

THE SECRET SELECTOR

How investment risk assessments and benchmarks influence investment choices

Introduction

Who selects investment solutions? Go ask advisers and you'll get different answers – "I do!" "The paraplanning team." "The investment committee." "The boss." Whoever it is, behind the person there's a process.

And, at the heart of the process is an assessment of what level of investment risk aligns with the customer's attitude to risk and a means to evaluate the past and likely future performance of investment solutions. The aim of the process is to ensure advisers are recommending the right investment solution to each of their customers. If performance is a key driver of investment recommendations, then how you decide what solutions to compare will inevitably have a significant influence on the outcome.

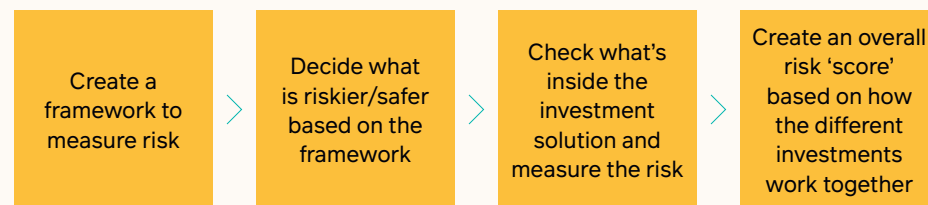
In this paper, we delve into how investment risk assessments and benchmarks can influence investment selection, what to look out for when assessing risk and performance, and what advisers can do to adapt their process when selecting investments.



Assessing investment risk

Risk is the potential for the solution to not do what you need it to. That could be not growing capital, not paying out enough income, not preserving capital or some combination of those. Risk can be assessed at the individual asset class level or for a portfolio as a whole.

There are many ways to assess investment risk. Most processes will follow these steps:



Some of the common ways to assess investment risk are:

The proportion invested in equities or 'risk assets'

This has the advantage of simplicity and works well for diversified multi-asset portfolios. It doesn't work well for concentrated portfolios, as there can be significant variation in the risk of an individual equity. There isn't a universally agreed approach for determining what is a 'risk asset'; some strategies will include real estate, high yield bonds or emerging market bonds as equivalent to equities in terms of risk. This approach also oversimplifies the 'non-risk assets' within which the risk will also differ a lot.

Volatility

This is how much the returns of an investment move away, or deviate, from their average return. A more volatile investment moves further and more frequently from its average. One problem with this approach is that it treats falls and rises the same way. There are also lots of different time periods you can use to measure volatility – for example, do you check the move each day or each month? If you're ever comparing the volatility of two solutions, make sure it's the same methodology being used for the calculation.

Drawdowns

This is the fall in the portfolio value from its highest point to its lowest point. It can be more relevant for customers and easier to understand than volatility. It's a historical figure, though, so the future may be better or worse.

Ratios

There are many types of ratios which are created using the return and the volatility of a portfolio. The most well-known is the Sharpe Ratio, which measures the return relative to the volatility. These are more complex to explain to customers, but have the benefit of enabling you to compare risk across very different investment solutions.

Correlation and Beta

These are measures of how similar the returns of a portfolio are to a benchmark index, such as the FTSE 100 Index. They can help identify solutions that improve diversification. The challenge for multi-asset solutions is determining what the reference point should be.

