Good Practice Overview

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Strategic asset allocation tools with risk profiling software

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This paper is in response to member's requests to provide a summary of good practice within one source document and is based upon the Personal Finance Society's understanding of the regulators rules and current stance. Whilst a summary, it is not intended to be inclusive and should not be relied upon at the exclusion of other sources of information.

Introduction

Strategic Asset Allocation (SSA) Tools make it easier for advisers to construct investment portfolios where the firm takes control of the asset allocation decisions (as opposed to a managed fund or multi-manager fund where these asset allocation decisions are made by the product provider). This Good Practice Guidance is designed to highlight some of the considerations you will need to take in respect of your firm's approach to asset allocation and the extent to which it may vary between clients. For example, if you are not providing an ongoing review service, you should consider if an investment solution that is self-rebalancing is more suitable for your client, or make sure they are aware of the implications of not re-balancing their portfolio regularly.

There are many tools available to help with the assessment of a client's attitude to investment risk, asset allocation and fund selection. Whichever tools you decide to use, your firm remains responsible for the advice provided and will need to take account of the resources required and the training needed to ensure all staff involved are competent in this area.

A comprehensive review is available via Square Mile (please click on the link and follow the instructions). The review includes details on the approaches adopted by Barrie & Hibbert, Distribution Technology, eValue, Towers Watson, AKG and Ibottson and the 'traditional approach' to asset allocation in non-optimised managed portfolios. It also provides an explanation of the differences between Deterministic and Stochastic Modelling approaches and an overview of the common factors limiting effectiveness of the optimised modelling approach. Additionally a summary of the Oxford Risk and FinaMetrica risk profiling tools is included.

We hope you find this Good Practice Guidance and the review useful.

Regulatory context

FSA's 2011 guidance paper – 'assessing suitability'

- The above states in section 5.1 that it is important to highlight that the firms providing the advice or discretionary management remain responsible for assessing suitability, even if they use a tool provided by a third party as part of assessing the risk a customer is willing and able to take.
- If a firm uses a third party tool to help make suitability assessments for their customers, the regulator expects that firm to:
  - ensure that the tool is suitable for use with its customer base;
  - understand how the tool works, so it can interpret and evaluate the results when it is applied to individual customers;
  - understand to what extent the tool will help meet its regulatory requirements;
  - have a robust process to mitigate shortcomings or limitations of the tool; and
  - where a tool (such as an asset-allocation or fund-selection tool) suggests investment selections, to understand the product, market and asset risks for these investments.

Good practice

- Firms should ensure that when using third party tools to assess suitability, that they are familiar and up to date with guidance issued by the FCA, including:
  - FSA's March 2011 Guidance Paper – 'Assessing Suitability'
  - FCA's June 2012 Retail Distribution Review Finalised Guidance – Section 5 – 'Advice tools and investment strategies'.
- Firms need to take reasonable steps to ensure that the tool is fit for purpose, taking into account their business model and suitability assessment process.
- Whilst often useful in aiding advisers (and discretionary fund managers), they should be aware of the limitations inherent within SSA models which can mean they may not be able to, on their own, determine the risk a customer is willing and able to take, or to make a suitable investment selection, in all circumstances.
- Care is required when interpreting the outputs of some models. For example, a number of models assume that returns are normally distributed and that correlation coefficients remain constant. Empirical evidence demonstrates that these assumptions are false and as a result, the underlying risks described by some SAA models may not be fully represented.
- SAA models cannot and do not predict the future. Whilst they may be a step up from traditional 'rules of thumb' in advisers' financial planning, they act as no panacea. These models should be used to only ever approximate the likely behaviour of financial products and can only ever act as a guide. As such, care should be taken to ensure that they do not create a false sense of security for advisers and their clients.
- Firms should ensure that they understand the distinction between the 'deterministic' or 'stochastic' approach adopted by the underlying model engine. Put simply, a deterministic approach is likely to be simpler than a stochastic approach but may well be less refined in the results it generates.
- When selecting tools, firms should seek the assistance of providers in respect of supporting information that helps the firm understand:
  - the extent to which the tool will help the firm meet their regulatory requirements
  - the scope of the tool including situations for which it has, or has not, been designed to work
  - any limitations of the tool, including any circumstances for which the tool should not be used*
  - any assumptions relevant to the use of the tool, for example, about the advice or discretionary management process or target market
  - ensuring that supporting information is clear and easily accessible.
- Advisers and discretionary managers have a responsibility to demand all relevant information from the tool provider to enable them to determine whether a tool is appropriate for use with their customer base.
- The conduct of business rules require firms to ensure customers understand risk – some firms find the use of such tools helpful in meeting that requirement. Where firms are using these tools, they should ensure this is adequately recorded on the customer file. However, even where such tools are used, firms should be mindful of the fact that it remains their responsibility to ensure their customers achieve the appropriate level of understanding.

*Common limitations of SAA models that firms should be aware of include:

- Use of historic volatility to gauge future risk – most models use long term average volatility to gauge future risk, but volatility changes over time
- Tail risks – where statistical techniques based on probability theory inherent in some models can underestimate the frequency of extreme events
- Breakdowns in correlations – models that ignore changes in market dynamics may underestimate the risks within proposed asset allocations
- Assumptions of positive nominal interest rates – whilst a reasonable assumption, many of the models assumes that interest rates are and will remain positive. If nominal interest rates did turn negative, it would have an impact on these models
- Sequencing risks – deterministic models do not incorporate such timing factors.

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This overview has been written in conjunction with Square Mile Investment Consulting and Research Limited who have made available to Personal Finance Society members independent research covering Strategic Asset Allocation (SAA) tools that are commonly used in conjunction with risk profiling outputs.

www.squaremileresearch.com/Registration