MS17/1.2: Annex 5

Market Study

Investment Platforms Market Study

Interim Report: Annex 5 – Model Portfolio Review

July 2018

Annex 5: Model Portfolio Review

Introduction

1. In recent years, some platforms have developed more extensive business models, offering tools to guide consumers' investment decisions such as model portfolios. A model portfolio is an investment solution that consists of a number of pre-selected funds.

2. Platforms are increasingly designing and managing their own model portfolios. There has been steady growth on Direct to Consumer (D2C) platforms, with assets under administration (AUA) in platforms' in-house model portfolios increasing three-fold from £4.5bn in 2011 to £14.1bn in 2017. Provision on adviser platforms has increased at a faster rate, from £0.9bn to £22.5bn or by 25 times over the same period. In our consumer research, 17% of non-advised consumers told us that they chose model portfolios.

3. We wanted to understand whether non-advised investors who use model portfolios without the help of a financial adviser are able to make informed decisions, including whether platforms have enabled consumers to shop around and choose the best model portfolio for them. We have considered the following issues:
   - whether risk naming conventions could make it difficult for consumers to compare model portfolios offered by different providers
   - how much consumers pay in total to invest in model portfolios, and whether consumers who pay more for a portfolio receive better net returns on a risk-adjusted basis.

4. We assessed whether our quantitative findings were applicable to the model portfolios constructed by both D2C and adviser platforms. Our focus was on D2C platforms as advisers are likely to be better able to assess whether a model portfolio's underlying assets and charges are suitable for their clients.

Scope of the analysis

5. The products in scope of our analysis were risk-targeted model portfolio [1] manufactured by platforms. A model portfolio can be set up as a fund, in which case the portfolio itself is subject to our fund rules. For the purposes of our assessment we included risk targeted multi-asset and multi-manager funds manufactured by platforms[2] and comparable firms.

6. Our sample covered various portfolio structures, including those that are lists or baskets of funds (referred to as 'non-unitised' portfolios) and those that are structured as funds themselves, referred to as 'unitised' portfolios. Unitised portfolios include both multi-asset and multi-manager funds (also known as 'fund-of-funds'), commonly structured as UCITs.

[1] Risk targeting is a forward-looking exercise, in contrast to risk rating which is assigned at a single point in time.

[2] Including portfolios manufactured by entities within the same group as the platform.

7. For the purposes of our assessment we included:
   - non-unitised portfolios which the platform constructs and that can be accessed by multiple consumers. For some of these portfolios, it may be possible for the consumer to rebalance the portfolio themselves.
   - a sample of comparable products, both unitised and non-unitised. These were model portfolios manufactured by comparable firms, such as asset managers, life insurers and retail banks.

8. We excluded:
   - non-unitised portfolios that are bespoke to the individual consumer
   - non-unitised portfolios which are rebalanced by the platform over time
   - model portfolios hosted on platforms manufactured by 3rd parties, as our focus in this review is portfolios provided by platforms themselves[3]
   - a small number of platforms' portfolio solutions due to the recent creation of the solutions or lack of data

9. The different portfolio types in scope of our analysis will all be referred to as (ready-made) 'model portfolios'.

10. Our analysis covers products manufactured by platforms during January 2012 – June 2017. This is the time period for which firm data are available and provides a reasonable length of time over which to assess how portfolios have performed. We recognise that our findings are historic and reflect strong market performance over the time period.

Data

11. Our 2 data sources were firm submissions to the Investment Platforms Market Study data request and Morningstar Direct. Figure 5.1 outlines the data we gathered and the source of the data.

Figure 5.1: Data description and sources

Data	Source
General information: portfolio name, ISIN, fund manager (for unitised portfolios)	Firm submissions
Annual charges borne by consumers excluding standard platform fees and monthly net returns net of these charges (for non-unitised portfolios)	Firm submissions
AUA at the end of each year (and half year for 2017)	Firm submissions
Benchmark information, asset allocations	Firm submissions
Annual charges, monthly net returns (for unitised portfolios)	Morningstar Direct

Note: Total expense ratio (TER) has been used in place of OCF for unitised portfolios when OCF is not available. In determining the total return of each fund, Morningstar assumes reinvestment of all cash and bonus unit distributions in order to account for variations in the size and timing of distributions. Morningstar does not adjust the total returns for broker commissions, but does account for management and administrative fees and other costs automatically taken out

[3] If the platform belongs to an integrated firm, the products manufactured by the asset management part of the business are also in scope. Third-party portfolios/funds, bespoke solutions or those constructed by advisers for their own customers are excluded from the review, as well as pension and life products.

of fund assets (excluding initial charges and exit fees). Data for unitised portfolios is at the share class level from January 2012 to June 2017, converted to the fund level with average monthly returns and annual OCF weighted by AUA across all share classes available on a given platform for a given fund. This is to avoid over- or under-representation of a particular portfolio in cases where some firms submitted all share classes of the same portfolios while others do not. The aggregation to fund level also provides an assessment of the whole portfolio, weighted by AUA in each share class.

