taking a holistic view

August 2008

Peter Jordan examines the effect cash has on the overall risk/return measures within a client's ISA portfolio.

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In the 2006 Pre-Budget Report, changes to ISA regulations were announced that would allow the cash component to be transferred into the stocks and shares component, which subsequently became effective from 6 April 2008. Following this announcement there was great expectation that significant amounts would move across into the stocks and shares component, particularly given the potential £40,000 that could be held in cash ISA products by clients who had regularly used their full cash allowance together with previous TESSA allowances.

However, four months after the rule change the majority of investors appear to be holding back on such transfers. This will be due to a number of factors but the recent market downturn is likely to be a major cause for hesitation, especially given the fact that transferring cash is a one-way street – you cannot transfer back to cash.

Of course, the decision whether or not to transfer a proportion away from cash depends on the circumstances of the individual. But it is vitally important to assess the balance of cash in the context of the ISA portfolio as a whole – and to ensure the entire portfolio continues to act in line with the client's expectations.

reducing volatility

When constructing portfolios, asset classes with a low volatility can have a dramatic effect on the overall portfolio volatility. Cash and fixed interest enjoy much lower volatility than most equities, and when included in a portfolio alongside equities can reduce volatility significantly.

In figure 1 we have looked at the amount of cash held in conjunction with an existing portfolio that fits within the Risk 5 volatility boundaries. The chart demonstrates how the overall risk level decreases as the level of cash increases. With just 8% of the overall portfolio held in cash the risk level drops from a Risk 5 to a Risk 4. It then drops into a Risk 3 when the overall portfolio has 25% held in cash, and to a Risk 2 when the cash level gets to 46%.

quantifying risk

Skandia's client risk profiler asks clients a series of questions to quantify the level of risk they are most comfortable with. The output is a risk 'score' from 1-10, with 1 being the most risk averse and 10 the most risk tolerant. Each level of risk reflects to a volatility range as shown in the table:

Risk Category	1	2	3	4	5	6	7	8	9	10
Lower	0.00%	3.25%	5.75%	7.82%	9.46%	11.11%	12.75%	14.39%	16.03%	17.68%
Mid	2.00%	4.50%	7.00%	8.64%	10.29%	11.93%	13.57%	15.21%	16.86%	18.50%
Upper	3.24%	5.74%	7.81%	9.45%	11.10%	12.74%	14.38%	16.02%	17.67%	-

Volatility is used by many, including Skandia, to determine risk and is the mathematical calculation of standard deviation. Volatility is the most common method of describing risk, and is measured by calculating the annualised standard deviation of monthly returns. Standard deviation measures the range of movement in a set of data away from the average. As the range of movement around the average increases, so does the standard deviation and therefore the risk. A different way to look at it is as a measure of uncertainty. It is not designed to determine the direction of movement, only the magnitude.

risk adjustment

Taking a holistic view of a client's assets can dramatically change the risk level you adopt within each proportion of a portfolio of products. Take for example a Skandia Risk 5 rated client investing into ISAs. If since the advent of ISAs they had fully invested into both components as they had then stood (ie mini cash and mini stocks and shares), their Skandia Risk 5 stocks and shares component would have grown to just over £45,000, while their cash component would have grown to over £33,000.*

The proportion in cash represents 42% of the overall portfolio, which collectively performs at a risk level very close to the bottom end of a Risk 3. Assuming they are comfortable with the risk level 5 they had been rated at, this represents an overall underperformance against that accepted level of risk. To have achieved an overall performance in line with risk level 5, their equity component could have afforded an increase in risk level to a 10 to counterbalance the cash component's low volatility.

Figure 2 shows how the proportion of cash held can affect a portfolio's overall level of risk. For example, if the cash in the previous example was 25%, the risk level of the stocks and shares portfolio would need to be increased to a Risk 7 to match client expectations of Risk 5 overall.

This scenario may seem a little extreme and something that many would be uncomfortable advising. However, the change in regulation allowing transfer from cash to stocks and shares ISAs has made possible a more moderate alternative solution of reducing the proportion held in cash while taking on only a slightly higher level of equity risk.

meeting expectations

Clearly cash holdings, as with other asset types, have a significant impact on the overall portfolio. Taking a holistic view, particularly regarding the split between the cash and stocks and shares components of ISA holdings, may reveal that a client's overall investments are at odds with their risk appetite. If neglected, it could result in a client's assets failing to reach their full potential.

The central point to remember is that volatility is driven by performance, be that positive or negative. It is important to review your clients' portfolios to ensure that funds are performing as expected and remain within their risk expectations. Skandia's online investment tools provide you with the ability to do this at the touch of a button.

figure 1 – rising cash level reducing volatility

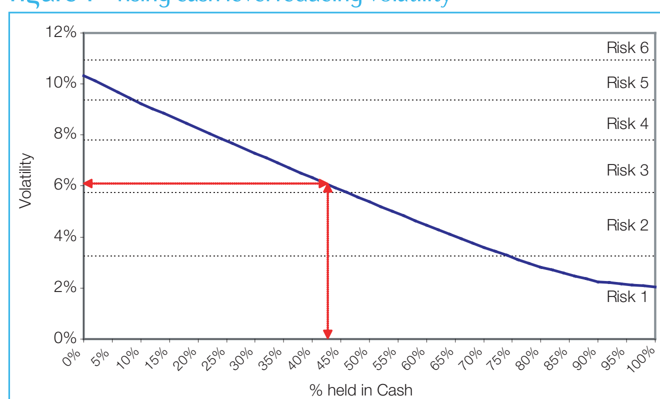

Figure 1 – assumes Risk 5 mid range volatility, 10.29%. Cash Volatility data is provided by Watson Wyatt.

figure 2 – increasing risk to account for cash

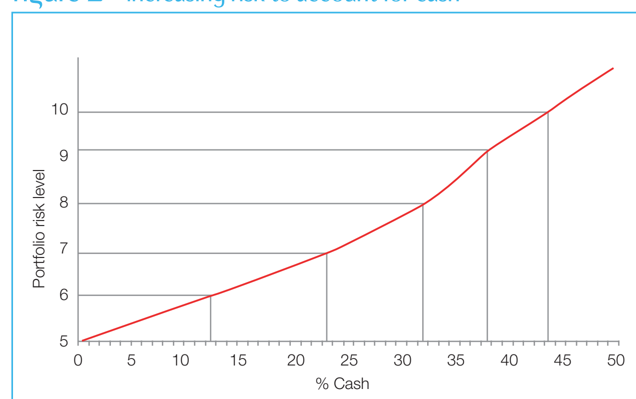

Figure 2 – assumes mid range volatility for each risk level as per above table combined with cash to achieve an overall Risk 5 mid range volatility of 10.29%. Cash volatility data is provided by Watson Wyatt.

* Risk 5 portfolio assumes £4,000 invested annually, Selestia Risk 5 asset allocation model (48% UK fixed Interest, 18% UK Equity, 9% North American, 9% Europe, 5% Japan, 3% Far East ex Japan, 3% Emerging Markets, 5% Global Specialist). Performance is based on the IMA sector performance on a bid-bid gross total return basis from 1 January 2000 - 1 June 2008. Cash returns assume £3,000 invested annually and performance in line with Bank Of England 'End month average interest rates, cash ISA account – Building Societies' (IUMWSIS).

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