



The Risk of Financial Planning Tools

The demand for Financial Planning Tools is increasing but so are the challenges. The market is awash with options of dizzying complexity so selecting the tool that is right for your organisation is not a task to be taken lightly. Vaughan Jenkins provides a beginners guide to some best practice and some of the leading tool providers.

The first half of 2011 has seen a strong focus by the FSA on the suitability of the financial advice provided to consumers. Only last January the regulator reviewed eleven risk-profiling tools and found that nine of these had weaknesses “which could, in certain circumstances, lead to flawed outputs”. Whilst similar weaknesses were identifiable in non-tool approaches, these results and the guidance issued subsequently were to be a significant wake-up call to advisers, tool manufacturers and product providers.

And recently the FSA was castigating practices amongst several wealth managers in a “Dear CEO” letter, stating that a review it had conducted showed that:

14 out of 16 firms were judged to pose a high or medium-high risk of detriment to their customers, based on the number of client files which had a high risk of unsuitability or where the suitability could not be determined.

- Overall, 79% of files reviewed had a high risk of unsuitability or the suitability could not be determined.
- 67% of the files reviewed were not consistent with one or more of the following: the firm’s house models; the client’s documented attitude to risk; and the client’s investment objectives.

What perhaps makes these findings all the more remarkable is that advisers have never had such a choice of sophisticated financial planning tools to support their decision-making process. These range from lifetime cash flow modelers using deterministic projections through to complex stochastic asset allocation tools which can model the probability of outcomes, some based around multiple goal-based attitudes to risk.

So, is the inability to generate suitable client portfolios a problem with the tools themselves, the ability and prejudices of the advisers using them or some combination of factors? Here we provide an overview of the issues to be addressed with a brief synopsis of some the financial planning tools available and the suppliers’ trying to meet the twin challenge of usability and suitability assessments.

Suits you sir?

The first week of the New Year saw a new guidance document from the FSA on assessing suitability based on a thorough understanding of their risk profile. The regulator has expressed concern for some time regarding how advisers analyse and communicate risk with consumers. Their review of investment files between March 2009 to September 2010 resulted in them feeling that half of the cases (366) failed the suitability test. Of the 366 cases, 199 failed on the grounds of inadequate assessment of customer attitude to risk.

The FSA research broke the problems down into these key areas:

- Poor descriptions of attitudes to risk (vague and/or failing to differentiate risk)
- Failing to select suitable products matched to risk profiles (related to poor analysis and poor customer insight)
- Inappropriate focus on the risk a customer is willing to take (lacking a holistic view of needs)
- Lack of understanding of products and underlying assets (skewing asset allocations)
- Lack of responsibility when using tools (inadequate understanding of workings)
- As a result of studying good and poor practice, the FSA guidance now sets out the measures that firms will be judged by. Given the failings identified, product providers, tool providers and advisers have some remedial work to do if they are to avoid further censure.

What are the key lessons?

A recurring concern in the guidance is that firms fail to adequately assess *capacity* for risk as well as *attitude* to risk. This is a subject we have consulted on (and discussed with leading risk-profiling firms such as FinaMetrica who support this view). Risk capacity is not only about withstanding a capital loss but also the potential effects on income. The FSA will be looking for this to be covered in suitability assessments but in such a way that information is not conflated to produce muddled outputs (e.g. jumbling risk capacity, investment horizon and attitude to risk incoherently).



Here we can only highlight a few of the current players and some interesting new offerings but the good news for advisers is that the vendors are alert to the FSA's concerns. Better yet, despite all of the focus on direct to consumer web developments and "robo-advisers", some toolmakers are increasing their focus on adviser firms rather than just large financial institutions.

Voyant

Whilst seeking to penetrate large providers after the notable success of being selected at AXA Elevate, Voyant has found favour with a growing number of IFAs. This has been in part at the expense of Prestwood Truth. It recently completed an integration with FinaMetrica which added to its appeal although Voyant's user interface remains too complex for some users.

Moneyscope

This cash flow planning tool, now with added 'what-if' scenario features, has competed successfully against Truth and Voyant. Cheaper and simpler, it delivers on its more limited scope as a component of a full financial planning solution

Value FE

A leader in sophisticated asset modelling, it has made further advances in its attitude to risk questionnaire and fund analysis tools. It has been present on product provider extranets and inside 1st Software and Focus:360°, as well as being used by banks, making it one of the

most pervasive products in this category.

