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Investing in the post-RDR UK

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managing director

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What was RDR?

- Commission ban*
- Customer agreed remuneration (cash)
- Qualified – QCF 4 (NFQ 6/7)
- Independent or "Restricted"

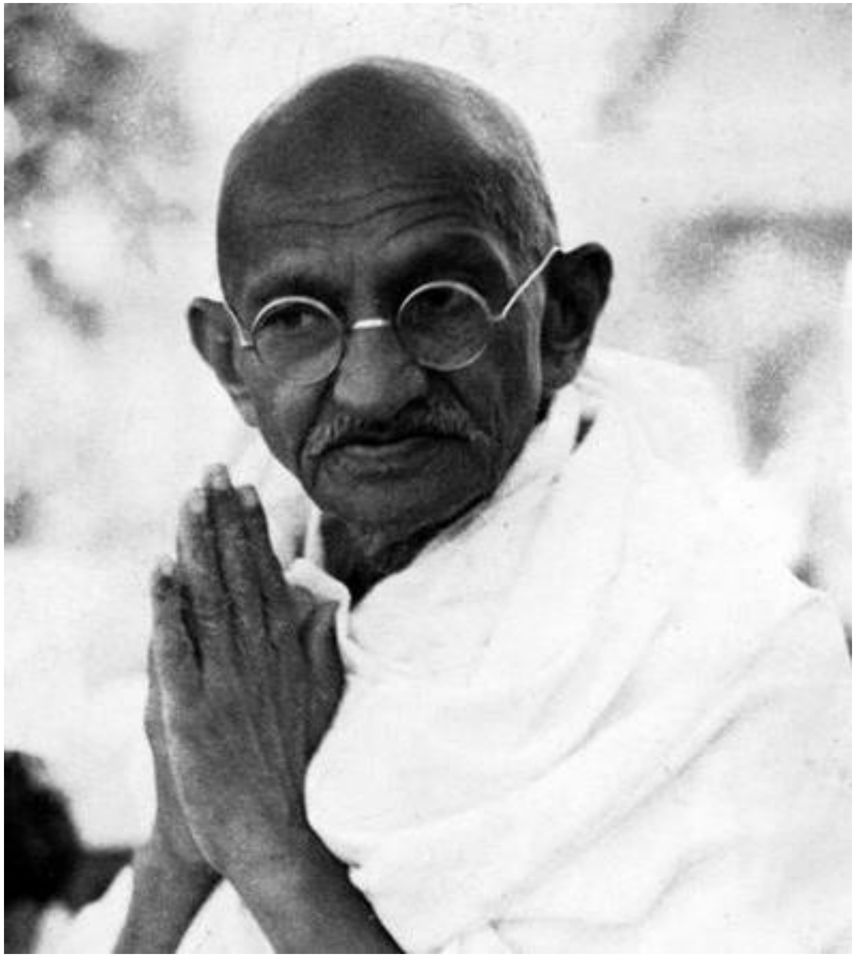
*Except Protection products

Good in parts…

- Quals – binary outcome
- Independence
  - False sense of its importance
  - Expensive to deliver
- Adviser charging
  - "Car Crash"
  - Commission cut and paste
  - Cash rule not adhered to
  - Illustrations = TCO, less tax, and inflation!
- Salesmen who run a business?

RDR Success?

- Products
  - allow advisers to offer services that protect margins whilst reducing the level of charges levied in the guise of adviser charging.
- Advisers
  - Develop wide range of services, with range of different costings and investment options.
  - Segment clients by services they want, not wealth.
- Delight clients, and work with providers with same thinking



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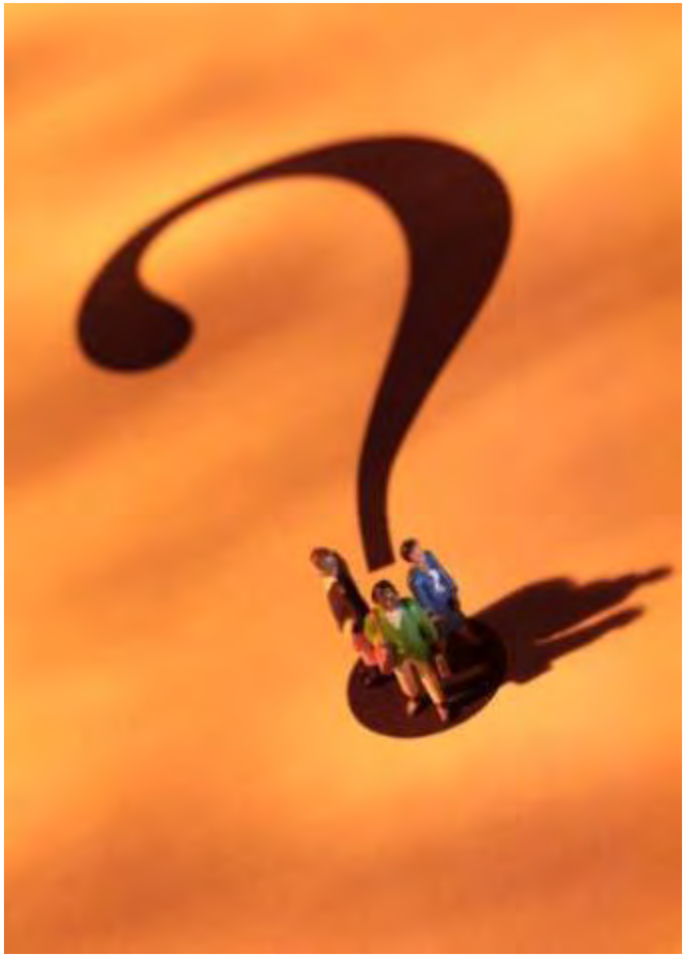
Adviser proposition - What do clients want?

