member perspective is the appropriate terms upon which to consider whether the plan is meeting its commitments to plan members. The latter perspective – the investment manager perspective – is the lens through which evaluation of investment managers should take place. Based on the authors’ professional experience, the distinction between these two perspectives is not always appreciated by plan trustees, management or academia.

<sup>21</sup> Rabin (2001) also argues that investors are “loss-averse” rather than risk-averse.



Olsen and Khaki (1998), in discussing how risk is treated in the time diversification literature, make three important points. Firstly, Olsen and Khaki (1998) dismiss expected utility theory as the framework that can resolve the time diversification debate. They note that “the dismissal of time diversification on positive grounds cannot be justified by appeal to the traditional discounted-SEU model (p. 58).” Olsen and Khaki (1998) are indirectly confirming our critique of expected utility theory as normative, because it seeks to impose a model of risk aversion on the hypothetical investor. A further specific critique Olsen and Khaki (1998) make of expected utility theory – or what they describe as “the traditional SEU models” – is that “decision makers do not treat probabilities and outcomes in the multiplicative fashion assumed by the traditional SEU models... decision makers use an additive model of risk (p. 60).” We see here another example of the strengths of the behavioural stream in the literature: a willingness to look beneath the surface of the classical economic models and attempt to reconcile their assumptions with the behaviour of investors. Without this correspondence between the behaviour of investors and economic theory, we risk economic theory becoming an elegant, but not altogether informative, caricature of reality.

Secondly, Olsen and Khaki (1998) continue to provide a range of behavioural insights. Olsen and Khaki (1998) go further than Olsen (1997) and contend that the magnitude of loss is not only an important aspect of risk, it is of paramount importance in understanding risk from the investor's perspective. For example, they note “... investors consider risk a positive function of probability and size of loss, with considerably greater weight being given to the size of the loss than to the possibility of loss (p. 60).” Olsen and Khaki (1998) go on to provide a cautionary note about how the importance of loss relates to probability, emphasising that “... the tendency to ignore low-probability negative outcomes could lead to financial catastrophe. Thus, potential outcomes should not be dismissed as a matter of course when a large portion of one's wealth is at risk (p. 61).” Although large negative returns might be rare, when the portfolio size effect of Basu and Drew (2009a) sees a rapid rise in portfolio wealth as an investor approaches retirement, even a small negative return can result in large impacts on terminal wealth. Insights like this encourage consideration of the full distribution of terminal wealth outcomes, as well as a number of downside risk measures. Olsen and Khaki (1998) even go as far as to question whether time diversification is indeed compatible with a behavioural conception of risk. They note that: “questions remains, however, of whether the concept of time diversification is generally consistent with the concept of risk as it has been documented in other studies of investment behaviour (p. 59).”

Olsen and Khaki's (1998) third, and final, important point is their clear recognition that time diversification is a contested idea, and might therefore reasonably be described as a puzzle. Even at the point in time when their article was published they acknowledged that “the lack of closure on this topic stems from the [economics] profession's failure to accept a common definition of risk (p. 58).” As will become apparent, when we review the applied stream in the literature, there are many more definitions of risk proposed in the literature. Some scholars – in particular those advocating expected utility theory – impose a theoretical framework and, based on a number of assumptions, reach a conclusion regarding the presence of time diversification. Others prefer to estimate risk as objectively, and as empirically, as is possible.

Fisher and Statman's (1999) study has three goals. Firstly, it sets out to explore time

diversification's assumptions. In doing so, they confirm many of the earlier critiques of Samuelson's (1969) expected utility theory approach. Fisher and Statman (1999) state plainly: "Samuelson's [1969] mathematics are right, but his assumptions are wrong (p. 90)." Fisher and Statman (1999), in the tradition of this stream of the literature, also contrast the received theory with the behavioural realities. For example, they note in relation to Samuelson (1994) that: "An unstated assumption under the mathematical truth, however, is that investors correctly assess the probabilities of losses. They do not (p. 91)." In a similar way, Fisher and Statman's (1999) second goal is to introduce a "wide range of factors that affect investment choices," beyond risk and return. If one was to take into account factors beyond the investment decision, there are many studies that would assist us (e.g. Bodie *et al.* 1992; Vanini and Vignola, 2002; Gollier, 2002; Cocco *et al.*, 2005). The third, and final, goal of Fisher and Statman (1999) is to "explore the prudence of the time diversification prescription (p. 88)." It is almost as if the authors have grown frustrated with the time diversification debate itself, and instead resort to questioning whether time diversification's classical generalisation – that stocks are less risky over longer horizons – is sensible given the multitude of factors that bear on investment choice. Fisher and Statman (1999) conclude on a wistful and resigned note: "The time diversification debate teaches us little about the relationship between risk and investment horizon, but it teaches us much about the many factors that affect financial choices (p. 96)."

Whilst this behavioural stream in the literature provides useful critiques of particular research – in particular, expected utility theory – it fails to provide any comprehensive or coherent alternative framework for addressing the time diversification puzzle. Instead it provides some useful points: (1) risk should be measured from the perspective of the plan member; (2) risk should be measured relative to the investor's current status not on an absolute level (Booth, 2004); and, (3) that both the magnitude and the probability of loss are relevant considerations in understanding risk. So, while we remain cognisant of the valuable insights of the behavioural literature, a behavioural approach has no answers regarding the puzzle. This is in large part because, as outlined above, the behaviouralists tend to focus on critiques of the existing literature rather than the introduction of new approaches that can be replicated and extended. The behaviouralists' principal contribution may be summarised thus: they help nudge the debate away from abstract returns-only thinking to a more comprehensive wealth focus.

### 3.1.4 Applied approaches

Fourth and finally, there exists what Booth (2004) has described as an "applied" stream of literature that dwells less on theoretical paradigms and more on empirical approaches to addressing the time diversification debate. Booth (2004) states: "In contrast to the theoretical literature, an applied literature has developed based on... simulation [techniques] (p. 3)." These studies generally define risk in a certain way and then turn to measuring that risk over various time horizons in order to identify whether time diversification exists or not. Numerous studies have been conducted and, with time, later authors have sought to synthesise the previous literature often before introducing yet another measure that is claimed to settle the debate (see, for example, Kritzman and Rich, 1998). This led Kritzman (2000) to conclude that "...the time diversification debate, for many, has degenerated into a referendum on the meaning of risk, which is futile

(p. 50).” Until now, however, no one study has examined all these measures using consistent data and methodologies. This lack of consistency means that it is difficult to determine whether the conflicting evidence of time diversification is truly conflicting, or whether it results from a different set-up, or a different range of measures<sup>22</sup>. Before turning to Samuelson’s (1969) remaining assumption, this paper must first discuss the important studies in this applied stream of literature, which generally revolve around particular measures of risk.

#### 3.1.4.1 Standard deviation and variations

Consistent with Markowitz’s (1952) framework, the time diversification literature first defined risk as the standard deviation of annualised returns and found that, as investment horizon lengthens, risk falls (Bernstein, 1976; Garrone and Solnik, 1976; Lloyd and Haney, 1980; Lloyd and Modani, 1983; McEnally, 1985; Lee, 1990). This finding has been periodically confirmed by later studies that revisit, and attempt to synthesise, the time diversification literature (e.g. Kritzman and Rich, 1998; Kochman and Goodwin, 2002; Guo and Darnell, 2005). McEnally (1985) disagreed that this was an appropriate measure of risk instead arguing that “unpleasant surprises in *total* (original emphasis) returns on terminal values - the values to which the annual rates of return would compound - not surprises in the average *annualised* (original emphasis) rates of return themselves (p. 24).” Using this measure, McEnally (1985) and later authors (e.g. Bernstein, 1985; Leibowitz and Krasker, 1988; Lee, 1990; Peavy and Vaughn-Rauscher, 1994; Kochman and Goodwin, 2001; Hickman *et al.*, 2001; Kochman and Goodwin, 2002; Gollier, 2002) found that, when measured this way, risk rises as investment horizon lengthens.

#### 3.1.4.2 Distribution of outcomes

McEnally’s (1985) work is important because it steered the debate away from parametric measures of risk and considered two additional classes of measures: firstly, measures that examine the range of outcomes, and secondly, downside measures of risk. In particular, McEnally (1985) looked at the range of annualised and total returns. Later studies followed McEnally (1985) but examined a range of other measures over various investment horizons. Leibowitz and Krasker (1988) considered the 5<sup>th</sup>, 25<sup>th</sup>, 50<sup>th</sup>, 75<sup>th</sup> and 95<sup>th</sup> percentiles of returns. Reichenstein and Dorsett (1995) looked at ending real wealth percentiles, in particular the 5<sup>th</sup> percentile and the median (or 50<sup>th</sup> percentile). Thorley (1995) looked at the mean, 10<sup>th</sup> and 90<sup>th</sup> percentile of portfolio wealth over five different horizons. Hickman *et al.* (2001) consider the median, in addition to the mean and standard deviation of terminal wealth. Mukherji (2008) looks at the median, the minimum, the maximum, and range of terminal wealth where \$1 is invested each month over the investment horizon.

#### 3.1.4.3 Downside risk measures

In studying downside risk, McEnally’s (1985) estimated semi-standard deviations (below the mean) for both average annualised and total returns and found that each measure behaved similarly to their standard deviation counterparts. Mukherji (2002, 2008) found similar results using semi-standard deviation, although he refers to it as downside deviation. The next downside risk measure introduced into the time diversification literature was shortfall risk, which is defined as the probability

<sup>22</sup> Bianchi, Drew and Walk (2014b) explore this point.

of falling short of some threshold return (Leibowitz and Krasker, 1988). In most of the literature, the threshold is the return from T-bills, which is generally regarded as the risk-free asset. Leibowitz and Krasker (1988), and later scholars (e.g. Leibowitz and Langetieg, 1989; Butler and Domian, 1991; Leibowitz and Kogelman, 1991; Reichenstein and Dorsett, 1995; Cohen *et al.*, 1996), found that shortfall risk reduces with horizon implying that stocks are less risky over longer horizons. Other authors test these findings using different models. Reichenstein and Dorsett (1995), for example, find that estimates of shortfall risk behave in similar ways for both random walk and mean reversion models. Bierman (1997) uses a binomial model to explore the risks of hypothetical gambles, expressed in shortfall risk terms, as time horizon increases. Thorley (1995) extends the shortfall risk literature by considering the conditional risky option mean (that is, the mean return when it underperforms the risk-free option), as well as the probability of underperforming the risk-free value.

Critics of shortfall risk, like Olsen and Khaki (1998), have argued however that what needs to be taken into account is not only the probability of loss but the *magnitude* of the loss. Leaning on other work of other authors (Diamond 1988; Joag and Mowen 1990; Kaplan and Garrich 1981; Lopes 1995), Olsen and Khaki (1998) argue that not only is the magnitude of loss important, it is given greater weight by investors than the probability of loss. This finding is particularly relevant when we discuss accumulation models which affect portfolio size, for example, where wealth is a function of contributions as well as returns. A downside risk measure that does have the ability to capture the magnitude of a loss is value-at-risk (VaR), which is proposed in the time diversification literature by Panyagometh (2011). In examining VaR and relative VaR he finds that “the risk of loss becomes lower with the increase in the length of the investment period (p. 96).”

### 3.1.4.4 Risk-adjusted measures of performance

As noted earlier, Bierman (1997), in critiquing Bodie's (1995) option pricing framework for being narrowly focused on risk, emphasised that reward-for-risk calculations are relevant in understanding portfolio choice problems. That expected risk and reward are positively related is, after all, one of the more durable truths of finance. The time diversification literature includes a number of different measures which seek to understand the reward-for-risk trade-off over various investment horizons. Levy (1972) found that as investment horizon lengthened the estimated Sharpe ratio increased, suggesting a better risk-return trade-off and the presence of time diversification. Levy's (1972) findings were generally confirmed by later authors (e.g. Lloyd and Modani, 1983; Levy, 1984), although Hodges, Taylor and Yoder (1997) find evidence of a hump-shaped profile noting that “...the Sharpe ratio for each portfolio first increases and then decreases as the holding period is extended (p. 77).” Levy (1984) uses the Treynor ratio, a reward-for-systematic-risk measure, and finds that the risk-reward trade-off also improves with horizon for three separate groups of stocks (aggressive, defensive and neutral)<sup>23</sup>. Using the Sortino ratio, Sinha and Sun (2005) find that the reward for downside-risk also improves with time horizon. Mukherji (2002, 2008) reaches similar conclusions using the coefficient of downside deviation, which is essentially the reciprocal of the Sortino ratio. While each of these measures allows us to

<sup>23</sup> Systematic risk in this context, and in the Levy (1984) paper, refers to the capital asset pricing model (CAPM) beta coefficient ( $\beta$ ).

consider both the return and the risk aspects of the time diversification puzzle, they each have a weakness in common with shortfall risk. Neither these reward-for-risk ratios nor shortfall risk take into account the increase in the potential magnitude of loss that results from multi-period compounding over a long horizon of, say, 40 years. This deficiency is of greater consequence when one considers problems outside the initial endowment paradigm so prevalent in the time diversification literature.

### 3.1.4.5 Novel measures of time diversification

Until now, this literature review has only discussed measures that are well known in the broader finance literature. A small number of scholars have developed their own measures in order to shed light on the time diversification puzzle. One measure,  $T^*$ , introduced by Guo and Darnell (2005), is defined as “the investment horizon such that the total stock return over this holding period will not become negative at [a given] confidence level (p. 69).” Put another way, using the  $T^*$  measure we are, say, 95 per cent confident that we will not have a negative total stock return if the investment horizon is lengthened to  $T^*$  years or longer. While this measure is mentioned in the context of the time diversification debate, it doesn’t do much to resolve the question of whether time diversification exists or not. Rather, it allows us to compare the risk of alternative asset return processes. Guo and Darnell (2005), for example, find that a mean-reverting process has a lower  $T^*$  than a random walk process. This would be the expected result because a random walk process would be expected to have paths which diverge from the mean for longer meaning that, for a given level of confidence, the  $T^*$  for a random walk process would be higher (or longer).

Another novel measure, and the last to be considered here, is the time diversification index (TDI) of Fabozzi *et al.* (2006). The TDI is a ratio of normalised risk measures for investment horizons of different length. Fabozzi *et al.* (2006) argue that the strengths of TDI as a measure include that it does not require any specific assumption regarding the risk profile of agents, and it can be computed for any model and any risk measure. For example, if we were to assume that risk is measured by standard deviation, the TDI is essentially calculated by dividing the reciprocal of the Sharpe ratio for the longer horizon by that of the shorter horizon. According to Fabozzi *et al.*’s (2006) rule, time diversification exists where the TDI is less than unity. Using a range of risk measures in calculating the TDI, Fabozzi *et al.* (2006) find little evidence of time diversification.

### 3.2 Samuelson’s final assumption

In order to complete this literature review, it is necessary to address the third and final assumption underlying Samuelson’s (1969) expected utility theory which was raised at the outset: that wealth is only a function of returns.

In relation to this third and final assumption, it is important to note that almost the entire time diversification literature takes place within an “initial endowment” framework. Typically, one of two approaches is taken. Firstly, many studies do not mention wealth at all and instead confine themselves to the analysis of accumulation models which are only a function of returns (e.g. Lloyd and Haney, 1980; Lloyd and Modani, 1983; Leibowitz and Langetieg, 1989; Lee, 1990). Alternatively, the study is set-up with some focus on wealth that is a function of only returns and an

explicit level of initial wealth (e.g. Marshall, 1994; Reichenstein and Dorsett, 1995; Thorley, 1995; Levy, 1996).

Despite a number of papers making passing references to more realistic and complete models (e.g. Bodie *et al.*, 1992; Kritzman and Rich, 1998), only a very small number of relatively recent studies actually incorporate periodic cash inflows, or contributions, in any way (e.g. Jagannathan and Kocherlakota, 1996; Hickman *et al.*, 2001; Mukherji, 2008; Panyagometh, 2011; Pástor and Stambaugh, 2012; Ayres and Nalebuff, 2013). In addition, a handful of studies analyse cash outflows (or withdrawals from wealth) as a way of studying the interplay between consumption and retirement investing (e.g. Samuelson, 1969; Merton, 1969; Merton and Samuelson, 1974). Thus, the time diversification literature is overwhelmingly dominated by studies where returns are the only determinant of terminal wealth.

The prevailing institutional setting can't support such an assumption. In reality, terminal wealth is a function of not only returns, but of contributions (which in turn are partly a function of salary growth) and asset allocation. The issue of the influence of contributions and asset allocation is taken up in Bianchi, Drew and Walk (2014a) and Bianchi, Drew and Walk (2014b), respectively.

## 4.0 Summary

Each of the competing streams in the time diversification literature has been the subject of specific criticism. The assumptions underlying Samuelson's (1969) expected utility theory approach have been comprehensively challenged by proponents and opponents alike. Of these critiques, two present themselves as being particularly convincing. Firstly, the requirement to assign a risk aversion specification to our hypothetical investor is normative and, as the behavioural literature shows us, the risk preferences of investors are by no means uniform. This normativity tends to result more in debates about risk preferences, than in discussions about the substance of time diversification: the relationship between risk and investment horizon. And, secondly, in addition to there being little consensus about what risk aversion specification best represents the "average" investor, the conclusions from the expected utility theory framework are not robust to alternative specifications. Furthermore, as Kritzman and Rich (1998) make clear, this sensitivity to specification holds for the asset return process as well. Thus, the verdict on time diversification can change dramatically by merely changing the risk aversion and/or asset return process specification, and any semblance of generality in results is lost.

Option pricing theory has been subjected to three specific critiques from both within the paradigm, and in competing paradigms. Firstly, some scholars argue that Bodie's (1995) option pricing approach implicitly ignores reward-for-risk calculations in favour of risk-only ones. Whilst this focus might be defensible given the substance of the time diversification debate, stocks are a popular investment because with the risk comes (expected) return. Risk/ return calculations should therefore at least be considered. Secondly, as Taylor and Brown (1996) argue, when Bodie's (1995) constant standard deviation assumption is relaxed, his findings fail. The option pricing framework is thus similar to the expected utility theory stream in that both appear sensitive to the major variable in their specification. Finally, as Kritzman and Rich (1998) suggest, Bodie's (1995) "option angle (p. 71)" perpetuates the debate over the meaning of risk. Thus, we see this recurring

theme regarding the meaning of risk taking place between paradigms, as well as within paradigms.