Distribution Technology

It claims to have signed 1,000 new firms to its Dynamic Planner tool in Q1 2011 alone in the wake of the FSA report. The risk profiler has won plaudits for its clarity. It forms part of a set of modules that can combine into a full 'eco-system', a multi-channel sales platform. In the past, actuarial consultancy-based competitors have questioned the asset modelling aspects but it now has over 30,000 financial advisers to use its risk profiling and asset allocation modules, developed in conjunction with Oxford Risk.

Overseas tools to note...

Figlo (Netherlands)

Not a new firm but one that came to prominence via the Bluerock-sponsored Finovate Europe event, a showcase for new personal finance software. It is leveraging its bancassurance solution used by ABN AMRO and is looking outside Europe for customers for its budget and cash flow tools

Finantix (Italy)

Well established in Continental Europe, it is focusing its sales effort on an iPad version of its comprehensive wealth management solution. An enterprise-wide solution, expect more product developments in 2011-2.

Hello Wallet (USA)

Another recent Finovate attendee, this firm has built a presence in the US workplace market with an attractive cash flow and budgeting system with a simple goal-based wealth-builder. Like Figlo, not a complete investment and risk analysis tool.

EISI (USA)

The US market leader, with some 250,000 professional users of this needs analysis and planning software. The NaviPlan Select version can model up to 30 user defined asset classes and contains 9 standalone calculators covering loans, retirement and protection goals. It shares the Ibbotson Mean Variance Optimizer™ found in the Morningstar toolset.



Risk questionnaires therefore need to be easy to understand and unambiguous (both in terms of the questions and the answers provided). Firms will also need to consider whether they require multiple attitudes to risk (in relation to specific goals, for example) or a single overall attitude to risk profile. The terminology regarding levels of risk needs to be reviewed and changed if necessary. Terms around reasonable or moderate risk were a particular cause for concern, and profiling tools must cater for loss-averse customers. Several recommended model portfolios we have seen do not actually map back to those clients stating that they do not want to place any capital at risk.

The FSA suggests that descriptions should 'clearly quantify the level of risk'. This may seem to conflict with its warning that the profiling process should not assume an unreasonable level of mathematical ability. Good practice examples provided include the use of simple diagrammatic representations of relative risk. In particular, the FSA warns against relying solely on volatility as a proxy for risk. So firms must also take into account inflation risk, liquidity risk and the impact of interest rate changes and a lack of diversification.

Whilst automated tools and model portfolios have become more common place, firms must match their profiling and recommendations together in a robust system. Advisers (and providers) are required to understand the underlying assumptions and mechanisms in the tools that they use. This is a significant challenge for even large bancassurers let alone small IFAs as understanding the assumptions and inner workings of Monte Carlo simulations is very complex. Life offices have tended to rely upon actuarial consultants to validate both their asset allocation models and the relationship to suitable fund choices. The line of sight from attitude to risk to model portfolio through to specific product recommendation is at the centre of the FSA's concerns.

Firms are also required to monitor changes in attitude to risk over time and should analyse the risk profiles being derived relative to expectations for the customer base. There must be a feedback loop to ensure suitability and recalibrated processes if required.

Refreshingly, the FSA guidance does recognise that the customer's attitude towards risk and capacity to sustain loss may be incompatible with the customer's needs and objectives. The key point here is to clearly define the gap; the consequences of this and to record how the customer may have come to accept a different level of risk as a result of this analysis.

Spoilt for choice?

With these guidelines in mind, we have worked with a number of firms of different sizes and types that are looking to select an appropriate software package, or build their own, that will support their advisory process. All have commented that whilst there are some attempts at comparisons of features between vendors available these are relatively superficial and costly – a ticks and crosses approach providing little insight into either the quality or overall usability of a package. (Nor, indeed, the product development route map and commercial health of the vendor). Some tools are far more cash flow and budgeting orientated as holistic financial planners, whilst other are more geared to investment analysis and decision-support. Others are effectively complete front-office business solutions, containing profiling and asset allocation elements. The table below provides a thumbnail sketch of software tools being used to support all or part of advisers' recommendations:

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