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# Investing in the post-RDR UK

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# What was RDR?

- Commission ban\*
- Customer agreed remuneration (cash)
- Qualified – QCF 4 (NFAQ 6/7)
- Independent or “Restricted”



\*Except Protection products



# Good in parts...

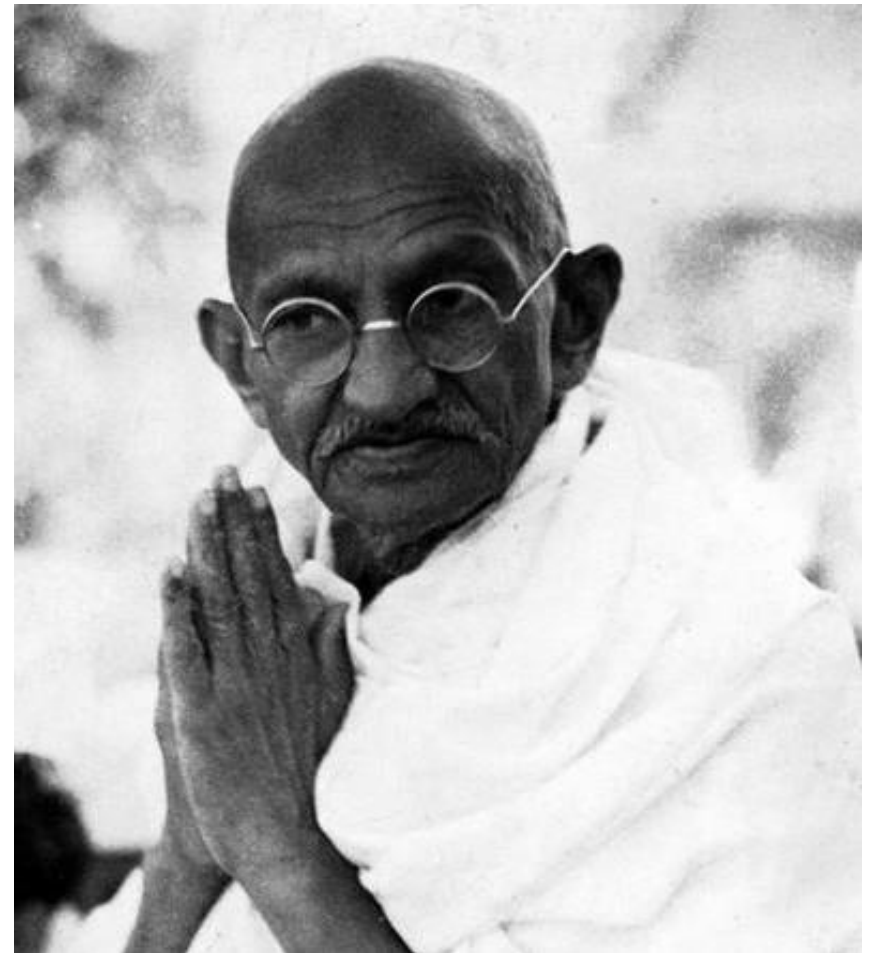
- Quals – binary outcome
- Independence
  - False sense of its importance
  - Expensive to deliver
- Adviser charging
  - “Car Crash”
  - Commission cut and paste
  - Cash rule not adhered to
  - Illustrations = TCO, less tax, and inflation!
- Salesmen who run a business?





