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From risk profiling to investment suitability:

The building blocks of a best practice investment proposition

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In recent months, the FSA's guidance on Investment Suitability has highlighted failings in current practice, creating an important dialogue within the industry. Retail investment platforms, providers and advisors have moved to update their propositions to reflect specific areas of concern. In contrast to the legacy of retail investment regulation, this principles-based approach is the correct one, and the net result of this should be better customer outcomes in future.

With the benefit of six months' hindsight, it is now worth asking "So what?"

What changes have had the biggest impact for customers, and how can the FSA's guidance paper together with this practical experience inform the evolution of best practice.

Best Practice: Moving Beyond Attitude to Risk

Perhaps the most fundamental issue being addressed in the guidance paper is highlighted by the following excerpt:

FSA Finalised Guidance 11/05:
"Some firms unduly focus on the risk a customer is willing to take...

...suitability is not just about making investment selections that reflect a customer's attitude to risk"

While it is important to ensure your attitude to risk assessment questionnaire (ATRQ) meets current standards, the client's attitude to risk is only one input into the selection of a suitable investment, not the solution. Simplifying the problem to changing the design of the ATRQ is likely to have only limited impact on customer outcomes.

If the fundamental issue is ensuring that investment selection is aligned with customer objectives, then the most important 'gap' highlighted by the FSA paper is not the ATRQ itself, but the reliance on the customer's attitude to risk as the basis for an investment recommendation.

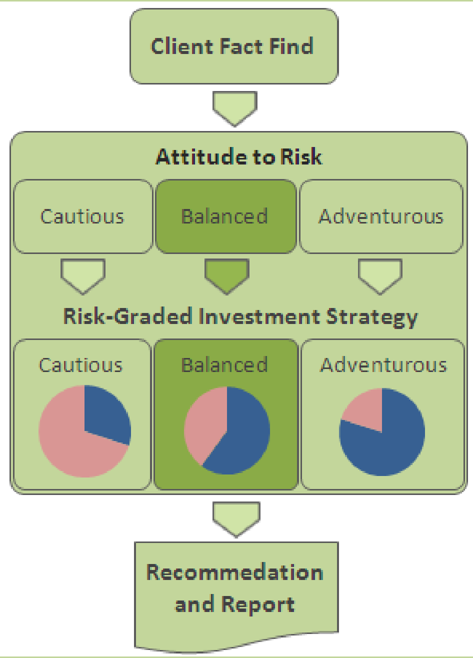
Identifying the gaps in the current process

In order to boil down the 31-page paper into a more concrete 'gap analysis', we will focus on some key themes highlighted in the paper:

- the risk a customer is willing ***and able*** to take
- a customer's ***capacity for loss***
- identifying customers who are unwilling or unable to accept the risk of loss

Although the FSA did not publish details of the 11 "risk profiling" tools surveyed, the following box attempts to provide a generic illustration of the "risk profiling" framework characterised in the report, and describe some of the gaps in more concrete terms:

Existing Risk Profiling Framework



Outline Gap Analysis

- Customers are not provided with information that allows them to understand potential loss in the proposed investment, or whether that investment is likely to meet their investment objectives.
- In the absence of such information, the customer's attitude to risk (risk profile) is the primary, or only, factor used to make an investment selection.
- An assessment of "attitude to risk" does not contain information about the customer's financial needs or "capacity for loss".
- Investment options are categorised into broad groups (e.g. "Cautious", "Balanced", "Adventurous"), based on volatility. This approach to risk grading takes no account of a customer's investment needs.
- As a result, investment selections often fail to account for the customers' financial needs, or their ability to absorb loss.

While most advisors already capture customer objectives within the fact-find, this aspect of the investment selection process may not be formalised to the same degree as the assessment of attitude to risk. While the link from attitude to risk to investment selection may be clearly defined and is simple to record within an audit trail, the link between the customer's objective and the final investment recommendation may be less explicit and more difficult to verify.

Filling the gap: key components of a best practice investment proposition

While firms will want to ensure their chosen ATRQ meets the guidelines described in the paper, we have identified a number of additional 'best practice' checks that firms should consider when reviewing their investment selection process:

1. **Ensure the fact-find captures the key information required to select a 'suitable' investment:**

Fact-Find Element	Examples
Relevant investment objectives:	"I expect my fund to grow above inflation, and will need the cash in the next 5-10 years." "When I retire, I'd like my pension pot to generate an income of around £10,000 pa"
The client's ability to accept any outcome that does not meet their investment objective in full	"I do have other sources of retirement income, but want to top that up to sustain my lifestyle."
Assess the extent of loss that the client could accept in relation to their investment objective	"I could live with as little as £7,000 pa, but any less than that would get very painful."
Assess the client's ability to accept short-term fluctuations in their fund or portfolios	"If my fund fell by more than 10% at any stage, I would become very uncomfortable."

2. **Offer appropriate risk-graded investment options:**

While there is no single 'optimal' investment solution for a customer, there are some sensible guidelines that can be followed:

- The primary factor determining customer outcome will be the long-term investment strategy. While individuals have their own views on the relative value of different markets, in the context of selecting an investment which accounts for a customer's investment objectives and risk profile, these tactical views will be secondary to the long-term investment strategy.
- The process should aim to find the *lowest risk* investment strategy that can meet the client's investment objective. A process based on "attitude to risk" is will naturally select the investment option with the highest level of risk a customer is willing to take.
- Where distinct investment objectives mean customers are exposed to different risk factors, this should be reflected in the design of the investment strategy. For example, a "very low risk" pension customer seeking to limit any losses to future retirement income is likely to adopt a different asset allocation strategy to an investment customer seeking to avoid loss of capital.
- Investment options should be illustrated and compared using appropriate measures of risk. These should relate to the customer's investment objective, rather than investment volatility.

