ADVISER BUSINESS MODELS
WHAT LIES BENEATH?

FE'S 2018 REPORT
INTO FINANCIAL ADVICE
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INTRODUCTION

SINCE OUR LAST REPORT WAS PUBLISHED the financial advisory industry has gone from strength to strength, with demand for advice increasing and markets performing well. But at the same time, the burden for advisers of running their business has also grown as new regulatory requirements have been introduced.

This has driven a trend amongst some firms towards increasingly outsourcing or 'insourcing' parts of their investment process to aid efficiencies. While much of this outsourcing or insourcing is designed to mitigate risk, it also introduces another layer of risk – the risk that the solution adopted by the firm does not always do what it says it will, or that it is not woven into the adviser's process in a way that produces the right outcome.

Risk has never been such a big issue for financial advisers. Not only do today's financial advisers need to correctly assess clients' attitude to risk and map it across to suitable portfolios – they also need to become risk management experts ensuring their firm is run in a way that accords with the regulator's requirements. This report – the third in a series published over the last three years – gives further evidence that advisers increasingly understand where their core competences lie and where they do not. For many, that quite rightly means an increased reliance on outsourced solutions, be it for portfolio construction, assessment of attitude to risk or monitoring of performance. However, even if advisers choose to buy in expertise as part of their investment propositions, it shouldn't mean they can sidestep responsibility for understanding investment solutions and their complexities.

What this report shows is that advisers are aware of many of the risks that threaten their businesses. Is my investment process robust? Has the client understood? Are my records good enough? Are markets about to get choppy? But by taking the tools, products and services made available to them at face value many advisers may also be running risks they are unaware of, in some cases adopting processes that make them responsible for risks they do not know they are on the hook for. Not enough advisers are being inquisitive enough when it comes to the components that make up their investment proposition. Many, though by no means all, advisers are not asking whether the tools they are using are fit for purpose, whether they interact with each other in a logical way, whether they are managing risk efficiently, and whether they are inadvertently shoehorning clients into unsuitable investments.

This research reveals a disconnect between many advisers' client risk assessment processes and the way they are mapped to suitable investment options. Advisers are also too trusting of the tools they use, in many cases doing insufficiently deep and regular due diligence to ensure they are and remain fit for purpose, or worse still, adopting a DIY approach in areas such as risk mapping – areas where tools exist that can do the job to a professional standard.

This report comprises data from questionnaires completed by over 130 advisers in the period November 2017 to January 2018 as well as other market data from FE. It also looks back to similar research carried out by FE in 2016 and 2017.

FE has published this report to highlight best practice and areas where advisers could make improvements to avoid exposing themselves and their firms to business risk and regulatory action.

This report shows some positive signs of improvement in the robustness of adviser investment propositions, although it also highlights some concerning trends away from best practice. Advisers need to adopt a more critical approach to the tools and products that are components of their investment processes, and be more rigorous and methodical about challenging and reviewing their own centralised investment proposition. Only by looking under the bonnet of the tools they use can advisers future-proof their businesses against the very real risks that can lie hidden below the surface.

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EXECUTIVE SUMMARY

GIVEN THE IMPORTANCE OF RISK MANAGEMENT TO INVESTMENT OUTCOMES it is surprising how many advisers are behind the curve when it comes to dealing with it. Responses to the survey that is the basis of this research evidence widespread variation in the way that advisers map risk outputs to investment options and questionable practices of blending multi-asset funds and other pre-packaged model portfolios to reduce risk. This sometimes misguided approach to mapping appears to stem from a tendency for advisers to take the tools and services that are presented to them at face value, rather than doing in-depth due diligence to understand how they work and how they connect together. Blending multi-asset and other model portfolios appears to be happening because some advisers think, incorrectly, that it automatically increases diversification. It may be that certain clients want to combine multi-asset or model portfolios where they have different buckets of investments with different time horizons and risk requirements. However, where this is not the case, blending in this way will not automatically increase diversification.

The data suggests that some advisers may be at risk of shoehorning, both at a portfolio level and a client risk profile level, suggesting a tendency to put clients into a one-size-fits-all solution, as well as a lack of monitoring of processes in some firms. Shoehorning was highlighted by the regulator as an issue in its 2012 paper on centralised investment propositions*. However, in many other areas, adviser models are developing positively.

*http://www.fsa.gov.uk/static/pubs/guidance/gc12-06.pdf

Key points

- Mapping risk outputs to suitable investment options is one of the biggest potential risks to advisers' investment processes. Advisers are not being scientific in mapping attitude to risk questionnaire outputs to the investments being placed within portfolios
- The number of advisers never using risk profilers is actually rising, with 44% never using them in the 2018 data compared to 31% in the previous survey
- The number of advisers putting clients' assets into a single solution. 31% of advisers say they intend over the next 12 months to put 90% or more of their clients in a single investment proposition, down from 40% two years ago
- Advisers are increasingly turning to the sub-optimal practice of blending or combining their clients' assets across more than one model portfolio or multi-asset fund. 73% sometimes engaging in the practice in this year's survey, up from a figure of 64% in the 2016 survey and 71% in 2017
- Firms are failing to monitor recommendations from ATRQs into portfolios at an aggregate firm level
- There is a potentially concerning increase in the number of advisers not using risk targets when building a portfolio, with 44% saying they never do, compared to 31% a year ago. However, this may reflect increased use of outsourced solutions
- More than half (54%) of advisers have not adapted their investment process over the last two years
- 90% of the firms surveyed are carrying out reviews all aspects of their investment proposition at least annually, with 39% doing so twice a year
- 21% of advisers canvassed say they may launch a robo adviser proposition over the next two years, with 13% definitely intending to do so. That compares with 32% and 11% respectively in 2016 and 2017 respectively
- A lack of integration between systems is advisers' top frustration with their current investment process, indicating a reliance on technology and external tools to run their investment propositions and save time
- Just 53% of advisers have reviewed their ATRQ in the last 12 months