- Target returns?
  - Better than Cash?
  - Better than inflation?
  - Better than the market?
  - Better than anyone else?
- Liability Driven Investment
  - Goal-based investing (not speculation!)
- How is it delivered?

Adviser philosophy - What do you believe in?



- delivery of Beta
  - Asset allocation, modelling, MVO/Black Litterman
- the security pricing mechanism
  - what causes securities to be mispriced
- manager's ability to exploit this mispricing
- how beliefs can be exploited to generate alpha
  - if alpha is necessary!
  - Passive versus active
  - Costs versus risk adjusted returns

Investment Process – Putting beliefs into practice

- Better outcomes for clients – TCF 2 and 5
- Demonstrates “Best Practice”
- Forms key part of Service Charter, and supports Fee Schedule
- De – risks business - regulation
- Common approach across all RIs
- Sounder relationships with the Fund Groups
- Important supporting document for Clients

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Investment Process - What does it look like?

- Structured
  - What you do, and the steps
  - What you don't do
- Investment Process Document
- Regularly Reviewed
  - New ideas inform your philosophy
- Firm wide awareness
  - Training requirement
- Incorporate into "corporate brochure"

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Investment Process - What does it cover?

- Your investment philosophy
- Client Risk Assessment process
- Asset Allocation process
- Fund Selection Process
- Review and Rebalancing Procedures
- Investment Committee
  - Structure, roles and responsibilities

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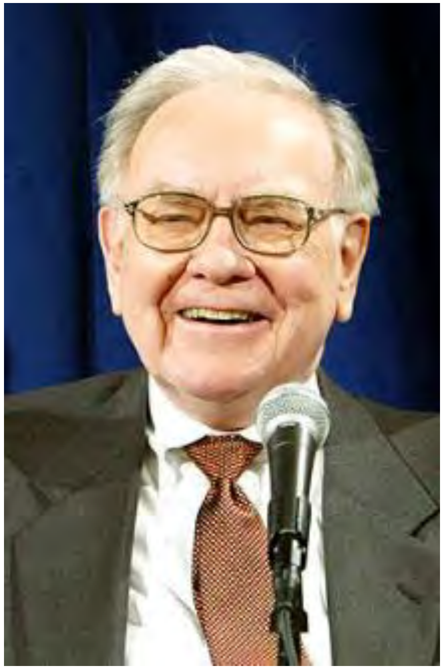
Typical adviser investment process

advisers' risk

- Assessing suitability
- Risk assessment and discussion
- Design the portfolio to match
- Asset allocation process
- Manager selection
- Monitoring and analysis
- Reporting

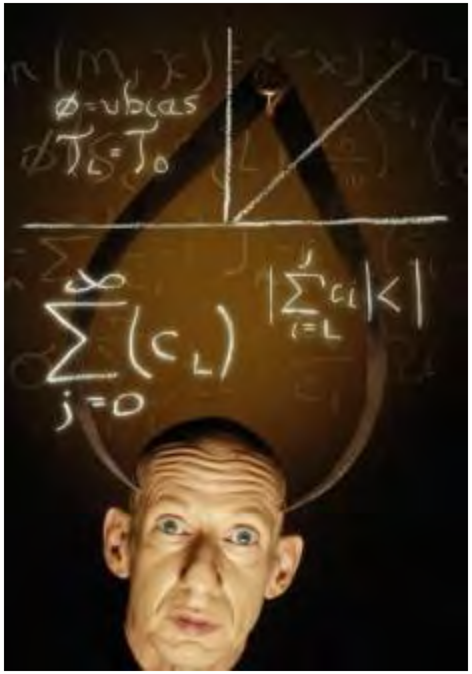
Risk



'Risk comes from not knowing what you're doing.'

Warren Buffet

investment theory in 1973



- Market conditions
  - Efficient Markets Hypothesis (EMH)
  - prices always reflect all available information
- Investor behaviour and preferences
  - acts rationally so as to maximise wealth
  - acts in self-interest

rational expectations wealth-maximiser

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perception…

perception…and bias

- Market conditions
  - Vodafone – why are you selling if I'm buying?
  - volatility – prices move by more than theory predicts
  - bubbles and crashes in an efficient market?
- Behaviour
  - non wealth maximising – tipping
  - ethical/socially responsible investment

perception of information

efficient markets?

