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Investment Choice

Introduction

The world of investment products is in need of substantial re-invention.

Despite very low interest rates and strong recent performance, demand from consumers is depressed. The flagship products of the last decades have been found badly wanting. A significant amount of mis-selling has brought investment products up the Central Bank's agenda.

I believe that the biggest change affecting the design, presentation and sale of investment products will be an obligation **to be much more specific about risk**. The present situation where providers assign ratings on different bases and to different scales does little to inform consumers and their advisers – the current regime is most unlikely to persist if for no other reason that it is so easy to do better and regulators have a significant appetite to do better!

Accepting that this will change, the most likely format will be that prescribed by CESR (Committee of European Securities Regulators). Its methodology for UCITS is likely to migrate to Unit-Linked funds and would oblige providers to give a specific ranking (on a scale of 1–7) by reference to historic volatility. This will mark a quantum leap forward in terms of properly presenting the risk of investment products to advisers and consumers.

Managed/Consensus – RIP?

The flagship of the Single Premium ("SP") market up to the early Noughties was the Managed Fund. While the market backdrop was difficult, the failure to even keep pace with CPI over 10 years is a savage indictment. With Managed Funds having had annualised volatility of **12/13%** over the last decade, and maximum drawdowns of over **40%** during 2007–09, it is hard to argue that they were suitable for middle-of-the-road investors. At this stage the deficiencies of Managed Funds are fairly well known but in essence they were not diversified enough, were dominated by Equities and were 'managed' primarily by reference to the peer group. Huge over-weightings in Irish equities were another feature.

Those readers who work for product providers or as intermediaries will say that the Managed Fund has been dead for several years now and that is probably true of the SP market. However it is still *a massive feature* in the huge group pensions market where the Managed 'derivative', Consensus, is still very widely used as the default option (which typically attracts 75%+ of the money); this is quite ironic because these schemes tend to have the most high profile/sophisticated advisers.

From about 2005, the investment of choice became Property – during this most extraordinary phase proper product development atrophied as resources were directed to 'the only game in town'.

So, post Managed/post Property **where is the SP market heading?**

Multi-Asset Funds

Also known as 'Diversified' funds, we now have quite a number of offerings which broadly fit this category. The most obvious difference from Managed/Consensus is much lighter equity weightings, and significant allocations to other asset classes, typically commodities, bonds, and property. At this stage most providers have such a product and more are on the way.

In previous articles I have described the first raft of multi-asset/diversified funds as welcome additions to the product arena, but primitive: a characteristic is relatively fixed allocations between a number of asset classes, the weightings of which were cast without any obvious effort to optimise risk and return. Because of their latitude to exploit relative value or adapt to market cycles I would expect that "Real/Unconstrained" funds will eclipse the Multi-Asset offerings, at least in terms of sales.

Absolute Return (AR)

This term means different things to different people, but AR funds will normally have an explicit annual or multi-year return target, typically framed by reference to cash. {Interestingly, CESR defines funds with a return objective as "Target Return"; "Absolute Return" funds will be those having an objective set by reference to volatility.}

Where an AR fund sits on the risk spectrum is the key question; the managers of any well-run AR fund should be able to indicate an expected range for volatility, having set appropriate parameters and by having a clearly-defined risk management regime.

Under my firm's definition, only funds which can take 'short' positions are considered to be true AR.

In so far as AR funds rely heavily on generating 'alpha' (manager skill), the absolute return area offers a lot of room for disappointment… if Manager A's gain is Manager B's loss, the aggregate outcome is likely to be zero *before* costs. In fairness a lot of AR return is 'beta' (market return) too and there is a strong argument that more highly-motivated, flexible and faster moving AR managers can profit at the expense of the more traditional 'long-only' managers.

As the appetite for AR has grown, many established providers have tried to set up AR teams – some have succeeded, at least as many have failed. Apart from creating the right culture, getting individuals who were 'long-only' for their previous careers to start taking short positions requires a huge change of mind-set: if you own something it can only lose 100% but an asset you short can double, treble or worse.

One particular fund has become very much the flagship of AR in Ireland – how it succeeds is likely to have an inordinate influence on the further growth of AR in Ireland. Should its performance disappoint for a year or two (perfectly possible), belief in AR more generally would be undermined.

Real/Unconstrained

Another breed of funds has emerged which are often confused with AR but differ in the key respect that they cannot go 'short' – these are more accurately named 'real return'.

These funds have the scope to deliver real value to investors provided the managers have the requisite skill. Those which can deliver returns within acceptable levels of volatility could be very successful over the next decade. While those funds which generate the best performance will attract the most attention the ones which do best **per unit of risk** should be the winners over time.

Structured

The word 'structured' connotes Tracker bonds in many peoples' minds but the term embraces very much more. Structured products have been a very substantial part of the investment landscape in Ireland, with the investment almost invariably being for a finite period with the up-side pay-off coming from a derivative.

It is hard to be definitive about more traditional structured products because the value they represent changes as interest rates and the price of derivatives move. Being almost always for a finite period and open for subscription for a period of weeks/months, the selection of products changes continuously. Current interest rates and option pricing make it very hard for providers to present products which appear to represent value and we have seen structures becoming more complex as a result. In some cases an impression of value derives from the price counterparties with poor credit standing need to pay to secure funding.

A potentially more interesting variation of 'structured' is a fund which invests in risk – seeking assets but with a 'safety net' typically provided using options. While in general the logic of long-term investors paying for short-term protection is hard to sustain, such product has been well-received; more will be introduced and I would expect them to be popular.

Income Funds

We are in an era of low interest rates and as demographics move on I envisage that funds which target the generation of income will become a mainstream feature of the SP market. (This has certainly been the case in the UK).

The ARF market could well become a major driver for income-oriented funds as people seek to draw income without depleting capital. The tension between the priority of making savings last for decades in the face of drawdown needs and the investor's innate risk aversion does present a serious challenge and the documentation of both product providers and advisers will need to be very careful drawn.

Conclusion

I see the approach advisers take to investment bifurcating over the next 2/3 years; those with low competence in this area are likely to be much better off (indeed might be restricted to in the future) recommending a single fund solution – this would most likely be some form of diversified fund which sits at the level of the risk spectrum appropriate for that particular client. This may be just what many clients want and work out fine in the end.

More expert advisers and indeed more experienced consumers may wish to retain an element of control by using a number of single-strategy fund components to build a portfolio. Such portfolios would be carefully constructed to sit at the appropriate position on the risk spectrum.

Those using this approach will need to acquire greater understanding of volatility and correlation/co-variance. In short, advisers will either up their game and engage properly with the investment agenda or settle for advising on 'packaged' products (of which there will be a very much improved choice). Consumers with more customised portfolios will require a level of on-going monitoring, periodic re-balancing and communication which will be demanding of the adviser but justify his/her role.

For their part, fund managers who have skill will have a great platform through the likes of the Real/Unconstrained and AR funds, and could be highly successful. Those who do not will be mercilessly exposed in a world where management by peer group and benchmark hugging are passé.