CHAPTER 1

MAPPING RISK – A TWO-STAGE PROCESS

O NE OF THE BIGGEST POTENTIAL RISKS TO ADVISERS' INVESTMENT PROCESSES identified in this report is the mapping of attitude to risk questionnaire outputs to the construction of portfolios. Our research shows significant evidence of a disconnect in many advisers' understanding of the way the client risk profiling assessment interacts with the risk profile of the investment portfolio. Many advisers are assuming both the risk profile outputs of ATRQs and of portfolios speak the same language, and that all they need to do is simply connect the two together. It does not necessarily follow that an investment portfolio or option that is described as 'medium risk' will be suitable for a client assessed as 'medium risk', yet many advisers appear to be taking this to be the case.

Do you use an attitude to risk questionnaire as the starting point for discussions around a client's risk appetite?

Response	%
Yes	91%
No	9%

Which attitude to risk questionnaire provider do you use in your investment process?

Provider	%
FinaMetrica	16.42%
Distribution Technology	20.90%
EValue	26.37%
Oxford Risk	2.99%
Morningstar	7.46%
Network specific ATRQ	1.49%
Platform specific ATRQ	4.48%
In house created ATRQ	16.42%
None of the above	13.43%

Positively, 91% of advisers are using an ATRQ at the outset of discussions with the client about their risk appetite, with EValue, Distribution Technology and Finametrica the most common commercial providers used. Only 17% of use an in-house ATRQ. While ATRQs should only be used as a starting point for a conversation about risk, and goals and capacity for loss are equally important, this is a significant increase on the finding that only 76% of advisers were using them in the 2016 survey.

Is the Attitude to Risk Questionnaire done at an Account or Portfolio level?

Answer	%
Account level	64%
Portfolio level	36%

Almost two thirds of advisers, 64%, are carrying out the ATRQ at account level, meaning they may be failing to ensure they understand the risk their client is prepared to take with the different buckets that make up the components of their savings and investment strategy.

How do you assess a clients' capacity for loss?

Answer	%
Via conversation	59%
Using an ATRQ	25%
Other (please specify)	17%

Do you review the outputs of all ATRQs conducted in your firm at an aggregated, firm level i.e to identify trends or potential issues?

Answer	%
Yes	33%
No	67%

Two-thirds of advisers are ignoring expert recommendations* that firms should take an aggregated firm-level sample of ATRQs from a minimum of 30 files to see whether significant trends were shown to exist within firms. The research found 67% of advisers do not review the outputs of all ATRQs at a firm level, compared to 33% that do.

Monitoring outputs from ATRQs into portfolios at an aggregate firm level enables larger firms to identify where individuals within firms are not following best practice, or where the firm's process directs considerably more clients to a particular fund than is suitable. Such checks can help organisations detect whether some members of staff may be giving advice and making recommendations that do not meet the firm's usual standards.

* Rory Percival Training and Consultancy Ltd: An ex-regulator's guide to risk profiling tools

If you use a third-party risk mapping tool, which one do you use?

Tool	%
Distribution Technology's Dynamic Planner	22.64%
Defaqto	7.55%
FE Analytics + Investment Planner	33.96%
FinaMetrica	9.43%
EValue	7.55%
Oxford Risk	1.89%
Morningstar	7.55%
Other (please specify)	9.43%

Do you feel there are any limitations with your current approach?

Answer	%
Yes	33%
No	67%

If you use a third-party risk mapping tool, have you reviewed the underlying mapping methodology yourself?

Answer	%
Yes	48%
No	52%

Do you think your third-party risk mapping tool has any limitations?

Answer	%
Yes	50%
No	50%

While half (50%) of advisers think their third-party risk mapping tool does not have limitations, a third do have concerns over their process. We would suggest that this latter group have a better grasp of the risks to their businesses. A majority (52%) have not reviewed the underlying mapping methodology used by their third-party risk mapping tool, despite suggestions from regulatory

experts* that this is best practice. And half (50%) think third party risk mapping tools have limitations, with advisers describing current tools as simplistic and too generic.

THE CLIENT AND THE INVESTMENT: MAPPING TOGETHER TWO DIFFERENT RISK PROFILES

A 2017 paper written by former FCA technical specialist Rory Percival (An Ex-regulator's Guide to Risk Profiling Tools) highlighted the complex but important issue of risk mapping. The paper explains that just because a person is identified as being in the middle of the population in terms of appetite for risk, that does not mean they are medium risk in terms of investments. Percival's paper states: 'What the advisory and fund management sectors think of as medium risk is on another scale. The key point is whether the two scales relate to each other.'

The research, into the capabilities of six of the most commonly used adviser risk profiling tools found significant variations in their measuring of the '50 client' – the person who is 50 out of 100, or in other words completely medium risk. Giving the middle answer to each question, scores for the different tools ranged from 50 to 59, highlighting the inconsistency of some tools.

Furthermore, the asset-backed holdings recommended for the '50 client' also varied widely, recommending asset-backed component varying between 43% and 71.5% of the portfolio.

Earlier research carried out by FE has shown that while a minority of advisers do use third-party risk mapping tools designed to ensure the risk in portfolios matches the ATRQ assessment, more than three quarters of advisers are manually mapping ATRQs to investment options. Many of those not using risk mapping tools are taking the approach of matching a model asset allocation to an investment option they believe is appropriate. Others are using other tools as a workaround to achieve an approximation of a suitable mapping.

Qualitative research carried out as part of this study found a proportion of advisers who complain that some risk mapping tools are too generic, lack detail, do not have the coverage to serve the adviser wanting to be genuinely whole of market and steer the user towards specific provider products.

