

efficient and effective

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Peter Jordan demonstrates why a structured approach to ISA asset allocation can provide significant benefits, while helping your business meet regulatory requirements.



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Throughout its history the PEP and then ISA market has been heavily influenced by past performance and fund pickers. This is why investment themes emerge from time to time which conspire to create 'fad funds' or sectors that benefit from sales spikes.

Often investors, especially those acting without personalised advice, invest indiscriminately in 'hot' funds without any diversification of investment risk.

While there has always been a strong suspicion that this type of strategy may not have produced satisfactory outcomes, this approach has never been closely scrutinised.

follower of fashion

In order to cast some light on the issue we generated some simulations to demonstrate the type of investment outcomes that may be associated with

parts of this market. Our starting point was to identify the fund that appeared to benefit most from a theme-driven sales spike in each of the last nine years (see table). Even before running any simulation it was clear that there was huge variability in the performance experience of these funds. The 'worst' fund fell by over 60% while the 'best' fund trebled in value. This made us wonder what overall result would have been achieved by progressively investing all of each year's annual ISA subscription in whatever the 'hot' fund was.

Although investing progressively on this basis would increasingly develop diversification, as the portfolio developed it would have delivered a very rough investment ride. This outcome would have varied from a 40% profit to a 50% loss over the period measured (see chart 1).

Year	Fund Name	Sales Rank	Performance
2000	Henderson Global Technology	1st	-62%
2001	Axa Framlington Health	1st	-33%
2002	Fidelity American	3rd	13%
2003	BlackRock Gold & General	5th	217%
2004	Liontrust First Income	2nd	34%
2005	Aberdeen Property Share	3rd	-6%
2006	Norwich Property	3rd	-6%
2007	Norwich Property	2nd	-21%
2008	M&G High Interest	1st	1%

Sales Rank is based on Q1 gross Skandia ISA sales for the relevant year. Source for performance: Financial Express, 1 January of each year to 1 June 2008, bid to bid, with net income reinvested. Past performance is not a guide to future performance.

undesired outcomes

Chart 2 shows how the portfolio would have developed. This provides a strong clue as to why this approach would have delivered such a volatile outcome. Although the profile depicts a diversification of sorts, this has taken time to evolve and has occurred by accident rather than design. While many of these 'DIY' investors would have been encouraged to shun personalised and structured advice in favour of receiving a 'discount' deal it should be clear that advising clients on this basis is a non-starter if advice is now required to deliver the FSA's Treating Customers Fairly (TCF) outcomes. Outcomes 4 and 5 are particularly relevant in this context:

4. Where consumers receive advice, the advice is suitable and takes account of their circumstances.

5. Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

As the theme-driven approach leads to the possibility of unsatisfactory TCF outcomes it represents a significant but avoidable risk for advisers. An objective and risk-matched approach to portfolio construction will produce more effective diversification and performance aligned with each investor's expectations. By using Skandia's current risk-based asset allocations as a proxy for a structured asset allocation approach and making a number of assumptions it is possible to produce a conceptual comparison with the 'themed' fund approach.

meeting expectations

We assumed each asset class performs in line with the relevant IMA sector average. As a consequence of this assumption it was not sensible to re-balance the portfolio as there would be no basis for identifying any associated switch costs. We assumed the same profile of subscriptions as in the first simulation for the 'themed' approach.

