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“My crystal ball is no clearer than yours” a UK IFA

Introduction

This chapter will:

- explore options for the way an advisory firm develops client investment strategies.
- enable firms to review the clarity, effectiveness and efficiency of approaches taken to date and whether a degree of revision is appropriate.

The process used when developing client investment strategies must be robust, repeatable and based on principles understood by clients at outset and when reviewing their investment arrangements.

In this chapter, we will examine the:

- importance of documenting the firm’s proposition
- investment philosophy and execution equation
- relevance of adopting a uniform “house view” on investment beliefs and execution
- high level regulatory context
- generic investment beliefs espoused by many firms
- typical process employed by advisory firms
- considerations when developing a “house view” along steps in the investment process e.g. which tasks will the business retain in-house and which elements will be “out-sourced”
- consideration in adding value to investors’ experiences
- outline content headings for an investment proposition document

Importance of documenting the firm’s investment proposition

A key output of a firm’s proposition design would be a client investment policy document.

Typically, such documents describe a firm’s:

- investment beliefs and philosophy
- investment advice process
- approach to selecting investment solutions
- investment administration strategy (e.g. wrap platform)
- approach to due diligence

The document would be a reference point for all parties interested in the firm’s investment processes. It also saves people in the business from wasting time, effort, expertise and value in “re-inventing wheels”.

The “Investment Philosophy and Execution” Equation

A consistent and clearly articulated philosophy is one side of the investment proposition equation. The other side of that equation is represented by the methods a firm uses to put its philosophy into practice i.e. execution.

Method(s) of execution chosen (e.g. multi-manager, advisory model portfolios, discretionary management) may vary from time to time, segment to segment or client to client.

In order for the equation to balance, the investment solution recommended must be demonstrably faithful to the philosophy and beliefs espoused by the business. In other words, does the solution do “what it says on the tin”?

Adopting a “house view” on investment

All staff and advisers within an advisory business need to embrace a “house view” on the principles underpinning investment solutions recommended to clients.

This does not mean advisers are placed in a strait-jacket or that clients are shoe-horned into any Centralised Investment Proposition developed by the business. As a rule, one client meeting two different advisers from the same firm, should expect:

- to be guided through the same investment process
- receive recommendations similar enough in content so as to make any differences relatively insignificant and certainly not structurally diverse e.g. one adviser recommending active funds within a bond, the other recommending passive investments within a SIPP.

The nuts and bolts of plans advisers assemble for clients should emerge from a uniform and “corporate” set of beliefs and principles. It is up to firms to then decide the degree of latitude it can afford to give its advisers when it comes to assembling portfolios for clients. A major factor in this decision will be the obligation resting on the firm to take responsibility for future maintenance and review of whatever solutions are implemented today by its advisers.

Regulatory Context

The ways advisory firms deal with, and demonstrate consistency in creating and charging for, clients’ investment strategies have been the subject of regulatory pronouncements under various headings such as:

- Treating Customers Fairly (TCF)
- Retail Distribution Review (RDR)
- Centralised Investment Propositions (CIPs)

The Regulatory Requirements

What are the FCA looking for in terms of Treating Customers Fairly?

- A well-defined process to explore a client’s attitude towards volatility in investment values
- Discussion regarding a client’s capacity for loss
- A well-defined asset allocation process – which is matched to client risk
- A clear and documented approach to fund selection and review
- A process for clients who pay for a regular review and investment update service
- Consistency of approach across the business and all advisers

The key words here are “clear, defined, documented, process & consistency”.

These are really terms associated less with a regulatory imposition than with common business sense. A business will be more efficient and find it easier to demonstrate consistency of inputs to satisfy TCF / Risk Profiling requirements when operating one robust and clear process for:

- Risk profiling/Capacity for Loss appraisal
- Asset allocation
- Fund selection
- Tax Wrapper selection
- Route(s) to market, endorsed at business level rather than dictated at adviser level

Operating a “free-for-all” range of processes invites into the business the virus of variability, discussed at length in Chapter 2.

The inputs and processes used should be reviewed and tested periodically, probably annually, to ensure they remain appropriate.

Generic investment beliefs

The remit of this chapter is not to dictate the investment beliefs of advisory firms. However, as a generic reference point, we will assume most readers will recognise, relate to probably concur with the summary below. The rest of the chapter is based on the beliefs outlined here:



Typical investment advice process

In order to set out the issues for consideration in the design and build of a client investment proposition, this chapter will work its way through steps in the following process. This is one which most advisers will recognize and possibly already follow, albeit with one or two steps maybe in a different order from that set out here:

1. Establishing the client’s goals and timescales
2. Exploring the client’s attitude towards investment risk
3. Agreeing the client’s capacity for loss
4. Diversification

- a. Creating an asset allocation “blueprint” for the client
 - b. Deciding on asset allocation management strategies
 - c. Fund management “strategy” – Passive or Active
5. Implementation
 1. Fund/stock selection criteria
 2. Re-balancing
 3. Upgrading
 4. Degree of delegation/out-sourcing
 5. Segmentation
 6. Disciplined maintenance of the client’s strategy
 1. Time in the market
 2. Managing investor behavior

1. Establishing the client’s goals and timescales

An initial meeting can take account of a client’s personal and financial circumstances and broader investment attitude, experience and knowledge. For example:

- Is the client looking for capital growth or protection over the short/medium/long term?
- What are the client’s current income requirements?
- What will be the client’s income requirements in the future?
- How much money does the client have to invest after setting aside short term, liquid funds?
- What are the client’s existing investments
(will they remain fit for purpose in light of client’s current requirements?)

2. Exploring the client’s attitude towards investment risk

Establishing a client’s attitude to, or appetite for, investment risk means taking account of several factors such as:

- The anticipated length of time before they want to use the capital accumulated
- Whether they need income from their investments
- Cash reserves to meet unexpected circumstances
- How they think their earnings might grow
- Whether they have any debts
- Their overall view on investing
- The importance of protecting their investment from the effects of inflation
- The question of ‘liquidity’- how easy will it be to get their hands on their money?

