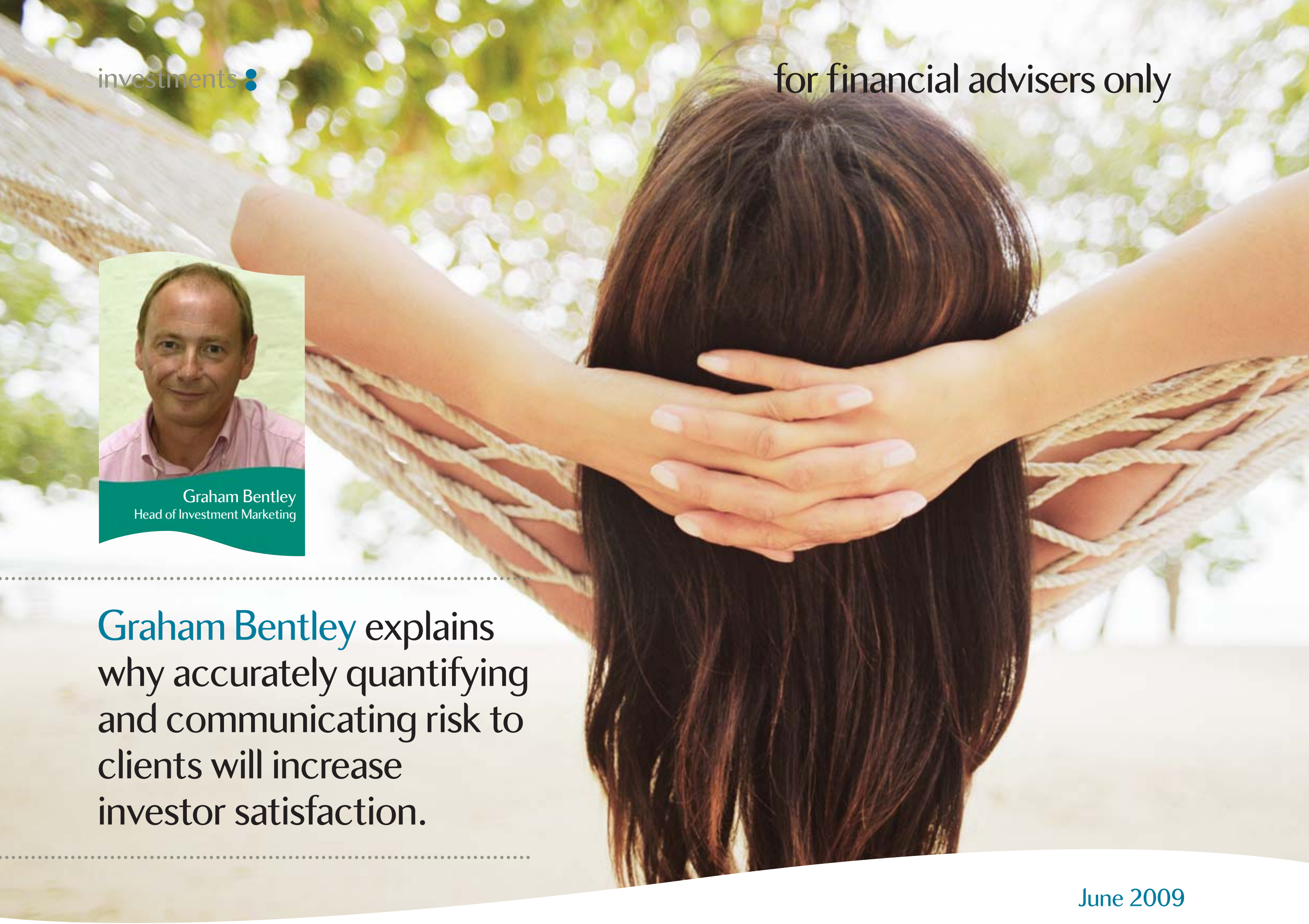
for financial advisers only



Graham Bentley
Head of Investment Marketing

Graham Bentley explains why accurately quantifying and communicating risk to clients will increase investor satisfaction.

