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IS YOUR INVESTMENT PROPOSITION CREATING RISK IN YOUR BUSINESS?

We have written this document as a tool for firms thinking about their investment advice process as part of a review of their client proposition. It seeks to identify some of the core competences needed by advisers who, as part to their client proposition, wish to provide investment advice.

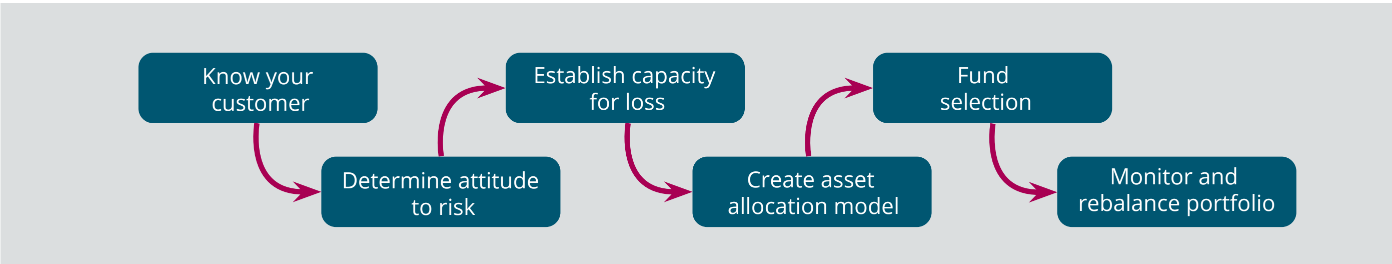
Introduction

To some consumers 'risk' is a horrible four letter word! However, professional financial advisers know that risk goes hand in hand with a much nicer word, 'reward'. To achieve their financial planning goals and objectives many consumers will have to take some degree of investment risk to achieve returns above the low levels they'd get from cash.

As a profession, our key challenge is to ensure that our recommendations, where risk is involved, are suitable and proportionate and most importantly understood by our clients.

The investment advice process, including the value an adviser adds to the client's financial wellbeing has been much debated. Historically though it was focused on the selection of financial products and the underlying investment funds. This is still important, but greater emphasis is expected on the relationship between identified goals and objectives and the recommendations that flow from the adviser. This is the area where we believe advisers can add true tangible value.

The basic functions of the investment advice process



Know your Customer

None of us would try to provide advice to someone where we could not demonstrate that we had a very good understanding of their financial position. We would want to know about their income and expenditure, assets and liabilities. We would also of course want to know what their financial goals and objectives are.

In the context of investment risk, we would also want to gauge a good understanding of their knowledge and experience in investments. That is not to say that someone without experience or knowledge of investment should not invest, but it does place a greater duty on us as advisers to ensure we communicate well with our clients.

Some goals and objectives might imply that the client should take no investment risk with their money.
For example, someone who has capital that will absolutely be employed for a specific purpose (for example, a house purchase in two years time) might be encouraged not to invest at all but keep their capital in an interest-bearing bank account. Even if such a person has a high-risk tolerance, common sense seems to suggest avoiding the potential for falling values.

On the other hand, a client with a low tolerance for risk but with a long-time frame until retirement might be recommended to invest in risk based funds in order to achieve a desired level of post retirement income.

It is all about linking the degree of investment risk to the client's goals and objectives.

Determine attitude to risk

Asking the direct question "What experience do you have of investing?" is a good opener. Don't be fooled though by a negative response, such as "I haven't any experience of investing". Some consumers don't necessarily see their pension pots or ISAs as "investments". They may believe that it's only an investment if we are talking about shares they directly hold.

A risk profiling tool is a good starting point. Different attitude to risk tools give different ratings and **so blunt use of such tools needs to be carefully considered.** Remember, it is just a tool to use as a starting point for the client discussion, rather than a definitive statement of what investment risk a client should take.

The FCA at their Positive Compliance sessions felt that at times there was over reliance on such tools without reference to the specific financial planning needs of the client. From a behavioural science perspective, they noted that clients tend to be overoptimistic about the possibility of future investment returns.