Source: FCA analysis

12. Our model portfolio review covered:
    - the size of model portfolio solutions by platforms (using AUA data as shown in Figure 5.1 above)
    - an assessment of whether naming conventions used in these portfolios consistently reflect their risk level (implied by their asset allocations)
    - the range of charges and their relationship with net returns

13. The sample size for each stage of our analysis is as follows.

Figure 5.2: Number of portfolios for each stage of the analysis

Firm type	AUA	Asset allocations	Range of charges	Net returns
Adviser platforms	546	540	355	296
D2C platforms	125	125	99	88
Comparable firms	126	125	106	62
Total	797	790	560	446

Note: The total number of portfolios with AUA data included in our analysis is 797 for both platforms and comparable firms. The smaller sample size for various stages of the analysis is due to data availability. We used three-year performance to calculate net returns; no non-unitised portfolios from D2C platforms were covered in the net returns calculations because they have existed for less than 3 years.

Source: FCA analysis

Naming convention, risk categorisation, and asset allocation

14. Currently, there is no consistent industry-wide standard to categorise portfolios based on their risk levels. We wanted to understand the implications for investors so we assessed the variation in risk levels of portfolios with similar labels such as 'cautious', 'balanced', and 'adventurous'.

15. These naming conventions covered 118 portfolios, or approximately 20% of the total number of model portfolios provided by platforms, and 26% of AUA invested in platforms' portfolios in 2017.[4] Taking both portfolios from platforms and comparable firms into account, these naming conventions covered 21% of portfolios and 41% of AUA invested in these portfolios in 2017. For the remaining 80% of portfolios from platforms, naming conventions did not imply comparability between portfolios. Given that consumers are less likely to consider these portfolios to be comparable, we excluded these portfolios from this part of the analysis.

16. We assigned each portfolio in our sample an Imputed Risk (IR) category, with 1 being lowest risk and 6 being highest risk based on a set of asset allocation criteria for each risk category. Our main asset allocation criteria followed the criteria used by Dynamic Planner's (DP) Model Portfolio Service (MPS) risk profiling.[5] We considered

[4] This is 14% in AUA for portfolios from D2C platforms and 34% for adviser platforms.

[5] Dynamic Planner is a risk profiling and financial planning service used by financial planners and other financial institutions to ensure investment suitability.

both the broader and more granular target asset allocations from their MPS, along with average asset allocations across their MPS. A portfolio was assigned an IR category if the absolute difference between the portfolio's asset allocations and the allocations of that IR category was the lowest among six IR categories. The IR assigned most frequently for each portfolio using these sets of asset allocations from DP was used as the final IR for that portfolio.

17. We also considered other asset allocations used by the industry for a set of specified risk levels. We found that the asset allocations from DP are closely aligned with the MSCI WMA Private Investor Index Series complied by PIMFA.[6]

18. This approach provides a high-level indicator of the risk level associated with each portfolio. It does not account for sector-specific and country-specific risks of the underlying holdings. For portfolios without the granular breakdown of asset allocations into UK/World excluding UK equity and UK/World excluding UK bond, we used total equity and bond instead.

Figure 5.3: Average asset allocations for each Imputed Risk (IR) category among portfolios manufactured by platforms in our sample

IR	UK equity	World excl. UK equity	UK bond	World excl. UK bond	Property	Cash	Others
1	7	8	32	16	4	15	18
2	15	23	24	17	5	8	9
3	22	31	16	13	6	5	8
4	23	43	7	7	6	4	9
5	33	50	2	3	3	2	8
6	18	73	0	1	1	1	4

Source: FCA analysis

19. The IR categories assigned to portfolios allow us to demonstrate the variation in risk level associated with portfolios with similar labels. Figure 5.4 below shows the highest, most frequent and lowest IR category for similarly labelled portfolios (max, mode, and min IR respectively). We found similarly labelled portfolios had a range of IR categories and an overlap in the IR categories of differently labelled portfolios. For example, portfolios with 'high risk' labels such as 'adventurous' and 'aggressive' had IR categories from 3 to 6. These IR categories significantly overlap with portfolios named with a 'medium risk' label such as 'moderate' and 'balanced'.

Figure 5.4: Variations in IR categories for similarly labelled portfolios manufactured by platforms

Name	Max IR	Mode IR	Min IR	Number of portfolios
Adventurous	6	4	3	25
Aggressive	6	4	4	6
Moderate	4	3	2	5

[6] Please see https://www.pimfa.co.uk/private-investor-indices/current-asset-allocation/

Name	Max IR	Mode IR	Min IR	Number of portfolios
Balanced	5	3	1	35
Cautious	3	1	1	28
Conservative	2	2	1	9
Defensive	2	1	1	10

Note: The table above includes only portfolios manufactured by platforms. However, we found similar results when including comparable products in the analysis, indicating that this is a wider issue than a platform-specific issue. 'Growth' and 'income' only portfolios (without the above naming conventions) have not been considered in this analysis due to the lack of specific implied risk levels.

