



Adviser Forum

Good Practice Notes 2:

Investment forecasting, fund selection and portfolio
rebalancing tools

April 2008



Notes

- 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 Forum has previously developed a set of good practice notes for risk profiling and asset allocation tools and these can be found at:
 - <http://www.adviserforum.org/goodpracticenotes/default.asp>
- The following document focuses on identifying good practices for advisers (who use) and tools suppliers (who develop) investment forecasting, fund selection and portfolio re-balancing tools.
- 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.

Objectives of the working group

- Increase adviser awareness and understanding as to how investment planning tools operate.
- Identify what information should be made available to advisers to assist them in achieving this understanding.
- Develop set of industry agreed notes and guidance for advisers and tool suppliers.

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).
- Investment forecasting tools
- Fund selection tools.
- Portfolio rebalancing tools

Areas deemed out of scope for Working Group

- E-commerce functionality of investment planning tools.

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Short term working group

Adviser Firms	
2plan	SIFA
Heath Lambert	Thinc Group
Three Sixty Services	
L&P Providers	
Clerical Medical	Scottish Widows
Friends Provident	
Tool Providers	
Barrie & Hibbert	Distribution Technology
Wrap Platforms	
Cofunds	Funds Network
Skandia	

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Achieving good practice

- The use of investment planning tools has become an integral part of the advice process.
- 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 parties 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.
- Adviser Forum has also develop good practice notes for risk profiling and asset allocation tools and it is recommended that both documents be read in conjunction with each other.
- The key recommendations of this document 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.

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Investment forecasting tools

What are the issues?

- Tools are being designed to perform different functions so there is a distinct need for advisers to be clear about the nature of the tool they are using.
 - For example, some tools are intended to assist the adviser when delivering advice on a provider's own product range, other tools are designed to be generic therefore will not take into account specific products.
 - In the current environment it is not clear whether tool suppliers are making available information that will help the adviser determine the precise function of the tool they plan to use.
 - As tools can be either specific or generic in nature this will mean that the underlying information that is used to determine the investment forecast will vary.
 - Currently, there is a lack of clarity as to which tools are taking into account product/fund related charges or, the impact of taxation when investment forecasts are being made.
 - Reasons why this is important for advisers to understand:
 - The working group identified tool suppliers taking a different approach to the factors they take into account within their investment forecasting tool, for example some take into account taxation, some consider the impact of product charges, other tools may do both or none.
 - This is causing some confusion as the tools that are taking into account taxation and/or product and fund charges could be construed by some advisers as producing quasi illustrations. As an investment forecast (a forecast is commonly used to show, generically speaking, how the future might look given a particular set of assumptions. Forecasts are not generally intended to compare specific products and charges) bears no relation to a product illustration (The FSA defines a projection as "a projection of the amount of any future benefit payable under a contract or policy, being a benefit the amount of which is not ascertainable under the terms of the contract or policy when the calculation is made". One of the principal purposes of projections is to allow the comparison of charges) it is appropriate that this issue be addressed within this document so that moving forward advisers understand this difference.
 - Advisers need to be given the means to understand the capabilities and limitations of the tool they are using so they are not inadvertently misled i.e. believe that certain assumptions are factored into the forecast when they may not be or, vice versa.
-
- In response to these issues put forward by advisers the working group focused their attention on addressing the following key areas:
 1. Are advisers clear whether the tool they are using is product specific or product generic in nature?
 2. What charges or taxation do investment forecasting tools take into account?

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Investment forecasting tools

1. Tool suppliers should make it explicitly clear to the adviser what the investment forecasting tool is designed to do.

Recommendations to tool suppliers to address this:

- A statement of purpose should be clearly displayed to the adviser when they log into the tool, this statement should be also be included within a tool suppliers fact sheet . Advisers should understand if the tool will:
 1. Assist advisers advise more effectively on a provider's own product range or, if it will assist advisers generally regardless of a product range.
 2. Offer specific or limited product and fund selection capabilities or, if it will give the adviser capability to select products at a 'generic' level.
- It would be sensible to ask advisers using the tool to confirm that they understand what the tool is designed to do. Confirmation should be sought at adviser (user) level, rather than at firm level. To ensure that this information is not overlooked it would be prudent to keep acceptance of general terms and conditions separate from this confirmation.
- This issue is an important recommendation and providers would be encouraged to give it due prominence.

2. Tool suppliers should make it explicitly clear whether or not the investment forecast tool takes into account any product and fund and/or taxation.