# 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





# 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



*walk the talk.*

- 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



# 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”



# Investment Process - What does it cover?

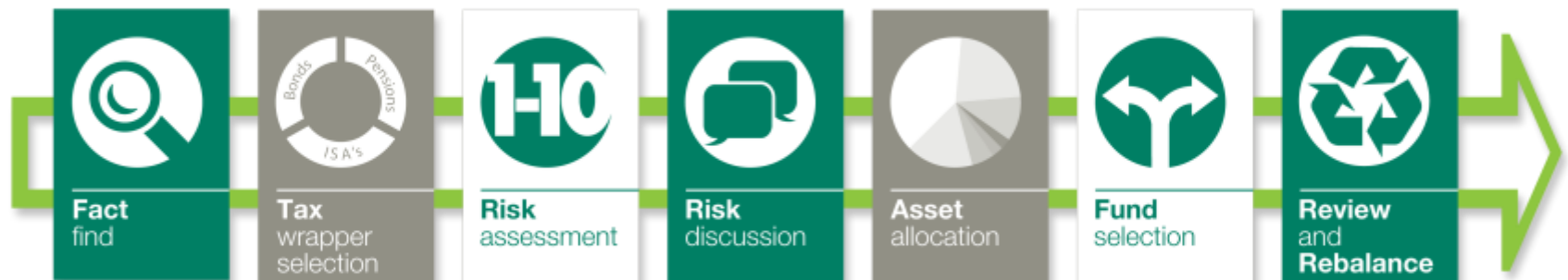


- Your investment philosophy
- Client Risk Assessment process
- Asset Allocation process
- Fund Selection Process
- Review and Rebalancing Procedures
- Investment Committee
  - Structure, roles and responsibilities



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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

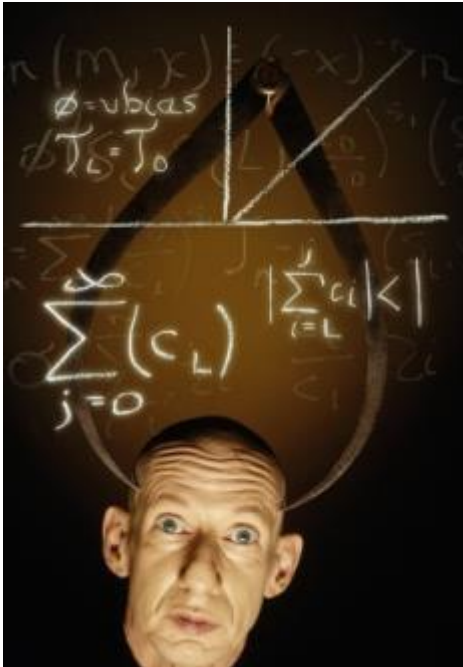


‘Risk comes from not knowing what you’re doing.’

*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*



# how does your brain work?

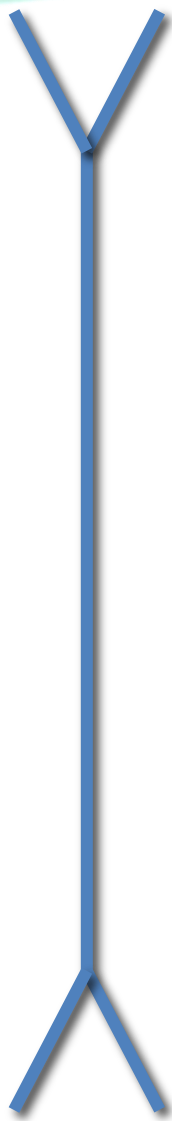


- Solving ill-posed problems
- Infinite permutations
- How do you know it's an urn falling off a table?