Use of a risk profiler tool can sometimes reinforce this optimistic bias so it is important to make reference to the downside of investing with an equal emphasis to the upside. Being aware of client biases will help the adviser to have deeper conversation with their clients around the subject of risk.

Fund selection

There are of course multiple ways to take the investment advice to the next step. For some advisers, selection of suitable single asset class investment funds to populate the asset allocation model is their chosen method.

Establish capacity for loss

Capacity for loss will flow from the client's goals and objectives. There are some circumstances in our clients' lives where investment loss is of serious concern. Examples, such as inability to retire at a certain point in time perhaps or inability to pay off a debt, spring to mind.

Create an asset allocation model

It is generally accepted that before product and investment funds are recommended attention should be paid to the creation of an asset allocation model. The risk profiling tool will often help with this work.

Having a mixture of cash, fixed-income, equity and commercial property assets is a generally accepted way of providing suitable investment diversification. Marrying this asset allocation model with the attitude to risk of the client then starts to produce a very good audit trail for investment advice compliance purposes.

Other advisers might decide to outsource the fund selection and there two popular ways of doing this;

The adviser might beauty-parade a selection of discretionary fund managers and use their offering to populate the asset class model that has been designed. Close attention to due diligence is needed for this approach and **outsourcing the provision of this service does not absolve the adviser from risk management responsibility.** The FCA is keen that due diligence criteria is focussed around the need of the consumer as much as it is around the need of the adviser.

Some good questions to start with when considering outsourcing to a discretionary fund manager include "What exactly is it we are looking for? and am I confident that the discretionary fund manager understands what my clients want? These client focussed questions will hopefully help us to avoid "shoehorning" our clients into a one size fits all investment proposition.

An alternative might be the selection of a multi-asset class fund where a fund manager makes the asset class selection. This approach might be described as relatively low maintenance, although the adviser will still be required to carry out regular due diligence to ensure the continued suitability of the selected multi-asset class fund. For example, a multi-asset class fund might have one risk profile and our clients will have a varied range of risk profiles, so will the fund be suitable for all of them?

Monitor and rebalance portfolios

An investment left alone long enough may well deliver unexpected, perhaps disappointing results. Client circumstances change over time as well, so a continued monitoring of ongoing suitability is a vital part of the adviser service.

Higher levels of risk can also drift into a portfolio as a result of increases in the value of, for example, equity content within the portfolio. **So, rebalancing becomes an essential part of the risk management process. In an advisory approach this is done by recommendation to the client typically based on the outcome of the review meeting. With discretionary fund managers and multi asset class funds this is more of an automated process with the manager rebalancing all client funds simultaneously.**

This is also an opportunity to continue the relationship with the client and ensure that they remain on track to achieve their financial goals and objectives. It is also part of the continued education process so that clients know and understand every part of their portfolio.

What does the FCA expect from you?

In terms of risk descriptions, the FCA at a recent Positive Compliance session identified a range of unclear or misleading risk descriptions including;

