

## Wraps and Platforms in the Post-RDR World




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### FinaMetrica

- Psychometric personal financial risk tolerance assessment and application methodologies for individual investors
- Privately owned, Australian business commenced 1998
- Co-founders combined experience 80 years in all parts of service chain
- 3,000 leading edge advisers in 15 countries, directing Au\$30 billion plus
- 75% subscribers are international, translated into 7 languages
- Average subscription duration 5 years plus
- 430,000 profiles completed,
- Up to 12,000 new profiles per month
- 'Practice Solution' for small to large advisory groups
- 'Enterprise Solution' for multi-channel businesses.

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## Wraps and Platforms in the Post-RDR World

### Today's Agenda

- The mismanagement of investment expectations
- Surprises in the equity risk premium analysis of seven developed economies
- A four part process to deliver consistent advice
- Five things to do to protect and grow the business

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### Current Issues Within the Global Wealth Management Industry

Major **inconsistencies** in the personalisation of advice resulting in low level of management control have lead to:

- **investment product failure** in the eyes of the media, governments, regulators and investors
- **lack of confidence** in integrity of financial advice
- **sub-optimal profitability** for advisers, advisory businesses and fund managers
- **low** level of institutional **morale**
- impending & **increasing Know Your Client** impositions.

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## Advisory Businesses Put Their Reputation and Corporate Value at Risk Every Day

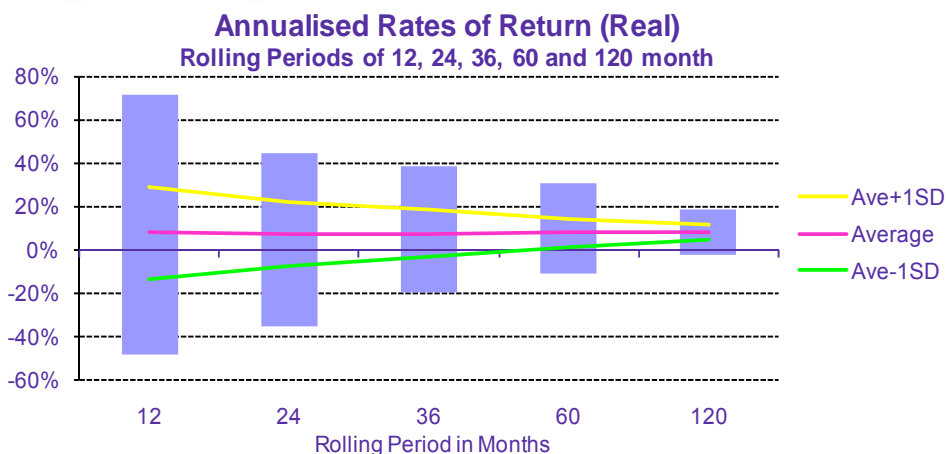
- Allow their recommended fund managers to **misleadingly explain risk**,
- **Inaccurately and inconsistently assess** investors' risk tolerance,
- Accept their advisers' use of **non-standardised and personal descriptions** of financial risk and volatility with investors, and
- Do **not have a defensible and rigorous method** for their advisers to arrive at portfolio recommendations.

**Fundamental Problem is INCONSISTENT Communication of Risk**

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## Typical Investment Manager's Explanation of Volatility



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## Deliberately Misleading?

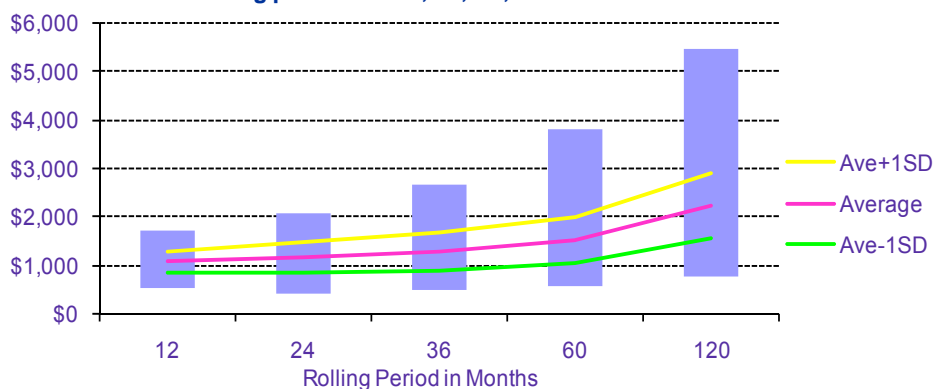
- Statistically correct but financially flawed
- Graphics suggest that volatility of investment outcomes reduces over time which is simply untrue
- Concentrates on percentage volatility not dollars.
- Ignores consequences of inflation
- Usually focused on one or sometimes two standard deviation of volatilities which ignore outlier events.
- No help preparing clients for
  - ❖ the excess optimism that occurs when markets are rising beyond normal
  - ❖ the excess pessimism that occurs when markets are in declines beyond normal.