Advisers choosing not to use third-party nvestment risk profiling tools need to make sure they have the competence to lift the bonnet on their investment risk tools and ensure they seamlessly match up with investment recommendations.

Few advisers perceive genuine risk in these approaches. This is perhaps not surprising since it is only in the last two years that some big networks have started incorporating risk mapping tools into their proposition, and even then, they have not been mandatory. But the slow pace with which the industry is adopting risk mapping tools does not reduce the risk for those not using them.

LOOKING UNDER THE BONNET OF HOLDINGS

A major disadvantage of using pure asset allocation mapping is that it assumes all investments are the same. The five funds in Figure 10 are all from the UK All Companies sector, so on the face of it, for advisers adopting a pure equity allocation approach to mapping, all these funds are equally suitable as an equity element of a portfolio. But only one fund, Slater Growth, carries exactly the same FE risk score as the FTSE All Share, which is what ATRQs generally mean when they refer to UK equity. The most volatile - the Standard Life Investments UK Equity Recovery - carries almost three times the volatility of the least volatile, the Unicorn Outstanding British Companies.

Without drilling into the data on the funds themselves, this approach assumes they should all behave in the same way as the FTSE All Share, which is clearly not the case. This range of outcomes results from the different styles they are following, as evidenced by the wide dispersion of data across FE risk score, maximum drawdown, annualised volatility and annualised return.

Fig 10 **Variance in risk scores can be wide**

Fund name	FE Risk Score. GBR	Max Draw Down	Volatility annualised	Return annualised	Notes
FTSE All Share	93	-16.32	12.63	10.15	Index - what the ATRQ counts as UK equity
JOHCM UK Opportunities	71	-8.45	10.09	8.18	Invested in large and mega cap companies that make most of their money overseas, currently 30% in cash
LF Lindsell Train UK Equity	96	-10.30	12.19	14.69	Very concentrated fund of less than 30 holdings, hardly representative of UK market
Slater Growth	93	-15.09	10.34	14.03	Invests in small growth companies in the UK
Standard Life Investments UK Equity Recovery	158	-28.42	20.84	16.24	Invests in mid and large recovery companies
Unicorn Outstanding British Companies	69	-6.87	7.68	10.92	Invests in funds on the AIM market

Data is from 31/12/2014 – 31/12/2017

CHAPTER 2

A MUDDLED APPROACH TO RISK

GIVEN THE IMPORTANCE OF RISK IN DETERMINING HOW TO CONSTRUCT INVESTMENT PORTFOLIOS it is surprising how many advisers are attempting to manage it using sometimes unsophisticated or misguided strategies. The research shows that the practice of blending multi-asset or multi-manager funds or pre-constructed model portfolios, in the misguided belief that doing so reduces risk, is not only widespread but, worryingly, on the increase. Advisers are also using risk targets less today than in previous years, despite professing to place a high value on understanding and delivering on clients' holistic risk needs.

Furthermore, as well as bundling multi-component funds together in the hope of muddling through to a risk profile that approximates suitability, many advisers are also bundling peopletogether; merging couples into a single risk-profiling assessment, or merging appetite for risk for different savings goals when different approaches for different buckets of assets might be more suitable.

Blending too many holdings into a portfolio can cause extra layers of cost and introduce correlations that move the investor's portfolio further away from the efficient frontier of risk and return.

Do you ever combine more than one Model Portfolio or Multi-Asset Fund in a portfolio for a client?

Answer	%
Yes	29%
Sometimes	43%
No	27%

If yes, what is the primary reason for doing so?

Reason	%
Reducing manager risk	9.38%
Increasing diversification	59.38%
Trying to hit a risk target	14.06%
Other (please specify)	17.19%

An increasing number of advisers are blending or combining their clients' assets in a single portfolio across more than one model portfolio or multi-asset fund, with 73% engaging in the practice in this year's survey, up from a figure of 71% in the 2017 survey and 64% in 2016. The survey found that 29% did so regularly, with 43% doing so sometimes. While the desire to increase diversification was given as the primary

reason for doing so (59%), it is concerning that the proportion of advisers taking this approach is growing rather than shrinking given the potential for incurring increased charges for clients and the potential for complex and unexpected risk patterns to emerge when strategies are blended in this way. That said, whilst blending these pre-packaged solutions could have potentially unintended consequences, clients may need to invest in different strategies to meet long and short-term needs in drawdown, for example.

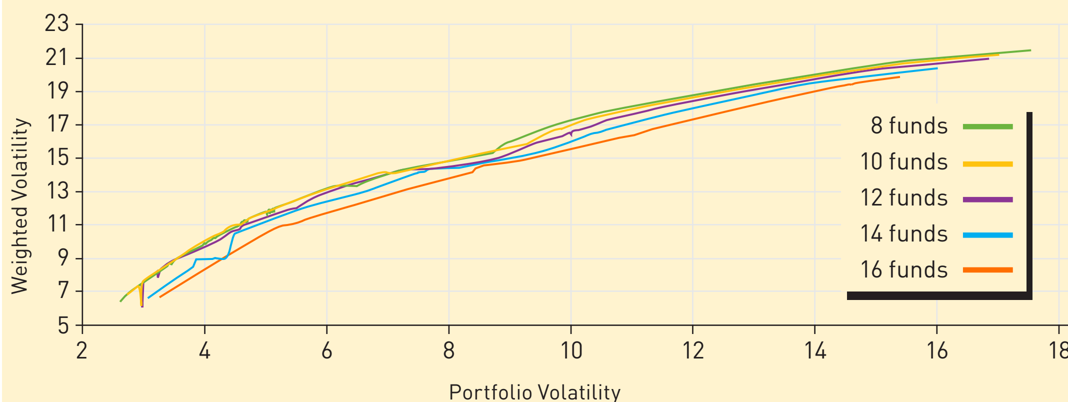
HOW MANY FUNDS IS OPTIMAL?