Source: FCA analysis

20. Figures 5.5 – 5.7 below show the variation in asset allocations which can explain why the risk level of similarly labelled portfolios varies. We grouped portfolios into 3 groups – low, medium, and high risk – based on their labels and showed the variations in asset allocations within each group. The asset types shown here are total equity, total bond, cash, and other assets, which is broader than the asset types used in our IR category assignment.

21. In Figures 5.5 – 5.7, each portfolio is represented in the same order across the four asset types. So, for example, the first bar in each asset type represents the same portfolio and they add up to 100% of the total asset allocation for that portfolio. In addition, portfolios are colour coded based on their IR categories. We observed the following:
    - there is a wide variation in asset allocations, most noticeably in total equity and total bond, for the same group of portfolios (high/medium/low risk)
    - there is also a wide variation in IR categories within the same group of portfolios, driven by the variation in asset allocations

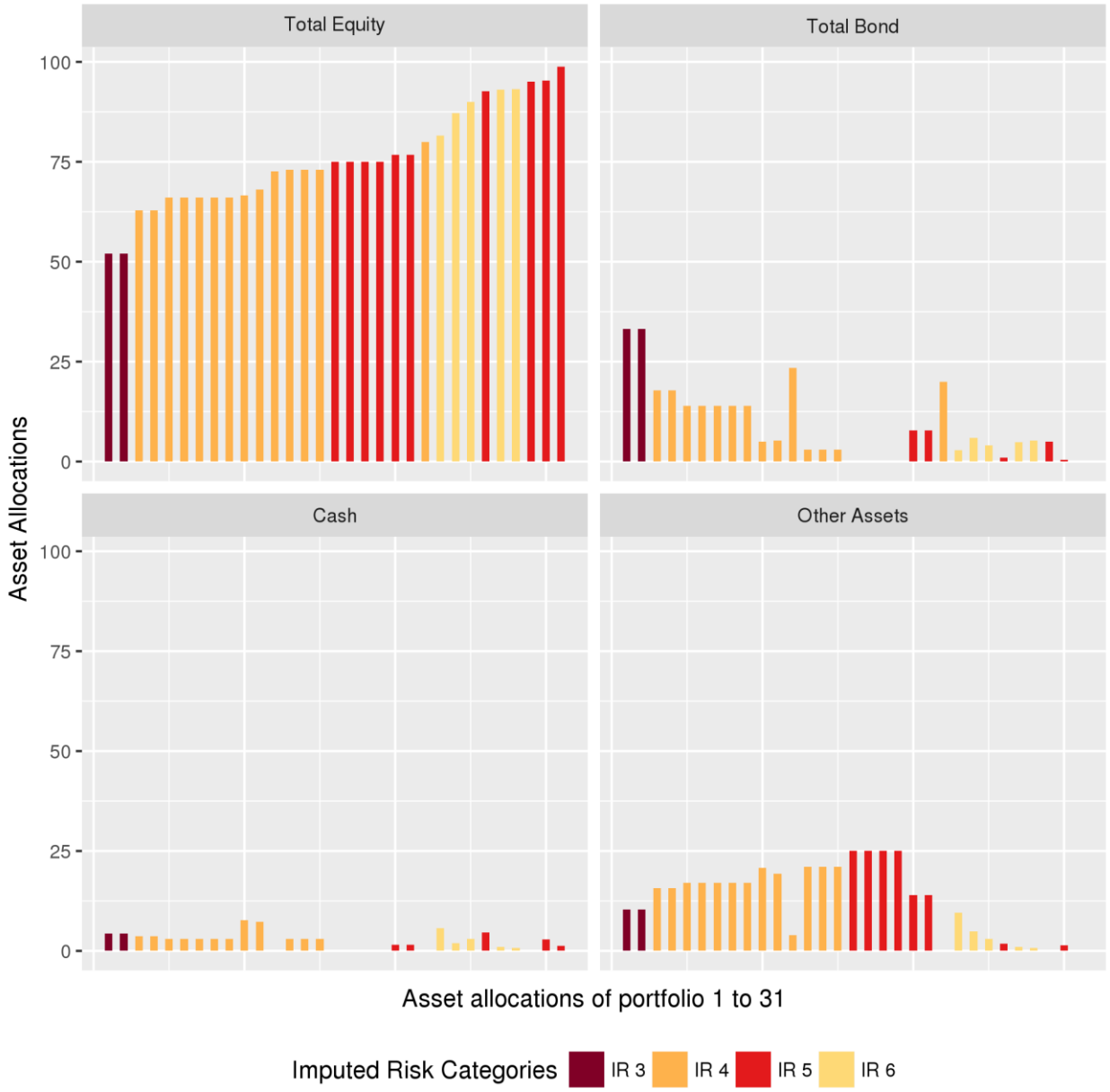
22. Across all naming conventions, we found inconsistency in the risk level when assessed by reference to asset allocations, though this was more pronounced for portfolios with medium and high-risk labels. In Figure 5.6 portfolios where the name implies medium risk, including words such as 'moderate' or 'balanced', the allocation to bonds varied substantially from less than 5% to over 60% and similar variation was found with allocations to equity. Thus, many portfolios labelled as medium risk could potentially be better categorised as high risk or low risk.

