EValue

Powering financial insight

HOW TO... RECOMMEND SUITABLE FUNDS THAT MATCH THE CLIENT'S RISK PROFILE

How to Guide from EValue

INTRODUCTION

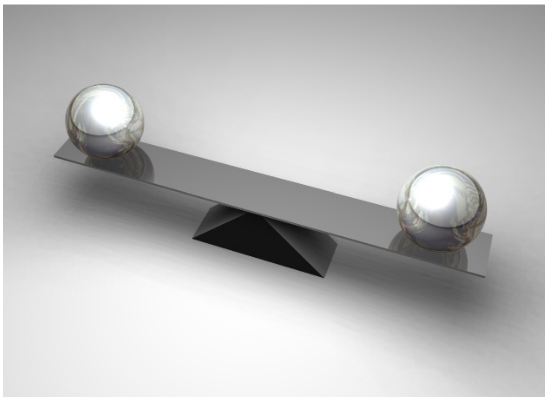
In the first of our 'How To' series for advisers we'll be looking at what you need to consider when recommending a suitable fund, or portfolio of funds, to your client.

This guide explores the process of selecting and recommending a suitable fund (or portfolio of funds) for your client, while ensuring it takes into account any existing assets your client may have and the client's desired investment term. It is an area about which the Financial Conduct Authority (FCA) has strong opinion, with its predecessor the Financial Services Authority (FSA) having published previously its guidance note on 'Assessing suitability'.

The FSA's document highlighted concerns about advisers' over reliance on risk profiling tools. It emphasised that the onus is on the adviser to really know his or her client before making a recommendation. The FSA also made clear its view that advisers must have a robust and flexible process in place to ensure that any fund or portfolio they recommend to a client matches their risk profile.

The following 5 steps outline the key benchmarks advisers should have clearly in mind when selecting and recommending suitable funds for their clients.

1. DELIVERING CONSISTENCY IN THE ADVICE PROCESS



The design and implementation of a consistent advice process is key to recommending suitable funds to clients. This means using the same structured approach with all clients, on the understanding, of course, that everyone has individual requirements.

Fund recommendations are made at a specific point in the advice process, namely after you've completed a fact find with your client.

At this stage, you will already have ascertained the client's attitude to risk, which is likely to be established through:

- the completion of a fact find and attitude risk questionnaire
- a discussion about his or her capacity for risk
- a good understanding of his or her investment objectives

Nevertheless, in order to meet the standards outlined by the regulator in its guidance notes, other considerations must also be made before a fund recommendation can be made.

2. DESIGN A SOLUTION

Once you have sufficient details about your client's current situation and future needs, you can begin to design an appropriate solution for them. Your actions at this stage are likely to include:

- selecting an appropriate product type, taking account of your client's tax position and any other requirements
- carrying out a charges comparison between potential providers
- making a choice between funds that meet your client's requirements and objectives

3. AGREE THE INVESTMENT TERM

When making selecting appropriate funds, you need to take into account your client's expected investment term. This is an area which the FCA takes extremely seriously.

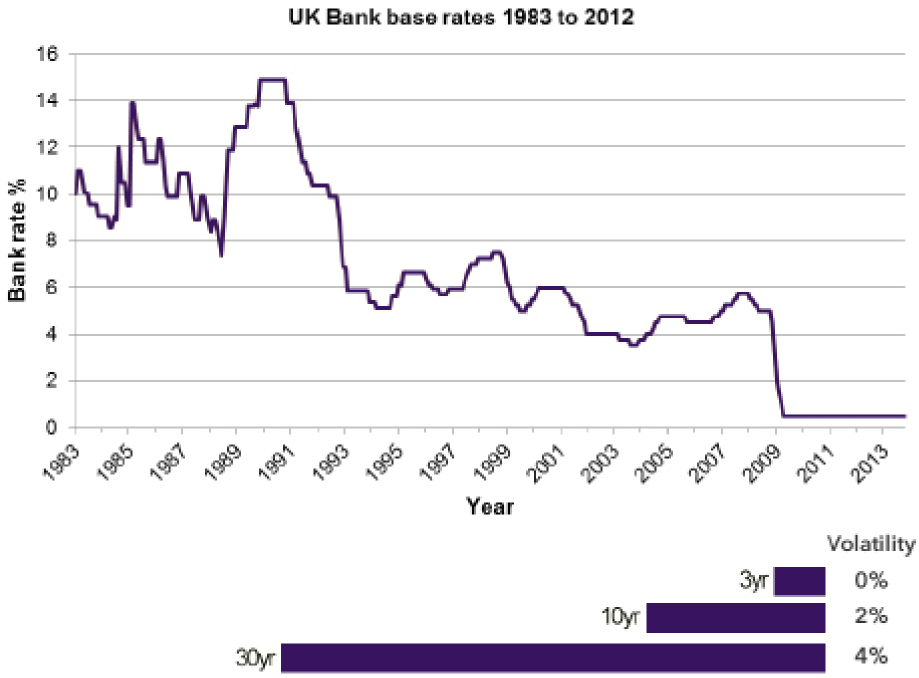
> "..adviser needs to bear in mind if you obtain risk over a certain term there is more to the story. Clients must be aware of the potential outcomes, losses and the timescale context."
>
> Rory Percival, FCA, FT Adviser, April 2013

