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Asset allocation in investment

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Intellectual property

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Introduction

Introduction

This free course is on asset allocation in investment. To start with, you will learn how to assess investor objectives and constraints and how to turn them into an expected return appropriate for the investor, with an amount of risk suitable for the investor.

In this course, you will also be introduced to how portfolios can be put together which meet investor requirements and also deal with the investor's particular constraints, such as tax, currency, or regulation.

This OpenLearn course is an adapted extract from the Open University course B861 *Investment and portfolio management*.

Learning outcomes

After studying this course, you should be able to:

- recognise how typical client objectives and constraints impacts on asset allocation
- set client risk and return objectives in the context of an asset allocation process
- describe the reasons for a written investment policy statement and its major components
- recognise typical client objectives and constraints and how these impact on portfolio choice
- explain how to set client risk and return objectives in the context of an asset allocation process

1 Model portfolios and asset classes

In this section, we look at publicly available model portfolios aimed at individual investors. Instead of tailor-making the portfolio for each individual's specific needs – a service usually offered only to ultra-high net worth individuals with assets in the tens of millions of dollars - most individual investors are typically offered a limited range of model portfolios ranging from low to high risk. We look first at the APCIMs model portfolios and then at model portfolios based on investor questionnaires offered by an internet trading company.

A publicly available version of the model portfolio approach for individual investors is the APCIMS Private Investor Index Series, launched in the late 1990s and now called the FTSE/WMA Private Investor Index Series. At that time APCIMS offered three model portfolios aimed at providing UK private clients with benchmarks for three investment strategies: income (lower risk), balanced (medium risk) and growth (higher risk).

The FTSE/WMA index series originally included four different asset classes: UK equities, non-UK equities, UK bonds and cash. The proportions varied according to the level of risk acceptable to the client. By choosing UK equities, UK bonds and UK cash, as three out of the four suggested asset classes, the currency risk to a UK investor was minimised. The constituents of the FTSE/WMA indices have changed over time, and now include hedge funds and commercial property to provide yet further diversification. Table 1 shows the percentages recommended in 2000.

Table 1: FTSE/WMA index weightings for different risk portfolios in 2000

Model Portfolio	Income (%)	Balanced (%)	Growth (%)
UK equities	50	55	60
Non-UK equities	5	20	25
UK Bonds	40	20	10
UK Cash	5	5	5
Total	100	100	100

Source: http://www.ftse.com/products/downloads/FTSE_WMA_Private_Investor_Index_Series_Asset_Allocations.pdf

A broader approach to low and high risk was taken by Gregory and Rutterford, who developed a set of model portfolios in 2000, using portfolio theory optimisation and based on the then most recent ten-year historic performance of return, risk and correlation between asset classes and allowing for short-term as well as long-term investment objectives. This was also aimed at UK investors.

Gregory and Rutterford developed an investor questionnaire for an on-line broking firm for individual investors. The questions asked were divided into two sections, those relating to risk tolerance and those relating to time horizon. According to the scores in each section, one of five types of portfolio was recommended – conservative, moderately conservative, moderate, moderately aggressive and aggressive.

The model portfolios are shown in Table 2

Table 2

Model Portfolio	%UK equities	%ROW equities	%Gilts	%Tbills	Geometric Return %	Std. Dev
Conservative	10%	10%	10%	70%	10.6	3.6
Moderately Conservative	20%	20%	20%	40%	11.8	7.2
Moderate	30%	30%	30%	10%	12.9	10.8
Moderately Aggressive	50%	30%	15%	5%	13.8	14.0
Aggressive	80%	15%	0%	5%	14.8	17.9

Here a conservative portfolio for an investor with low risk tolerance and a relatively short time horizon included 20% equities (UK and Rest of World (ROW)), 10% UK gilts and 70% Treasury bills. An aggressive investor using this set of model portfolios would invest 95% of his or her portfolio in equities.

