hitting the target

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Peter Jordan explains why the need to accurately match investment advice to a client's attitude to risk is driving opportunities to consolidate client assets.

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Matching investments to a client's attitude to risk is perhaps the most difficult yet most important aspect of financial advice. This is why the requirement to do so forms a significant part of the TCF outcomes and has featured in many of the FSA's guidance and consultative documents concerning the RDR, fund platforms and consolidation activities.

While this regulatory focus raises the stakes for investment advice, it is also the single most important reason for consolidating existing assets. Some simple analysis of various markets clearly demonstrates that the types of investment fund that have dominated the UK market are unlikely to have delivered an outcome that is matched to an investor's attitude to risk, unless the definitions of risk are so wide and subjective to be of little value.

If we cast our minds back only a few years, an investor would probably have been subjectively assessed and labelled as 'cautious', 'balanced' or 'aggressive' in terms of their attitude to risk and invested in funds falling into those categories. However, overlay modern risk assessment and analysis techniques and it soon becomes clear that this approach can be high risk in terms of meeting customers' perceived expectations from their investment.

finding the right balance

We conducted research into managed funds, including a detailed analysis of risk within the balanced managed sector. Using three-year volatility and performance figures we were surprised to see just how much the risk levels of balanced managed funds varied across the market.

> **Is the investment recommendation suitable given the customer's attitude to risk and personal circumstances?**
>
> Question 3.3 - FSA Pension Switching Advice Suitability Assessment Template.

In the scatter graph we have analysed the risk ratings of 489 balanced managed life funds using data from Financial Express. Using the Skandia risk scale of 1-10, it would not be unusual to assume that a balanced fund would be expected to have a risk rating close to 5. Our research showed that only 23 funds (5%) within the balanced managed life fund sector matched this level of risk. The average rating was 7, with an uncomfortably wide range of outcomes spanning the sector. Similar outcomes were also observed within the pension and UT/OEIC balanced fund universes.

consolidation opportunity

These outcomes suggest that there are compelling reasons for clients to consolidate. A simple assessment of a client's attitude to risk followed by a risk assessment of their existing investments will typically establish that consolidation can deliver some clear benefits linked to the requirement to treat customers fairly.

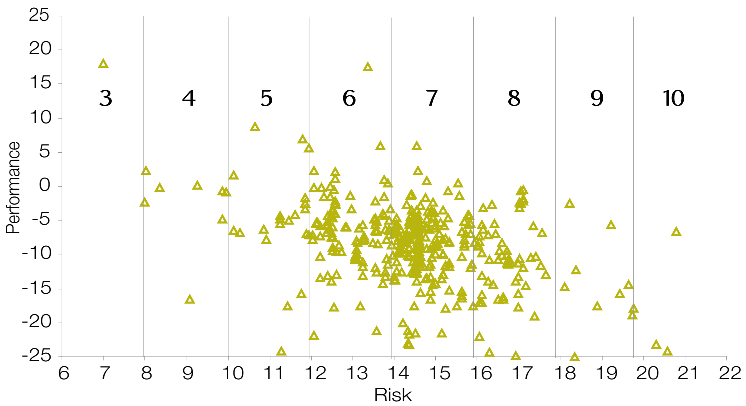
While consolidated reporting and the prospect of extra returns have historically been the drivers for consolidations, this opportunity moves consolidations into different territory. Instead the objective will be to provide risk matched investment advice which is reviewed on an ongoing basis throughout the life of an investment to deliver an investment experience which is in line with the investor's expectations. This means that while the investment may deliver additional investment returns, this need not be at the expense of incurring additional risks that are not in line with the investor's attitude to risk.

delivering as expected

The Spectrum range of funds is designed to achieve exactly this but it is only possible because the risk rating system objectively defines each risk rating so that the fund manager can manage each fund to achieve the required outcome. Irrespective of whether you recommend Spectrum funds or decide to run portfolios on behalf of customers it is essential to ensure that the investment outcomes meet client expectations as defined by the risk rating process if this is the main reason for consolidating.

This level of investment advice, whether achieved through risk-rated funds like Spectrum or through portfolio management, means clients will typically incur additional costs as a result of the consolidation exercise and ongoing advice and service. It is therefore crucial that any cost increases are identified and highlighted so that clients can evaluate this against the benefits of the additional services they will receive.

wide of the mark? Balanced Managed Life Funds



Source: Financial Express 1 October 2009. Three-year cumulative performance vs three-year annualised volatility – life balanced managed sector. Past performance is not a guide to future performance.

additional cost

If cost is an issue, and this is likely with some clients, then it may be important to develop risk-rated portfolios populated with low-cost passive funds to cater for the needs of this customer segment. Although the precise effect will depend on the individual funds chosen, it is reasonable to assume that costs can be reduced by 0.50% per annum by using passive funds available on the Skandia Investment Solutions platform. In many cases this will certainly overcome a large part of any cost differential.

However, sacrificing risk-based advice and chasing returns to overcome cost concerns will increase the risk of making the same mistakes highlighted in our analysis. Achieving greater returns without additional risk is exceptionally difficult to accomplish and so pursuing extra returns will nearly always lead to higher levels of investment and compliance risk given recent regulatory comments.

The consolidation of customer assets represents a huge business opportunity as the Retail Distribution Implementation Plan takes shape, and the size of the opportunity means there will be an intense focus on how this process is managed. It has, therefore, never been more important to design and adhere to a process that clearly highlights the cost and benefits of consolidation in terms of outcomes that live up to client expectations.

Supporting this is a key focus for Skandia and an area in which we hope to add even greater value over the coming months as we continue to develop our market-leading tools and specialist support teams.

To find out more about how Skandia can support your consolidation processes and lessen risk within your investment processes, please speak with your Skandia consultant.