

Financial software

Caution!

Current very low volatility levels are masking true investment risk. What is it all about?

For many years, stock markets behaved in a relatively more consistent manner – with a gradual improvement in the main indices reflecting steady progress. Unfortunately today, equity prices, along with other asset prices have been drawn into the experimental vortex of central bank activities such as quantitative easing. In the recent past we have had several 'once in 20 year' events including the Tech bust, Lehmans and the great depression. The extreme policy decisions (that have also saved investors skins it must be noted) have created artificial investment conditions that are influenced more by currency manipulations than traditional fundamentals.

No one knows how the unravelling which is being anticipated will play out in the investment portfolios of our customers. More

than ever, risk is on the agenda. The specific point we have arrived at now, is one where both fixed interest and equity volatility is tracking very low across many areas, and may be a less reliable measure for risk than historically has been the case.

Most of us have evolved our approach to investment using volatility based measures, often aligned with more 'qualitative' research. Advisers know which Fund Managers have proved resilient in down markets, but across diversified portfolios, research teaches us that it is Asset Allocation that drives performance.

An adviser's experience and market intuition can no longer offer sufficient evidence of the objective research that the regulator expects to see.

The Financial Conduct Authority (FCA) and investment suitability

The FCA made establishing 'suitability' of investment central to the RDR requirements. The FCA has stated that a professional adviser must:

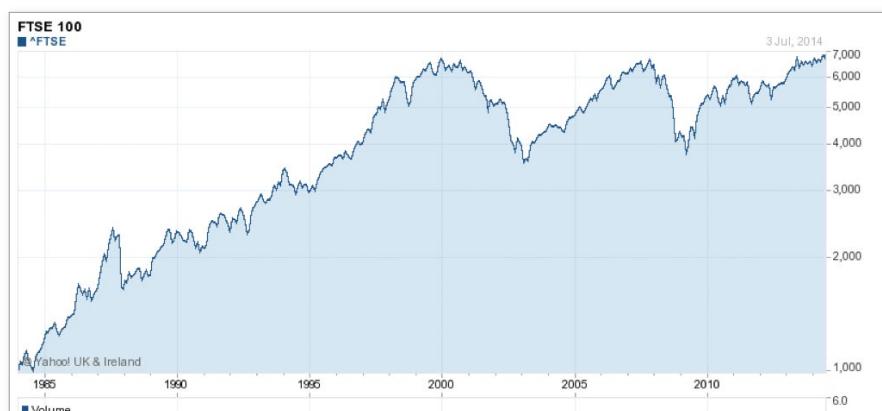
- know and understand the financial circumstances of their client;
- use a robust process to establish their client's Attitude to Risk and Capacity for Loss;
- understand why they are recommending a certain Asset Allocation (strategy);
- understand how the funds recommended satisfy the strategy;
- understand the tools they use to arrive at these decisions;
- review the strategy on a regular basis.

The FCA has stated that not only should a client understand:

- what their attitude to risk means and agree with it;
- understand what their 'Capacity for Loss' may be;
- quantify possible losses;
- assess client's ability to absorb falls in the value of their investments.

Synaptic Modeller assists you, as an adviser in meeting and evidencing the FCA requirements relating to client and investment risk and suitability. Request a demo by calling 0800 783 4477.

Business as usual? Breakout or breakdown?





The Synaptic Capacity for Loss quotient – a consistent measure and single point of reference for risk:

The Synaptic Risk Rating service is built around the stochastic model derived from the Moody's Analytics Economic Scenario Generator. The latter is an award winning engine that is widely recognised as one of the leading applications of its kind. A risk model is only as good as its ability to capture probabilities of unknowable outcomes. The Moody's Analytics (formerly known as Barrie + Hibbert) model has demonstrated its reliability through many market changes, including the recent downturn.

- A great advantage of replacing the traditional (backward looking) volatility route with the (forward looking) stochastic route is the removal of reliance on volatility as a proxy for risk, an approach which has several known drawbacks – including an inability to model the sequence of good and bad years within an investment horizon. (For example a bad year at the beginning of the term can mean losing money instead of gaining money due to the loss of compound interest).
- The outputs from the stochastic model form a distribution graph. The graph identifies the 'most likely return' in the form of a mean, but also the possibility of higher or lower gains. The 'Capacity for Loss' quotient is simply

the '95th percentile' – identifying that the outcome has a "once in twenty year" chance of happening.

- Assuming our investment's asset classes are known, the stochastic engine projects possible outcomes over a given term (default 10 yrs), calculating the Capacity for Loss quotient (min gain), as well as the projected maximum and average returns.
- The Capacity for Loss quotient is therefore meaningful to any client in the context of their personal circumstances, allowing the adviser to document the client's Tolerance for Loss and actual Capacity for Loss quotient, based on a realistic understanding of the probability of those projected outcomes occurring.
- Fund managers and providers who have their investment instruments rated in this way can therefore be confident they know where their propositions fit in these advisory firms' risk categories.

The screen below from Modeller shows the ability of the adviser to explore how different strategic asset allocations will perform according to the Moody's (formerly Barrie + Hibbert) stochastic engine.



See synaptic-risk.capitafinancialsoftware.co.uk/capacity-for-loss for more information.



SL Deposit	1	2	3	4	5	
SL Global Managed	1	2	3	4	5	↑
SL Long (15 yr) Corporate Bond	1	2	3	4	5	↑
SL Long (15 yr) Gilt	1	2	3	4	5	
SL Long (15 yr) Index Linked	1	2	3	4	5	
SL Medium (10 yr) Corporate Bond	1	2	3	4	5	↑
SL Medium (10 yr) Gilt	1	2	3	4	5	
SL Medium (10 yr) Index Linked	1	2	3	4	5	↑
SL Property	1	2	3	4	5	↑
SL Short (5 yr) Corporate Bond	1	2	3	4	5	
SL Short (5 yr) Gilt	1	2	3	4	5	↑
SL Short (5 yr) Index Linked	1	2	3	4	5	
SL Sterling Extra Yield Bond	1	2	3	4	5	↑
SL Global High Yield Bond	1	2	3	4	5	↑
SL Short Duration Global High Yield	1	2	3	4	5	
Governed Portfolio 1 (l)	1	2	3	4	5	↑
Governed Portfolio 2	1	2	3	4	5	
Governed Portfolio 3 (s)	1	2	3	4	5	
Governed Portfolio 4 (l)	1	2	3	4	5	↑
Governed Portfolio 5	1	2	3	4	5	
Governed Portfolio 6 (s)	1	2	3	4	5	↑
Governed Portfolio 7 (l)	1	2	3	4	5	↑
Governed Portfolio 8	1	2	3	4	5	↑
Governed Portfolio 9 (s)	1	2	3	4	5	↑
SL GRIP 1	1	2	3	4	5	
SL GRIP 2	1	2	3	4	5	
SL GRIP 3	1	2	3	4	5	
SL GRIP 4	1	2	3	4	5	
SL GRIP 5	1	2	3	4	5	↑