1.2 Investor objectives

It is usual for investment advisers to get potential clients to fill in a questionnaire to try to ascertain the investor's risk and return requirements. The activity which follows is based on an actual investors questionnaire. Select view to access the questionnaire.

Activity 1 Investor questionnaire

Allow around 30 minutes for this activity.

Now complete the individual Investor Questionnaire designed by Gregory and Rutterford and determine which model portfolio from Table 2 is deemed appropriate for you. Once you have completed it, and found the model portfolio recommended to you, consider whether you think it is right for you in terms of asset allocation.

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2 Risk and return expectations

One important reason why investors today might not hold the same equity proportion as in 2000 is that the portfolios recommended by Gregory and Rutterford were estimated using historic ten year returns, standard deviations of returns, and correlation coefficients. In other words, their recommended model portfolios were based on what had happened in the 1990s and not on what was expected to happen in the 2000s. That a particular ten-year return is likely to be repeated in the following ten years is highly unlikely. An analyst forecasting ten-year returns would like more than one data point to be confident of his forecast. For example, the Barclays Equity Gilt Study goes back to 1900, which is only 11 or so decades ago. In addition, economic conditions may have changed so that, even with a long historic time series, forecasts of future returns, volatilities and correlations may not be appropriate. Seismic events such as 2008 and 2016 have woken investors up to the fact that risk cannot be measured by volatility alone. Which is why there is much more emphasis on liquidity – is an asset saleable within a reasonable time frame? – and on drawdown - the decline in value from peak to trough over a period - as well as how long a portfolio takes to recover that loss.

The investment management regulator, the Financial Conduct Authority or FCA (previously called the FSA), has recognised that the simple measure, volatility or standard deviation of returns, is not enough to capture the complexity of risk as understood by investors.

2.1 Identifying client attitude to risk

Read the FSA (now the FCA) factsheet Attitude to risk - an adviser prompt and answer the question in Activity 2.

Activity 2 Types of investor risk

Allow around 20 minutes for this activity.

List three aspects of risk - other than standard deviation or historic volatility – which are relevant to the investor and are mentioned in the FSA factsheet.

Provide your answer...

Answer

The three aspects of risk mentioned in the FSA factsheet that are relevant to investors are, economic and political risk relating to factors such as interest rates, the inflation rate, and possibly exchange rates.

The ability to understand risk. Financial literacy (also known as financial capability) is part of the UK government's strategy to help potential investors make risky investment decisions in as informed a way as possible.

The third is to do with expectations. As mentioned above, the past is not a good predictor of the future. This is why investment management firms and advisers spend a lot of time forecasting future returns and risks for different asset classes.

3 Pensions at a glance

Another reason why equities appear in relatively high percentages in the APCIMs model portfolios, and in those recommended in the Gregory and Rutterford questionnaire, is that the UK investment management industry prefers equities to bonds. The UK has a long tradition of equity investment going back to the South Sea Bubble in 1720 and beyond. Countries such as Germany, on the other hand, have a tradition of preferring bonds, also aided by history (the equity market collapsed under hyperinflation in the 1920s), and regulations may not allow insurance companies or pension funds in certain countries to buy equities at all.

Activity 3 Pension fund reading

Allow around 30 minutes for the reading and activity below.

The OECD document 'Pensions at a glance 2013' shows that bonds and equities combined make up the highest proportion of pension fund portfolios. But, despite having similar investment objectives, pension funds differ a lot in terms of asset allocation across countries, especially in terms of bonds and equities.

Read pages 196-7 in Chapter 8 of *Pensions at a Glance 2013*. It shows that bonds and equities combined make up the highest proportion of pension fund portfolios. But, despite having similar investment objectives, pension funds differ a lot in terms of asset allocation across countries, especially in terms of bonds and equities.

3.1 Equities in pension funds

We will now explore how pension fund asset allocations differ across countries.

Activity 4 Pension fund asset allocation

Which three countries have the highest proportion of equities in their pension funds?

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Provide your answer...

Answer

Australia, US and Finland.

