Investment Advice - Risk to Become Central

By Paul McCarville, Principal, Clarus Investment Solutions

Recent times have seen the highest pace of product development that I can remember: as well as the quantity of new funds available there is real diversity. Even in the structured/tracker area many of the offerings are unrecognisable from what went before (and are far more complex). Absolute Return funds are becoming mainstream and other funds using derivatives are gaining acceptance.

In the face of growing product complexity **how are Brokers to understand risk and adequately represent it to their clients?** The risk ratings of product providers have not proven especially reliable in the past, with many anomalies and inconsistencies. Some of the descriptions are worse than 'anomalies' – one product currently being promoted is represented at a risk level well below that indicated by objective measures.

To be fair to them, most providers do their best to properly represent risk, but they do so within different scales (1-3/ 1-5/1-7) and using different bases. It is time that the providers agreed, or were persuaded or compelled to use a common framework; and the good news is that this is on the horizon.

A methodology prescribed for UCITS by the **Committee of European Securities Regulators (CESR)** is likely to migrate to the world of unit-linked funds before too much longer. It will provide a specific ranking (more accurately a 'synthetic risk and return indicator') on a scale of 1-7 based on historic volatility. While not perfect, it will be consistent and objective **and therefore of real value to Brokers and consumers.**

Bringing in the CESR methodology, while a huge step forward, ***is not a panacea.*** It is based on five years of weekly price movements, which many funds will not have. Then there is the matter of structured products and Absolute/Total Return funds. In all probability it is with new, 'non-standard' funds/products that problems are most likely to arise.

The CESR methodology includes procedures for such 'non-standard' funds, or funds where the actual history is too short, but they are both mathematically complex <u>and</u> challenging in terms of the well-informed judgements that are called for. Where there is room for interpretation there is room for manipulation. The inadequate labelling of a current product referred to earlier (and previous episodes) would suggest that an assumption of integrity on the part of all providers at all times is probably unwise.

Whether or not the CESR methodology arrives, Brokers would do well to look to Maximum Drawdown as a key risk indicator – as the biggest possible loss which could have been suffered over a given period, such figures can be quite a stark reminder of what can happen. This measure stands comparison

between all types of fund and is especially useful in the area of Absolute Return. While most providers do not provide this metric, Brokers who have a good database/data provider can generate it themselves. Certainly those who bought equity-based products in the middle years of the last decade would have been well served by being shown the scale of losses suffered in the 'tech-wreck' of '01/'02.

Even if we assume that the risk ratings of individual products are completely dependable, what happens when products are combined? No matter how ingenious product development is or how outstanding performance, most Brokers and more astute consumers will not want to commit totally to one provider. As most readers will know combining equal allocations to a '6' and a '2' does not necessarily produce a '4'; Brokers who want/need to combine products will need to find some other way of gauging the risk profile.

If the effort to assess the risk of a fund or portfolio is an inexact science, so also is assessing the risk tolerance of the client. The client's capacity to take risk is probably even more crucial - it is here that measures such as volatility and maximum drawdown can come into their own. Telling a client that they have X probability of losing more than they can afford (or that their ARF will be depleted too soon) is no more than a well-informed estimate, <u>but it is surely a lot better than the alternative!</u>

While very much an advocate of risk profiling software, it is just a tool to put parameters around or kick-start a discussion. I would be concerned that third parties such as regulators, PI insurers, the FSO or the courts think that the process of gauging the client's risk profile and marrying that to risk-defined products is a more 'exact' activity than it is, or ever should be. Having said that, better definition around the riskiness of investment products on the lines of CESR will represent very substantial progress.

The more structure and objectivity can be shown to have been involved in the advisory process, the more Brokers will have to fall back on if things go wrong. It is also likely that the advice they provide will be better, and consistently so.

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