

The Concept of Risk Targeting Within Multi-Sector Funds

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Super System (Cooper) Review

- David Bell of St Davids Rd Advisory recommended:
- *“Shift to a risk targeting framework. This would replace the concept of asset mix defined products. The onus for risk and return would be placed in the hands of the investment managers of the super fund (where it belongs). This would force the industry to implement substantial improvements to risk management practices (and I believe substantial improvements are required). Investors would also have a better understanding of how much risk they are taking.”*
- *“The Panel agrees with these views”*

Risk Targeting Explained

- A fund manager defines their products by the amount of risk they are targeting. This may be complemented by exposure guidelines. Under a risk targeting regime the key objectives of the manager are:
 1. To achieve the stated risk objective
 2. Maximise the return given the level of risk

Measure of Risk

- Risk is typically defined by standard deviation. While there are flaws with this measure, such as its ignorance of large negative tail events, standard deviation (when explained as volatility) is a term broadly understood by the majority of investors
- Could use VaR, but this is more difficult to explain and requires a standardised approach
- Could also use drawdown

Existing Regime

- Multi-sector funds (such as super funds) tend to be defined by the split between growth and defensive assets
- The definition of 'growth' and 'defensive' can be blurred
- There is little or no active management of total risk
- There is a focus on peer group risk
- Volatility outcomes vary over time

Simple Example

- A typical growth option may have a 70 / 30 split between growth and defensive assets
- Under a risk targeting regime a similar style of fund may be labelled as a 10% volatility fund
- It will not have a 70 / 30 growth / defensive split all the time but may average a similar exposure over time

Super System (Cooper) Review

- Recommendation 4.11
 - *“Trustees of large APRA funds should disclose each diversified investment option’s investment return target and risk target...”*
- 6.2 Risk and return targeting
 - *“The Panel suggests that trustees, in devising diversified investment strategies, focus on the investment return objective and level of risk, rather than on asset class exposure for the particular investment strategy or option. This could be called ‘risk and return targeting’.”*

Super System (Cooper) Review (ctd)

- Benefits (6.2 ctd)
 - *“Trustees would be responsible for managing the total investment risk of the diversified investment option, rather than focusing on the management of asset allocation benchmarks.”*
 - *“Trustees would have greater flexibility to adjust their asset allocations in changing market conditions in order to maintain their targeted risk/return balance, avoiding their portfolios being anchored to portfolio weightings that have been overtaken by market circumstances.”*

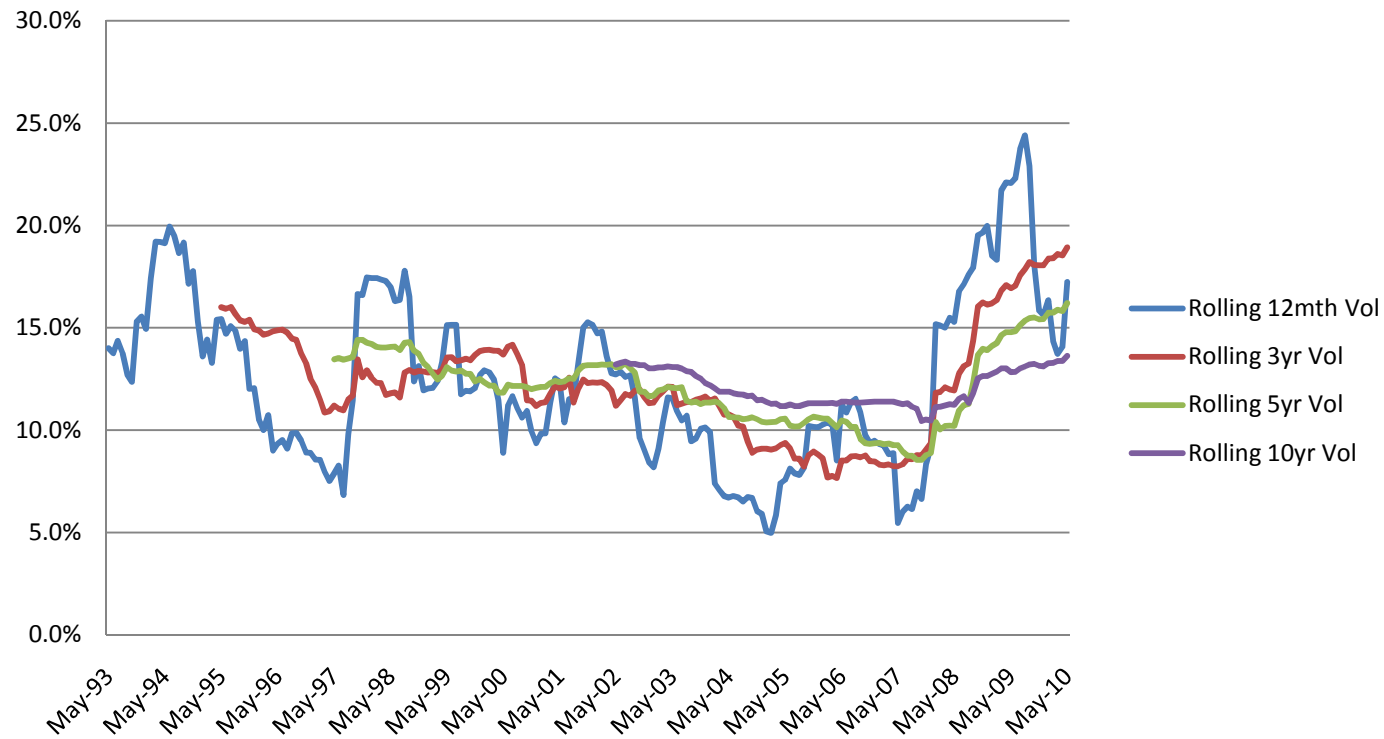
Super System (Cooper) Review (ctd)