  For example, the 60 year-old pension customer is concerned with how much annuity income his pension fund will buy in five years' time, and should compare investment options based on a measure of risk that relates to future annuity (income).

3. **Use tools to identify investment options which align customer objectives with risk profile**

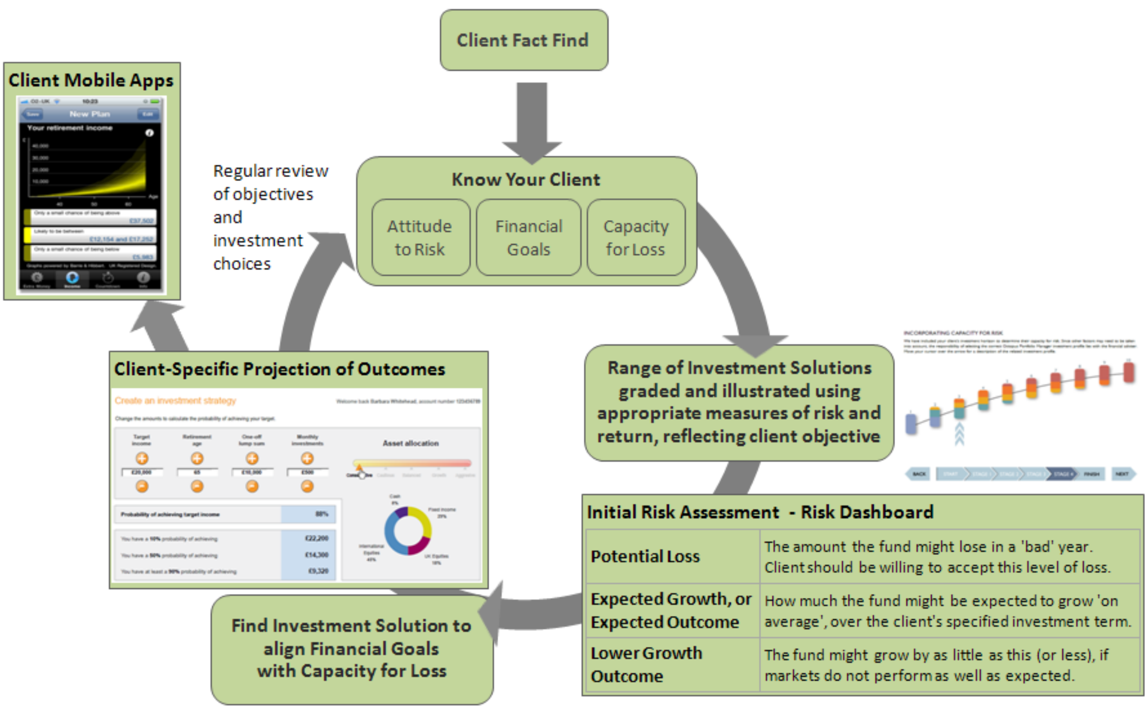
An important role for the advisor is to reconcile the customer's investment objective and capacity for loss (downside risk). The key requirement at this stage is to ensure that the investment recommendation can be linked explicitly to the customer's objective.

At this stage, a stochastic projection tool is required to understand the potential outcomes from any proposed investment strategy, in relation to the customer's own personal circumstances and specific investment objectives:

Example Customer Objective	Assessment of Risk v Objective
"When I retire, I'd like my pension pot to generate an income of around £10,000 pa"	"There is a 62% chance the chosen investment option will produce a retirement income of at least £10,000 pa"
"I do have other sources of retirement income, but want to top that up to sustain my lifestyle."	While the fact-find implies the customer can accept some risk, can they accept only a 62% chance of hitting the target and maintaining "current lifestyle" in full?
"I could live with as little as £7,000 pa, but any less than that would get very painful."	The tool shows that in 'bad' markets, there is less than a 5% (1 in 20) chance of an outcome worse than £7,000 pa.
"If my fund fell by more than 10% at any stage, I would be very uncomfortable."	Analysis shows that any investment option with a potential loss of less than 10% in any year will give low chance of achieving £10,000 pa target. The customer will need to decide whether they can accept a higher level of risk, or accept a lower retirement income.

One notable point is that the customer's *attitude to risk* does not form a key element of this final stage of the investment selection process.

The role of these distinct components in the selection of a suitable investment option is shown in the following process flow:



Does your process measure up?

An effective attitude to risk questionnaire is not the answer to selecting a suitable investment option. Through our work with leading advisory firms and platforms, we have identified the core components of evolving 'best practice' investment propositions:

- A fact-find process which captures the customer's investment objective and capacity for loss
- A set of risk-graded investment options which can be evaluated using appropriate measures of risk that reflect the customer's investment objective
- A stochastic risk modelling tool which allows possible outcomes from the proposed investment solution to be projected based on the customer's own personal circumstances and investment objectives

Putting these additional components in place is becoming much easier.

Barrie & Hibbert have developed a range of investment analysis and financial planning modules to ensure advisors and distributors not only align themselves with FSA guidance, but remain at the forefront of rapidly evolving industry best practice.

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