– Markets do not behave as EMH predicts

– People are not (economically) rational

economics versus psychology

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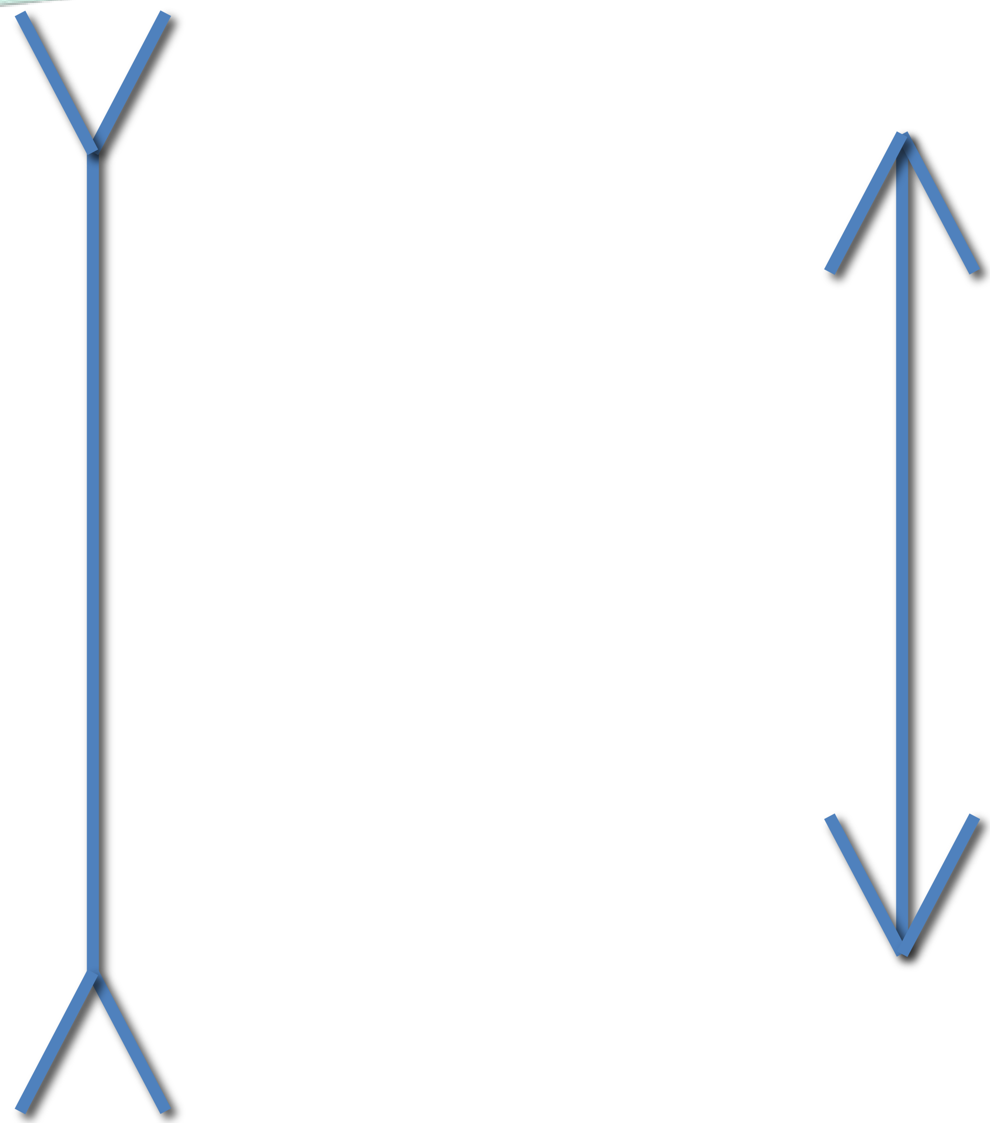
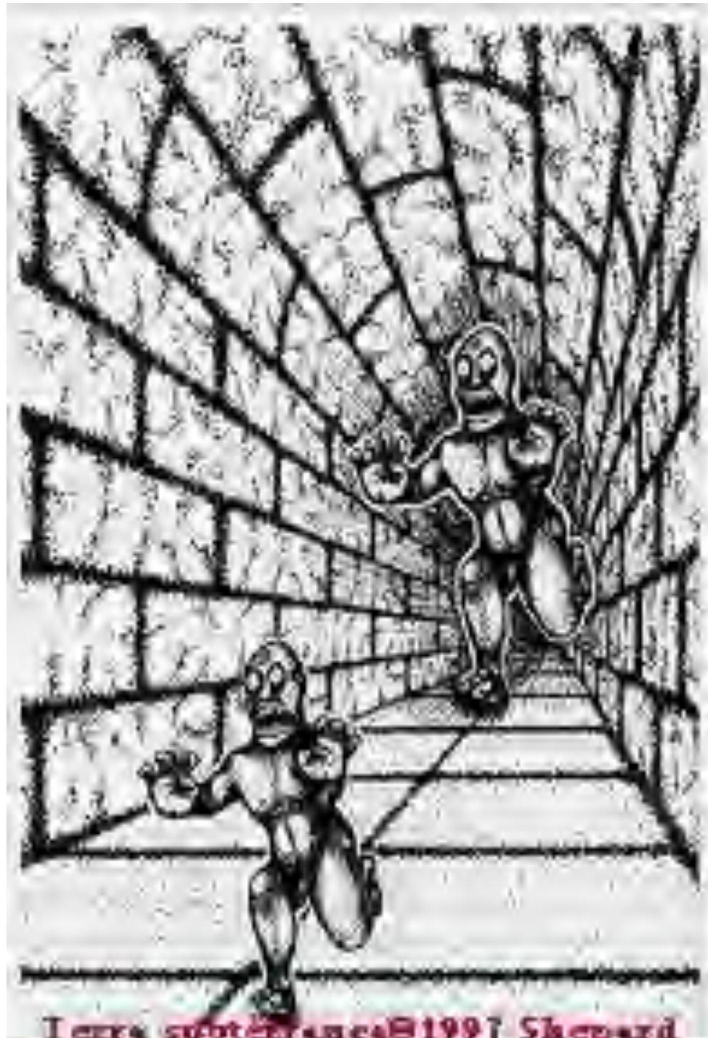
how does your brain work?

- Solving ill-posed problems
- Infinite permutations
- How do you know it's an urn falling off a table?

