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The Strange Case Of The World's Luckiest Investor – Until Disaster Struck- Part 2

In my last column we looked at how a carpenter from Vancouver Island in Canada managed to turn a modest investment of less than C$20,000 into a massive C$416 million over just three years. He did this by trading derivatives, largely in Tesla, and using lots of leverage. Unfortunately his extraordinary run of luck ended when the Tesla share price fell from a high of around US$300 per share in September 2021 to around US$100 12 months later. Subsequent to that disaster the carpenter in question, Mr Christopher DeVocht, sued his financial and tax advisers for "breach of contract and negligence". Part of the case against RBC seems to assert that RBC did not adequately determine their client's risk tolerance levels. This week we will examine some of the problems with risk profiling and in three weeks' time look at the Notice of Civil Claim which sets out Mr DeVocht's case against his financial adviser, RBC Dominion Securities and his tax adviser, Grant Thornton.

Risk profiling is an aspect of the retail financial planning world that I have always had an interest in, not least because some people's professed tolerance for downside volatility seem to change according to how well the stock market has done in the last 18 months. The actual reality is that risk profiles aren't fixed – they are dynamic depending on whether greed or fear is dominating sentiment at that point in time. How dynamic they are varies by individual and that probably won't be apparent to a financial advisor for many years into their relationship with the client. Even after realising that a client has a bipolar investing disorder the chances are that, without dispensing the appropriate medications, the advisor may not be able to influence the client's investment decisions. Discretionary Investment Management could theoretically solve this issue but it comes with a new set of problems: firstly if the client insists on reducing risk and threatens to litigate if "staying the course" turns out badly most risk averse compliance departments will likely recommend the least risky option .Secondly if markets begin a long period of sustained weakness a DIMS adviser might be reluctant to adapt to a changed environment as this means acknowledging that the original investment plan was flawed.

A second, less obvious but equally important issue with risk profiling is that what appears to retail investors as an attractive feature of a financial advisory firm can actually be part of an elaborate charade to provide a halo of legitimacy to what is actually a mercenary sales approach. Probably the best example of how the technique can be used to deceive was the case of one very large and popular financial advisory firm active in the 1980s to 1990s. This firm cynically employed risk profiling as a marketing strategy to allay the fears of the client (that they were being badly advised) rather than genuinely seeking to understand what mix of products was appropriate. In this deception a long series of questions were asked and then everyone got sold those products which paid the highest commission at the time, irrespective of the results of the questionnaire. Today with "the cowboys" long having left the scene and only highly qualified, FMA authorised, financial planners and wealth advisors left risk profiling is still problematic and subject to abuse. However whilst the pursuit of commissions was the problem in the 90s, today the problem is annual recurring fees and specifically the quantum thereof. A few months ago in "What's a reasonable price for financial advice" we saw that the average fee structure of three large players in the NZ retail advisory scene was 1.8% pa. With investment grade bonds yielding around 4.0% and "beating the bank", a popular performance metric for retail investors, there is an obvious "tension" between asset allocation profile and fees. Advisors know that sooner or later even the most naïve trustee will do the maths and realise that 4.2% less 1.8% won't beat the bank.

Therefore, as was the case in the 90s, there remains today a strong financial incentive for advisors to manipulate the risk profiling process so as to advocate equities. A cynical observer would observe that, no matter the outcome of the risk profiling process, "all roads lead to risk", whether it be overweighting equities or choosing junk bonds over investment grade.

So despite the fact that both the compliance department and the client want to get risk profiling right financial advisors need to sell risk. As is usual profitability concerns dominate much of the behaviour in the finance sector and, because it's an imperfect science anyway, many clients end up overweight risk thus explaining why so many people "feel like getting out" when the market goes down a lot.

However as the DV story illustrates risk profiling is risky from a financial advisors perspective. Today, in New Zealand, we now have a regulator who keeps a close eye on behaviour and outcomes and a number of dispute resolution schemes which ostensibly provide a low cost alternative to hiring a lawyer. Financial advisors are compelled by law to pay to belong to a dispute resolution scheme thus the companies enjoying the privilege of a captured market are keen to show the government and the FMA that they are busy helping retail investors so as to keep the good times rolling.

Lastly, actually translating the risk profile questionnaire results into an appropriate portfolio isn't straight forward either: Whilst you might think that a "balanced" 40 bonds, 60 equities portfolio will be less risky than a "growth orientated" asset allocation of 30 bonds, 70 equities that's not always the case. If half the bond exposure of the balanced portfolio is junk, as is typical, and if the equities are individual stocks, as is also typical, the first portfolio might be vastly more volatile than the latter.

If the current market malaise continues expect the risk profiling area to get more publicity and perhaps even the dispute resolution schemes will get genuinely busy.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.