23. In addition, 20% of the portfolios named with a 'medium-risk' belong to the IR 1 and IR 2 categories and could be considered more aligned with low risk than medium risk as their names suggested.[7] This is consistent with the wide range of asset allocations for these portfolios.

24. We found mismatching between portfolio names and their risk levels also applied to the model portfolios manufactured by comparable firms, including asset managers, life insurers, retail banks. Among our sample of comparable products, around 42% of the 'medium-risk' portfolios were assigned to the IR 1 and IR 2 categories, based on their asset allocations.

[7] It is 15% for D2C platforms and 22% for adviser platforms.

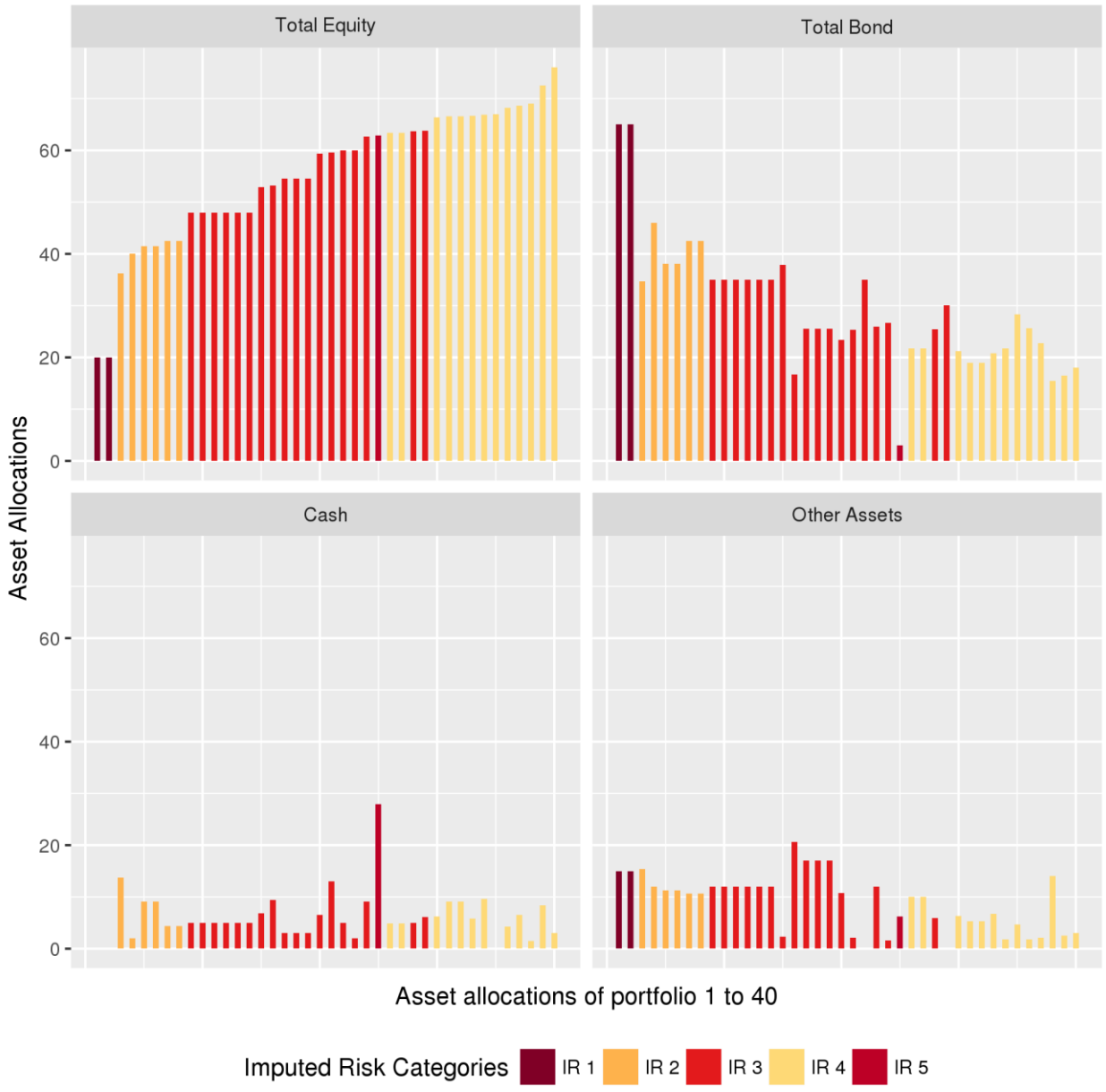
Figure 5.5: Variations in asset allocations across high-risk labelled portfolios manufactured by platforms



Note: Portfolios included here contain the word 'adventurous' or 'aggressive' in their labels which would give consumers the impression of a high-risk investment.