The strength of the behavioural finance literature is that it provides timely critiques of the broader literature by reminding scholars that flesh-and-blood investors don't necessarily correspond to the hypothetical investor represented in much of the theory. In particular, it highlights the importance of wealth conceptions of risk over their return-only counterparts. Its principal drawback is that it fails to provide any comprehensive or coherent framework for addressing the time diversification puzzle. Instead it offers some important points to consider when we evaluate risk measures; for example, both the magnitude and the probability of loss are relevant considerations in understanding risk.

The applied stream in the literature is characterised by a modest reliance on economic theory, and an empirical approach to methodology. It also attempts to approach the research questions from within the institutional setting, in contrast to the vast body of time diversification literature which appears detached from, or indifferent to, it. The principle deficiency of the applied stream in the literature is that it has grown as new risk measures emerge without there being any resolution in sight. In this respect, Kritzman's (2000) remark about the time diversification debate degenerating into a referendum on risk remains as true as ever.

Whatever the preferred paradigm, it is almost certainly true that the answer doesn't lie in approaches that abstract from the realities of investing. Investors do not have uniform, easily-caricatured risk preferences, and terminal wealth is not a function only of returns. Those looking to unravel the time diversification puzzle would do well to start in the world as it exists, not as we would like it to exist.



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## INVESTMENT RISK PROFILING: LESSONS FROM PSYCHOLOGY

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### ABSTRACT

The risk profiling process is one of the most under-utilised assets the financial planning profession has at its disposal. This paper presents a novel approach to risk profiling, which is based on the application of the psychology literature to develop an empirical risk profiling system. This paper provides a theoretical foundation for considering the risk profiling system by applying the literature from self-control, optimism, financial literacy, and risk tolerance, to a risk profiling system. This paper discusses how understanding client levels of self-control can impact 'stickability' to a financial plan, and how prior knowledge of optimism, financial literacy and risk tolerance can enable financial planners to have more engaging discussions and design more tailored financial plans for their clients. This is the first stage of the research project, with the second stage the development and testing of a risk profiling system based on the theory within this paper.

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## Introduction

Financial planning is a profession in flux with a series of legislated changes occurring in quick succession over the last two years, leaving many wondering what the future holds. Regulators of financial planners seek consumer protection, and attempt on a regular basis to raise the standards of advice, focussing often on remuneration, education, and compliance disclosures (FOFA, 2016). However, there is one aspect of financial planning which is simultaneously ingrained in professional financial planning practice, and yet unable to be regulated: risk profiling of clients. Despite the challenges around regulating this process, ASIC has found that the risk profiling system is one of their main concerns via their recent shadow shopping exercise (ASIC, 2016). This aspect of financial planning is so important because it gets to the heart of how the client interacts with their financial world. For example, clients have different propensities to make impulsive financial decisions which sabotage their long term wealth creation goals, or they might be overly optimistic about the future and thus fail to save. While accounting or stock broking may deal with the quantitative aspects solely, financial planning is as much about knowing the psychology of the client and building a relationship of trust, as it is about achieving wealth for the client. An integral aspect of this process is risk profiling. Developing a full risk profile may extend for many meetings, and often involves questionnaires found in the academic literature. However, the qualitative nature of this process makes it impossible to systemise and regulate.

Where does that leave the financial planning regulator when it comes to their profession in flux and keeping consumers safe? It leaves them in a situation where it is up to the profession itself to set the risk profiling standards, not the regulator. While this may make the regulator and consumer groups uncomfortable, on the other hand it does provide the financial planning profession with the opportunity to unify and develop a risk profiling standard of the highest level. The development of this standard provides the financial planning profession with the opportunity to stop looking inward, pointing the finger and grumbling about the regulated minimum standards by working together towards a risk profiling methodology that results in quality advice for clients. This paper seeks to provide a theoretical analysis of factors which will be incorporated into a risk profile system, and as such forms the first part of a two-stage research project, with the second stage the development and testing of a risk profiling system based on the theory in this paper.

Risk profiling is, at every step of the way, psychological personality profiling. Founded in the psychological literature<sup>1</sup> the inherent personality and character trends unearthed in risk profiling and the use of the process for uncovering this profile, has been taken up by business people and implemented as a business survey, although of only one aspect of a risk profile: tolerance for financial risk. This does injustice to the client and their unique combination of tolerances for risks in their financial and lifestyle situation, because it artificially simplifies their overall risk profile to one aspect, which arguably cannot be considered in isolation. Further, this over-simplification puts the business process and need for efficiency above the client, which goes against what an ethical financial planner would do, given that the psychology of the client is at the heart of financial advice

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<sup>1</sup> The psychology literature has long been interested as tolerance for risk, or ambiguity tolerance, and studies on this topic have been conducted by Bandura (1997), Kimball, Sahm, and Shapiro (2008), Kinnier, Kernes, and Dautheribes (2000), Nelson (2015).

success. This is evidenced by advice from the Financial Ombudsman Service (FOS) that 70 per cent of the cases that are escalated through them are because of inadequate or incorrect risk profiling of the client (FOS, 2015). Additionally, financial planners who follow risk profiling systems which are not empirically tested put themselves at risk of incorrectly investing a client's assets (asset allocation), and this exposes them to litigious risks, particularly in market downturns. This paper argues that the investment risk profiling system of financial planning requires re-evaluation, and expansion to include the psychological factors which have the potential to impact the accuracy of risk profiles, and to increase the success of the financial plan.

To date, the research on risk profiling has been limited to topics which are not directly applicable to the actual risk profiling process required by professional financial planners, namely assessments of financial risk tolerance which follows quantitative analysis of trends in proxies for the same (e.g. (Chavali, 2016; Hanna & Chen, 1997); Kimball *et al.* (2008); Nguyen (2015); Rahmawati (2015); Roszkowski and Grable (2005); Sung and Hanna (1996); Van de Venter, Michayluk, and Davey (2012); Yusof (2015)) or an assessment of survey validity from an economic perspective which treats the client as a purely rational actor (eg. (Droms & Strauss, 2003; Gerrans, 2015; Grable, Lytton, & O'Neill, 2004; Grable & Lytton, 1999; Hanna, Gutter, & Fan, 2001); Kimball *et al.* (2008); Nelson (2015)). Given the gap in the literature regarding investment risk profiles, this paper will contribute by applying a range of perspectives which have previously not been considered. The outcome of this approach is ultimately to provide a theoretical foundation from which the risk profiling system currently in use can be re-evaluated and adapted to consider current research.

The current paper follows a methodology which seeks to establish a theoretical foundation from which the risk profiling system can be developed. In order to determine which aspects of the psychology literature are relevant for risk profiling, the psychology literature has been combed to determine the four most powerful areas of research which have direct implications for financial planning client relationships and financial outcomes. The four psychological aspects to be considered in this paper are: self-control, optimism, financial literacy, and risk tolerance. Each of these areas for research will be discussed with direct relevance to implications for risk profile development. Each theoretical section will conclude with examples of how previous research contributes to our understanding of individual client factors which may impact the success of their financial plan. This paper also considers the literature on investment strategies and how it relates to the risk profiling process and psychological literature. This paper concludes with a summary of the implications of this theoretical analysis and outlines stage two of the research project: the development of a risk profiling system.

The remainder of this paper is structured as follows. The second section discusses risk profiling, psychology, and implications for ethics and professionalism in financial planning. The third section presents the relevant literature from psychology. The fourth section presents research relevant to investment strategies, and the fifth section concludes.

## Risk Profiling and Psychology

It could be argued that the heart of professionalism<sup>2</sup> is ethics<sup>3</sup>. Those occupations which have risen to professions have widely accepted and enforced ethical procedures which rest on a foundation of academic literature and targeted journals, such as medicine, accounting, nursing, and law. Such professions commonly have established professional bodies which connect all members to the community and the next generations of professionals, while simultaneously operating as self-regulatory bodies which establish and enforce codes of conduct and audits of their members. This system allows the regulatory bodies of those professions to focus on other issues. In the case of financial planning however, there is still a long way to go before the above steps to professionalism are achieved. This is despite the fact that most financial planners undertake their practice in highly professional ways. It has been noted that the division between financial planners and the financial planning bodies compounds the lack of community engagement and hence community distrust of this occupation despite it developing a foundation of higher education qualifications and ethical conduct to rival established professions. Given the contentious nature of current risk profiling practices within financial planning, by considering the relevant psychological research, a more complete risk profiling system can be developed.

The financial planning process is often misconstrued in the media as being focussed on product and investment advice (Rose, 2106), when in reality the majority of financial planners add value to clients' lives through highly strategic advice (Gerrard, 2016). Financial planners provide a great deal of psychological benefits to clients including empowerment and confidence in their financial future (Hunt, Brimble, & Freudenberg, 2011). However, in order to provide clients with peace of mind, financial planners must understand the client and invest heavily in relationship development, a costly process which takes time. The process of risk profiling provides financial planners with the opportunity to discuss targeted risk tolerance and risk capability questions in an effort to provide them a greater understanding of how they can serve their clients with unique strategic and product advice. The next section discusses the psychological research relevant to the financial planning risk profiling process.

## Psychological Research Relevant for Risk Profiling

Psychology literature regarding persistent trends in characteristics of people is directly relevant to understanding how the financial planning risk profiling system can be developed. There is a large body of research on persistent personality traits linking aspects of personality such as intelligence with the need for achievement (Harris, 2004), and extraversion with creativity (Schuldsberg, 2005). Additionally research on success in business has found that temperament is more important than talent (Thompson, 2009) and that emotional stability is the most reliable predictor of financial

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<sup>2</sup> Professionalism in this context means the current journey that the financial planning industry is on to be recognised by the community as a 'profession'. Hence, although individual financial planners operate as professionals, the industry as a whole needs to be recognised as such by the community. This process is termed professionalism.

<sup>3</sup> Ethics in this context means the collectively defined and upheld principles within client relationships and business processes of financial planners.

success (Brandstätter, 1997, 2011). Trends in personality and risk tolerance are of integral importance to researchers across many fields of study to understand groups of people to help tailor facilities and products for their needs. Given the purely psychological nature of risk profiling, it is critical that risk profile systems of the future incorporate the relevant academic literature on these topics. Additionally, behavioural finance biases become relevant in the making and monitoring of financial decisions, such as herding, overconfidence, loss aversion, and framing (Shleifer, 2000), which can impact on the risk profiling and investment process.

The current templated questionnaires for risk profiling of clients is in a multiple-choice format which inherently applies there is a right or wrong answer. Questions seem to mirror financial literacy surveys, with items such as: *On the risk-return graph shown, indicate your preferred level of risk and return.* This question requires explanation to clients who have not studied Markowitz and the optimum portfolio (Markowitz, 1952, 1989), and forces an answer from all. Despite that, many spend years studying Markowitz's portfolio theory, and are not in a high power-imbalanced meeting when illustrating their understanding of the concept. Many clients understand the general risk-return trade-off given the media coverage of events such as the Global Financial Crisis. As such, when presented with this kind of questionnaire, it is predictable that clients feel a certain social pressure to be more risk averse than they would otherwise feel (Fisher, 1993). A more complete understanding of the client including their behavioural trends, historical events which led to risk aversion, and a holistic understanding of the client would arguably result in a stronger client-professional relationship and higher quality financial advice. This can be achieved through a combination of empirically tested, succinct survey items (a maximum of 20 items would be necessary), with tailored question prompts based on the survey responses.

In line with this, this section discusses the following topics of psychological research and theoretically applies the research to the financial planning risk profiling process with a view to theoretically constructing the aspects required for an empirical measure of risk profiling. Topics discussed are: Self-control, Optimism, Financial Literacy, and, Risk Tolerance.

### Self-Control

Many aspects of financial planning are similar to those of accounting or finance. For example, financial planners routinely consider a client's financial situation regarding their assets and liabilities, and their cashflow. In both accounting and finance, these two perspectives provide the foundation for much of the analysis and decision making, as it is in financial planning, only applied to personal finance. The personal cashflow of clients is often an integral component of developing a financial plan, and the regular income available for investing in wealth protection or wealth creation is critical. However, many clients have disconnected reporting regarding their expenditure, and actual expenditure. To compound this issue, the cashflow details are often the cornerstone of a financial plan seeking to provide long term financial security. Risk profiling systems do not consider an individual's self-control levels, despite the fact that self-control has the potential to determine not only the amount of available income each period to support the financial plan, but also adherence to the financial plan itself.

The history of research on self-control can be traced to well before financial planners began to document risk profile questionnaires, yet there is no self-control measurement in risk profiles. Research by Shefrin and Thaler (1977) initially described self-control as the internal battle between the immediate and future selves, which was subsequently applied to the field of economics in a broad based article which established self-control as the cornerstone of economic achievement (Schelling, 1978). A significant body of literature has since considered self-control in relation to other identifiable character traits. For example Puri and Robinson (2007) found that optimism mediates the relationship between the immediate and future selves in that over-optimists, expecting positive future outcomes, allocate a greater amount to their future selves for enjoyment. On the other hand, Puri and Robinson (2007) found that moderate-optimists tended to experience fewer self-control challenges and hence fewer corrective steps after behaviour which went against allocating towards their future self. Research has also considered self-control specifically in relation to financial behaviour, with authors finding that self-control is a better predictor of over-indebtedness than financial literacy (Gathergood, 2012).

The research on self-control is directly relevant for risk profiling questionnaires. This research suggests that risk profiling systems, whether in survey or interview format, should consider a client's level of self-control. Incorporating specific questions or discussion around self-control may provide financial planners with an opportunity to build trust in the client relationship through showing care for the client's unique financial personality characteristics. Further, there are direct implications for the specific financial plan details, where clients who have low self-control would need formal systems such as restricted access to savings that has been committed to the achievement of long term financial plans. Without prior knowledge of self-control levels, it would be impossible to anticipate a client financially sabotaging the financial plan to which they had agreed.

### Optimism

Persistent trends in positive expectations, ie. optimism, is an integral component of the risk profiling discussion because optimism levels have been tied to business success and entrepreneurial behaviour, which may directly influence a client's ability to stick to a financial plan. Financial planners who understand these basic characteristic traits are likely to be better adept at understanding their clients and how best to communicate strategies and challenges to them. In addition, persistent trends in optimism can help financial planners communicate in specific ways to clients regarding the particular risks in their strategy.

Of direct relevance to the risk profiling system is that people with high levels of optimism have low sensitivity to the costs of their investments (or interest rates on loans) (Yang, Markoczy, & Qi, 2007). This has potential implications for the communication of risks and costs by a financial planner, where clients with low levels of optimism may need to have more communication regarding the justification of fees and charges associated with their financial plan. The academic literature tends to indicate that overly-optimistic people have consistent adverse behaviours such as inaccurate forecasting abilities (Flyvbjerg, 2008), less investment prudence and lower work ethic (Puri & Robinson, 2007). On the other hand, those with moderate levels of optimism have been found to make prudent financial decisions and work more (Puri & Robinson, 2007). Although optimism has been found to be correlated with most of the 'Big 5' Personality traits (Sharpe, Martin, & Roth, 2011), when combined



with risk aversion, optimism has the tendency to result in the first best option being chosen (T. C. Campbell, Gallmeyer, Johnson, Rutherford, & Stanley, 2011). This is relevant for the risk profiling system where it would be of benefit to financial planners to know their client's optimism level in order to communicate the alternative and recommended strategies most effectively. This has potential implications for the communication of the risks associated with different financial planning strategies for clients with different levels of optimism.

Optimism has been consistently linked with high levels of risk tolerance, such as the risk of entrepreneurship (De Meza & Southey, 1996), self-selecting into short-term debt (Landier & Thesmar, 2009), and overestimating future income (Seaward & Kemp, 2000). This research provides financial planners with the knowledge they need to adapt risk profiling systems to incorporate an understanding of the personality characteristics which might provide a reasoning for certain risk tolerances. For example, high risk tolerance may be because of optimism rather than linked to the risk tolerance which comes from a more complete personality behind the trends. It is argued that risk profiling systems, both quantitative and qualitative, be adapted to incorporate measurements of optimism. Prior knowledge of a client's optimism levels would allow financial planners to design a financial plan which clearly communicates the need to keep working for high optimism clients, as an example.

## Financial Literacy

The topic of financial literacy<sup>4</sup> is a topic which has gained prominence in recent years because of its direct association with empowering consumers to affect their own sound financial decisions. Given that one of the key benefits of financial planning is client empowerment (Hunt *et al.*, 2011), this topic is intimately linked to a risk profiling discussion. Indeed, financial literacy has positive impact on people's lives only if they also have the confidence, motivation, and ability to use this information.

Previous research has generally associated financial literacy levels to home or school education on financial theory and behavioural strategies. However, recent research has found that financial literacy is in fact a choice, as it has a current consumption cost and depreciates over time (Jappelli & Padula, 2013). This research implies that the decision to acquire financial literacy is affected by the same things that affect savings decisions over the life-cycle. In the context of the broader financial market, these authors indicate that financial market deepening will result in higher levels of financial literacy and higher levels of savings via an increased incentive to invest in financial literacy as a result of private pension funds and similar investment innovations (Jappelli & Padula, 2013).

Research on financial literacy is undecided on whether it has any measurable positive impact. Authors have discussed that financial literacy programs have little proof regarding their effectiveness (Ben-Shahar & Schneider, 2011) (p.667). Authors have reported that the effect of financial literacy programs across a broad number of studies either have not been found, or are very small (Willis, 2008)(p.208-209). These studies confirm previous discussions in this paper which emphasise that relying on financial literacy as a method to ensure consumer protection within financial planning is contrary to academic literature on this topic.

<sup>4</sup> Financial literacy in this paper refers to the 'information, knowledge, and skills to evaluate options and identify those that best suit needs and circumstances (USA-Department-of-Treasury, 2006).