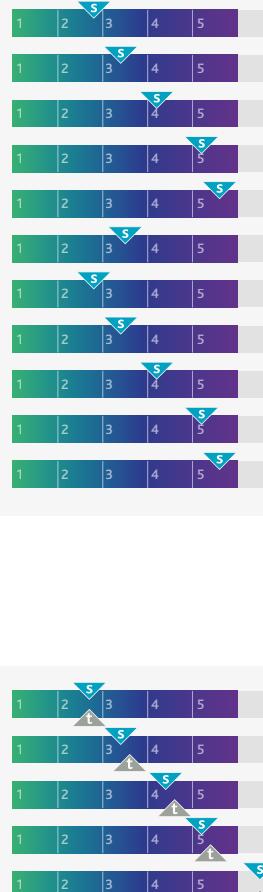
MPS Adventurous	1	2	3	4	5	↑
MPS Growth	1	2	3	4	5	↑
MPS Balanced	1	2	3	4	5	↑
MPS Global Income	1	2	3	4	5	↑
MPS Income	1	2	3	4	5	↑
MPS Conservative	1	2	3	4	5	↑
MPS Defensive	1	2	3	4	5	↑
MPS Absolute Focus	1	2	3	4	5	↑



CF Canlife Portfolio III	1	2	3	4	5	
CF Canlife Portfolio IV	1	2	3	4	5	
CF Canlife Portfolio V	1	2	3	4	5	
CF Canlife Portfolio VI	1	2	3	4	5	
CF Canlife Portfolio VII	1	2	3	4	5	↑
CF Canlife Total Return Fund	1	2	3	4	5	
Canlife Portfolio 3	1	2	3	4	5	
Canlife Portfolio 4	1	2	3	4	5	
Canlife Portfolio 5	1	2	3	4	5	
Canlife Portfolio 6	1	2	3	4	5	
Canlife Portfolio 7	1	2	3	4	5	↑



Atlas 3
Atlas 4
Atlas 5
Atlas 6
Atlas 7



PRUDENTIAL

PruFund Cautious	1	2	3	4	5	
PruFund Protected Cautious	1	2	3	4	5	
PruFund Growth	1	2	3	4	5	
PruFund Protected Growth	1	2	3	4	5	
PruFund 0-30	1	2	3	4	5	
PruFund 10-40	1	2	3	4	5	
PruFund 20-55	1	2	3	4	5	
PruFund 40-80	1	2	3	4	5	
Defensive Portfolio	1	2	3	4	5	
Cautious Portfolio	1	2	3	4	5	
Cautious Growth Portfolio	1	2	3	4	5	
Balanced Portfolio	1	2	3	4	5	
Adventurous Portfolio	1	2	3	4	5	
Managed Defensive	1	2	3	4	5	
Cautious Managed Growth	1	2	3	4	5	
WP Optimum Return	1	2	3	4	5	

Synaptic Risk Rating based on following analysis:

 Strategic Asset Allocation

 Tactical Asset Allocation



Multi Asset Open Defensive



Multi Asset Open Strategic



Multi Asset Open Growth



Multi Asset Open Adventurous



Open World



Multi Asset Defensive



Multi Asset Strategic



Multi Asset Growth



Multi Asset Adventurous



Wealth Builder



Multi Asset Allocator Defensive



Multi Asset Allocator Strategic



Multi Asset Allocator Growth



Multi Asset Allocator Adventurous



Multi Asset Allocator World



Multi Asset Income



Multi Asset Balanced Income



Multi Asset Income & Growth



Multi-Index 3



Multi-Index 4



Multi-Index 5



Multi-Index 6



Multi-Index 7



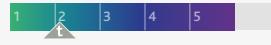
Corporate Bond Monthly Income



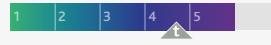
UK Money Market



Premier Defensive Growth Fund



Premier Diversified Fund



Premier Worldwide Growth Fund



Premier Multi Asset Income & Growth



Premier Multi Asset Distribution Fund



Premier Multi Asset Monthly Income Fund



Premier Conservative Growth Fund



Premier Liberation Absolute Growth Fund



Premier Liberation IV Fund



Premier Liberation V Fund



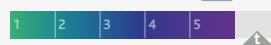
Premier Liberation VI Fund



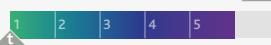
Premier Liberation VII Fund



Premier Liberation VIII Fund



Cash



Cash Plus



Capital Builder



Capital Builder Plus



Conservative



Balanced



Balanced Plus



Growth



Growth Plus



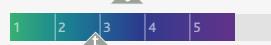
Dynamic Growth



High Income (100% MAMI)



Income and Growth (50% MAMI 50% CG)



Income (75% MAMI 25% CG)



Seven Investment Management

AAP Moderately Cautious Fund



AAP Balanced Fund



AAP Moderately Adventurous Fund



AAP Adventurous Fund



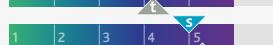
Moderately Cautious Fund



Balanced Fund



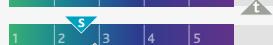
Moderately Adventurous fund



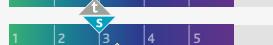
Adventurous Fund



Personal Injury Fund



AAP Income Fund



Sustainable Balance Fund



Access the Synaptic Risk Fact Sheets and the
Synaptic Attitude to Risk Questionnaire by visiting
synaptic-risk.capitafinancialsoftware.co.uk

(s) These portfolios were constructed with short investment timelines (5 year) in mind.

(l) These portfolios were constructed with longer investment timelines (15 year) in mind. Otherwise Synaptic Risk Ratings assume a 10 year investment horizon. You should consult Scottish Life directly for further information before recommending.