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## Investor's Experience of Volatility

**\$1000 Invested, All Ords Accum, End-Values (Real)**  
 Rolling periods of 12, 24, 36, 60 and 120 months



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### Real Returns from an Investor's Perspective

Even over 10 years an investor may lose purchasing power.

Most likely return is doubling of purchasing power over 8 to 10 years.

Few investors would have experienced 3 to 5 times increase in purchasing power.

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### Review of Equity Risk Premium

- From an investor's perspective
- Similarity across seven countries.
- Before costs, taxes and any portfolio implementation leakage.

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## FM's UK Portfolio Splits

Portfolio	Defensive/Growth		Asset Allocations				
	Defensive	Growth	Cash	Fixed Int.	Int. FI	Shares	Int. Shares
1	100%	0%	10%	60%	30%	0%	0%
2	85%	15%	5%	50%	30%	10%	5%
3	70%	30%	0%	40%	30%	20%	10%
4	50%	50%	0%	30%	20%	30%	20%
5	30%	70%	0%	10%	20%	40%	30%
6	15%	85%	0%	5%	10%	45%	40%
7	0%	100%	0%	0%	0%	50%	50%

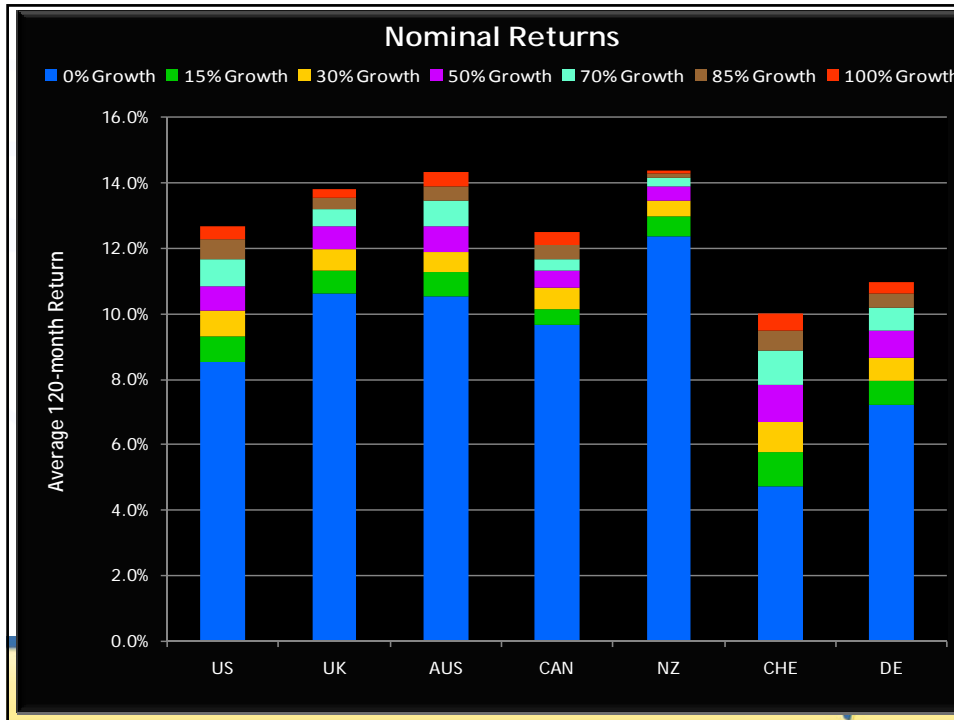
**Cash:** United Kingdom Total Return Bills Index (Source: Global Financial Data, Inc.).  
**Fixed Interest:** United Kingdom 10 Years Government Bond Total Return Index (Source: Global Financial Data, Inc.).  
**International Fixed Interest:** JP Morgan Global Government Bond Index. For the period prior to the commencement of this index in 1986, a proxy based on 10 year US Government Bonds was used.  
**Shares:** United Kingdom FT- Actuaries All-Share Total Return Index (Source: Global Financial Data, Inc.).  
**International Shares:** MSCI World ex UK Gross Index.  
**Bank Deposits:** Bank of England, Sterling Certificate of Deposit rates (3 months) end month. For the period prior to the commencement of this index in 1975, Global Financial Data's 3-month Time Deposit Rate was used.  
**Inflation:** Retail Prices Index – All Items (Source: National Statistics.) For the period prior to the commencement of this index in 1987, the Global Financial Data, Inc. equivalent was used.

