

Smart ideas about wealth

A consistent view of risk and reward

Published: 14 August 2006

This article first appeared in New Model Adviser

Last year, my wife, whose job involves training advisers for a financial services trade body but who is also an experienced and highly qualified financial planner in her own right, addressed a group of advisers on the subject of 'constructing an asset allocation model'. After covering objectives, assumptions, risk tolerance, investment process and diversification, she was surprised to hear the question "But what is the best asset allocation?" While it is encouraging that more attention is being paid to the subject, it would therefore appear that the mechanics of implementing a robust process are more of a mystery. The good thing is that it is not as complicated as some people would have us believe.

The answer to my wife's question is, like that to so many questions of course, 'It depends'. The author was fortunate, like a number of his contemporaries, to be introduced to the importance of asset allocation by the late Tony Shepherd, former head of financial planning at Ernst & Whinney and also a past chairman of the Institute of Financial Planning. Tony even designed a computer program (back in the days before MS Windows) to make the task of implementation and ongoing management easier and the principles behind that are still used by a number of planners today.

In essence, the things on which the construction of an asset allocation for a portfolio depends are several variables. When these variables are fed into a coherent and consistent process, the outcome should be a model which varies only according to the changes in assumptions and not to any changes in process. How many variables are used will depend on the person designing the process but it is worth remembering that more complexity and precision are not the same as more accuracy and it may therefore be preferable to have a few robust assumptions and pieces of data than a large number of them.

One point that must be made early is that this article is about strategic asset allocation, i.e. establishing and maintaining a long term portfolio structure which will vary only if the investor's circumstances change or (less frequently) if some new research indicates a better way of constructing portfolios. The strategic asset allocation decision, because it depends on the circumstances of each individual investor, is one which can only be made at the investor level by them and their advisers – it should be evident therefore that it cannot be delegated to a third party who has no knowledge of the investor's objectives and risk tolerance, such as a fund manager, however expert the latter may be in their own field. At its most basic level, the split can be considered as one between debt (cash and fixed interest) and equity (assets in which the investor has a stake in one or more enterprises). Tactical asset allocation or market timing, by which the adviser or manager attempts to identify under- and over-valuations before they are corrected, is entirely irrelevant to this decision. If you believe in its effectiveness, then fine, but it has nothing to do with the client's goals so it can be delegated to a third party manager and need not trouble the financial planner.

Smart ideas about wealth

A reasonable starting point might be to consider the two opposing elements of risk (how much excitement can the investor stand?) and return (how much return do they want or, more importantly, need?). The former is a measure of their psychological tolerance and we assess this using a psychometric profiler designed by the Australian firm FinaMetrica. There are several other tools available but a number seem to confuse themselves by including questions about objectives, which is a different issue altogether, so it is perhaps as well to be wary of these. The outputs from FinaMetrica's tool include a split between low risk and high risk assets (such as cash equivalents and equity) with which the investor would be content assuming that risk were the only factor. While this does not necessarily give the final answer, it does provide a consistent basis for arriving at a conclusion.

More complicated to determine is the required rate of return for the portfolio. Although tools are available in spreadsheet packages to calculate this, the inevitable complexity of regular, level, escalating, occasional, net and gross cashflows, combined with variations in inflation, tax rates and bands etc. make the construction of a tool which can deliver this number via a consistent process a time-consuming task. Given the critical importance of this number to portfolio planning (if you do not know what return you need, how will you know how you need to invest to achieve it and whether or not that is in conflict with your risk tolerance?) and the fact that the complexity is all in the inputs not the calculation itself, it is perhaps surprising that the proprietary software packages designed for financial planners do not appear so far to have assigned a great deal of importance to providing this feature.

Having said that, there is a school of thought, such as that propounded by Mark Hebner of the US firm Index Fund Advisors, that says that required rates of return are irrelevant and that as people live longer and spend more than they expected, they need as high a return as is consistent with the degree of risk that they can stand. This has the benefit of reducing the need to do the calculations as to what is required and it is fine if the required return is lower than the return that is comfortably achievable given the investor's risk tolerance. However, it does not really help if the opposite is the case. Without knowing what return is required, they will not know whether it is necessary to adjust their expenditure, savings rate or goals and thus could pursue an investment strategy with which they are comfortable but which will not allow them to achieve their goals, a fact which may not become apparent until it is too late to rectify the situation.