Source: FCA analysis

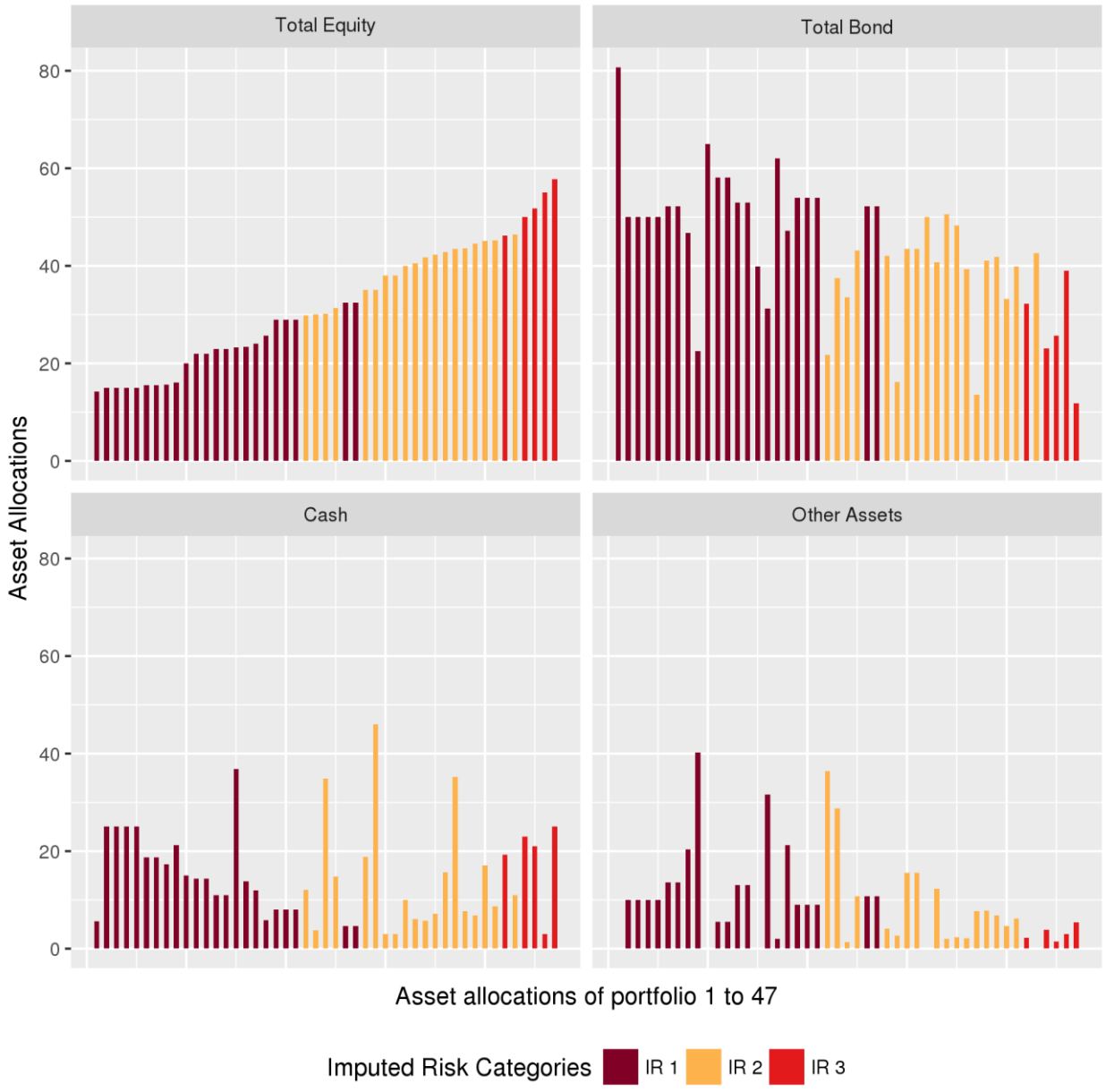
Figure 5.6: Variations in asset allocations across medium-risk labelled portfolios manufactured by platforms



Note: Portfolios included here contain the word 'moderate' or 'balanced' in their labels which would give consumers the impression of a medium-risk investment.

Source: FCA analysis

Figure 5.7: Variations in asset allocations across low-risk labelled portfolios manufactured by platforms



Note: Portfolios included here contain the word 'cautious', 'conservative' or 'defensive' in their labels which would give consumers the impression of a low-risk investment.

