



## FEATURE ARTICLE

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Issued by: **Andrew Gadd, Head of Research - Lighthouse Group**

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### **What's in a Name?**

In my career to date in financial services I have come to understand that just as you should never judge a book by its cover you should be very careful in terms of judging a fund by its sector.

As we are all aware due to the large number of funds that investors can potentially invest in the Investment Management Association (IMA) runs a classification system based on sectors. The IMA sectors divide up over 2,500 of the funds available in the UK, including some offshore (EU) funds, into smaller groups. There are over 30 IMA sectors. Many of the sectors focus on investment strategy such as income or growth while others focus on capital protection or are so-called specialist sectors such as Absolute Return. The IMA sector classifications should help you to understand the broad focus of different groups of funds, with many based on geographical restrictions. Putting funds into sectors should also mean that you can compare similar funds, e.g. maybe in terms of performance or fund charges?

One particular IMA sector grouping that has had a great deal of press coverage recently is the Managed sector. With reference to this grouping and the specific sector definitions within it (especially Cautious Managed) the problem for me is that unfortunately "cautious" in this sector classification does not necessarily equate to a level of risk that many might think appropriate/acceptable!

The most high profile example of this recently was Arch Cru. As I am sure many of you are aware the Arch Cru Investment Portfolio was listed in the IMA Cautious Managed sector despite the fact that it invested heavily in private equity and private finance. When this investment failed the IMA said that the sector's name related to the sorts of assets held in the funds listed in their sectors rather than their risk levels – in fact an IMA spokesperson specifically commented at the time that: "The word cautious should not be taken literally. It's actually asset-based rather than risk based. None of our sectors are risk based."



Now with reference to the Arch Cru investment this qualified for the Cautious Managed sector on asset allocation grounds but at the same time it demonstrated a low volatility figure and this was seen by some IFAs as further evidence that this was indeed a cautious investment. The low volatility figure should however have been questioned. In the case of Arch Cru the low volatility figure was achieved at the “risk” of reduced liquidity and that was ultimately the undoing of the fund.

Of course the IMA are not the only organisation to provide sector classifications. Another example is the Association of British Insurers (ABI) and according to their website:

“Do the sectors explain risk? No, the sectors are not designed to reflect the relative risk of funds. They are designed to group together funds that are similar, so that they may be compared on a like for like basis.”

Now as a result of criticism of sector classifications in February this year the ABI announced that sector names including “Cautious” and “Balanced” were to be replaced with “Mixed Investment” plus a clear statement of how much each type of fund can hold in equities. The ABI said that the new labels were, “Significantly less likely to lead to misinterpretation” and decided to change its sector names after research among consumers found that the existing names failed to adequately communicate risk. Thus from April this year instead of, for example, a “Cautious Managed” sector the ABI now have a “Mixed Investment 20 to 60 per cent shares” sector.

In response to this in May this year the IMA announced that after reviewing their sector classifications they planned, from July, to rename the Managed sectors A, B and C and to introduce a new Managed D sector. The IMA explained that the new names had been chosen to show that the funds in these sectors are in some way “managed” – which indicates that the manager has a degree of discretion (in this case relating to a degree of freedom over asset allocation) that is not present in all sectors. With reference to this the IMA explained that: “The names are intended deliberately to provide no other information about the sector, thereby encouraging users of the sectors to do more due diligence to understand the nature of funds that would fall into the underlying sectors. The use of A, B, C and D does not even indicate the order of the risk/ reward hierarchy across the four sectors, and to access this information the user would have to access the definition.”

There was however such a large negative response to this from the investment industry that the IMA has been forced back to the drawing board for further consultation and has said that new proposals will be brought to the table in due course.

### **So where do we go from here?**

Fidelity have said that their main criticism of the ABI names is that by stating the equity content, it implies this is the only risk element in the fund, Fidelity wants the IMA to focus on the amount the fund can invest in total in “risk assets”. Fidelity have explained that with derivatives now widely used and a



number of other asset classes like property and commodities now common place in managed funds, they feel that focusing on equities could be completely misleading.

Fidelity have therefore suggested names similar to those used by the ABI but with sector definitions based on a maximum percentage in "risk assets". Fidelity believe that further details on these risk assets, and the risks present in all asset classes, could be included in the sector definition and/or notes.

Alternatively Rathbones have said one of the problems with the current IMA classification for Cautious, Balanced and Active is it encourages managers to take higher equity exposure to beat the peer group. Rathbones have explained that they believe that any significant reorganisation of the sectors must look at the "risk side" of the equation when determining what funds should be placed in which sectors and that funds should be categorised by the risk they are taking relative to equities, rather than by their equity exposure per se, and in addition each sector should have an ideal time horizon to which an investor should be willing to commit money, especially if there is an extreme market event.

Finally Blackrock have gone even further and are urging the IMA to adopt a framework for the Managed sector based on volatility bands, downside risk and diversification rules. Blackrock believes that each of these attributes are equally important and any sector definition should not be based on a single factor. Under Blackrock's proposed framework both the naming and structure of the Managed fund sector would be altered, addressing what it calls the "inadequate percentage/asset class" weighting approach. Blackrock believe that downside returns/risk should be considered a critical measure for the Cautious Managed sector because it can be understood intuitively by investors and the sectors should not be policed by a single measure. Blackrock therefore believe that introducing volatility bands, upper equity limits and "stress tests" would provide investors with the essential pieces of information they need to select a fund, with "worst case scenario" assessments likely to prove particularly useful.

## **Conclusion**

In my view all of the suggested new methods of sector classification have their merits but also have their problems, indeed I may be in a minority of one here but for me even the original new sector classifications suggested by the IMA had its merits.

As I see it the fundamental issue lies in the simple fact that past performance is in no way guaranteed to be a reflection of the future and therefore providing various statistical measures of risk is by definition potentially flawed in certain instances - although I accept that it is better than nothing.

Ultimately I believe that the bottom line is that there is no "magic" or perfect solution to Managed Fund sectors definitions, some suggestions are potentially too simplistic while others are potentially too complicated. Ultimately however whatever happens I believe you are going to have to "look under the bonnet".



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***General enquiries phone number: 08000 85 85 90***

***General enquiries email address: [enquiries@lighthousegroup.plc.uk](mailto:enquiries@lighthousegroup.plc.uk)***