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FEATURE ARTICLE

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Millionaire Portfolios

We are all aware of the various challenges facing IFAs at the moment such as the various aspects of the RDR and ensuring that we treat our customers fairly. With these challenges of course come opportunities and this is why, in my opinion, we have over the last few years seen strong growth in the area of multi manager investing and why indeed I think that this trend is likely to continue into the future.

First some background. Multi manager offerings can, in simple terms, be split into two main types, manager of manager and fund of funds. Manager of manager funds operate on the basis of the investment manager giving specific mandates to a range of individual fund managers to invest money as part of the overall portfolio while fund of funds portfolios are based on an investment manager purchasing a range of individual collectives from the general marketplace with each individual collective having an investment mandate that they themselves have specified. There are various arguments in favour and against each of these approaches such as the different cost structures and level of control exercised by the overall investment manager.

Within these broad classifications we can then have what are called fettered and unfettered offerings. Fettered funds are those that are limited to investment within an investment company's own funds while an unfettered offering is free to invest across the whole market. Again there are arguments for and against each of these structures with the main ones usually revolving around cost versus investment expertise in different geographical areas and indeed between different asset classes.

Focusing particularly on unfettered fund of funds offerings historically these have been criticised for their inherent double charging although in recent years competition pressures have meant that charges have come down and become more competitive. Advisers are also now focusing more on Total Expense Ratios rather then simply annual management figures.

So why have unfettered fund of funds become more popular over recent years?

Fund of funds have become popular with IFAs for a variety of reasons with the most obvious being that they offer a diversified portfolio of holdings in a single, tax efficient, actively managed fund.

Back in the 1990's and earlier many IFAs would put portfolios of collective funds together themselves for clients and "manage" these on an ongoing basis. Generally this appeared to be fine as long as markets were going up but it did raise a number of potential issues:

- Possible tax implications of moving underlying assets if they are not held within a tax efficient wrapper.
- For many IFA firms they are unable to commit resources to an investment management specialist who will monitor client's holdings on an ongoing basis and ensure that the portfolios match a client's attitude to risk.
- Any changes to fund holdings require a recommendation and subsequent approval from the client as these were generally not discretionary services.
- Performance measurement of any "model" portfolios difficult to measure against individual client portfolios as not a "wrapped" investment, such as a fund of funds unit trust.
- Asset allocation decisions/changes potentially difficult to implement – especially for smaller portfolios and relatively small changes to asset allocation models.
- Lack of specific expertise of the adviser in fund selection and risk appraisal analysis.

The result of all of this has been that as the investment market has become more challenging in a low growth low inflation environment and as new investment opportunities such as UCITs 3 appeared coupled with the regulator looking at ensuring that clients are treated fairly, outsourcing fund selection became a more attractive proposition to many IFAs.

Linking Risk and Asset Allocation

Now we all understand that when considering investments risk rating is vitally important because in the UK there are many examples of individuals being mis-sold products which did not match their risk profile. The benefits of getting it right however are also significant. From the client's perspective there is the opportunity to avoid unwanted investment experiences which are either too risky, or indeed what the Sandler review called "reckless conservatism" where many UK consumers adopt a "low risk" investment strategy at the risk of significant opportunity cost. Sandler also said in his Review of Medium and Long Term Retain Savings in the UK in July 2002 that, "Research has shown that asset allocation plays a significant role in standard investment returns but that it is often overlooked by intermediaries."

An additional driver for using fund of funds structures over recent years has therefore been the increased availability of fund of funds where the asset allocation of a fund of funds structure is directly linked to a client's individual risk profile. In particular I can think of the Lifestyle offerings from F&C and the risk rated funds from LV= Asset Management.

Now the assumptions behind risk profiling and asset allocation are all based on Harry Markowitz and his 1955 thesis on Modern Portfolio Theory. This theory proposed how investors use diversification to optimise their portfolios. The theory assumes that investors are risk adverse, meaning that given two assets that offer the same expected return, they will prefer the less risky one. An investor will therefore only take on increased risk if compensated by higher expected returns. Conversely an investor who wants higher returns must accept more risk. The exact trade off will differ by individual based on their attitude to risk. The implication is that an investor will not invest in a portfolio if a second portfolio exists which has better expected returns for the same level of risk. A Markowitz Efficient Portfolio is one where no added diversification can lower the portfolio's risk for a given return expectation (alternatively, no additional expected return can be gained without increasing the risk of the portfolio). The Markowitz Efficient Frontier is the set of all portfolios that will give the highest expected return for each given level of risk.

The aim is to achieve the highest return for an acceptable level of risk or alternatively the lowest risk for the needed rate of return. By identifying the right combination of assets matched to an investor's appetite for risk, risk can be reduced and the performance potential of an investment boosted.

The challenge for an IFA is determining an asset allocation which lies on the "efficient frontier" for the given risk profile of a client. If a portfolio sits on the efficient frontier it will, based on past performance, provide the best return that can be expected from a given level of risk, or the lowest level of risk needed to achieve a given expected rate of return. This illustrates the benefits of diversification; by changing the asset allocation based on the identified risk profile, an investor can be put on the efficient frontier.

The question is how does an IFA determine what a client's level of risk is, what an appropriate asset allocation is for this risk profile, populate this asset allocation on an ongoing basis with the "best" funds in the market and do all of this within a tax efficient environment? The answer in many cases is an unfettered fund of funds structure.

Of course funds such as F&C Lifestyle and others like them must be viewed with a certain degree of caution as well as from a positive perspective.

Investors should always remember that any asset allocation will always be based on past performance and that, as we all know, past performance is not necessarily representative of the future, especially over relatively short time frames. Indeed this is one of the reasons that fund of funds such as F&C Lifestyle allow the manager a degree of short term "tactical tilting" in terms of asset allocation while still meeting the longer term risk profile.

Also the cost issue is potentially still a factor in some cases but the fact is that at the end of the day you get what you pay for. If an adviser is looking for a fact finding process using behavioural finance principles leading to a risk rating which is then replicated by an investment with an asset allocation based on this risk rating on an ongoing long term basis with the underlying investment being a tax efficient portfolio populated with a range of collective schemes chosen for their qualitative and quantitative excellence in specific areas then offerings such as F&C Lifestyle and LV= Managed Portfolios will potentially be appropriate – one might even describe them as “Millionaire Portfolios” as some of the country’s wealthiest families have set up their own fund of funds unit trust structures to manage their wealth for them.

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