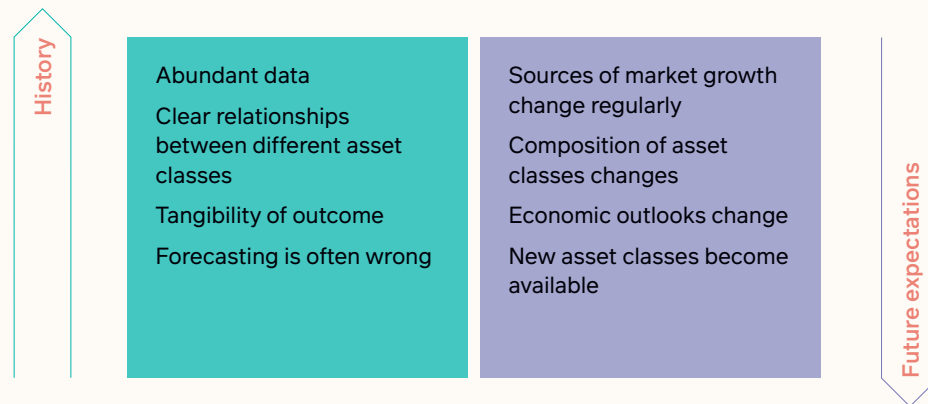
Scenario analysis

This involves measuring how a portfolio would perform in different market environments. The scenarios could be hypothetical or based on historical events such as the Global Financial Crisis in 2008. The scenarios that are chosen can have a large impact on whether an investment looks risky or not.

Past vs. future

A tension in investment risk is how much to rely on historical data versus future expectations. Looking at the past, you have the advantages of abundant data, clear relationships between asset classes, and tangible outcomes. Plus, forecasting is often wrong. The risk with just using the past, though, is that the sources of market growth change regularly, as does the composition of asset classes. The economic outlook will also change, due to changes in technology, trading patterns, consumer preferences and geopolitics. Historical data also won't help much for evaluating new asset classes.

How you rate the riskiness of an asset class can be heavily influenced by what weight you give to its past performance versus its future expectations. For example, emerging market bonds look very risky when you look back at historical data. In the early 1990s, the index had less than 20 countries, so an issue with any of them would cause sharp price changes. If you look at the characteristics of the market today, it looks much less risky. The index for sovereign bonds issued in US dollars has changed dramatically and now has 54 countries. In 2022 – the most recent period of volatility in bond markets – emerging market local currency bonds performed much better for portfolios than UK and US government bonds.



Common disagreements on risk

Investors frequently disagree about the risk of asset classes. Here are some of the common disagreements you might see if you surveyed a large number of investment providers:

Asset class	Why it's riskier	Why it's safer
UK government bonds	<ul style="list-style-type: none"> • Gilts are sensitive to changes in interest rates and inflation which means the capital value can change substantially. 	<ul style="list-style-type: none"> • Governments are less likely to go bust than companies in a severe economic downturn.
Emerging market bonds	<ul style="list-style-type: none"> • Countries can be weaker financially. • Countries can default. • 'Local' currency bonds add currency risk. 	<ul style="list-style-type: none"> • The emerging markets USD government bond index contains bonds from 54 different countries, with no country having a weight of more than 7%. • Emerging markets have higher GDP growth and lower debt to GDP ratios than developed countries.
Real Estate Investment Trusts Listed infrastructure equities	<ul style="list-style-type: none"> • These are listed equities, invested in illiquid physical assets, and prices will move each day. • High income payouts make the companies sensitive to changes in interest rates and inflation. 	<ul style="list-style-type: none"> • Higher levels of dividends provides a buffer for capital losses. • Lower correlation to other equity sectors. • The companies own or operate physical assets, which can bring a level of inflation-protection.
Absolute return funds	<ul style="list-style-type: none"> • Holds multiple asset classes and it can be hard to understand the drivers of returns. • May use complex investments, like options, futures and forwards. 	<ul style="list-style-type: none"> • The funds often take many small positions. • Can be less correlated to bonds and equities, enabling them to reduce overall risk.
Bricks and mortar real estate	<ul style="list-style-type: none"> • Illiquid asset class and investors can receive lower prices if they need to sell quickly. • The prices lag publicly traded assets and so risks can be disguised. • Can be leveraged. 	<ul style="list-style-type: none"> • Can provide protection from inflation and inflation-linked income. • Less correlated to bonds and equities.
Emerging market equities	<ul style="list-style-type: none"> • Less stable governments. • Weaker regulatory framework. • Higher historic volatility. 	<ul style="list-style-type: none"> • Variations in performance across countries can mitigate volatility. • Favourable demographics and higher GDP growth rates.
US equities	<ul style="list-style-type: none"> • High expectations in stock prices. • Concentration of large cap indices. • High uncertainty around government policy, particularly on trade. 	<ul style="list-style-type: none"> • Historically delivered a high level of growth. • Large companies have market power and are operating in areas that are growing quickly. • Dynamic economy with lower taxes, more flexible labour force and cheaper energy costs than other developed countries.