- Benefits (6.2 ctd)
 - *“It would leave the detail of the asset allocation in the hands of the trustees, who are best placed to understand the needs and attitudes of members, with the member simply identifying their risk and return preference (if any)”*
 - *“A risk-targeting framework is forward-looking while the current performance information is backward-looking and does not provide members with a proper indication of the expected future returns. Disclosing forward-looking information would help manage member expectations by highlighting the potential volatility of a particular strategy.”*

Volatility Over Time

- Volatility pictures need to be thought through

ASX 200 Accumulation Index - Rolling Volatility



Return Distributions

- Many industry participants use normal distributions to explain likely outcomes to clients
- However, if volatility is not consistent over time then these distributions can be misleading (the tails are likely to be longer than presented)

Risk Targeting is Not New

- Risk targeting is not a new concept
- It is commonly used in the hedge fund industry and applied intermittently amongst institutional asset managers and multi-sector managers

Key Benefits

- The key benefits of a risk targeting framework are all directed towards the end investor:
 1. Ownership and responsibility for risk resides more explicitly with the fund manager
 2. End investors are better placed to understand their investment risk exposure

Ownership & Responsibility

Fund managers become more responsible for:

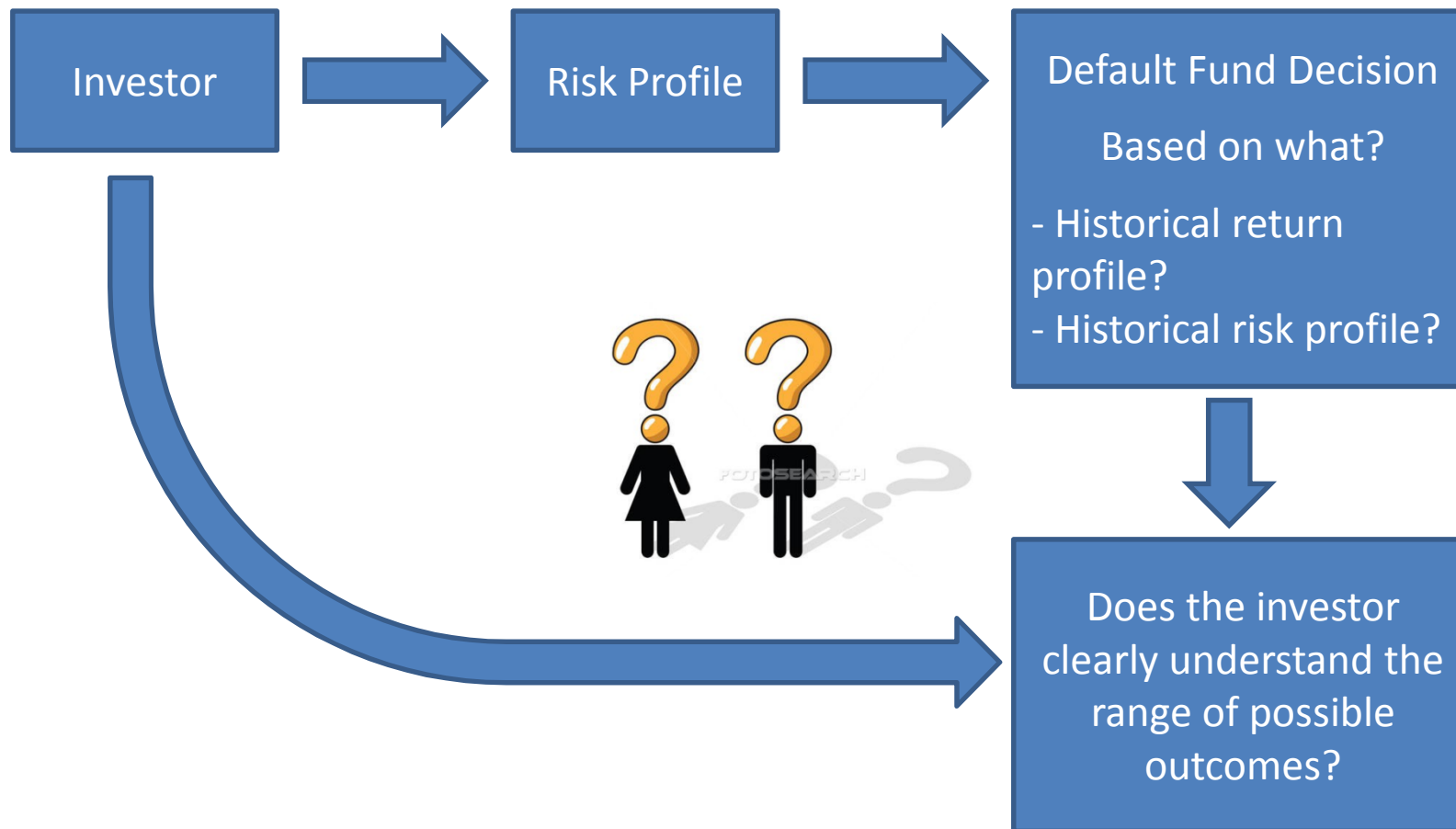
- Assessing the risk and return potential of asset classes and other investment opportunities – these risks are no longer accepted without question as part of a generic growth / defensive blend. This is important given that asset allocation is the largest driver of multi-sector fund return and risk outcomes over the long term
- Taking ownership for the asset allocation of a fund, rather than managing tracking error around the asset allocation ‘benchmark’ defined by a product categorisation
- Blending individual investment risks together at a portfolio level