we make assumptions about the way the world is

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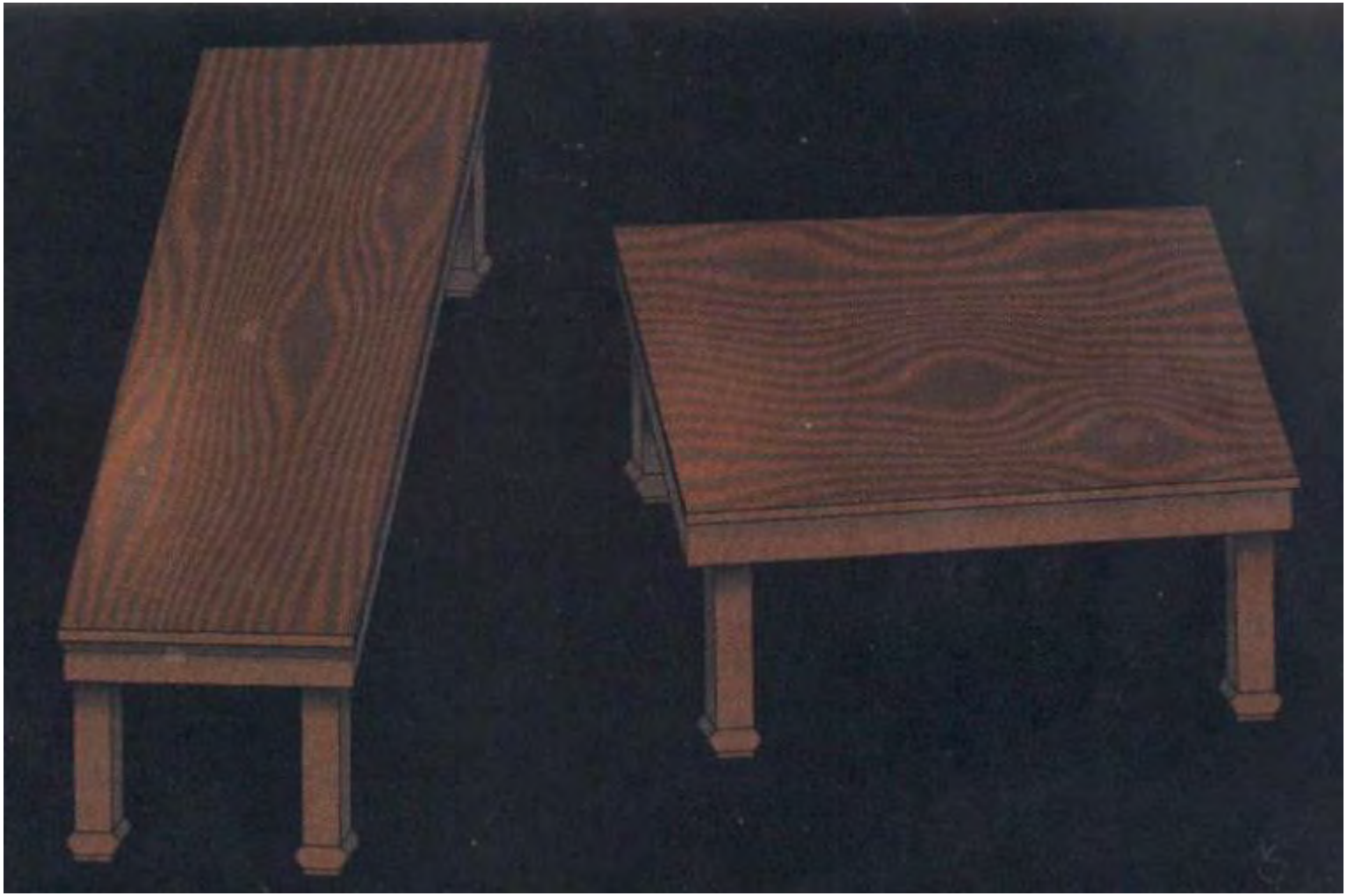

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we are not good at estimating…

- take a piece of A4 paper 0.1mm thick…
- fold it in half…then in half again…
- after 100 folds…How thick will the resulting piece of paper be?
- 90% sure it is between….and ….?

13.4 billion light years*!