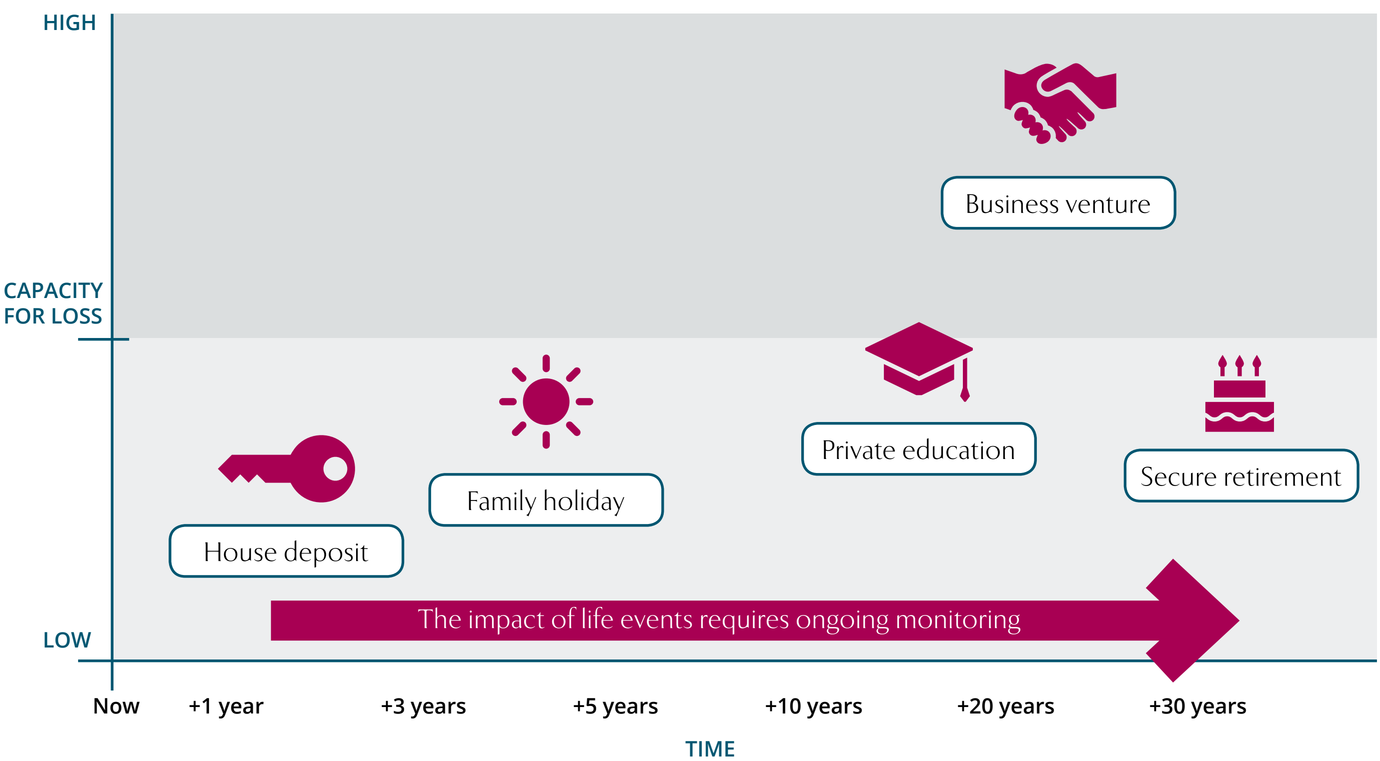
- Use of language that didn't help consumers' understanding of risk
- A failure to quantify risk in a way that a consumer might be expected to understand
- Descriptions of risk that might be inconsistent with a consumer's understanding for example, the word "cautious" might mean something different to consumers and advisers
- Statements that lacked objectivity and were more about emotion
- Asset classes and investment funds that might be named, but without any definitions provided
- The mixing of objectives and risk
- Use of jargon without any consumer explanation of what that meant.

The skills you need and the challenges you face

This section considers the key requirements your practise needs to fulfil to deliver high quality investment advice.

Capacity for Loss vs Client Goals

Take a look at this schematic. Which of the client's goals and objectives in your experience were most likely to require the client to take some degree of investment risk? On the other hand, which life events probably mean the best advice is to avoid risk?