Although many authors have found that financial literacy programs are ineffective, the impact of financial literacy itself is a separate discussion. Authors have found that underlying financial literacy can reduce the effects of financial shock and increase savings rates (Klapper, Lusardi, & Panos, 2013). Authors have also found that combined with low self-control, low financial literacy results in adverse debt behaviour (Gathergood, 2012). In addition, low financial literacy has been found to be associated with a higher cost of credit, lower confidence, low improvement behaviours, and higher interest rates on loans (Disney & Gathergood, 2013). Indeed, these authors found that lower financial literacy was associated with a greater chance of obtaining high-cost consumer credit in the first place (Disney & Gathergood, 2013).

Despite the uncertain impact of financial literacy on client behaviour (Ben-Shahar & Schneider, 2011), it is clear from the literature that discussions around financial literacy have the potential to provide not only engaging material to discuss with the client, but also a potential avenue for increasing professional transparency. This paper argues that the result of professional financial planning practice should be increasing education of the client to such a level that financial planning clients are fully able to understand the discussions regarding the advice and strategy relative to their situation. This education requires continual and intentional financial literacy discussions which are based on a valid measure of a client's initial levels of financial literacy.

There are methods to gauge a client's financial literacy without involving tedious questionnaires and discussions which feel judgemental. This paper proposes that financial planners incorporate alternative measures of financial literacy in the risk profiling process, such as financial games or 'betting' to determine a client's present bias (Fischer & Ghatikar, 2010; Takeuchi, 2011). Through this knowledge financial planners will be equipped to develop tailored discussions for the client throughout the relationship which communicate the value of financial planning.

## Risk Tolerance

Risk tolerance has the potential to affect whether people become entrepreneurs and what proportion of risky assets they are comfortable holding, both of which are issues which can relate to whether and how clients seek financial advice. In addition, the amount of uncertainty people are comfortable in accepting is of direct relevance to explaining the behaviour of clients, particularly those who may be acting as much out of personality reasons as financial need (Yang *et al.*, 2007)<sup>5</sup>. Research has identified that there is support for intuitively understood demographic trends in risk tolerance in that female headed households have reduced risk tolerance compared with male headed households (Sung & Hanna, 1996)<sup>6</sup>. Despite the inherent importance of identifiable risk tolerance in a range of financial sectors, including financial planning, there is little practical

<sup>5</sup> Research has explored the assessment of financial risk tolerance and its role in household decision making (Gable & Lytton, 1999). Measures for financial risk tolerance have been adapted to include questions which are very basic and can be used with the wider population regardless of financial literacy (Kimball *et al.*, 2008). Other authors have constructed scales relating to ambiguity tolerance, an issue related to but not the same as uncertainty (Mac Donald JR, 1970)

<sup>6</sup> It should be noted that this research explicitly states that these findings are likely to be as a result of social programming rather than genetic risk aversion tendencies. In addition, research has emphasised the need to discuss risk tolerance before discussing the potential benefit of strategies which are associated with different risk levels (Droms & Strauss, 2003).

and relevant literature on the topic.

## Investment Research Relevant to Risk Profiling

Professional financial planners are required to place a large amount of effort in communicating their value to clients. This is because clients often have the perception that financial planners have the key role of reducing taxation and increasing investment returns. While this may be some of the potential skills a financial planner has to offer, the real financial planning relationship encompasses much more. Professional financial planners lament that clients are preoccupied by an aspect of their activities which, while being clearly measurable, is not where the greatest value is added. For these reasons, the current paper considers the investment research which is relevant to risk profiling as it has the potential to illustrate some of the strategic investment issues which may be relevant for the initial stages of a client relationship. For example, investment strategies which are based on either life-cycle (Bodie & Treussard, 2007; Gomes, 2008) or dynamic (Basu, Byrne, & Drew, 2009) philosophies have the potential to be interconnected to client risk tolerance and risk capacity (Viceira, 2007), as well as overall investment returns.

## Investment Strategies

Asset allocation is the most important contributor to investment returns, particularly in the years prior to retirement (Basu & Drew, 2007; Byrne, Dowd, Blake, & Cairns, 2006). However, despite this weight on risk capacity, or the quantitative features of an investment strategy, authors have also confirmed that there is no room for a one-size-fits-all investment option for clients (Antolin, Payet, & Yermo, 2010). This is partly because each person has a unique amount of human capital, which is generally the largest asset of working people (Bodie & Treussard, 2007). Authors have gone so far as to indicate that there is a human capital trade-off with young people (who have the most human capital) required to invest in risky assets to offset the large inherent position taken in conservative assets through human capital (Viceira, 2007). The results of previous research are important for understanding the current context within which financial planners provide personal financial advice. In the current system, financial planners develop investment strategies which combine a number of trade-offs and restrictions such as predicted investment returns, client risk tolerance, regulatory restrictions, and client goals. Once the investment strategy has been developed, specific investments are recommended to implement the investment strategy. The risk profile of a client is reflected in the asset allocation of investments. This is of critical importance because it is an issue which is often highly contentious as a result of the significant impact it can have on financial returns, particularly in the short term (Brennan, Schwartz, & Lagnado, 1997; J. Y. Campbell & Viceira, 2003; Eychenne, Martinetti, & Roncalli, 2011).

The research on investments and asset allocation further confirms that the role of the financial planner is among the most complex and professional in financial services. Financial planners are required to combine a large amount of different information relating to the client's preferences, their objective ability to take investment risk, and the amount of human capital held by the client. With this information the financial planner must develop a strategy which is aligned with the client's risk profile such that the ethical standards of the profession are upheld. Hence, the development of a risk profiling system which leverages off the psychology literature allows that the investment

strategies which have been optimised by financial planners will actually align to the client's risk profile and help the client to achieve their goals. It is important to remember that a risk profiling measure is only as sound as the investment strategy it guides, and hence both of these areas of financial planner expertise are worthy of consideration in this paper.

### Conclusion

Financial planning is a profession in flux which will benefit from a more robust and empirically tested framework of risk profiling. This paper has provided the theoretical foundation which outlines the first stage of a research project designed to achieve a new risk profiling system.

The risk profiling system of financial planners provides immense opportunity for the profession to be recognised in the community as being of the highest ethical standards which operates for the benefit of clients and their families. The current state of affairs, where each Australian Financial Services (AFS) Licensee has a similarly designed questionnaire based on limited empirical research is at the core of the areas of change in the profession currently. This paper argues that the risk profiling methodology provides financial planners with the ability to rise above the limiting regulation and display a high level of transparency, integrity, and empowerment of clients. The natural by-product of this behaviour is community recognition of professional standing. This paper provides the theory behind the development of a new risk profiling system which will be developed as stage two of this research project.

This paper has presented the academic literature relating to particular psychological and investment research which provides a framework for understanding the potential avenues for risk profile development in the financial planning profession, and which will be documented in later stages of this research. It has been shown that some aspects of personality, such as temperament, self-control and optimism, are equally as important as financial literacy and risk tolerance. Through illustrating this research side-by-side the current paper allows a perspective of risk profiling which has not been previously afforded in the literature. Further, this approach has illustrated how the second stage of this research project, the development of a risk profiling system, will be developed.

The next stage of this research project will be the development of a risk profiling system which incorporates analysis and reporting on client levels of self-control, optimism, financial literacy, and risk tolerance. The second stage of this research project will also include development and testing of a new risk profiling system.

Financial planners have, at this point in time, the wonderful opportunity of having a very low base standard of risk profiling from which to catapult a new standard. Given that this stage of the financial planning process is inherently impossible to regulate to any quality level (above a questionnaire), this area provides financial planners an opportunity to unite and present a process to the community which is built on empirical research and the broad considerations of personality and behaviour – aspects of clients which are already considered by professional financial planners.

This paper proposes that the risk profiling system adopted by all financial planners is one which incorporates questionnaires and discussion regarding the aspects of financial risk tolerance identified in this article. The series of discussions identified in this paper, combined with ongoing

self-reflection by the client, provides financial planners with clearly communicable value of their relationship to clients. This paper argues that financial planners seeking professionalism need to first reflect on their internal practices through which they have the ability to exceed expectations and establish a new benchmark of financial planning. The theory provided in this paper establishes a framework from which an empirical risk profiling system may be developed.

This research contributes to the academic literature by providing a theoretical application of core psychology literature to the specific task of risk profiling, which has not been documented before. Further, this research has established the theoretical first stage in the wider project of developing a robust and empirically tested risk profiling system, something which is also absent in the financial planning literature to date. This paper has core limitations in that it provides only a theoretical consideration of how the psychology literature applies to risk profiling, and primary data is not discussed. These limitations will be addressed in the next stage of this research project when the actual risk profiling tool will be tested.

The core of every profession is ethics. It is clear to all that a code of ethics by professional bodies is not enough to provide the community with the security of knowing their financial planners put their best interests first. Financial planners need to establish ethics at the core of their business practices, and the greatest opportunity for this right now, is the risk profiling process, as evidenced by the percentage of FOS claims which are based on incorrect risk profiling. An overhaul of the risk profiling processes undertaken by financial planners would result in clients of financial planners gaining insight into the value their financial planner provides, their own personality, and their investment strategy. The foundation of quality financial advice is an appropriate risk profile for the client which has been developed using empirically tested, relevant methodology. This paper proposes that in order for financial planning to develop into a recognised profession, systemised approaches which ensure quality advice and quality professional relationships need to be developed. This paper provides a foundation for considering the aspects which are relevant to be measured and reported on for each financial planning client. Through the systematic empirical research process on risk profiling, a profession-led risk profile assessment will be developed, leaving the regulator other things to focus on.

*Author's note: If you would like to be involved in stage-two of this research project, the testing of the new risk profiling system, please email [k.hunt@griffith.edu.au](mailto:k.hunt@griffith.edu.au).*

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## EXAMINING THE LEGITIMACY OF THE CURRENT 'AUTHORISED REPRESENTATIVE' LICENSING MODEL

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### ABSTRACT

Legitimacy of licensing individual financial advisers through third party licensees is currently debated by the media and in practice, with unsubstantiated claims evident in the majority of commentaries. A sticking point is the lack of a theoretical framework within financial planning theory to obtain substantiated evidence. We rectify this by applying Suchman's legitimacy theoretical framework to the current authorised representative licensing model to collect validated evidence in future empirical research. This not only advances financial planning theory, but raises further questions for future empirical research, which should provide policymakers data required to make evidence-based decisions around licensing advisers.

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## 1.0 Introduction

In the absence of compelling scientific evidence is the debate, in the media and in practice, concerning the legitimacy of the current authorised representative (AR) licensing model for individual Australian financial advisers. The lack of a theoretical framework within financial planning theory defining, modelling and measuring legitimacy is leading to a deficiency in scholarly attention on this matter. To rectify this deficiency, Suchman's theoretical framework is qualitatively interpreted, applied and extended to inspect the legitimacy of appointing, authorising and regulating (licensing) individual advisers through third party licensees as specified in the Commonwealth Corporations Act 2001 (the Act) (Commonwealth of Australia, 2001). Applying legitimacy to financial planning theory, for the first time, in this way lays the theoretical foundation to (1) advance financial planning theory, (2) raise further questions for future empirical research and (3) provides policymakers a basis to obtain credible evidence required to make evidence-based decisions around licensing advisers. Our analysis begins with a brief historical background discussion on the legislative framework of licensing advisers in Australia, together with a simple description of the Australian AR licensing model. The significance of examining the legitimacy of the existing AR licensing model is then highlighted. Subsequently, the main section then attempts to interpret Suchman's legitimacy theory by applying it to the AR licensing model. In the closing statements, we present some recommendations for future research direction and the way forward in applying our stated theoretical framework.

## 2.0 Background to the Legislative Framework of the AR Licensing Model

Since 1996 the current AR licensing model has been rooted in the implementation of Financial Services Reform (FSR) and the subsequent Corporate Law Economic Reform Program [CLERP] (Corbett, 1999; Overland, 2007). CLERP with Wallis's Financial Systems Inquiry recommendations published in 1997 led to the Commonwealth Financial Services Reform Act 2001 (FSRA) on 11 March 2001 (Hutson and Vonnessen, 2003; Parliamentary Joint Committee on Corporations and Financial Services, 2014). FSRA repealed the old licencing system of multiple licenses regulating the activities of inter alia insurance agencies, brokers, securities dealers, accountants and solicitors (Pearson, 2006). Chapter 7 in the new Commonwealth Corporations Act 2001 replaced the old corporation's legislation. From 11 March 2002 (Australian Securities and Investments Commission, 2016e), a single licensing system (Banister *et al.*, 2013), namely the Australian Financial Services License (AFSL) authorised financial institutions (licensees) and their ARs to offer financial products and services to the public (Pearson, 2006; Hutson and Vonnessen, 2003). The 2008 Global Financial Crisis and corporate scandal headlines of unethical behaviour (Ap, 2011) led to a loss in public trust and confidence in the financial advice industry (Ap, 2011; Taylor *et al.*, 2013). The Australian Government responded with the Parliamentary Joint Committee on Corporations and Financial Services (2009) [Ripoll Inquiry] (Australian Government, 2014) resulting in Future of Financial Advice (FoFA) legislation (Australian Government, 2014) to deal with inter alia conflicts of interest (Alexander, 2011) from product sales (Burke and Hung, 2015). One FoFA intent was improving Australian retail clients' trust and confidence (Ap, 2011) by professionalising the financial advice sector away from a sales-driven distribution network (Burke and Hung, 2015).

FoFA reforms started with consumer credit legislation. Under this legislation, effective 1 January 2010 (Ap, 2011), the Australian government regulated conflicts of interests relating to loan products (Banister *et al.*, 2013). Australian Securities and Investments Commission (ASIC) enforced from 1 July 2010 an Australian Credit Licence (ACL) as specified in the National Consumer Credit Protection Regulations 2010 on licensees and their 'credit representatives', who can also be ARs (Holley Nethercoate Commercial & Financial Services Lawyers, 2014). Ostensibly, this additional regulation moved FoFA away from single licensing back to multiple licenses. Banister *et al.* (2013) maintained the overlap between the ACLs, full AFSLs and the limited AFSLs initially confused advisers. After FoFA critics contended its proposals would not prevent unethical behaviour (West, 2009; Hartnett, 2010), more financial corporate collapses ensued, specifically Trio Capital and Storm Financial (Commonwealth of Australia, 2016). Subsequently, three tranches of FoFA legislation were implemented to amend specific clauses of the Act (Kell, 2013). Operative 1 July 2012, and mandatory compliance commencing 1 July 2013 (Burke and Hung, 2015), the first and second tranches were implemented as separate yet related FoFA regulations (North, 2015), covering client's best interests duty, annual fee disclosure statements and renewal notices where clients would opt in every two years to continue ongoing fees. It banned conflicted commission and volume payments (Burke and Hung, 2015). A voluntary transition period and grandfathering arrangements were implemented so that licensees and advisers could adjust their business models to comply with FoFA. Initially, ASIC took a facilitative approach to compliance; thereafter, all AFSL licensees had to comply (Australian Securities and Investments Commission, 2016c). The third tranche covering commissions, best interests duty, opt-in requirements and fee disclosure statements, was mooted on 19 November 2014 (Australian Securities and Investments Commission, 2016c). The Australian Senate reversed the law back to the initial regulations before their implementation (Australian Securities and Investments Commission, 2016c). Afterwards, the Government worked on foundations of the disallowed regulation. A few provisions in the disallowed legislation were reinstated when two regulations were implemented on 16 December 2014 and 1 July 2015 (Commonwealth of Australia, 2015).

In addition to the above changes, amendments were made to the previous accountants' FSRA AFSL licensing exemptions (Banister *et al.*, 2013). Until 30 June 2016, accountant's Regulation 7.1.29A exemption (Halsey and Halsey, 2014) applied, allowing accountants to, for example, set up self-managed superannuation funds (SMSFs) (Adams, 2002). Operative 1 July 2016 this exemption was repealed (Commonwealth Government, 2013). Now accountants must hold a full or limited AFSL or become ARs under another licensee's AFSL should they advise on certain financial products and services, *inter alia* SMSFs (Global Accounting Alliance *et al.*, 2016). With FoFA reforms taking hold, some maintained the reforms were reactive (Valentine, 2013), unnecessarily complex, a burden and reducing advice availability to the public by increasing advice costs (Mennen, 2014). Accordingly, the Australian Government announced on 20 November 2013 a Financial System Inquiry [Murray Inquiry] reviewing the financial services industry's overall strength (Commonwealth Government, 2014). To encourage advice costs flow-on-effects to clients, the review's purpose was simplifying the system's overall complexity, providing certainty, reducing compliance costs and lowering administrative burdens by decreasing red tape (North, 2015). Furthermore, Murray recommended lifting professional, ethical and education standards

among advisers (Parliamentary Joint Committee on Corporations and Financial Services, 2014). On Murray's recommendations, from March 2015 a parliamentary joint committee (PJC) considered measures to raise these standards by expecting all new advisers to complete a minimum degree qualification, obligatory ongoing professional development, as well as a structured professional year as a prerequisite for registration (Parliamentary Joint Committee on Corporations and Financial Services, 2015). This PJC inquiry culminated in an exposure draft legislation tabled on 3 December 2015 for consultation with industry (Australian Government, 2015). Although at the time of writing consultations were completed, the legislation is on hold. Notably, this legislation included an independent industry-established standard setting body (Australian Government, 2015), which it is surmised should impact the legitimacy of the AR licensing model.

Notable during the Murray Review's consultation phase was a brief dialogue in the Australian Senate about a single financial license for each individual financial adviser, rather than one license for an institution (licensee) contractually engaging a number of advisers (Commonwealth of Australia, 2014e). Surprisingly, the final Murray report made no recommendations regarding individual licensing (Commonwealth Government, 2014). Instead, his report concluded the existing regulatory framework of product design, product distribution, disclosure and financial advice is insufficient to deliver reasonable treatment to clients (Commonwealth Government, 2014).

Many (specifically Kingsford Smith, 2011; North, 2015) contended the legislation would be unsuccessful in bringing tangible benefits to the public. Pearson (2006) pointed at the licensing model as a risk to clients with expensive compliance costs and significant adviser turnovers. Superficially, FoFA reforms dealt with specific clauses in the Act, neglecting the overall manner in which advisers were licensed through third party licensees, specifically those advisers affiliated to product issuers.