How risk rating tools influence recommendations

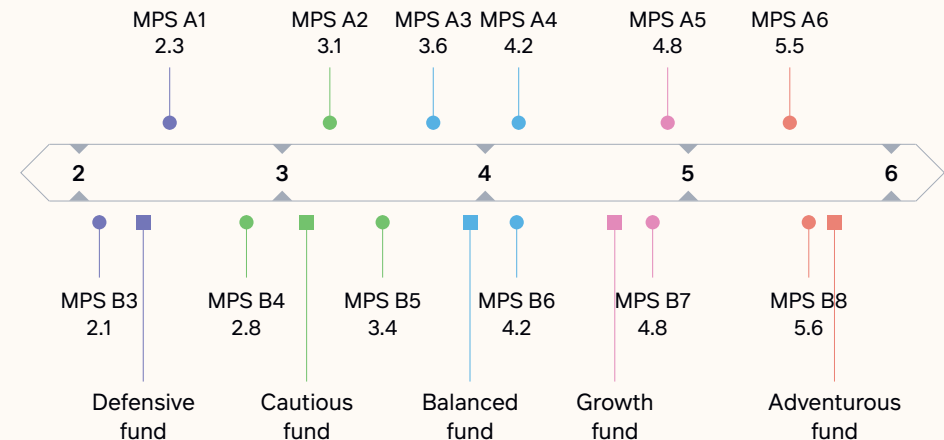
When you use a risk rating tool, you're relying on the company's views on risk to decide what investment solutions are appropriate for different customer risk tolerances. Of course, no one knows the future so these assessments are always subjective. A key thing to be aware of is how the risk rating assumptions influence how investment solutions are grouped into buckets.

Past performance and costs are widely used by advisers as key metrics for deciding which investment solutions to adopt. There will also be considerations for the experience of the customer – does she/he want to have a portfolio where they own the underlying funds and can see the changes? Or, does she/he want the simplicity of owning a single multi-asset fund? Is passive or active management preferred?

Most ratings are on a scale, but for practicality solutions are grouped into buckets. There will always be solutions that are more and less risky within a category.

This scale shows how two MPS providers and a fund range are rated by a prominent risk rating provider. The colours represent which portfolios are compared to one another under the mapping. MPS A's portfolio 3 has a rating of 3.6 and is included in risk category 4. But, it's actually much closer in risk to MPS B's portfolio 5, which has a rating of 3.4, than to the other portfolios in its risk category 4.

MPS A's portfolio 3 has 43% in equities. The other models in risk category 4 have equity exposures of 54%, 61% and 60%. The strategies are in the same category because MPS A has higher allocations to emerging market bonds, emerging market equities and alternatives such as listed infrastructure equities and absolute return funds than the other investment solutions. This risk rating provider considers these to be riskier assets. In contrast, asset classes such as UK government bonds and US equities are considered safer by this particular risk rating provider.



This graphic is based on publicly available information from two MPS ranges and a multi-asset fund range, which has been compiled by M&G Wealth Investments LLP. The risk rating provider is a prominent UK company that works with adviser firms. We have anonymised the information, as the goal is to illustrate the variance within a single risk category.

If past performance is a key metric, then how investment solutions are grouped into risk buckets may have a disproportionate influence on what you recommend. That's why it's vital to understand how the process works and be aware of the risk views that you're adopting.

Using a set of fictional model portfolios, let's look at how that could happen:

Investment solution	Risk category	5 year performance (pa)	Current equity weight
Superior MPS	Growth (65%-80% equity)	6.6%	69%
Best MPS	Growth (65%-80% equity)	6.2%	65%
Perfect MPS	Growth (65%-80% equity)	7.0%	74%
Wonderful MPS	Balanced (50%-64% equity)	5.1%	50%
Excellent MPS	Balanced (50%-64% equity)	6.0%	63%
Top Notch MPS	Balanced (50%-64% equity)	5.8%	55%

With the categories above, you'd end up using the Perfect MPS and Excellent MPS, as they have the best performance in their category. But, they may have achieved that just by having the most risk as they also have the most equity exposure.