In addition, it is important that clients understand the various types of risk associated with investment issues, such as

Inflationary risk

Clients should be aware of the potential erosion of the purchasing power of capital left in cash deposits

Taxation risk

Clients need to be aware of the impact of taxation regimes in order that the net value of their resources are not taxed unnecessarily

Shortfall risk

Some clients’ objectives will be pipe dreams unless they take more risk than their initial profile outcome suggests they are prepared to tolerate. Therefore, a conversation would be required about the need to:

- accept more risk **or** invest more money **or** compromise on their goals.

Economic / political

All sorts of unpredictable issues can arise to rock the boat which no scientific modelling can predict. e.g. changes of government, war, banking crisis etc.

Currency risk

There is a risk that returns from certain types of investments involving overseas exposure could be adversely affected by movements in exchange rates.

Interest rate risk

A rise in interest rates payable on any financial debt owed by a client may mean the expense of the debt may exceed returns on their investments.

Methods used to help agree a client's "risk" profile

In March 2011 the FSA expressed key concerns regarding client's understanding of investment risk in their "Finalised Guidance – Assessing Suitability". Their main concerns were that:

- clients were not being helped to considering the various types of risk
- many processes ignored an option of "no risk" in terms of attitude to investment risk (many would dismiss a "no risk" category because the effect of inflation represents a risk to the real value and buying power of a client's cash resources)
- advisers didn't understand the
 - tools they were using
 - assumptions used to produce the outputs
- there was insufficient consideration of capacity for loss or the level of risk that is required to meet identified objectives – sometimes it may need to be higher or lower than the score suggests.

Original methods of matching a client's attitude to risk with an insured fund amounted to little more than ticking a box on an application form to indicate whether the client was: very cautious, cautious, balanced, aggressive or speculative.

Later, psychometric questionnaires provided the opportunity for a greater depth of discussion. Most firms have never solely relied on the outcomes of these questionnaires.

A commonly understood expectation across the advisory profession now is that, as part of evaluating a client's needs, an adviser will

- have a conversation with clients about the various forms of risk
- explain what their "risk profiling" questionnaire is designed to do before they complete it.
- discuss outcomes of the client's answers to the questionnaire
- discuss any anomalies between these outcomes and what they may have said in previous discussions or with what they thought the outcome might have been
- agree with the client what feels the most appropriate "profile" in relation to the range of objectives and timescales (short, medium, long term)the client is looking to address.

The outcome of discussing the results of the questionnaire may result in a conclusion regarding the client's risk profile which differs from that produced by the questionnaire itself

3. Agreeing the client's capacity for loss

Advisers also have a responsibility to assess clients' capacity for loss. This means assessing whether, if the possible risks of their potential investments were realised and they were to lose money, it would have a detrimental effect on their standard of living.

This should be taken into account in establishing the risk clients are able to take. A client's capacity for loss may affect the risk profile score used when developing a recommended investment strategy.

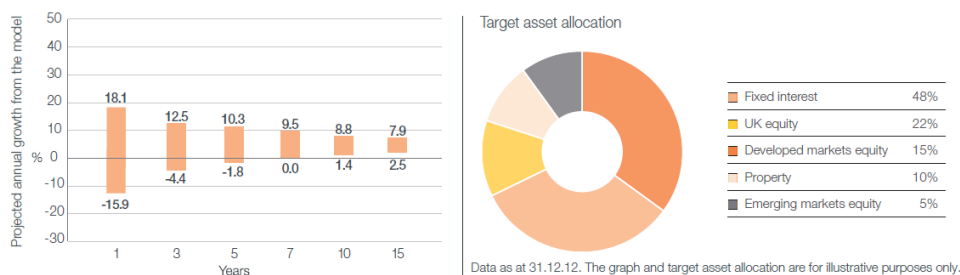
It is also relevant to establish what their experiences have been in the past of investing and how they felt and what their learning was from those experiences.

Some firms use standard tables to illustrate degrees of potential loss associated with different risk profiles such as:

Amount Invested	Risk profile	Estimated maximum likely loss	Estimated maximum likely gain
£50,000	1	£1,414.78	£1,027.66
£50,000	2	£2,756.00	£3,350.05
£50,000	3	£3,916.60	£5,265.08
£50,000	4	£6,441.00	£9,088.34
£50,000	5	£7,892.32	£11,311.48
£50,000	6	£9,368.28	£13,729.23
£50,000	7	£10,793.80	£16,087.00
£50,000	8	£11,984.04	£18,114.33
£50,000	9	£13,374.62	£20,473.43
£50,000	10	£15,500.43	£24,082.95

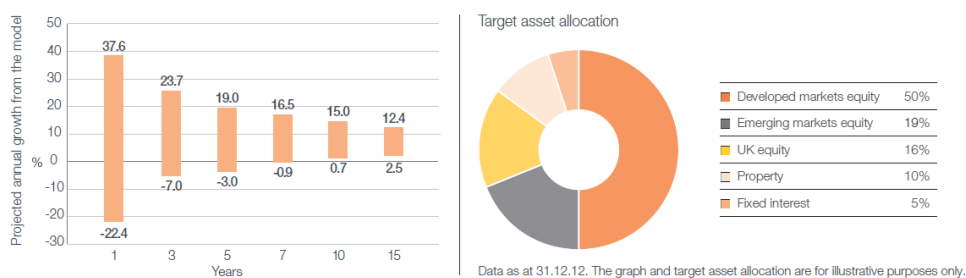
Source : Distribution Technology LTD (This table should not be used in isolation of the full guide)

Risk profile 3



You are prepared to accept investment risk in return for growth potential. Typically you will invest in a wide variety of assets including exposure to shares. This will increase the amount by which your investment will rise and fall in value. You could get back less than you invest.