About the service: Synaptic Risk Ratings are worked out by analysing the underlying asset classes within the fund or portfolio. CFSL have requested asset allocation information from participating providers in a specific format aligned to the risk framework of the system. These asset classes are used by the model to determine the risk rating, a process that may result in a level of approximation though in most cases this will be insignificant. It is also possible that certain asset classes may not be represented exactly in the manner that providers would prefer.

Reasonable endeavours are made to provide accuracy and consistency, however neither participating providers nor CFSL can be held responsible for any errors or omissions. No recommendation should be made solely on the basis of the Synaptic Risk Ratings, and additional research should be undertaken for any case. This service is intended for use by investment professionals only.

Financial software

The Synaptic Risk Proposition

Eric Armstrong

Provider & Platform Relationship Manager
Capita Financial Software

The role of stochastic modelling alongside volatility based or qualitative research.

FT Adviser journalist Matthew Jeynes published a thought provoking piece on 29th April titled 'Advisers warned of 'dangerous flaws with risk tools'. The warnings were concerned with the reliance on volatility as the basis of 'risk-targeting' tools to build in-house propositions, reflecting on different aspects of the shortcomings of using volatility as a proxy for risk.

When you consider the overarching dominance of the couple of market leading solutions that have been adopted by the advice industry, you can appreciate that something of a systemic risk has developed. As Matthew's article points out, where such a uniform treatment of risk has been applied 'the methodology used by some.. has 'flaws' that could direct low-risk clients into assets set to collapse in value'.

This is an area of concern for the regulator, fund promoters and advisers alike. Matthew highlights recent research from IVEAGH in respect of risk-targeted funds, indicating that 40 percent of respondents had said that they had 'developed our own in-house proposition, or intend to'. Not only are fund promoters uniformly aligning to the problematic risk rating services by default, adviser firms are building their own investment strategies in line with these frameworks. The risks inherent in such a 'mono culture' aside, it would seem the greater risk flows from the over reliance on the volatility based methodologies.

As reported by Matthew, experts in multi asset investing as diverse as Sarasin, Whitechurch Securities and Charles Stanley are adding to what are becoming increasingly well documented concerns over the reliance of Volatility as a proxy for risk.

In its various guidance around investment suitability, the regulator has highlighted the problems with over reliance on these tools, and puts the onus firmly on the adviser's shoulders to demonstrate that they have recommended levels of investment risk that are appropriate to their client's objectives, and just as importantly, that their clients fully understand and agree with the recommendation. Having therefore, a consistent and reliable measure of risk is essential to complete the recommendation, in a way that is 'robust', 'repeatable' and 'reviewable'.

Synaptic have responded to this challenge by building an investment risk analysis and review tool, that accesses one of the most sophisticated risk engines in the market – the Moody's Analytics (formerly Barrie + Hibbert) Wealth Scenario Generator, the market leading 'stochastic engine'. The engine is at the heart of the Modeller tool, enabling the user to gain a view of investment outcomes, ensuring that the adviser can have an informed discussion of both growth and possible loss.

Leading distributors have embraced the advantages of a probability based risk model, sidestepping the challenges that over reliance on volatility pose. The stochastic model provides multiple economic scenarios, and the



SYNAPTIC
MODELLER

Synaptic software allows specific holdings or notional investments to be 'projected' according to the various asset classes that make up the investment. Following the logic that asset allocation drives performance, this tool provides a comprehensive view of possible outcomes.

Pressure from the regulator to evidence research used in the evaluation of investment risk is turning the spotlight onto the research commonly used. The volatility based systems tend also to be combined with a 'qualitative' overlay. This is where the ratings agencies 'set' a risk level based on their opinion. This absolutely may have its place, but cannot be considered to be an objective risk measure, based on transparent methodology. This is why we are promoting the stochastic route, to be used alongside a firm's preferred 'qualitative' measures.

The Synaptic Risk Rating Service (See overleaf)

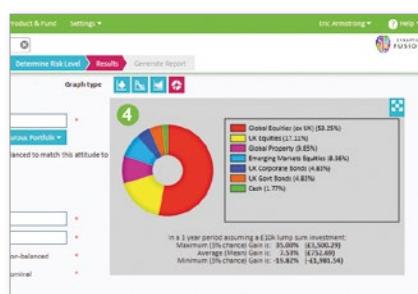
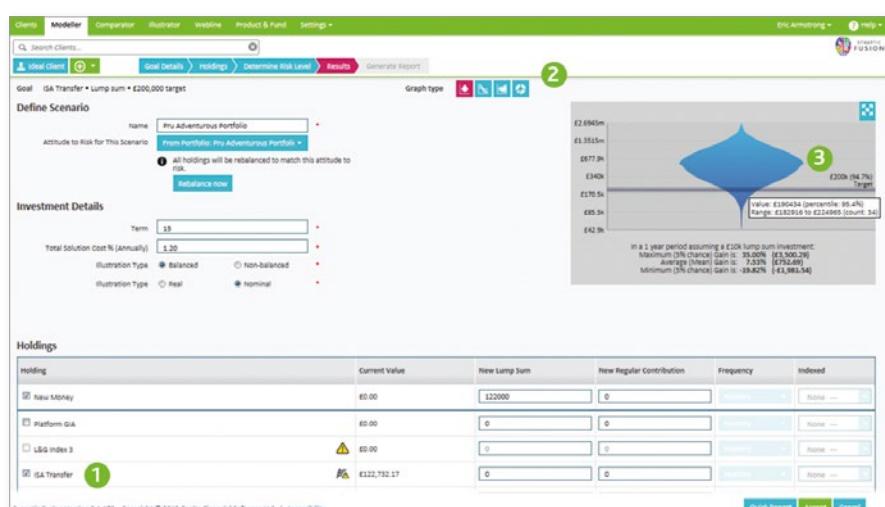
This is a new service that offers advisers research and reports based on the stochastic outputs of the Moody's engine. Subscribers to Synaptic have the ability to undertake this research using the Modeller tool, but the Risk Service maintains an updated range of investments, representing the choices of subscribers, including ratings on portfolio solutions from Providers such as Quilter Cheviot and Royal London.