chart 1 – performance of themed ISA portfolio*

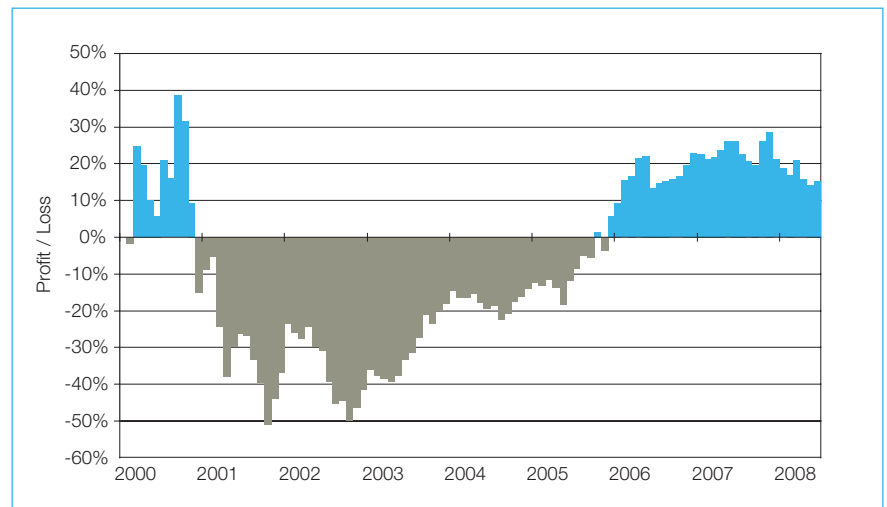


chart 2 – themed ISA fund exposure*

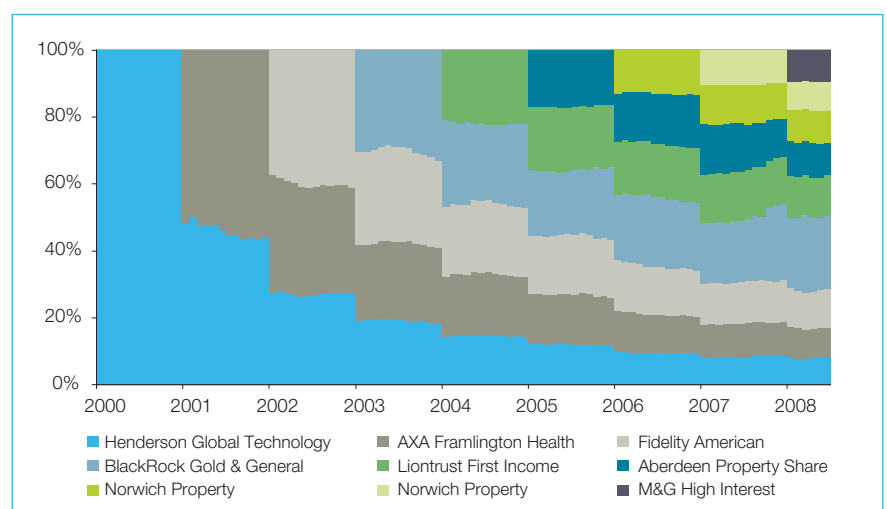


chart 3 – risk vs return – risk based vs themed

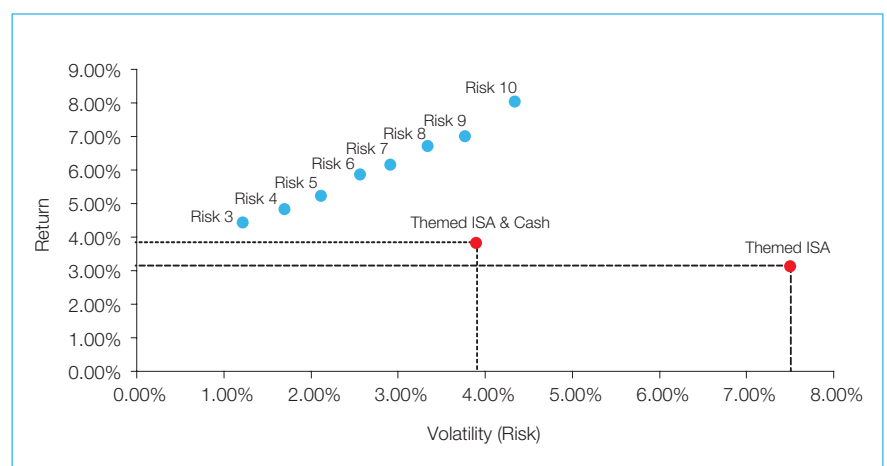
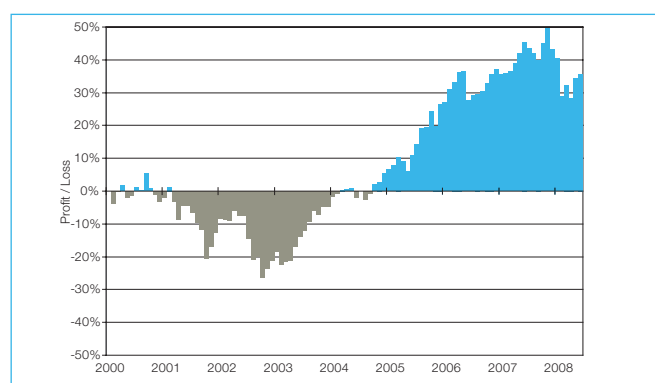


chart 4 – performance of risk level 8 ISA portfolio



Past performance is not a guide to the future.