*126,765,060,022,823,000,000,000 kms

how we calculate the odds – likelihood

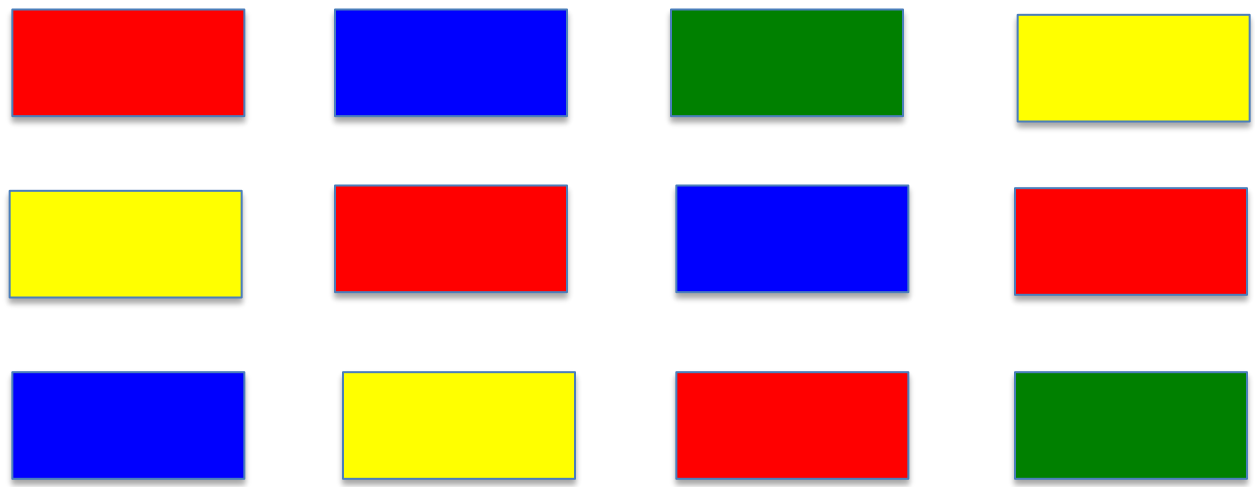
A 'Heuristic' - 'System 1' thinking

state the colours you ***see***, as fast as you can

ROW 1

ROW 2

ROW 3



state the colours you ***see***, as fast as you can

ROW 1	RED	BLUE	GREEN	YELLOW
ROW 2	YELLOW	GREEN	BLUE	RED
ROW 3	GREEN	RED	YELLOW	BLUE

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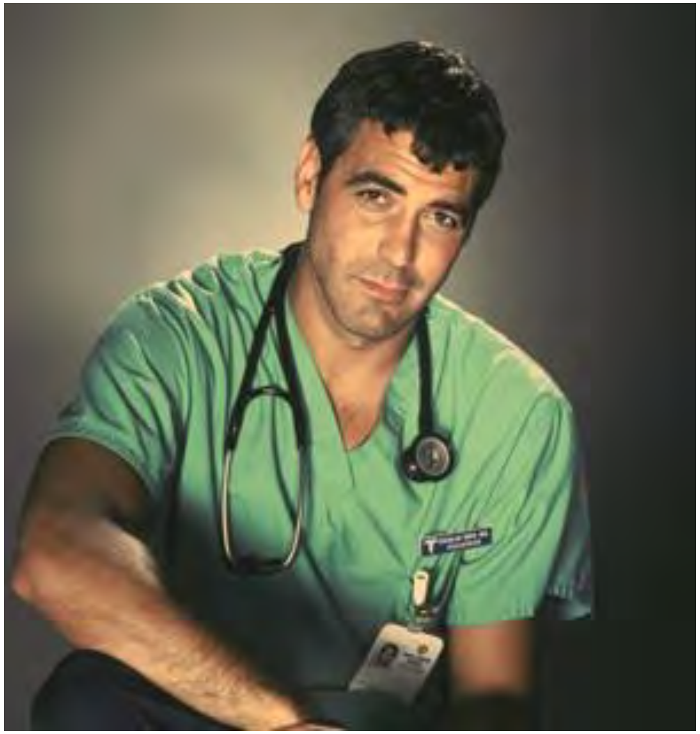
state the colours you ***see***, as fast as you can

ROW 1	RED	BLUE	GREEN	YELLOW
ROW 2	YELLOW	GREEN	BLUE	RED
ROW 3	GREEN	RED	YELLOW	BLUE

Thinking, fast and slow

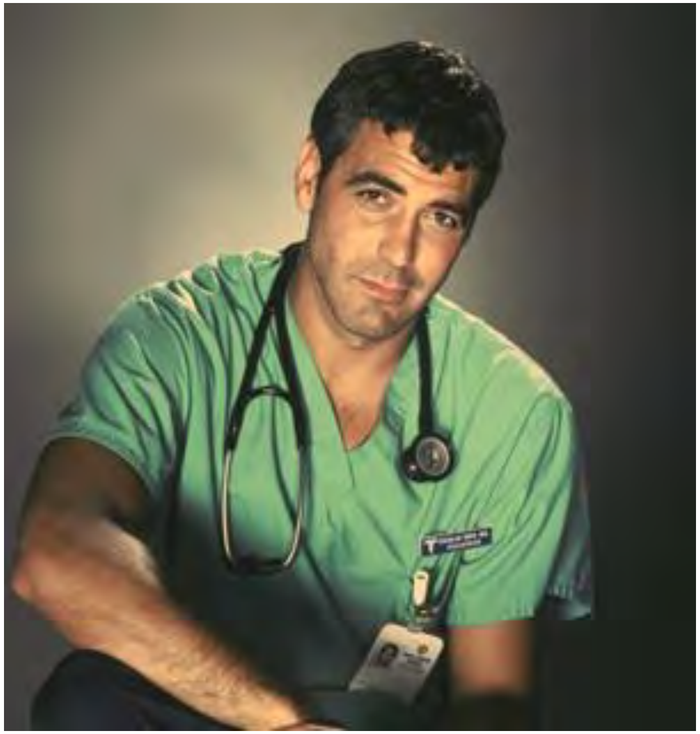
- System 1
  - Using your ‘instinct’, intuition or ‘default’ response. This is fast and automatic.
  - Survival advantage
- System 2
  - Using your analytic ability and reasoning. This is slow and requires focus and effort
  - Not innate

base rate neglect



- a particular heart disease has a prevalence of 1/1000 people. A test to detect this disease has a false positive rate of 5%. Assume that the test diagnoses correctly every person who has the disease. What is the chance that a randomly selected person found to have a positive result actually has the disease?
- this question was put to 60 students and staff at Harvard Medical School

base rate neglect



- a particular heart disease has a prevalence of 1/1000 people. A test to detect this disease has a false positive rate of 5%. Assume that the test diagnoses correctly every person who has the disease. What is the chance that a randomly selected person found to have a positive result actually has the disease?
- this question was put to 60 students and staff at Harvard Medical School
- almost half gave the response 95%. The average answer was 56%.

< 2%

stereotypes

- *'he is an extremely athletic looking young man who drives a fast car and has an attractive blond girlfriend.'*
- now answer the following question:
- *is he more likely to be a premiership footballer or a nurse?*
- *65,755 male nurses*, 634 premiership footballers***

insensitivity to prior probabilities

Source: *Nursing and Midwifery Council, ** www.premierleague.com

what has this got to do with us?

- Brain makes assumptions about numbers, causality and likelihood
- Investing over a lifetime is an ill-posed problem
- Investors have to make assumptions
  - Advised, unadvised
  - Ill-advised?

…and stake their life savings on them

Attitudes to risk

- Are people risk averse?
- What is 'capacity' for risk?
- How can we define risk?
- Are investors rational?
- How do we minimise risk and maximise return?

pick a card

correct!

