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Insight and Financial Adviser host an expert roundtable discussion on fund allocation and its future

What clients care most about is losing money

Dominic Welling

Melanie Tringham: Now more than ever the issue of asset allocation is up in the air. With markets going from one direction to another and questions being asked about whether other assets are still non-correlated in the same way that we have been used to, now is a good time to refresh our ideas about asset allocation, whether the same theories hold true or whether it is worth having another look.

Matthew can you give us a bit of context about the state the markets are in and whether now is a good time to be thinking about asset allocation, and what challenges it poses for financial advisers?

Matthew Merritt: The financial crisis which came to light back in July of last year has moved on very swiftly to become something the scale of which is beyond all previous banking crises, going back at least to the 1930s.

Central banks and governments have put forward a range of packages which should in time stabilise the financial system, but the market's continued fragility is a reflection that the real economic impact of that crisis is still in its relatively early stages.

So any discussion on asset allocation needs to be framed against that backdrop, and a lot of the underlying assumptions that people have got used to are being challenged.

When we are thinking about asset allocation we need to be thinking about the wider universe that we should be incorporating and the roles of strategic and tactical asset allocation.

Also, there are additional risks we need to consider.

People tend to think about risk in terms of volatility, which is one aspect but what the last few months have highlighted is other risks; the risk of illiquidity, the risk of counterparty exposure, and the crisis has thrown up a whole range of issues about money we should consider.

Melanie Tringham: One thing to think about is what sort of feedback or queries IFAs are getting from their clients.

Marcus Blase: Normally, when markets are rising you do not hear from your clients, but when the markets go down, you can virtually guarantee the phone is ringing. Clients want to know what is going on. I think it is still too early to say how long we are going to be in this bear market, and what type of recovery we are going to have because no one has got a crystal ball.

Pension funds are down by easily 20 per cent so people who are close to retirement, whether it be six years, five years or three years to retirement, their pension funds are going to be really hit and I do not know how many of them are aware of this at the moment.

I am sure many are, but to what extent, and this is one of the problems we are facing at the moment.

Graham Bentley: Clearly these are unusual circumstances but I am not actually sure how many people looking at the market know how unusual it is.

The interesting question to start with rather than where does asset allocation go from here as far as clients are concerned and considering the state the market is in, is to think more in terms of what asset allocations did people have before we got to here that meant they suffered maybe more than they might have done given the strategy that was taken.

How many people knew what the volatility of that portfolio was before they built it, or its expected volatility, as opposed to thinking, well diversification is a bit of a mix of things I will just pop a bit of fixed interest in here, a bit of equity in there and see how we go along rather than testing it to say what is my value at risk. Now people are saying, I did not expect all these things to fall together, but sometimes they do.

Trevor Whiting: We decided that we had to be active with clients, getting to them before they came to us. In times like this a lot of investment advisers and IFAs put their head below the parapet because they know that if they contact the client then they are probably going to get bad news and a bad reaction.

They are going to get upset clients and people generally do not like to do that. But I think we have to do that,

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when times are like this we have to reassure our clients, rather than waiting for that phone call to come.

That it is so important from an adviser perspective that no matter what you have done with your asset allocation, reassure the clients that what you have done is there for a reason, yes it may need to be changed, but also you have to stand by your original advice.

Melanie Tringham: Do you think advisers are going to come under more pressure from clients? Is there going to be a need for more client management, to try and persuade them we are living in extraordinary times and however much the portfolio has fallen, you have done the best you could in the circumstances?

Keith Iles: That is definitely going to happen because in the falling market people are just going to look around for someone to blame.

I am probably different in the way I have approached a lot of things, and I have had a problem for a long time with the exam answer to asset allocation - where asset allocation is just a diversified fund, a little bit of this, a little bit of that, and hope it all comes good.

I have not held that view for years. You have got to look at the times, where we are and where we are heading. The traditional model has only been fine because that was the way the wind was blowing. Right or wrong, whether the people who advised clients knew what they were doing, they turned out to be correct purely because that was the

direction the wind was blowing, now times have changed considerably.

Graham Bentley: That is a very important point. The idea of something I read in a magazine somewhere that somebody says I should have X of this or Y of that or whatever, is different from a mathematical or strategic view. The classic example is property.

Anybody who had a high exposure to property would have looked fantastic over the last six or seven years or even a lot longer than that.

Keith Iles: Do the risk questions apply anymore?

Graham Bentley: One of the problems that you get with risk profilers is what they do is behave as if it is a one-off set of questions. You are a paratrooper, therefore you will be a bull market fan for the rest of your life for example.

All that a risk profiler should do is say given a population of people there will be some who prefer more risk than others, and if you look at the population it will move depending on what the background is, so if it is a bullish market, what happens is everyone shifts to the bullish end. If it is bearish, like it is now, it moves back in that direction. All you are either doing is saying you are less risky than someone else, but in terms of the definition, the definition is how much money can you afford to lose before you have to stop?