Do you think this alters when looking at public pension plans?

Provide your answer...

Answer

Yes, the US is near the bottom in terms of equities and Australia only average for public pension plans.

Now which three countries have the smallest amount of bonds and equities as a proportion of the total?

Provide your answer...

Answer

Germany, Japan and Korea all have less than 50% of their portfolios in bonds and equities. Korea has a lot of cash, the other two countries have a significant proportion in ‘other assets’.

This leads us to the third reason why you might think equities are overweight in the model portfolio allocations. We discuss this in the following sub-section, Choosing asset classes.

4 Choosing asset classes

In this section you will look at the choice of asset classes available to investors, how this has changed over time, and how this has affected the choice of what investors include in their portfolios.

4.1 Trends in asset classes

Since the 1980s, a number of new asset classes have been added to the three basic types of asset: equities (UK and non-UK), bonds, and cash.

The figure below shows how, in the last few decades, more and more asset classes have been added to the opportunity set to aid portfolio diversification.

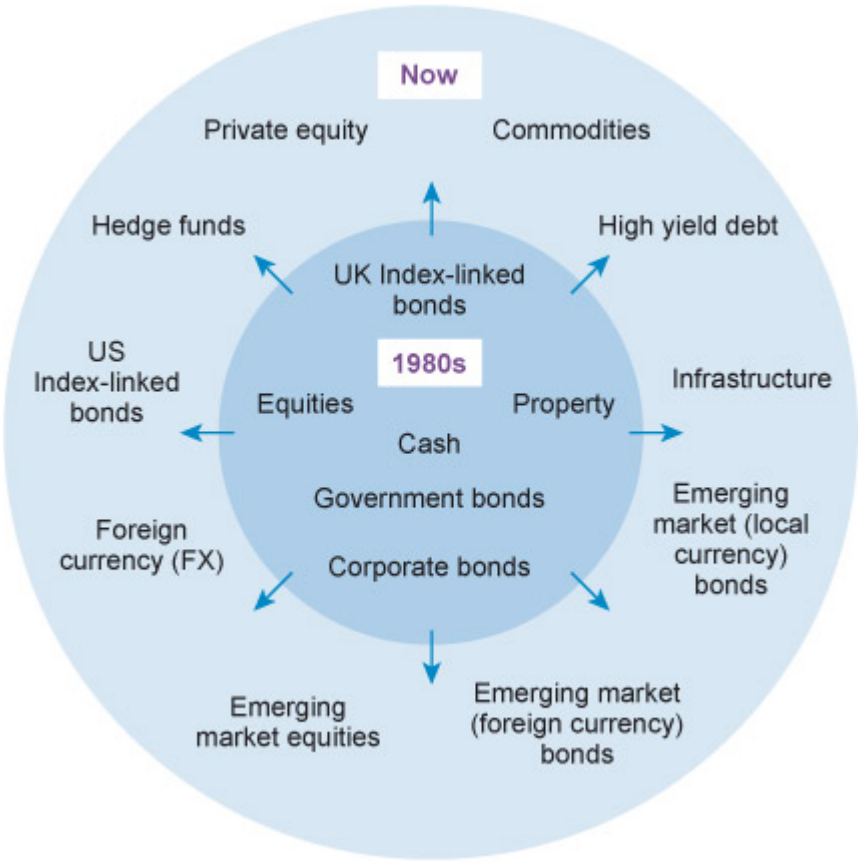

Figure 1: Trends in asset classes

For example, since the early 2000s, new types of asset, sometimes called alternative assets, have been developed. These include private equity, hedge funds, commodities, infrastructure funds, structured products, and many more. Private equity is equity investment in companies not listed on a stock exchange, often with substantial leverage to raise expected equity returns. Hedge funds are funds with specialised investment strategies, often using leverage and derivatives, aiming to offer a good return per unit of risk and low correlation with conventional bond and equity markets. An example of a hedge fund strategy is so-called long/short (buying shares expected to rise in value, selling short those shares expected to fall in value, with zero net exposure to the stock market).