*we make assumptions about the way the world is*



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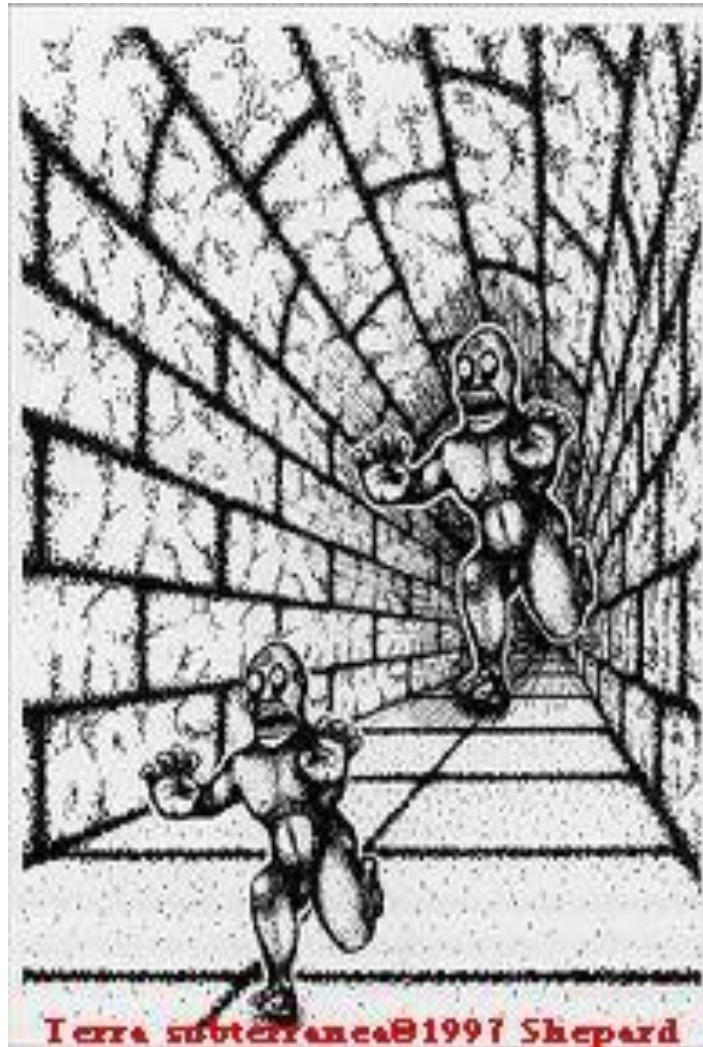


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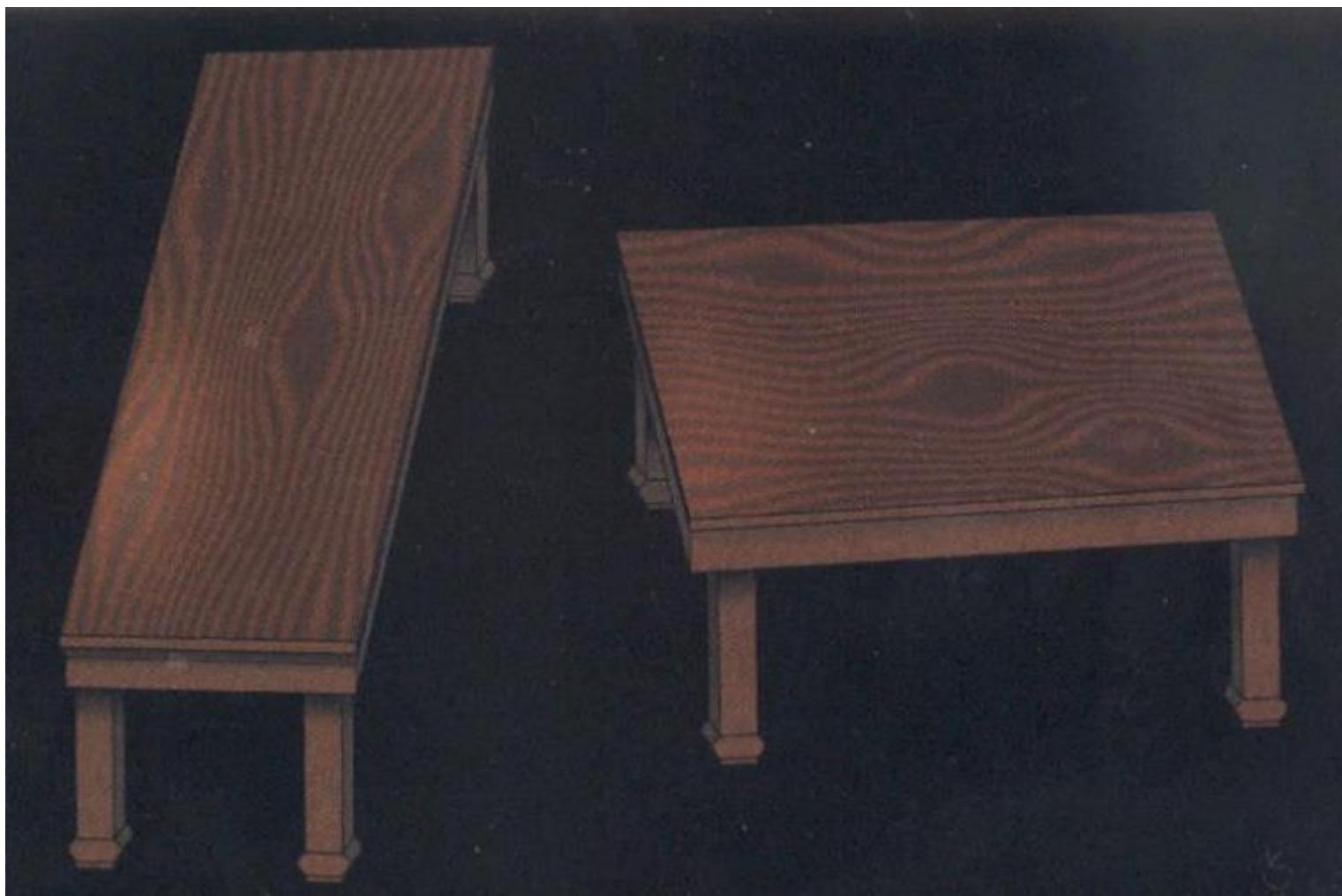