## 2.1 The Current Authorised Representative Licensing Model

Part 7 Division 5 is a key part in the Act relating to licensing financial institutions (licensees) and their ARs (financial advisers) (Banister *et al.*, 2013; Jones, 2012). It is supported by the Corporations Regulations 2001, Schedule 2 and 3 in the Corporations Amendment Regulations 2013 (No 3), Explanatory Memoranda and ASIC Regulatory Guides (Global Accounting Alliance *et al.*, 2016). ASIC enforces a process appointing, authorising and regulating individual advisers through third party licensees (Beal and McKeown, 2009) prescribed in Sections 916A, 916B, 916C, 916D, 916E and 916F of the Act (Commonwealth of Australia, 2001). The licensees' role is providing internal and external legitimacy for the actions of their advisers, which outwardly is demonstrated by a rigorous selection process (Bender, 2011) using a monitoring, supervising and training compliance system (Bennett, 2000). From 31 March 2015, ARs must be registered on the ASIC Financial Adviser Register available for public access (Australian Securities and Investments Commission, 2016b). With a few exceptions (Commonwealth of Australia, 2001) licensees may choose to hold a full (Teale, 2008; Commonwealth of Australia, 2001) or a limited AFSL (Commonwealth of Australia, 2001). For example, under a limited AFSL, advisers may advise on SMSFs, superannuation products, securities, simple managed investment schemes, general and life insurance, and basic deposit products. Alternatively, advisers can obtain a full license offering

comprehensive ('holistic') personal advice (Australian Securities and Investments Commission, 2012b). Individual ARs do not require a licence as specified in Section 911A, unless they deliver financial advice without supervision via an AFSL licensee (Parliamentary Joint Committee on Corporations and Financial Services, 2009, p.23). Consequently, a review of non-scholarly literature and apparent in practice (Holley Nethercoate Commercial and Financial Services Lawyers, 2014; Power, 2015; Global Accounting Alliance *et al.*, 2016), which was not explicitly defined in scholarly works, indicated ARs can only practice their craft when they are either: (i) self-employed and independent with their own AFSL, thus taking on AFSLs' legal and financial accountability; (ii) self-employed by becoming contracted/franchised via institutional licensees and using the licensee's support services without taking on AFSLs' legal and financial accountability; or (iii) employees of institutional licensees with AFSLs whereby the AFSLs' legal and financial accountability lies with the licensee.

Along similar lines, prominent in the media and in practice (Power, 2016; Fox, 2014; Spits, 2014; Lester, 2016; Jacobson, 2016; Pokrajac, 2014; Commonwealth of Australia, 2001) yet insufficiently addressed in scholarly literature is the identification and definitions of the categories of licensees and their ARs. On these grounds we define advisers as: (I) independent providing independent advice. Therefore, legally they can use the terms 'independent', 'impartial' or 'unbiased' as specified in section 923A of the Act, because they either meet: (a) the Independent Financial Advisers Association of Australian's (IFAAA) gold standard and strict independence conditions, with no direct or indirect ownership, affiliation or association (henceforth, affiliation) links to product issuers, and charge no commissions or asset-based fees (for example licensees Roskow Independent Advisory and Brocktons Independent Advisory); or (b) the requirements in section 923A, with no direct or indirect affiliation links to product issuers, charge no commissions, but charge asset-based fees (for examples licensees Pitcher Partners Wealth Management and Aspire Financial Consultants). (II) Aligned to product issuers providing aligned advice. Therefore, legally they cannot use the terms 'independent', 'impartial' or 'unbiased', because they do not meet the requirements in section 923A (for example AMP-owned licensees and the bank-licensees). (III) Non-aligned to product issuers providing non-aligned advice. Therefore, they cannot legally use the terms 'independent', 'impartial' or 'unbiased', because they only meet some of the independence principles as prescribed in section 923A (for example licensees, Professional Investment Services and Count).

Surprisingly, there are various allegations (see, for example, Vickovich (2015)) of mid-sized licensees and their ARs advertising themselves as 'independent' while under the misconception of following the independent advice principles when instead they are selling their own 'white label' products recommended from single platforms and/or allow commissions or asset-based fees. Thus potentially misinterpreting the requirements in section 923A of the Act. Therefore, it is apparent more research is required to understand how practitioners understand the definition of independence as defined by the Act. Also subject to deficits in academic works, yet apparent in media commentaries (Vickovich and Micallef, 2013), were discussions on the advantages and disadvantages of licensing advisers through third party licensees. Some advantages include inter alia third party licensees allowing advisers to focus their attention on the client while leaving back-

office, compliance and regulatory burdens to the licensees. Licensees affiliated to large institutions are in a better position to pay compensation to clients for losses suffered if legal compliance breaches or unethical behaviour occurred (Pokrajac, 2014). Disadvantages include inter alia advisers unable to market themselves as independent to clients who consider independence important, as well as being restricted by the licensees' approved product list when providing advice to clients (Santhebennur, 2014).

North (2015) contended the licensing regulations disseminated a range of business models covering different sizes. Debatably, leading to inconsistent standards between licensees (Vickovich, 2014c) for compliance audits, education, training, supervision, licensee licensing requirements and conduct (Bennett, 2000). Valentine (2008, p.283) critically reasoned not all advisers operate on a level playing field, nor carry uniform regulatory burdens under the existing licensing model. For example, S765A of the Act does not regard physical assets such as direct real estate (property), wine, art, stamp collections and credit facilities as financial products (Commonwealth of Australia, 2001). So inter alia mortgage brokers, real estate agents, art dealers, coin and stamp dealers do not require an AFSL or are only partially covered by the AFSL regime. Furthermore, Smith *et al.* (2009) propounded the view the Act excludes estate planning or non-product strategic advice. Haigh (2006) observed despite FSR legislation introducing a legal and ethical framework governing advisers and licensees, commensurate levels of accountability are missing. Under FoFA legislation accountability is not at the individual level, but at the institutional level, where the majority of advisers are affiliated to product producers (Parliamentary Joint Committee on Corporations and Financial Services, 2009). Prior to statutory best interest duty obligation, Gor (2005) noted the accountability burden rested entirely on licensees to authorise representatives to offer financial services. Thereafter, it rested with both the licensees and their ARs. Contrary to this, Serpell (2008) argued the scope of the AR licensing provisions were too narrow and unclear. It is therefore critical that further theoretical and empirical research is undertaken on the issue of licensing advisers through third-party licensees to safeguard the reputation of financial services business and industry.

## 2.2 Importance and the Scope of the Study

Given our discussion so far, and for the interest of financial advisory industry stakeholders, we believe it is important to scrutinise the legitimacy of the current AR licensing model using a theoretical model to obtain some scientific validation and verification. Despite the legislation regulating advisers through third-party licensees to protect the public, the transgressions list continually grows (Coorey and Eysers, 2015; Mennen, 2014; Ferguson, 2016). In recent years, to reduce more wrongdoings, attention focussed on the inherent conflicted remuneration of financial services (Batten and Pearson, 2013). This focus on remuneration included consideration by scholarly researchers (Kingston and Weng, 2014; Serpell, 2008; Moutsopoulos, 2005), inconclusive parliamentary debates on public record (Commonwealth of Australia, 2014b; Commonwealth of Australia, 2014f) and government inquiries (Parliamentary Joint Committee on Corporations and Financial Services, 2009; Parliamentary Joint Committee on Corporations and Financial Services, 2014), media commentaries (Ferguson, 2015; Santhebennur, 2015) and public submissions during consultation phases of the Australian inquiries into financial



advice (Kearney, 2014; Morris, 2014) leading to new remuneration legislation (Commonwealth of Australia, 2001).

Yet, Valentine (2008) claimed conflicts of interest from affiliation to product issuers is the reason for the contraventions. The regulator ASIC, the Ripoll Inquiry PJC and some Australian government officials (Banister *et al.*, 2013, p.1436; Vickovich and Garber, 2014; Parliamentary Joint Committee on Corporations and Financial Services, 2009) tentatively agree. Unsurprisingly, is the prolific questionable popular and professional media debate (Kennedy, 2012; Pokrajac, 2014; Johnston, 2014) around conflicts of interests from affiliations to product issuers. Unsubstantiated negative media commentary (Taurian, 2016; Santhebennur, 2016; Santacruz, 2016; King *et al.*, 2016; Cho, 2016; Vickovich and Garber, 2014; Vickovich, 2014b; Vickovich, 2014c; Vickovich, 2014a; Pokrajac, 2014) around conflicts from affiliations linked the licensing model. On the available evidence stakeholders neglected obtaining sound evidence ruling out whether (or not) the root of the problem contributing to the transgressions lies with the potential conflicts from affiliations between ARs and their third party licensees. Merely focusing on remuneration is arguably misguided.

On the existing available evidence, it seems reasonable to suggest the legitimacy of licensing advisers through third-party licensees affiliated to product issuers is important politically, especially when the licensing model could be a potential source of the lack in public confidence and trust (Taylor *et al.*, 2013). Thus, potentially stopping over 80 per cent of Australians to seek out financial advice (Ap, 2011; Australian Securities and Investments Commission, 2016a). During the Murray Inquiry, the appropriateness of outsourcing adviser licensing to third-party aligned licensees was questioned (Vickovich and Garber, 2014). Based on a recommendation by the Ripoll Inquiry (Parliamentary Joint Committee on Corporations and Financial Services, 2009), the feasibility of implementing individual licensing and independence was only briefly considered during this inquiry's submission phase (Commonwealth Government, 2014; O'Brien and Gilligan, 2014). ASIC believed licensing at the individual level or via a professional standards board is not an appropriate solution, instead opting for retaining co-regulation with licensee institutions (Tyson-Chan, 2006; Australian Securities and Investments Commission, 2012a). As a rebuttal Vickovich (2014a) reported, the SMSF Professionals' Association of Australia (SPAA) asked for a new licensing system to encourage independent advisers, akin to the Registered Independent Advisor regime in the United States. Likewise, journalist Taylor (2014) stated that Financial Planning Association (FPA) Australia is focussed on encouraging policymakers to accept a so-called Self-Regulatory Organisation (SRO). Bruce (2012, p. 344) observed, historically advisers never formally belonged to a profession nor were classified as professionals. Ostensibly, what is missing in the FoFA legislation is whether financial advisers are able to become a true profession in substance, like doctors, accountants and lawyers when they are not licensed in a similar manner. Initially, the legal profession adopted a self-regulatory model where its ethical standards are managed through legal professional associations, within law firms and barristers using the courts' rules (Parker, 2004). Accountants drew on the experience of lawyers to professionalise, according to Cooper and Robson (2006), by working together on an independence model (Carnegie and O'Connell, 2012). Surprisingly, Cull (2009) found no amount of legislation led financial advisers to professionalise via



self-regulation. Serpell (2008) supported licensing individual advisers via a standalone licensing or registration system separate from financial institutions. ASIC argued self-licensing is difficult to achieve, because the competencies of advisers working in different financial services sectors diverged (Australian Securities and Investments Commission, 2012a). To the contrary Macey (2002b) argued, financial planning as a multidisciplinary profession in itself supports a standalone regulatory system. ASIC is not confident one industry body can effectively be disciplined enough to enforce a self-regulatory code across the different financial sectors (Australian Securities and Investments Commission, 2012a). Whereas Macey (2002a) reasoned as the financial planning discipline increasingly specialises, they must develop standards for comprehensive advice separate from specialities, along similar lines to medical boards responsible for reviewing medical specialities.

The difficulty with professionalising financial planning is, historically to this day, financial planning is rooted in product sales (Knutsen and Cameron, 2012). Cull (2009) was of the opinion this embedded sales culture is the reason accountants felt financial planning did not meet all the requirements of a true profession. Yet interestingly, the accounting profession incorporated ethical standards for accountants providing financial services into their APES 230 standards (Accounting Professional & Ethical Standards Board Limited, 2013). Then in 2015 Certified Practicing Accountants (CPA) formed CPA Australia Advice. In 2016 they successfully applied for their own AFSL and ACL. So CPA members who want to avoid the self-licensing responsibilities could become ARs and provide independent financial advice through CPA Advice (King *et al.*, 2016; Certified Practicing Accountants, 2015).

From early writings by Bamber and Iyer (2002), accountants were restructuring to provide other non-accounting services internationally. Some of the 200,000 professionally qualified accountants (Accounting Professional & Ethical Standards Board Limited, 2012) are repositioning and redefining financial planning within their self-regulatory model (Brown, 2008; Global Accounting Alliance *et al.*, 2016). Though Brown (2008) cautioned the accounting profession of the challenges ahead especially, as Westover (2012) warned, when maintaining their professional independence. Non-scholar Cho (2016) suggested many accountants were not applying for their own licenses. Instead they were referring financial planning clients to licensed accountants, financial advisers and licensees. Brown (2008) forwarded the view accountants positioning themselves to provide independent financial advice sets the accounting profession's and the public's expectations, as well as what financial advisers should be doing for their clients in the future. This redefinition, Lambert (2013) suggested, should significantly influence financial planning. Some scholars' (Bateman and Kingston, 2014; McMeel, 2013) consensus view was the Australian, United Kingdom (UK) and the United States (US) systems to license advisers parallel each other relatively closely, and they continually monitor developments taking place in each other's countries. Their respective advisory or financial institutions and agents are obligated to register with their respective regulators (ASIC, FCA, SEC, FINRA) (Bateman and Kingston, 2014; Burke and Hung, 2015; Zabel, 2010; Financial Conduct Authority, 2015). Common in all these countries is their financial advisers are all regulated by their regulators via third party affiliates or principals. Arguably, conflicts of interests from affiliations to their third party institutions who

may also be product issuers plagues them all. For the sake of this discussion, investigating the legitimacy of AR licensing via third parties using a theoretical model is imperative, given that Burke and Hung (2015) documented that research on the impacts of FoFA is scant.

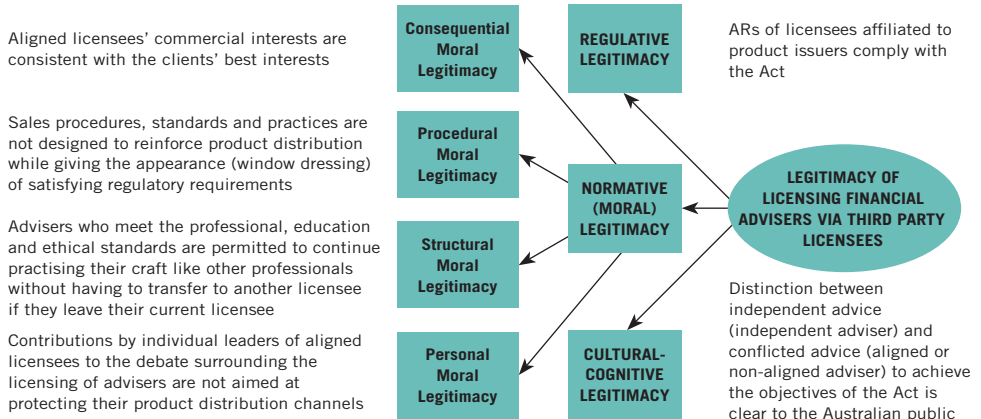
## 3.0 Suchman's Theoretical Legitimacy Framework

Against this backdrop, intellectual attention shifts to applying legitimacy theory in financial planning practice and profession. Díez-Martín *et al.* (2013) and other scholars (Pellegrino and Lodhia, 2012; Sonpar *et al.*, 2010; Bitektine, 2011) observe that legitimacy studies are evident since the mid-1990s. Internationally, empirical work in legitimacy theory focused on inter alia, organisational theory (Díez-Martín *et al.*, 2013), management theory (Bitektine, 2011), economic theory and political science (Ellis, 2006; Gualini, 2004). Some legitimacy theorists, studied specific industry fields, such as mining (Pellegrino and Lodhia, 2012), telecommunications (Low, 2010), healthcare (Sonpar *et al.*, 2010), while others have investigated specific professions, like accounting (Andon *et al.*, 2014; Fisher *et al.*, 2007). Evidence of legitimacy research investigating financial planning service is lacking. In an attempt to address this gap in the literature, Suchman's (1995) complete legitimacy framework is applied here. In contrast to most legitimacy research, where Doh *et al.* (2010) claimed, only one or two legitimacy criteria are often examined at a time. Suchman (1995, p. 574) defined legitimacy as a "generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions". Therefore, the legitimacy of ASIC licensing ARs through third party licensees as specified in Chapter 7 of the Act (Commonwealth of Australia, 2001), should be perceived as "desirable, proper or appropriate" (Suchman, 1995, p. 574), when operating within the financial advisory industry's "socially constructed system of norms, values, beliefs, and definitions" (Suchman, 1995, p.574).

Theoretically speaking, understanding the legitimacy of the AR licensing model is dependent on examining Suchman's (1995) three broad, yet specific, types of legitimacy: (1) pragmatic (regulative); (2) normative (moral); and (3) cultural-cognitive. Figure 1 visually represents these legitimacy types conceptualised within financial planning theory. Importantly, Scott (2014) highlights entities exhibiting regulative, normative and cultural cognitive legitimacy increases their survival rates.

**Figure 1: Legitimacy of the Current Authorised Representative Licensing Model**

*Note: Adopted from Suchman (1995) and Scott (2014).*



In the case of pragmatic legitimacy, Suchman (1995) outlines this as the perception of the social support for an entity's activities operating within some socially acceptable system. From existing literature, regulative legitimacy, derived from pragmatic legitimacy (see, Chen and Roberts, 2010; Rao, 2004), occurs when regulatory entities use laws to create a perception of trust and confidence in society (Kostova and Zaheer, 1999) by regulating behaviour (Scott, 2013, p59). Seemingly, the "tool of legitimation" (Chen and Roberts, 2010, p.654) ASIC uses to co-regulate individual advisers via licensees is the Act (Tyson-Chan, 2006, Australian Securities and Investments Commission, 2012a). ASIC's social control (Santana, 2012; Yeung, 2009) over licensees and their ARs gives the licensing model its "right to exist" (Pellegrino and Lodhia, 2012, p.70), which is being tested by the loss in public confidence and trust. Theoretical (Scott, 2014) and empirical legitimacy studies (for example, Bitektine, 2011; Chelli *et al.*, 2014) showed entities gain and maintain regulative legitimacy when a perception of compliance with the legislation is present. On these grounds, determining empirically licensing's regulative legitimacy involves examining whether (or not) a perception of licensing advisers through third-party aligned licensees risks their advisers from breaching regulatory compliance, because of their licensees' affiliations to product issuers. If the ARs of aligned licensees comply with the Act, then the licensing can be perceived as legitimate (Figure 1). Verifying regulative legitimacy is imperative, because licensees and advisers will lose their reputations when breaches in compliance are discovered and makes headline news. Furthermore, the financial losses suffered by clients results in the public choosing to avoid seeking financial advice when the ensuing distrust sets in (Carlin and Gervais, 2012).

