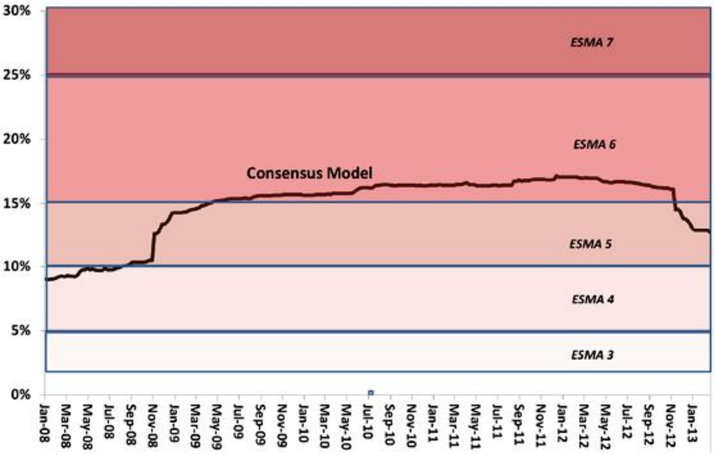
Representing risk to DC members

by Paul McCarville

Trustees have grappled for years with how to present the risk associated with investment choice. I have seen a panoply of barometers, thermometers, graphs, numerical scales and colour schemes being used, some of which did the job quite well.

Many people seem to believe this problem is now solved thanks to the **European Securities and Markets Authority (ESMA)** and its seven point scale. The measure which is plotted on that scale is known as the **Synthetic Risk Reward Indicator (SRRI)** and it is based on the volatility of weekly returns over 5 years.

I do not think that ESMA is the answer, in the first instance because it is not a stable enough measure: volatility is....volatile! The Consensus funds illustrate this particularly well:



In early 2008 Consensus funds would have been in band 4 and, given that there were 7 bands, it was understood to be, (and frequently represented as), 'middle-of-the-road' in risk terms. As events unfolded in the latter part of 2008 and early 2009, Consensus funds fell by over 40% and migrated upwards into band 6.

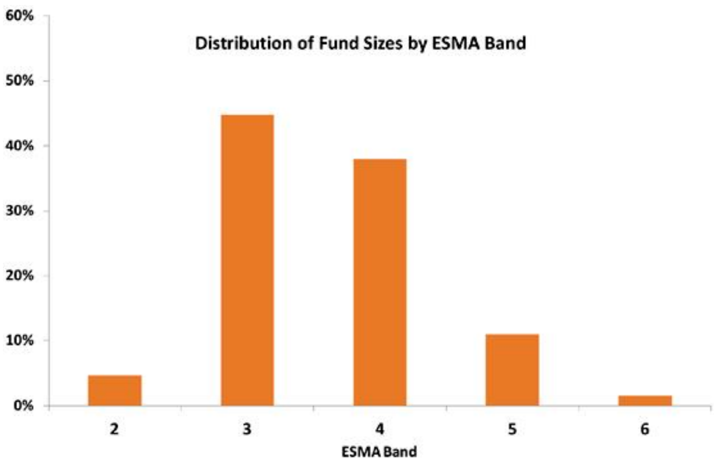
A better system would see volatility over a longer timeframe used, perhaps in conjunction with Maximum Drawdown, again over a sufficiently long period. One of the leading Irish life companies has opted to base its risk measure over a longer timeframe and recent proposals in Canada suggest that 10 years be used.

A second problem with ESMA is the banding regime:

Risk Class	Volatility Intervals	
	equal of above	less than
1	0%	0.50%
2	0.50%	2%
3	2%	5%
4	5%	10%
5	10%	15%
6	15%	25%
7	25%	

The volatility bands used by ESMA are obviously arbitrary, and there was as much or little justification for settling on those tramlines as any other. In practice the vast majority of the funds used by DC schemes will currently be clustered in bands 4 and 5. Latterly the relationship between ESMA and the choice of funds has become circular given the latest generation of risk-graduated funds. These are now the flagship offerings of most providers with many based around ESMA or a derivative. The general proposition is that the volatility of the relevant fund will sit within an ESMA or other range. In the retail investment arena the advice process will normally see the investor being risk-profiled, a practice increasingly being used in DC. This is usually accomplished using a risk profiling tool. (Disclosure: Clarus has developed risk profiling software which it licenses commercially}.

Now that risk-graduated funds have been with us for a few years it is interesting to look at which funds have attracted the money and how this compares with DC behaviour. The risk-graduated fund families which align with ESMA (from Zurich, New Ireland and Friends First) show that 45% of the assets were in funds at level 3. With an upper tramline on volatility of 5%, these are quite low on the risk spectrum. (One such fund currently has no less than 72% in cash and bonds.) Assets in funds at level 4 (volatility 5%-10%) accounted for another 38%, <u>with just 13% being in funds targeting levels above 4.</u>



While this may seem strange to those associated with the running of DC schemes, it is entirely consistent with the research conducted on Irish people which shows a pronounced aversion to financial risk. In what could hardly be a greater contrast, the bulk of DC money is in funds which would sit at ESMA 5. All of the Consensus funds are rated '5': the Lifestyle funds which accounted for over 82% of DC money (IAPF DC Investment Survey – 2014) on average hold 65% in equities.

So, for better or worse, the regulated advice process with all its strictures on Knowing Your Client, risk attitude and capacity, and aided by the use of risk profiling tools has directed the bulk of money into lower risk funds, while most of the DC pension money goes into higher risk funds.

At one level such different behaviour is not hard to justify - DC members generally have multi-decade time horizons and many future contributions to make: that makes them beneficiaries of volatility provided they can deal emotionally with the bad times.

While only time will tell, it is not hard to envisage some sacrifice of return being associated with the management of funds to volatility targets and this would be a poor bargain for most DC members. This potential trade-off should be a key focus of trustees who are considering the use of volatility-targeted funds. Our research of such funds has revealed them to be a far more diverse group than meets the eye with substantial enquiry being warranted.

My fear is that a naïve adoption of the tools used in the 'retail' advice arena, and particularly a focus on volatility could be very detrimental to DC member outcomes. There is clearly a need to better represent risk to members but ESMA is not the answer. **Volatility is a far less important factor for those on the DC journey and helping people to deal with the emotional reaction to periods of loss should be a key focus of education and communication.** Risk profiling has a place, but only if properly understood and applied intelligently. It may sound very old-fashioned, but trustees must look to protect members from themselves, and that most especially pertains to the selection of funds which are excessively conservative. A long time horizon and lots of future contributions makes DC members fundamentally different from the lump-sum investors primarily served by the retail advisory regime with its now ubiquitous focus on volatility.

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