**NOT** Optimised Portfolios: For Illustration Purposes Only

## Nominal Returns from an Investor's Perspective

- Representing 7 portfolios with from 0 to 100% growth assets
- Average of rolling 10 year returns, accumulation indexes, monthly stops, rebalancing annually, 1970 to current
- 7 countries: US, UK, Australia, Canada, NZ, Switzerland and Germany
- Discloses broad range 10 -14% pa return

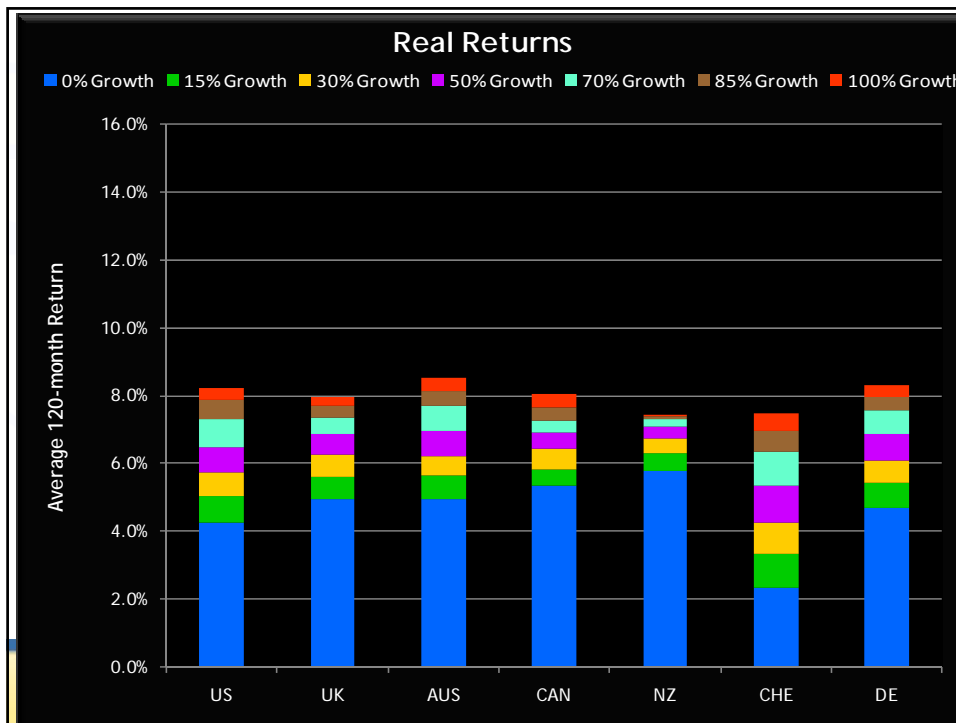
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## Adjusted Returns after Inflation

- Returns more consistent across countries
- Returns within 7 to 8% pa for growth assets
- Bond and cash returns show wide variation

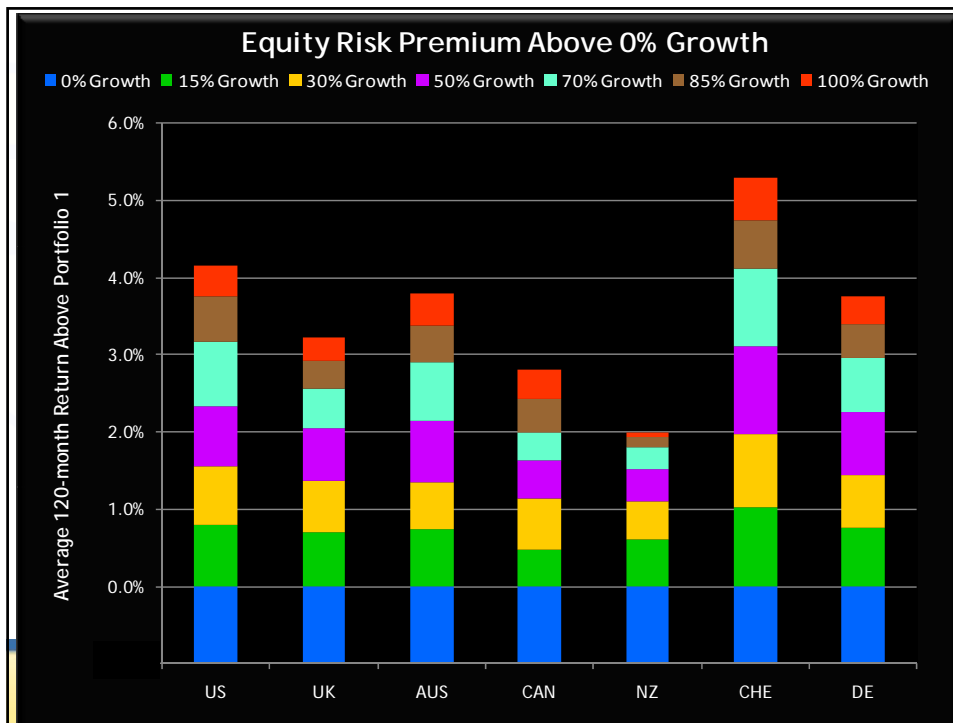
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## Equity Risk Premium Normalised from an Investors Perspective