Jonathan Davis: I have never used a profiler in 20 odd years of business. It is just a way to cover your back for the FSA. The risk that people talk about is that they do not want to lose money. It has been shown time and time again in psychological studies that we are more than twice affected by a realised capital loss than a realised capital gain. People absolutely hate losing money.

Five years ago, when the stock market and property was not as troubled as it is now, there was this big thing that grew in the profession about diversified portfolios. In the last five years the IFP's been pushing it and the PFS has been pushing it. Those portfolios will now be down 20, 30 or 40 per cent in the last year. The clients will not be happy. The only risk that they care about is losing money.

Now where we are at, the stock market for example is 40 per cent down, commercial property is probably similar but it is more hidden, bonds are on their way, and the discussion will move from diversified portfolios which have been the perceived wisdom, to tactical asset allocation, which I have to say I have been pushing and advising my clients on for the last three or four years.

Matthew Merritt: We believe in having a diversified portfolio but to be able to move that asset allocation tactically and within very wide bounds. Now how do you do that other than by waking up in the morning and thinking whether you feel lucky or not?

There are multiple solutions that involve moving away from a static asset allocation but they require a solid understanding of risk management and the role of tactical asset allocation. To me the two are pretty much interlinked alongside a sensible understanding of what different asset classes can do for your portfolio.

All of the points I am hearing are all valid but I do not think there is a one size fits all solution. You can actually pull these building blocks together to achieve different results depending on a client's risk tolerance.

Graham Bentley: My colleague here is absolutely right in terms of what clients care most about is losing money. And that asymmetric utility argument is well made.

It points out something else as well. From a fund manager's point of view, from an economist's point of view, from a marketing person's point of view, it is a textbook thing. From an adviser's point of view it is somebody in your face, and that is the big difference. Trying to explain all the numbers and so on to a client. Clearly if you are fortunate, then you have a rocket scientist for a client who you can have that conversation with but typically not and the danger is trying to over simplify the other way so that people's expectations tend to be more positive than they should be.

Trevor Smith: I am an asset allocator and look at all asset classes. A prime example of calling markets was two years ago when there was obviously a very good run on property.

We held up a high exposure in a client's portfolio but we saw that it was coming to an end. We sold out of property completely; we just ditched it as an asset class until we wanted to come back to it. So we had called the property market. I cannot see any difference between that and calling the equity market. We do not have to hold equities in the portfolio. I do not see that tactical allocation is not achievable, you just have to have a strong conviction.

Melanie Tringham: It is important to bear in mind that any kind of asset has some kind of risk attached. We are living in such extraordinary times that there is an array of different risks attached to different kinds of assets that are making us stop and think.

Marcus Blase: From an IFA's point of view, it is a case of getting right back to grass roots, when you go out and see a client and find out their attitude to risk. It is fundamental that you go in and firmly establish what that attitude to risk is.

Jonathan Savage: The fundamentals behind asset allocation in theory seem sound. My worry is first that people are inaccurately self-identifying their attitude to risk, and nine times out of 10 they will get it wrong because they will not understand. Second, you are putting them into a model which from a statistical point of view is based on fiscal assumptions which in reality break down.

Yes in theory asset allocation is phenomenal, it works, you look at the statistics, you look at the graphs, the theory behind it is great, but as I tell clients, in theory Communism works. To delegate the task of risk management to a stochastic modelling process which has so many assumptions behind it, and delegating the attitude of risk decision to the client is irresponsible.

Graham Bentley: You are right to say that to leave it to a subjective discussion about what risk is about from a client's point of view is absolutely asking for trouble. That is why the biggest weight in that questioning process should always be how much money can you afford to lose.

What the profiling process is designed to do is to take away some of the behavioural biases that individuals have when they are making selections. Nobody is saying that is the right way to do it and everybody else is wrong, all it is saying is if you do not want to take responsibility for making those asset decisions yourself, use a machine.

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Jonathan Savage: The fundamental point is that you are exploring diversification, you are looking at different assets but you are not leaving it up to a model. You are making subjective decisions based on your expertise and essentially you are chasing asset classes of the best performing in your opinion at the time, whether that works or not

I do not know but my perception of it is you are charging a fee because you are trying to marry two ideas together, personal input and asset allocation.

Trevor Smith: Nobody has ever come to me and said actually what you want to look at is what is going to happen in the future. Where is this world going, where is this market going and so on.

That does not feature in any asset allocation model I have seen. The dictionary definition of stochastic is proceeding by guess work. And I think that says it all really. I prefer to rely on my personal view of the future.

Matthew Morritt: What I sense here is that there is an awful lot of confusion about what people are talking about as asset allocation.

Strategic asset allocation involves holding pretty much static weightings say, 60 per cent equity, 40 per cent bonds and not moving significantly away from that allocation. This approach tends to be driven by historic risk/return and correlation analysis.

Tactical asset allocation involves having the scope to move meaningfully into or out of asset classes depending on perceived opportunities. Certainly the former will be under considerable scrutiny after recent events but the latter is not easy. Its important [illegible] match between wha[illegible] they are getting and [illegible]

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