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# we are not good at estimating...

- 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\*!*



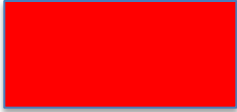

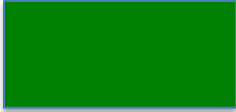




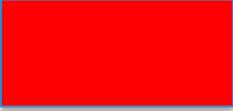




# how we calculate the odds – likelihood



*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*



# 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?



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# pick a card





correct!





play again?





# play again?

- but this time  
bet your house

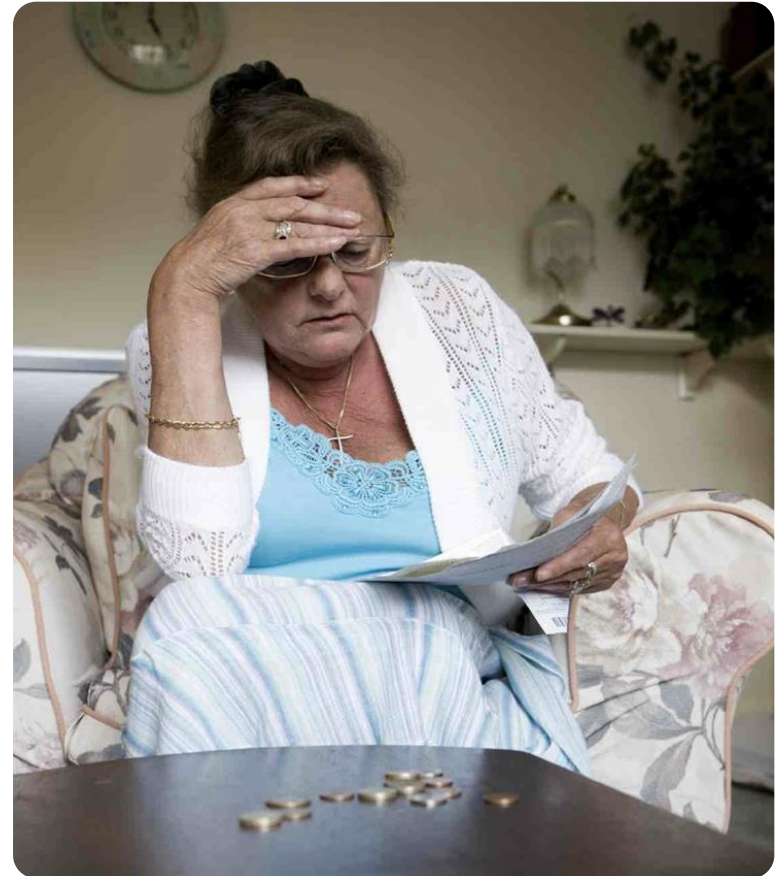


*risk is meaningless without a consequence*



# 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?





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# 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?
- $EV = \text{Probability of a gain} \times \text{value of a gain}$
- $50\% \times €100 = €50$
- how big does the pay-off need to be?
- it's not just about risk...