- Base return, zero, is 0% Growth
- Cash and conservative bond funds
- 50% growth assets, typically delivers just over 2% additional return
- 50% growth assets is consistent with average risk tolerance of advisers' clients

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### Average 120 Months Returns 1970 to Present

Growth	US	UK	AUS	CAN	NZ	CHE	GER
0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
15%	0.8%	0.7%	0.7%	0.5%	0.6%	1.0%	0.8%
30%	1.6%	1.4%	1.3%	1.1%	1.1%	2.0%	1.5%
50%	2.3%	2.1%	2.1%	1.6%	1.5%	3.1%	2.3%
70%	3.2%	2.6%	2.9%	2.0%	1.8%	4.1%	3.0%
85%	3.8%	2.9%	3.4%	2.4%	1.9%	4.7%	3.5%
100%	4.2%	3.2%	3.8%	2.8%	2.0%	5.3%	3.8%




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**UK: Largest Three Falls**

Growth Assets	Incremental Return	Accumulated Return	Depth of Fall	Started Falling	Depth of Fall	Started Falling	Depth of Fall	Started Falling
0%	0.0%	0.0%	-6.5%	Jan-09	-5.1%	Feb-94	-4.5%	Jun-79
15%	0.7%	0.7%	-7.1%	Jan-73	-6.5%	Jan-09	-6.3%	Feb-94
30%	0.7%	1.4%	-16.8%	Jan-73	-11.6%	Aug-87	-9.0%	Jan-90
50%	0.7%	2.1%	-27.6%	Jan-73	-18.1%	Sep-00	-17.4%	Aug-87
70%	0.5%	2.6%	-36.8%	Jan-73	-31.1%	Sep-00	-24.2%	Oct-87
85%	0.4%	2.9%	-43.5%	Jan-73	-39.1%	Sep-00	-27.7%	Oct-87
100%	0.3%	3.2%	-49.9%	Jan-73	-46.3%	Sep-00	-36.3%	Nov-07

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### Equity Risk Premium Lessons

- 2008 was not necessarily the worst portfolio period in recent history, even if it was the worst in recent memory
- Return has not consistently increased with risk
- Incremental return is valuable to those with lengthy investment horizons but has lesser consequences for those with shorter time spans
- Need to emphasise non-investment related benefits of financial advise in proposition to clients.

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### Who Decides if the Equity Risk Premium is Worth the Risk?

- Risk and return, in terms of the three worst drops in the last 40 years, is shown for each of the seven portfolios.
- How might the investor respond if similar drops occurred in the future?
- Should we be discussing such a scenario regularly with the investor?