Recommendations to tool suppliers to address this:

- It is strongly recommended that the following information be made easily available to advisers.
 - Details of any specific charges at product or fund level that are included within the investment forecasting tool e.g. annual management charge (1%), initial charge (3%), establishment charge (1% first 3 years, 0.5% years 4 & 5), initial allocation rate (101%).
 - Details of taxation of product and/or taxation of underlying funds that are included within the investment forecasting tools e.g. net or gross for pensions, offshore products.
 - Details of any charges being applied at product and or fund level that are included within the investment forecasting tools e.g. 1% annual management charge.
 - Conversely, if no charges or tax considerations have been used within forecasting tools this should also be made known to advisers.
- An effective method could be to include sign posts on the tool that can direct advisers to this information.
- In instances where tools are taking into account taxation and/or charges it is recommended that the tool supplier reinforces the difference between an investment forecast and investment illustration.

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Historic and future returns data

What are the issues?

- Some advisers may not have a sufficient understanding of the historic and future returns data that investment planning tools use, or how that data is used to make predictions about potential future gains on a clients investment.
- Reasons why this is important for advisers to understand:
 - Tools can differ based upon a wide variety of factors including the types of information they use.
 - Advisers have an obligation to familiarise themselves with the types of information tool suppliers use to make future predictions e.g. market views, options pricing, internal expertise, as they need to have an appreciation of the factors that can impact the outputs generated by the tools they are using.
- Whilst there is a substantial amount of detailed information that could be made available to advisers it is highly unlikely that most advisers would require this.
- The challenge is to ensure that advisers have access to relevant information in a concise format with the option to request further data from the tool supplier if it is required.
- Broker Consultants are often the first port of call for advisers however there is a concern that such individuals may be asked to respond to actuarial related questions concerning tools when they are not qualified to do so.

Recommendations to tool suppliers to address this:

- Provide advisers with details of both historic and future asset class data that is used. This should also include information detailing how far back the historic asset class data goes. For an example of how this information could be delivered please refer to page 18.
- In some instances advisers may wish to make further enquiries as to the nature of the historic and future returns data, tool suppliers should ensure that such information can be readily provided upon request.
- Broker Consultants should avoid engaging in any actuarial type discussions with advisers, unless qualified to do so, and should always refer the adviser to a technical help desk facility.



Fund selection tools

What are the issues?

- Tool suppliers tend to use fund ratings data supplied by a range of external e.g. Finex, Lipper, Morningstar / Standard & Poor's, OBSR, to assist advisers select funds that are suitable for a client portfolio.
- As advisers are then reliant upon third party data to assist them through the fund selection process this raises some important considerations for advisers:
 - The need to know which data feed supplier is being used.
 - The need to understand what measures are used to rate funds
 - The need to understand whether the tool can analyse the underlying fund holdings
- Some adviser firms may have developed their own methodology and approach to fund selection therefore it will be important for such organisations to understand which tools within the marketplace are aligned to their own investment philosophy.

Recommendations to tool suppliers to address this:

- Tool suppliers should make the following information available to advisers and it is recommended that this information be provided within the tool suppliers fact sheet.
 - The name of the data feed supplier that is being used within the tool.
 - Details of the measures that are used to rate funds e.g. volatility, performance etc.
 - Specify whether funds are analysed at fund or sector level e.g. top 10 holdings or by named sectors such as automotive, chemicals, mining, technology etc.

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Portfolio rebalancing tools

What are the issues?

- In the current climate an adviser must either have the regulatory permissions to engage in discretionary fund management activities or, specific permission from the client, prior to rebalancing the clients portfolio.
 - The FSA have raised this as a risk within their Discussion Paper 07/2 Platforms: the role of wrap and fund supermarkets, and state “Firms should manage the risk of unauthorised transactions”.
 - There is a clear difference between advising on funds that require a periodic review and those funds that are purchased via a multi manager and therefore are designed to rebalance themselves.
 - Adviser firms are concerned that some advisers may be drawn into rebalancing activity without fully understanding the requirements and obligations they need to fulfil before engaging in this. Advisers believe this is an area where measures need to be put in place to assist them manage such risks.
 - It is important for advisers to agree with clients a rebalancing timeframe, i.e. portfolio is reviewed after a specified period to ensure that the investments remain in line with the clients stated objectives e.g. annually, bi-annually, monthly etc.
 - Advisers moving into the investment arena may overlook the need to physically set up a rebalancing alerts that will prompt them to review the clients investments. Some tool suppliers do suggest within their marketing literature possible rebalancing timeframes that could be adopted by advisers however, such statements are designed purely to prompt the adviser into this course of action and should not be interpreted that the tool supplier will set the rebalancing on the advisers behalf.
 - Unwrapped investments e.g. Unit trusts, OEICS, if rebalanced could be subject to a CGT charge though it is recognised that this will be dependent upon any gains achieved compared against the clients annual allowance. There is a concern that some advisers may rebalance a portfolio without considering the wider tax implications for the client.
 - There are various methods of re-aligning clients to their intended portfolios on review and there is a need for clarity around which is being operated especially where any changes lead to advice that results in the sale/purchase of funds. As this constitutes new business the adviser and client need to understand what has triggered this course of action. In the current environment it not easy to discern the approach a tool supplier is taking.
- In response to these issues put forward by advisers the working group focused their attention on addressing the following key areas:
 1. What checks and balances could be put into place to prevent advisers, who do not have the correct regulatory permissions or client consent, from inadvertently rebalancing client portfolios?
 2. Where rebalancing facilities are offered, is it always clear to the adviser on what basis this service operates?