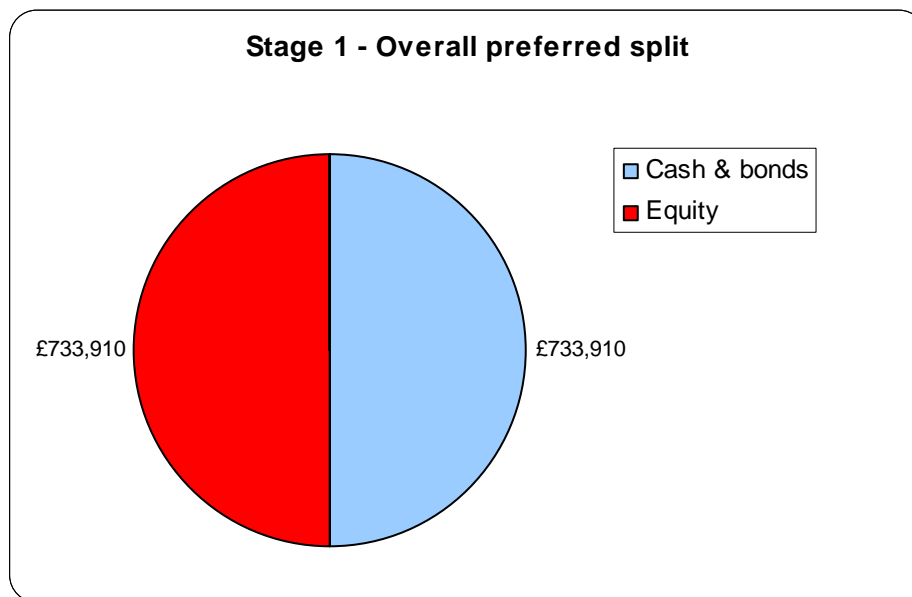
While risk tolerance can be used to determine the sort of split between debt and equity with which an investor would be comfortable, and possibly with which they will be able to achieve their goals if the expected rates of return are achieved over their time horizon, it does not cater particularly well for the uncertainty which is an inevitable part of securities markets (without uncertainty, the returns from markets would not be higher than those from risk-free assets) and the likelihood that these returns will not be delivered in a predictable manner. The approach which we employ is to divide the portfolio into notional components which are each assigned a specific role. We use up to four: contingency fund for unexpected outflows (held in cash), short term portfolio for anticipated shortfalls in the next ten or so years (cash and fixed interest assets), long term portfolio for longer term liabilities (mixture of fixed interest and equity) and what we call an 'ideas portfolio' which holds other investment assets which will not be managed (i.e. rebalanced) or relied upon for financial security but which may deliver some additional capital and/or income in the future. These assets typically comprise such things as shares in a private company, rental property and VCT or EIS investments, although inevitably not all investors will have such an ideas portfolio.

Smart ideas about wealth

It is not particularly important what approach to asset allocation any firm adopts, there being many which are sensible; what does matter is that everyone who will be involved in following it buys into the process you have chosen and that they then follow it and can explain it in a consistent manner to people outside the firm. Committing the approach to written form as a philosophy which is available to prospective clients and contacts (e.g. via your website or in hard copy form) is a useful discipline as it forces the thinking to be logical and coherent – it is important that everyone involved in the firm has the opportunity to contribute to it as those with the best ideas are not necessarily the people in charge. Naturally, there is nothing to prevent updates being made as new information comes to light over the years.