The Ratings service, along with the aligned Synaptic Attitude to Risk Questionnaire, is currently offered free to Synaptic and CCD users, and free for 6 months to others. This generous offer is borne out of a key objective we have with our wider tool set, which is to increase the adoption of stochastic metrics. You can visit the site to register at synaptic-risk.capitafinancialsoftware.co.uk.

Following the recent launch of the service, we have reviewed the format and included projections for both 'strategic' and 'tactical' asset allocations. Participating providers and their investments are included overleaf.

The Synaptic Modeller Risk Based Journey

As next quarter, the users of Synaptic Modeller will have further options for conducting their research, following requests that portfolios built or distributed within an organisation can be projected within the Stochastic engine without going through the 'rebalancing' cycle within Modeller. This has been facilitated to streamline advisers' access to the stochastic engine. Please feel free to request a demonstration.



1. Pull preferred investment solutions, including portfolios into the research
2. Probability and extent of loss (and growth) is quantified and represented graphically in easy to understand metrics
3. Stochastic projections can be represented in different graphic formats
4. Synaptic system allows analysis and reporting of portfolio asset allocation

This article is for investment professionals only and should not be relied upon by private investors.

Risk-profiled funds – the perils of the peer group

A notable recent trend in the industry has been the increasing use of risk-profiled fund solutions by advisers. This is understandable given the FCA's increased focus on suitability and the fact that these solutions can provide a cost-efficient way of meeting client needs. However, because each of these products is very different in how it is constructed and the outcome it is designed to achieve – comparison is challenging.

Contact details:

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It is, of course, the client who is paramount in the minds of advisers and designers of fund solutions and it's imperative that the client is able to understand what to expect from any recommended product. It follows that when reviewing the performance of a solution, such a review should be carried out in the context of it is designed to achieve. In other words, is it delivering its stated outcome for investors – and therefore meeting your clients' expectations?

Assessing fund performance – there's a right way and a wrong way

Risk-profiled funds tend to follow a multi-asset approach, combining different asset classes in order to provide both a diversification benefit as well as offering a range of risk profiles.

While all risk based funds look to keep risk at an appropriate level, there are many different ways to achieve this. One way to ensure risk is kept at an appropriate level is to manage the fund to a long-term strategic benchmark, constructed to deliver a given level of risk over time. The methodology for constructing the strategic allocation will vary for each solution, but ideally it will be set using an in-depth analysis of the historical volatility and correlation of the different asset classes. At Fidelity, we test a large number of different

scenarios for how asset classes could behave over the long term. Our approach is based not on the historical performance of individual asset classes, but how they tend to behave relative to each other. This means we can be confident that the portfolio will maintain the desired risk and return characteristics in the future.

Because managers approach this fundamental part of fund design differently, they will offer different asset mixes, potentially holding different asset classes. They will use different risk and return assumptions to underpin their modelling, resulting in different long term expectations. All in all, multi asset funds from different providers – while designed to have similar risk characteristics – may hold very different asset allocations and look very different to each other. This means that care needs to be taken when comparing funds and that makes a simple peer group analysis approach problematic.

Risk-profiled funds are often judged against funds which fall within the IMA 'Mixed Asset' sectors. However, the rules for the IMA Mixed Asset sectors are very flexible in terms of asset allocation. For example, one fund within the Flexible Investment sector can have an equity exposure of 100% while another could hold no equities at all. The



James Bateman

**Head of Portfolio Management
Fidelity Solutions**

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This article is for Investment Professionals only, and should not be relied upon by private investors. The value of investments can go down as well as up and clients may get back less than they invest. Investments should be made on the basis of the current prospectus, which is available along with the Key Investor Information Document, current and semi-annual reports, free of charge on request by calling 0800 368 1732. Issued by FIL Investments International, authorised and regulated by the Financial Conduct Authority. Fidelity, Fidelity Worldwide Investment, the Fidelity Worldwide Investment logo and F symbol are trademarks of FIL Limited. RM0514/3379/SSO/1114

sectors include many different funds following diverse investment approaches and asset allocation policies. In performance terms, such wide sector parameters will typically favour funds which take extreme positions. So, funds which maintain a relatively high exposure to growth-oriented assets should be expected to outperform in bull markets but underperform in bear markets. Conversely, funds which consistently maintain higher relative weightings to safer assets should be expected to outperform in bear markets but underperform in bull markets. Of course, there is nothing wrong with funds taking extreme asset allocation positions or having wide asset allocation parameters so long as the funds' investors have understood and are happy with the risks involved.

Risk based funds, however, are designed differently – they are managed to defined client risk profiles and so will generally have much more constrained asset allocation parameters. They are not designed to take big bets between asset classes – if they did, their risk profiles could well become incompatible with the profiles of the funds' investors at any given time. Comparing the performance of risk-profiled funds to funds which take much bigger asset allocation bets is therefore inappropriate – it's like comparing apples to

About James Bateman

James Bateman is Head of Portfolio Management for Fidelity's Investment Solutions Group. The Investment Solutions Group is a 23-strong team* of specialists in solutions design, tactical asset allocation, manager selection and risk management. The group has a 20-year history of developing solutions tailored to match specific client objectives and risk profiles. Based in London, Paris, Tokyo, Singapore and Hong Kong, the team manage more than £28 billion* for investors around the world.

* Source: Assets and resources are those of FIL Limited as at 31 December 2013.

pears. The performance of a risk-profiled fund should be compared to its strategic asset allocation benchmark. This is because the strategic benchmark is a proxy for the client's risk profile and this should be taken into account when analysing performance of any risk based solution. It may sound obvious, but if a fund is performing in line with or ahead of its benchmark, then it is meeting the needs and expectations of the underlying investors. It is for this reason that many providers of risk-profiled funds, including Fidelity, have removed their funds from the IMA peer groups.

Consequently, we recognise that it's not easy to compare risk-profiled solutions to each other but believe that there is no substitute for an in depth review of each solution under consideration as this is what allows the adviser to gain a solid understanding of the approach taken – and the investor outcomes expected. By investing time at this early stage, the adviser can demonstrate they have met suitability requirements in selecting the most appropriate long-term solution for their client, which in turn should lead to a long-term happy client base.

For more information please contact your local Fidelity representative, visit our website at fidelity.co.uk/multiasset or call FidelityLine 0800 368 1732.

How do savers think about risk?

