

risk profiling for financial advisers only

why risk profile?

The Skandia investment tools allow you to build optimised asset allocated portfolios of funds for your clients which aim to meet their investment needs by taking an appropriate level of risk.

But what level of risk is appropriate and how do you determine that level for your client?

Could you be sure that if you asked your client to rate their attitude to risk on a scale of 1 to 10 the answer would be accurate?

Skandia has found that investors often cannot accurately judge their own risk appetite in this way and that a series of suitably chosen questions, graded appropriately and then aggregated with carefully chosen weightings, can provide a more accurate way of calculating risk scores.

In our experience we have found that individuals often have inconsistent views on how to achieve their goals. It is therefore important to assess the client risk score from a range of questions, so that the answers to individual questions do not have an undue bearing on the final risk score. For this purpose Skandia has developed a risk profiling questionnaire with advice from Watson Wyatt, a leading investment consultancy.



who is Watson Wyatt (WW)?

Watson Wyatt is a global investment consulting firm. The UK investment practice has significant experience in providing investment strategy advice to the UK's largest institutional investors. They count among their investment clients some 40% of FTSE® 100 pension plans and many of the largest non-life insurers.

the skandia risk profiler

The Skandia Risk Profiler is a set of questions designed to translate an individual’s general views on investment risk into a single number – a ‘client risk score’. This client risk score corresponds with an appropriate asset allocated portfolio optimised to provide the maximum return for a given level of risk – according to Modern Portfolio Theory.

The Skandia Risk Profiler is available for individuals, trustees or retirement planners, although the differences between the three are slight.

Each assesses the following factors:

Client’s financial circumstances:

1. The term of the investment.
2. Client’s level of cash reserves to meet unexpected expenses.
3. Client’s view on the potential for their earnings to grow in future.
4. The size of client’s investment portfolio.
5. Client’s debt position.
6. Retirement provision (retirement risk profiler only).

Client’s risk tolerance:

1. Client’s overall view on investing.
2. The importance of avoiding short-term losses.
3. The level of loss that would concern the client.
4. Client’s view on whether any losses incurred will be recovered.
5. The importance of protecting the investment from the effects of inflation.
6. The extent to which the client is prepared to assume greater investment risk in order to achieve higher investment returns.



how does it work?

It is important for the Risk Profiler to address each of the factors listed above in order to produce an appropriate risk score. All the possible answers to each of the questions have an associated score out of 100, with a higher score reflecting the client’s willingness and ability to assume more investment risk and a lower score reflecting a willingness to accept less risk.

Whilst using questions to determine a client’s risk profile is very important, some questions will contribute more to an understanding of the client’s risk profile than others. Consequently, each of the questions within the proprietary Skandia Risk Profiler is weighted accordingly to influence the impact the question has on the final risk score*. For example, by asking the client’s view on the potential for their earnings to grow in future helps to determine how important the investment is likely to be later on and how it may affect their ability to take risk now.

However, this question is less significant in determining their attitude to risk than a question determining to what extent they agree that any fall in value they incur will be recovered by holding on to their investment. If the investor feels losses will be recovered, they will be more willing to incur them, ie tolerate risk. Accordingly the latter question has a higher weighting.

Ultimately, the higher the final score from the questionnaire, the higher the investor’s tolerance to investment risk. The final investor risk scores range from 1 to 10, with 1 being the most risk-averse and 10 being the most risk-seeking. Each risk score maps to a specific expected level of volatility and an asset allocation designed to perform accordingly.

* The full scoring methodology behind Skandia’s risk profiler is protected and consequently not available for external use.

what does each risk score mean?

Until recently, investors may have found themselves categorised in terms of investment approach as cautious, adventurous, or varying degrees in between.

But, for example, what does cautious actually mean?

The IMA definition of a cautious fund is:

‘Funds investing in a range of assets with the maximum equity exposure restricted to 60% of the fund and with at least 30% invested in fixed interest and cash. There is no specific requirement to hold a minimum percentage of non-UK equity within the equity limits. Assets must be at least 50% in Sterling/Euro and equities are deemed to include convertibles.’