What if you used 60%-69% equity exposure as the risk category?

	Risk category	5 year performance (annualized)	Current equity weight
Superior MPS	Balanced (60%-69% equity)	6.6%	69%
Best MPS	Balanced (60%-69% equity)	6.2%	65%
Excellent MPS	Balanced (60%-69% equity)	6.0%	63%

The Superior MPS becomes the new preferred option. That wasn't driven by a change in the performance it has delivered – just recutting the categories! However, maybe the 6.0% is actually the most impressive performance in the category, though, given the portfolio has achieved it with less equity than the other two?

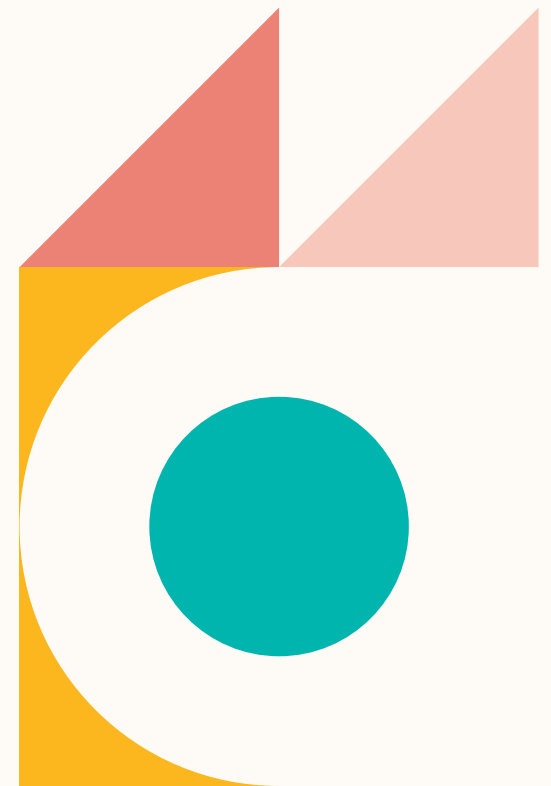
In the long run, equity markets will tend to outperform bonds due to having more inherent risk. So, that means models with more equities are likely to outperform within risk profiles over longer term periods as well.

In market environments where equities are flat or slightly negative, performance is less likely to be driven by which solution has the more equity exposure. When you look at periods that include market ups and downs, it captures more of the skill of the manager. The challenge is that the recent period has been a very bifurcated market – nearly all equities have rallied in the past two years, while most bonds have been lacklustre.

Concentration risk

The other aspect that some risk rating approaches don't consider is the concentration of exposures. Investment firms report their asset allocation to risk rating providers. The reporting is done at a high level in categories specified by the risk rating provider – for example, US equities, UK equities, UK Government bond, etc. The assumptions used for a specific asset class may not reflect the actual risk in the investment solution. A provider could have all of their Europe ex-UK equity exposure in a growth oriented fund that holds 30 stocks, but the risk rating provider might use a broader Europe ex-UK benchmark that has hundreds of stocks. This could lead to the risk being underestimated. With government bonds, the difference in risk between owning a short-dated UK Gilt vs. a long-dated one will be considerable. This is because a bond with a longer maturity will be more sensitive to changes in interest rates and inflation.

Risk rating providers have tackled this issue in different ways. A handful look at the actual holdings of the investment solution, meaning concentration can be evaluated. Other providers have expanded the asset class categories to be more granular. For example, the provider may ask investment providers to report short-dated and longer-dated UK Gilts exposure separately.



Multi-asset benchmarks

The purpose of a benchmark is to help the customer and adviser understand the outcome they've received. The most important question is does the benchmark provide insight to customers on whether the portfolio is delivering good value? They are also often used as risk categories in investment selection processes.

