For professional advisers only

The Challenges of Risk Profiling Tools

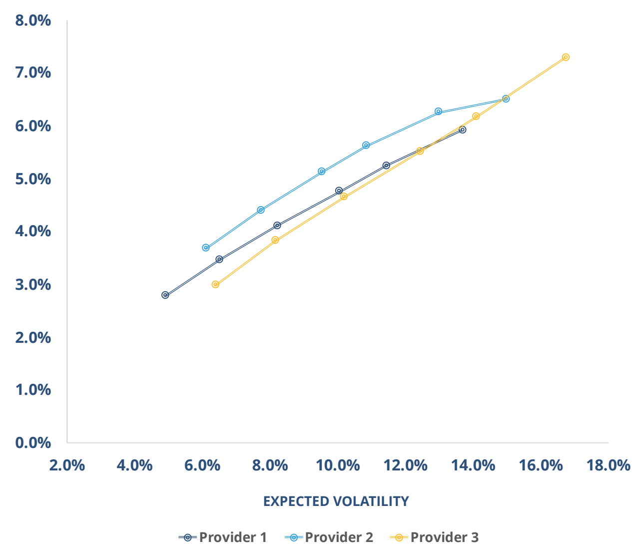
Introduction

Risk profiling tools have done a great job of aligning funds in a consistent manner across the market and have provided a framework for advisers to manage client expectations – the 'apples with apples' philosophy. However there remain a number of challenges, that have varying levels of implications, that one must be aware of within the process. The following discusses some of these.

Linking Investor Risk and Investment Risk

There is no clear way to link the output from a questionnaire (the investors attitude to risk and capacity) and the resulting investment products. In order to achieve this there would need to be a common statistic that clearly links the two. Given this does not exist, a *clearly worded* and *quantifiable* link must be established that looks to describe the investment journey. An implication of this, other than the subjectivity involved in creating the link, is that mixing the investor and investment output from two differing providers is fraught with risks. The chart below looks to demonstrate this by showing the expected return and volatility for a range of risk targeted solutions. For each range, the same asset allocations have been used but different capital market assumptions have been applied from three providers.

In isolation there is nothing wrong with adopting capital market assumptions when trying to create asset allocations and long range forecasts; and you would expect differences of opinions to appear within this process. The problem however lies when mixing the output from the investor risk journey, with output from a different investment provider as the *clearly worded* and *quantifiable* link becomes obsolete.



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Asset Class Definitions

When setting an asset allocation framework one of the first things to consider is which asset classes are to be covered. These asset classes should then be clearly defined and from which a set of capital market assumptions are typically created. The capital market assumptions are then used to: create 'efficient' portfolios, measure onward suitability of a portfolio and also drive some form of financial forecast, or the stochastic projection. This framework in theory works well and does control the vast majority of the risk budget – however by defining asset classes, or individual buckets of risk, it implies that every fund in the market not only neatly fits into the buckets, but also has the same capital market assumption expectations. Financial Express recently commented on this within its 2018 'Report into Financial Advice 'and quoted a range from 71 to 158 from UK Equity funds (a fund scoring a 100 would be deemed to have the same level of risk as the UK Equity market). Extrapolating this across multiple asset classes only serves to create a greater opportunity for deviation away from the expectations formed by the capital market assumptions and most importantly, from what the client is expecting.

Asset Class Mapping

Following on from the previous point, when adopting a risk profiling tool, asset allocation data is generally provided from external sources. Each of these sources have different collating mechanisms and rules for determining how a fund is split over the varying asset classes. It is not uncommon to review the output from each provider for the same fund and receive differing asset allocation breakdowns. Unfortunately, there is no industry standard in how to report on asset class coverage, unlike performance measurement standards and therefore it is likely that the mapping conundrum will exist for the foreseeable future. This challenge is acutely abundant within multi asset, particularly the fund of fund approach, in addition to global equities, strategic bonds and of course the absolute return sectors. This therefore creates not only operational challenges but also suitability challenges when using the tools to build risk targeted portfolios.

Concluding Comments

Tools that look to improve outcomes for clients and make them aware of the market risks involved with their investment goals are a good thing and should be supported, however they only go so far with the full investment construction process. Their view is solely top down, creating investment solutions at the asset class level only, and does not have a strong link to any bottom up fund picking component. The tools by the nature of how the capital market assumptions are created rely heavily on market risk as their key determinant of suitability and do not consider manager specific fund styles or risks. To complete the process our view is that a qualitative (or bottom up) fund research component must be incorporated into the portfolio construction process in an effort to smooth some of the challenges posed above.

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