Our data tells us there is no consistency in the number of holdings advisers are selecting for portfolios. We see portfolios ranging from 25 holdings down to single figures. So how many funds is optimal?

After carrying out extensive research we have come to the conclusion that a ten-fund portfolio is most reliable. The key to efficient portfolio construction is optimising the diversification ratio, which entails understanding how each fund works with every other fund in the portfolio to increase the portfolio's overall diversification, thus ensuring maximum market exposure for the same level of risk.

The impact of multiple funds can be identified by charting the actual volatility of the optimised portfolio versus the weighted volatility of the constituents of the portfolio. The greater the difference between these two numbers the greater diversification benefit the portfolio is achieving. Figure 1 shows the results for portfolios with 8, 10, 12, 14 and 16 funds. The portfolios were created using our FE Invest Approved Fund list of recommended funds and each holding was required to make up between 5% and 20% of the overall portfolio. No other restrictions were applied.

The differences between an 8 and 10 fund portfolio are minimal. However, as the number of funds increase, the portfolio starts to lose its diversification benefit and becomes less optimal. The differences between the portfolios becomes increasingly extreme as the number of holdings increases. The efficiency of the 8-fund portfolio begins to be diminished when an adviser increases the restrictions during the optimisation process, for instance by imposing asset class and regional restrictions.



It can be advantageous to have more funds in a portfolio if the client is going to utilise niche strategies, such as biotech or exposure to Latin America. However, for mainstream portfolios the research clearly shows that 10 holdings is optimal. Generally speaking the more holdings the adviser adds, the more they limit the upside potential of the portfolio, creating something that is more and more akin to an expensive tracker.

Because every multi-manager fund is different, and because it is not possible to identify the extent to which different multi-manager funds duplicate correlated holdings, advisers will struggle to understand precisely how many holdings will be optimal if they adopt a blended approach.

If you use multi-asset funds, how do you compare risk targeted multi-asset funds and total return funds against each other?

Response	Percentage
Third-party ratings tools (e.g Dynamic Planner, FE Analytics)	62.67%
Meet with the providers	25.33%
Own analysis	44.00%
n/a	21.33%
Other (please specify)	2.67%

The majority (63%) use third-party rating tools to compare risk targeted multi-asset funds and total return funds against each other, although not all advisers are doing so. Others are addressing this complex task by using a combination of their own analysis and meeting with providers.

How often do you increase the risk level of a client?

Response	Percentage
Often	11%
Occasionally	80%
Never	9%

While advisers see their role as identifying a client's risk profile, they generally do not see it as trying to educate them into changing it, even if it will mean they are more likely to achieve their goals. Just 11% of advisers say they often increase the risk level of a client to help them achieve their goals, while 80% say they only do so 'occasionally', instead relying on the ATRQ.

How do you deal with joint ownership of accounts where the Client and Partner have different risk appetites?

Clients adopt a variety of ways of dealing with joint ownership of assets where the client and partner have different risk appetites, including adopting a median risk approach for the entire portfolio or having two entirely separate portfolios. One respondent suggested that the situation of different risk appetites existing between parties 'does not happen', while another adviser 'takes the view of the partner that is more sensible' and tries to convert the other to that view. Another said, 'we sometimes use the high-risk profile, sometimes the low risk and sometimes the median'. While the regulator has not been explicitly prescriptive as to how to deal with different risk profiles within couples, regulatory experts say the safest way to proceed is to assess both individually.

Do you believe that clients can have different risk profiles according to the amount or duration of their investment or do you tend to assess a client's risk attitude as a whole?

Answer	%
I asses it as a whole	35.14%
I amend the output of the questionnaire if the investment term is shorter/longer	31.08%
I do a different questionnaire for each investment type or wrapper	24.32%
Other (please specify)	9.46%

The majority of advisers do not operate a bucketing strategy for the different investment horizons of different parts of client's portfolio, with just 24% completing a different questionnaire for each investment type or wrapper. This result is identical to the 2017 survey figure. While a bucketing strategy represents best practice, some advisers said they would only operate one if the client agreed, suggesting the time clients are prepared to spend filling in questionnaires is a factor in their decision as to whether or not to adopt this approach.

When building a portfolio do you ever use a risk target?

Answer	%
Yes often	26%
Sometimes	29%
No	44%

Do you know what % of risk targeted funds in your portfolios came within their targets last year?

Response	%
Yes	31%
No	67%

The research identified a worrying decline in advisers' use of risk targets when building a portfolio, with 44% saying they never use them, compared to 31% in the 2016 survey. This trend may, however, be influenced by the increase in outsourcing.

Furthermore, the proportion of advisers who are not checking whether their risk-targeted funds are hitting their target is also on the increase, with more than two-thirds of advisers (67%) not knowing the percentage of risk targeted funds in their portfolios that came within their targets last year. That marks a worrying increase from an already concerning 57% who did not two years ago.

Monitoring risk performance on an ongoing basis is one of the key services delivered by advisers charging clients on an ongoing basis. If advisers are not performing this basic ongoing function they could potentially expose themselves to the challenge that they are charging their clients for something they are not delivering. This is a challenge we understand and we have developed our adviser tools to help address this need for ongoing monitoring.

Do you review your clients' risk profile annually?

Response	%
Yes	63.38%
Only if the circunstances have changed	19.72%
Not annually for all clients	16.90%

Despite not checking whether the actual investments they have put their clients into are delivering the risk exposure they are intended to, a majority (63%) are still checking their clients' risk profile annually. The fact that advisers are choosing to check their clients' risk profile annually yet are not making similar checks with regard to their portfolio's risk profile highlights a gap in advisers' understanding of the disconnect between the risk profile of the individual and the risk in the investments.