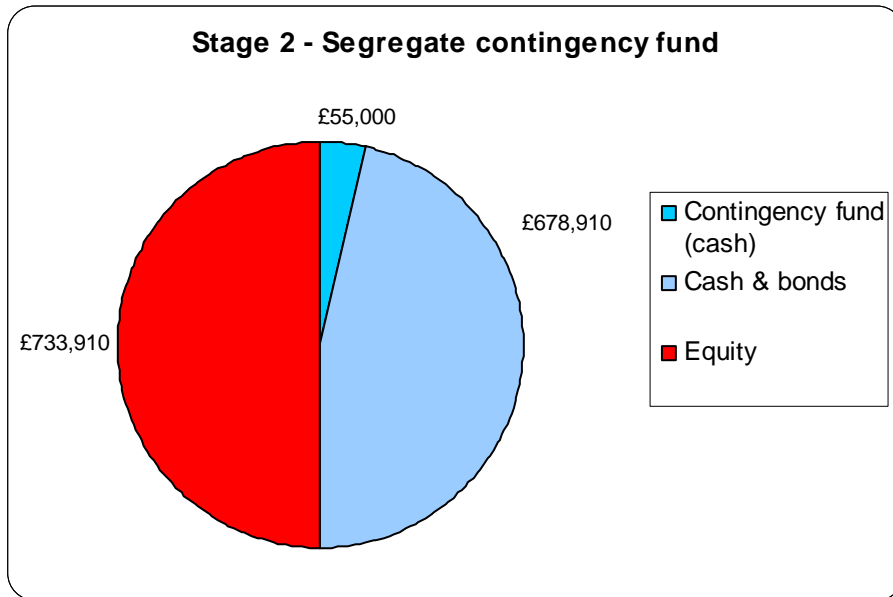
Example portfolio

By way of example, consider a not untypical scenario. Mark and Angela are both aged 43 and have investment assets comprising £265,000 of cash, £40,000 of woodland, a portfolio (including PEPS and ISAs) of £850,000 managed by the private banking arm of a high street bank, two with profits investment bonds worth £124,000, insured personal pension funds worth £50,000 and other equities worth £177,000. The results of their risk profiling exercise suggest that they would be comfortable with an asset mix of around 50% low risk and 50% high risk assets but their current portfolio has more like two thirds in risky assets.

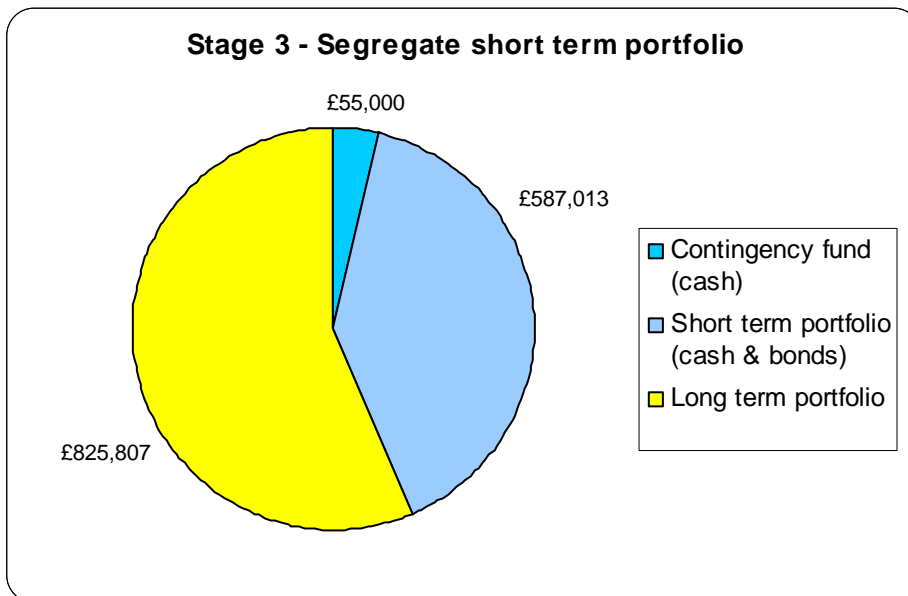


Mark and Angela spend around £110,000pa but have post-tax income of around £78,000, which is expected to reduce when Mark reduces his working hours at age 48, from which point they expect their expenditure to fall to around £68,000 while earnings will continue at a reduced rate until 2016. In addition, they intend to spend £70,000 on home improvements in the near future although they do plan to realise around £500,000 of equity by trading down from their current £2m home in 2009, followed by trading down again at around age 70. The net effect of all these inflows and outflows worked out as a deficit of around £650,000 in today's terms over the next ten years.