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sitting pretty

My wife recently persuaded me to invest in a pair of chickens. Live ones. The idea was they would provide my two-year-old son with an insight into caring for animals. We already have a cat, but considering the feline only comes back to the house to feed and to check her mail, she wasn't deemed to be a suitable example of life in the wild.

Reflecting on the threat to my border perennials from these featherbrains, I was anxious to ensure the birds were suitably domesticated. The chap who delivered them assured me that a simple shake of a plastic cup containing dried maize every time we were about to feed them would quickly establish a signal – after a week that sound would be sufficient to bring them running from wherever in the garden they happened to be rooting. True enough it worked; they had learned through what psychologists term reinforcement learning.

The shake of the cup becomes the signal for a treat, which is reinforced every time they hear the shake; thus an association between a behaviour and a consequence is formed. From a psychologist's point of view, there are four possible consequences to any behaviour:

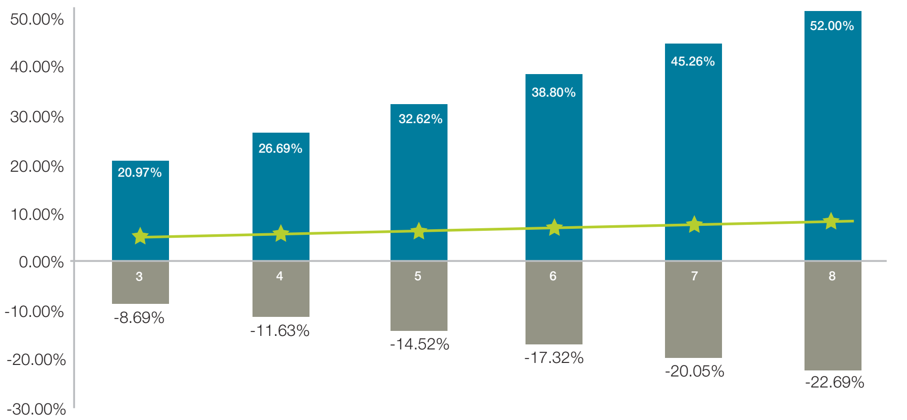
1. Something good can be offered.
2. Something good can be withdrawn.
3. Something bad can be offered.
4. Something bad can be withdrawn.

In this somewhat simplistic world (if I were so inclined), I could introduce a signal associated with a punishment, were the chickens to peck at my petunias – gunfire, for example. Now as with animals, humans learn to choose responses associated with producing favorable outcomes (1 and 4) and avoiding unpleasant ones (2 and 3). The theory predicts that behaviour which avoids negative outcomes should rapidly disappear in the absence of explicit reinforcement; in fact studies show that once an animal manages to avoid punishment – it will continue to perform the avoidance response even when it never experiences negative feedback again.

achieving goals

In a 2005 study*, researchers scanned the brains of humans performing a simple task, focusing on an area of the brain called the medial orbitofrontal cortex, that has been linked to reward-related stimuli, particularly when the reward involves money. The results showed that as far as brain activity is concerned, avoiding negative outcomes and receiving rewards amount to the same thing for the brain: achieving a goal. Reward serves as an external signal that reinforces behaviour associated with a positive

spectrum funds – the potential returns



Source: Skandia Investment Management Limited (SIML). Figures based on three-month LIBOR (London Interbank Offered Rate) as at 18 June 2009 and show the implied volatility and mean expected return figures of Spectrum funds 3 to 8 to two standard deviations (ie all returns are expected to be between these extremes in 95 years out of 100, this is often described as a 95% confidence level). Figures are shown net of tax, underlying manager fees and SIML AMC. The figures shown are the expected arithmetic average returns and the ranges assume that returns are based on a log normal distribution. Research by SIML has shown that Spectrum risk levels 3 to 8 encompass approximately 95% of investors' portfolios.

outcome, while punishment amounts to an intrinsic reward signal that reinforces actions linked to avoiding bad outcomes. In other words the presentation of 'something good' (eg long-term positive investment returns) alongside presenting 'something bad' (eg potential losses) makes it extraordinarily difficult for a prospective client to make an investment decision. The client will feel more comfortable with something bad being taken away.