A population survey: implications for customer engagement and communications

As RDR and auto-enrolment wash through the UK retail investment market, customers will come face-to-face with a changing market-place: online and simplified advice, D2C and worksite platforms, default funds.

While the regulatory lines between these new models remain blurred, all of these will involve a fundamental change in the customer engagement model, and the way in which product information is communicated. The underlying challenges are clear enough:

- How do we engage customers to enable them to make savings decisions and take action: start saving, choose a suitable product, set appropriate contribution levels?
- How do we enable customers to make well-informed investment decisions?

The Pensions Institute, part of Cass Business School, has recently published the findings of a population survey which seeks to understand how savers' perceive risk and make investment decisions in relation to their savings goals¹.

This research highlights important inconsistencies between savers' attitudes to investment risk and their savings goals. The results demonstrate that investors' behavioural biases can lead to poor investment decisions, and outcomes which are misaligned with savings needs. The research findings have been summarised in the form of five "Key Lessons" (see the box below), and have clear implications for how we engage customers and communicate the risks and benefits of investment products.

Population Survey

The Pensions Institute commissioned a YouGov population survey of a representative sample of 4,154 individuals from the UK adult population. The sample included those not participating in the workforce, as well as employees and retired workers. The survey included questions relating to the respondent's attitude to risk, their capacity for loss, and the amount of savings risk (i.e. the size of shortfall in relation to savings goals) they were willing and able to take. The survey considered the trade-offs savers make in order to manage these risks.

Improving Savings Outcomes: Communicating Investment Risks

Traditionally, the management of risk for retail savers has relied on aligning attitude to risk with portfolio volatility. Many of today's risk rating solutions continue to rely on this approach.

However, the Pensions Institute's research has shown that investors find it difficult to evaluate the trade-off between investment risk (fluctuations in portfolio value) and savings risk (the risk of failing to achieve savings goals). This leads to investment decisions which are predominantly influenced by the customer's attitude to investment risk and behavioural biases, rather than their savings needs.

The "Key Lessons" stated in the research report – summarised in the following section – can be applied to support the design of new engagement models and communications tools. These must enable investors to understand the

unavoidable trade-off between investment risk and savings outcomes:

Savings Risk

- What are my savings goals? How much do I expect to get back from my savings plan?
- What would I regard as a 'good' or 'bad' outcome?
- What are the different risk factors that could impact my savings outcome?
- What is the size of the potential shortfall, in relation to my savings targets?
- Could I absorb this shortfall; would it have a material impact on my standard of living?

Investment Risk

- Do I understand and accept the expected level of portfolio volatility, i.e. likely fluctuations in portfolio value?
- Do I understand and accept the potential loss I might experience in a particularly 'bad' year?

New engagement and communication tools, such as the Synaptic Risk Rating service, are designed to communicate risk in terms that customers can relate to their savings needs and their capacity for loss. Investment solutions such as risk-targeted, target date and diversified growth funds reflect the industry's efforts to accommodate individual risk preferences and savings goals.



Philip Mowbray

Moody's Analytics

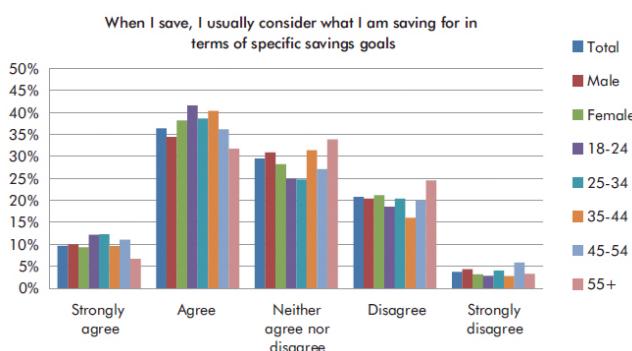
The following 5 Lessons are taken from the Pensions Institute research report:

Lesson 1: Help savers focus on their savings goals

Only half of respondents appear to consider what they are saving for in terms of specific savings goals.

Most people prioritise "rainy day" savings over specific savings goals.

Savers appear more concerned with what might happen, rather than what they know will happen and should plan for.



Source: Pensions Institute Research Report¹

Lesson 2: Provide better information to help savers understand if their plans are adequate to achieve their savings goals

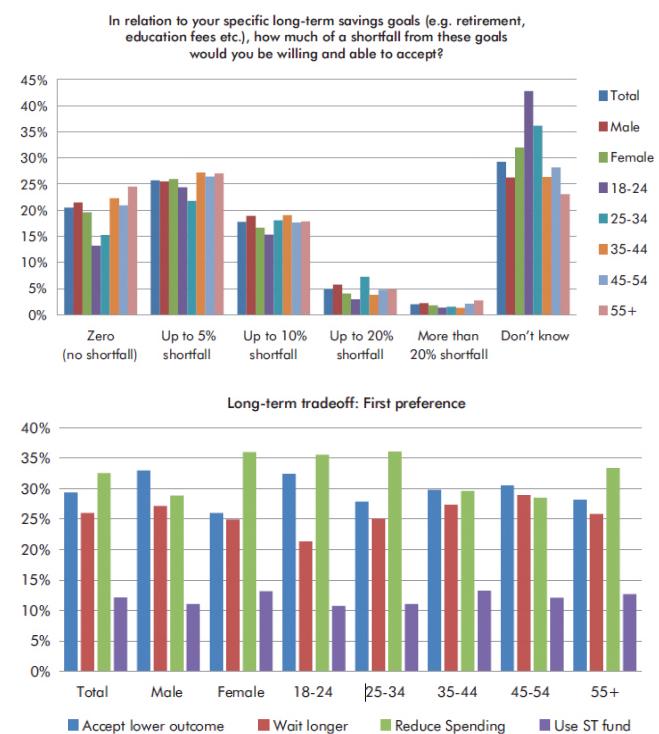
The survey identified that savers are reluctant to accept any significant shortfall (more than 10%) in relation to their long-term savings goals.

The survey also showed that savers prefer to reduce current spending and save more, rather than accept a bigger shortfall in long-term savings outcomes.

These results appear in stark contrast with broad evidence of a long-term savings 'gap'.

Savers would benefit from better information showing the relationship between the amounts saved today and the risk of failing to achieve future savings goals.

Pre-commitment devices such as 'save more tomorrow' can also be employed as effective nudges to ensure people remain committed to their savings plans.