How often do you verify that the portfolios on which you advise, still meet the outputs of your risk questionnaire, within the parameters you have set?

Response	%
Monthly	9%
Quarterly	21%
Half yearly	17%
Annually	45%
Other (please specify)	9%

The overwhelming majority of advisers say they verify that the portfolios within their investment proposition still meet the outputs of their chosen risk questionnaire - within the parameters set - at least once a year. It is essential that advisers regularly review their outsourced service providers as it is the adviser who will ultimately bear the responsibility if they are not correct. For this reason 9% conduct such reviews monthly, 21% do so quarterly and 17% do so half-yearly.

CHAPTER 3

RISKS IN ADVISERS' INVESTMENT MODELS

The qualitative research carried our for this report suggested that advisers were uneasy about the investment processes operated within the firms they worked for. Advisers described a range of behaviours within organisations that raise their concerns, including a tendency to put clients in a box and not fully discuss outcomes, investing on gut-feel rather than risk and a lack of satisfaction with provider services. Some advisers within very small firms describe their concern at 'having to do everything myself' while others saw a bare minimum asset allocation approach adopted within their organisation.

As well as the potential risks associated with blending and mapping to investment choices already mentioned, the quantitative research carried out for this report identified a number of potentially problematic areas within current investment process models. The data points towards concentration risk and potential shoehorning by some, particularly into in-house models. A minority of advisers are planning to put all their clients' assets into a single solution.

In this year's survey 31% of advisers say they intend over the next 12 months to put nearly all (90%) of their clients' investments in a single investment proposition. This figure is down from 40% two years ago, with in-house model portfolios responsible for half this figure.

This trend suggests that the regulator's repeated warnings about advisers' needing to have a broad investment proposition that offers a wide choice of options is having some impact.

Some advisers also appear complacent when it comes to reviewing their investment proposition, despite regulatory pressure to do so.

Do you use in-house model portfolios?

Yes	59%
No	41%

Do you use external model portfolios?

Yes	46%
No	54%

A majority of advisers (59%) use in-house model portfolios, slightly down on the figure in the 2016 survey, when 60% of respondents said they used in-house model portfolios. Of advisers using external model portfolios an overwhelming 84% use more than one, with a majority of 53% using between two and four.

Why do you use externally run model portfolio services?

When asked to give one reason why they chose to use external model portfolios advisers cited time pressure, risk management and the desire to tap into deeper investment expertise and research capabilities. But asked to rank seven key attributes of external model portfolios none stood out, suggesting external model portfolios offer advisers multiple benefits.

If you use third party model portfolio providers, how do you compare them?

Response	%
Third-party rating tools (e.g Defaqto, FE Transmission)	71.43%
Meet the providers	46.94%
Own analysis	67.35%
n/a	4.08%
Other (please specify)	4.08%

Third party rating tools are the most popular method used by advisers for comparing external model portfolio providers, used by 71% of advisers, with 67% also using their own analysis and 47% meeting with providers. One could argue that advisers who do not meet with external model portfolio providers but simply rely on their own analysis are not doing sufficient due diligence on their external investment partners to ensure their own businesses are not put at risk.

Do you plan to make your own model portfolios available to advisers outside of your firm?

Response	%
Yes	12%
No	88%

A small minority of well-resourced advisers see a business opportunity in offering their model portfolios to advisers outside their firm.

What percentage of your client funds under advice are in each type of proposition?

%AUM

	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
In-house model portfolios	16.36% 9	5.45% 3	14.55% 8	5.45% 3	10.91% 6	7.27% 4	9.09% 5	9.09% 5	16.36% 9	5.45% 3
In-house fund selection to construct individual client portfolios	44.07% 26	15.25% 9	11.86% 7	5.08% 3	10.17% 6	1.69% 1	3.39% 2	3.39% 2	1.69% 1	3.39% 2
External model portfolios	30.56% 11	19.44% 7	8.33% 3	2.78% 1	11.11% 4	5.56% 2	11.11% 4	8.33% 3	0.00% 0	2.78% 1
External Multi-asset or Multi-Manager funds	32.65% 16	28.57% 14	16.33% 8	2.04% 1	4.08% 2	6.12% 3	2.04% 1	6.12% 3	2.04% 1	0.00% 0
External discretionary fund managers	57.89% 22	18.42% 7	13.16% 5	2.63% 1	2.63% 1	2.63% 1	2.63% 1	0.00% 0	0.00% 0	0.00% 0
Other (please specify)	71.43% 5	14.29% 1	0.00% 0	0.00% 0	14.29% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0

What percentage of your new client funds under advice do you estimate will go into the following propositions over the next 12 months?

%AUM

	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%
In-house model portfolios	12.50% 6	4.17% 2	14.58% 7	2.08% 1	6.25% 3	10.42% 5	8.33% 4	10.42% 5	18.75% 9	12.50% 6
In-house fund selection to construct individual client portfolios	44.68% 21	17.02% 8	6.38% 3	6.38% 3	6.38% 3	2.13% 1	0.00% 0	8.51% 4	4.26% 2	4.26% 2
External model portfolios	21.88% 7	18.75% 6	0.00% 0	9.38% 3	6.25% 2	12.50% 4	12.50% 4	9.38% 3	6.25% 2	3.13% 1
External Multi-Asset or Multi-Manager funds	34.15% 14	24.39% 10	4.88% 2	14.63% 6	0.00% 0	4.88% 2	7.32% 3	4.88% 2	2.44% 1	2.44% 1
External discretionary fund managers	43.33% 13	20.00% 6	16.67% 5	10.00% 3	3.33% 1	0.00% 0	0.00% 0	3.33% 0	0.00% 0	3.33% 1
Other (please specify)	80.00% 4	20.00% 6	0.00% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0	0.00% 0

A diminishing minority of advisers are planning to put all their new clients' assets into a single solution. This year's survey found 31% of advisers intend over the next 12 months to put 90% or more of their clients' investments in a single investment proposition, an encouraging trend when compared to the 40% that were doing so when we conducted the survey two years ago. Existing portfolios are less likely to be concentrated in a single solution by advisers, with 20% of advisers using the same approach to investing for 90% or more of their customers. This chimes with regulatory advice that recommends having a centralised investment proposition that caters for all types of investor that a firm serves.