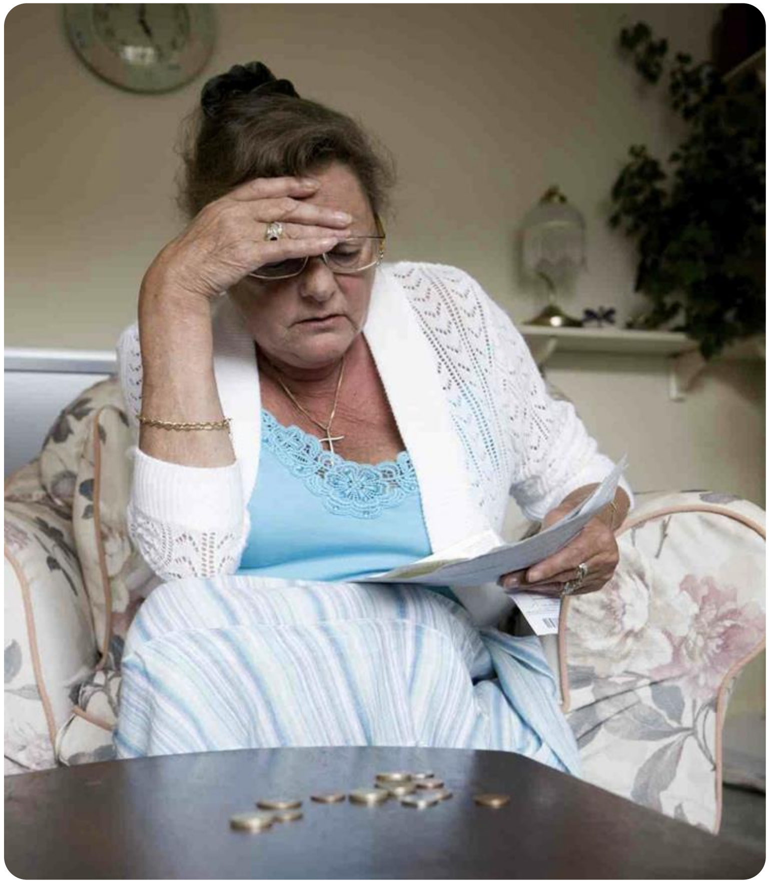
play again?

play again?

- but this time
  bet your house

risk is meaningless without a consequence

goals and consequences



- Capacity for taking Risk
- What do you want to do in retirement that requires money?
- What are the consequences of not achieving it?

risk – a definition

What is worth insuring against?

low probability, high impact

high probability, low impact

probability x impact

risk aversion

- 80% chance of winning €4,000 and a 20% chance of winning nothing?
- 100% chance of winning €3,000?

risk aversion

- 80% chance of losing €4,000 and a 20% chance of breaking even?
- 100% chance of losing €3,000?

loss aversion

- Risk = probability x impact
- Losses hurt roughly twice as much as gains feel good
- Selling winners, holding losers
- Regret aversion

probability and impact – value

- heads, I'll give you €100
- how much would you pay to play –€40?
- EV = Probability of a gain x value of a gain
- 50% x €100 = €50
- how big does the pay-off need to be?
- it's not just about risk…

early risk profilers…

What is Risk ‘Profiling’?

- An assessment
  - ‘Psychological’ profile
  - Impacted by perception
- Calibration
  - Profile is not portable
  - What does a ‘3’ mean?
- Attitude to Ferrari, versus capacity for buying/driving one

Risk discussion

- Attitude = Willingness
- Capacity = Ability/Means
- Need = Objective
- Not ‘shoehorning’
- Ask challenging questions!

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The cost of Recovery

- "What if…"
- Older clients have less time for recovery
- This is a necessary conversation…
- So what has been the experience?

Bear Market Depth

Growth rate	-20%	-30%	-40%	-50%
2%	11y 3m	18y	25y 10m	35y
4%	5y 8m	9y 1m	13y	17y 8m
6%	3y 10m	6y 1m	8y 9m	11y 11m
8%	2y 10m	4y 8m	6y 8m	9y
10%	2y 4m	3y 9m	5y 4m	7y 3m

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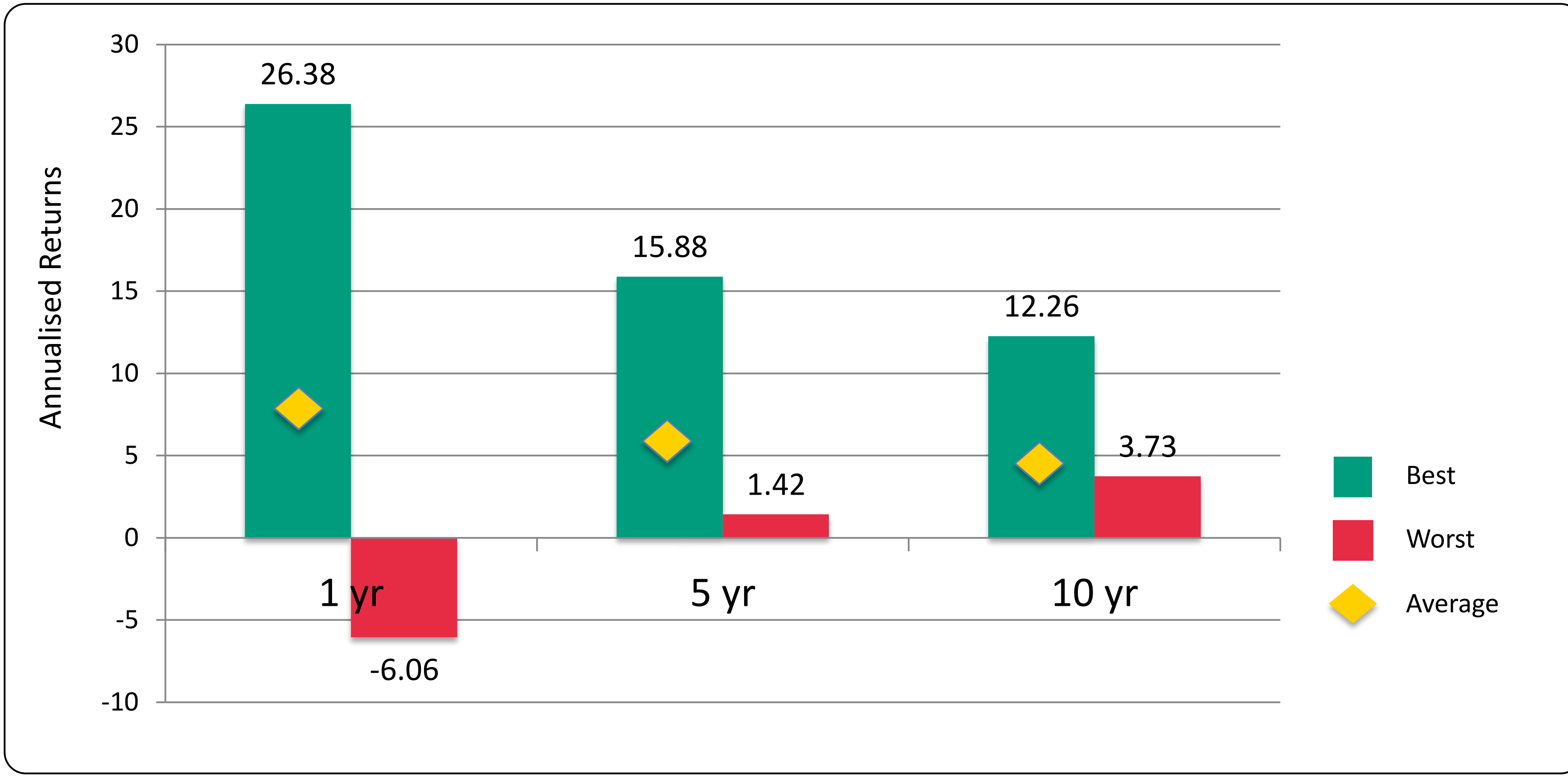
50/50 Portfolio since 1990



