MARKET INSIGHT

Balanced by name, balanced by nature?

As you are fully aware, IFAs are driven as part of the onboarding process, for clients to discern a risk profile that is appropriate for their circumstances. It's a well-trodden path and we all know where we stand because Balanced means Balanced. But does it?

Cautious, Cautious Managed, Moderately Cautious, Balanced, Low Risk, Cautious Balanced and Moderate – are they all clear and unambiguous as to the risk implied? Indeed, we are sure they are probably similar, but not as one might guess, the same, and it would seem we are not the only ones that think so - Professional Adviser published **an article** earlier this month, investigating a series of underlying themes that have facilitated the performance of certain investment philosophies and objectives within the Cautious sector.

So, what's in a name? Let us use a comparison we can all relate to. Everybody reading this will have eaten in at least two different restaurants. If you were to order the same dish in two different restaurants, they are unlikely to be identical, unless the restaurants are part of a bigger chain. The two meals might be generically similar, but they will not have the same taste, nor probably the same size or the presentation. Why? Because by human nature each of us is different - we are all individuals. Each chef will have different recipes, cooking methods, kitchen equipment etc., and the same applies to a DFM - each will have different thoughts on what weighting of assets defines the portfolio naming convention.

Here lies the issue - if one man's Cautious is another man's Balanced, what risk portfolios are your clients suitably attuned to? This comparison for IFAs is not easy as there is no standard naming convention - one must look deeper. Sometimes fund managers consider their Cautious fund to run around the 25-35% equity exposure, though others will work up to 50%. Likewise, some managers consider their Balanced fund to contain around 50% in equities, though others work to over 70%. The implications are quite far reaching as to the return, but more importantly the risk that is taken to achieve that return.

There are many services out there which try to classify a risk category for the public or for IFAs. However, most of these agents accept a broad weighting differential of underlying assets. If we are playing devil's advocate, then what use is the Cautious managed sector being at a 20-60% exposure to equities? A manager who promotes a very cautious product may never want more than 35% exposure to equity, where a more growth oriented cautious manager may want 50-60% - yet, they are compared openly in the same category. Does this seem just? In a strong market it is clear who will win, as it is equally clear in a poor market.

In the last quarter of 2018, we all experienced a painful market adjustment which saw all portfolios (almost without exception) fall across the DFM industry. Under MiFID II, it is now an obligation to send out letters to clients if their portfolios make a loss of more than 10% - so as you can imagine, this left a bitter taste amongst the many who received them.

Many 10% fall letters were sent out to Balanced portfolio holders, but some even went to Cautious portfolio holders! When something like this happens the naming conventions become interesting, because if you were a Cautious investor would you really in the last quarter of 2018 be expecting to receive such a letter?

In a strong equity market, a fund manager always riding the strong end of equity exposure under any naming convention may well outstrip the more cautious exposure of others - but risk has been taken to get there. To highlight this, in the last quarter of 2018 several Cautious managers lost 6-7%, and some lost 3-4%. Without being too clever about it, the former had 50% exposure to equities and the latter had around 35% exposure.

The key for all managers, TAM or any other, is to be brutally clear where one sits in terms of risk in a named portfolio - in our world that tends to be equity risk for the most part. Likewise, the key for IFAs is to understand where Cautious or Balanced really sits on the scale, and the risk involved - a naming convention is simply not enough.

Of course, active DFMs should change their weightings to look favourable in bull markets and more cautious in bear markets, but the industry does not often make those aggressive moves, and so the bulls become stale and the bears remain generally consistent.

The debate will surely rumble on, but we are more than cognisant that TAM is somewhat ‘safety first’, and clear, open and transparent about the risk parameters within which we work. All IFAs and clients can get the equity and market risk that they choose. This is not always to our benefit in such comparison on naming. But then, we do not want our Cautious investors receiving MiFID II 10% fall letters, and with one of the longest bull markets grinding to its latter stages, this may become very important indeed.

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