



**Adviser Forum**

**Good Practice Notes:**

**Attitude to Risk Questionnaires &  
Asset Allocation Tools**

**September 2007**



# Contents

- This document is not exhaustive but is designed to assist advisers in identifying suitable and adequate processes.
- This document has been prepared in good faith to assist adviser firms in assessing tools that may be used in the advice process, based upon current understanding of industry practice.
- Advisers are responsible for satisfying themselves as to the suitability and adequacy of the process.
- No liability can be accepted for decisions or actions that take place as a result of this document, E&OE.

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# Background to Working Group

## **Background**

- Adviser reliance upon Attitude to Risk and Asset Allocation tools is growing and they are now playing a significant role in helping advisers to determine advice.
- As a result advisers have stated that they need a better understanding of the underlying assumptions that the tools are based on as there are differences between tool supplier's offerings.
- For the avoidance of doubt, the term "tool suppliers" in this document refers to any organisation that is making investment planning tools available to advisers.
- Adviser Forum set up a short term working group to investigate the areas put forward by advisers.

## **Objectives of the working group**

- To identify what information could be made available to advisers to increase adviser awareness and understanding as to how investment planning tools operate.
- To develop a set of industry agreed guidance notes, incorporating good practice notes, a due diligence process and fact sheets to assist advisers further understand the different tool offerings.

## **Working Group scope**

- Investment planning tools that are available to advisers but not controlled/adjusted by the adviser firm (though in some cases the adviser/adviser firm may be able to make some modifications to the tool).
- Attitude to Risk Questionnaires (ATRQs).
- Asset Allocation modelling tools.

## **Areas deemed out of scope for Working Group**

- E-commerce functionality of investment planning tools.
- Stochastic Modelling tools (underlying assumptions and projections).
- Fund Selection tools.



# Short Term Working Group

## Adviser Firms

Heath Lambert	Sesame
SIFA	Three Sixty Services

## L&P Providers

Axa	Clerical Medical
Scottish Equitable	Scottish Widows
Winterthur	

## Tool Providers

Barrie & Hibbert	Distribution Technology
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## Wrap Platforms

Cofunds	Friends Provident
Standard Life	

# Achieving Good Practice

- The use of investment planning tools has become an integral part of the advice process. Risk profiling questionnaires have become embedded within the fact finding process. Investment advice frequently now involves the use of asset allocation / modelling tools. These help the adviser determine where the client should be invested and that the recommended portfolio is in line with their attitude to risk.
- Whilst the ideal would be for all advisers to source and manage their own tools, in the current environment, advisers are regularly using tools developed by third parties e.g. life and pension providers, wrap platforms etc. As a result advisers may not be involved in the development of the tool and therefore are reliant upon a third party interpretation of risk and their investment philosophy.
- The FSA however have highlighted the importance of advisers fully understanding how such tools operate.
- This document aims to assist advisers and tool suppliers in their understanding of the requirements and responsibilities of the parties involved in using and developing investment planning tools.
- The recommendations set out in the following pages have been produced as a result of industry collaboration and co-operation and is intended to create a Good Practice approach that organisations using or delivering such tools can refer to.

- DP 07/2 “Platforms: the role of wraps and fund supermarkets” makes specific reference to the role that investment planning tools are now playing part in the advice process.
- Whilst the DP refers specifically to Platforms it is reasonable to assume it should also be considered relevant to any providers making such tools available via their extranet sites.
- **Key messages from the DP:**
  - Advisers are ultimately responsible for any recommendations based upon the outputs of these tools.
  - Training and education of advisers is paramount where such tools are being used to assist in the advice process.
  - Regulator is concerned that customers could be disadvantaged if advisers fail to use tools properly.
  - Tool suppliers have a responsibility to ensure that advisers understand how their tools operate.
- Whilst the DP was published mid way through the Working Group’s activity, the contents of this document go some way to addressing the comments made by the Regulator in the aforementioned document.
- The key recommendations focus on:
  - Identifying the information advisers should be aware of prior to selecting / using a tool that is aiding the advice process.
  - Proposed framework for the delivery of this information to aid adviser understanding and education about the tools they are using.
  - The roles and responsibilities of suppliers who are delivering these tools to advisers, referring specifically to the provision of timely information and the appropriate facts.