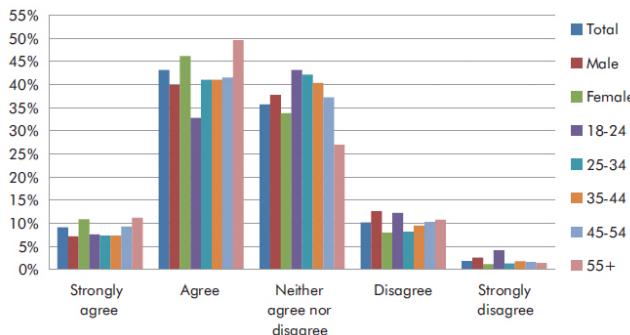
Source: Pensions Institute Research Report¹

Lesson 3: Explain how investment risk helps achievement of savings goals

Savers find it difficult to evaluate the trade-off between investment risk and savings risk.

Over 50% of respondents said they would prefer to miss their savings goals than take investment risk, with only 10% not prepared to do this. This has been referred to as 'reckless conservatism'.

I would prefer my savings to grow more steadily with lower risk / return, even if this means I am less likely to achieve my savings goals



Source: Pensions Institute Research Report¹

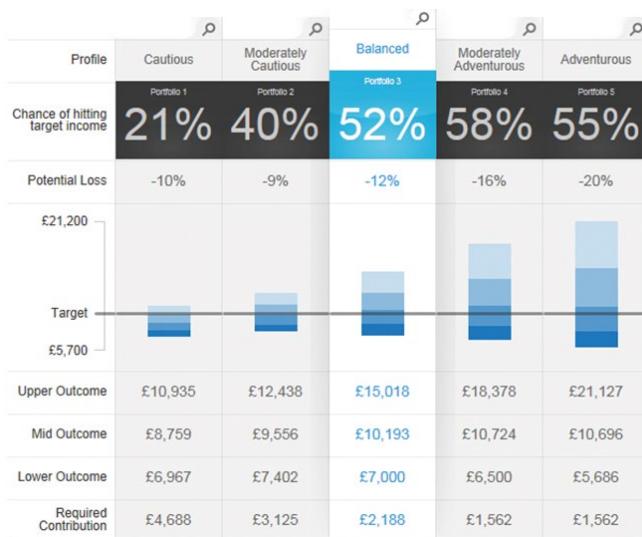
Lesson 4: Taken in isolation, a saver's attitude to risk score is not a good guide to the amount of savings risk a saver is able and willing to take

The research showed a clear relationship between the attitude to risk score and the level of investment risk people are willing to take.

In contrast, there was no relationship between attitude to risk and the amount of savings risk (i.e. the size of the savings shortfall) they are willing and able to accept.

Savers need information and tools to allow them to evaluate investment risk in terms of their savings goals:

- Explaining the effect of inflation in reducing the real value of savings
- Communicating investment risk in a way that does not simply show the 'downside' of investment in risk assets, but also explains the potential value in terms of achieving savings goals



Lesson 5: Savers would benefit from products with clearly communicated risk objectives

Investment products should have clearly stated risk objectives (e.g. volatility, downside risk or outcome targets), which can be aligned with the savings goals and risk appetites of different savers.

Recent responses from the fund management industry, including risk-targeted funds, target date funds, diversified growth funds and income targeting funds, are examples of the industry's efforts to accommodate individual risk preferences and savings goals.

Synaptic Risk Rating Service

Risk Category	1	2	3	4
Provider	Canada Life Investments	Fidelity Worldwide Investment	Legal & General Investments	Premier
Managed Money Plus Fund	Portfolio 3	Portfolio 4	Portfolio 5	Portfolio 6
Cash Portfolio	Multi Asset Open Defensive	Multi Asset Open Strategic	Multi Asset Open Growth	Multi Asset Open Income
Cash Plus Portfolio	Multi Asset Defensive	Multi Asset Allocator Defensive	Multi Asset Strategic	Multi Asset Growth
Liberation Absolute Growth Fund	Multi Asset Allocator Balanced	Multi Asset Allocator Growth	Multi Asset Growth	Multi Asset Income
Capital Builder Portfolio	L&G Multi-Index 3	L&G Multi-Index 4	L&G Multi-Index 5	L&G Multi-Index 6
Capital Builder Plus Portfolio	Corporate Bond Monthly Income Fund	Diversified Fund	Liberation V Fund	Multi Asset Income
Income and Growth Portfolio	Defensive Growth Fund	Multi Asset Distribution Fund	Multi Asset Monthly Income Fund	Multi Asset Income
	Conservative Growth Fund	Balanced Fund	Conservative Portfolio	Multi Asset Income
	Liberation Absolute Growth Fund	Liberation IV Fund	High Income Portfolio	Multi Asset Income
	Capital Builder Plus Portfolio	Income Portfolio		
	Income and Growth Portfolio			

Pensions Institute

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ASSET MANAGEMENT

Statement

The Pensions Institute research project was jointly sponsored by Moody's Analytics and Santander Asset Management. Any views expressed in this article are those of the author alone.

For further information go to www.moodysanalytics.com/RetailWealthMgmt or call 0131 625 7054.

Advisers should look beyond Volatility as a proxy for risk

The recently published 2014 Investment Outlook from Blackrock titled 'Squeezing out more juice' provides a fascinating perspective for anybody considering investment risk. Clients are being advised to be ready to pull out of global stock markets at short notice, or when the 'fruit starts running dry', in light of the challenges to the world economy.

The report suggests that it is 'momentum' that is driving stock markets, with price driving returns, not earnings. 'Rising correlations between bonds and stocks are making well diversified 'safe' portfolios riskier than they appear'. The report also outlines what has generally been accepted, that markets 'cannot deal with tapering', highlighting the uncertainties that central bank intervention brings. These escalating concerns point to the need for advisers to have a greater handle on the risk that their clients are exposed to than ever.

Blackrock present their 'forecast' for 2014 in probability terms – 55% 'Low for longer', 25% for the 'bull' market case, and 20% for 'bear'.