Risk profile 6



You accept a very high level of risk on your investment in order to seek very high growth potential in the long term. You are willing to accept sharp day-to-day increases or decreases in the value of your investments and you accept the risk of losing some or all of your capital.

Source: Partial copy of Architas Capacity for Loss Guide – these images should not be used in isolation of the full guide.

Quality warning!

An advisory business needs to ensure the outcome of a tool used to establish a client's risk profile is catered for by investment solutions recommended. It is not enough to rely upon a "balanced" outcome defined by the tool as being catered for by a solution which just happens to be labelled by its provider as "balanced". The firm needs to be clear that assumptions used in the solution design mirror the basis used in the risk assessment tool/questionnaire.

The value to clients of Steps 2 & 3 in process

- educating them and giving them a chance to discuss risk in more detail means they can make a better informed decision which in turn increases their confidence in the steps taken
- making them aware of the impact of volatility and the potential dips in value they may experience means they are less likely to make reactive, irrational and emotional decisions that could adversely affect their longer term fortunes
- taking time to involve and engage a client in the process which underpins recommendations made means they are less likely to be concerned by press and media articles they come across which set out how consumers should expect to be treated by advisers

A client's confidence in the decisions they make influences the peace of mind they feel subsequent to their decision. The root of that confidence lies in the time taken to ensure they understand the relevance of their attitude to investment risk.

So, there is great value in getting Step 2 & 3 right. What once may have been seen as an imposed "tick-box exercise" has become the foundation of a robust and transparent investment proposition.

4.1 Applying the principles of diversification

A widely accepted and employed method of designing a strategy aligned to an investor's risk profile is to ensure investments are spread across a suitably diverse range of assets. No single type of asset, investment strategy, or investment manager provides the best performance over all time periods.

Diversification should reduce the risk of a portfolio suffering simultaneous underperformance across all categories and can be achieved at several levels, including:

- Asset Class (Cash, Fixed Interest, Property, Equities)
- Assets within asset classes:
 - Geography (UK, US, Emerging Economies)
 - Sector (Financial Services, Pharmaceuticals, Retail)
 - Industry
 - Stocks
- Asset allocation management approaches
 - Strategic
 - Tactical
 - Strategic with allowance for tactical variations
- Fund management strategy options:
 - Active
 - Passive
 - Blend of active and passive
- Spread of fund managers

These are all key areas to be considered by anyone building a portfolio for client investment. Uncertainty regarding "house policy" with regard to diversification and inconsistency in application of the principle adds risk to a business and diminishes the value from which clients can benefit.

4.2 Diversification through “Asset allocation”

Each type of asset can respond differently to the same prevailing investment market conditions – asset classes expected to respond very similarly to each other are said to be highly “correlated”. Diversification within a portfolio across assets that tend to behave in different ways can help protect it against market fluctuations, whilst providing the potential for rewarding returns. Therefore, it is important to design a blend of assets which have:

- appealing long term risk/return characteristics and
- relatively low correlation with each other

That way, if one asset class falls at any point, there is a reasonable chance that the other may not, thus providing some protection and reducing volatility of returns for the portfolio. Price volatility can be unsettling and reducing that volatility gives a greater likelihood that investors can stick to their long term strategy and realise their goals.

The following diagram illustrates the benefits of diversification over a recent 10 year period in the investment markets.



Source: Morningstar as at 31.12.2012

Please note: Past performance is not a guide to future performance. The value of an investment can fall as well as rise and is not guaranteed. Investors could get back less than they invest.

The chart plots the average returns from 11 of the most common IMA (Investment Management Association) sectors. It highlights the fact that sectors attain a different position in the rankings each year with many moving from top to bottom in quick succession.

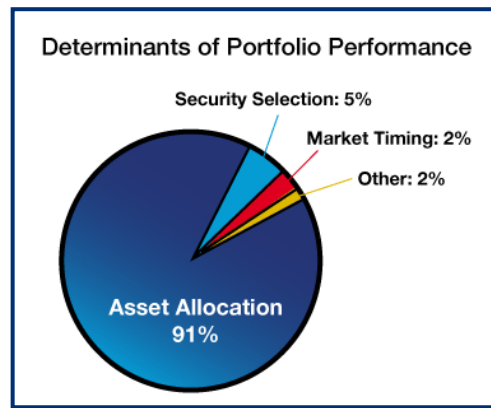
An asset allocation blueprint ensures diversification across types of asset. In general terms, an asset allocation for higher risk profile scores would contain a higher proportion of equity-based holdings than lower scores.

It is also important to ensure effective diversification within each asset class across a wide range of countries, currencies*, industries and stocks. This can also reduce concentration on a particular region or industry. In the event of a regional or industrial downturn the impact on a portfolio should be less damaging.

* Naturally, changes in the exchange rate will affect the sterling value of the investment.

The Influence of Asset Allocation on Investment Returns

Significant research supports the view that being invested in the right asset classes and funds at the right time has a strong impact on investment returns. The following diagram shows research output from Financial Analysts Brinson, Singer and Beebower (1991). They analysed what factors were the major determinants of variability in portfolio performance over time.



What is the view and practical manifestation regarding the various elements of asset diversification in your business and how is this articulated, documented and maintained?

4.3 Asset Allocation Management Approaches

The three main approaches to the on-going management of asset allocation are:

- Strategic – the long term view of asset allocation, based on a base mix of assets adhered to over the long term. Strategic asset allocation is very much the core of portfolio strategy.
- Tactical – a shorter term view of asset allocation. Tactical asset allocation is the process of making short term changes to asset proportions to exploit current market and economic opportunities in an attempt to generate additional investment returns or manage risk. Tactical adjustments may be a measured 'temporary' departure from the long term strategy, in the belief that some markets are temporarily over or undervalued.
- Targeted Volatility – a strategy that adjusts the asset allocation to maintain the levels of portfolio volatility within agreed tolerances.