Management of risk is seen as the most important attribute by advisers using external discretionary fund managers, external model portfolios and external multi-asset or multi-manager funds, while for those using in-house model portfolios and in-house fund selections to construct individual client portfolios, risk management is seen as a lower priority than performance.

Despite the impact of regulatory changes, Ombudsman rulings, the FAMR review and new FCA guidance and MiFID II regulations – which were impending at the time the research was conducted – a majority (54%) of advisers have not adapted their investment process over the last two years. This suggests either a level of complacency around regulatory matters or confidence that their investment proposition is watertight. Amongst the 37% of respondents who had made changes to keep their proposition up to date, some cited ensuring third party discretionary fund managers and platforms are Mifid II compliant as reasons for doing so. Or that they are confident their investment proposition is watertight

How do you ensure consistency when delivering investment advice?

Response	%
Having a defined written process	80.28%
Use of a process delivered by technology	36.62%
Regular review meetings with external investment management	32.39%
Regular exception reporting to monitor clients' investments	16.90%

A defined written process is seen as the most popular way to ensure consistency when delivering investment advice, and is the method used by by 80% of advisers. Technology-delivered processes were cited by 37% of advisers as key to ensuring consistency, while 32% saw regular review meetings with external investment managers as a key part of the process. This showed a marked diminution on the figures from the 2016 survey, when 88% of advisers used a defined written process, with 42% using technology-delivered processes. Regular exception reporting to monitor clients' investments in this year's survey was seen as key by only 17%.

CHAPTER 4

ADOPTING BETTER SYSTEMS AND PROCESSES

THE DAY-TO-DAY OPERATION OF ADVISERS' BUSINESSES is fraught with administration and a lack of integration between systems looms large in their minds. Advisers see technology as an enabler and mourn the lack of joined up technology in the industry. But in many areas their businesses are evolving in a positive way. They are likely to have an investment committee and are reviewing their investment propositions regularly.

Interest in robo advice remains for a significant minority of advisers, although the lack of an affordable white-label partner to facilitate digital advice is likely to hold back uptake.

How often do you thoroughly review ALL aspects of your current investment proposition?

Response	%
Every 6 months	39%
Annually	52%
Every 1-3 years	7%
More than 3 years	0%
Only when there is a specific need	4%

Have you changed your preferred investment solutions in the past 2 years?

Response	%
Yes	45.83%
No	54.17%

While not every adviser is reviewing investment propositions adequately, advisers are are taking a responsible approach to the frequency with which they are reviewing all aspects of their investment proposition, with 90% of them conducting a review at least once a year and 39% doing so twice a year.

Just under half of advisers have changed their preferred investment solution in the last two years, citing a wide range of reasons, including cost, moving to better-managed risk-rated portfolios as well as macro-economic reasons, such as wanting to reduce exposure to UK equities.

However, a significant minority of advisers are more complacent when it comes to reviewing their ATRQ, with just 53% having done so in the last 12 months, despite FCA guidance that an annual check should be made. 25% have only reviewed their ATRQ between two and five years ago, while 7% haven't reviewed theirs for five years.

ADVISERS' NEW OBLIGATION TO ENSURE THEIR ATRQS PASS MUSTER

MiFID II, which came into force on 3 January, 2018 introduced a new rule that states 'firms shall take reasonable steps to ensure that the information collected about their clients is reliable. This shall include ... ensuring all tools, such as risk assessment profiling tools ... are fit-for-purpose ... with any limitations identified and actively mitigated through the suitability assessment process'.

Research by the regulator carried out in 2011 found that nine out of the eleven risk profiling tools it tested, 'had weaknesses which could, in certain circumstances, lead to flawed outputs'. (FG15/11)

How many people are involved in making the investment decisions in your firm?

Do you have an investment committee?

The survey data shows that investment committees are now widespread, in situ in 78% of firms, and with 79% of respondents saying that between one and five people are involved in making investment decisions within their firm, and 21% of investment committees having more than five members.

However, very few firms have CFA level qualified staff sitting on their investment committee with the expertise that may be required to make informed investment decisions. Our FE Research team runs our FE Invest Model Portfolio Service and spends over 10,000 hours a year researching funds and visiting managers to conduct appropriate due diligence. This is something most IFA firms would be unable to replicate.

Do you use third-party ratings as part of your investment process?

Response	%
Yes	73.61%
No	26.39%

If yes, which ones do you use?