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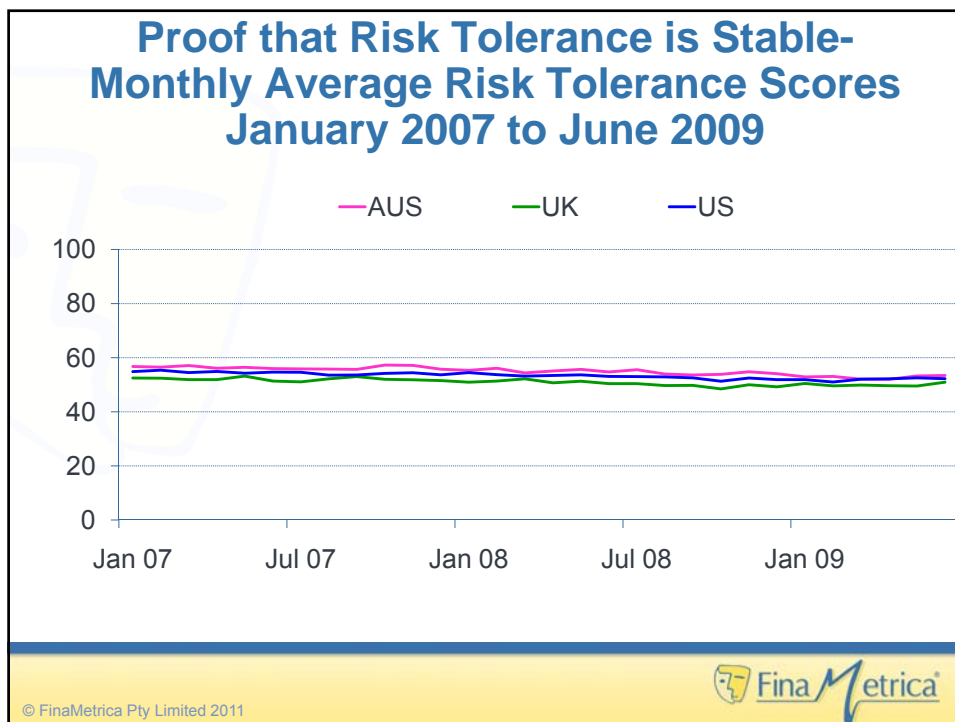
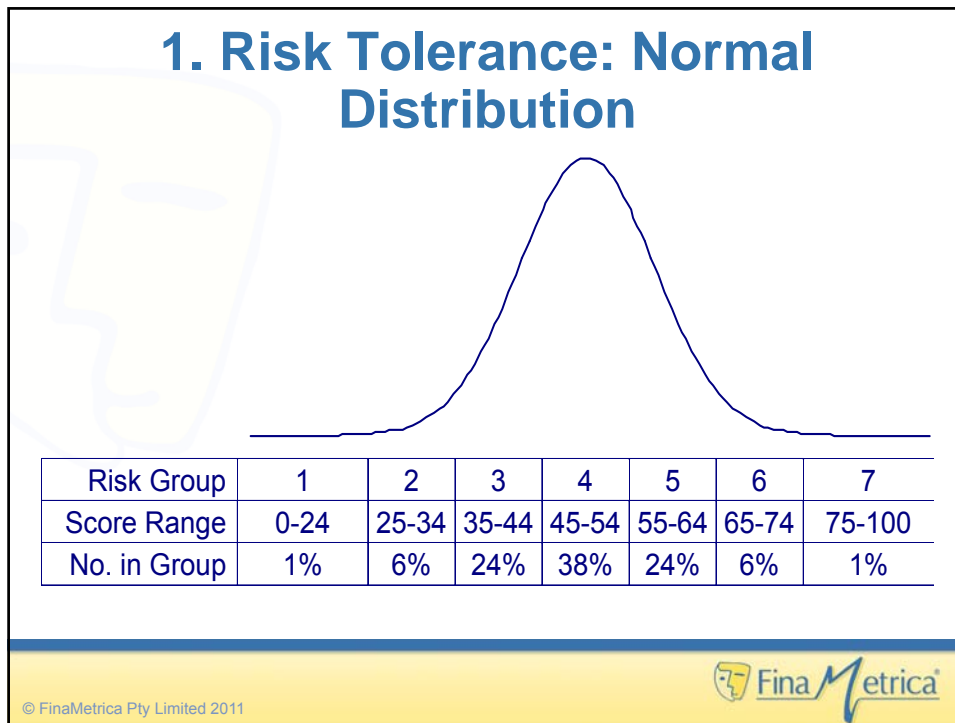
### To Overcome Current Industry Reputation Issues Advisory Businesses Need a

1. Psychometric [accurate] assessment of investors' risk tolerance
2. Proven methodology to engage investors in their plan
3. Simple process to test appropriateness of investment advice
4. Well tested method for setting investors' expectations.