Credit ratings allowed the development of complex bonds which could be structured to provide particular levels of credit rating, such as high yield, to meet particular investor

needs. High yield debt is debt issued by companies which have a below investment grade rating (or which has become high risk through poor performance). Commodities include gold, energy, minerals, etc., and infrastructure includes housing, railways, windfarms and motorways.

4.2 Changing asset allocation over time

Activity 5 changes in benchmark asset classes over time

Allow around 30 minutes for this activity.

Check the FTSE/WMA website and see which asset classes have been added to those shown in Table 1. Compare the equity and bond percentages in model portfolios now with those in Table 1.

Which asset class(es) has(ve) been reduced to allow for the introduction of new asset classes?

Provide your answer...

Answer

The latest update at the time of writing was for portfolios from June 2015.

You can also access up to date information on FTSE WMA Private investor index series asset allocation.

Table 3: FTSE/WMA model portfolio as at June 2015

Model portfolio	Conservative (%)	Income (%)	Balanced (%)	Growth(%)	Underlying asset index
UK equities	19	35	37.5	40	FTSE All-Share
Non-UK equities	11	17.5	30	37.5	FTSE All World. ex-UK
Bonds	45	32.5	17.5	7.5	FTSE Gilts All Stocks
Cash	5	5	5	2.5	7 day LIBOR-1%
Commercial property	5	5	5	5	FTSE All UK Property
Hedge funds/ Alternatives	15	5	5	7.5	FTSE/APCIMS Hedge (investment trust)
Total	100	100	100	100	

The most recent equity percentages are a maximum of 77.5% for the Growth portfolio compared with a maximum of 85% in 2000. However there is a swing towards non-UK compared to UK equities.

The equivalent figures for bonds/gilts are 45% now and were 40% in 2000. This increase can be explained by the introduction of a new model portfolio, called Conservative, which has almost half its asset allocation in bonds.

A maximum of 20% is invested in alternative asset classes – commercial property, hedge funds/alternatives - but these are used in both the low risk and higher risk portfolios. It is mostly bonds which have been reduced in importance to allow for alternatives. Note that the general term 'bonds' is used, rather than the more restrictive term, 'UK gilts', so that bonds may include high yield and/or non-UK bonds, which are riskier in sterling terms than gilts. However, the performance benchmark used is still a gilts index.

To summarise, perceptions of which asset classes to include change over time. This is partly to do with supply - for example it was relatively difficult to buy emerging market equities or bonds in the 1980s – and partly to do with demand - hedge funds, for example, can be designed to be uncorrelated with equity markets (although this does not always turn out to be the case in practice) and structured bond products can be designed to offer the particular credit rating sought by the investor.

4.3 Decline in demand for equities 1

The next activity explores why demand for equities worldwide has changed over time.

Activity 6 Global equity demand

Allow around 30 minutes for the reading and activity below.

Read McKinsey's executive summary on the future decline in demand for equities globally – the equity gap.

Select the five reasons why McKinsey expects major decline in demand for equities by 2020.

- ☐ Increased wealth in emerging economies
- ☐ The aging population of developed economies
- ☐ Developed economics are switching from defined benefits to defined contribution schemes
- ☐ Higher income tax rates on dividends
- ☐ Increased regulation on insurance companies
- ☐ The 2008 crash made investors wary of equities which was riskier than bonds
- ☐ Basel 2 and 3 regulations penalises financial institutions for holding equities
- ☐ Reduced wealth in emerging economies
- ☐ The 1929 Wall Street Crash

Answer

These are:

1. Increased wealth in emerging economies where tradition favours bank deposits or bonds.
2. The aging of the populations of developed economies: older people tend to hold more bonds and less equities than younger people in their portfolios.
3. Developed countries are switching from defined benefit (DB) pension schemes to defined contribution (DC) schemes which has the effect of moving market risk from the employer to the employee. Individuals with DC schemes are more risk averse than investing institutions investing on their behalf in DB schemes and so hold a higher percentage of bonds in their pension plans.
4. The crash of 2008 made investors wary of equities which are risker than bonds, especially given the good performance of bonds over the recent past.
5. Regulations such as Basel 2 and 3 penalises financial institutions such as banks from holding equities.