Where a firm builds its own or out-sources portfolio design, it needs a clear policy on their chosen approach to asset allocation management. Due diligence on preferred suppliers should provide evidence of a match between the firm's stated beliefs and the composition of solutions it recommends.

4.4 Management Strategies – Active or Passive?

These terms refer to the degree of trading activity taking place within a fund not about the degree of an adviser's involvement in portfolio monitoring and administration.

Active fund management seeks to exceed the average returns of the financial markets. Active managers rely on research, market forecasts, and their own judgement and experience in selecting securities to buy and sell.

Passive fund management is an approach which assumes markets are 'efficient' in that everyone has access to the same information rendering stock picking futile, adding cost rather than value. Investors would expect performance to "track" the indices of markets to which their funds are related.

Arguments presented by advocates of an Active strategy include:

- A passively managed fund should underperform the index it is tracking because transaction costs and management charges.
- While some active funds do underperform the index, there are plenty of funds which do outperform. Some have done so consistently for many years.
- Indices are generally constructed according to the free market capitalisation of shares, so the largest companies have the biggest weighting, whether or not they are the most attractive investments. This can mean that the holdings of a passive fund are highly concentrated in a handful of companies and sectors. For example, in May 2012, the ten largest companies in the FTSE 100 represented about 45% of the index. HSBC and Shell, the two largest companies, together accounted for 14.5% of the index.
- Passive investment means being fully invested at all times, whereas the active fund manager has the opportunity to hold some of his or her fund in cash if the market is falling.
- A passive fund has to take up an index constituent's rights issue, even if the company is failing.
- The regular re-balancing in indices can be exploited by active managers who know that passive funds will have to buy and sell certain shares on specific dates to match the index revisions. This can mean the passive funds are forced to buy at inflated prices and sell at depressed prices.
- Passive funds generally have to follow an index, so if there is no appropriate index, there can be no passive investment option. Some categories of fund, such as absolute return funds, are therefore only available as active funds.

Arguments presented by advocates of a Passive strategy include:

- Most actively managed funds underperform the market(s) in which they invest. This is only logical, because the investor community as a whole will perform in line with the index, which suggests half of managers will outperform and the other half will underperform. The impact of charges tilts the balance towards underperformance.
- Research by Burton Malkeil says that in fact 2/3rds of active funds under perform the average in any period and of the 1/3rd that over perform the average very few will do so in the following period of analysis.
- It is rare for even the best-performing funds to consistently beat the index. Much academic research suggests that it is very difficult to identify successful investment managers, other than with the benefit of hindsight.
- Fund managers have a very high turnover rate – the average manager stays in place for only three to four years.
- Annual management charges (which exclude trading costs) are generally much higher for active funds – typically 1.5% against 0.5% or less for passive funds.
- Active management also incurs additional transaction costs as the managers rearrange their portfolios. It is not uncommon for portfolios to have 100% annual turnover rates. For UK funds, there is the extra cost of stamp duty at 0.5% on each share purchase.
- Active managers often use an index as the starting point of their portfolio, not least because their performance is often measured against an index. This can lead to 'closet index tracking', where active management fees are charged for what is largely passive fund management.

A market trend – blending Active and Passive styles

A passive approach to fund management gives clients access to the markets at a competitive price. Active management, whilst more expensive, may add value because of the opportunities its managers can seize if they make the best decisions.

On the basis that "My crystal ball is no clearer than yours" there is a growing population of advisers who are adopting a "blended" approach as a means of diversification for clients and tempering costs, a potentially best of both worlds approach.

Indications from the regulator are also that a firm prepared to only make recommendations based on one style or another will need to hold themselves out as Restricted. A firm however that has a belief that one approach is more favourable than another but allows clients choice and has the capability and processes in place to advise on the alternatives can still be called Independent. Indeed if a firm has a fundamental belief in a particular philosophy and only 50% or even 70% of clients are buying into it, then it would say their argument is not compelling enough. It is not for the regulator to say that an adviser is right or wrong to believe wholly in active or wholly passive and suggest they should change their beliefs to ensure a particular title is maintained. You either believe or you don't or you can't be sure. Is it better to work with an adviser who is confident and has conviction or one that is unsure, hedging bets! We will look at the restricted / independent argument in a future publication as I see the titles applied as being another constraint in the market.

Potential impact of market trends

The value of funds held by personal clients up to the end of the tax year 2012/2013 was weighted heavily in favour of active fund managers. The case for a Passive style has become increasingly well publicised and is gaining credence as at least an element within many advisory businesses' solution design.

As the market for Passive funds grows, a tipping point may be reached. The number of active fund managers may reduce. A number of remaining managers could gain access to information in a more timely way than others, giving them a competitive advantage. Market forces could see active fund management charges reduce in response to competition from Passive funds. This would reduce the effect of charges on returns, which is ammunition used to argue against active management.

Firms may articulate the pros and cons of each approach in an impartial way and allow clients to form their own opinion. There are some dangers with this around consistency of approach, particularly where a firm has a number of advisers. Personal adviser perspective is likely to show through and questions could be raised over why one adviser might have clients "choosing" one route that others don't.

5. Implementation

Having decided on its investment philosophy, beliefs and process, an advisory business needs to find a way of putting them into practice efficiently, consistently and effectively.

In short, this means determining what kind of solutions and funds, within which tax wrappers represent the best route for a client's invested assets.

This chapter will not deal with tax wrapper selection as this is an element of the advice process linked to different considerations from the design of the underlying investment portfolio.

Also, it is recognised that solutions such as structured products may have a legitimate role to play in populating a client's overall investment strategy, but their merits will not be discussed here.

5.1 Fund selection

Creating well diversified portfolios of investment funds to match a range of client risk profiles requires significant research expertise and resource. Monitoring the blend of funds selected requires detailed analysis and review.