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# 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!





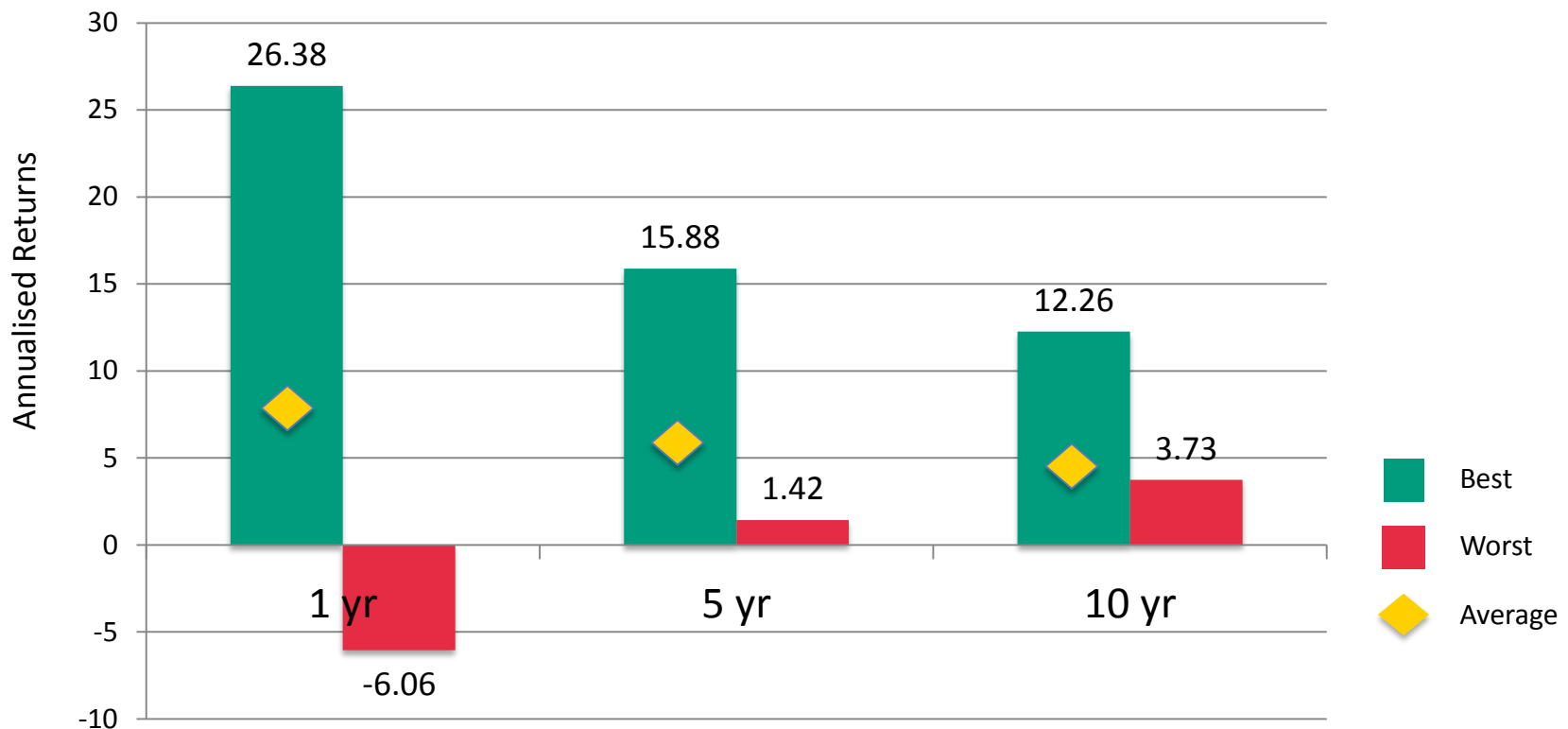
# The cost of Recovery

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

		Bear Market Depth			
		-20%	-30%	-40%	-50%
Growth rate	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