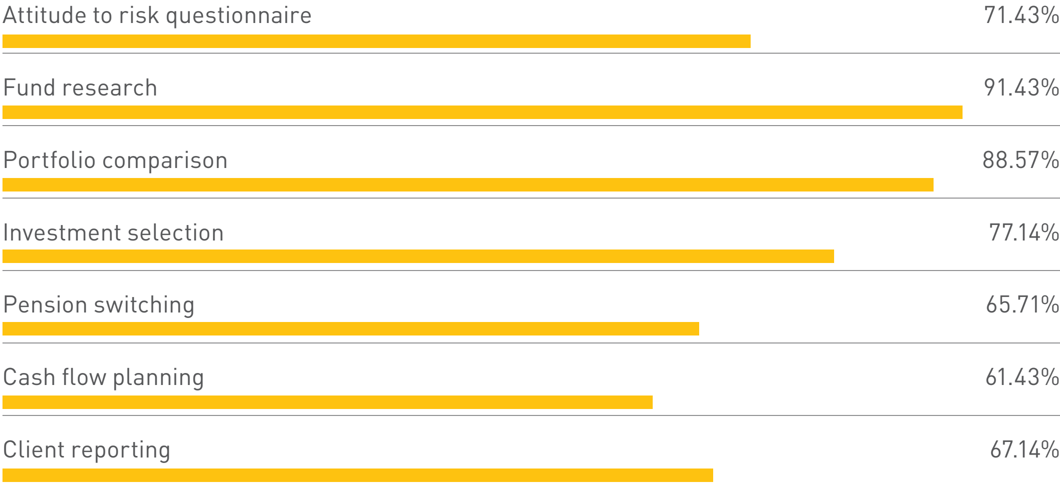
Rating	%
FE Crown ratings	78.18%
FE Risk scores	81.82%
FE Alpha Manager ratings	40.00%
Morningstar ratings	43.64%
Citywire ratings	16.36%
Square Mile ratings	10.91%
RSM ratings	10.91%

What is the main reason for using third-party ratings as part of your investment advice process?

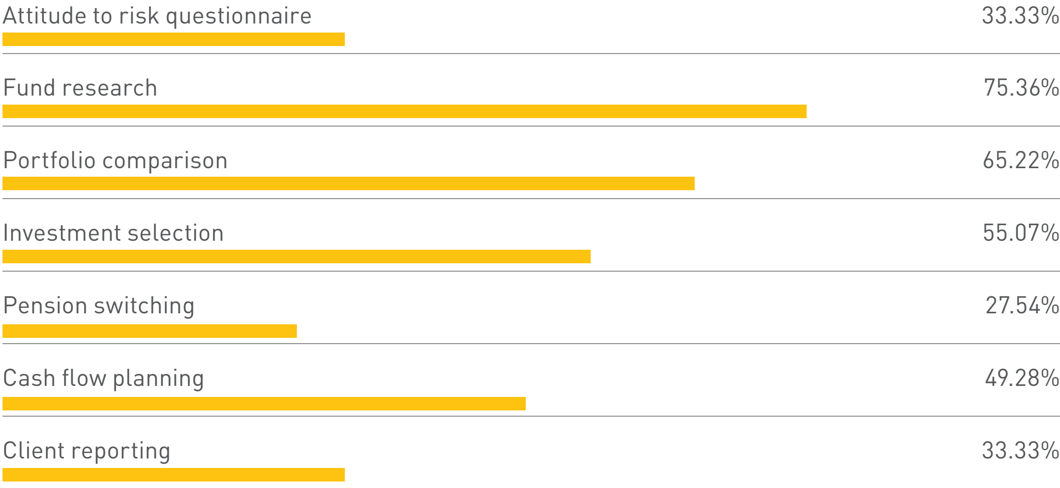
Reason	%
Communicating skills	19.30%
Selecting funds when compiling portfolios	43.85%
Opening performance monitoring	22.81%
Other (please specify)	14.04%

Almost three-quarters of advisers (74%) use third-party ratings as part of their investment process, using a wide range of ratings providers, with fund selection (44%) given as the most popular main reason for using them, followed by monitoring ongoing performance (23%) and communicating risk to clients (19%). Some advisers said they also used third-party ratings as a source of extra information on the managers they use.

Which elements of the investment advice process do you use technology for?



For which parts of the investment advice process do you believe technology adds the most value to your business



Technology is seen as adding the most value to advisers' businesses in the field of fund research, where it was cited by 75% as adding value. This was followed by portfolio comparison (65%) and investment selection (55%). It is also seen as useful for cash flow planning (49%) and attitude to risk modelling (33%).

What are the key drivers that would make you simplify your current technology suite

Driver	%
Cost savings	47.83%
Better integration between systems	65.22%
More customisation options i.e. tailored to your own firm's investment process	39.13%
Improved usability of tools	44.93%
A single software provider over multiple ones	34.78%

Better integration between systems was cited as the number one driver for simplifying advisers' current technology suites, cited by two-thirds of respondents (65%). Second most popular was cost (48%), followed by improved tool functionality (45%). A third of advisers want a single software provider to meet all their needs (35%).

What are your main frustrations with your current investment process?

Frustration	%
Too many steps/too time consuming	28.99%
Limitations of the Attitude to Risk Questionnaire	28.99%
Requirements of recording/documenting the process	30.43%
Lack of integration between systems	34.78%
Lack of gudance on mapping investment solutions to risk questionnaire outputs	19.54%
Lack of information available to compare portfolios like for like	31.74%
Dificulty in comparing third-party model portfolios	26.09%
Other (please specify)	7.25%

A lack of integration between systems is advisers' top frustration with their current investment process, a key concern for 35% of respondents.

Do you plan to introduce a robo-advice service into your advice proposition over the next 2 years?

Response	%
Yes	32%
No	65%
Maybe	21%

Just over a fifth of advisers (21%) say they may launch a robo adviser proposition over the next two years, with 13% saying they definitely intend to do so. That compares with 32% who said they may do so two years ago, against 11% definitely intending to. While only a handful of players have currently come in the market, the research suggests that there is a core of advisers who like the idea of adding a robo proposition, while the proportion of advisers interested but unsure has reduced.

The fact that take-up has been slow to date suggests those that do want to launch a robo proposition lack the time, resource and expertise to develop what is likely to be low margin business for them, and will wait for the development of a low-cost white-label solution.

CHAPTER 5

GEOPOLITICAL RISK – BREXIT WORRIES, EMERGING POTENTIAL

BREXIT WILL ALWAYS GARNER HEADLINES and the survey data shows a clear trend for advisers to move assets away from UK equities. This is not surprising give the potential for significant currency risk, and potential specific business risk for certain UK companies if the Brexit process does not go well.