You will need to consider:

- why establishing a time horizon for your client's investment is important, and
- how fund recommendations can vary over time, even for a single risk profile

If, for example, if you were to ask a sample of your clients about which type of asset they consider the least risky, cash would probably be the most popular answer. And certainly, for money to be accessed in the short term, this is likely to be accurate. If they invested £10,000 in a deposit account today and then wanted to withdraw it 1 month later, the chances are that they would receive £10,000 back. In addition, they would probably still be able to buy goods to a similar value. On the other hand, if this amount was left for 5 years, although they may still receive £10,000 (and maybe a small amount of interest), the impact of inflation may have reduced its spending power. Lets assume 'risk' to mean the probability of an investment losing its value over time. Inflation risk (the probability of an investment losing its value compared with prices) is a major factor when an investment in cash is being considered.

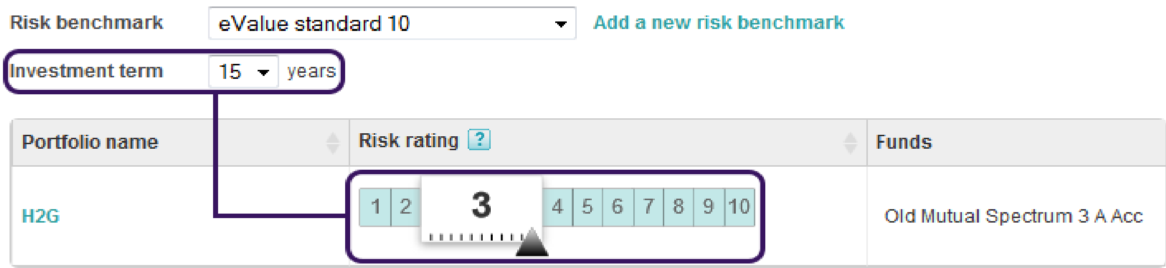
Cash has also proved to be an increasingly volatile investment over time. The following diagram demonstrates that, although in recent years there has been little or no movement in interest rates, over the longer term, there has been considerable change.

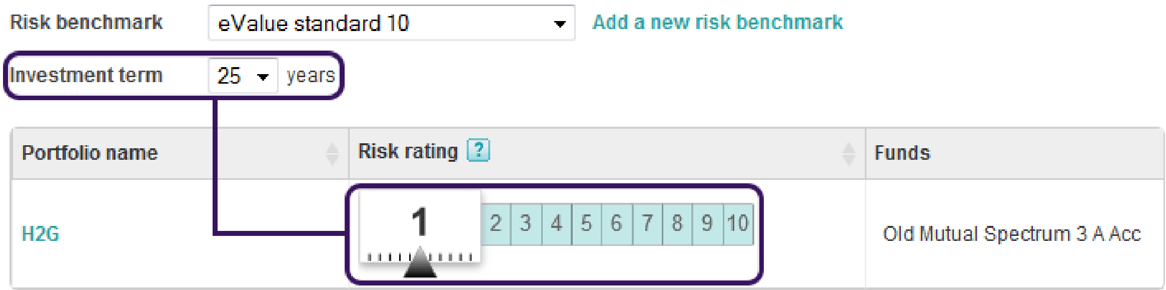


An investment in equities should be treated differently from investments in cash. Due to the potential daily price changes in this type of asset, they are considered to be, in the short term, a more risky investment than cash. If, for example, the client had invested £10,000 in equities and then sold them six months later, there is a chance that the investment might have grown to, say, £11,000. Alternatively it could have fallen to, say, £9,000.

Over this period therefore, the probability that value will be lost is greater with equities than with cash investments.   Let's, on the other hand, imagine that this investment is also left for five years. There can be no guarantee over the final return but is generally recognised that overtime an investment in equities becomes less risky. This is because the probability of it losing its value reduces.