# Attitude to Risk Questionnaires (ATRQs)

What are the issues?

- Advisers are taking a “pick and mix” style approach to ATRQs and Asset Allocation tools i.e. may use Supplier A’s risk profiling tool and Supplier B’s asset allocation model and *assume* they are all aligned to deliver the same outcome for the client.
  - There may be a lack of understanding about the different types of ATRQs available, what they are designed to do and how they function i.e. some produce a generic outcome and others are outcome specific.
- In response to these and other issues put forward by advisers, the working group focused their attention on addressing the following key areas:
1. Whose ATRQ tool are advisers using?
  2. What is the ATRQ tool designed to do?
  3. How Risk Questionnaires work and what outputs are produced?
  4. If and when changes are made to the ATRQ how are these communicated to advisers?

1. Advisers need to understand whose ATRQ they are using and whose assumptions are being used to determine the outputs.

## Recommendations to tool suppliers to address this:

- Include a clearly visible statement on the front of the tool stating whose assumptions are being used to determine any outputs. The following wordings have been put forward as suggestions as to how this need could be met:
  - “The ATRQ has been built by X organisation” or;
  - “The ATRQ has been built by X organisation though has been modified by Y organisation” – in this scenario the tool supplier should make available information to advisers outlining what modifications have been made to the ATRQ.

# Attitude to Risk Questionnaires (ATRQs)

2. ATRQs are not all the same and are not all designed to operate in the same way. To help educate advisers about these differences, tool suppliers should identify what their risk profiling questionnaire aims to do.

## Recommendations to tool suppliers to address this:

- Identify up front the type of ATRQ the adviser and client will be using e.g. is it assessing the clients psychological or behavioural attitude to risk or is it a combination of both.
- Identify up front what the questions are seeking to establish about the client:
  - Are the questions of a generic nature that can help to determine the client's overall attitude to risk?
  - Or, are the questions of a specific nature i.e. client has a specific financial goal and the questions will help to determine their attitude to risk in order to achieve that objective?

3. During the course of the working group's research, certain good practices were identified that advisers would like to see all tool providers adopt.

## Recommended good practice for tool suppliers:

- Provide descriptions of the types of risk profiles the tool uses i.e. cautious, balanced, adventurous. It would be helpful if these were clearly visible on the risk profiling tool itself and on any printable versions of the questionnaire.
- It would be helpful to include a validation process to assist the client check whether they have provided any responses that are inconsistent and provide a capability for clients to go back and review these responses and change them if necessary.
- ATRQ outputs could look to deliver the following information:
  - A risk profile (e.g. 1-10, balanced, adventurous etc).
  - A description of what that risk profile represents.



# Attitude to Risk Questionnaires (ATRQs)

- Language used to ask questions should be clear and concise and avoid setting overly complicated scenarios.
- Provide a facility to print off an attitude to risk questionnaire which includes all of the answers provided by the client as this can provide a useful audit trail for advisers.
- In addition, any reports generated by the ATRQ could also include details of all of the risk profiling questions and the responses provided by the client.
- General observation relating to ATRQs:
  - The number of questions offered by ATRQs can range from 5 – 25.
  - In some instances tool providers are offering multiple options i.e. advisers can select to use a questionnaire based upon 5 questions, 12 questions or 25 questions.
  - It has been recommended that advisers be made aware upfront as to how many questions are included within the questionnaire and whether there is an option to select from a range of questionnaires (i.e. 5 questions, 12 questions or 25 questions). Such information could be made available to advisers within the proposed fact sheets to help them understand the different approaches being taken.

4. It was identified that if a tool supplier should make any changes to the ATRQ, advisers would need to be notified about this. In response to this members agreed upon a process they felt addressed this requirement and would be feasible to deliver.

## **Recommended communication process for tool suppliers to assist them in notifying advisers when changes that are made to the ATRQ tool:**

- Advisers should be pro-actively notified in advance of changes being made including a description of what these changes will be.
- The initial notification to advisers should be made at least 2 weeks prior to any changes taking place. This is to cater for situations where an adviser and client are mid-way through the advice process. Consequently advisers will need to understand if the changes to the ATRQ will affect the process or any recommendations that have already been delivered to the client.
- The initial notification could be followed up with a reminder recapping details of the planned changes.
- There should be an actual notification on the tool itself for example, when adviser logs onto the tool there could be a statement advising them again of the changes that have been made. This could also include an acceptance process to confirm the adviser has read and understood this.
- This message should keep appearing on the advisers log in screen until the adviser has accepted that they have read and understood the changes.