Of course 'pulling out of markets' goes against the orthodoxy of investing for the long term – 'time in the market', not 'timing the market'. Nobody is suggesting that advisers who represent investors should adopt speculative strategies. But equally, as markets continue to evolve in new ways that cannot be aligned with

previous experience, then the assumptions that derive from examining volatility on the context of past performance will only get you so far. Volatility isn't what it used to be. For example, the consensus of experts including Blackrock is that bonds are very expensive, and investors should be factoring in the higher likelihood of high volatility in these markets should a correction ensue.

Nobody can predict the future, but what an adviser can do is consider the full range of possibilities, and put strategies in place that are optimised through diversification to perform across different possible outcomes. Modern Portfolio's concept of the 'efficient frontier' based on Volatility measurements is no longer sufficient in the light of what we have learnt in recent years. But if Volatility can only take you so far, how else can investment outcomes be modelled?

We contend that this is the role of the stochastic engine, such as can be found powering the Synaptic Modeller tool and

the Synaptic Risk Rating Service. This offers a comprehensive 'quantitative' measure for risk that can be included with the 'qualitative' research on which an adviser normally relies. This is significant because, as many advisory firms attest, it is difficult to acquire an objective measure for risk.

An easy way to think about the advantage of using a stochastic model is its ability to capture the sequence of good and bad investment years. Where the bad year occurs in a term will have a massive difference in the investment outcome. It may make the difference between losing money and making money (should the bad year come early). Volatility may be consistent in both cases, so is not necessarily a reliable predictor of returns.

In our experience, most advisers have evolved effective and proven investment solutions. What many do not have is access to reliable risk based measurement.

These escalating concerns point to the need for advisers to have a greater handle on the risk that their clients are exposed to than ever.

Visit synaptic-risk.capitafinancialsoftware.co.uk for more information about the Synaptic Risk Service, including access to the Synaptic Attitude to Risk Assessment tool.



Risk profiling Quilter Cheviot's Managed Portfolio Service (MPS)

Quilter Cheviot constantly strives to meet the evolving requirements of financial advisers and is now pleased to announce that our Managed Portfolio Service (MPS) strategies have been mapped by Capita's Synaptic Risk Rating Service.

Assessing the suitable level of risk that a client is willing and able to take is central to an adviser's investment decisions. Greater numbers of advisers are addressing this with the help of risk profiling questionnaires that generate risk tolerance scores and align clients to suggested products.

Some advisers produce their own robust risk rating scores using their in-house expertise but most have a preference for independent third party measures. Using established independent measures can prove a cost effective way of ensuring the consistency of risk measurements across a client base.

The general principle is that this type of risk profiling assesses an overall portfolio's level of risk, but does not necessarily indicate the suitability of the portfolio for each client. For example, an adviser may decide that a high risk equity portfolio is still the most appropriate investment strategy for their cautious client if the client has a large amount of low risk assets held outside of the portfolio.

It is therefore important to realise that risk tolerance scores are only one aspect of an adviser's suitability process and other factors should also be considered to provide a wider context. The FCA has stated that these other factors should also include the term of the investment and the client's knowledge and experience. We also feel that a face to face meeting between the adviser, their client and an investment manager should be a key part to any decision making process.

Capita's Synaptic Risk Rating Service

Capita's Synaptic Risk Rating Service is a research and financial planning system that aims to determine suitability based on six risk profiles that are underlined by Barrie + Hibbert probability-based models of future performance. This methodology is purely 'quantitative', so offers a measure devoid of any 'qualitative' overlay (or opinion).

Synaptic allows the adviser to illustrate risk in terms of the probability of losing money which ties in with the capacity for loss assessment ascertained in the client's questionnaire.

Six of our sterling-based MPS strategies have been reviewed by Synaptic and the conclusions of these profiles are shown below:

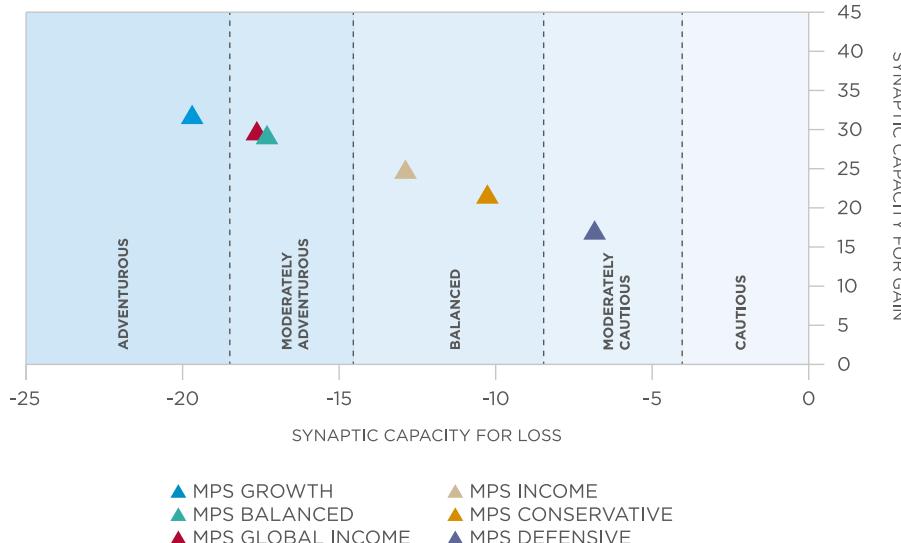
Please note that whilst the capacity for loss figure is generated by a Barrie + Hibbert stochastic model, the classification ranges have been defined by Synaptic and therefore they do not necessarily align with our internal definitions of 'balanced', 'adventurous' or 'cautious' portfolios. This difference highlights the arbitrary nature of a portfolio's name when assessing its risk and serves as a reminder of the need for detailed risk analysis when determining suitability rather than simply assuming a risk profile from a portfolio's name.

It is also worth noting that the varying weights of our MPS strategies, due to their active management, mean that they could move up or down a risk scale on Synaptic over time.



Julian Menges & Benjamin Mountain

Joint Heads of Quilter Cheviot Managed Portfolio Service (MPS)
Quilter Cheviot Investment Management



Our Conclusion

Using risk profiling questionnaires that map to third party independent risk ratings can form a useful part of an adviser's wider assessment of suitability. The FCA's guidance on assessing customer risk and the suitability of investment recommendations means that advisers need to be able to understand the risk exposure of all the products they recommend and should not form recommendations solely based on risk tolerance scores.

