

Addressing Investment Risk

A guide to approaching investment risk for use
by Financial Brokers and their clients

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The Risk Assessment Process

This document describes the process around the provision of investment advice to you. It also seeks to outline the context in which that advice is provided, with specific reference to risk. We hope that having read it you will appreciate the necessity for and usefulness of the **Know Your Consumer** process and also of the **Risk Profiling** exercise which we will complete with you.

The document is divided into two parts. **Part 1** gives an overview of the process. **Part 2** addresses the nature of investment risks in more detail.

As a Financial Broker authorised by the Central Bank we are obliged to provide investment advice which is **suitable**. Suitability in relation to investment advice or products is of necessity somewhat subjective and an area where experts frequently differ. It is a complex area that presents challenges for product providers, Financial Brokers and consumers. Even if the risk categorisation of individual products was perfectly consistent, professional skill and judgement would be required.

The process we outline in this document is structured and aims to bring consistency to the provision of investment advice by Financial Brokers with the primary aim of ensuring the suitability of advice. This document is based on a template developed for the Professional Insurance Brokers Association (PIBA), a trade association of which we are a member. PIBA has endorsed this document as a suitable guide to the process of investment risk and it is hoped that the guide will allow PIBA's Financial Broker members to meet the highest of professional standards and best practice in the Financial Broker industry. PIBA

cannot, and does not, through this document give investment advice either directly to Financial Brokers or indirectly to their customers.

This document was produced by PIBA with the assistance of Clarus Investment Solutions. PIBA is a national body representing 870 insurance and Financial Broker firms throughout Ireland (for more information see www.piba.ie). Clarus Investment Solutions is an independent investment consultancy (for more information see www.clarus.ie).

Fact-Find

As Financial Brokers we are obliged by law to go through what is commonly referred to as a 'Knowing Your Consumer' (KYC) process before giving any financial advice. We also feel this is crucial to giving you a quality service, since advice that is suitable can only be based on a proper knowledge of your financial circumstances, needs, objectives and priorities.

To assist us in the KYC process we have developed a template **Fact-Find** document, which aims to gather sufficient information about your assets and liabilities, income and outgoings, anticipated future commitments etc. Questions in relation to age/dependents/marital status/health/employment details will also form part of the process.

It is especially relevant in the case of investment advice that we are informed about the level of experience and understanding you have of investment products and markets.

Where investment advice is concerned the completed Fact-Find is vital in helping us to form a view on your **capacity to bear risk**. The Consumer Protection Code (CPC) specifically obliges us to assess your capacity to bear any risks attaching to products or services we recommend. While it also obliges us to align advice with your attitude to risk, many people's capacity to bear risk is less than the risk they believe they could handle.

We may look to complete a new Fact-Find periodically and after major life events.

Risk Profiling

In tandem with the Fact-Find we will guide you through a Risk Profiling exercise, which takes approximately 5-10 minutes. Based on the answers you give to the questions you will be categorised within one of a number of risk classifications.

We will discuss the results of the risk profiling exercise with you and should you be uncomfortable with or unsure about the outcome you will be offered an opportunity to repeat the process.

The classifications arising from our risk profiling process are aimed at gauging your approximate *psychological disposition* towards investment risk. (*This is the purpose of most risk profiling tools but may vary depending on the profiling tool being used*). Although research suggests this is not a characteristic or trait which changes much over time, risk profiling is an exercise which it is useful to repeat periodically.

It is a specific obligation under the CPC that in the Statement of Suitability attached to our advice (commonly known as 'Reasons Why' documentation) we show how the risk profile of the investment(s) we recommend to you are aligned with your attitude to risk.

Discussion

The completed **Fact-Find**, an assessment of your capacity to bear risk and the completed **Risk Profile** are the key building blocks needed to frame investment advice: however only a discussion with you will ensure that we have gained a thorough insight into your circumstances and a clear understanding of your financial needs, objectives and priorities.

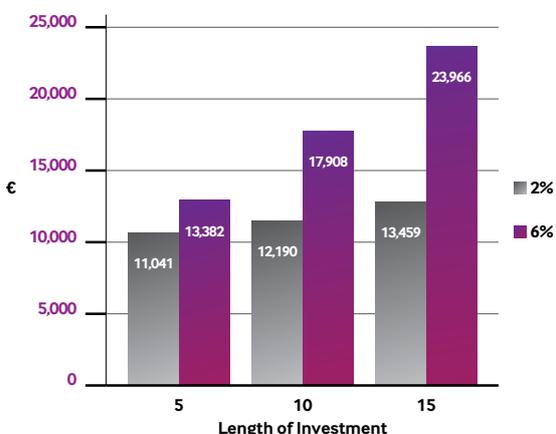
In situations involving more than one person this is even more important, as the most suitable investment advice will represent a blend of what might have been given to the individuals involved. While in the case of a couple the assets/liabilities/ income/outgoings may be common, *attitudes to risk are frequently very different*.