# Asset Allocation Tools

What are the issues?

- There is currently a lack of transparency about the underlying assumptions used by the asset allocation modelling tool.
- As a result advisers may not always be clear as to how these assumptions affect the outputs that are generated by the asset allocation tool.
- Information not always readily available to advisers to aid their education and understanding.

- In response to these issues put forward by advisers the working group focused their attention on addressing the following key areas:
  1. What information do advisers need to improve their understanding of the underlying assumptions used by asset allocation tool?
  2. Why do different tools generate different asset allocation models for the same client risk profile?
  3. If and when changes are made to the asset allocation tool how are these communicated to advisers?

1. Advisers should understand whose asset allocation model they are using and who is controlling the underlying assumptions.

## Recommendations to tool suppliers to address this:

- It is strongly recommended that advisers are able to identify which organisation/s are responsible for developing the asset allocation tool. The following wording has been suggested to assist tool suppliers in meeting this requirement:
  - “Asset allocation model has been developed by XYZ third party”.
  - “Asset allocation model has been developed by XYZ third party and modified by life office/platform”- in this case if advisers require further information about the modifications the tool supplier should make this readily available to them.
  - “Asset Allocation model has been developed in house”.

# Asset Allocation Tools

- Equally it is felt that Broker Consultants should receive training to assist their own understanding of the tools their organisation is making available to advisers.
- It is recognised that in the event of an adviser having a query about the tool they may refer this to their Broker Consultant in the first instance.
- It would therefore be advisable if Broker Consultants could either respond to the query with accurate information or refer the adviser to an alternative source.

2. It has been recognised that different asset allocation tools can generate differing outputs for the same client. Whilst it is commonly accepted that there is no one ideal asset allocation model, there should be a mechanism in place to assist advisers to understand why such variances exist.

## Recommendations to tool suppliers to address this:

- It was agreed that the recommendations put forward to deal with changes for ATRQs could also be applied here:
  - Tool suppliers should proactively notify advisers in advance of changes being made to asset allocation model.
  - Initial notification should be made at least 2 weeks prior to change taking place (where changes are small), though it was recognised if changes were more fundamental a longer lead time needed to be applied. **If changes have been made to economic assumptions these must be declared.**
  - Issue a reminder closer to the time reminding advisers of the planned changes.
  - There should be an actual notification on the tool i.e. when adviser next logs onto the tool there could be a statement advising them again of the changes that have been made and could also include an acceptance process to confirm adviser has read and understood this.
  - This message would keep appearing on the advisers log in screen until they accept that they have read and understood the changes.
  - If an adviser does not wish to accept the changes the adviser will need to ensure they have an alternative course of action in place.

# Due Diligence Process

What are the issues?

- Feedback from advisers suggests that it can often be a difficult and time consuming process to collate all the necessary information they need to make a detailed assessment of the tools being made available to them.
  - As investment planning tools are still relatively complex it is important to give advisers the support and assistance they need to assess these services.
- 
- The purpose of this draft due diligence exercise is to identify a list of questions that the adviser can use to help them understand how attitude to risk questionnaires and asset allocation tools are developed and how they operate in practice.
  - It has also been recognised that different asset allocation tools can generate differing outputs for the same client. Whilst it is commonly accepted that there is no one correct asset allocation model there should be a mechanism in place to assist advisers to understand why such variances exist and whether the tools they are planning to use are aligned to their own investment philosophy.
  - The following questions have been put forward as areas that should be investigated when conducting a due diligence process. The questions set out below are not exhaustive and are intended as a guide only.
  - **About the tool supplier – questions that can be included within a due diligence process:**
    - What is the financial strength of organisation delivering the tool?
    - Data protection process is in place i.e. is information collected about the client used for other purposes e.g. direct marketing, or passed onto third parties?
    - Have any third parties been involved in developing or delivering this tool?
    - Has the tool undergone an independent review/audit?
    - Can the tool supplier provide details of who their customers are i.e. other organisations who use the tool?