By having Synaptic's independent risk profiling services available for our MPS, it helps financial

advisers to map their chosen tools to the most appropriate MPS strategy as part of a wider product selection process.

If you would like more information on Capita's Synaptic Risk Rating Service please visit synaptic-risk.capitafinancialsoftware.co.uk

If you would like to discuss our MPS strategies in more detail, or organise a meeting with one of our investment managers, please contact Quilter Cheviot on 020 7150 4005.

Disclaimer:

Investors should remember that the value of investments, and the income from them, can go down as well as up. Investment and investment services referred to may not be suitable for all recipients.

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About Quilter Cheviot

Quilter Cheviot is one of the UK's largest independently owned discretionary investment firms, which can trace its heritage to 1771. Our firm is based in thirteen locations across the UK, Jersey and Ireland and has total assets under management of £15.2 bn (as at 31 December 2013). Quilter Cheviot focuses primarily on structuring and managing bespoke discretionary portfolios for private clients, charities, trusts, pension funds and intermediaries.

We are at the forefront of development and innovation. We led the way in developing outsourcing solutions for financial advisers, providing access to a range of managed portfolio strategies constructed using carefully researched funds.

Our investment managers are committed to building long-term relationships with financial advisers and their clients, established on a foundation of exemplary personal service and investment expertise.

Our commitment to excellence has been recognised by the award of a Defaqto 5* rating for both our Managed Portfolio Service and Discretionary Portfolio Service in 2013.

This article is for investment professionals only and should not be relied upon by private investors.

Dispelling the myths: risk-targeted versus risk-profiled multi asset funds

Over the last year or so, one of the major themes within the industry has been the growing popularity of risk-profiled and risk-targeted multi asset funds. This is hardly surprising given the regulator's increased focus on suitability. Additionally, these typically cost-efficient solutions have allowed advisers to cut costs at a time when they have been grappling with the implementation of the RDR.

Contact details:

For more information please contact your local Fidelity representative, visit our website fidelity.co.uk/multiasset or call the FidelityLine 0800 368 1732

Risk-based solutions provide many benefits. However, the difference between risk-profiled (or risk-rated) funds and risk-targeted funds is not always clearly understood by everyone. Descriptions vary, although risk-targeted funds are usually portrayed as being designed to meet defined volatility targets where the goal is to manage them within a set volatility band or "risk budget". On the other hand, risk-profiled options are sometimes dismissed as funds which have merely been allocated a risk rating based on the past volatility of the portfolio or asset mix.

These are very simplified definitions. They do not address the complexity of the individual approach taken by a fund provider in constructing a particular solution. I believe it is very important that advisers should have an understanding of what is 'under the bonnet' when choosing between different risk-based solutions. Indeed, if a risk-based managed solution is being used as a firm's Centralised Investment Proposition, then the FCA requires firms to conduct adequate due diligence to ensure suitability for the client segment for which it is being employed. Therefore, in order to determine which solution is right for your clients, we need to investigate both options further.

Risk-targeted funds – a more constrained approach

Risk-targeted funds will, as the name implies, put distinct constraints on a fund manager in terms of the volatility band in which they can manage a portfolio. So, for example, a fund with a volatility target of between 4% and 5% over a particular time period will be managed to ensure the level of risk within the portfolio does not exceed or fall below this level on an ongoing basis.

This approach delivers certainty for the investor in terms of the level of risk they will be taking. However, it also brings some disadvantages. Having to stick to strictly-defined risk parameters can mean the manager is too constrained, potentially leading to poor outcomes for the investors. For example, funds which target a particular level of volatility have struggled in recent years as overall market volatility has been relatively low. While this may seem to deliver a "safe" outcome for investors, it could also be delivering a lower return than if the fund manager had taken a greater level of risk.

We believe that the flexibility for fund providers to take more risk – when it is appropriate to do so and when it may deliver a greater return for



James Bateman

**Head of Portfolio Management,
Investment Solutions Group,
Fidelity Worldwide Investment**

We believe that the flexibility for fund providers to take more risk – when it is appropriate to do so and when it may deliver a greater return for clients – is important.

clients – is important. Equally, on the reverse side, being able to reduce risk when the outlook is less certain provides greater capacity to preserve capital.

Risk-profiled funds – benefiting from greater flexibility

Let's now consider how risk-profiled funds are managed. Firstly, we need to put to bed the idea that they are backward looking with a risk rating based purely on the past volatility of the portfolio. The fund manager will, of course, study long-term historical data so that they have an understanding of how certain combinations of asset classes will behave over time. Having an in-depth appreciation of volatility and correlations is obviously crucial and this analysis will be used to develop a suitable long-term strategic benchmark for a fund which, in turn, defines its risk profile.

At Fidelity, our benchmarks are constructed using the output from a complex proprietary modelling process. An understanding of how asset classes have behaved in the past helps us to create long-term expectations for how they might behave in the future. The models and assumptions are reviewed regularly to ensure they remain appropriate in the "real" world as markets and conditions change. In essence, our

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About James Bateman

James Bateman is Head of Portfolio Management for Fidelity's Investment Solutions Group. The Investment Solutions Group is a 23-strong team^{*} of specialists in solutions design, tactical asset allocation, manager selection and risk management. The group has a 20-year history of developing solutions tailored to match specific client objectives and risk profiles. Based in London, Paris, Tokyo, Singapore and Hong Kong, the team manage more than £28 billion^{*} for investors around the world.

* Source: Assets and resources are those of FIL Limited as at 31 December 2013.

asset allocation benchmarks are based on what we think is right in terms of risk and return outcomes for investors.

This strategic framework gives a risk-profiled fund its broad direction. Our fund managers also make tactical decisions based on current market conditions and their view on the prospects for the various asset classes. This flexibility allows the manager to improve returns and/or to reduce risk. However, it goes without saying that any tactical decisions need to be made within clearly defined limits to ensure consistency with the fund's risk profile, as is the case for the Fidelity range of risk-profiled managed solutions.

In contrast, the parameters set for many risk-targeted solutions are often based on how markets have behaved in the past and so their investment restrictions can mean that they are less able to take account of current and future market developments. Of course, all funds are different and the issue of risk is very complex. Therefore, to put a fund in a box with a simple label can be difficult. However, I do think the flexibility of risk-profiled funds gives them a clear advantage over those which take a risk-targeted approach.