A reaction to this client behaviour is alluded to in the recent annual review for 2008/09 from the Financial Ombudsman Service (FOS)**. Consumer complaints about investments almost doubled in the past year, according to the review. After allowing for an expected rise in complaints that are purely about investment performance, which the FOS has the discretion to 'dismiss', the report claims that difficult stock markets can expose poor advice and sales – for example, where consumers who were willing to accept only a low risk to their capital ultimately find they have actually invested in a higher-risk product. In these circumstances, says the FOS:

"We have to look carefully at the circumstance of each sale, to ensure that the product was suitable for the consumer at the time the investment was made...we examine 'suitability letters' or reports issued at the time of the sale, to see how clearly any risks were drawn to their attention. If we decide that warnings were inadequate – and that the product appears to be of a higher risk than the consumer was willing to accept – we may conclude that the sale was unsuitable."

Furthermore, the review has underlined the importance the regulators place on how clients' risk tolerance is assessed, ie the potential for losses and the likely consequences regarding their long-term expectations:

"An investor may have been identified as willing to accept a medium degree of risk, in the hope of a medium degree of growth. But in the complaints we have seen this year, advisers have not always considered the consumer's ability, or willingness, to absorb a corresponding decline in values."

client satisfaction

As we discussed earlier, it is difficult to present loss and gain in the same sentence so as to receive a cogent response from a potential investor. Where incentives to a salesperson are directly linked to the investment being promoted, it is difficult not to play down the 'something bad' and underline the 'something good'. However, this is not the issue for a professional financial adviser whose earnings relate to time, and ultimately to client satisfaction. Whatever risk-profiling tool you use, you still need to quantify the risk in something other than subjective terms; words like 'Balanced' or 'Cautious' are at best naïve and at worst dangerous, to both your client and your business.

How do you inform the investor of the likely gain and loss associated with a particular fund or asset allocated portfolio? Just what does 'Risk level X' actually mean? Investment returns can be expressed in terms of their variability over time – probabilities of loss and gain. This information is readily available given sufficient data and is known as Value at Risk. Returns can be expressed as extremes of potential gain and loss, to a prescribed degree of confidence (usually 95% or 99%). This can be illustrated via a simple chart, as used to support the Skandia Spectrum solution – see above.

Most importantly, when clients see that potential downside they may decide that possibility, however remote, carries such a potential impact (eg failing to meet school fees payments) that they sensibly look to a lower risk option – one that carries less potential distress, despite the lower potential returns that they might experience on the associated upside. This requires reference to the goals the client has expressed on their fact find – how would they feel if those goals were not achieved? Recording this process produces a clear audit trail of the decision-making process.

Discussing a potential loss should not be avoided. As Sam Walton, Co-Founder of Wal-Mart, describes, clients are the advisers' life blood:

"There's only one boss – the customer. And he can fire everyone in the company from the Chairman down, by spending his money somewhere else."

Be straightforward and transparent – the client will be more comfortable, and will ultimately thank you for it by staying loyal and recommending new investors to your business.

Don't be chicken when it comes to talking about risk!

For more information on risk measures, please contact your Skandia consultant, regional office or e-mail Graham Bentley at **graham.bentley@skandia.co.uk**

* Source: Public Library of Science – May 2006: Is Avoiding an Aversive Outcome Rewarding? Neural Substrates of Avoidance Learning in the Human Brain – Hackjin Kim[1], Shinsuke Shimojo[2] and John P O'Doherty[1]
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[2] Division of Biology, California Institute of Technology, Pasadena, California, United States of America.
** Financial Ombudsman Service – Annual Review 2008/09.