Part 1 - Overview

1.1 Risk, Return and Inflation

The idea that higher-risk investments should offer potentially higher returns is understood by most people – *otherwise everyone's money would stay on deposit.*

Most people understand that in normal circumstances and over time a deposit with a very secure bank will generate a fairly consistent, low return. They also understand that riskier assets such as shares or property have the potential to generate significantly higher returns than money in the bank. What is less well appreciated is the power of compounding better returns over time. The simple example below shows the growth of a €10,000 investment returning (i) 2% and (ii) 6% over 5, 10 and 15 years. After 15 years, the 6% investment has earned a cumulative 124% whereas investing at 2% earned just 35%.



Over the longer term the potential impact of inflation on savings and investments must also be recognised; deposits and other financial assets are particularly vulnerable to inflation – see Part 2 *Investment Risk*.

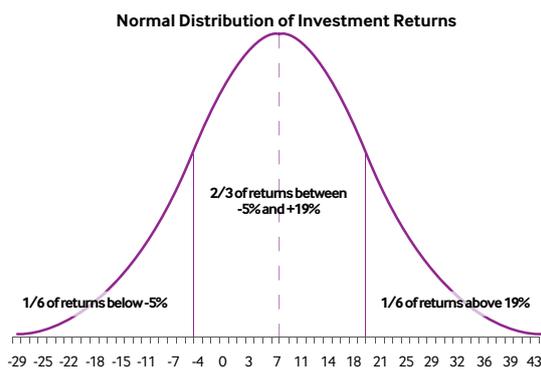
In a world experiencing the 2% inflation typically targeted by central banks, cash loses **33%** of its value in **20 years**. At **3%**, cash loses a quarter of its value **in just 10 years**. An understanding of the tension between the need to generate returns above inflation and the willingness or capacity of clients to take on risk is at the core of the process and central to how we frame investment advice.

1.2 Measuring Investment Risk

The words 'risk' and 'volatility' are used almost interchangeably, and as the section *Investment Risk* shows there are different types of risk, and many causes. The word 'volatility' more properly refers to the variability of returns – put simply, how much outcomes are likely to jump around from one period to another, and in relation to an average or projected outcome. We define it more precisely below.

While there is a large body of academic work on investment risk and there are some widely-used risk measures, **caution is advised in relying on those metrics**. In the first instance, all measures are based on the past and the future may be quite different: past data shows how a given measure used on the same asset over two different time periods can indicate substantially different risk characteristics. Secondly, any one measure can only describe one aspect of investment risk. Some risks (such as counterparty risk) do not lend themselves to quantifying in a single number.

The most widely-used measure of risk is **volatility**. This is defined as the standard deviation of actual periodic investment returns, computed over a reasonable sample size. It measures the degree to which returns vary from one period to the next, and indicates (in so far as the future will be like the past) how much future returns are likely to deviate from the average. The use of volatility is based on the belief that investment returns for most assets broadly conform to the well-known Normal Distribution (the 'Bell-Curve'). This is a reasonable although sometimes imperfect assumption. So, as shown in the example below, if the average return from equities is **7%** per annum and the volatility measure is **12%**, there is a two-thirds probability that the annual return falls between **-5%** (7% minus 12%) and **19%** (7% plus 12%). 19 out of 20 outcomes can be expected to fall within two standard deviations of the average – in this example, between **-17%** and **+31%**.



Average performance figures are often cited in fund documentation but unless the volatility is also supplied that information is next to useless. A very useful statistic which should be noted when available is the **maximum drawdown**, which is essentially the worst possible peak-to-trough fall an investment could have produced over a given time period. Someone seeing this statistic for world equities over the period 2000 - 2003 (**-54%**) would have been somewhat prepared for what transpired in 2007 - 2009 (**-49%**).

1.3 Product Risk Classification

The EU Financial Regulatory Authority, known as ESMA (and previously CESR) has introduced a seven-point risk/reward indicator system for certain types of investment products. While the regime does not currently apply to most of the funds on sale in Ireland, it is understood that all of the life assurance companies will voluntarily adopt the new risk/reward indicator during 2013.

The methodology is based on the volatility of weekly returns over the previous five years. Where funds have a shorter history it can be augmented with data from a representative benchmark. In the case of structured products ('tracker' funds) or absolute return funds, where the computation of the indicator may be problematic, the fund provider will take responsibility for identifying and explaining the appropriate ESMA rating.