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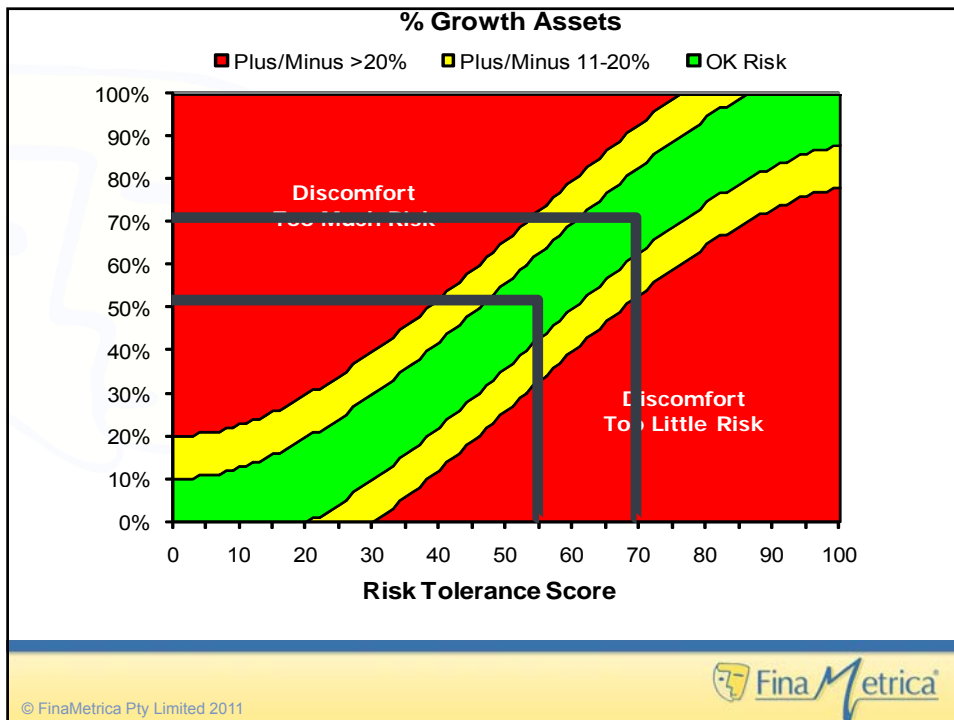
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## 2. Knowing the Investor's Financial Risk Tolerance Enables their Adviser Test the Appropriateness of Portfolios to Meet the Investor's Needs.

To do so the adviser requires initially to link to link from risk scores to broad asset allocation.

The next step is to decide if that broad asset allocation meets the financial needs of the client in terms of both cash flow to meet expenses and capacity to cope with loss.

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### 3. Building Blocks for a Financial Plan

- Clients' existing assets and liabilities
- Prospective cash flows based on goals and aspirations
- View of future capital market returns

### Morningstar: Ibbotson Asset Allocation Methodology

#### Develop asset class inputs:

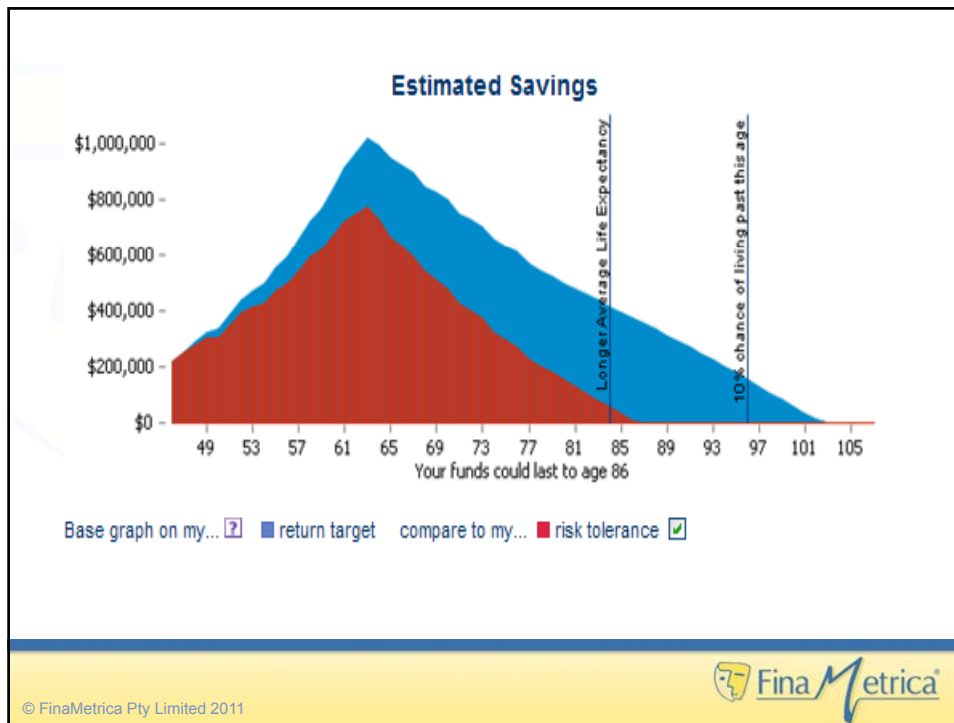
Ibbotson begins by analysing broad asset classes and constructs long-term expected returns, standard deviations, and correlation coefficients.