4.4 Decline in demand for equities 2

We now explore possible change in equity demand which may have changed since the McKinsey Report was written.

Activity 7 Recent developments in global equity demand

Allow around 15 minutes for this activity.

Do you think the arguments outlined in Activity 6 above have changed with respect to decline in demand for equities (made by McKinsey in 2011) since the paper was written?

Provide your answer...

Answer

1. As bond yields have fallen, investors may shift into equities.

2 & 3. The new rules on pensions in the UK are encouraging people to remain partially invested even after retirement. Also DC pensions can be invested in lifestyle funds which typically have a high equity content until 10 years before retirement. And the retirement age is increasing over time. 4. Equity returns have been relatively good since 2011. Also, Government bond yields are at record lows as a result of quantitative easing. Currently, around 40% of Eurozone bond yields are negative. The central banks are encouraging investors to buy riskier assets – so-called financial repression.

5. Given perverse incentives for institutions such as pension funds and insurance companies (e.g. the more bond yields fall, regulations require them to buy more bonds to meet their liabilities), there is likely to be a loosening of regulations which will allow these institutions to buy more equities.

What is the key behavioural bias that this highlights?

Provide your answer...

Answer

Individuals saving for retirement with DC pension funds invest less in equities (are more risk averse) than investment intermediaries when investing on individuals' behalf in DB schemes. The attitude to risk is different even though the investment objective – a good pension – is the same.

5 Yale endowment case study

We now explore the asset allocation of a US endowment fund, that of Yale University.

Activity 8 Asset allocation in practice

Allow around 45 minutes for the reading and activity below.

Read the first seven pages of the Yale endowment fund annual report for 2013. In particular, note its unusual asset allocation and the boxes on the Yale model and liquidity.

5.1 Yale endowment asset allocation

The following activity examines the unusual aspects of the asset allocation of the Yale endowment fund.

Activity 9 Critiquing the asset allocation strategy of the Yale endowment fund

What are the unusual aspects of the Yale Endowment asset allocation?

Select the correct answers from the options below.

- ☐ Yale has most of its assets in US equities.
- ☐ Yale has more unlisted than listed equity.
- ☐ Yale has large real estate and natural resources assets which can increase in value over the long term.
- ☐ The high allocation to absolute return or investments designed to never have negative returns.
- ☐ The low allocation to domestic equities and bonds.
- ☐ Yale has more listed than unlisted equity.
- ☐ Yale aims to match the relevant indices.
- ☐ Yale uses portfolio theory to determine its asset allocation and alters this in subjective ways.
- ☐ Yale uses equal weighting for its asset allocation.

Answer

Yale has a large percentage in assets which can be expected to increase in value over the long term – real estate and natural resources. This reflects its very long term time horizon. This is why Yale is less preoccupied with liquidity than other types of investor.

Yale has a very active strategy with respect to equity – it has more in unlisted (private) equity than in listed equity, but even the listed equity is chosen to be very different from a standard spread of US equities linked to, say, the S&P 500 index.

The high allocation to ‘absolute return’, in other words, investments designed to never have negative returns. These are often benchmarked relative to a 100% cash benchmark.

The low allocation to domestic equities and to bonds – just over 10% in total. This is very very different from the classic allocation of pension funds around the world of around 80% bonds plus equities.

Note how Yale uses mean variance analysis (Portfolio theory) to determine its asset allocation but also note how it alters this in a number of subjective ways.

6 Introduction to investment policy

This section looks at how an investment policy can be determined, considering the scope and purpose of the investing institution or individual, issues of corporate governance – which crop up when fund management is delegated to a third party – investment return and risk objectives, and risk management which includes how to measure performance and what policy to adopt with respect to rebalancing.