# Due Diligence Process

- **ATRQ – questions that can be included within a due diligence process:**

- Has the risk profiling tool been built and developed by your own organisation or has it been sourced from a third party? If third party, then it is recommended the adviser ask who they are.
- If the risk profiling tool has been sourced from a third party, has the tool been modified in any way and what is the nature of the change?
- What is the name of the organisation which conducts the underlying risk profiling research?
- Do you offer more than one risk profiling questionnaire?
- How many questions are included within the risk profiling questionnaire?
- How many different risk profiles are catered for?
- Provide the name of each risk profile offered.
- Provide a brief description of each of the risk profiles.

- **Asset Allocation Tools – questions that can be included within a due diligence process:**

- Has the asset allocation tool been built and developed by your own organisation or has it been sourced from a third party? If third party, then it is recommended the adviser ask who they are.
- If sourced from a third party, has the tool been modified in any way and what is the nature of the change? **If changes have been made to economic assumptions these must be declared to the adviser.**
- What is the name of the organisation which conducts the underlying risk profiling research?
- How many underlying model portfolios are used?
- How often are these models reviewed?

# Due Diligence Process

- What data do you use to create the projected future returns:
  - Historical data (price/values)
  - Current Market data (macro economic data)
  - Internal data/research
- How many asset classes are offered?
- What is the length of the period of data used with each asset class?
- Which inflation rates are assumed e.g. nominal interest rates, real interest rates, inflation, credit risk (corporate bonds), currencies and exchange rates, equity risk premium, inter asset correlations etc.
- How are time horizons structured? Request details of time periods used.
- Request details of each asset allocation model per risk profile and time horizon (see Appendix 1 for example as to how such information could be presented to advisers)
- Request details of additional research that has been used to develop this tool.
- It is also recommended that advisers request information relating to the size and profile of the test population that is used to test the tool. The working group recognise that whilst there is no optimal or ideal number, advisers should at least be aware of who the tool has been tested against.

What are the issues?

- Information about tools may be available but it is not easy to locate and advisers have found it difficult to collate information in a way that allows them to compare and contrast the different tool offerings.
- This has compounded the issue about advisers lack of understanding as to how tools operate.

- It has been recommended that the following information be made available in a Tool Fact sheet.

## **About the tool supplier**

- Details of outsource partners who have been part of delivering the tools.
- Details of any academic institutions who may also have been involved in conducting independent reviews/audits on the tool.

## **About the ATRQ**

- Identify if the ATRQ tool has been modified in any way and specify the nature of the change.
- State how many questions are asked by the risk assessment tool and if offering the option of using a number of different questionnaires i.e. 5 questions, 12 questions, 25 questions then include this information also.
- State how many different risk profiles are catered for, name them and provide high level description

## **About the Asset Allocation Tool**

- Identify if the Asset Allocation tool has been modified in any way and specify the nature of the change. (Note: if changes have been made to economic assumptions these should be declared).
- State how many underlying model portfolios are used
- Provide details of how time horizons are structured and include details of time periods used (0-5 years, 5-10 years, 11-15 years, etc and which category these fall into i.e. short, medium, long).
- State how often these models are reviewed.
- State how many investment sectors are offered and what these are.

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# Example of a Tool Fact sheet

## **About the tools supplier**

*Example text:*

The tools have been developed by ABC Plc who have provided similar tools to other providers in the market as well as to IFAs directly.

## **About the tool**

*Example text :*

- All of the components of the toolset are built in house, including the underlying asset model and risk profiling tool.
- The underlying research backing Psychometric Risk Profiling was commissioned from the ABC Institution, part of XYZ University.
- This web tool suite also includes qualitative fund ratings, which have been sourced from XYZ.

## **Academic Reviews**

*Example text:*

- Joe Bloggs and Fred Smith of The University of Somewhere developed the methodology being used in the risk profiling tool.
- The asset allocation methodology was developed by ABC Plc utilising the ABC underlying stochastic asset model used by a number of different institutions for a variety of purposes.
- The model has been audited by a number of different organisations including:
  - Elsewhere Business School – Mathematics department
  - Partner & Partner consultants
  - Various Life office providers as part of their due diligence process
- The last of these reviews was on XYZ date.