Under the CPC, product providers are now obliged to furnish the following to the Financial Broker at least annually:

- the key characteristics and features of the product
- the **target market of consumers** for the product
- the nature and extent of the risks inherent in the product
- the level, nature, extent and limitations of any guarantee attaching to the product and the name of the guarantor.

This information and any risk categorisation provided by the product provider directly or via data processors such as *MoneyMate* or *Financial Express* will form part of our assessment of the product and where relevant will be reflected in our Statement of Suitability documentation.

The introduction of objective risk measures computed on a consistent basis and the new obligations on product providers under the CPC represent welcome developments. The ESMA ratings will be particularly useful in showing how volatile a particular asset or fund is relative to another.

1.4 The Role of Professional Skill and Judgement

The wider use of objective and consistent measures around risk, while most welcome, is no panacea for the challenges presented by suitability and risk. **We believe that professional skill and judgement will always be required to provide investment advice:**

- because of the shortcomings of historical volatility as a measure
- because gauging risk tolerance and in particular assessing capacity to bear risk cannot be purely mechanical
- because relating a client's investment needs and objectives to their appetite for and ability to bear risk usually involves trade-offs which are hard to represent numerically.

Another key reason why judgement will be required is the effect of combining assets/funds. Assets may be blended in a portfolio which could itself be less risky than any of its components, if those components have low **correlation**. The correlation of assets measures the extent to which their price movements are interdependent, with zero correlation implying complete independence.

So, for example, putting equal amounts into investments with ESMA risk ratings of '6' and '7' could produce a '5' depending on the correlation of the two assets. While you might be classified as a 'Medium Risk' investor, good advice could quite possibly incorporate some allocation to one or more funds ranked higher up the risk spectrum.

Part 2 - Investment Risk

To most people, the simplest definition of investment risk is the possibility that they do not get back all of their initial capital when the investment matures or they need to liquidate it. The consistent popularity of capital-guaranteed products is testimony to people's preference for capital security. But investment risk has a number of dimensions, and a full consideration of it must look beyond the simple definition.

2.1 Helping You to Understand Investment Risk

Before undertaking any investment, you should ask yourself the following questions:

- A. What is the time horizon of my investment?
- B. Is there any possibility that I may need to encash the investment earlier than that?
- C. What use do I plan for the proceeds of the investment and what return do I need in order to meet that target?
- D. If the return were to fall short of that target, how much of a shortfall could I tolerate?
- E. Do I need to draw an income from the investment during its lifetime?
- F. If the answer to Q.E is 'YES', how much of a shortfall in the income could I tolerate?
- G. Am I investing a single lump sum or do I plan on adding regular or periodic contributions?
- H. Even if the return at maturity meets my expectations, the market value of the investment may fluctuate along the way. How much fluctuation can I tolerate?

Some of these are difficult questions, which do not lend themselves to precise answers. They should prompt you to think more thoroughly about (i) the nature of investment risk and (ii) how much risk you can tolerate. The Fact-Find process and Risk Profiling exercise will help to gauge the latter, but we need to ensure also that you have an adequate understanding of the different aspects of investment risk.

It is helpful to think of investment risk at two levels:
The **forms** of investment risk – *in what ways might my investment prove disappointing?*

The **causes** of investment risk – *what underlying factors might cause those forms of risk to materialise?*

2.1.1 Forms of Investment Risk

Permanent Loss of Capital

Permanent Loss of Capital is the simplest form of investment risk: the investor gets back less than 100% of what she invested. In general, the more volatile the asset the greater the risk of Permanent Loss of Capital.

Shortfall Risk

Permanent Loss of Capital is really a special case of the more general Shortfall Risk: the investment returns less than what is needed to meet the purpose for which it was made. Over the very short term the two are the same. If you are, for example, setting aside some cash to cover known expenses falling in the near future (such as school fees, holidays etc.), then receiving back the

initial investment should be sufficient, and it would not be prudent to undertake higher risk in pursuit of a higher return.

But over the longer term (such as investing to provide a retirement income twenty years from now), you will almost certainly need to generate some return to meet your objective, and accept some risk that the return falls short. A pension investor could choose to hold only cash in their fund, but the level of contributions needed to ensure an adequate pension would be prohibitive. Conversely, she could invest exclusively in equities in the expectation of a high return over the long term, but must bear the risk that volatile markets fail to deliver that return. Shortfall risk has a double-edged nature: a shortfall might happen because your investment approach was too bold, but it could also happen because you were too conservative.