Selecting funds to populate the various asset sectors within an asset allocation blueprint presents many challenges including:

- Making sound choices by staying abreast of options from over 30,000 investment funds available in the UK.
- Finding sufficient, reliable information - how can the causes of good or poor fund performance be confirmed?

- Keeping track of all the manager changes that take place so we know who is truly responsible for performance.
- Confidence that several funds selected for a diversified portfolio are not all investing in similar things.
- Keeping fund “intelligence” up to date. This is the hardest challenge of all – getting access to meaningful information to judge whether change is needed and having the necessary objectivity to make changes.

There are myriad factors that can be taken into account regarding fund selection, such as:

High Performance – Identifies fund managers who can demonstrate consistent high performance against the market

Low Volatility – Identifies fund managers who have achieved good returns and done so with low volatility

High Alpha – Identifies fund managers who have achieved good returns over and above their peers or sector

Low Maximum Loss – Identifies fund managers who have managed the downside of investing by achieving a low maximum loss

Low Tracking Error – Analyses a fund’s total return and compares that return against the amount of risk taken to achieve it

High R2 – Identifies how much of a fund managers return is due to good investment management as opposed to general market trends

High Information Ratio – To understand the relationship between the level of risk being taken and the return achieved

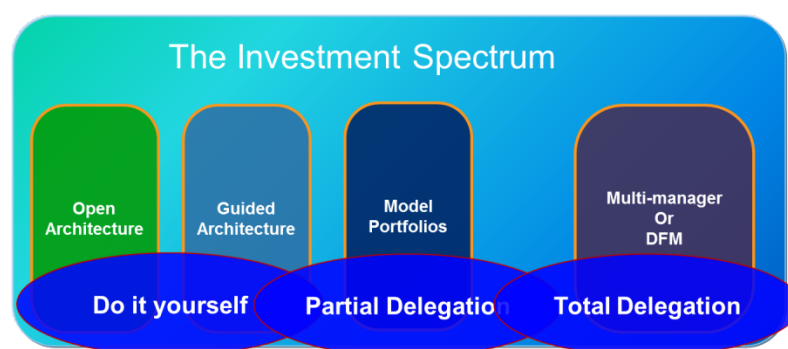
Low Semi Variance – To understand the fund managers downside volatility – i.e. a high semi variance = a high downside risk

High Sharpe – Identifies how much of a fund managers return is achieved by making smart investment decisions i.e. a higher ratio = less risk

Low Correlation – To understand how different fund managers achieve their returns, by analysing the underlying stock holdings and comparing the impact – E.g. Ice Cream and Umbrellas

These factors and the volume of funds available raise the prospect of delegating elements of solution construction to a trusted third party. Various delegating options exist across the investment spectrum.

Delegation of solution design and construction must not, of course, be confused with abdication of responsibility and accountability for ensuring the solution created is fit for a client’s purpose



Open Architecture Option

Technology enabling **Open Architecture** provides firms with the means to conduct universal fund research and create in-house portfolio recommendations. This enables a totally “do-it-yourself” approach to portfolio construction

Guided Architecture Option

Technology enabling **Guided Architecture** provides firms with a degree of fund “filtering”, so the universe of funds available is reduced to those funds meeting certain qualifying criteria. The firms then use the resultant panel of funds to construct client portfolios.

Implications of creating in-house client portfolios

When building portfolios, firms without discretionary investment powers have 2 options:

- They can create and maintain a series of “model portfolios”.
The firm would build enough models to cater for the range of risk-ratings emerging from that stage of its investment process –e.g. ratings of 1-7 or 1-10.
This means all clients sharing the same risk rating from their profiling can be offered a pre-ordained portfolio matching their rating.
- They can also decide to build an individual portfolio for each client they meet.
This is known as creating a “bespoke” portfolio.

The key difference between the 2 options rests in the inherent administrative implications.

If a firm runs say 7 model portfolios, no matter how many clients they deal with, they only need to maintain 7 portfolios when it comes to governance and fund selection. At worst, some clients may decline advice to “re-balance” or “upgrade” the version of a model they own. Through wrap platform technology, the administration of this issue is straight-forward.

If a firm builds a new portfolio for each client it engages, then after engaging 50 clients, they have taken responsibility for maintaining 50 different portfolios, even if several of them were built for clients with the same risk profile score

A be-spoke approach is by definition, highly personalised and should come at a higher price than a model. However, a higher charge may erode the real benefit and value a client derives.

If running bespoke or model portfolios in house a firm needs to be confident in its ability to: perform the upgrades effectively across all clients on time, undertake its commitment to re-balance on the due dates, maintain due diligence on the portfolios, obtain express client consent for any changes unless they hold discretionary powers and manage any CGT implications.

Investment Committee

For firms building and maintaining in-house portfolios, there is the added governance obligation regarding up to date asset allocation “blueprints” applicable to the range of risk profiles for which its portfolios are designed to cater.

In addition, the firm needs to operate a robust process for reviewing the funds it regards as suitable for inclusion in portfolios.

Most firms running client portfolios will need to have at least a quarterly investment committee reviews. These meetings should feature:

- agendas
- minutes from the meetings
- clearly recorded decisions
- documented actions
- records to show actions have been followed through within the service agreement criteria.

Key questions the committee need to address include:

- How often are “selected” funds reviewed?
- What triggers are used to determine whether a fund should be de-selected?
- What are the systems and processes does the firm use to ensure any portfolios in need of a change are identified and amended in a timely and cost effective way?

Investment Administration

If client holdings are spread across a range of routes to market, firms will have a number of systems, companies and processes to deal with in order to manage changes.

They may have grouped their clients into say 6 portfolio groups. However, if they have 6 typical product / platform / supermarket routes to market they will have created up to 36 different processes to follow.