# 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 8<sup>th</sup> November 2013. Source FE Analytics



# odds on picking the best portfolio?

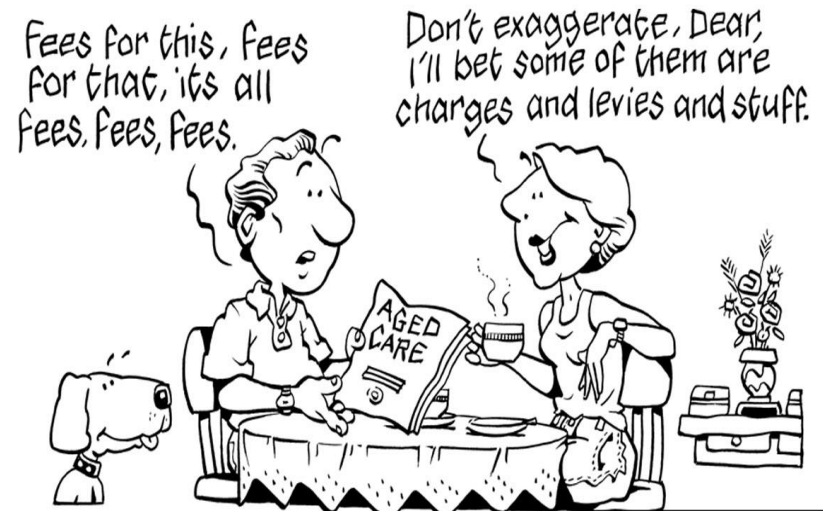
- 3.66 times  $10^{30}$  -to-1
- There are  $\sim 1.75 \cdot 10^{25}$  grains of sand on earth\*
- 251 babies are born every minute\*\*...
- ...Proverbially, only one of them is a sucker





# 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
- $TCO \leq MAR - 4.1\%$
- 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  $\neq$  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