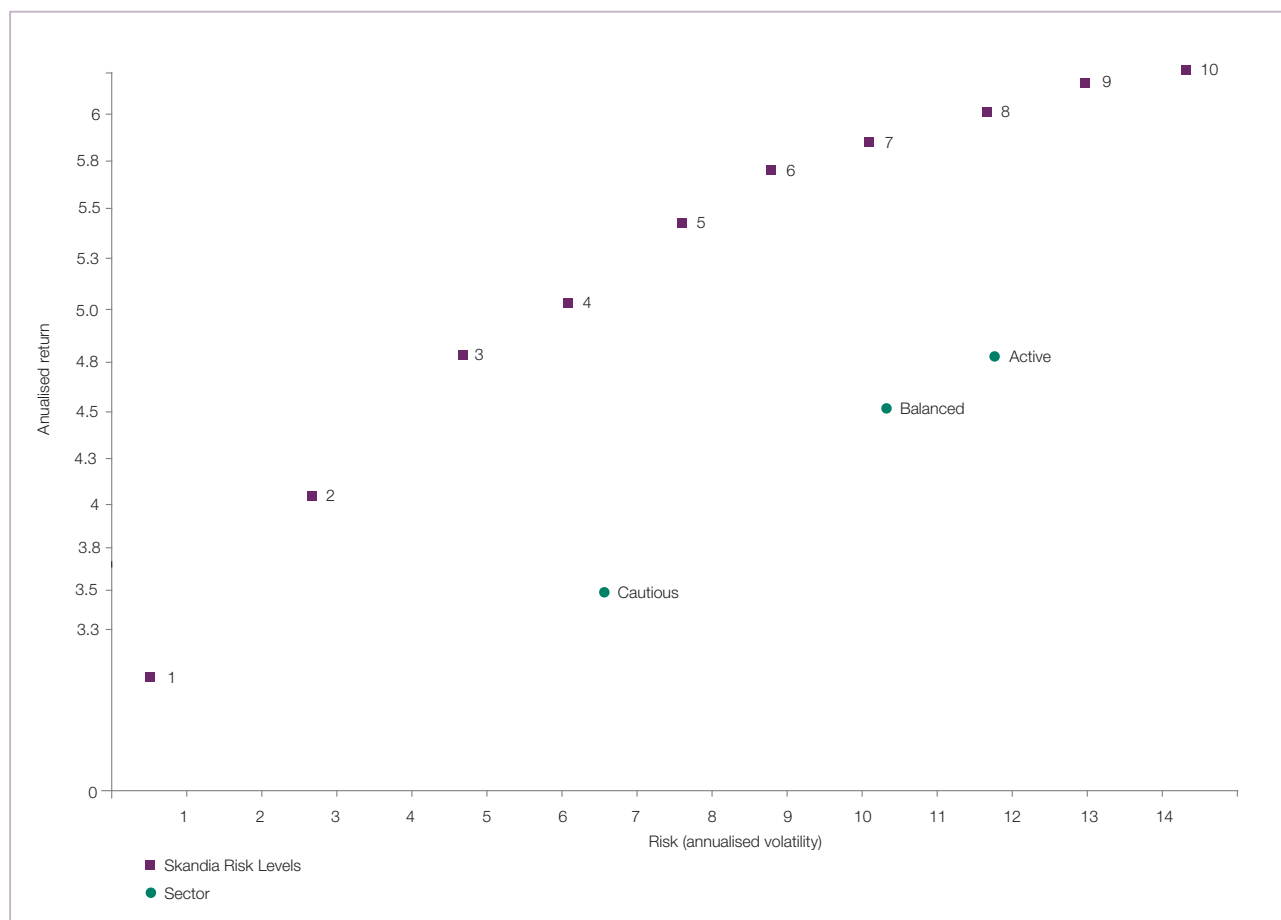
In this instance a ‘cautious’ investor could find themselves in a fund with exposure of up to 60% equity or alternatively with no equity exposure at all. According to the Skandia investment model, this would equate to a prospective, ie expected, investment risk level of between 1 and 6 depending (mainly) on the size of the fund’s equity component. This is further evidenced over the last five years, where the volatility of the funds within the IMA Cautious Managed sector has ranged from 0.42 to 12.71.

This would correspond to Skandia risk levels 1 to 7 and clearly indicates the differences in equity exposure between funds in this sector.

To provide further detail, Skandia has divided the investment risk spectrum (or the efficient frontier) into 10 risk levels with each mapping to a specific level of volatility. This means each risk score’s associated asset allocation aims to maximise return for its given level of risk 68% of the time (ie one standard deviation) – and that’s it.

If describing each risk score by way of volatility appears insufficient, how else might we consider it? One way would be to demonstrate the different risk scores by comparison of historic risk and return performances of the Skandia risk levels and the Cautious, Balanced and Active Managed sector averages. For the purpose of this exercise, shown graphically below, the Skandia portfolios are populated with sector averages as proxies for the different asset classes. As you can see, the Skandia risk levels allow for financial advisers to identify and match the risk levels of their clients far more precisely than the more generic and established approach.

Risk vs return for period 01/11/2001 to 31/08/2008



Source: Financial Express Analytics, total return annualised ratios over rolling 36 month periods (from 1 November 2001 to 31 August 2008).

glossary

- **Convertibles**
A corporate bond which can be converted into shares in the issuing company.
- **Efficient Frontier**
For every level of risk there is a portfolio with the highest expected return and for every level of return there is a portfolio with the lowest anticipated risk.
- **IMA**
The Investment Management Association, who classify fund sectors. There are currently 30 different IMA sectors.
- **Modern Portfolio Theory**
The measurement of investment risk and the matching client risk tolerance with an appropriate asset-allocated portfolio.
- **Standard Deviation**
See Volatility.
- **Volatility**
Volatility frequently refers to the standard deviation of the change in value of a financial instrument with a specific time horizon. It is used to quantify the risk of the instrument over that time period. Volatility is typically expressed in annualised terms, and it may either be an absolute number (£5) or a fraction of the initial value (5%).

For further information on Modern Portfolio Theory and the Efficient Frontier, please see the [optimised asset allocation sales aid](#).

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PDF6227/29-1048/August 2009