6.1 The investment process

The following activity will allow you to explore a template for an investment policy statement as recommended by the CFA.

Activity 10 Investment policy statement template

Allow around 45 minutes for the reading and following activity.

Read the document by the CFA entitled
Elements of an Investment Policy Statement for Institutional Investors.

What are the key elements to be included in a policy statement?

Provide your answer...

Answer

The key elements of an investment policy statement are:

- Scope and purpose
- Governance issues
- Investment, return and risk objectives
- Risk management including performance and risk measurement plus a process for rebalancing.

We will discuss risk management issues in more depth in Unit 6.

An example of a long-term return objective is often given in real terms. Why do you think that is?

Provide your answer...

Answer

The level of inflation current at the time of specifying the investment policy may be very different from levels of inflation experienced in the decades to come. Real return objectives neutralise this potential problem. See Section 3b of the CFA investment policy statement.

When using an investment policy statement, how can you ensure that a portfolio is sufficiently diversified?

- ○ By specifying a strategic asset allocation of the different asset classes having used risk, return and correlation data to optimise the mix.
- ○ By employing a number of fund managers.

Answer

By specifying a strategic asset allocation of the different asset classes having used risk, return and correlation data to optimise the mix. See Section 2e of the CFA investment policy statement.

Give an example of a special factor which might be included in the investment policy statement.

Provide your answer...

Answer

One example is the exclusion from the portfolio of securities in the same industry as the company whose pension fund investment policy is being considered. For other examples, see Section 2e of the CFA investment policy statement.

Now look at some investment policies in action.

6.2 Alpha case study

The case study below explores an actual investment management agreement and what constraints were imposed in terms of asset classes on the investment manager.

Activity 11 Investment management case study

Allow around 45 minutes for this activity.

This is an extract from the investment management agreement (IMA) for a British charitable foundation (endowment fund), code name Alpha, made in 2008.

The table below gives the benchmark portfolio and the risk constraints on the portfolio, imposed through maximum and minimum percentage values for the asset classes and also for the types of assets to be included in the portfolio. The stated investment objective was to outperform the benchmark portfolio over rolling three year periods.

Table 4: Benchmark asset allocation, benchmark indices and constraints for Alpha portfolio

Asset class	Allocation (%)	Ranges (%)	Benchmark index
UK Equities	50.0		FTSE All Share
Global Equities	25.0		
	(33.4)		FTSE AW North America
	(33.3)		FTSE AW Developed Europe (ex UK)
	(33.3)		FTSE AW Developed Asia Pacific (inc. Japan)
Equities	75.0	60.0-85.0	
UK Bonds	25.0	15.0-40.0	FTSE A All Stocks
Total	100.0		
Overseas Assets		15.0-35.0	
Non-benchmark		0.0-20.0	
Higher Risk Non-benchmark		0.0-7.0	

Additional constraints

Bond investments are to be in investment grade A or higher. Higher risk non-benchmark assets (e.g. emerging market equity or debt, or securities investing in illiquid assets) should be limited to 0.0-7.0% of the portfolio, forming part of the 0.0-20.0% of the non-benchmark assets. Non-benchmark assets are assets which do not form part of the designated benchmark indices. Direct investment in illiquid assets is not allowed, e.g. hedge funds, real estate, private equity but is allowed if investment is made via a fund which provides liquidity.

What are the three main investment characteristics of this investment mandate?

Select the correct answers from the options below.

- ☐ More than 50% in bonds in the portfolio
- ☐ Growth
- ☐ Emphasis on liquidity
- ☐ A majority in overseas assets
- ☐ Discretion to fund managers on what they could buy

Answer

The main investment characteristics of the mandate are growth (a high proportion of equities), an emphasis on liquidity, and a considerable amount of discretion given to

the fund managers in terms of what they can buy and how much they can deviate from the benchmark portfolio.