When choosing funds, which sectors have you increased your exposure to over the last 6 months?

	INCREASE	NO CHANGE	DECREASE
US Equities	21.88% 14	57.81% 37	20.31% 13
UK Equities	17.19% 11	53.13% 34	29.69% 19
European Equities	45.00% 27	51.67% 31	3.33% 2
GEM Equities	50.85% 30	44.07% 26	5.06% 3
Absolute Return	23.73% 14	61.02% 36	15.25% 9
Corporate Bonds	13.11% 8	57.35% 35	29.51% 18
Gilts	1.67% 1	60.00% 36	38.33% 23
Multi-Asset Cautious	21.05% 12	71.93% 41	7.02% 4
Multi-Asset Adventurous	11.86% 7	71.19% 42	16.95% 10
Property	22.03% 13	61.02% 36	16.95% 10
Ethical	15.52% 9	81.03% 47	3.45% 2

Concern over Brexit may be impacting advisers' approach to asset allocation, with almost a third (30%) reducing their UK equity exposure over the last 6 months, while European equity exposure has increased by 44%.

However, while advisers are reducing their UK equity exposure, understanding fund selections in the sector right is still a big priority for them, with UK Equities including Income and UK All Companies making up the biggest percentage of the 50 most researched funds in the period January to September 2017, at just over 20% of all searches.

Also out of favour are corporate bonds, sold by 29% of advisers, whereas we still believe they offer some diversification benefits in the long term - as part of an overall portfolio - which is why they still feature in our FE Invest portfolios. Most in vogue are global emerging markets, with just over half of advisers (51%) increasing their exposure.

Views on the prospects for Trump's America are mixed, with 22% of advisers increasing their exposure to US equities in the last 6 months, compared to 20% who reduced it. Expectations of interest rate increases mean virtually no advisers increased their clients' Gilt exposure, while 16% of advisers increased exposure to ethical investments.

Advisers' instincts are in accordance with FE's own analysis on Brexit and the UK's investment potential in relation with the EU and the rest of the world.

We think the political risk in Europe is receding following last year's elections and we are seeing some favourable economic trends

- GDP grew 0.6% in third quarter
- The ECB announced a reduction in quantitative easing from Đ60 billion to Đ30 billion
- Unemployment in the zone is at its lowest level since 2009
- Strong earnings see French and German equities surge to record levels
- Valuations in Europe are very attractive when compared to the US
- European recovery has been slower than the US, whereas the US is in late stage recovery, so there is still plenty of upside potential in Europe

Emerging Markets

- Fundamentals have done a much better job of keeping up with the strong performance figures than developed markets
- Strong earnings
- Benefited early in 2017 from reflation trade
- Valuation gap is starting to narrow between emerging and developed markets suggesting that the best time to have invested may have passed however

Which funds do advisers want to know more about?

Data on the funds most researched through FE Analytics over the year to December 2017 reveal a preoccupation with Europe that is undoubtedly linked to Brexit, with Jupiter's Europe Excluding UK fund the most researched fund by a considerable margin: it was searched by advisers on 44% more occasions than the second most searched for- Fundsmith Equity fund. The table of the most searched for funds also suggests advisers are researching funds they feel negatively about as much as those they are looking to invest in.

Fundsmith Equity and CF Woodford Equity Income come second and third in the list, although probably for different reasons. Fundsmith Equity has delivered 132% in the five years to March 23, 2018, while CF Woodford Equity Income recently dropped out of the UK Equity Income sector after failing to beat the FTSE All Share index over the past three years.

Two Targeted Absolute Return funds have made it into the top 10 most researched funds, reflecting the challenges the sector has faced. The poorly performing Newton Real Return fund, which has delivered 6.6% over the five years to March 23, 2018, compared to the Targeted Absolute Return benchmark's 13.5%. Advisers who were researching Standard Life's struggling GARS fund may have been considering whether to drop it from clients' portfolios, as evidenced by the manager reporting outflows of £10.7bn in February.

Fig 46 **The top 10 most researched funds – January – September 2017**

EQUITIES	NAME	SECTOR
Jupiter	European	Europe Excluding UK
Fundsmith	Equity	Global
CF Woodford	Equity Income	UK All Companies
Stewart Investors	Asia Pacific Leaders	Specialist
Invesco Perpetual	High Income	UK All Companies
Standard Life Investments	Global Absolute Return Strategies	Targeted Absolute Return
Newton	Real Return	Targeted Absolute Return
Newton	Global Income	Global Equity Income
Lindsell Train	LF Lindsell Train	UK All Companies
Artemis	Global Income	Global Equity Income

FINAL THOUGHTS

ADVISERS ARE KEENLY AWARE that the regulator is keeping a watching brief on investment processes and as a result are increasingly looking to third-party providers for help to remain compliant. This strategy will remove elements of risk from their processes. The next step for advisers is to ensure that they have fully understood how third-party service providers integrate into their businesses – what they do and what they don't do, how they work and how their outputs interact with other parts of their systems. Advisers should be mindful that introducing an outsourcing or 'insourcing' element into their business may take away one element of risk but can also introduce another.

Advisers' awareness of this is in some cases expressed through their frustration at the general lack of integration of systems in the industry. This frustration is doubtless well-founded, but advisers cannot escape the fact that ensuring their own processes are integrated, reviewed and fully understood remains their responsibility. Advisers are able to outsource specific functions, but they are not able to outsource responsibility for these functions.

On a positive note, this report did find considerable evidence of improvement in the way advisers are running their businesses. By establishing robust processes to ensure they regularly review the components of their advice proposition and lift the bonnet on the tools and services they bring in, advisers will be able to further enhance their propositions, and ensure they go from strength to strength.

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