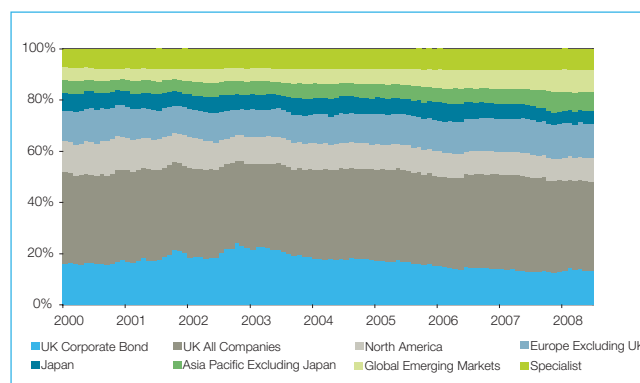
Chart 3 plots the risk and return outcomes for all of the simulations. This confirms how effectively a 'structured' approach might manage risk and return relative to the unstructured 'themed' approach. A further key benefit is that the 'structured' approach has effectively differentiated between clients and provides a basis for making sure that advice is matched to circumstances. In the era of TCF it is this consistency that is the real winner for advisers.

To provide further detail we compared a Skandia Risk 8 category with the 'themed' approach (as less than 2% of investors rate more highly than Risk 8). The outcomes shown in charts 4 and 5 should be contrasted with charts 2 and 3. This shows that even though Risk 8 has a strong equity flavour the downside risk has been managed without compromising the potential for additional returns. This has been achieved without allowing for re-balancing which would be expected to improve the outcome over this timescale.

cash plus?

A historic characteristic of the transactional ISA segment is that investors have typically subscribed to the cash component within their annual ISA allowance. Although chart 3 shows that this would have improved the outcome, it is sobering to reflect that the risk outcome was the same but returned approximately half as much as the Risk 9 portfolio. Furthermore, it would also have underperformed the Risk 3 portfolio even though it incurred roughly three times as much risk.

chart 5 – Skandia risk level 8 – fund exposure*



summary

Overall it is clear that a disciplined and well-defined approach to asset allocation can produce positive outcomes that will help to reduce the risks associated with providing investment advice. Portfolios that perform in line with expectations will minimise unwelcome surprises and the anxiety associated with this during periods of extreme volatility – which should help build more stable client relationships.

Although the 'structured' approach can produce spectacular results it is important to appreciate that this is underpinned by sector average performance. The key message to take from this is that the focus should be on avoiding sub-average performance rather than hunting top performing funds, ensuring asset classes are diversified sufficiently to minimise this possibility.

While Skandia's market-leading range of investment tools supports advisers who wish to pick funds and monitor portfolios, the time, effort and risk associated with this role is unattractive for some advisers. This is why the Skandia Spectrum Funds, which achieve broad diversification without the transactional complexity associated with a large number of funds within a single fund, are proving such an attractive proposition. •

For further details about adopting Skandia's risk-based approach to investment, please speak to your Skandia consultant or regional office.

skandia risk profiler

To use Skandia's risk-based approach, client expectations must be ascertained via our ten question 'Risk Profiler'. The resulting score from 1-10 determines the asset allocation for the portfolio.

Skandia Risk Profile questionnaires are available online through Selestia Investment Solutions, SkandiaWrap or at the literature library on the Adviser Extranet.

Risk portfolios 1 and 2 are not available for ISA investment due to the high proportion of these portfolios invested in cash and fixed interest.



*Source data:
Themed portfolio assumes an equal investment in January of each year. Performance is bid-bid gross total return to 1 January 2000 - 1 June 2008. Funds invested are as follows: 2000 – Henderson Global Technology, 2001 – AXA Framlington Health, 2002 – Fidelity American, 2003 – Merrill Lynch Gold & General, 2004 – Liontrust First Income, 2005 – Aberdeen Property share, 2006 – Norwich Property, 2007 – Norwich Property, 2008 – M&G High Interest.

Risk based portfolio assumes asset allocation as shown below. Asset performance assumes IMA sector performance on a bid-bid gross total return basis to 1 January 2000 - 1 June 2008 using the sector indicated. Property performance is based on Finex UK property index.

Risk/return charts are based on annualised volatility of the investment holdings during the period and compound annual growth rates.

Past performance is not a guide to future performance.

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