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Portfolio rebalancing tools

1. As the use of investment planning tools grows amongst advisers it is recognised that this brings with it risks that need to be addressed to assist advisers from overstepping their regulated status or engaging in activities they do have not client consent for.

Recommendations to tool suppliers to address this:

- To minimise the risk of an adviser inadvertently conducting a rebalancing exercise it would be helpful if tool suppliers could raise a flag to draw such risks to their attention, for example:
 - Include a warning/notice on the tool reminding advisers that they will need the appropriate permissions before proceeding with this course of action.
 - It is suggested that this could be in the form of a validation button that asks the adviser to confirm whether they a) have regulatory permission to perform this function or b) have the express consent of the client.
 - This information could be included in any output document that is created and could therefore serve as a useful audit trail.
- In addition, it is also recommended that:
 - The tool flags the need for advisers to set rebalancing timeframes as agreed with the customer.
 - Flag to advisers that rebalancing can trigger certain charges therefore they should consider the impact to the client before engaging in such activity.

2. It is vital that advisers understand the basis on which a portfolio is being rebalanced therefore this information should be made available upfront.

Recommendations to tool suppliers to address this:

- Advisers should understand if the portfolio has been rebalanced:
 - to the original asset allocation (i.e. if it has been agreed that the recommended asset allocation should be kept for a period of time, then a situation may arise where the portfolio is rebalanced to the original asset allocation until such time where it has been agreed with the client to review the asset allocation again);
 - to the current asset allocation for the original risk profile;
 - to the current asset allocation for current risk profile.

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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 due diligence exercise is to identify a list of questions that the adviser can use to help them understand how investment forecasting, fund selection and portfolio rebalancing tools operate.
- 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.
- **Investment forecasting tools**
 - Does the investment forecasting tool take into account the impact of product and fund charges as well as taxation at wrapper and fund level?
 - If charges and taxation are taken into account then are they specific to products/funds or do they tend to be more generic?
- **Asset class returns data**
 - Does the tool supplier use both historic data (data that looks at past events) and future data (data that is used to predict how events may turn out in the future) within their investment forecasting tool?
 - What asset class data is used and how far back does that information go e.g. equities returns data can go back as far as 100 years or as little as 10 years.
 - *It is worth noting that different tool suppliers may use different tool suppliers will use different returns data therefore it may be worthwhile asking the tool supplier to explain why they have used the returns data they have selected to increase your own understanding in this area.*

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Due diligence process cont.

- **Fund selection tools**

- Is the tool supplier using an external fund rating agency or are taking a different approach such as using their own internal expertise to rate funds (recognised that the latter approach would be rare but if it is used then advisers should ask for additional information concerning the approach and methodology used)?
- Irrespective of the approach being taken it would be advisable for advisers to establish:
 - What fund rating data is used i.e. data feed supplier used, types of fund ratings available
 - What fund risk profiles are applied and how many different profiles are available
 - How are funds being analysed i.e. at sector level or underlying fund level.

- **Portfolio rebalancing**

- On what basis does rebalancing occur?
- What audit trails are in place to monitor/record rebalancing activities.



Tool fact sheet

- It is recognised that there is a clear need for advisers to have a better understanding about the tools they are using to assist the advice process however, there needs to be a careful balance as to how much information advisers actually need.
- 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.
- One of the key recommendations of this working group has been to see the development of a “tools fact sheet”. The aim of this document is to present back to advisers the salient facts about the tools they are using.
- Overleaf is a template that has been created to assist organisations, that are delivering tools to advisers, understand what information they need to make available to these users to ensure they have appropriate facts available to them prior to utilising the tool.
- It is strongly recommended that all organisations that are delivering investment planning tools to advisers make such a document available to them.
- Suggestion for a factsheet was originally made in the good practice notes for risk profiling and asset allocation tools, these recommendations are in black text.
- Recommendations in blue text are a result of the findings of the good practice notes for investment forecasting, fund selection and portfolio re-balancing tools.

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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.

Statement of purpose

Example text:

- This tool is designed to assist advisers advise more effectively on a provider's own product range. Or ;
- This tool is designed to assist advisers generally regardless of a product range.

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.
- ATRQ has been built by ABC Plc utilising the ABC underlying stochastic asset model used by a number of different institutions for a variety of purposes and uses their standard methodology unmodified.
- 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.
- The underlying research backing Psychometric Risk Profiling was commissioned from the ABC Institution, part of XYZ University.
- 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.

