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tales of the unexpected?

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In order to fully meet client expectations – and those of the regulator – it is crucial that client risk assessment and ongoing portfolio management is robust, clearly audited and easily understood. Peter Jordan gives details.

The recent guidance issued by the FSA concerning their review of pension switching has provided considerable clarity for advisers using platforms to consolidate pensions and other assets. While circumstances will vary, there appear to be three major overriding messages:

- any additional costs must be clearly explained and justified;
- investment advice at the point of sale and over time must accurately reflect a client's attitude to risk; and
- regular reviews must take place to check attitude to risk, portfolio structure and performance and rebalancing needs.

The guidance on attitude to risk (ATR) is a strong reminder that the requirement to meet the expectations of the consumer and the regulator has important consequences for investment advice. Treating Customers Fairly Outcomes 4 and 5 are clear in that advice needs to be suitable, take account of a customer's circumstances and that any resultant investment needs to perform as customers have been led to expect.

In the past there has been limited guidance, resulting in relatively straightforward processes which may do little more than assess an individual's ATR as 'cautious', 'balanced' or 'aggressive' – and then direct them to a fund or portfolio that 'matches' that requirement. Clearly, the online functionality available through platforms has enabled advisers to build a comprehensive investment process more quickly and efficiently. While some adviser firms have chosen not to utilise the tools available through platforms, instead providing their own solutions, the FSA guidance on pension transfers makes it clear that this does not avoid the need to assess risk and effectively match investments to different risk profiles.

Attitude to risk

3.5 Advisers must assess the customer's attitude to risk (ATR) and personal circumstances and recommend funds that are suitable. In 40% of unsuitable cases the fund(s) recommended were not suitable for the customer's ATR and personal circumstances. In 22 cases this was because the fund(s) recommended were too high risk. In two cases the fund(s) recommended were too cautious. The reasons for the advice being unsuitable included cases where the adviser had taken insufficient account of:

- the nature and overall risk level of the investment(s) recommended;
- the impact the term of the policy has on the choice of funds. For example, in some cases there was little understanding that a fund that is suitable over a term of ten years is unlikely to be suitable for a term of three years for a customer with the same ATR;
- the customer's investment knowledge and experience; and
- the benefits of diversification – sometimes the adviser did not appear to appreciate that investing in a single area or asset class (for example, property) is more risky as the customer has 'all their eggs in one basket'.

Ongoing investment advice

3.6 Where an 'asset allocation' approach[17] has been recommended, the scheme needs to be reviewed periodically and rebalanced where necessary, to ensure it continues to be suitable. Otherwise, a portfolio made up of individual funds to meet a certain asset allocation will become unbalanced over time and this may mean the solution no longer meets the customer's attitude to risk and personal circumstances. The same risk applies when funds with different risk profiles are used. In order to be suitable in these cases, the adviser has to explain the importance of such reviews, or offer them, or put them in place. In 26% of unsuitable files, none of these had been done.

Source: FSA, Quality of advice on pensions switching, December 2008.

Any process, whether in-house or provided by a third party, should provide satisfactory answers to the following questions:

- Does the method for assessing risk follow an objective, consistent and repeatable process?
- Does it accurately discriminate between different customers?
- How is the recommended asset allocation determined?
- Are any underlying assumptions realistic and how often are they reviewed?
- Are the risk and return targets quantified for each risk category?
- Do the asset allocation and the underlying fund choice match the customer's ATR and investment expectations?
- Will it be possible to demonstrate that the advice was and has remained suitable at any point in time?

pension transfer guidance – key points

FSA
Financial Services Authority
Using the FSA's pension-switching advice suitability assessment template

- Full and accurate cost comparison
- Consider less expensive alternatives
- Match investments to attitude to risk
- Show how extra costs are overcome without compromising attitude to risk
- Regular reviews

risky business

Ensuring that the underlying funds match a customer's ATR is possibly the most challenging aspect of risk assessment and portfolio management. Furthermore, unless the attitude to risk is quantified objectively it will not be possible to determine and monitor whether the underlying funds meet the customer's ATR over time.

The infrastructure and tools that Skandia's Investment Solutions platform provides ensures advisers have an effective basis for consistently executing this requirement. The foundation for this is that part of the asset allocation process defines control ranges for investment volatility and fund beta which match the customer's ATR at point of sale and over time.

At point of sale there is functionality to make sure that the funds selected do not compromise the asset allocation required to match the ATR and the system evaluates the three year historic beta of funds to ensure that the portfolio beta is within the control range. Subsequently, the portfolio is evaluated based on historic three year volatility and beta to ensure that it continues to perform within the control ranges. Where there is a mismatch the system provides a rebalancing option to realign the portfolio.

a question of risk

While there are a wide range of approaches to portfolio construction, the ability to accurately assess risk so it can be mapped to the investments is crucial. Unless attitude to risk is quantified (something many alternative approaches will not do) it is virtually impossible to accurately match to the investments – it would be equivalent to attempting to measure body temperature without the use of an accurate thermometer! If, for example, a client was risk-assessed without objectively defining the ATR and was invested in a discretionary managed fund then it may not be possible to ensure the fund accurately matches the client's ATR at outset and over time. This process becomes more complicated if the fund does not define its risk benchmarks and does not report against them over time. Similar issues arise if an adviser outsources portfolio construction and management to a third party without adequately defining the risk categories.

Where investing in discretionary funds (including adviser-run OEICs) a further complication arises because a narrow range of risk categories and matching funds are operated. Often this decision is taken to ensure fund viability and control administrative costs rather than because it is the right approach for clients. This could dilute the quality of risk assessment and investment advice because investors with significantly different ATR characteristics could be accommodated within the same fund.

In many respects the 'peace of mind' of outsourcing fund management may not be justified without consideration of ATR. There are no easy options as advisers that outsource must gain as much understanding of ATR and underlying discretionary portfolios as those who don't outsource. Whichever route is followed the responsibility and therefore the risk of matching a portfolio to a customer's ATR will always lie with the adviser and not the discretionary fund manager.

Overall it is clear that any effective process requires considerable attention and expertise. This is why the Skandia Spectrum range has been so successful. The funds allow advisers to efficiently match investments to a client's risk profile with a clear audit trail. Moreover they are continually rebalanced to ensure the asset allocations maintain their risk-return characteristics within a changing economic environment.

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Calls may be monitored and recorded for training purposes and to avoid misunderstandings.

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