As a result of these differences in behaviour, a fund's volatility and therefore its risk profile, can change over time. In the following example the fund being assessed is risk profile 3 over a term of 15 years (using the EValue 'standard 10' benchmark with Funds Risk Assessor). Over 25 years however this reduces to risk profile 1.





This illustrates the point very clearly that understanding the term for which your client plans to invest is vital before making a fund recommendation. It is likely that a different fund will be appropriate for a longer term than if they plan to access their money sooner, even though their individual risk profile remains the same.

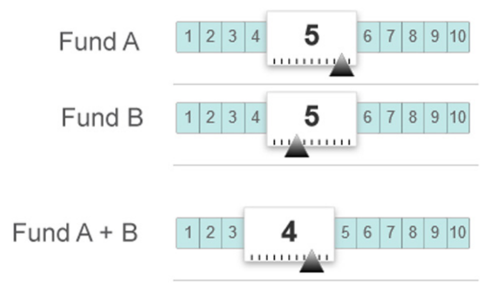
4. CONSIDER EXISTING INVESTMENTS - DIVERSIFICATION AFFECTS RISK

A well-diversified portfolio (one that includes a mix of shares or asset classes) is likely to be less risky than a portfolio that focusses on a single company or market sector. This is because, at a given point, where a particular type of share is falling in value, another one within the same portfolio is likely to be rising in value.

Let's take an example where a portfolio consists of shares in ice-cream companies and also raincoat companies. At any given time one of these is likely to be rising in value while the other is falling, due to market conditions.

The advisory process is not about simply recommending a fund (or funds) that matches a client's risk profile. Any other investments held by your client also need to be considered in order to ensure that the overall solution, including your new fund recommendations, aligns with the client's risk profile.

Even if your client has just one other fund and it matches his or her risk profile, you cannot be certain that, by selecting a further fund with the same profile, the overall result will be as expected.



Assets interact and change the overall risk profile when put together

An effective method of selecting funds in this situation is to use an online solution, such as EValue's Portfolio Analyser, and to carry out the following analysis:

- Identify the overall risk profile, over the planned investment term, of your client's current portfolio
- Compare this with his or her actual risk profile
- Select potential funds to be removed and/or added to his or her portfolio
- Calculate the combination of existing and new funds that matches your client's risk profile

The final step can either be carried out manually, or with the help of Portfolio Analyser's forecast & optimise facility.

5. SELECT AN APPROPRIATE FUND

We have followed a number of steps to identify an appropriate fund selection for your client. It would now appear to be a straightforward task to simply choose a fund that matches their requirements. There is however, a further consideration, which involves having a clear understanding of the underlying objectives for the fund manager of the fund being considered.

Let's look at two funds (funds A and B) that are launched at the same time. Both invest 70% of their asset allocation in a spread of UK equities and the rest in a mixture of cash, fixed interest securities and corporate bonds. Not surprisingly they receive the same risk rating of 7 on the risk profiling system used.

Moving forward 12 months, equity markets have risen substantially therefore the fund's value has increased by 20%. As a result, the equity content of the fund has risen to 90% of its asset allocation. Its risk rating has also increased to 9.

The manager of fund B has taken a different approach. He has concentrated on maintaining the balance of equities. As values have risen he has sold equities, converting them to less volatile assets. A year after launch the value of this fund has risen by 10%. Fund B's risk rating has remained at 7.

Surely, on the face of it, fund manager A has done his job more effectively. Certainly investors in fund A, receiving their annual statements after one year, are likely to be very happy with their results.

We will now move forward a further 12 months. Equity markets have fallen with the result that fund A has lost all its growth from year one. Fund B, although affected by the market, has experienced a much smaller loss and its value is still greater than its launch.

Now, who is happier?

Although fund B's performance has been less spectacular than fund A's, it has achieved its objective of maintaining its set risk profile.

In this example there is no right or wrong strategy as far as the funds are concerned. In a situation however where you are required to recommend a risk based solution to your client, the possible future behaviour of a fund must be considered.

6. THE EVALUE APPROACH

There will always be a range of factors that can impact the performance of a given investment portfolio, but getting the balance between assets consistently right and in line with your client's goals and attitude to risk is a clear priority for advisers and a requirement from the FCA. Ultimately, it ensures that the advice given is of a high standard as advisers provide recommendations that take into account client's existing assets, by blending existing and new funds together and matching them to the clients profile. This ensures that rather than delivering a "one profit fits all", advisers can offer investment solutions that are individually tailored to each client with minimal effort.

We hope you found this EValue 'How To' Guide helpful. Look out for others appearing on our website at ev.uk where you can also find details about our range of EValue's Adviser Solutions.

If there is a subject you'd like to know more about, then we'd love to hear from you. Please email us directly.

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