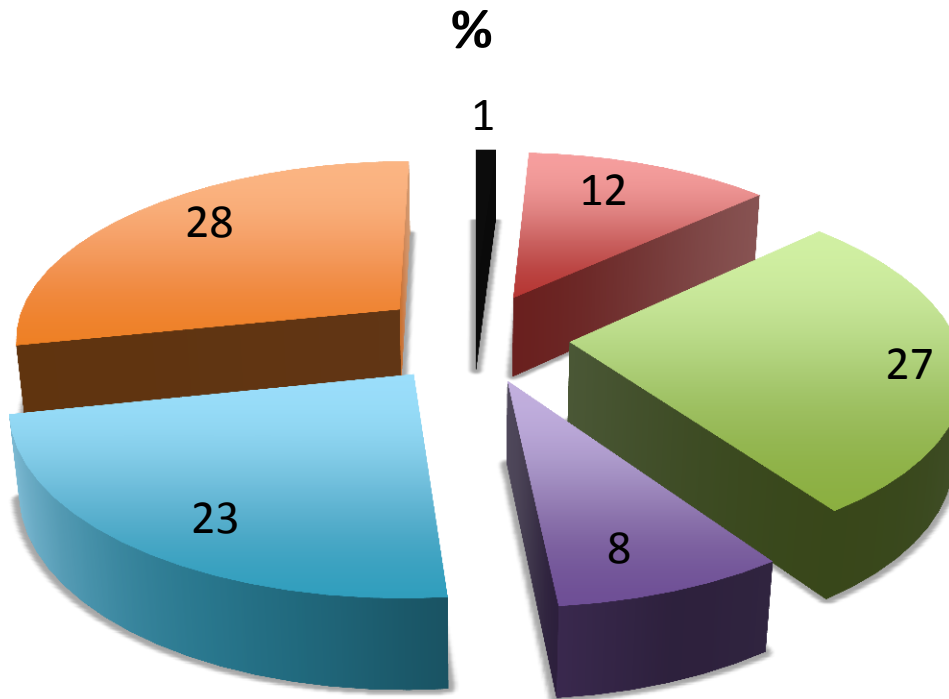


# Suitability Process – FAIR

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



# How the market looks...



■ DIFs

■ Bepoke DFM

■ 3rd Party Model Portfolios

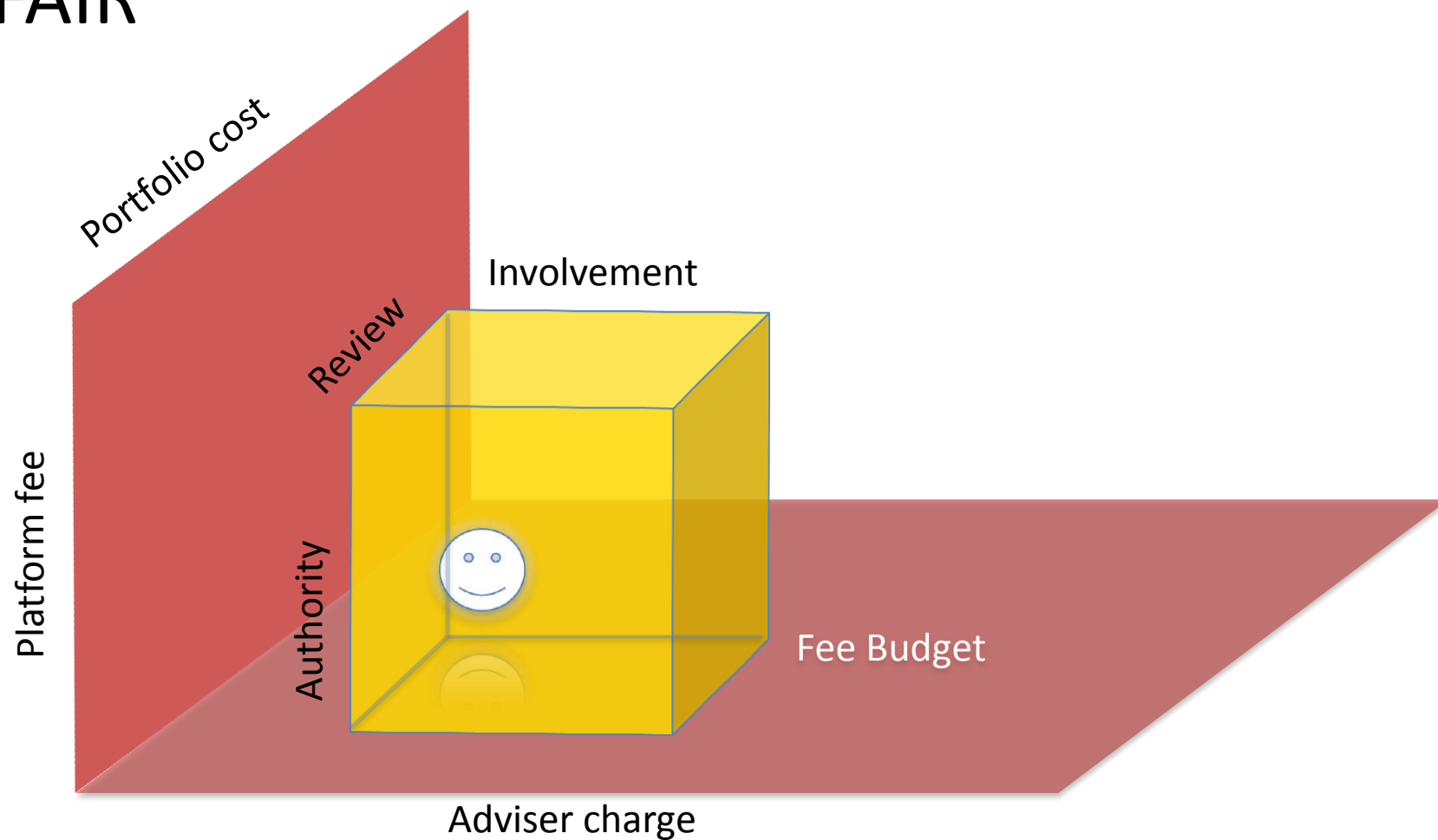
■ Multi-Manager

■ In-house model portfolios

■ Bespoke fund picking



# 'FAIR'





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# Summary

## **Investments and Financial Planning**



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



# Questions, and challenges!