About the Asset Allocation tool:

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.
- 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.

Economic assumptions used within the Asset Allocation model

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 made to the Asset Allocation model

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.

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Example of a tool fact sheet cont.

Charges and taxation:

Example text:

The investment forecast within this tool takes into account specific product/fund/tax charges. Details of these charges are made available on the tool. *Or ;*

The investment forecast within this tool does not take into any specific product or fund charges and instead uses a generic charge of X% AMC within the investment forecast. *Or ;*

The investment forecast within this tool does not take into any specific product or fund charges.

Fund selection tool

Example text:

- The tools uses fund ratings data supplied by XYZ supplier and the following fund ratings are used to rate funds available via the tool: volatility, performance, risk etc.
- The funds are analysed at fund or sector level.

Portfolio rebalancing tool

Example text:

The tool offers a rebalancing facility and this will rebalance the client to the original asset allocation selected at outset (*or*) to the model the current asset allocation model (*or*) to the clients original risk profile.

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.

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Appendix 1 - asset allocation model matrix

- In the initial Good Practice document which considered risk profiling and asset allocation tools (<http://www.adviserforum.org/goodpracticenotes/default.asp>) it was recommended that tool suppliers develop an Asset Allocation Matrix so that advisers could easily determine each asset allocation model per risk profile and time horizon. This document includes an additional recommendation, this can be seen below. The Asset Allocation Matrix has been modified to cater for this new requirement.
- Such a matrix should 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
 - How far back the asset class data goes (*new recommendation*)

- It is recommended that this information be updated to reflect any changes to the asset allocation models.
- It is also recommended that this information be made available as part of the due diligence process and upon request.

• **Example Asset Allocation matrix below:**

Example Risk Profile		Very Cautious				Cautious				Balanced				Aggressive				Very Aggressive								
Example Time Horizons		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	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs	5 yrs	10 yrs	15 yrs	20 yrs	25 yrs
How far back does data go?	Asset Allocation Model																									
29 yrs	Cash	45%																								
17 yrs	UK Corporate Bonds	20%																								
26 yrs	UK Index Linked	10%																								
17 yrs	International Corporate Bonds	10%																								
27 yrs	UK Gilts	10%																								
27 yrs	UK Fixed Interest	0%																								
38 yrs	UK Equities	0%																								
38 yrs	European Equities	0%																								
38 yrs	North American Equities	0%																								
20 yrs	Japan Equities	0%																								
20 yrs	Asia ex-Japan Equities	0%																								
20 yrs	Emerging Market Equities	0%																								
20 yrs	Pacific Basin and emerging markets	0%																								
20 yrs	Global / Overseas Equities	0%																								
21 yrs	Specialist Equity	0%																								
22 yrs	Property	0%																								

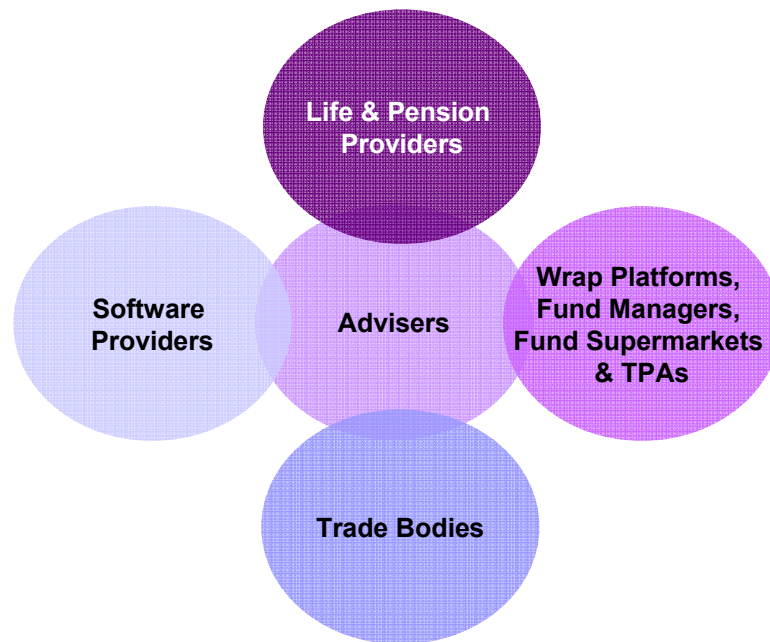
- Shows far back asset class data goes (*new recommendation*).
- Shows the different asset classes that are used within the tool.
- Shows the splits between the asset classes
- Shows the time horizons that are used by the tool (if these are used)
- Shows the different risk profiles the tool uses.

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Adviser Forum

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.

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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 consulting 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:

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