'The same approach to risk will mean less confused clients'

FinaMetrica co-founder and director Paul Resnik discusses the 'five proofs', which encourages the client to take part in the decision-making

A major challenge for many investment advisers and consequently investment managers and others who provide support services to meet advisers' needs is a clear and coherent approach to investment suitability.

The FSA's March 2011 guidance paper made it clear that suitability with regard to risk was not being undertaken to a satisfactory level generally and that nine of the 11 risk profiling tools reviewed failed to pass muster. There was a flurry of changes in the ensuing months as the industry and risk profiling tool suppliers attempted to take account of the FSA's concerns. But how effective were the changes?

Obviously, the FSA remains concerned. In its recently published Retail Conduct Risk Outlook 2012, it said: "...most of the drivers of the risk still persist and there remains recent evidence of ineffective customer risk profiling across the range of different firms giving investment advice" and: "Our recent thematic and supervisory work has concluded that consumer risk profiling is ineffective across a range of different firms giving investment advice."

It is not a huge leap of logic to suggest that, prima facie, a percentage of investment recommendations made using processes that failed to meet the FSA standards generated inappropriate recommendations. The simple tables below provide some insight as to how to calculate the number of clients and the sums involved. The key inputs are the number of advisers offering advice, their typical number of clients and average sums of money invested.

Even after discounting for the fact that not all risk profiling errors will have resulted in bad advice, the number of clients and amounts invested are still very substantial. This probably explains why so little emphasis has been placed on reviewing clients advised prior to the issue of the guidance paper.

So how might the industry have found itself in this position?

When reviewing the advice behaviours of generally bigger advisory firms, there are often significant inconsistencies in the way they:

- Allow their recommended fund managers to confusingly explain risk
- Inaccurately and inconsistently assess investors' risk tolerance,
- Do not have a defensible and rigorous method for linking risk tolerance to portfolios
- Accept their advisers' use of non-standardised and personal descriptions of financial risk and volatility with investors.

Researching good adviser activities here in the UK, the US, Australia and elsewhere shows a broad pattern of best practice that can be summarised as the "five proofs". In essence, it is an approach to advising that encourages the client to participate in the decision-making. It results in a suitability process that makes good sense to regulators and compliance managers and, most importantly, allows advisers to sleep comfortably at night knowing they are doing a good job for their clients. They are:

- Prove you know your client, their circumstances, needs and aspirations (particularly their risk capacity)
- Prove you looked at the alternative strategies available to them – change goals, work longer, etc
- Prove you know the product/s recommended. You should know the critical issues such as all the costs involved and any conflicts should be fully disclosed. Specifically, you should know how the product might behave when there are extreme market conditions, such as changes in liquidity or valuation methods, and performance outliers
- Prove you explained the risks in the product/s recommended and the proposed plan to the client
- Prove you received your client's consent to the risk in the plan and the product.

Good examples of the process that can be adopted to deliver suitable investment advice has been termed Adapt. It starts with a robust assessment of financial risk tolerance and the production of a detailed personalised risk report consistent with the FSA's guidance. The five steps in the Adapt suitability process are:

- Awareness: by reading through their risk tolerance report clients should understand their risk tolerance compared to the population with particular emphasis on any meaningful differences they have from the norm.
- Discuss: advisers should talk through the risk tolerance report with their client(s), with particular emphasis on any differences from their risk group and any partner. They should agree a risk score which will be the client's instructions to the adviser about the level of risk they would prefer to take.
- Asset allocation link from agreed risk score. The adviser should have a logical basis for taking the risk score to a possible portfolio recommendation.
- Project asset allocation forward using cash flow modelling to confirm moneys will be available to meet clients' needs as they fall due and test for risk capacity. This iterative cycle would include testing for minimum and preferred lifestyles, working longer, use of non-investment assets, etc. It is highly likely that the asset allocation that has a high likelihood of meeting their needs would be significantly riskier than the one that is consistent with their risk tolerance.
- Test client understands the risks, particularly frame performance and volatility expectations as this is critical input into the final part of the planning process, obtaining their informed consent to the risks in both the plan and the investments.

> 'The key inputs are the number of advisers offering advice, their typical number of clients and average sums of money invested'

Probably the most important issue is to manage the usually inconsistent explanations of investment risk that clients receive from their advisers and their fund managers. The difference can be found in the different intents of each business. The fund manager generally paints the investment in the best possible light whereas the adviser has a fiduciary obligation to the client to disclose realistic outcomes, particularly extreme events. When advisers and fund managers adopt a similar approach to explaining returns and risks, clients are less likely to be confused.

The Adapt process clearly aligns with the intent of the five proofs and provides a logical basis for taking clients' individual needs and circumstances to a matching portfolio recommendation. In turn, the client's expectations for the likely returns from and volatility of the portfolio will have been appropriately framed to minimise surprises. All in all, probably just what the FSA and clients expect.

Total number of clients

Adviser numbers	200 clients per adviser	500 clients per adviser	750 clients per adviser
25,000	500,000	1,250,000	1,875,000

What total amounts might be at risk of being misadvised?

Total amounts at risk

Number of clients	£50,000 per client	£100,000 per client
500,000	£250bn	£500bn
1,250,000	£625bn	£1,250bn
1,875,000	£938bn	£1,875bn