Shortfall Risk is inherently related to inflation. For the long-term investor, what matters is the *real return*, because the spending need they are trying to meet (such as a retirement income) is almost certainly real in nature. We will discuss inflation further as one of the **causes** of investment risk.

Temporary Loss of Capital

Question H highlights the fact that an investment in volatile assets (such as equities) is liable to fluctuate. Even if the client’s eventual return is good, there may be times along the way when losses are shown. Clients who have a robust disposition towards risk may be comfortable with this and are happy to ride out the volatility in the expectation of better long-term returns. Those of a more nervous disposition may be less well equipped to cope with it. The risk inherent in temporary loss of capital is that it prompts the fearful investor to make a bad decision – for example, by selling his holdings at a very low point in the market cycle or ceasing contributions to a pension plan.

Question G is asked because it is important to understand the impact of volatility on the client who is steadily accumulating assets, such as the pension saver. If a constant monetary value is invested at regular intervals, then volatility is inherently good, because more of the underlying investment will be acquired at ‘low’ prices rather than at ‘high’ prices.

This is the well-known phenomenon of ‘dollar-cost averaging’. For example, would you choose to invest two instalments of €1,000 into Company A at

- (i) the same share price for both – €1.00
or
- (ii) €0.80 for one and €1.20 for the other?

Of course (ii) is the better choice; it provides you with 2,083 shares as against 2,000 in the less volatile scenario.

The Effect of Dollar-Cost Averaging - Example				
		Investment	Share Price	Number of Shares
Stable Price	Installment 1	€1,000	€1.00	1,000
	Installment 2	€1,000	€1.00	1,000
	Total	€2,000		2,000
Volatile Price	Installment 1	€1,000	€0.80	1,250
	Installment 2	€1,000	€1.20	833
	Total	€2,000		2,083

For the client who is systematically selling down their portfolio in order to generate income (such as an investor in an Approved Retirement Fund) the opposite is true: higher volatility is more damaging to their wealth.

Liquidity Risk

Question B prompts you to ask whether you might need to encash your investment earlier than planned.

Liquidity Risk is the risk that, when you try to do so, it is not possible to sell at all (which is often the case with structured products) or that you can only sell at a price far below the underlying value, or that very heavy transaction costs arise. Property as an asset carries high liquidity risk; at times it may be difficult to effect a sale and transaction costs can be very high. The early surrender penalties which commonly apply in the first five years of a life assurance policy are a more general, albeit mild, form of liquidity risk.

Income Risk

Questions E and F address your investment income needs. Sometimes the income from an asset can fall, or cease altogether, even if the capital value is unaffected. An example might be where a rental property suffers a vacancy. If the investor cannot tolerate the loss of income,

even over a temporary period, they may be forced to make an unfavourable decision, such as early liquidation of the asset.

2.1.2 Causes of Investment Risk

The previous discussion focused on the forms of investment risk – what are the different ways in which my investment may disappoint? You must also be aware of the causes of investment risk – what are the possible factors which might trigger disappointing outcomes?

Market Risk

Market Risk is the foremost cause of risk in most investors' minds. Assets such as equities, bonds, property and commodities are actively traded in financial markets and their prices will always fluctuate – some more markedly than others. Currency risk is one aspect of market risk. Price changes may be exaggerated by currency movements, with many broader-based investment funds comprising a significant proportion of non-euro assets e.g. a global equity fund is likely to have well over 50% of its holdings outside the euro area.

Markets typically move in response to interest rates, expectations of economic growth, changes in corporate profits, and a host of other factors including sentiment. They are inherently forward-looking; the current market price of any asset is related more to future expectations than the current reality. Investor sentiment tends to be unstable, so that the fluctuation of financial market prices is usually greater than the fluctuation of the underlying fundamentals. This means that assets can often be priced well above their intrinsic value and sometimes well below, something the patient investor can exploit.

Inflation Risk

Inflation is the enemy of savers. Unlike Market Risk, it is asymmetric – it will never work in your favour. In modern developed economies, it is almost unknown for inflation to turn negative for anything but brief interludes, whereas there is a constant risk of higher positive inflation for an extended period. Central Banks typically devise monetary policy with a 2% inflation level as one of their objectives.

It is easy to underestimate the damage done by inflation over the longer term. For example, a level of only 3% is

enough to erode real purchasing power by one-quarter within ten years. Viewed in this context, a capital guarantee on the nominal value of an investment may not be the Holy Grail that is demanded by so many clients.