Legitimacy is not only about the “right to exist” (Pellegrino and Lodhia, 2012, p.70), but also what is judged as “the right thing to do” (Yeung, 2009, p. 286) morally. Therefore, normative (moral) legitimacy focusses on specific morals, values or ethics (Chua and Rahman, 2011; Chen and Roberts, 2010) of an entity's goals, activities, structures, and/or outcomes, within a socially accepted (Johnson and Holub, 2003) and constructed value system (Bitektine, 2011). Australian financial planning professional associations and licensees shape the moral professional foundation for advisers. They interpret and implement the regulative rules using as their defence compliance (Carnegie and O’Connell, 2012) with the Act. Consequently, understanding the licensing model's normative (moral) legitimacy requires scrutinizing the following sub-categories Suchman (1995) identified, and illustrated in Figure 1 above: (1) consequential; (2) procedural; (3) structural; and (4) personal.

Consequential moral legitimacy is the moral assessment of an entity's socially valued outcomes (Suchman, 1995, p579). Data gathered during two ASIC reviews in 2011 and 2014 showed licensees' main source of revenue were paid by fund managers or product issuers. In the literature, specifically aligned licensees are seen as “commercial businesses using advisers as a sales force” (Parliamentary Joint Committee on Corporations and Financial Services, 2014, p.24) to support shareholder theory (Kofman and Murawski, 2015, Lindorff and Peck, 2010, Griffiths, 2007, p.231) instead of stakeholders' interests to develop social capital (Lindorff and Peck, 2010). Yet ASIC expects licensees and their ARs when managing conflicts of interests to put the client's best interests first, even if not in the licensees' or the licensees' shareholders' interests (Australian Securities and Investments Commission, 2016d). Conflicts of interest can be managed through disclosures (Serpell, 2008) and complying with the best interests duty, however Bruhn and Miller (2014) suggested this was not always done effectively.

Maclean and Behnam (2010) maintained financial institutions struggle to manage their regulatory compliance when the legal requirements conflict with or compromise their commercial activities. They indicated resolving this tension is critical to ensure legitimacy. In support, Lindorff and Peck (2010) wrote legitimacy requires managing these institutions for the benefit of all stakeholders, not just shareholders and employees. Therefore, whether (or not) licensing advisers through third-party aligned licensees creates tension between the licensees' commercial interests and their clients' best interests should determine the existence of consequential moral legitimacy. The premise is if aligned licensees' commercial interests are consistent with the clients' best interests, then licensing advisers through third-party aligned licensees is more difficult to challenge (Figure 1) and existing licensing retains consequential legitimacy. Establishing this is important, because Griffiths (2007) suggested focussing on immediate shareholders profits results in negative social costs to retail clients. Furthermore, Bearden (2002) pointed out financial interests can compromise advisers' professional judgement, hence damaging the adviser-client professional relationship of trust notwithstanding the quality in the advisers' work. Bearden (2002) contended a defining characteristic of any profession is conflicts of interests matters and should be avoided (Bearden, 2002). Any incompatibility between the institutions' values and the professional values of the adviser manifests into institutional-professional conflicts, which requires compromise (Bamber and Iyer, 2002). In light of Australian policymakers' push for professional standards (Parliamentary

Joint Committee on Corporations and Financial Services, 2015), English (2008) indicated to decrease the likelihood of experiencing this conflict, professionals should work in institutions sharing the same values and goals as the profession.

Procedural moral legitimacy is the moral assessment of the entity's socially acceptable practices, standards and procedures (Suchman, 1995, p. 579). In legitimacy theory, decoupling (Cole and Salimath, 2013) occurs where formal policies, processes and rules for legislative compliance differ from actual practice (Carruthers, 1995) and behaviour (Scott, 2014). Unconfirmed are allegations licensees implement legislated practices, standards and procedures reinforcing the advisers' product distribution role (Parliamentary Joint Committee on Corporations and Financial Services, 2014, p.24), which Sampson (2010) contended is sometimes without detection. Secondary non-academic sources claimed Australian aligned licensees limited their ARs to recommendations of mainly products they select and assess for the approved product list (Australian Government, 2014, Sheehan, 2016). Additionally, Lee (2007) suggested licensees and their representatives are linked to a deceptive sales culture, where these representatives are used to cross- and up-sell specific products from the approved product lists (APL). West (2009) alleged there is no reason why aligned licensees would want their representatives to retain, recommend or include on their APLs a competitor's financial products. ASIC found in a review the statutory fiduciary duty obligations failed to impact most institutions' APLs, except for a few amendments such as a reduction in the number or types of products on the list (Australian Securities and Investments Commission, 2014). Newnham (2012) maintained licensees are adept at keeping in place distribution channels masquerading as sources of advice. Except for the inductive qualitative analysis by Maclean and Behnam (2010) of a US financial services organization where widespread deceptive sales practices occurred, there is a deficiency in Australian research empirically validating or verifying the above claims.

In this aspect, future research should empirically verify the licensing's procedural moral legitimacy by examining the existence of perceptions that licensing advisers through third-party aligned licensees result (or not) in deceptive sales procedures, standards and practices to reinforce product distribution, while giving the appearance (window dressing) of satisfying regulatory requirements. Should this not be the case, then the licensing demonstrates procedural legitimacy (Figure 1). This information is significant, because Maclean and Behnam (2010) demonstrated decoupling the compliance program from practice results in the loss of external legitimacy, because internal legitimacy of the formal compliance program is damaged, which then culminates in unethical practices becoming institutionalized. An Australian study by Smith (2009) suggested an ethical culture promoting ethical behaviour within AFSL licensees is dependent on the presence of formal and informal systems and procedures.

Suchman (1995) defined structural moral legitimacy as the moral evaluation of adopting formal structures acceptable to society. Presently under the existing licensing regime a licensee appoints, authorises and regulates multiple representatives (Australian Government, 2014). Significantly, doctors may prescribe certain pharmaceutical products they favour (Everingham, 2014), but they are not licensed to practice their craft through these third-party pharmaceutical institutions. Lawyers, doctors and accountants work for corporate commercial institutions but they retain

autonomy and control within their job role (Rubin, 2015). When lawyers (Arteta, 2016; Australian Bar Association, 2016) and doctors (Medical Board of Australia, 2012) leave their workplace they retain their professional status, their license to practice and ability to work without needing to transfer to other corporate institutions. Similarly, when accountants leave public practice they can retain their registration with their professional associations (Bamber and Iyer, 2002; Institute of Chartered Accountants of Australia, 2012). Bearden (2002), Cheetham and Chivers (2005) set out numerous characteristics of a profession, which is further supported by a substantial body of literature (see for example, Watts and Murphy, 2009; Frumento and Korenman, 2013). Through their independent bodies such as the Medical Board of Australia, Law Societies of each State, Australian Bar Association, Institute of Chartered Accountants Australian Board and the CPA Board, Tom (1995, p.3) noted each new entrant into the profession must meet their specific entrance and ongoing requirements. These characteristics, Cheetham and Chivers (2005) held, provides a profession its legitimacy. In contrast, Australian financial advisers are not self-regulatory, collegial, independent, structured, hierarchical and client-focussed (Riaz *et al.*, 2011). Nor do they operate within a recognised professional body with status within a society as observed in other professionals (Riaz *et al.*, 2011). Unlike other professionals, Schuchardt *et al.* (2007) confirmed financial advisers do not control their specialised knowledge and skills. Clayton Utz Financial Services Reform Group (2002) observed this included qualified Certified Financial Planners® (CFPs®) who lose their professional status to earn a living once they leave a licensee, unless they sign up with another licensee. The available evidence seems to suggest even highly qualified and professional advisers lack professional autonomy (Smith *et al.*, 2009) similar to other professionals under the present licensing regime to practice their craft.

The present debate in the media revolves around advisers being viewed as quasi-employees controlled by their licensees (Pokrajac, 2014). This may be a problem, because Smith *et al.* (2009) suggested licensees lack the breadth within their systems and procedures to ensure an effective ethical climate and culture for professional advisers. Interestingly, Young and Thyl (2014) found during their qualitative study some financial institutions' leaders hold the view individual's behaviour cannot be regulated, only structures can be put in place for individuals to buy into. The premise here is the Australian financial advisory industry is buying into a formal structure without critical assessment or evaluation. So, to empirically evaluate the licensing model's structural moral legitimacy requires examining whether ARs, meeting all the professional standards, are permitted to continue practicing their craft as a professional adviser (they retain their professional status), like other professionals, without requiring to transfer to another licensee or become self-licensed when they leave their current licensee. On these grounds, if professionally qualified advisers are permitted to continue practising their craft, like other professionals, then the licensing model shows structural legitimacy. This is important, because with proposed new Australian legislation, policymakers are trying to professionalise financial planning (Parliamentary Joint Committee on Corporations and Financial Services, 2015). Furthermore, advisers licensed through a third party commercial rather than a professional institution may, possibly, act as a disincentive for potential new entrants to pursue a career in financial planning. Particularly, when despite meeting the requirements of a true professional, they are no longer legally authorised to provide financial advice, unless they transfer to another licensee once they leave a current licensee. This paper's

views are grounded on the assumption that if financial advisers are to become a true profession, then they should be structurally licensed in a similar manner to other professions.

Personal moral legitimacy is achieved through the moral and social evaluations of charismatic individuals' roles (Carnegie and O'Connell, 2012; Goretzki *et al.*, 2013) exerting their personal influence to dismantle or create new entities (Suchman, 1995). Non-scholarly literature makes allegations about certain key people as members of seniority of multiple diversified licensees (Vickovich, 2014c) and financial planning professional bodies (Vickovich, 2014b) with varying stakes (Commonwealth of Australia, 2014d) presenting as committee members on panels to respond as lobby groups at roundtables (Vickovich, 2014c), private and public hearings making submissions (Australian Bankers' Association Inc, 2014) to persuade or dissuade the government to increase or decrease the amount of legislation. Although not empirically assessed and substantiated, each contributing different, sometimes opposing recommendations to the debate surrounding regulating individual advisers, while simultaneously implementing competing training, accreditation and professional recognition programs (Reese, 2011). Young and Thyl (2014) suggested that financial institutional leaders' duty and moral obligation are to all stakeholders, not only shareholders, to be doing the right thing to obtain their implicit or explicit consent to operate. The extent stakeholders provide this consent they claimed provides these institutions the legitimacy to operate.

Legitimacy is not only about the "right to exist" (Pellegrino and Lodhia, 2012, p.70) and the "the right thing to do" (Yeung, 2009, p. 286) to meet legal and moral obligations. Additionally, cultural-cognitive legitimacy is a perception of shared understanding, activities, norms and beliefs (Santana, 2012) with the aim to perpetuate an institutional order (Kury, 2007) based on cognition or awareness (Meyer, 2007). With assumedly shared common understandings, activities, norms and beliefs with their clients and the media, ARs under the their licensees' control, operationally enact the rules (Kury, 2007) as specified in the Act. In other words, with cognitive legitimacy it is taken-for-granted (Carnegie and O'Connell, 2012) "this is how we do things" (Kury, 2007, p.373) (Figure 1). Namely, ASIC appoints, authorises and regulates individual advisers through third party licensees. Simply, with the legislation clients and their advisers should have as Scott (2014) notably theorises a shared understanding as to 1) who they are (identity), 2) what is expected of them (role) and 3) how effective they are (performance). With identity Arman and Shackman (2012) purported the Australian general public can distinguish between the different designations in the medical, legal and accounting professions, yet they cannot do the same for advisers. With adviser roles, some government officials contended, Bernie Ripoll's FoFA reform recommendations provided a strong legal framework distinguishing advice from sales (Commonwealth of Australia, 2014c). As a refutation, North (2015) explained, because the definition of financial advice is narrowly tied to product, the Act does not assist in clearly distinguishing the delivery of independent professional advice from financial product sales advice. Accordingly, clients and their advisers should have a shared understanding of the advisers' identity and role so the objectives of the Act can be achieved (performance). For purposes of this paper, the objectives include inter alia protecting the public, aligning the adviser-client interests, managing, controlling or avoiding conflicts of interests and encouraging competition between financial services providers (Corbett,



1999, Ap, 2011). Perkins and Monahan (2011) wrote achieving these objectives is important for the sake of public support, trust and confidence in the financial advice industry.

In light of the previous discussion, personal moral legitimacy of the licensing model is evident, if the distinction between independent financial advice (independent adviser) and conflicted financial advice (aligned adviser) to achieve the objectives of the Act is clear to the Australian public (as depicted by Figure 1). This is important to establish, because Rubin (2015) argued confusion around titles and designations undermines the trust society requires to justify granting individuals professional autonomy, necessary to qualify as true professionals.

## 4.0 Future Research Directions and Implications

The existing literature seems to take a negative view on advisers being appointed, authorised and regulated through third party licensees. It seems, the difficulty in obtaining a balanced view, is due to the deficiency in financial planning theory and availability of empirical evidence that is supported by epistemologically sound conceptual frameworks to understand the legitimacy of the licensing model. Not only is the legitimacy of the current licensing model for individual advisers inconclusive and under-researched, but also whether licensing advisers through third party licensees is a significant problem is unclear. Consequently, in an area where no prior research is evident, we apply an established theoretical framework to examining the legitimacy of the current AR licensing model. The framework provides an opportunity to develop a standard instrument for further empirical analysis using dimensions such as regulative, consequential, structural, procedural, personal and cultural-cognitive as criteria to capture the perceptions, for example of ARs, regarding the desirability, proprietary, or appropriateness of the current AR licensing model. The application of Suchman (1995, p. 574) theory will not only advance financial planning theory, but also provide a scholarly platform for future empirical research to provide policymakers, domestically and internationally, with initial data and analysis tool to assist with policy decisions around the regulation of individual advisers.

## 5.0 Conclusion

Within the predominantly FoFA legislative framework, Australian financial advisers are appointed, authorised and regulated through third party licensees as specified in the Commonwealth Corporations Act 2001. Licensing advisers in this manner is apparently confronted by mainly negative mixed messages from various stakeholders without any compelling scientific-based evidence of what is appropriate for this emerging profession. Without enough peer reviewed financial planning literature supported by epistemologically sound definitions, principles, models, norms and decision rubrics, it is difficult to present a balanced view in the paper. No academic researchers have yet attempted to define, model and measure the legitimacy of the licensing model, because seemingly the conceptual construct is difficult to define and quantify. The proposed rectification is applying Suchman's theoretical legitimacy framework as a theoretical foundation to obtain conclusive evidence to validate whether (or not) the licensing model is legitimate. Not only will this advance financial planning theory, but will also raise questions for further investigation. Furthermore, empirical data collected using this framework will provide policymakers concrete evidence to make decisions around licensing individual advisers without



having to rely on unconfirmed claims. Until empirical research based on a theoretical construct is undertaken, a vacuum in financial planning scholarly theory, empirical research literature, as well as the myths and unsubstantiated arguments surrounding licensing advisers through third party licensees will remain. This study therefore proposes Suchman's legitimacy theoretical framework as an important theoretical contribution to empirically evaluate and verify the legitimacy of the current licensing model for individual financial advisers.

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## FINANCIAL LITERACY EDUCATION *WITH* ABORIGINAL PEOPLE: THE IMPORTANCE OF CULTURE AND CONTEXT

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### ABSTRACT

Learning about effective ways to manage money is a 21st century skill and the focus of financial literacy education (FLE) initiatives globally. Individuals deemed to have lower levels of financial literacy are often the targets of financial literacy workshops/programs. In this research paper the key outcomes are identified from a qualitative study that explored the FLE practices *with* an Aboriginal community in Canada (that the author is a member of). This includes conceptualising what influences financial decision-making and the role of culture and context in financial literacy education *with* a Community instead of *for* a Community. Discussed is the importance of adopting a *praxis approach to FLE* and integrating *site based education development with* Community members instead of imposing education *on* individuals. Last, outlined in this paper is how the above findings may offer insights for financial educators and/or planners participating in financial literacy education and engaging *with* Aboriginal clients.

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## Introduction

### Financial literacy education and financial regulation in Australia

Australia's deliberate government policy of deregulation and economic rationalism, poor educational resources, and lack of concern on the part of the financial services sector have all been key factors in generating conditions necessary to create social exclusion and alienation. (Hajaj, 2002, p. 1)

Financial literacy is a critical 21st century life skill (Lusardi, 2015) with the current economic climate having led to an opportune moment for financial literacy education (FLE) (OECD, 2013). Globally governments and policy makers are responding to this cry for knowledge by developing and supporting educational initiatives that aim to improve individual's financial decision-making (OECD INHF, 2012). Despite these global efforts, FLE remains to be acquired by default for most Australians (Hajaj, 2002) or through financial sales advice dressed up as financial advice from the financial institution(s) an individual banks with. In Australia, these financial institutions including the 'big banks' have had their own share of media attention for all the wrong reasons including '... no less than 24 government-led inquiries' since 2009 (Gluyas, 2016). These questionable financial practices resulted in Prime Minister Turnbull calling for an end to scandals in the banking sector. Westpac, ANZ, Commonwealth and the National Australian Bank were mentioned for unethical behaviour and/or financial advice scandals (see Coorey & Durkin, 2016; Hatch, 2016; Sharpiro, 2016 a&b). Thus the debate about the role of FLE and financial regulation remains strong (Lusardi & Mitchell, 2014).