These form the inputs for the mean-variance optimization [a statistical technique].

Because forecasting is a critical and pivotal step in the asset allocation process, Ibbotson develops proprietary capital market forecasts for each asset class using a combination of historical data, current market information, and additional analysis.

Each forecast becomes an input in portfolio creation.

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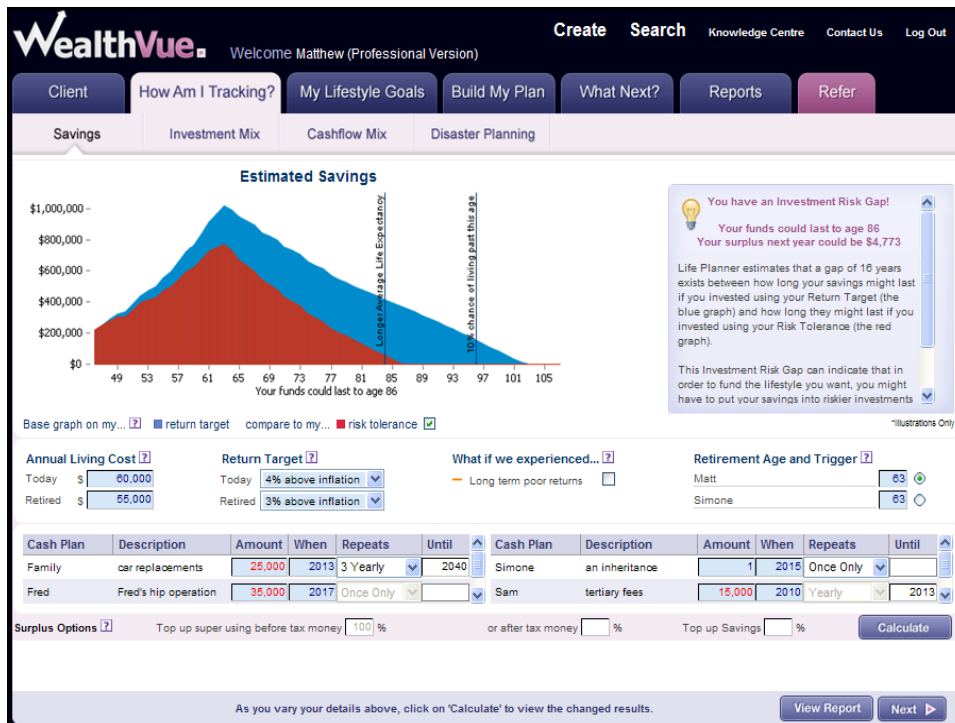


## Clients' Options

- Spend less/save more
- Work more effectively/ for longer
- Access other assets i.e. downsize home
- Change goals
- Reduce investment costs and taxes
- Diminish, investment implementation leakage
- Last issue is to decide on the investment risk

**The interplay between the options is the basis for the adviser's ongoing relationship with the client.**

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## 4. Personalise Investment Manager's and Adviser's Explanation of Risk

- Engage investor [and partner] through link to their risk scores
- Project forward to show consequences on investors' future plans
- Enables investors' informed consent to the risk in their financial plan

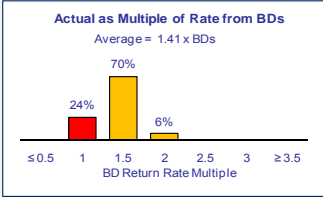
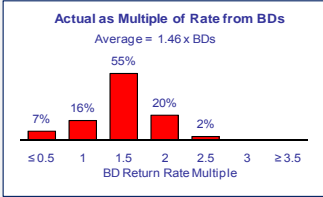
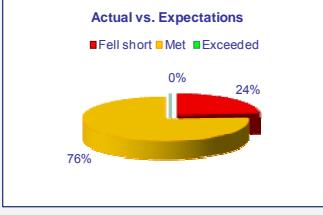
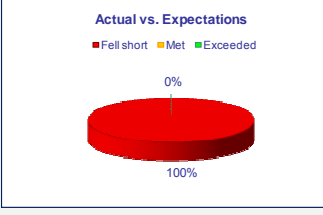
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Risk Group 4 ( 45 to 54)	Risk Group 6 ( 65 to 74)
Members of Risk Group 4 typically make the following choices,	Members of Risk Group 6 typically make the following choices,
<b>Preferred Portfolio?</b> (50% equities)	<b>Preferred Portfolio? (Q16):</b> (85% equities)
<b>(Q16):</b>	<b>10 yr Return</b> Ten year return of <b>at</b>
<b>10 yr Return</b> Ten year return of <b>1.5 to</b>	<b>Expectations? (Q21):</b> <b>least 3 times Bank</b>
<b>Expectations? (Q21):</b> <b>2 times Bank</b>	<b>Deposit/CDs/Term</b>
<b>Deposit/CDs/Term</b>	<b>Deposit rate.</b>
<b>Deposit rate.</b>	<b>Sensitivity to Volatility?</b> Total value of
<b>Sensitivity to Volatility?</b> Total value of	<b>(Q14):</b> investments could fall
<b>(Q14):</b> investments could fall	by <b>33%</b> before the
by <b>20%</b> before the	investor would begin
investor would begin to	to feel uncomfortable.
feel uncomfortable.	