Smart ideas about wealth

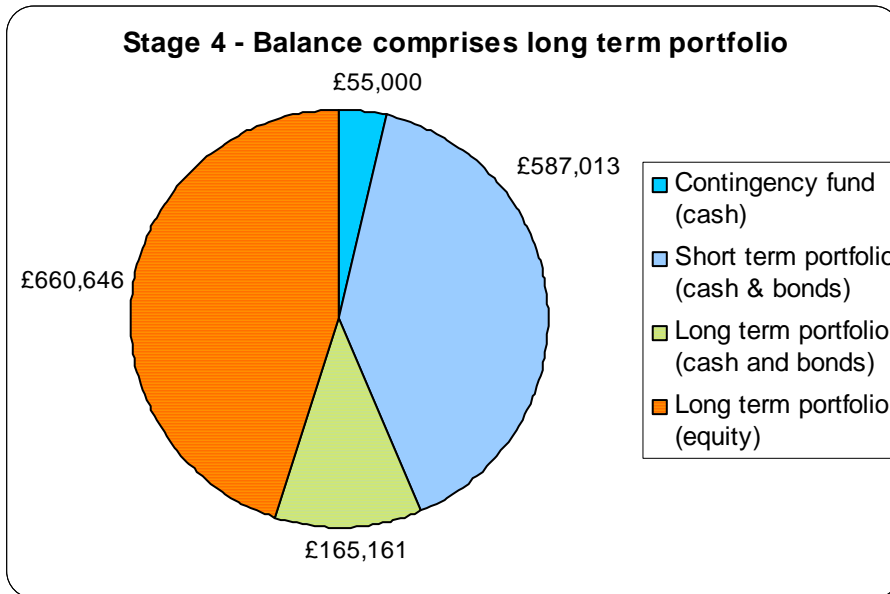


The woodland was assigned to the ideas portfolio and after allocating an agreed six months' net expenditure to a cash reserve, a further £587,000 was allocated to meet the cashflow deficits expected in the next ten years. This left approximately £826,000 for the long term portfolio.



The analysis of their lifetime cashflow indicated a required return of around 5%pa after costs and tax; on the assumptions we agreed with them, this would be achievable with a long term portfolio split 20% low risk assets and 80% high risk ones. Taken overall, and including the assets already allocated to the contingency and short term funds, the resulting allocation required worked out to around 55% cash and fixed interest and 45% equity. Since this appears sufficient to meet their goals and falls within their risk tolerance, this was the split which was implemented.

Smart ideas about wealth




Of course, there is every likelihood that the assumptions we have made will all be wrong to a greater or lesser degree, as we are working with uncertainties over long periods of time. The long term portfolio is therefore reviewed on an ongoing basis and rebalanced when the weights of the individual components deviates by more than an agreed percentage of the target weightings. This enables the returns from outperforming assets to be captured before they reverse and the proceeds are then reinvested in those components which are underperforming. We do not attempt to make market timing calls as there is something of a lack of evidence to suggest that it can be done reliably and economically – if any of the pundits who opine on the future direction of markets or elements thereof really knew what was going to happen and when, it is unlikely that they would be dumb enough to tell the rest of us, so we save ourselves a considerable amount of work and our clients considerable losses by not even trying to second guess them.

Contacts	Telephone	Email
Jason Butler	07973 951107	jasonbutler@bloomsburyfp.co.uk
Campbell Edgar	07717 897609	campbelle@bloomsburyfp.co.uk
Carolyn Corless	07775 712969	carolync@bloomsburyfp.co.uk
Robert Lockie	07951 725880	robertl@bloomsburyfp.co.uk

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