## **About the Attitude to Risk Questionnaire (ATRQ)**

*Example text:*

This risk profiling tool is designed to use proven techniques to provide a guide as to how a client 'feels' about risk. The outputs are designed to inform a discussion with the client regarding risk, rather than operate as a substitute for such a discussion. The risk levels within this process have been calibrated to match the asset allocations within the companion asset allocation tool.

This risk profiling tool has been calibrated based upon research conducted by XYZ based upon a sample of 1,023 UK adults representative of the UK population.

- ATRQ has been built by ABC Plc and uses their standard methodology unmodified.
- The risk profiling tool has been supplied with a choice of two questionnaires of a psychometric and behavioural nature, offering either five or eighteen questions.
- The questionnaire puts the client into one of 5 profiles (Very Cautious, Cautious, Balanced, Aggressive and Very Aggressive)
- Each risk profile is calibrated to a specified asset allocation within the companion asset allocation tool.

# Example of a Tool Fact sheet cont.

## **General description**

### *Example text:*

This Asset Allocation tool is designed to show an efficient asset allocation based upon the client's level of risk. It can also be used to analyse the efficiency of client's current portfolio against a set of efficient asset allocations calculated within the tool.

This asset allocation tool is based upon the principles of Modern Portfolio Theory (MPT) proposed by Markowitz (1952), which seeks to find the optimal portfolio for a given level of risk. MPT provides a simple and effective tool for the construction of optimal portfolios from a range of possible assets. The optimisation is based upon 12 different asset classes which are detailed below. A combination of historical prices and data and internal research by XYZ Company is used to feed the tool.

In order to arrive at the specific optimised portfolio a set of rules or constraints are applied to the outputs of the process. These rules are decided upon independently by XYZ Company and an example rule would be XYZ.

## **Economic assumptions**

### *Example text:*

Specify the key economic assumptions are nominal interest rates, real interest rates, inflation, credit risk (corporate bonds), currencies and exchange rates, equity risk premium, inter asset correlations etc.

## **Modifications**

### *Example text:*

The asset allocation model has been developed by ABC Plc. The Life Office provider has modified the model by restricting investment in property to a maximum of 10% to fit with the underlying view of the markets.

## **Model Asset Allocation**

### *Example text:*

- The tool contains ten model asset allocations, each of which is aligned with a specific risk tool profile within the companion risk profiling tool.
- The tool uses three time horizons - short (less than 5 years), medium (5 to 10 years) and long (greater than 10 years)
- The tool takes account of 9 investment sectors being UK Equities, US Equities, European Equities, Japanese Equities and Pacific Equities, Property, Gilt, Corporate Bonds and Cash.

## **Reviews**

### *Example text:*

The underlying asset model is updated every quarter with changes to the model portfolios being made when the model suggests that there has been a greater than 10% shift from the most efficient portfolios.