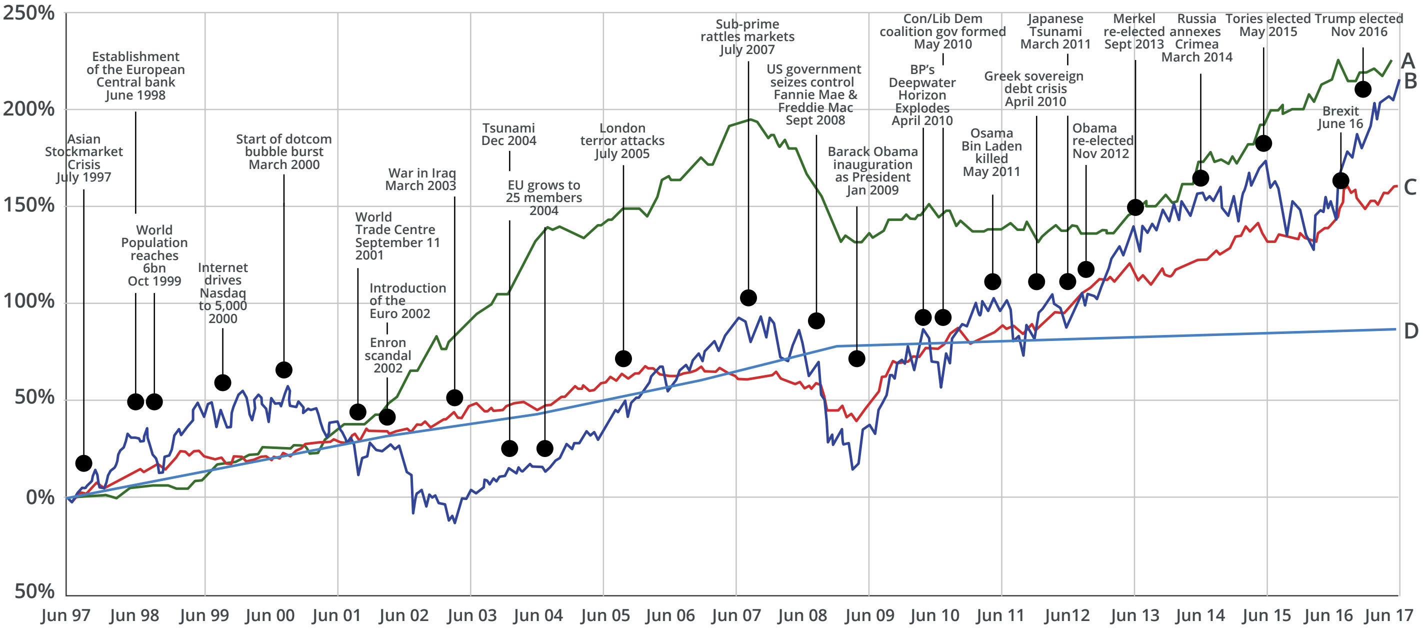


There is a correlation in many instances between short duration and avoidance of risk. Over longer terms investment volatility, for example a sharp fall in the value of the portfolio, the client's financial position can still be recovered so their capacity for loss might be considered greater than that available to investors who have short term known goals.

Of course, this all requires ongoing monitoring to ensure that the client remains on track to achieve those goals and objectives.

Understanding market conditions

How well do you monitor market conditions and understand their impact on clients' investments?



A - Halifax Property(NSA) TR in GB [225.54%]
B - FTSE TR in GB [214.64%]
C - UT Sterling Corporate Bond Retail TR in GB [214.64%]
C - Bank of England Base Rate TR in GB [214.64%]

Source: FE Analytics June 2017

Pricing Spread: Bid-Big • **Data Frequency:** Daily • **Currency:** Pounds Sterling

Who could have predicted that post BREXIT and post Trump the equity markets might have risen so sharply in some cases to historic highs? Some may claim to have been able to predict this but such claims might be treated with real caution.

Trying to time investment markets is fraught with risk. Being out of an equity market for just a few days can often mean missing out on a big chunk of investment gains. The classic investor error of buying at the top of a market and selling at the bottom is often a sign of two forms of human emotion - "greed and fear".

Look at the above chart and you will see that over long periods of time the value of equity investing tends to rise. However, there are periods of time when buying when the market has peaked driven by a degree of greed and then selling when fear kicks in is going to result in real losses. Of course, buying when markets are low and selling when high generates real profits.

This though is difficult to do consistently and few investors can achieve such results. Better to have a suitably diverse portfolio of assets and to invest for the long term.

Asset classes and their correlation

We've already considered the options for creating and implementing your own asset class models. **And this chart demonstrates just how important asset class selection is.** Having the skills in-house to make these decisions and constantly monitor the mix requires a high degree of specialism and expertise.