End Investors

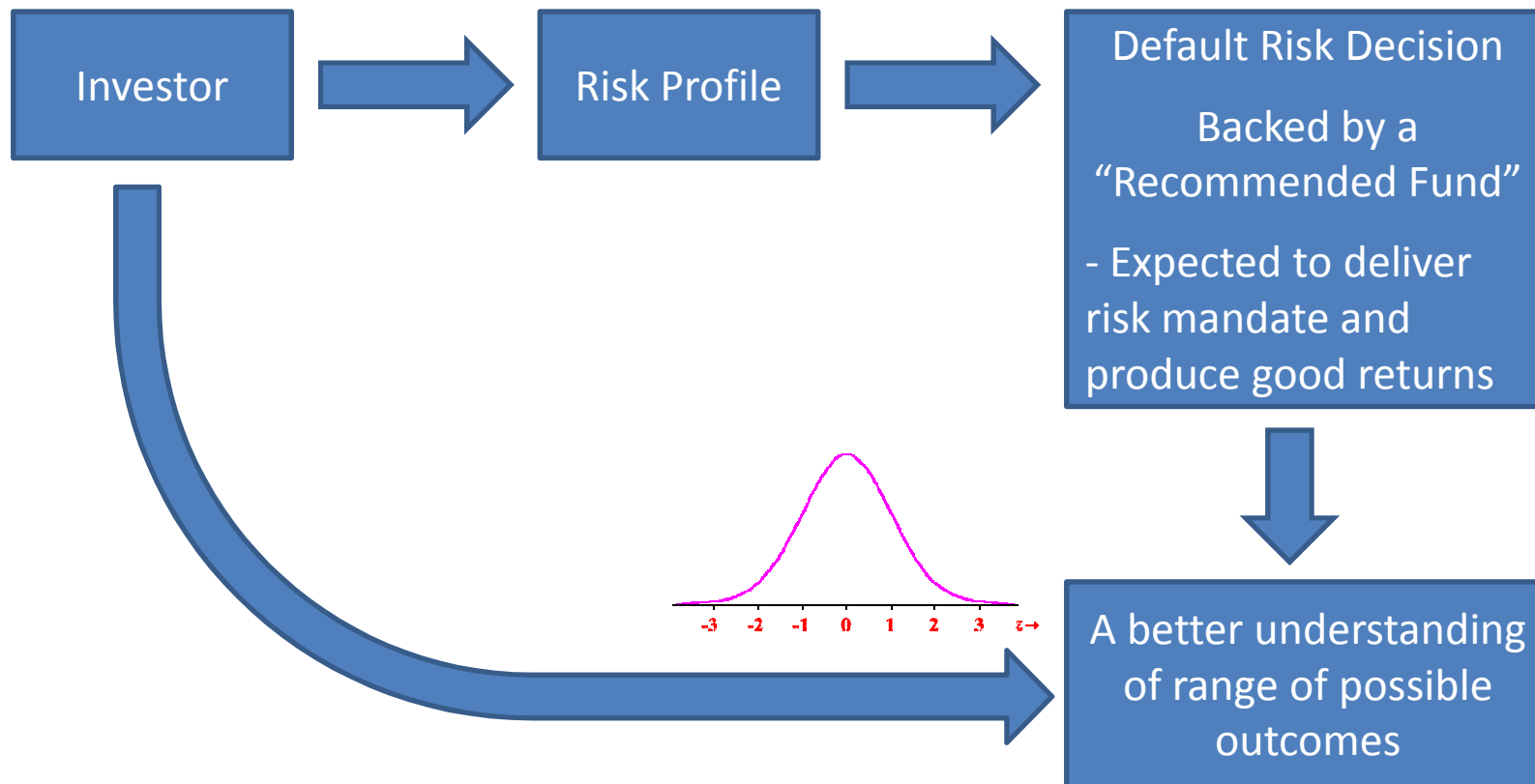
There are multiple benefits for end investors:

- All product risk is actively managed, meaning a greater alignment between fund manager and investors
- The end investor no longer has to forecast asset class returns and risks themselves in choosing their multi-sector solution
- It provides a sound basis for comparison of super funds and multi-sector funds
- The definition of risk is clearer (summarised as a volatility number) from which an investor can better understand the range of outcomes and their likelihood. It matches better with the concept of investor risk profiling, an important component of the financial planning process