# Glossary

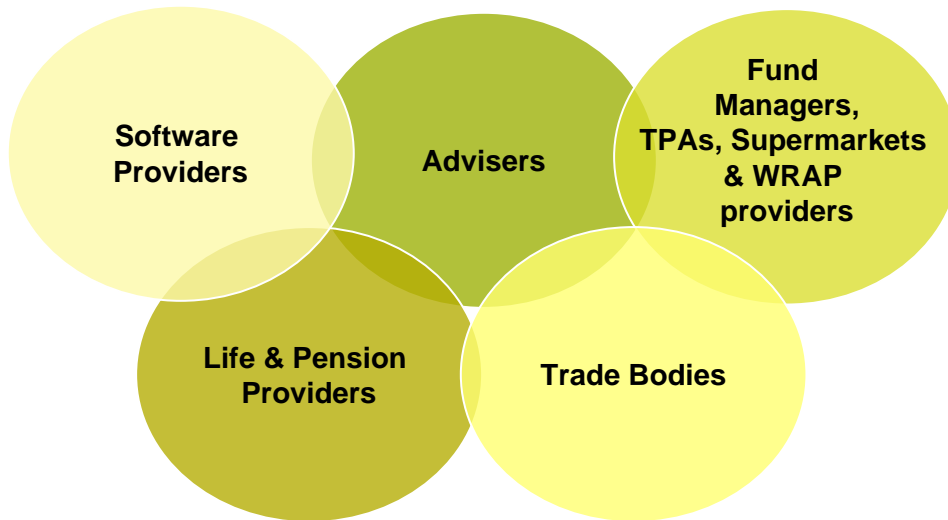
Term	Description
Adviser Forum	<p>Adviser Forum is an environment where major adviser and product provider forms can work together to discuss key business issues and identify how to address them co-operatively.</p> <p>The purpose of Adviser Forum is to facilitate business efficiencies in the personal finance sector for the benefit of advisers, providers and most importantly consumers.</p>
Asset Allocation Tool	A tool that is used to construct a model portfolio by allocating the clients investment into various sectors.
Attitude to Risk Questionnaire (ATRQ)	This consists of a series of questions that clients are asked to respond to. At the end of the process the questionnaire generates a risk profile for the client.
Economic assumptions	These are assumptions or models on various underlying economic factors that allow the investment to be modelled. These can include, but are not limited to inflation, interest rates, credit risk, currencies and equity premium.
Efficient frontier	The Efficient Frontier plots the risk and return of all combinations of assets within a portfolio and is designed to show investors which combination of assets offers them the lowest risk for a desired level of return or the highest return for a specified level of risk.
Model portfolio	A model portfolio consists of fund or selection of funds with an asset allocation structured to match a model asset allocation.
Model Asset Allocation	A model asset allocation is an asset allocation (a mix of different assets) intended to be optimal ( i.e. the best possible) under a given set of rules i.e. limits on types of assets for a given set of criteria i.e. risk profile and time horizons.
Regulator	In the context of this document the regulator is the Financial Services Authority.
Time horizons	These are the periods that the investment is intended to be for. These are often defined as short (0-5 years), medium(5 -15 years) and long (greater than 15 years).
Tool Suppliers	An organisation that is making investment planning tools available to advisers.

# Appendix 1 – Asset Allocation Model Matrix

- It is recommended that an Asset Allocation Matrix include a breakdown of each asset allocation model by:
  - investment sector per risk profile
  - time horizon
- The asset allocation breakdown should show:
  - which investment sectors are used for that risk profile and time horizon
  - percentage split of investment sectors across the model
- It is recommended that this information be updated to reflect any changes to the asset allocation models.
- It is also recommended that Fact sheets should make reference to the availability of this information and how advisers can access it.
- **Example Asset Allocation matrix below:**

<b>Example Risk Profile</b>	<b>Very Cautious</b>					<b>Cautious</b>					<b>Balanced</b>				
<b>Example Time Horizons</b>	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs
<b>Asset Allocation Model</b>															
Cash	45%														
UK Corporate Bonds	20%														
UK Index Linked	10%														
International Corporate Bonds	10%														
UK Gilts	10%														
UK Fixed Interest	0%														
UK Equities	0%														
European Equities	0%														
North American Equities	0%														
Japan Equities	0%														
Asia ex-Japan Equities	0%														
Emerging Market Equities	0%														
Pacific Basin and emerging markets	0%														
Global / Overseas Equities	0%														
Specialist Equity	0%														
Property	0%														

## Adviser Forum Core Groups



- Adviser Forum is an environment where the major adviser and product provider firms can work together to discuss key business issues and identify how to address them co-operatively.
- The purpose of Adviser Forum is to facilitate business efficiencies in the personal finance sector for the benefit of advisers, providers and most importantly consumers.
- It focuses on improvements to business processes, achieving cost savings and service enhancements.
- Solutions to these issues will, for the most part, be found through the use of technology however discussions are not restricted to technology solutions alone; issues are addressed from a business perspective.



# Financial Technology Research Centre

- The Financial Technology Research Centre (FTRC) is a specialist consultancy focused on the intermediated distribution of packaged personal finance products, advising a wide range of trade bodies, financial institutions and software companies on the use of technology in the personal finance market.
- The entire team have worked in adviser businesses and total over 60 years of industry experience.

**Any queries relating to these Guidance Notes should be directed to Poppy Morgan, Head of Forum Development:**

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