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Canada Life

Risk-target managed or risk-profiled funds, what's the difference?

With markets seeing an uncharacteristic degree of volatility recently, many advisers will naturally be getting calls from clients worried about the safety of their investments and their returns.

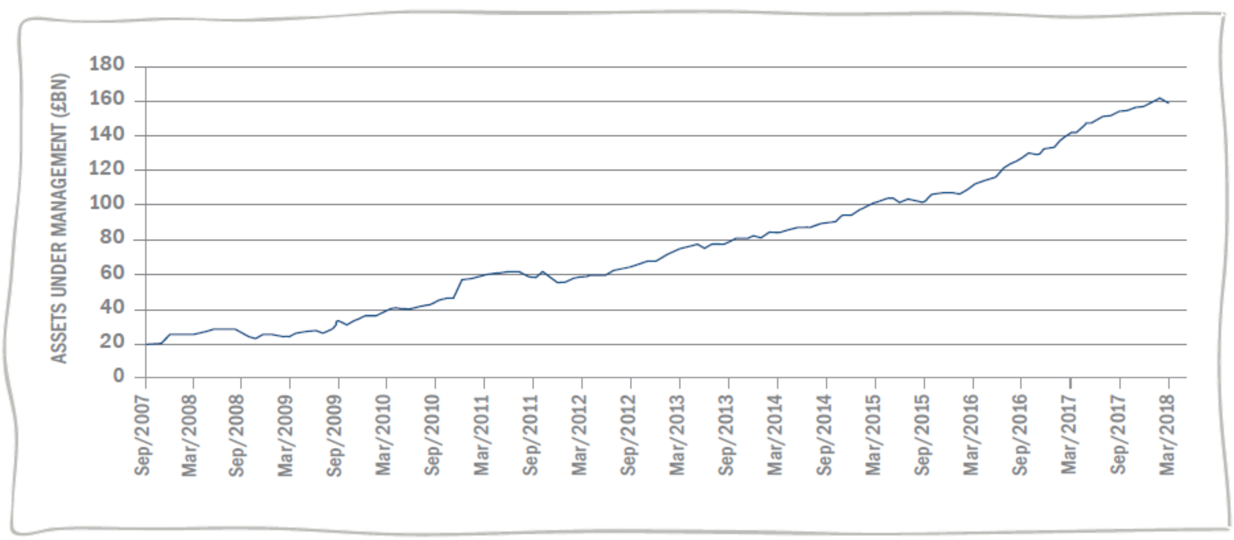
Some advisers will see this as a great opportunity to talk to them about risk – in particular, how best to match an investment with their risk profile, and perhaps be better prepared to ride out the financial storms.

It can sometimes be a tricky conversation, but the good news is that there is a solution, and one that could potentially deliver serious benefits to advisers and their clients.

Risk-target managed and risk-profiled funds were popularised after the 2007 recession and designed to help investors determine their appetite for risk and find appropriate funds. They are a solution that could have been created for the needs of today. They were born in turbulent markets, and designed to give clients an incredibly clear view of both their potential risks and returns.

In the last five years the amount of money invested in risk-rated Dynamic Planner funds alone has increased from £66 billion AUM to around £160 billion, an upward trend that market conditions such as we're seeing are likely to further accelerate.

Total assets invested in funds currently risk-rated by Dynamic Planner
(includes both risk-profiled and risk-target managed funds)



Source: Morningstar Direct & Dynamic Planner, data correct as at 28/02/18. Figures include all funds that currently have a risk-profile or risk-target managed 1-10 rating from Dynamic Planner.

Why are these funds growing?

There are different reasons for this growth. Certainly it would be understandable if investors were more risk averse in the post-recession world of 2007, so a simple risk classification scheme was the right idea at the right time.

Another reason lies with the Financial Conduct Authority which in 2012 introduced guidance which put the onus on ensuring that investments always remained suitable squarely on individual advisers. Firms providing investment advice were required to have robust processes and controls when recommending or replacing an existing investment, to consider its suitability for a client on an individual basis, and establish controls to mitigate risks.

The move by the FCA played no small role in the rise of risk profiled funds, with many advisers welcoming a risk-rating on funds that offered a straightforward way to meet both the FCA's requirements and their clients' need to manage risk.

How do they work? Risk-profiled and risk-target managed

Risk-profiled funds are risk-rated by analysing the historic returns from the fund and its benchmark with a focus on the volatility of returns. Funds with a higher volatility will generate a higher risk profile than those with lower volatility. However, because risk-profiled funds are flexible in their allocations, active managers have over time made changes that caused their funds risk rating to shift.

This was not ideal for some advisers or their clients, and in 2015 we saw the official entrance of risk-target managed funds, which aim to provide advisers with solutions that would ensure long-term client suitability. Unlike risk-profiled funds, risk-target managed funds are managed to strict asset allocation guidelines, independently set by a specialist agency. In practical terms, this means that advisers can invest in a risk level 3 fund, for example, and know it would always remain at that level.

Risk-target managed funds have grown by 400% in five years, from £1.3 billion in 2012 to £5.4 billion in 2017, a significantly higher rate of growth than risk-profiled funds. While in some ways it's early days for these funds their upward trajectory has been clear so far. As we have seen both risk-profiled and risk-target managed funds have enjoyed consistent growth.

At Canada Life we see this growth as down to the risk scheme's ability to help manage investment suitability over the longer term. Ultimately, these schemes free up advisers to add value to the account in other areas, while providing their clients with a clear way to understand their investment risk.

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