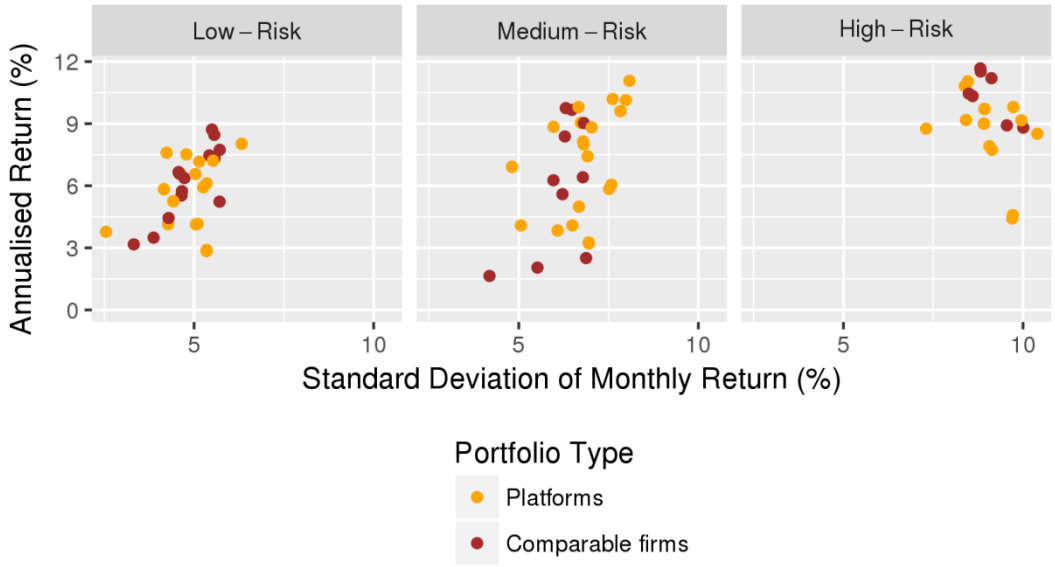
Source: FCA analysis

25. When assessing risk using volatility over a three-year period, we found a similar picture (see Figure 5.8). On average, portfolios experienced volatility reflective of their naming convention, with low-risk named portfolios having the lowest volatility and high-risk the highest on average. However, there was significant variation in volatility between similarly labelled portfolios. We also observed an overlap between naming categories, again highlighting the potential confusion caused by naming conventions. This finding is applicable across portfolios by D2C platforms, adviser platforms and comparable firms.

26. Our findings indicate that judging risk based on naming conventions does not necessarily help consumers understand the degree of risk they would be exposed to. At worst, such naming conventions, along with lack or inconsistency of information available on platforms, could mislead investors into portfolios with a significantly different level of risk than they expect.

27. Our analysis here only covers portfolios within the relevant naming conventions as described above. Further work will be done to understand the extent to which these findings are applicable to other portfolios not using these naming conventions.

Figure 5.8: Volatility versus Annualised Net Returns by portfolios' labels across advised and direct to consumer platforms



Note: Low-risk portfolios include those labelled 'cautious', 'conservative' and 'defensive'. Medium-risk portfolios include those labelled 'moderate' and 'balanced'. High-risk portfolios include those labelled 'adventurous' and 'aggressive'. This analysis includes in-house model portfolios of D2C and adviser platforms, and of comparable firms.

Source: FCA analysis

Impacts of charges on net returns

Range of charges

28. We assessed the range of charges for the model portfolios in our sample where data were available from firm submissions and Morningstar Direct (see Figure 5.2). Our sample included both D2C and adviser platforms, as well as those from our sample of comparable firms.

29. We found a wide range, from 0.05% to 2.5%, of average charges during 2012 – 2017[8] (0.05 – 1.85% for 2017 charges only). We also considered the range of OCF for similarly comparable portfolios from firms within the Investment Association and/or the Tax Incentivised Savings Association that were not included in our sample. These were unit trusts[9] that consumers may be able to purchase directly on a non-advised, non-discretionary basis. We found that their 2017 OCFs fell within the

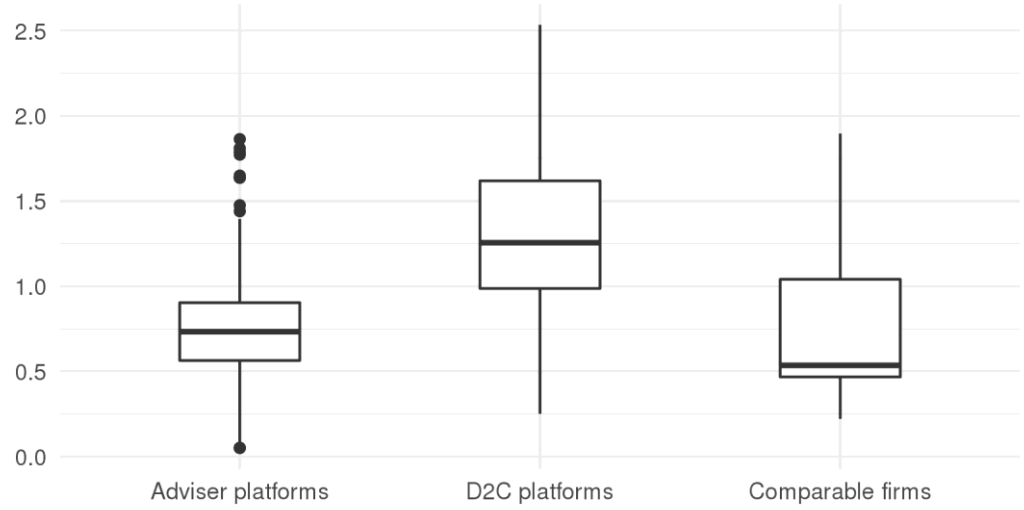
[8] For the years that the portfolios have existed.

