For professional advisers only

Understanding how your Attitude to Risk (ATR) tool is calibrated

As your business models evolve in the post-RDR world, and your financial planning processes continue to undergo improvement, Square Mile observes that many centralised investment propositions rely on the use of third-party strategic asset allocation tools.

This piece will cover:

- Some of the important distinctions in the way that risk tools are calibrated and the implications this has for users
- Non-linear payoff between investment risk and reward
- How adopting a little more risk can materially enhance returns for a portfolio – and how, as more risk is adopted, the incremental return benefits diminish

The FCA continues to emphasise advisers' responsibility to understand how such tools work to ensure the best outcomes for investors.

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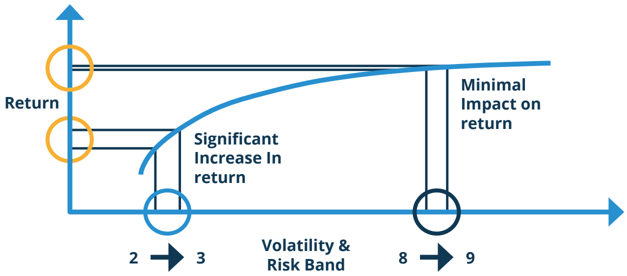
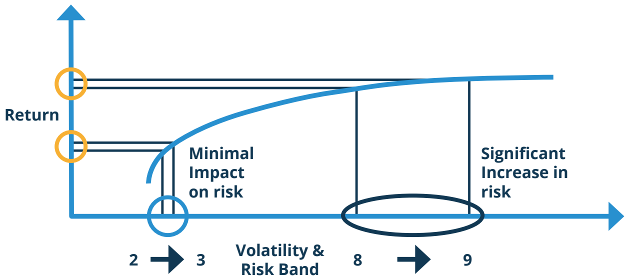
Risk and Return

Several risk tools – for example DT – are calibrated so that risk bands are determined by equal amounts of volatility. The non-linear relationship between risk and return ensures that the incremental expected return benefit of moving from risk class 2 to 3 is normally greater than, say, moving from 8 to 9 (see chart below). The curvature of this line depends upon the risk and return assumptions for each asset class within the model.



Other risk systems, such as EValue, do not apportion risk ratings in equal volatility bands. EValue widens the volatility bands as you move up the risk scale and this results in a more linear progression in the expected return profile. The chart below demonstrates this in a stylised manner; note the significant jump in the volatility range moving from risk grade 8 to 9, relative to moving from 2 to 3. The regulatory required fund SRRI number is also calibrated in similar fashion.



The right approach

Square Mile does not suggest that one approach is right and the other wrong. However, this subtle difference in approach taken by different models raises some interesting questions – in particular: how are clients appropriately placed into the correct risk band?

Care must be taken to ensure that the output from the ATR tool is correctly calibrated with the risk grading scale used within the strategic asset allocation model. This is not so much of a worry when advisers stick with tools from a single suite but it becomes a concern when a more modular approach is used. A more modular approach allows advisers to cherry-pick what they see as the best ATR tool, the best SAA modelling etc. within their planning process. However, it is very clear that advisers need to take great care in calibrating risk bands across their planning process. Mismatches can easily be overlooked and only become apparent once a client suffers an unexpected loss.

More worryingly, we have found some advisers who have taken the recommended asset allocation positions from different modelling to arrive at an 'average' allocation. The various approaches to risk banding by the different systems makes them incompatible. The idea that taking an average somehow presents a more robust output doesn't make sense, given the fundamental differences in the way that the risk bands are calibrated. As it happens, DT's model currently produces a relatively linear payoff between risk and return (we suspect this is due to the strong return potential of emerging market equities), so the potential problem is less significant than it otherwise might be. However, advisers who build their strategic allocation by taking a mixture of output from multiple tools could easily create problems for themselves and their clients.

Financial planning tools such as ATR systems and SAA tools are complex systems. Advisers should be aware of the limitations and weaknesses of the tools that they use. Nevertheless, when correctly employed, these tools can help to produce a robust financial planning process fitted around a centralised investment proposition.

For more information on risk tool calibration please email us at info@squaremileresearch.com or call 020 3700 7397.

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