Source: FE Analytics.
Portfolio 50% MSCI World Index and 50% Barclays Global Aggregate, in GBP

asset allocation
de Finetti – subjective probabilities

- How to calculate exposure to risk assets
- What is the worst loss you could tolerate?
- What is the worst you can envisage?
- What is the risk free return?

$$\frac{0.2 + 0.026}{0.5 + 0.026} = 43\%$$

fund selection

- The Ruler test
- Brand
- The 'star'
- Exceptional results are the exception by definition

pick a fund

- 1,684 funds*
- Odds on randomly picking best fund 3 years in a row?
- 4,775,581,503 -1
- Odds on picking best fund in each IMA sector?

*Non-Managed Funds with a 1 year track record to 8th November 2013. Source FE Analytics

odds on picking the best portfolio?

- 3.66 times 10^{30} -to-1
- There are ~ $1.75*10^{25}$ grains of sand on earth*
- 251 babies are born every minute**…
- …Proverbially, only one of them is a sucker

Source: *Marcus de Sautoy **US Census Bureau

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Returns - *MAR*

- Client MAR must be greater than:
  - Risk-free + Inflation rate (4.1%)
  - + TCO
    - Portfolio AMC plus
    - Adviser charge(s), plus
    - Platform fee + trading expenses plus
    - Product and personal expenses
- TCO ≤ MAR – 4.1%
- Risk premia imply sub 6.5% realistic MAR…
- Implying sub-2% TCO – lower if IRs rise