[9] Unit trusts are a type of investment funds which are split into units that investors can buy or sell. They are considered 'open-ended' funds because the creation of units can be unlimited and thus the price of each unit depends on the net asset value of the funds' underlying investments.

0.57 – 1.47% range, consistent with the range of charges for comparable firms in the figure below.

30. Note that for some comparable firms (robo-advice firm and asset managers' online portals), the charges presented here have already included their equivalent of platform fees. We would like to understand more about what drives the difference in charges of portfolios from platforms and comparable firms in our future analysis.

Figure 5.9: Average model portfolio charges 2012 - 2017



Note:

- Charges for model portfolios on adviser platforms do not include adviser fees.
- This is based on all charges associated with investing in model portfolios offered by adviser and D2C platforms, but not platform fees.

Source: FCA analysis

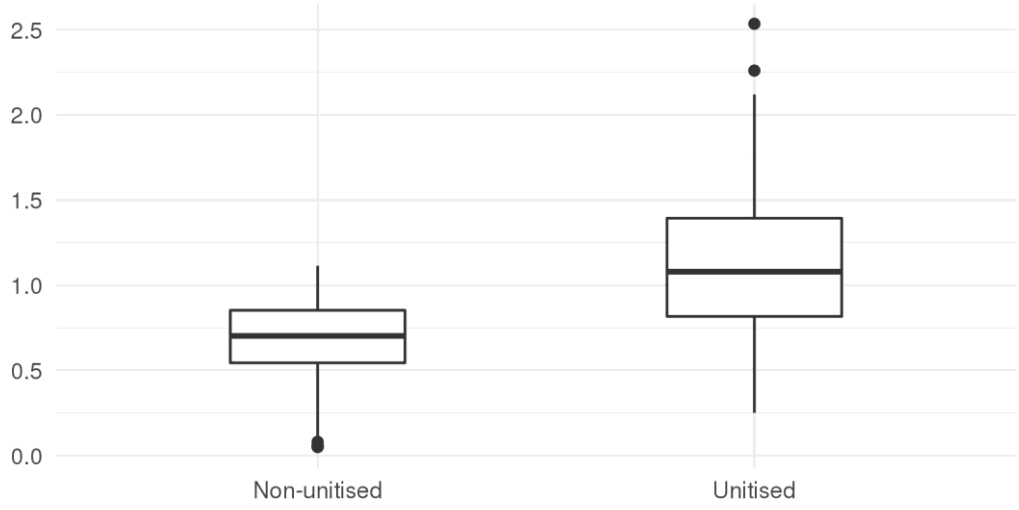
31. It is reasonable to expect that portfolios with passively managed funds may be cheaper than those with actively managed funds. Unitised portfolios may be more expensive than non-unitised portfolios using the same underlying funds if they do not incur additional management charges. We explored whether this was the case for the portfolios in our sample.

32. **Model portfolios with passively managed funds:** Based on what firms have indicated and how model portfolios are labelled, we identified 62 platform portfolios that were considered passive. The range of average charges during 2012 – 2017 among these portfolios was 0.15 – 0.85%, with an average of 0.34% which was lower than the average of 0.9% for non-passive portfolios.

33. However, due to the multi-asset, multi-manager nature of most model portfolios, it is not straightforward to distinguish these model portfolios from those investing in active funds. Within our sample, some model portfolios have been labelled 'passive blend' and similar, indicating that some, but not all, underlying funds of the portfolios are passive. In addition, even with all passive underlying funds, a model portfolio can still be considered active due to the portfolio management, ie platforms actively choosing the underlying funds.

34. **Unitised vs non-unitised:** It is reasonable to expect non-unitised portfolios to be cheaper than unitised ones if they do not have the same level of overhead management charges. We observed that unitised portfolios indeed tend to have higher charges than non-unitised portfolios, among those manufactured by platforms. Note that most portfolios from D2C platforms included in our analysis are unitised while a significant portion of portfolios from adviser platforms are non-unitised.

Figure 5.10: Average charges during 2012 – 2017 for non-unitised and unitised portfolios



Note: The sample includes 97 unitised and 258 non-unitised portfolios from adviser platforms, as well as 93 unitised and 6 non-unitised portfolios from D2C platforms.

Source: FCA analysis

Relationship between charges and net returns

35. Given the wide range of charges consumers can incur for investing in a model portfolio, we wanted to understand what impact charges have on net returns for consumers. Since riskier portfolios may be able to earn higher gross and net returns than less risky ones with the same level of charges, it is important that we control for risk when assessing the relationship between charges and performance. We used the Sharpe ratio to measure the risk-adjusted returns from portfolios. [10] We used returns net of fund charges from Morningstar Direct for unitised portfolios and from firms' data submission for non-unitised portfolios from July 2014 to June 2017 (ie three-year performance).