It may also be that the different routes utilised do not enable access to the latest range of funds the firm wishes to include in its portfolios. Some clients may therefore end up with a fudged version of the centralised model. That way lies confusion, risk and poor service standards.

To reduce the dangers of variability with the associated impact on costs and risks of oversight, model portfolios are best managed through as few routes to market as possible. It is also important that the routes have the right level of flexibility and options to fully or best meet the philosophy and beliefs of the firm. For example, there is no point in having a blended or passive philosophy and not having a route to market that can offer a reasonable selection of these options.

Third-party Portfolio Design

Partial delegation can be achieved by utilising the services, subject to due diligence, of a third party provider of model portfolio solutions. Administered via wrap platform technology, these models are designed in accordance with a stated approach to client risk profiling and their belief in the shape of associated asset allocation blueprints.

Total Delegation

Total delegation, in terms of administration, can be achieved through the use of referred discretionary investment managers or multi-manager solutions.

Investment via Discretionary Fund Managers (DFM)

DFMs offer bespoke portfolios or run their own model portfolios. It is important if outsourcing to A DFM that a firm’s due diligence tests the robustness of their systems and processes to maintain the portfolio in line with the client’s objectives. If they are running bespoke portfolios how often is the asset allocation monitored and up-dated and at what cost?

Some DFMs manage client portfolios via platforms, in which case the range of investment instruments will be based upon those accessible via the platform.

Client’s Attitude to Risk and Investment Brief Communicated to DFM

It is important to communicate in writing to the DFM the level of downside risk a client is willing to take. It is also important if a certain level of income is required to communicate this to the DFM as well.

It is important to agree targets, benchmarks and review dates with the manager and the client so the brief is clearly understood by all involved.

Asset Allocation via DFMs

The DFM will devise and maintain their own approach to asset allocation, which may be based upon a strategic approach with room for short term tactical variations.

DFM Selection Criteria

Aspects firms need to analyse when selecting a DFM to which they wish to refer clients could include:

- Ownership Status – Is the firm owner managed or owned by a third party
- Nature of the core business
- Fund Management Personal
- Structure of the research and support network
- Fees payable for all aspects of work undertaken
- Assets under management split by retail and institutional
- Asset split by defensive, balanced and aggressive mandates
- Average Portfolio size
- Performance
- Benchmarking usually against APCIMs (Association of Private Client Investment Managers)
- Risk Controls at portfolio level and manager level
- Asset Allocation – Process and also review process
- Custodians and Investor Protection
- Reporting – how often will reports be issued, in what format and what access does the client have to their portfolio manager
- Relationship management with advisory firm etc

Reviewing DFM Relationships

As with any other investment “partner”, on-going relationships with DFMs need to be subject to a review of due diligence at a pre-determined frequency or if the firm sees signs that the DFM is failing to meet the criteria agreed as the basis of their relationship.

In the event of needing to change DFM’s or revert investments to another Investment Manager what are the cost and timing implications of doing so? These should be understood and agreed with a client in advance.

Multi-manager solutions

Multi-manager funds are created by specialist companies with the resources, research capability and technical proficiency to enable the implementation of underlying investment beliefs and to manage funds on a day to day basis.

Multi-management is a strategy for investing whereby a group of investment managers or funds, each a specialist in their own field, are blended into one holding multi-manager fund, i.e. a “fund of funds”. The skill of a multi-manager is to carry out quantitative and qualitative research and analysis across a variety of criteria to arrive at appropriate decisions regarding manager and fund selection relevant to a pre-defined asset allocation model or volatility measure.

The multi-manager takes responsibility for:

- Ensuring effective diversification is achieved in designing the solution
- Research into, and selection of, funds to be held within the fund of funds
- Maintaining the pre-defined asset allocation blueprint or volatility measure for the fund
- On-going monitoring
- Changes to funds held within the overall “fund of funds”

The sale of holdings within a multi-manager fund does not currently give rise to a disposal for CGT purposes. This aspect can represent an advantage when seeking to create a tax efficient investment strategy for clients. However the CGT liability can accumulate over time, so it is important from a financial planning perspective to annually review if some disinvestment and reinvestment should take place in order to realise a gain and re-base the portfolio.

5.2 Disciplined maintenance of a client's strategy - Rebalancing

“Analysis by Skandia shows that over a ten year period an investment portfolio that has been rebalanced annually would have returned 16% more than the same portfolio if it had not been rebalanced. In addition, the rebalanced portfolio would have been significantly less volatile over the period.” Skandia Sept 2009

Other research shows more marginal growth benefits nearly all seem to illustrate that re-balancing a portfolio to its original asset allocation “blueprint” fosters lower volatility, which in turns tends to reduce investor anxiety.

Vanguard Fund Management’s “Best practices for portfolio rebalancing” suggest that in general an annual rebalancing strategy, with some tolerance considerations of around 5% drift from the desired asset allocation is sufficient in the majority of circumstances.

A business running its own portfolios, or running portfolios designed by a third party, will need to decide on the frequency of re-balancing. Some firms feel quarterly is relevant, others opt for annual re-balancing. In this context, re-balancing will incur a degree of cost for a business and potential tax considerations for clients will need to be borne in mind.

DFMs re-balance according to the mandate agreed as part of their service to clients.

Re-balancing in multi-manager funds takes place within the over-arching fund itself, so no CGT implications arise. It is good practice however for a firm to realise gains periodically but this is easier to control.

5.3 Disciplined maintenance of a client's strategy - Up-grading to new versions of portfolios

Once the underlying asset allocation blueprint for a particular portfolio needs to be changed and/or funds regarded as suitable for retention in a portfolio alter, then a new version of the portfolio will be created. This means existing clients invested in the previous version can be offered advice to “up-grade” to the new version, but without discretionary permissions the client needs to approve such an upgrade in one way or another.