List three ways in which risk been constrained in this portfolio.

Select the two correct statements from the options below.

Risk has been constrained by:

- ☐ Quantifying risk by tracking error in the benchmark portfolio
- ☐ Limiting the amount of higher risk in any asset class
- ☐ Limiting the amounts in a particular asset class

Answer

Risk has been constrained by limiting the amounts in a particular asset class and by limiting the amount of higher risk securities in any asset class - through credit rating, through type of market (developed/emerging) and through liquidity. However risk has not been quantified, e.g. in terms of tracking error with respect to the benchmark portfolio.

Which of the following statements is correct about constructing the most risky portfolio within the investment guidelines?

- ○ 60% equities and 20% non benchmark
- ○ 85% equities and 7% higher risk non benchmark

Answer

Assuming that higher risk non-benchmark assets are the riskiest investments, the highest risk portfolio would be, say, 7% higher risk non-benchmark investments and 85% equities, with the remaining 8% in non-benchmark assets. However, given the requirement for a minimum of 15% in bonds, the non-benchmark assets would have to be bonds.

What do you think were the riskiest assets in the Crash of 2008?

Provide your answer...

Answer

In practice, many so-called structured bonds had credit ratings which under-estimated their true risk, so the ‘bond’ and ‘non-benchmark’ categories performed poorly. Also funds investing in illiquid assets themselves proved to be illiquid and many suspended pay-outs and suffered losses, although they had promised investors liquidity.

6.3 CalPERS case study

This activity explores the long-term asset allocation strategy of a US public sector pension plan with an ethical stance.

Activity 12 CalPERS asset allocation

Allow around 45 minutes for this activity.

Now look at the web site of CalPERS (California Public Employee Retirement Scheme), one of the largest investing institutions in the world. It is the public sector pension fund for the state of California with assets of around $300bn. In particular, look at their assets and their asset allocation strategy.

Watch the video of the CEO of Calpers on sustainability.

Video content is not available in this format.

How does this compare with those of Yale and 'Alpha'?

Provide your answer...

Answer

CalPERS follows a strategic asset allocation policy that identifies the percentage of funds to be invested in each asset class. Policy targets are typically implemented over a period of several years on market declines and through dollar cost averaging. Listed below is CalPERS current asset allocation mix by market value and policy target percentages as of 30 September 2014. You will find a more up to date version when you access the website.

Table 5: Allocation & Market Value by Asset Class

Asset Class	Current Allocation (%)	Interim Strategic Target (%)!Warning! inherit not supported2	Actual Investment ($ Billions)
Growth	**63.1%**	**61.0%**	**$186.2**
Public Equity	52.5%	51.0%	$155.0
Private Equity	10.6%	10.0%	$31.2
Income	**17.7%**	**19.0%**	**$52.3**
Real Assets	**10.2%**	**12.0%**	**$30.0**
Real Estate	8.7%	10.0	$25.6
Forestland	0.8%	1.0%	$2.3
Infrastructure	0.7%	1.0%	$2.1
Liquidity	**1.9%**	**2.0%**	**$5.5**
Inflation	**5.4%**	**6.0%**	**$15.9**
Trust Level !Warning! inherit not supported3	**1.7%**	**N/A**	**$5.0**
Total Fund*	100.0%	100.0%	$295.0

Source: https://www.calpers.ca.gov/index.jsp?bc=/investments/assets/assetallocation.xml

Interim strategic targets adopted by the Investment Committee at the May 2014 Investment Committee meeting.

Trust Level includes: Absolute Return Strategy, Multi-Asset Class, and Overlay, Transition, and Plan Level. !Warning! inherit not supported*Figures are rounded for viewing purposes.

CalPERS clearly has a growth strategy with a total of 63.1% targeted for equities (public and private) as well as over 10% in illiquid 'real' assets. Unlike 'Alpha', it is prepared to invest in illiquid assets and is also interested in sustainable investment.