Interestingly the financial institutions are also behind many of the financial education workshop/ programs and resources developed and offered in the community (see MoneyMinded, 2013; StartSmart, 2016) and professional development offered to educators (i.e. Commonwealth Bank). The other big player in the financial education space is the Australian Securities and Investment Commission (ASIC). They developed the national financial literacy strategy (ASIC, 2011a) and the national and consumer financial literacy framework (ASIC, 2011b) to steer the financial literacy efforts in Australia. Despite ASIC's role as financial regulators they also promote individual responsibility through effective financial decision-making. ASIC continues to develop and promote financial literacy resources for individuals and educators through their MoneySmart and MoneySmart Teaching websites. These resources aim to assist and enable individuals to effectively navigate their own finances, make effective financial decision and/or provide lessons for teaching financial literacy (see MoneySmart Teaching). With national reach MoneySmarts Teaching resources are offered as an example of how to teach students about financial literacy. Of concern is the connection to mathematical problem solving and age appropriate tasks. For example the relevance of a developing a simple financial plan for Year 5 students (see Australian Curriculum) could be questioned unless it is contextualised into a financial problem that is relevant to this age group and their experiences. Similarly the activity of budgeting and savings (see MoneySmart Teaching for Year 5s) for a month at age 10-11 may not be the most relevant task unless these students have an income such as an allowance and have expenditures that they are regularly responsible for paying. Thus, teaching financial mathematics is likely more about allowing students

to work on a financial dilemma that is contextually, culturally and age appropriate. It also involves students acquiring financial/mathematical skills in a social context and the ability to develop multiple solutions through collaborative discussions instead of focusing on individual financial practice and independent work.

As such efforts are being made to reach compulsory school aged children with age-appropriate 'financial dilemmas' (Sawatzki, 2013 p. 604; 2015; 2016) and through financial maths inquiry based tasks (Blue & O'Brien 2016) that require students to use mathematical and social problem solving skills. Financial decision-making also involves ethical considerations that move beyond money, the individual, and includes considering others and how they are affected by financial decisions made by others. Lucey, Angello and Laney (2015) describe a 'thin' and a 'thick' view of financial literacy. The conventional or thin view of FLE focuses on the individual and their ability to make effective financial-decisions whereas the thick view of FLE considers how others are affected by an individual's financial decision-making (Lucey *et al.*, 2015).

FLE does have a pivotal role to play in supporting the international policy priority of financial inclusion (Atkinson & Messy, 2013). Governments and policy makers regard FLE as essential learning for all (see Taylor & Wagland, 2011), with FLE added to many school curriculums around the globe (ASIC, 2012; Bosshardt & Walstad, 2014). FLE has emerged as a high-priority global initiative and many countries have developed policies focusing on financial inclusion (OECD INFE, 2012). In some financially excluded communities (including Aboriginal communities in Canada and Australia) FLE is used to reach individuals through the use of generic one-size-fits-all training programs (see Blue, 2016 for Canadian example and Wagland and Taylor, 2015 for an Australian example).

## **FLE for the most vulnerable and marginalised populations**

Empirical evidence in Australia (Altman, 2000; ANZ Survey of Adult Financial Literacy in Australia, 2015; Australian Securities and Investments Commission (ASIC) 2011a) and Canada (Collins, 2011a; Thiessen, 2009) has revealed that Indigenous<sup>1</sup> people have the lowest financial literacy and socio-economic status amongst their respective populations. Financial management skills are crucial for all households, particularly those with low-income levels (Lyons *et al.*, 2006). However, there is evidence to suggest that individuals living on low-incomes are effective budgeters (Dowler, 1997, 2008; Pettigrew, Webb, & Gahesh, 2005), yet their financial skills have failed to move them from conditions of poverty. Structural barriers and social structures continue to perpetuate inequities for Indigenous peoples globally. Recognising that these barriers and structures exist involves understanding why FLE alone is not enough to help people achieve financial well-being (the ultimate goal of FLE) (see Blue, 2016; Collins, 2011a for Canadian examples and Lahn, 2008; Wagland and Taylor, 2015 for Australian examples). In the Australian Aboriginal context Bianchi, Drew, Walk and Wiafe (2016) advocate for policies to improve education, employment and income as they found a significant retirement gap for Indigenous Australians when compared to non-Indigenous Australians. However, concern about how this retirement gap will be filled and by

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<sup>1</sup> Indigenous is used as a globally-inclusive term to refer to individuals from an Aboriginal background throughout this paper (Wilson, 2008).



whom remains unknown. The authors also found that non-Indigenous women and Indigenous men share a similar retirement gap (Bianchi *et al.*, 2016). With financial literacy being tied to financial well-being (Atkinson & Messy, 2012) these retirement gaps facing Indigenous people and Non-Indigenous women remain an ignored financial well-being concern.

## Financial literacy and its links to banking and increased risk for scams

Hajaj (2002 p. 12) discusses the 'bank fee poverty trap' that is designed to retrain a different type of customer, not the customers who have their bank fees waved because they hold home loans and/or other investments. These 'other' customers instead face ongoing fees that must be paid until they are able to meet the minimum balance requirements (Hajaj, 2002). This trap is a real possibility for individuals on low-incomes who are often the targets of community run FLE workshops. Furthermore, individuals with lower levels of financial literacy are reported to be at increased risk for financial scams (Lusardi & Mitchell, 2013). With much attention "... devoted to methods of protecting people from their own financial illiteracy and inability to make informed financial decisions" (Lusardi & Mitchell, 2014 p. 34). Many researchers continue to see the benefits of both increased FLE and financial advice working together instead of independently exclusive (Collins, 2011b; Finke, 2013). Hajaj (2002) discusses Aboriginal Australian communities that were targets by financial planners selling life insurance and burial policies without disclosing fees and charges that guaranteed high commissions to the sellers and no benefit to the vulnerable buyers. This example is not that dissimilar to the scandal that rocked the Commonwealth banks life insurance arm, CommInsure (Ryan, 2016). It highlights the need for a cautious and critical eye when dealing with individuals pushing products that benefit themselves more than the client including FLE resources.

## Financially excluded communities and the practice of FLE

My PhD research critically examined the role of FLE practices in a financially excluded Aboriginal community in Canada after a generic FLE train-the-trainer workshop failed to gain traction (see Blue, 2016). In conjunction with some Community members, the study explored Community members' experiences with FLE, their interest in FLE, the relevance and their FLE needs. The two main objectives of the study were to understand how FLE occurs in a financially excluded Community (this was achieved by hearing from some Community members about their experiences with FLE) and to understand why FLE was important for the Community rather than make assumptions about what the Community needed. This included a praxis (the moral, caring and ethical aspect of teaching) approach (see Grootenboer, 2013) to FLE and site based education development where educators and Community members work together for the best interests of the Community (Kemmis *et al.*, 2014).

## Research questions

This research paper focuses on three research questions that emerged during and after the study mentioned above. These include:

- 1) How might socio-economic status affect financial decision-making?
- 2) What is the role of culture and context in FLE practices?



### 3) What role might financial planners have in FLE initiatives with Aboriginal people?

It was important to understand the FLE practices experienced in a financially excluded Aboriginal Community with Community members in order to know what works, and what does not. As there are high levels of individuals living in poverty in this Community how socio-economic status may affect financial decision-making was important to conceptualise. Aboriginal ways of being, knowing and doing (Martin, 2003) including some Community members' perceived propensities to share resources clashed with the often-individualistic wealth accumulation focus of conventional FLE. Seeking an understanding from some Community members about why FLE was, or was not, important in the Community was essential to comprehend how FLE might be developed in a more culturally and contextually appropriate way.

### Methodological and Theoretical Approach

Indigenous research methodologies guided the research approach (Wilson, 2001; 2008). This methodology is similar to a qualitative approach to research but different because of the relational accountabilities associated with the research (Martin, 2014; Wilson, 2008). As a member of this Community the overlying accountability to do the right thing for my Community distinguishes this methodological approach from a purely qualitative approach. It was also the epistemological (ways of knowing), ontological (ways of being) and axiological (ways of doing) processes and practices (Martin, 2008) shared with Community members that ensured this study was consciously considered and relevant. As the practice of FLE was of interest the theory of practice architectures (Kemmis *et al.*, 2014) was used. This theoretical lens was used to understand how FLE practices were enabled and constrained.

### Research design

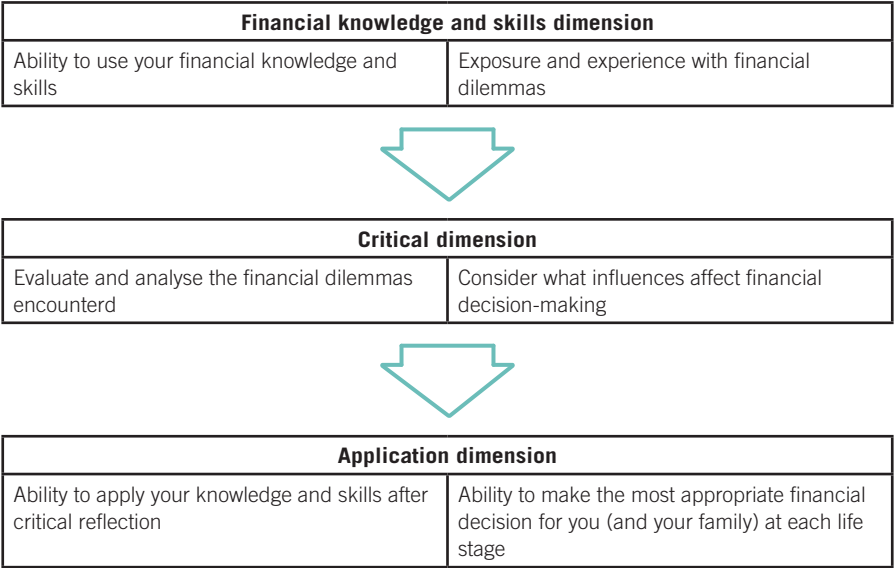
Both purposeful (Light, Singer & Willett, 1990) and snowball sampling (Maxwell, 2013) were used in this study as the Community was deliberately chosen to provide an in-depth understanding of the FLE practices that operate in the Community. The sample size was determined after two research trips to the Community. Data was collected in various ways: at the Employment Summit (55 Community members completed a short survey); interviewing 19 Community members; attending a Chief and Council meeting; and, co-hosting and presenting at a Community meal (with over 40 members present). Although this data is not specifically reported on in this paper general findings that may be applicable to improving FLE practices are discussed in the next section of this paper.

### Findings and Discussion

Financial literacy involves a knowledge dimension and an application dimension (Huston, 2010). I expanded on Huston's (2010) definition of financial literacy by incorporating Arthur's (2011) notion of critical financial literacy (see Figure 1).

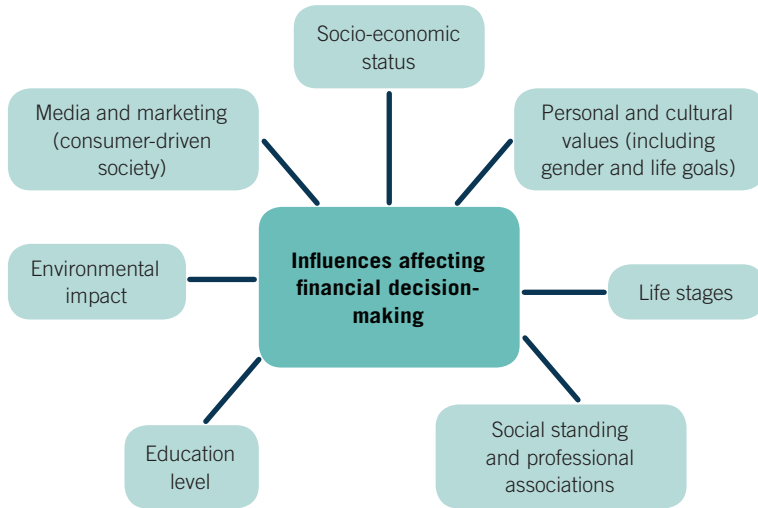


Figure 1. Concept of critical financial literacy (Blue, 2016).



In this expanded-upon concept of financial literacy the critical dimension (that resides between the knowledge and the application dimension) is where the individual critically evaluates and analyses the ‘financial dilemma’ (as coined by Sawatzki, 2013) and considers possible influences affecting their decision. Possible influences that affect an individual’s ability to make financial decisions when faced with a financial dilemma are illustrated in Figure 2. They include: personal and cultural values, social and professional circumstances, education level, environmental impact, media/ marketing pressures, psychological state, life stage and socio-economic status. For each of the influences, the three dimensions (knowledge, critical, and application) of financial literacy (see Figure 1) depend on the circumstance of each and every individual. As an example, an individual with cultural values that include putting others before themselves, or environmental values such as sourcing recycled goods, may be influenced to purchase a more expensive item during the critical reflection dimension of financial decision-making.

**Figure 2. Possible influences of financial decision-making (Blue, 2016).**



The conceptual models (Figure 1 and Figure 2) developed based on research findings (see Blue, 2016) include a more inclusive and compassionate approach to financial decision-making that includes the overlooked aspect of cultural values, gender and socio-economic status.

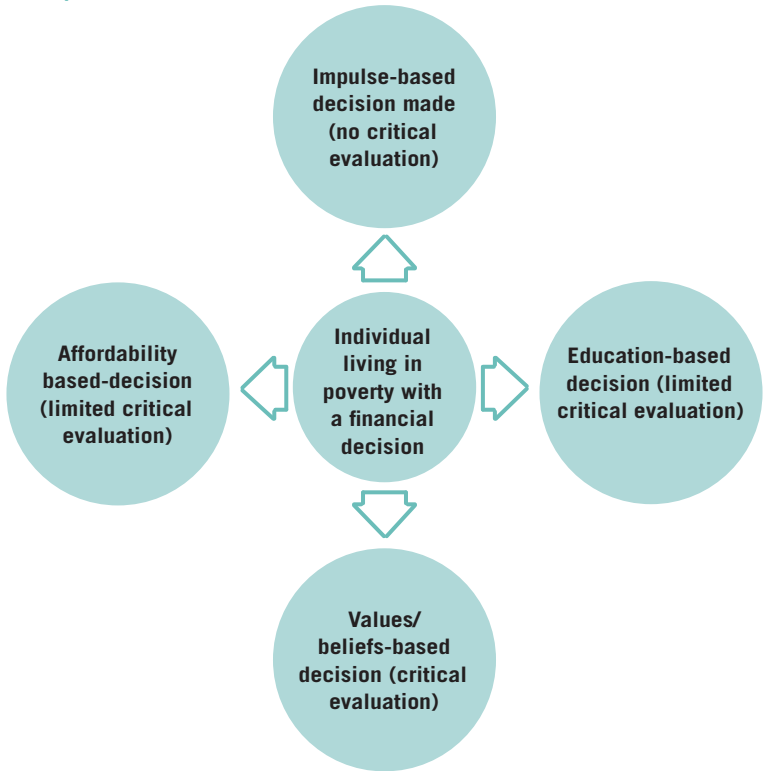
As definitions for financial literacy often include effective financial decision-making that leads to financial well-being (see Atkinson & Messy, 2012). I argue that financial literacy is more about an individual's capacity to acquire financial knowledge and apply this to the financial dilemmas faced at various life stages. It also involves critical reflection about the impact of an individual's financial decision-making and how this affects others while considering what influenced their financial decision (i.e. socio-economic status, education level, personal and cultural values, life stages, social standing and professional associations, media and marketing, and/or the environment). It is important to consider that many 'financially literate' individuals living on low-incomes will never achieve financial well-being as the lack of knowledge is not the problem; the low wage is.

### **What does socio-economic status have to do with financial decision-making? (RQ1)**

Through the teaching of financial literacy, it is often expected that students will increase their personal, and retirement, savings and become confident and "effective" financial decision makers (OECD, 2005). Herein lies the false promise of FLE that after attending a FLE course/program/workshop that an individual's current financial circumstance is easily remedied. Although some

basic skills can be taught and acquired at these workshops, it is naïve to expect that a full financial makeover will occur and be sustained after attending such a program (Pinto, 2009). Instead, more questions than answers can result, with individuals often blaming themselves for not being able to change their financial circumstances (Willis, 2008). The reality of financial decision-making for individuals living on low incomes might look more like Figure 3 with impulse based decisions, affordability based decisions, values/beliefs decisions and/or decisions based on FLE.

**Figure 3. Reality of financial decision-making of individuals living in poverty (Blue, 2016).**



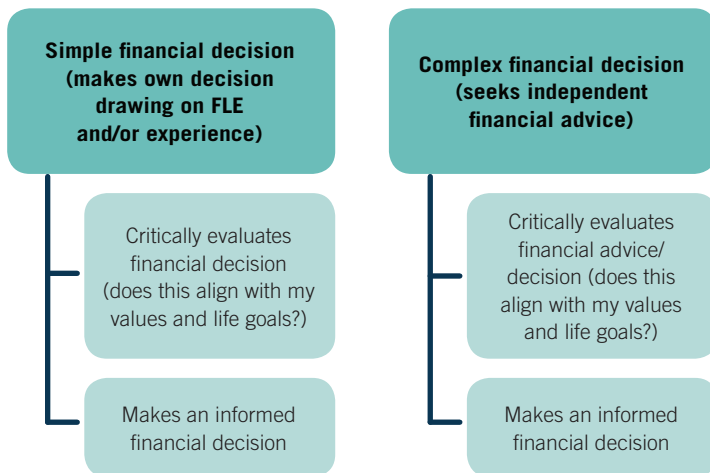
**Importance of culture and context (RQ2)**

The concept of culture and its impact on financial decision-making has largely been ignored in FLE in both Australia (Wagland & Taylor, 2016) and Canada (Blue, 2016). Yet research shows

limited assets and interested in establishing a financial plan). Such an initiative could also be a key to rebuilding trust and confidence in the profession (Cull & Sloan, 2016).

FLE that is used to guide individuals with simple financial decisions is a real possibility (Blue & Brimble, 2014); whereas, more complex financial decisions are likely best made with advice from independent financial planners and in consultation with family members. A model of financial decision-making might include: confidence to independently make 'simple' financial decisions; seeking independent financial advice for 'complex' financial decisions; critically evaluating the financial decision and/or financial advice received against an individual's own values and life goals; and, making informed financial decisions based on the FLE and/or financial advice given that aligns with their values and life goals (see Figure 4) (Blue & Brimble, 2014). This model describes possible pathways for an individual who is not living in poverty and is facing financial decisions.