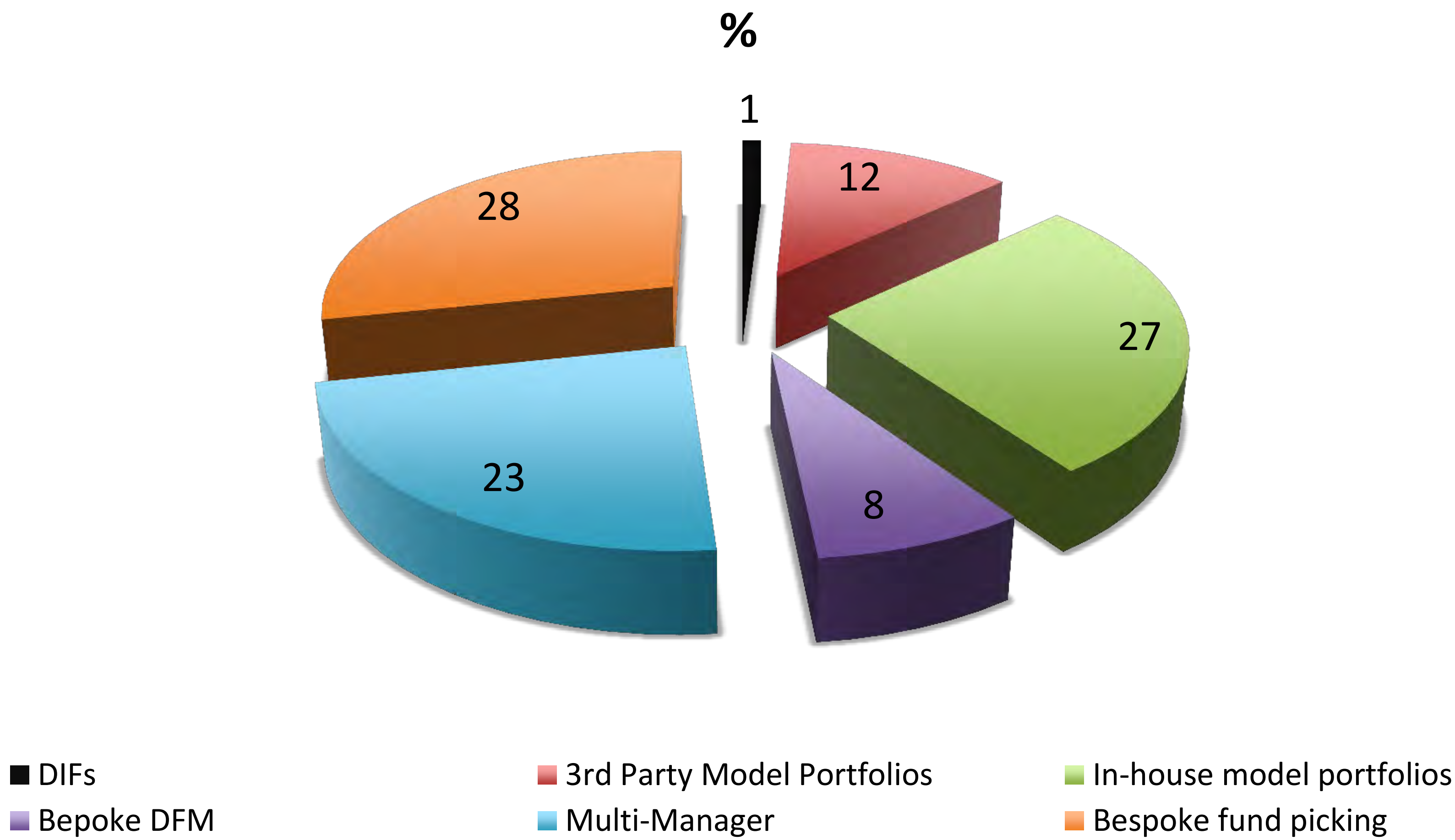
Segmentation

- Charging – start from scratch, not commission rate
- Strategies:
  - Wealth
    - Wealth ≠ Wisdom and sophistication
  - Need
  - Willingness
  - Financial planning v investment planning
  - All clients are different
  - But differing problems may be solved by the same solution
- Suitability

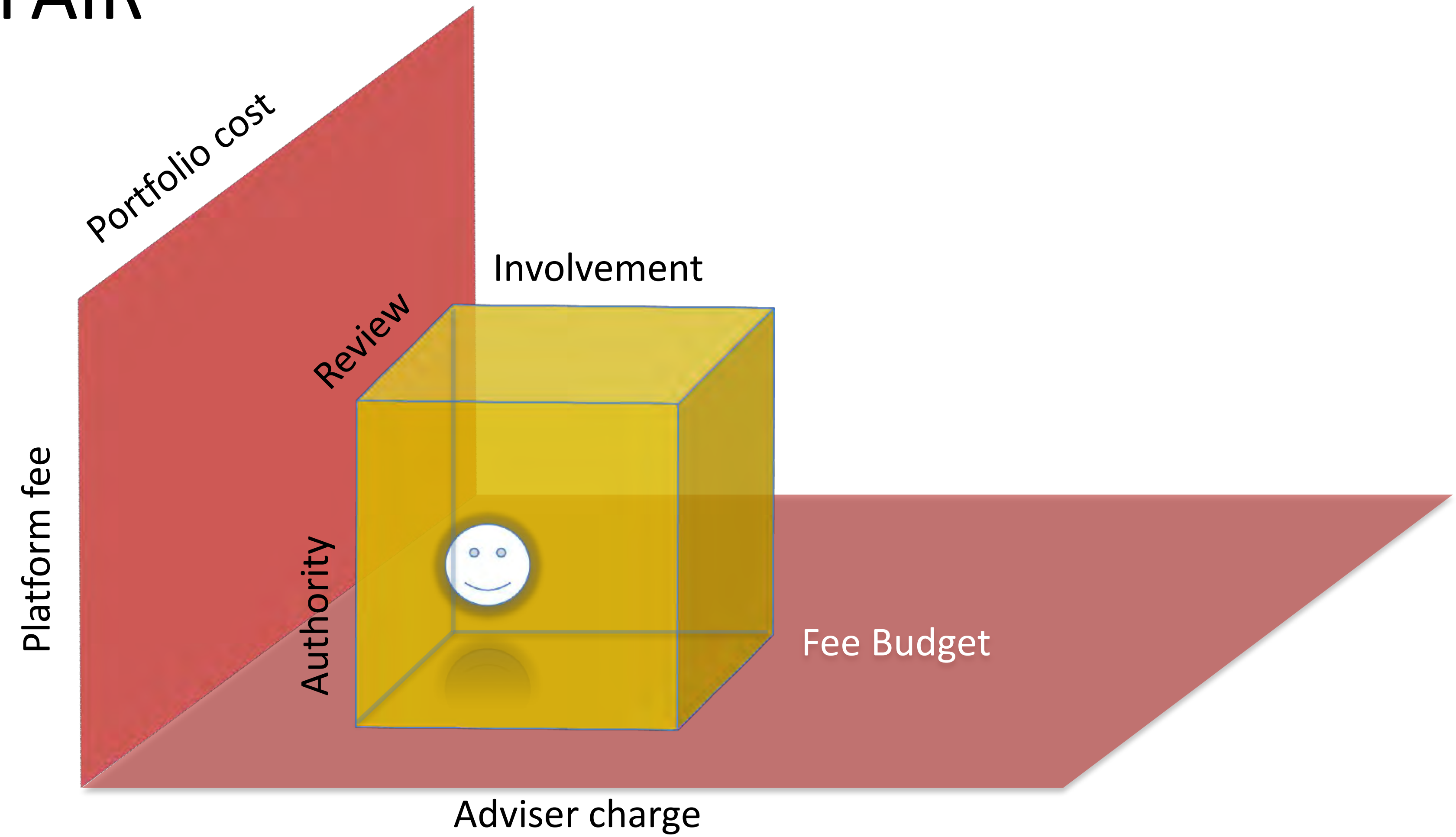
Suitability Process – FAIR

- **F**ee budget
  - Total Cost of Ownership (TCO), versus return potential
  - How much would you bet to win €1 profit? €1? €10?
- **A**uthority – Knowledge and Experience
  - Knowledge – breadth and depth
  - Experience – successes AND failures
  - Could the customer give an informed investment presentation?
- **I**nvolvement needs
  - Likelihood of changing personal circumstances
  - Asset allocation/ethical preferences
- **R**eview needs
  - Every meeting costs time and money
  - Frequency versus customer benefit
  - Tolerance/awareness– market observation, triggers for portfolio change

How the market looks…



'FAIR'


Portfolio cost
Involvement
Review
Platform fee
Authority
Fee Budget
Adviser charge

Summary


Investments
and Financial Planning
GLASBERGEN
"I retire on Friday and I haven't saved a dime.
Here's your chance to become a legend!"

Questions, and challenges!