DFMs in effect constantly “upgrade” client portfolios. Models will be upgraded through the discretionary nature of their management activity. Clients with highly bespoke portfolios may prefer a conversation with the DFM regarding a change, but this will be agreed as part of the on-going service agreement between manager and client.

Multi-manager funds are constantly up-graded within the fund structure as the fund of fund manager has a mandate to trade stocks as he/she sees fit in line with the objectives and nature of the fund

5.4 To outsource or not to outsource?

The degree of delegation an advisory firm undertakes in respect of its investment solution design and management is a major decision and will be based on a number of factors such as:

- can the firm consistently add value by constructing and maintaining portfolios of funds for clients achieving greater value for money and performance than would be achievable otherwise?

- if so, is it charging profitably and appropriately for doing this
- can the firm do this and deliver the bigger added value picture (tax & trust strategy, service, planning, investment behaviour management etc) to clients at a profitable and appropriate rate?

If they have the in house investment expertise but struggle to make it profitable, then is there flexibility on pricing and / or more efficient means of managing portfolios?

If they have the in-house investment expertise and it is profitable but they struggle to add value in terms of the bigger picture, then can they afford to buy in that expertise or invest in developing that expertise with what they have, or do they become an outsourced service themselves to other financial planners?

If they want to focus on the bigger added value picture but investment expertise and management either doesn't exist, gets in the way or they don't want to do it, then they can fully outsource the investment management.

Outsource requirements

Outsourcing responsibility does not mean outsourcing accountability.

An advisory firm still has to formulate its key philosophy and beliefs and then find external expertise to faithfully follow that remit.

A firm needs to carry out due diligence on the organisation to which it has decided to delegate tasks within the investment process – this applies as much to risk-profiling questionnaires as it does to DFMs and multi-manager investment houses.

The clearer and more detailed the due diligence and selection criteria used, the more effectively a firm can filter the market down to a manageable number. Final selection may be subject to a standard “beauty parade”.

5.5 Segmentation of investment options

Just as firms need to segment their Client Service Propositions there invariably needs to be some segmentation of how they deliver their investment services within the client propositions.

A typical scenario:

- Many firms are now adopting a strategy of using Multi-managers for clients who want a transactional or light touch service, that typically have low or modest fund amounts. This ensures their portfolios are rebalanced and maintained in line with the originally agreed risk profiles between events or extended review dates.
- For the core of their client base that have engaged in an annual review service they may run a model portfolio service
- For their very affluent clients they may provide the option of a bespoke portfolio service for an additional fee to ensure they cover the extra cost and risk associated with this service.

There are obviously a range of variations on a theme.

6.1 Investment discipline - Time in Market versus Market Timing

When running portfolios or outsourcing the management of them, what are your beliefs around Market Timing?

The graph below shows the impact on capital value of taking time out of the market.

Missing the best 5 days in the market means losing the best part of 40% of the growth otherwise available – gaining £311,000 instead of £498,478

Missing Top-Performing Days Can Hurt Your Return
Hypothetical investment of £100,000 in the FTSE All-Share Index over the last 20 years (1991–Aug. 2011)



Sources: BlackRock; Thompson Reuters Datastream. FTSE All-Share Index (total return). It is not possible to invest directly in an index. Past performance is no guarantee of future results. The information provided is for illustrative purposes only and is not meant to represent the performance of any particular investment.

The history of investing over the last 100 years tells us that:

- the economy goes through cycles (inflation, deflation etc)
- disasters happen –natural (earthquakes, tsunami) or manmade (war, terrorism etc)
- some assets will always out-perform others over the longer term

This is the reasoning that lies behind the long term view of asset allocation (Strategic).

Most investors, Warren Buffet included, would suggest it is more about “Time in the Market” but some active believers will see the merits of being able to react to certain situations.

What do you believe in?

If there is an element of timing involved in the way you execute your investment strategies you need to be clear about the criteria used to determine timings of changes.

6.2 Investment discipline – managing investor behaviour

What adds most value to a client’s chances of achieving their investment objectives?

The most significant factors which impact upon a client’s chances of achieving their financial objectives are:

- Investor behaviour
- Tax wrapper choice & management
- Trusts & financial planning

Of all of these the greatest impact comes from investment behaviour. It is basic human nature that leads clients and advisers to make, irrational, emotional and inappropriate investment decisions.



The three most valuable words an adviser can use with a client at times in their financial planning career is “Don’t do that”!

Clients and advisers for that matter can get very nervous around short term events, and lose sight of the key messages about time in the market, longer term strategic asset allocation. Although the FTSE or Dow Jones may suffer a fall in values, clients’ investments are often more widely diversified in terms of asset classes, geography, markets and sectors.

Research consistently shows that more value is destroyed by advisers and clients who exit and enter the market. Since the advent of on-line trading, research in the US illustrates that trading too much is a wealth hazard, with something like 70% of internet traders lose money.

Research group DALBAR inc, “Quantative Analysis of Investor Behaviour” 2006 – found in the 20 years to Dec 2005 the S & P 500 returned an average of 11.9% per annum. The typical equity investor lost 9% of that value in costs of buying and selling to get in and out of the market, averaging a return of just 3.9%.

Helping manage investor behaviour

Achieving good returns over the long term is not that hard given a process, but the distractions are growing for investors, as markets are more volatile and communications more frequent.

It is important that their advisor helps them understand what these distractions can be and manages their reactions to them.

- Information is more readily available and the ease and speed of transacting has grown.
- There is greater focus on short term results – data constantly banded about to attract would be investors and more importantly create inappropriate behaviours of fund management teams
- Infectious beliefs amongst investors – a limited number of celebrity analysts can set market expectations.
- Greater use of borrowed money to invest – hedge funds, derivatives, futures etc.

Maintaining focus and discipline when all around are losing theirs is key. Indeed market volatility is a good thing for the level headed investor as that is when wealth moves from irrational investors to rational ones. “A fool and his money are soon parted” Arthur Zeikel.