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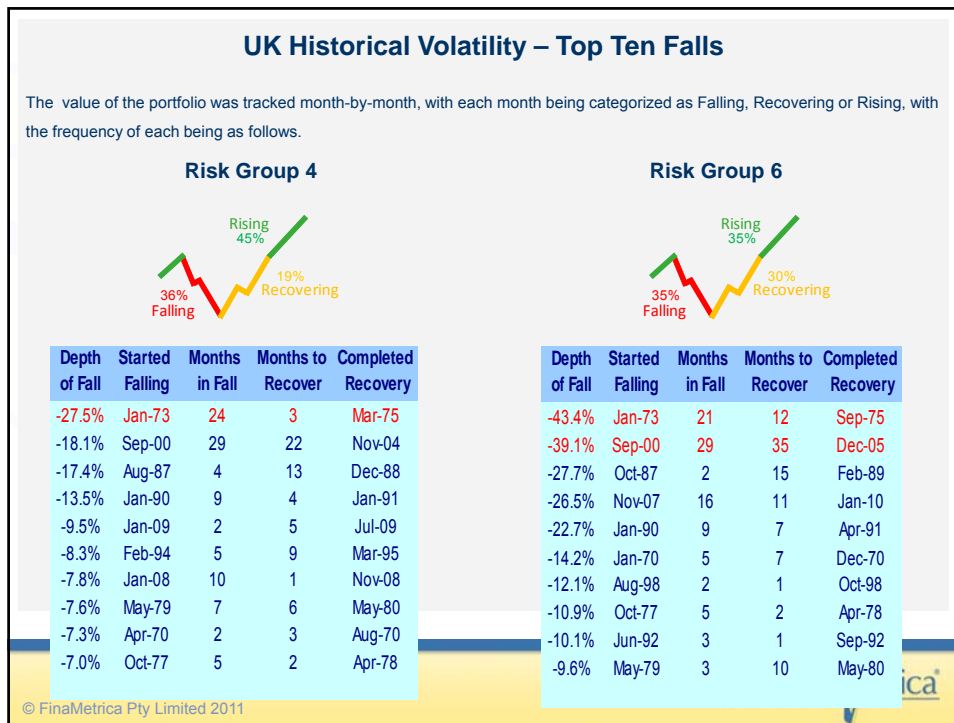
### UK Historical 10-year Returns

The actual annualised return from Portfolio 4 and 6 is expressed as a multiple of the return from 3 months Bank Deposits for each 120-month rolling period. The bar charts shows the frequency of actual returns expressed as a multiple of the rate of return from Bank Deposits.

Risk Group 4	Risk Group 6
<p><b>Actual as Multiple of Rate from BDs</b> Average = 1.41 x BDs</p> 	<p><b>Actual as Multiple of Rate from BDs</b> Average = 1.46 x BDs</p> 
<p><b>Actual vs. Expectations</b></p> 	<p><b>Actual vs. Expectations</b></p> 

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## Tipping Point to IFA Model

### Old World Order

- 'Super' business profits
- 'Investment' of the month'
- Investment orientation
- Investment differentiated
- Idiosyncratic portfolios [?]
- Investment advising
- Product remuneration
- Caveat Emptor
- Idiosyncratic advice
- Paternalistic advice
- 'I know this fund is right for you'

### New World Order

- Reasonable business profits
- Investments to meet needs
- Client centric
- Investments commoditised
- Model portfolios
- Client advising
- Service remuneration
- Customer rights- Respect for clients
- Process driven advice
- Collective decision making
- Client's informed consent



## Wraps and Platforms in the Post-RDR World

### To Protect and Grow the Business

- Prepare for greater regulation, it is inevitable.
- Take control of investment expectations
- De-emphasise alpha and promote wealth protection
- Standardise portfolios
- Encourage clients to take the investment decisions, move to 'informed consent' model.