Here are three common benchmark types used for multi-asset portfolios:



Index composites

This means a benchmark that is made up of several indices, such as 30% S&P 500, 10% FTSE 100, 5% UK Gilts, 15% US Corporate bonds, etc. Using an index benchmark is a good approach for a portfolio or fund that invests in a single asset class, like US equities. It tells you if the manager is outperforming the passive index and delivering value. It's less useful for multi-asset funds because it doesn't give information about whether the asset allocation is outperforming peers. If the index composite represents the long term asset allocation of the portfolio, then the portfolio and the benchmark will always be very close together. It can be helpful to show whether a manager is outperforming with fund selection and tactical asset allocation views.



Cash/CPI + X%

This uses an interest rate, such as the Bank of England Base Rate, or inflation rate and then adds a desired outperformance target per year. This approach works well for absolute return or bond strategies. Bond returns have ties with cash rates and inflation rates, so it's reasonable to look at how much more you're getting versus those options. Cash rates and inflation are not an accurate measure for equity market returns, though. If you're measuring a multi-asset strategy with a sizable amount of equity then you'll probably have very little correlation in the outcomes from year to year. They also don't give you any information on how your multi-asset strategy is doing vs. other strategies.



Peer groups

The benchmark is an average of the performance of other similar investment strategies. This approach gives insight into whether the asset allocation of the portfolio is delivering value. It also includes the costs to hold, trade and manage the investments. The challenge is setting the peer group. Most approaches use equity weights, as it's simple to measure.

There are some benchmark approaches that advisers should ask questions about if they encounter them

1. The benchmark has more fees included in the performance returns than the model/fund.

Here are two ways this can happen:

- A model portfolio on platforms, which only includes the investment management fee and fund costs, is compared to the ARC PCI indices, which include investment management fees, fund costs, custody and advice. That could give the model portfolio a cost advantage of 0.75% to 1% per year.
- When investment solutions report gross rather than net performance. For example, an investment manager might report their model portfolio performance gross of their investment management fee and then compare performance to the IA sectors indices, which do include an investment management fee.

2. Using a benchmark with materially less risk than the model/fund.

To some extent this is unavoidable, because peer group benchmarks like the IA and ABI have very wide equity ranges. Here's an example of a difference worth questioning:

- A model portfolio with 90% equities uses the IA Flexible as its benchmark. The IA Flexible index has an average of 73.6% in equities vs. the IA Global Index, which has 96% in equities.

It's worth looking at how much the fund/model varies from the average weight in the peer group and adjusting expectations accordingly. Funds and models may cluster around the higher equity weight, because they know that having more equity exposure is the easiest way to outperform in the long run.

The IA and ABI Mixed Indices provide good comparisons over longer periods of time, particularly for investment strategies where the manager can adjust the equity and bond weights. Over shorter time periods, they are less useful as the performance difference may just reflect differences in equity weights.

What can advisers do?

Benchmarks and risk frameworks often underpin the processes for selecting investment solutions. Assessing investment risk is subjective and requires taking a view. If you're using an investment risk assessment provider, then make sure you understand how their risk profiling process works and be aware of its 'preferences'. There are no wrong views. If you know what the system may bias itself towards then you can adjust for that.

For example, a risk assessment process might treat emerging market bonds like equities, meaning that portfolios with a meaningful amount of emerging market bonds are compared against models with higher equity allocations. If emerging market bonds are underperforming equity, then the models will not perform as well.

A second good practice is to use more than one system or metric in your risk assessment process. For example, don't just consider volatility; also consider the percentage of the portfolio in equities, as this will tend to drive longer-term performance within risk profiles in positive market conditions. Or, if you're using a third party provider, check the historical volatility and equity weights of the models in the groups. You can be aware of what models have less equity and take that into consideration.

Performance should continue to be a key input in how advisers select investment solutions. The challenge is grouping investments into categories where there are very similar risk levels. There will always be a human judgement element in selection processes, because any process will have weaknesses.