End Investors – Current Scenario

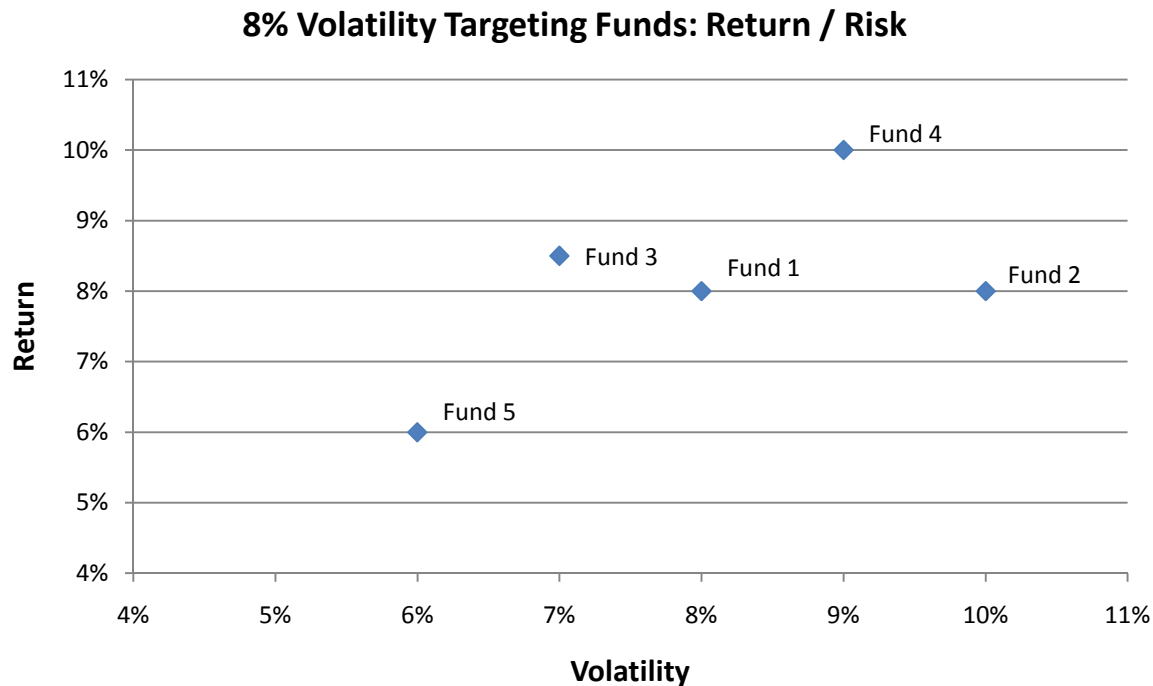


End Investors – Potential Scenario



Example

- The example below illustrates the comparison of funds with a risk target of 8%



Example

In the chart above:

- Fund 2 has taken more risk without delivering higher returns – can they manage their risk profile?
- Fund 4 has taken more risk but this has been rewarded. Still this was not the level of risk the investor expected
- Fund 5 has been too conservative. This is not good as the investor may not be taking enough risk to meet their financial goals
- Fund 3 has managed risk conservatively and managed to deliver good returns

Detractions – Minor Concern

- There will be a greater dispersion of return and risk outcomes amongst fund managers. Is this necessarily bad in an environment of choice? Could be dangerous for MySuper...
- Potentially adverse tax outcomes as a risk targeting regime could lead to greater portfolio turnover as fund managers change their view on the risk and return outlook for different investments. However tax could be incorporated into the return assessment (and Cooper wants it to be)
- It may lead to increased cost in the form of investment staff and risk management systems. The best fund managers have these people and processes in place already

Detractions – Of Greater Concern

- The end client may feel more comfortable about the volatility of their exposure, but potentially have less confidence in the return expectation (eg. the risk may not be consistently sourced from traditional equities over the long term, and in effect partly replaced by the skill of the investment manager) – how do you forecast return in a structure that has less consistent exposure to asset classes?
- There is the potential of negative outcomes in environments where growth assets perform well. Can this be explained to clients?
- Risk targeting may make it more difficult to use investments and instruments with skewed distributions

Detractions – Of Greater Concern

- The return distribution will still not be normal – investments, instruments, events, changing correlations will all contribute to skewed outcomes
- The measure of volatility is important – end investors are probably more interested in the volatility of long run outcomes than the volatility of a series of more frequent observations
- Volatility does not distinguish between upside and downside volatility
- If fund managers react to higher volatility observations by reducing exposure this may actually exacerbate boom-bust market cycles. Of course we hope that fund managers reduce risk based on fundamental reasons, thereby reducing the amplitude of boom-bust cycles...

Comments on Return Targeting

- The Cooper Review also mentions the concept of ‘return targeting’ (alongside risk targeting)
- This is where a group indicates the return they are targeting, along with the risk they are targeting to achieve that return
- This is not the topic of this presentation but some comments:
- This would be very difficult to implement at an industry-wide level
- It could only be implemented as a broad guide because any commitment to future returns is dangerous
 - And remember that every manager will have a different mix of assets
- It could only be used as a guide at an industry-wide level. Imagine if it was applied at a fund by fund level – funds would be encouraged to compete on return targets...

Summary

- The concept of risk targeting is interesting because it can make the understanding and selection of default funds easier for investors
- However there are a number of detractors, minor and major, that need to be explored further before implementation
- From an investor's perspective the balance of key arguments is greater understanding of risk but no greater (potentially lower) understanding of return potential
- Investors are probably unaware of the revolution it may create in terms of multi-sector funds managing risk and return more actively, which should be of great benefit