**Figure 4. Realistic expectation of FLE for individual not living in poverty (Blue, 2016).**



## Implications for financial educators and/or planners

FLE program policies are entering the danger zone and are walking the fine line between self-determination and colonisation in Canada (Pinto & Blue, 2015), because teachings offered in these generic FLE programs are designed, on the one hand, to liberate individuals, and on the other hand, could also appear to be on civilising missions. FLE programs that aim to increase the possibility of self-determination of Indigenous peoples within the postcolonial ideal, must 'hold both economic and non-economic objectives in tension' (Overall, Tapsell & Woods, 2010, p. 157).

Achieving financial well-being involves having secure employment and being paid a wage that covers your household expenses. Education (not just financial education) can lead to a better paying job and without a steady decent paying job an individual is unlikely to ever experience financial well-being. Therefore, efforts might be better steered towards a progressive praxis-based approach to FLE that embraces the collective well-being approach to life shared by many Indigenous people worldwide and incorporates the importance of others in financial decision making by exposing what also influences an individual's financial decisions. The danger of focusing on individual needs and wealth accumulation at all costs is that the caring and compassionate aspect is ignored. Lucey *et al.* (2015) argue for a critical, compassionate approach to FLE that better reflects being a good citizen (i.e. an individual who makes financial decisions that they feel good about). Indeed, a more collective well-being approach to FLE would value the importance of how individuals help others as they provide for themselves. This is the challenge that needs to be overcome before a more socially just approach to FLE is adopted wholeheartedly.

Last, it was the interpersonal communication skills used by financial planners that were found to develop trust with clients. These skills included listening and caring using both friendly and professional behaviour (Cull & Sloan, 2016), respect and cultural awareness which may be important when working with Indigenous clients. However, government efforts will need to shift their focus from FLE *for* Indigenous people (civilising missions) to FLE *with* Indigenous people (self-determination). Therefore the approach to FLE in Australia may need to look beyond the conventional or individual wealth accumulating approach to a praxis approach that considers how individuals are impacted by others' financial decisions and what influences financial decision-making. With financial planners best positioned to complement FLE initiatives for complex financial decision-making concerns.

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## INDUSTRY DEMAND FOR FINANCIAL PLANNING GRADUATES

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### ABSTRACT

The financial planning industry is evolving into a profession, underpinned by a range of regulatory, professional and market changes. A key component of the challenge to professionalism is to attract high calibre new entrants to financial planning degree programs and into the emerging profession. This paper details results of a survey of 191 financial planning practices on their expectations and plans for new entrants. The study finds that there is growing interest in the graduate pathways and methods of obtaining access to a talent pool. In addition, the majority of firms indicated that they would like to grow their staff numbers in the five years (to 2019) and nearly two thirds indicated that they will be seeking graduates for these growth positions. This paper will explore the demand for new entrants, particularly university graduates, into financial planning.

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## Introduction

In Australia, there is an increasing need for a reliable, accessible and professional financial advice profession to assist individuals in effectively managing their finances to achieve financial independence and well-being. The last five years have seen the financial planning industry evolving with significant regulatory, professional and market changes driving the evolution of the industry.

The purpose of this paper is to gain insight into the demand from the financial planning industry for new entrants, including industry expectations about qualifications and contributions to supporting new entrants.

This research is timely with the Australian Government having undertaken to introduce legislation in 2016 to raise the professional standards of financial advisers, as part of the government response to the recommendations of the Financial Services Inquiry report in 2015 (Commonwealth of Australia, 2015a). Most notably, in the draft legislation released in 2015, new terms 'requiring advisers to hold a degree, pass an exam, undertake continuous professional development, subscribe to a code of ethics and undertake a professional year' were included (Commonwealth of Australia, 2015b). The new standards regarding education and exam requirements are proposed to commence on 1 January 2019 and existing advisers will have until 1 January 2024 to reach degree equivalent status and until 1 January 2021 to pass the proposed exam (Australian Government, 2016). Notwithstanding transitional arrangements for existing planners, only suitably qualified financial planners will be able to be registered as a 'financial planner' following implementation of the proposed legislation.

This paper will demonstrate that industry is already giving strong support for the new qualification requirements for new entrants and that the bulk of expectations regarding qualification levels are in line with new qualification requirements. To do that, we detail data from a comprehensive survey of 191 financial planning practices across Australia on their expectations and plans for new entrants, including career changers. The challenge of transition arrangements for existing planners was out of scope for the survey and will be an area of further research.

With the nascent stage of the financial planning profession, research such as that undertaken as part of this project will help to build a baseline of expectations about new entrant qualifications and expectations for growth and opportunity in the industry. This research may be useful as a benchmark for growth and qualification arrangements for future research as the regulatory reforms regarding financial planner qualifications are implemented, and contributes to the emerging body of knowledge regarding Australian financial planning.

Ultimately, this paper supports the broad stakeholder agenda for quality and timely financial advice. With less than one in five Australians having an ongoing financial planning relationship (AFA, 2014), those financial planning practices who are able to meet the challenges of human capital management in the emerging financial planning industry will have significant potential opportunities for reward.

The next two to five years are critical for financial planning practices, which have an opportunity to consolidate their position in the industry and lead the drive to professionalism. However, there are also significant challenges for business owners including attracting high calibre, suitably qualified new entrants and growing a business in a challenging business climate. For those businesses that are able to attract the right new entrants as part of their growth and help their current people to adapt to the new paradigm of professionalism, there will be significant opportunities to consolidate or grow their business.

This paper is organised into six sections with the next section, section 2, providing more detail on the context of new entrant qualifications and the financial planning professionalism agenda. Section 3 of the report presents the method deployed for the study and the resultant data obtained is provided in section 4. The last two sections contain discussion of the results (section 5) and the conclusion, limitations and future research directions (section 6). This early entrant perspective helps shed light on demand for newcomers to a financial planning profession.

## Background

The economic and social importance of financial advice has become increasingly apparent as the Australian community, government and industry seeks to improve the quality of advice outcomes. The global financial crisis (GFC) of 2008 placed financial planning and financial planners firmly in the spotlight, as client losses revealed numerous questionable business practices. The 'Future of Financial Advice' (FoFA) reforms followed the GFC and were in progress from 2010 through to 2015, as well as a Parliamentary Joint Committee report on financial services in 2014 and the Financial Systems Inquiry (FSI) report to Government in October 2015 followed by related draft legislation (Commonwealth of Australia, 2015a).

Matching job opportunities to financial planning graduates with the right skills and experience (to meet new legislative requirements) is critical to helping industry keep pace with demand for financial planning. Adding to the complexity of recruiting to meet demand and legislative change is the need to manage the transition of graduates through the first stages of their career. The transition into financial planning has been found to be difficult and expensive for both students and prospective employers as outlined in the following statement:

It may take years for a new graduate to become worth more than an entry-level wage; therefore, the employer pays a wage in excess of the value actually contributed by the graduate. In addition, employers incur costs in the form of in-house training, certification and licensing, supervision, and turnover. Employers hope to recoup these expenses when the graduate becomes more productive by paying a wage that is lower than the value of the employee to the firm at that time, typically within two to three years. It is at this point that many employees leave their original mentors for greener pastures with employers more willing to recognize the current value of their newly acquired skills. This tendency leaves the graduate's mentor less willing to hire inexperienced candidates in the future. (Goetz *et al.*, 2005, p. 232-233).

This cycle of turnover in the early stages of a financial planning career may be improved through implementation of 'career path' focussed recommendations from the raft of policy reports and regulatory reforms mentioned earlier in this paper, starting first with the professional year recommendation. Part of the focus on increasing standards across the industry as outlined in the FSI report, includes recommendations regarding establishing an independent body to lead a number of key reforms such as the professional year or other structured pathway into the profession for new entrants, which could alleviate the uncertainty and hence some of the turnover in the early financial planning career stages (Commonwealth of Australia, 2015a). Numerous definitions of professionalism have been used throughout the debate on professionalism in the financial planning industry. Some of the earliest hallmarks of a profession have been listed as: an occupation for which the necessary preliminary training is intellectual in character, involving knowledge and to some extent learning, as distinguished from mere skill; an occupation which is pursued largely for others and not merely for one's self; and an occupation in which the amount of financial return is not the accepted measure of success (Brandeis, 1914). As the financial planning industry evolves, the ability of the profession to provide clear and viable career paths for new entrants is vital to the future health and prosperity of the profession (Putnam *et al.*, 1998).

Throughout the FoFA and related reform process, academic stakeholders have also undertaken reform in the financial planning teaching area across numerous universities and TAFE institutions across Australia. In 2010, the Financial Planning Academic Forum (FPAF) was established and in 2011 the Financial Planning Education Council (FPEC) was established, bringing together tertiary stakeholders who are leading change in the academic area to support the drive to professionalism in financial planning.

In addition to offering a wider range of programs in formats that are preferred by industry stakeholders and students, the academic community has undertaken an increasing range of financial planning-specific research. Quality, focussed research is needed for a financial planning profession, not only in building a body of knowledge about financial planning, but also in building a theoretical basis for financial planning practice. The financial planning industry has been identified as having a weak theoretical base. Even though financial planning is based on a process, as noted by Grable (2005, p. 94) "there is no unifying theory of how financial planning works".

Researchers currently borrow theoretical models from home economics; agency theory; Modigliani's life cycle theory; Markowitz's modern portfolio theory through the Capital Asset pricing Model (CAPM) and Efficient Market Hypothesis (EMH) and other frameworks from disciplines such as finance and psychology, but there is no formal body of theory available for financial planning (Warschauer, 2002). Borrowing theories from other disciplines is sound; however, when university administrators look for ways to streamline academic offerings, those programs that lack a strong theoretical basis tend to be the first to be eliminated (Grable 2005). A stand-alone theory base for financial planning would assist the public in understanding why financial planning is performed (Altfest, 2004). Stronger theoretical development in financial planning will bring longevity to financial planning programs as well as bringing greater recognition of financial planning as a

profession (Cull 2009), which has been building as a focus of study and industry development since the 1980s (Cowen *et al.*, 2006).

Building the theory and research base for financial planning will, in turn, help meet the demand for appropriately qualified new entrants to financial planning, by strengthening the qualifications pathways for new entrants. Further, along with increased efforts to build a body of knowledge regarding financial planning, there has also been an increased focus on sharing research among the academic community, and with industry and the community. In addition to publication of research in a wide range of trade press and at industry stakeholder forums, Australia's Financial Planning and Investment Symposium has been held annually since 2012 to bring together financial planner researchers and stakeholders interested in leveraging research outcomes, and the Financial Planning Research Journal was launched in Australia in 2015.

In addition to building a formal research culture, academic stakeholders have undertaken to increase and maintain the relevance of their degree program content and format, to attract more students into the program and to increase employability. There has been an increasing focus on the broader range of skills the industry is seeking in graduates, including both technical and interpersonal skills, building on the required knowledge and skills highlighted in the Birkett Report (1996). Another area of focus has been in the area of work-integrated learning (WIL). The aim of WIL is to support the students' move to employment and to produce highly relevant qualifications, by integrating workplace learning into teaching and learning. WIL is a critical part of making students better qualified, better prepared to enter the workplace, and to have the support to challenge unprofessional behaviour and enter the profession as change agents in the future profession (Brimble *et al.*, 2012).

This paper will offer insight into the expectations of industry stakeholders for new entrants over the next five years (to 2019). The next sections of this paper will detail the methodology and results of the survey of 191 financial planning firms on the intentions for growth and expectations for new entrants.

## Methodology

The data used for this paper was drawn as a component of a larger research project that was conducted as a joint industry-university project between Zanetti Recruitment and Consulting (ZRC) and Griffith University. The overriding focus of the study was on remuneration structures in financial planning across Australia. This paper details the findings regarding new entrants that came out of the broader study.

The overall project utilised a survey methodology that was operationalised in three stages with the first consisting of instrument design. A review of the literature suggested there was not a suitable instrument available that dealt with the specifics of the financial planning industry. Thus the research team designed a new instrument through an iterative question development and refinement process that drew on both the research and recruitment expertise of the research team. At this stage the research process was also designed and human research ethics clearance was obtained and the instrument was built in an online survey tool. The survey focused on issues of



remuneration, benefits, incentive and bonus structures, role types and titles, role scope and future plans for staffing.

The resultant instrument was then pilot tested (in stage two) by five practices and a New South Wales recruitment firm (outside of the research team) and then the instrument was executed through an online survey platform in stage three. A target sample of 200 responses was sought from financial planning practices, with a strong emphasis on SME firms. Small firms are defined in this study as those with less than \$1,000,000 in gross revenue and medium as those with revenue between \$1,000,001-\$5,000,000 and a minimum of four staff. A cross section of licensees was sought in order to avoid concentration in the sample and therefore avoid potential bias. This included self-licensees and outsourced licensees. Regional and CBD practices were sought for participation, to look at capital city bias. However, there was some increased focus on the eastern seaboard for practical and convenience issues. The final survey instrument was launched on 31 July 2014 and remained open until 19 September 2014.

Once obtained, the data was then downloaded from the web survey system and subjected to accepted thematic and analytical research techniques to address the research questions. An interim report on this stage was produced and informed the second empirical stage and the final white paper which was distributed to participants in the survey and to clients on a commercial basis.

One of the key premises for the project is to prepare for the ever changing and increasingly complex financial services environment. Part of this challenge is to meet industry demand for new entrants who have relevant qualifications. The research question for this paper focusses on the demand for new entrants as follows: *What is the industry demand for new entrants into financial planning over the next five years (to 2019)?*

For this paper, data from 191 respondents who completed the survey is included. The individuals who completed the survey on behalf of the firms were predominantly owners/principals or practice managers/general managers who represented 89 per cent of respondents. The majority of these had 10+ years of experience in a financial planning firm, which suggests sufficient seniority and experience of respondents in relation to the survey credibility. The aim of the project was to bring to light information on small and medium sized enterprise (SME) financial planning practices. In line with this, the sample includes 25.2 per cent of respondent firms with annual gross revenue under \$500,000, and a further 28.4 per cent with annual gross revenue between \$500,000 and \$1,000,000. A further 38.1 per cent of firms reported annual gross revenue of between \$1,000,001 and \$5,000,000.

In addition, data has been collected on what new entrants are offered in the first two years of commencing in the financial planning industry in terms of training, career planning and other development incentives such as mentoring and bonuses.

This paper on new entrants forms part of a series of high value topics that have been selected for publication to a broader audience. The results regarding new entrants are detailed in the next section.

## Results: New entrants/early career financial planners

Results for new entrants reveal a growing interest in the graduate pathways and methods of obtaining access to a talent pool. This appears to be very much an emerging interest; however, the majority of firms (85.1%) indicate that they would like to grow their staff numbers in the next five years and 64.5 per cent indicated that they will be seeking graduates for these growth positions (see table 4.1 for details). When firm size is taken into account, it becomes evident that 100 per cent of large firms (over \$5 million in gross revenue) indicate that they will be seeking graduates for growth positions compared to 61.8 per cent of SMEs (<\$5 million in gross revenue).

With regards to planning the recruitment of new entrants (whether graduates or otherwise), even when moderate business size is taken into account there is an evident size effect with larger firms more likely to be planning to recruit more new entrants (48% of firms with gross revenue less than \$1m; 59% for gross revenue of \$1m-\$5m; and 86% of firms with gross revenue greater than \$5m); have a standard career progression (30% for <\$1m; vs 50% for \$1m-\$5m; vs 71% for >\$5m); have a formal induction (69% for <\$1m; vs 84% for \$1m-\$5m; vs 100% for >\$5m); and have incentive packages (47% for <\$1m; vs 59% for \$1m-\$5m; vs 90% for >\$5m). Larger firms have stronger recruitment intentions (48% for <\$1m; vs 59% for \$1m-\$5m; vs 86% for >\$5m). While not as much as for firms over \$5m in revenue, all firms have moderate intentions to use graduates to meet these recruitment demands (61% for <\$1m; 63% for \$1m-\$5m; 100% for >\$5m). Small, medium-sized and large firms are similar in relation to formal (62%) and informal (95%) training and career planning (67%) offered to new entrants.

Firms of all sizes have a strong desire (78% for <\$1m; 83% for \$1m-\$5m; 92% for >\$5m) for a formal graduate recruitment process to be put in place. For smaller organisations in particular, this is largely seen to be indicative of the capacity constraints to take on new entrants including the ability to invest in building relationships with educators and students. This is further supported by the source data with smaller firms (less than \$1m) more likely to use online job sites and less likely to use recruitment agencies or go direct to education institutions. Finally, smaller firms (less than \$1m) are also more likely to expect administrative staff (receptionists/EA/PA) to have qualifications such as RG146 in comparison to firms with revenue over \$2m, most likely reflecting the greater variety in jobs tasks in a smaller office.

Interestingly, of the 54.8 per cent firms who would like to recruit new entrants, overall, 81.8 per cent, indicated that they wanted a structured graduate recruitment and development pathway through the initial years into a financial planning career. Personal networks were the most common recruitment pathway into financial planning for these firms, with 29.4 per cent (or 129 responses, which was the highest recorded number for any one choice in this question) indicating that they use personal networks to recruit new financial planning staff, followed closely by online recruitment sites (17.5% or 77 responses), direct from university (17.3% or 76 responses) or through a recruitment agency (16.9% or 74 responses) (percentages based on total of multiple responses to this question). Furthermore, it appears a majority of firms (65%) state they have a standard career

pathway in place for new entrants and many have induction programs and formal/informal training.

In terms of expected qualifications of new entrants, these generally rise from no/low level qualifications for administrative staff (receptionists) through to 45 per cent of respondents expecting new entrant planners to have a Bachelor's degree or above. This is of particular relevance given the recent moves by some licensee groups, professional bodies and the PJC recommendations regarding qualifications for financial planners to be set at Bachelor degree as a minimum qualification going forward. Thus this data may shift over coming years as these new standards are implemented.

Similar expectations are evident for CSO and paraplanners, while small firms seem to have a slightly higher preference for financial planning specific bachelors and postgraduate qualifications for financial planners.