CalPERS, unlike Yale, states that it has decided to move out of Absolute Return strategies, i.e. out of funds which aim to generate positive returns, regardless of the state of the stock market. This is presumably due to disappointment at the performance of this asset class.

CalPERS has a very long term investment horizon, as evidenced by its emphasis on sustainability.

7 Ethics and regulation

This section focuses on the role of regulation in ensuring that investors, in particular retail investors are protected when they make financial investments.

7.1 Ethics and regulations

The FSA factsheet you are about to read highlights the importance of the seller of financial services 'knowing' his or her customer.

Activity 13 Know your customer

Read the Financial Conduct Authority (FCA) document entitled Our Strategy, dated 8th December 2014.

Read the factsheet provided by the FCA called Knowing your customer and assessing their needs.

What are the inherent conflicts in financial markets and how have these been dealt with by the role of the FCA?

Provide your answer...

Answer

Unregulated, competitive 'free markets' are desirable for efficiency and low costs but may lead to losses by retail investors. Also, financial market failure can damage the entire economic system.

The three operational objectives of the FCA, shown on page 5 of the FCA document, are the consumer protection objective, the competition objective, and the integrity objective. The conflicts have not been dealt with, merely acknowledged.

Which questionnaires are recommended for financial advisers to get their customers to complete?

Please select the correct answers from the options below.

- ☐ The retirement planning questionnaire
- ☐ A household income questionnaire
- ☐ The inheritance tax questionnaire
- ☐ The portfolio management questionnaire

To me, the surprising question was the one concerning political and ethical views. The customer can then be oriented towards ethical funds, which avoid investing in such sectors as weapons, tobacco or alcohol. You may have found other questions surprising.

Which question asked by the FCA did you find most surprising?

Provide your answer...

Answer

You may have been surprised by the question concerning political and ethical views. The customer can then be oriented towards ethical funds, which avoid investing in such sectors as weapons, tobacco or alcohol. You may have found other questions surprising.

7.2 Investment advice in practice

This activity looks at investment advice in practice and how it may not be as good as the templates seem to suggest.

Activity 14 Examples of poor investment advice

Allow around 30 minutes for the readings and activity that follows.

Read the letter from the FSA to CEOs of wealth management firms in 2011.

Read the press release and commentary on Bank Santander's £12.4m fine for not following 'know your customer' rules and mis-selling investment products as a result.

The FSA identified significant problems in a number of wealth management firms in 2011 and the CEOs of these firms were warned of this by the FSA. And yet, Bank Santander failed to act on the warning which led to a £12.4 million fine by the FCA in 2014.

What were the main problems with Santander Bank's advice to clients?

Select the correct answers from the options below.

- ☐ It failed to correctly identify customer needs and their attitude to risk
- ☐ It sold the customer email list to other organisations
- ☐ It failed to complete any type of investor paperwork
- ☐ It failed to check if products they sold to clients were suitable over time

Answer

It failed to correctly identify customer needs and their attitude to risk. It also failed to check, as it had promised, that products they had sold to clients continued to be suitable over time. Notice how the press release mentions a loss of trust on behalf of customers.

This is not a one-off. See the FCA list of press releases for an insight into the extent of mis-selling.

Conclusion

In this course free course, *Asset allocation in practice,* you have learnt how to determine different investor objectives with respect to risk and return and investor constraints such as investing in sustainable sectors or being concerned with taxation or currency issues.

You have seen that determining investor requirements allows investment advisers to create an optimal asset allocation for the portfolio which aims at an expected return appropriate for the investor, and with the amount of risk which the investor is prepared to take on.

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Table 1.1: adapted from:
!Warning! Tahoma not supportedhttp://www.ftse.com/products/downloads/FTSE_WMA_-Private_Investor_Index_Series_Asset_Allocations.pdf

2.1 Financial Services Authority Fact Sheet (2015) Attitude to risk – an advisor prompt (not exhaustive). http://www.fsa.gov.uk/ 7.1 Financial Conduct Authority (2014)

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