Over many years different asset classes perform better or worse than other asset classes and diversification has a positive set of virtues.

Positive Correlation / Low Correlation / Negative Correlation	2016			2015			2014			2013		
	Cash/Money Market	Equities	Fixed Interest	Cash/Money Market	Equities	Fixed Interest	Cash/Money Market	Equities	Fixed Interest	Cash/Money Market	Equities	Fixed Interest
Cash/Money Market		-0.07	0.79		-0.31	0.71		0.61	0.22		0.86	0.26
Equities	-0.07		0.07	-0.31		-0.34	0.61		0.46	0.86		0.48
Fixed Interest	0.79	0.07		0.71	-0.34		0.22	0.46		0.26	0.48	

Source: FE Analytics June 2017

Difficulty of picking the right funds

Is there such a thing as the "best" investment fund? Past performance as we all know is not a consistent guide to future good performance. So perhaps a more appropriate word is a "suitable" fund. There are after all many thousands of collective investment funds from which to choose.

Suitability might be determined by comparing the investment fund selected against a chosen benchmark. Different asset classes perform differently during different parts of the economic cycle. So, having a portfolio with a suitable blend of assets (cash, fixed-income, shares and commercial property) and then comparing the performance of those funds against chosen benchmarks helps to ensure that selected funds remain suitable.

Do you build the resource in-house to carry out due diligence, research and constant monitoring of funds, or are you more comfortable outsourcing this to investment specialists?

Investors and advisers want, if they can, to see that their selected funds are performing as they should be expected. Of course, actively managed funds are not always going to outperform their selected benchmark as this will depend upon the skill and discretion employed by the fund manager.

This chart shows how markets are constantly changing, demonstrated by the yearly changes in a range of market indices.

Picking a fund benchmarked against a market index will require a strong understanding of the drivers to that market, as well as constant monitoring.

Name	04/05/2016 to 04/05/2017	04/05/2015 to 04/05/2016	04/05/2014 to 04/05/2015	04/05/2013 to 04/05/2014	04/05/2012 to 04/05/2013	04/05/2011 to 04/05/2012	04/05/2010 to 04/05/2011	04/05/2009 to 04/05/2010	04/05/2008 to 04/05/2009	04/05/2007 to 04/05/2008
Bank Of England Base Rate TR in GB	0.30	0.50	0.50	0.50	0.50	0.50	0.50	0.50	3.21	5.50
FTSE 100 TR in GB	23.34	-9.12	6.13	8.45	19.77	-2.00	14.33	32.39	-28.73	-2.37
Halifax Property(SA) TR in GB	3.56	8.07	10.61	6.83	3.81	-0.44	-4.63	9.01	-17.72	-4.22
LBMA Gold Bullion LBMA Sterling/Troy Ounce in GB	12.74	14.60	1.32	-19.84	-5.78	8.36	19.35	31.67	37.62	25.44
Moneyfacts 90 Days Notice 100K in GB	0.73	0.91	0.92	1.03	1.43	1.50	1.31			
MSCI World TR in GB	31.21	-2.21	20.62	7.22	24.39	-3.36	9.18	28.53	-18.53	-1.50
ONS House Price TR in GB	2.50	8.64	5.30	8.32	1.69	0.55	-1.98	8.13	-14.25	-0.03
S&P 500 in GB	30.60	1.28	25.45	7.52	22.38	4.03	4.88	28.13	-15.34	-5.28
UK Consumer Price TR in GB	2.30	0.30	-0.20	1.83	2.40	3.00	4.48	3.72	2.38	2.94
UT Mixed Investment 40%-85% Shares Retail TR in GB	18.20	-3.87	10.51	4.80	14.09	-2.09	8.74	23.79	-17.94	-3.96
UT UK All Companies Retail TR in GB	21.19	-5.89	7.67	14.20	18.57	-1.42	15.54	27.23	-25.65	-9.16
UT UK Gilts Retail TR in GB	6.80	4.71	8.80	-3.95	4.67	11.67	4.92	3.25	8.83	5.22
UT Asia Pacific Excluding Japan Retail TR in GB	37.46	-12.45	23.00	-6.48	16.20	-5.93	13.29	37.47	-17.10	15.93
UT Europe Excluding UK Retail TR in GB	29.78	-4.39	8.96	15.02	27.06	-16.35	20.28	18.39	-24.76	-3.02
UT Global Bonds Retail TR in GB	7.28	3.11	3.36	-4.87	8.76	2.77	4.18	15.02	6.67	5.42
UT Global Retail TR in GB	28.27	-4.36	16.18	5.75	18.05	-4.24	9.53	27.44	-19.98	-2.02
UT Japan Retail TR in GB	30.20	-2.20	27.98	-8.72	28.73	-4.90	-2.67	25.74	-13.11	-9.02
UT North America Retail TR in GB	31.92	0.16	25.38	9.74	18.15	3.78	5.60	29.39	-12.15	-5.07
UT Property Retail TR in GB	5.02	3.93	12.35	3.42	10.60	-1.22	9.50	22.58	-32.46	-17.92
UT UK Equity Income Retail TR in GB	18.43	-5.04	8.40	14.22	20.33	-0.33	14.91	25.65	-24.12	-12.31
UT UK Gifts Retail TR in GB	6.80	4.71	8.80	-3.95	4.67	11.67	4.92	3.25	8.83	5.22
UT UK Smaller Companies Retail TR in GB	25.27	4.59	2.32	27.53	18.02	-0.70	29.79	33.04	-26.91	-17.73