To protect against inflation risk, the client is obliged to take on more volatility, generally by investing at least partly in 'real' assets. Certain assets are regarded as 'real' (equities, property, commodities) and are generally expected to hold their value over the very long term in the face of rising price levels. The linkage can be very loose and may be not be relied on over the shorter term, when other factors may dominate returns. Inflation-linked bonds are a particular case of real assets, where the face value is guaranteed (by the issuer) to rise exactly in line with the price index to which they are linked.

Nominal assets (conventional bonds, bank deposits) have values which are defined strictly in monetary terms, and are much more exposed to the adverse impact of inflation. In the case of deposits, market interest rates might be expected to go up when inflation is higher, but very often they fail to keep pace with very high inflation – as was the case in the 1970s and 1980s. Nominal bonds are very vulnerable to inflation risk and the longer the maturity the greater the risk.

Debt Risk

An investment funded wholly or partly by debt will always be more risky than one funded from your own resources. (The same is true of an asset which has debt wrapped within it, such as a highly geared company). The effect of debt is to magnify the investor's gains and losses from the returns on the underlying asset. This phenomenon is obvious, but what is often overlooked is the liquidity risk which debt can pose. The lender may prematurely withdraw their funding, or change the terms adversely, and the end result is often a forced disposal of the investment on unfavourable terms. This has been the unhappy experience of many property investors in recent years.

Debt Risk can often interact in a bad way with Income Risk. If the income from an asset is needed to service the debt funding it, even a temporary fall in that income can be very damaging.

Counterparty Risk

The risk that the investor suffers losses because the product provider or intermediary defaults on its obligations is known as **Counterparty Risk**.

Counterparty Risk – Provider

With some investment products, the provider takes ownership of the client's money and assumes a corresponding obligation to them. Bank deposits are the most familiar form of such an investment. **Life assurance policies**, in which **unit-linked funds** are packaged, work in the same way. In Ireland, the Central Bank supervises the solvency of life companies, ensuring that there is a buffer of capital – the solvency margin - between their total assets and their liabilities to policyholders. The required solvency margin is set at 150% of the minimum mandated by EU rules. The balance sheets of life companies tend to be relatively stable in the face of market volatility, because assets are closely matched to policyholder liabilities. Isolated failures have occurred – notably the UK's Equitable Life in 2000, where it could not meet guaranteed annuity rates – but in Ireland no life company has become insolvent since the 1930s.

Tracker bonds also carry counterparty risk to investment providers. The capital-guaranteed element of the investment is usually structured as a deposit with a domestic bank. The potential investment return is also the obligation of a bank, more often than not a separate investment bank. The CPC requires Financial Brokers to convey the level, nature and limitations of any guarantee and state how the foregoing are aligned with the consumer's attitude to risk.

Investments in funds other than unit-linked funds or tracker bonds (generally termed **collective investment schemes**) do not usually involve a counterparty risk to the provider. Typically, the client acquires units in a vehicle which may be a unit trust or an investment company.

The majority of such funds on offer to the general public conform to the EU-standard UCITS classification. With all funds regulated by the Central Bank, the assets of the fund are strictly ring-fenced from the provider's own assets and they are held by a separate custodian entity which itself must be Central Bank-regulated. Barring outright fraud by the custodian, counterparty risk should not be a major source of concern for the client. In the case of a

custodian's insolvency, the assets in safe-keeping for third party clients should not be available to creditors.

Counterparty Risk – Financial Broker

Our firm is not a product provider and does not engage in handling client cash. We will only ask for payments to be made out to the product provider or their paying agent. Just as importantly, in the case of redemptions the funds will come in the form of a cheque payable to you, issued by the product provider or their paying agent. It is almost impossible, therefore, that we (or any competitor who adopts the same practices) could misappropriate your funds.

Regulated Financial Brokers are covered by the **Investor Compensation Scheme**. This provides compensation to private individuals of 90% of their loss, up to a maximum of €20,000, in the event that the Broker defaults on their financial obligations to clients.

Regulated Financial Brokers are also required to hold professional indemnity cover for negligent errors of €1.85 million.

Excessive Costs

Fees and charges can be quite complex and may include policy fees, allocation rates, bid/offer spreads, management fees and early surrender penalties. Over the long term the impact of charges can be very significant and a key part of our service is to assess all the cost information and explain it to you as clearly as we can. The level of costs and the certainty around them will form part of the analysis on which we base our advice to you.

Taxation Risk

All investments are subject to taxation, either actual or potential. Governments have virtually unlimited power to 'move the goalposts' and apply a harsher taxation treatment during the lifetime of your investment. In recent years both DIRT and funds exit tax rates have been edged up and the arbitrary 0.6% levy applied to private pension funds is an even starker example of tax changes interfering with investment outcomes.