The key ingredient is not the speed and amount of information but experience and knowledge as:

Aversion to loss is a wealth hazard

Research shows that the pain of loss is twice as great as the pleasure of an equivalent gain. Investors hate the way a loss makes them feel even more than they fear the loss itself. Whilst losing money can hurt the bank balance it is the regret which strikes the heart which can be more impactful. The fear of regret may cause an investor to avoid investing or pull out too soon.

Memory loss

People tend to place more emphasis on events that happened last week than last year. Hence the impact is felt around when it happened not how big the impact was. They will focus on the fact they lost 25% of what they had this time last year and not that their money grew in 7 of the 10 years they held the investment and has over doubled since inception. This can make it difficult for investors to place short-term events in the long term context of their overall strategies.

Latest fad

If something is being talked about in the media as the latest investment opportunity, the chances are that the opportunity has already been missed as it will be factored into the price already, but investors will so often follow the herd. “We have learned that past investment records make lousy Crystal Balls” (Fortune 11th Oct 1999)

Arun Abey in “How Much Is Enough” relates a first time investors experience to a first time flyer.

Whilst planes may have been built to sustain far more turbulence than they encounter, when the ride gets bumpy it doesn't stop the first time flyer from worrying if this is normal, is anything wrong, are we going to crash and die?

Frequent flyers seated nearby seem quite calm, continuing to read or watch a movie etc. They may always remain a bit nervous, but they gain confidence from reassurance and the knowledge that the odds are stacked in their favour as long as they and the pilot remain calm. Investors should be reassured that:

- They will lose money one year in four
- Markets will take a fast and significant dip from time to time,
- It is understandable to feel nervous, but there is no need to panic and evacuate the plane.

Adding value to an investor

When considering the time a firm spends on the various activities it performs in relation to providing financial planning and investment advice it should consider the cost benefit of its various activities.

In relation to the cost savings they may or may not make in choosing the right product solution or the benefits they may or may not deliver in better portfolio performance how much more value can they definitely add by:

- Having the time and ability to help clients understand risk and enter into the investment market with greater awareness and confidence, manage their expectations.
- Having the time to be proactive and reactive to the concerns of clients that will arise in volatile times to stop them making decisions they may come to regret
- Having time to ensure clients have and review a financial plan that optimises their tax position and adequately protects their wealth with trust arrangements in place? The client who has their investments returning 4% free of tax is better off than the one who got 6% return but was liable to 40% tax.
- Providing confidence to an investor by way of having a articulating a clear philosophy, set of beliefs and strategy for deploying them.
- Keeping them “in the market”, forward focussed, rational amidst the media hype and herd mentality and stop clients reflecting on the past – you can't drive a car using by simply using a rear view mirror.

Lessons from Warren Buffet

Warren Buffet invested in his first stock at age 11 with \$38 and by 64 had grown his investments to \$44 billion. His success was not down to speculation and chasing fads but following a clear disciplined approach that enabled him to manage his mind and therefore emotions when it came to investing.

He points out “to invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework”.

“It is better to be sure of a good result than hopeful of a great one”.

His basic investment approach is study the quality and value of the stocks, set long term goals, develop a plan and stick to it. The core attributes he displayed were - patience, discipline and rationality.

An adviser without a clear philosophy, set of beliefs and process for delivering them can be as dangerous to their clients as the clients are to themselves.

Documenting your philosophy & beliefs

It would be good business practice to have an Investment Philosophy document to walk through with clients. In essence it might have the following sections:

- Outline of the advice process you follow that leads to an investment recommendation
- How you go about helping clients understand their attitude to risk / capacity for loss
- Your beliefs when it comes to investing
 - Active / passive
 - Asset Allocation
 - Time in the market / timing
 - Diversification
 - Fund selection
- How you deliver in line with these beliefs
 - In house
 - Out-source (due diligence)
- On-going review and management

Summary

In a market where more and more information is readily available at a faster and more frequent rate to fund managers, advisers and investors the propensity for them to act in an irrational way grows, hence the escalating volatility over the last decade. It is therefore critical that a firm and the investment house have clearly stated philosophies and beliefs that they adhere to, which brings some rationality to the situation.

For most clients there is far more value to be delivered by an adviser who can support them by helping them understanding risk and the experiences they are likely to have on their financial flight, and counsel them through the emotional roller coaster of investing keeping them focused on the long term plan and strategy, than those who are pre-occupied with second guessing and trying to out-perform the market.

We are seeing a growing trend and confidence in the advisory market to outsource investment management to those that they believe can better deliver active returns than themselves and / or opting for a passive strategy to release them up to add value in other ways, de-risk themselves and their own emotions from matters they have less control or influence over.

When it comes to Investment Management whoever manages the portfolio needs to ensure that the right systems and processes are in place to monitor and maintain the asset allocation and hence re-

balance periodically. These two factors have more significance to the success of a portfolio than the fund selection or market timing. Source: Brinson et al 1991 Financial Analysts Journal.

As a result of the requirements under RDR to deliver what it says on the tin, consistently. Firms more than ever need to rationalise the routes to market they use to invest client's money and consider using model portfolio / multi-manager options ahead of bespoke options, except maybe for the very affluent clients who can afford to pay for this level of attention if there is extra value to be added. The rules have really challenged the advisors to think about how skilled they are at investment management and whether they want to attach their reputational value add to investment performance or not.

With the erosion of the value add advisers can provide in the market in terms of product selection and active portfolio management, in the next chapter we will explore the other ways advisers are replacing the time they used to deploy in product research and portfolio selection to add value through financial, cash-flow and lifestyle financial planning.

Indeed these things are critical to help clients:

- establish why they should invest and maybe save more,
- evaluate what level of risk they need to accept, more or less than currently,
- maintain a clear focus and discipline when all around may be losing theirs