Pricing Spread: Bid-Bid • **Currency:** Pounds Sterling

key: 1st 100th Percentile

Source: FE Analytics June 2017

Market falls and increased/decreased risk

It can take a very long time indeed for a portfolio to recover from a significant market fall. Depending upon the extent of the fall and the growth rate achieved afterwards, you can see from the chart that in some instances many years are required for the portfolio to return to its original position.

Bear Market Depth

Growth rate	-20%	-30%	-40%	-50%
2%	11y 3m	18y	25y 10m	35y
4%	5y 8m	9y 1m	13y	17y 8m
6%	3y 10m	6y 1m	8y 9m	11y 11m
8%	2y 11m	4y 8m	6y 8m	9y
10%	2y 4m	3y 9m	5y 4m	7y 3m

Source: Sandringham based on FE Analytics June 2017

At the most extreme example if the market fell 50% and the fund grew at 2% per year, it would take 35 years for the portfolio to return to its pre-fall starting point. That may even be beyond the life expectancy of the investor.

Consider how exaggerated this position might be if the portfolio was generating income? It simply might never recover or even be eroded altogether.

Clients with a lower risk tolerance or smaller appetite for risk will have to wait longer for recovery than clients with a greater appetite and tolerance for risk.

At these times clients often ask if they should increase their chosen degree of risk. How do you respond to that? It isn't necessarily the case that increasing risk levels is a solution to achieving shorter recovery periods and we should really go back to basics and investigate whether there has been any change to the client's goals and objectives. If not, why take more risk than the client has to?

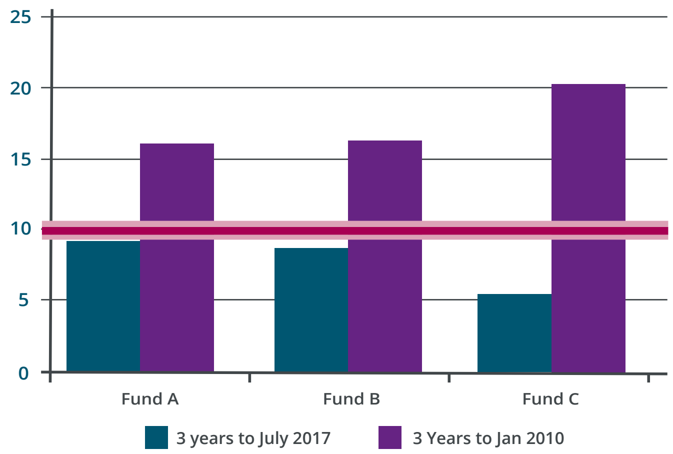
Risk Rating Volatility

Even funds that have similar titles and appear in the same classification sector can have highly variable volatility ratings, so choosing funds that have the same risk ratings doesn't mean they will have similar volatility.