The analysis above is supported by comments to an open ended question in this section of the survey. In relation to the broader agenda, planners note the need to improve standards and work to put recruitment processes in place as outlined in respondent comments below:

*"It would need to be a structured program with some means of vetting the applicants. It is too hard to recruit when there are large numbers of applications to consider."*

*"The Financial Planning profession needs to improve the minimum education standards for new entrants if we are to be taken seriously as a profession."*

*"Minimum education standards and experience must be in place before an individual has the opportunity to provide advice."*

*"Finding people interested in entering the Financial Planning industry has been hard; negative publicity (eg: SMH pg3 16/8/2014) about the professionalism of Financial Planners does not encourage people to enter the industry."*

There is also evidence of the recognition that new entrants can assist with business growth and development. This is however tempered by other views regarding concerns about general work readiness and the breadth of the skill set of new entrants. For some this raises questions in relation to the pathway for new entrants:

*"Undergrads would be good for my growing business - part time, after hours for data input etc. to get a feel for the business."*

*"Plan on opening communications with unis and particularly interested in Chinese national graduates."*

*"I would like a new person intending to come into the industry and mentor them into a long term career."*

*"We hired a graduate over 12 months ago and it has been great."*

*"It's not about the knowledge they have but their character and ability to relate to people."*

*"It is extremely difficult to manage expectation of Gen Y entrants. They generally want to achieve so much in very little time so staff retention becomes very challenging."*

*"I have found graduates have an unrealistic expectation of their ability and knowledge and as such are overpaid for their worth to a professional practice. As a result they can go to a bank and receive higher salaries and bonuses and become corrupted and frankly useless."*

*"The industry is now technically driven and is losing key people skills and prospecting ability."*

*"Additional note, there is a high level of "selling" involved in financial planning, be it selling yourself or selling the company services and we've found that new entrants are not qualified/prepared in this area."*

*"It is "Risky" as they historically have no knowledge of the Industry...and Gen Y folk think they should progress from CSO to CEO within 2 years :-)"*

Finally, in relation to the issue of skills/attributes in demand, our respondents focus in on soft/interpersonal skills and suggest more needs to be done to prepare new entrants:

*"The best planners have not just technical skills but also empathy and wisdom, and the social graces. I think a new entrant pathway should include volunteering, the development of genuine interests outside the profession, communication and presentation skills and manners/deportment! It's surprising how often I come across even postgraduate degree qualified candidates who struggle to construct a sentence, don't know how to shake hands and slurp their coffee."*

*"Clear articulated passion to work in an environment with client focused outcomes."*

*"Work ethic, enthusiasm, attention to detail and excellent writing skills, adaptive and willingness are all the attributes we look for."*

*"Personality type (personal ethics included); and personal networking style are considered."*

Overall, the data shows there is growing interest in, and recognition of, the role that new entrants play in the financial planning human capital market. While there are some differences between the intentions and structures of small and large firms, overall the results suggest that this will become a more important part of financial planning in the future. This is likely to be driven also by changing standards across the sector.

The data also shows demand for a structured industry graduate recruitment process and for further attention to be given to skills development and general work readiness. Thus in relation to the research question, we find there is strong demand for new entrants and a degree of consensus on the qualifications and support structures for new entrants, although this is likely to evolve over time as the demand for qualified and suitable new entrants intensifies as new standards for advice are implemented over the next three to five years.

While not the focus of this paper, other relevant findings in the survey in terms of attracting high calibre new entrants relate to the current prospects for women in financial planning and the overuse of personal networks for recruitment. The survey results reinforced that there is an

overwhelming lack of gender diversity in the financial planning industry. The general manager position and compliance manager position were the only roles in the survey that had 50:50 gender representation. There is still a wide disparity in terms of representation of women in financial planning roles and director level roles and women are over-represented in the lower paid client service officer and paraplanner roles. In addition, 'personal networks' being the most common recruitment pathway into financial planning for firms may also be limiting diversity. Gender diversity and recruitment channels are highlighted as areas of future research.

Summary data on new entrants and qualification expectations is provided in tables 1 and 2, followed by a discussion of the results.

**Table 1: Summary data for new entrants**

Question	Response	Frequency	%
Do you currently, or would you like to recruit new entrants (e.g. graduates or career changers) to the industry?	Yes	103	54.8%
	No	85	45.2%
Do you have a standard career progression pathway for new entrants?	Yes	70	64.8%
	No	38	35.2%
Are new entrants provided with:			
A formal induction?	Yes	75	78.1%
	No	21	31.8%
Formal training in their first two years?	Yes	53	61.6%
	No	33	38.4%
Informal training in their first two years?	Yes	92	94.9%
	No	5	5.2%
Incentives Packages	Yes	56	62.2%
	No	34	37.8%
Career Planning	Yes	61	67.0%
	No	30	33.0%
Other		3	-
Would you like to see a structured graduate recruitment and development process put in place at the industry level similar to that in other professions such as accounting and law e.g. long-term internships?	Yes	153	81.8%
	No	34	18.2%

Question	Response	Frequency	%
Are you planning to grow staff numbers in the next 5 years?	Yes	160	85.1%
	No	28	14.9%
For firms with gross revenue of <\$500,000	Yes	40	78.4%
	No	11	21.6%
For firms with gross revenue of \$500,000-\$1,000,000	Yes	50	89.3%
	No	6	10.7%
For firms with gross revenue of \$1,000,001-\$2,000,000	Yes	37	80.4%
	No	9	19.6%
For firms with gross revenue of \$2,000,001-\$5,000,000	Yes	22	100%
	No	0	0
For firms with gross revenue of >\$5,000,000	Yes	11	84.6%
	No	2	15.4%
SME firms combined (\$0-\$5,000,000)	Yes	149	85.1%
	No	26	14.9%
Are you planning to use graduates for staff growth in the financial planning roles in your firm?	Yes	100	64.5%
	No	55	35.5%
For firms with gross revenue of <\$500,000	Yes	22	55.0%
	No	18	45.0%
For firms with gross revenue of \$500,000-\$1,000,000	Yes	31	66.0%
	No	16	34.0%
For firms with gross revenue of \$1,000,001-\$2,000,000	Yes	22	59.5%
	No	15	40.5%
For firms with gross revenue of \$2,000,001-\$5,000,000	Yes	14	70.0%
	No	6	30.0%
For firms with gross revenue of >\$5,000,000	Yes	11	100.0%
	No	0	0.0%
SME firms combined (\$0-\$5,000,000)	Yes	89	61.8%
	No	55	38.2%

Question	Response	Frequency	%
Please indicate the following methods that you would most likely use to recruit for new entrants into the financial planning pathway (multiple responses allowed)			
Direct from a university program		76	17.3%
Recruitment agency		74	16.9%
Online, large job site eg seek,		77	17.5%
Online specialty job sites eg financial planning sites		27	6.2%
Online networking site (eg LinkedIn)		46	10.5%
Personal networks		129	29.4%
Print ads		6	1.4%
Other (please specify)		4	0.9%

**Table 2: Expected new entrant qualifications**

Are there minimum qualifications you would require new entrants to have?	Receptionist		Personal / Executive Assistant		Client Service Officer (CSO)		Paraplanner		Financial Planner (early entrant)	
	#	%	#	%	#	%	#	%	#	%
RG146	26	17.8%	40	26.7%	73	36.5%	51	21.7%	41	14.5%
Diploma of Financial Planning (or equivalent)	3	2.1%	15	10.0%	51	25.5%	74	31.5%	63	22.3%
Advanced Diploma	0	0	2	1.3%	10	5.0%	55	23.4%	48	17.0%
Bachelors (Related)	1	0.7%	5	3.3%	9	4.5%	20	8.5%	46	16.3%
Bachelors (Financial Planning)	0	0	1	0.7%	6	3.0%	28	11.9%	64	22.7%
Postgraduate (Financial Planning)	0	0	0	0	0	0	2	0.9%	18	6.4%
Certified Financial Planner (CFP)	0	0	0	0	0	0	0	0	0	0
None	116	79.5%	87	58.0%	51	25.5%	5	2.1%	2	0.7%

## Discussion on attracting new entrants/graduates to financial planning

Prior to the GFC, the market for human capital in financial services was tight, with firms competing aggressively for new talent and experience. The sheer appetite for advice (therefore growth in resources to support it) bid up the price of human capital to, arguably, unsustainable levels. Following the GFC however, the market was less restricted as human capital became more available and the pipeline of new entrants through a growing number of tertiary education and institutional academy pathways grew. During this time the debate over industry standards (education, continuing professional development, professional designations, etc.) gained traction.

For both career changers and for school leavers, there needs to be a compelling case for entering a financial planning career. Financial planners in each of the career cycle stages are a critical part of the future of the financial planning industry and will have their unique challenges and opportunities in the move to professionalism. As the regulatory and industry led changes begin to take hold, the impact on human capital management will be pronounced. Increased entry and ongoing education requirements, changes to remuneration structures, technological advances that will influence advice mechanisms and client communication, and changes in the way staff work will all be influential and drivers of change. This highlights the importance of human capital management and the need to attract and retain the 'right' people.

In terms of the survey results regarding demand for new entrants from industry, the results show that demand for new entrants into financial planning is very high with 85.1 per cent of financial planning firms suggesting they would like to recruit financial planners in the next five years and 64.5 per cent of those indicating they would like to grow those numbers through recent graduates of financial planning (or related) degrees. Expectations regarding qualifications for new entrants into financial planning are reported as being mainly bachelor level degree qualified. These results are similar to expectations for qualifications in other studies. Salter *et al.* (2011), for example, found that when US respondents were asked what type of degree was sought when hiring an entry-level graduate, 66 per cent of respondents reported seeking graduates with a financial planning degree, followed by 50 per cent seeking a bachelor's in a business area and 35 per cent for a bachelor's in any area.

Thus, the results of data analysed in this paper show that the financial planning industry is set for continued growth in terms of clients, funds under management and new entrants into the financial planning profession.

However, there is a discrepancy between the 85.1 per cent of firms indicating intentions to grow staff numbers and the 64.5 per cent intending to recruit graduates, which is perhaps an indication of a number of factors:

- That SMEs with a small number of staff may find it difficult to replace a resource gap with a new staff member who may have less experience. The smaller firm may also not have the breadth of resources to absorb the work while training a less experienced staff member, with any impact on immediate resourcing needs therefore impacting on service to clients and pressure on existing staff.
- Churning of experienced staff (including financial planners) between firms.
- Certain roles may require a lower educational standard eg a career CSO.
- Continued intentions of training career changers without degree qualifications as they progress through current education pathways.

This data also suggests a discrepancy between the expectations evident in emerging legislation regarding qualification requirements of new and existing financial planners, and the expectations of financial planning firms regarding growth through newly qualified staff. However, this is likely due to the survey being conducted prior to educational requirements for financial planners being



announced. This is suggested as a subject for further research.

The cycle of turnover due to salaries not matching skill levels in the early stages of career transition may be somewhat tempered by a structured graduate development pathway for financial planning new entrants. However, the transition into the profession for new entrants takes a commitment from educational institutions, new entrants and industry to embrace a development pathway.

Interestingly, of the 54.8 per cent firms who would like to recruit new entrants, overall, 81.8 per cent, indicated that they wanted a structured graduate recruitment and development pathway through the initial years into a financial planning career. A structured approach coordinated, for example, by an independent body, professional associations or education councils in conjunction with employers could assist in this process and standardise the mechanism for all stakeholders. This high level of expectation for a structured graduate pathway bodes well with the recommendations of the FSI report regarding the establishment of an independent body to investigate and establish a structured graduate development pathway, including the possibility of a professional year.

In both industry and academia, there is a need for financial planning practices to work with universities to develop human capital development strategies that will align individual performance with business priorities in the emerging 'new world' of financial advice. This extends to all industry and academic stakeholders cooperating to create efficient and effective new entrant pathways. There is also a need to reposition the industry to allow more effective promotion of financial planning, paraplanning and other roles as a viable, rewarding and professional career pathway in order to attract the best and brightest candidates to universities and industry in order to meet the growth demands articulated by our participants.

The authors argue that the drive to professionalism is one of the most critical elements in attracting and sustaining high calibre new entrants into financial planning. The sustained focus on a pathway to professionalism is expected to attract high calibre cohorts of university entrants, as well as career changers directly into financial planning. The attraction of professionalism is multi-level. For example, students can anticipate more sustainable careers in a profession that has the respect and support of the community from which professionals draw clients. In addition, students can have confidence in the relevance of tertiary program offerings that integrate workplace relevant learning and even ultimately lead to a structured graduate development pathway, particularly as they have precedents to draw on for similar models such as in accounting (Yee *et al.*, 2010; Jackling *et al.*, 2007).

Other stakeholders, however, have argued that the new entry requirements may force some people out of the industry or turn people away, because the requirements have become too onerous and therefore need supportive transition arrangements for both new and existing financial planners (FPA, 2015). Over the longer-term however, the status of a profession is expected to attract more people into a financial planning career and ultimately, more clients into a financial planner's relationship (Hunt *et al.*, 2011).

We also argue that the other factors that will contribute to attracting new entrants include highly

engaging and relevant tertiary programs, as well as smooth transition arrangements into industry, such as through a structured professional year or graduate development pathway.

One critical factor that will be explored in further research, is improving the current prospects for women in a financial planning career. There is still a wide disparity in terms of representation of women in financial planning roles and director level roles and women are over-represented in the lower paid client service officer and paraplanner roles. As financial planning will be under increasing scrutiny in the move to professionalism, gender diversity will need to be improved, not only to gain credibility as a profession, but to build a larger customer base. A great opportunity awaits the industry not only in growing their female customer base, but also in reforming their culture and business models with gender balance, including improving the flexibility and attraction of the profession for all financial planners, which will be the subject of further research.

Another limiting factor in driving diversity is the overuse of 'personal networks' for recruitment, with 29.4 per cent of total multiple responses indicating that they use personal networks to recruit new financial planning staff, followed closely by online recruitment sites (17.5%), direct from university (17.3%) or through a recruitment agency (16.9%). Multiple responses were allowed in the recruitment preferences questions, so a combination of methods was also indicated. Nevertheless, personal networks can be limiting in the scope of cultural and social difference within those networks. In a changing environment focussed on customers, greater diversity in the workplace will assist in growing and reflecting a diverse customer base. Diversity in staffing will not only draw new clients by reflecting a more diverse customer base but also open up new connections for growth.

Optimistically, there is potentially no more exciting a time to enter the financial planning industry with the potential to increase the client base over the current one in five Australians (AFA, 2014). This paper has detailed the expectations of industry in terms of growth to 2019 and prospects for new entrants, including the support given for early career financial planners. This research is important for existing financial planning practices, as well as tertiary education providers, professional associations and other financial planning stakeholders interested in growing the emerging financial planning profession.

### Limitations and future research opportunities

The study utilised a survey method and thus the external validation of the data rests upon the degree to which the sample represents the population. Our sample is biased towards Queensland based businesses (49% of responses) with a small number of observations from the Northern Territory and Australian Capital Territory. In some areas, as noted, the sample size once the data is disaggregated is also small. This tempers the certainty with which we draw some conclusions and readers should keep this mind when interpreting this paper.

These issues raise the prospect of future research to extend this work including in the area of transition arrangements for existing planners, gender diversity and recruitment practices. It is the research team's intention to replicate parts of this study in the future to facilitate both a larger and more diverse sample to be collected and to track trends over time. This, we believe, will add

significantly to the value of the body of work beyond the baseline data as it will allow us all to develop an understanding of what is driving changes in the financial planning environment (for example regulatory changes, technological innovations, market behaviour, business/consumer/investor confidence).

### Conclusion

There are significant opportunities for financial planning firms that are able to adapt quickly to the new professional business ethos and environment, and encourage more Australians to seek financial advice. This report details the results of a financial planning survey with a particular focus on results regarding staff growth intentions of financial planning firms and their expectations for new entrants. The results highlight that the outlook for financial planning as an industry is for continued growth. The research contributes to our understanding of developments in staff planning for new entrants over the short and long-term in the financial planning industry. In addition, this research provides thematic evidence for future planning in terms of human capital management for financial planning firms.

We find our respondents are positive about the future with 85.1 per cent of the sample signalling an intention to grow staff numbers with new entrants (two-thirds with graduates) over the medium term. This signals a generally positive outlook, but also a shift in response to the increasing expectations in terms of new entrant qualifications as the industry moves towards professionalism. We argue that for this future demand to be met, industry and education stakeholders need to continue to build links to promote the financial planning career pathway and to more effectively and systematically manage the recruitment and retention of staff.

The results of this study show that the expectations from industry regarding qualification levels of new entrants are largely in line with current reform recommendations regarding a bachelor degree level qualification, with the majority (64.5%) of respondents indicating that they would like to grow staff numbers with new bachelor-level graduates. In addition, some new recruitment would likely be of existing planners with existing degree qualifications. The report also details overwhelming support for a structured career development pathway or professional year with 81.8 per cent of respondents who intend to grow staff numbers indicating that they wanted a structured graduate recruitment and development pathway through the initial years into a financial planning career.

This research adds to the body of research in financial planning particularly for small- and medium- sized enterprises which have been found to be under-researched, despite the pressing imperatives for evidence-based reform. Not only is this data important from the point of view of setting a comprehensive baseline of where financial planning new entrants are at in terms of career development demand and support, but also presents an opportunity for this baseline to be benchmarked against the optimal career development structure for the new era of professionalism in financial planning.

This paper has also highlighted key challenges for the industry in terms of attracting diverse new entrants. In particular, the gender disparity in financial planning and more senior roles is likely to underplay the compelling case for women entering the profession and will be an area of further

research. The overuse of personal networks for recruiting and managerial discretion for promotion and remuneration bonuses is also an area for change to increase confidence for new entrants of a level playing field.

Overall, this paper has shown that moving into a new phase of financial advice, there are significant opportunities for SME and large financial planning firms to engage new entrants into the emerging profession, as well as new clients who will be encouraged to seek financial advice in a fresh era when financial planners are genuinely trusted. For career changers moving into financial planning, there is also an opportunity for talent to see the pathways available to them and how professionalism may be rewarded.

The data in this paper establishes a benchmark for comparison across the sector and to support informed decision making by practitioners/licensees. Over time this will also provide useful trend data (through successive execution of survey instruments) and expand the body of knowledge in financial advice.

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