Rebalancing though makes real sense when there has been a market correction. Rebalancing also makes sense when markets have risen, if only to avoid ignoring the increase risk that may have found its way into the investment portfolio through the 'portfolio drift effect'.

Market change is also a good opportunity to reconsider selected funds. Are the selected funds considered as remaining suitable bearing in mind what has happened in that particular market?

Risk Rating - Variability



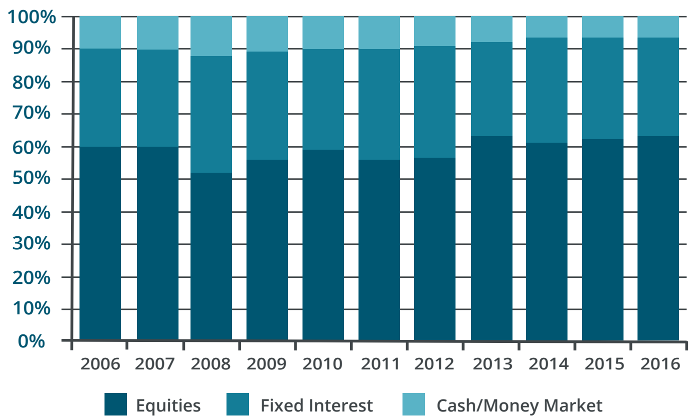
Fund A: Aviva Inv Multimanager 40-85% Shares 1 TR in GB
Fund B: Newton Multi-Asset Balanced B Inc TR in GB
Fund C: Old Mutual Managed A Acc GBP in GB
Enable range for risk rating 6

Source: Sandringham based on FE Analytics June 2017

Rebalancing and monitoring

Left alone long enough and a portfolio, which started out with the right asset mix can pretty quickly turn into something less suitable. A mix of cash, fixed income and equities at the start can shift the risk over time quite significantly.

The next chart shows how a portfolio which started out with 10% cash, 30% fixed interest and 60% equities in 2006, would have moved away from this allocation as a result of market performance. Without rebalancing the portfolio there may have been a shift in the risk return profile the client signed up for.



Source: FE Analytics June 2017

Key points to consider

The issues and challenges raised in this document may lead you to consider your own investment process. In doing so, we recommend you run through the following checklist to help you consider if you are creating risk in your business, and whether you need to re-consider your approach.

- How confident do you feel about the investment asset class model that you create?
- Is your process fully documented and if challenged, could you present a cohesive argument as to the effectiveness of your modelling? (How much you recommend in each of the asset classes).
- If you have outsourced and you are using someone else's models, how well do you know what sits behind those models? Are you up to date and confident that nothing significant has been changed in those models?
- How confident are you, where you create your own models, that you understand the factors that impact on the models?
- Are the assets in your investment asset class models negatively or positively correlated, and do you fully understand the impact of this?
- How do you demonstrate that your research is up to date and considers all of the material facts in determining your investment proposition?
- How do you evidence that your review process is robust and well structured?
- Do you confirm to each client the review service that they will receive in respect of their investment portfolios?
- What tests will you carry out to ensure that your investment models are efficient and that too great or too little risk has not inadvertently crept into the portfolio?
- What research do you carry out in deciding which investment funds to recommend to your clients?
- What benchmarks do you use to check the suitability of the recommended investment funds?
- Does it continue to satisfy the FCA's requirements to be RDR compliant?

How Sandringham can mitigate business risk with a best practice approach

We understand that we cannot predict future investment returns. Instead, we concentrate on getting the basics of investing right. Our solution is designed to remove as much of the uncertainty around investment selection that we still identify in numbers of propositions currently on offer to adviser firms.

To find out more about the investment management solution offer to Sandringham Partners contact;

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