36. We divided portfolios from D2C and adviser platforms into 2 groups based on whether their average charge over 2012 – 2017 was above or below the median charge of 0.82%.[11] We found that overall portfolios in the high-charges group tend to have lower net risk-adjusted returns, measured by the Sharpe ratio, than those in the low-charges group.[12] In addition, the Sharpe ratio and average portfolio charge

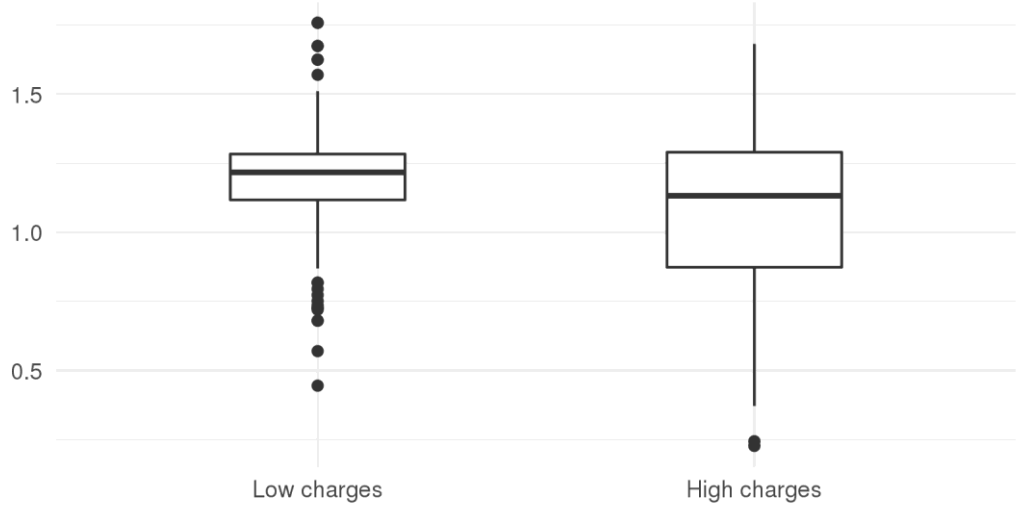
[10] The Sharpe ratio adjusts excess returns relative to the risk-free rate for risk measured by standard deviation. We used Bank of America Merrill Lynch 1-month GBP LIBOR interest rate as a proxy for risk-free rate in the Sharpe ratio calculation. This follows the approach Morningstar uses in its fund rating. See Appendix 1: https://corporate.morningstar.com/US/documents/MethodologyDocuments/MethodologyPapers/MorningstarFundRating_Methodology.pdf

[11] There are 424 portfolios for which we have data on both charges and net returns.

[12] This result is statistically significant at 99% confidence level based on Dunn's test.

are negatively correlated and statistically significant at 99% confidence level.[13] These findings also hold among portfolios from both platforms and comparable firms.

Figure 5.11: Annualised Sharpe Ratio for portfolios with low and high charges



Note:

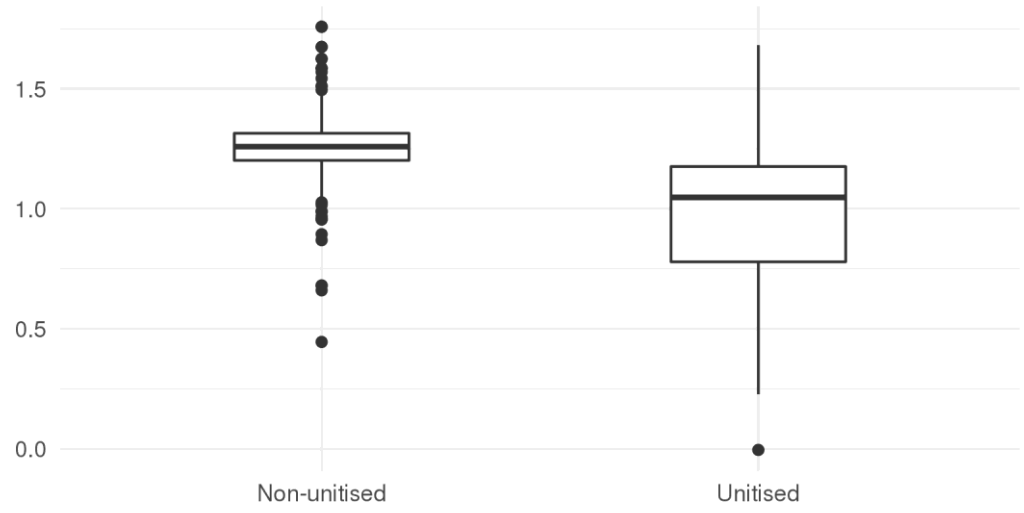
- Portfolios are grouped based on how their charges are relative to the median
- Annualised net returns are based on performance during July 2014 – June 2017.
- The difference in returns between low-charges and high-charges portfolios is statistically significant at 99% confidence level, based on Dunn's test. Sample size is 364 portfolios (with 17 passive portfolios) which we have data on both charges and net returns. These include 81 portfolios from D2C platforms and 283 from adviser platforms.

Source: FCA analysis

37. We found that the difference in range of charges between unitised and non-unitised portfolios shown in Figure 5.10 is also reflected in their net returns where non-unitised portfolios with lower charges, overall, have higher net returns than unitised portfolios. This is consistent with our finding from the previous section.

[13] This is based on the Spearman's correlation.

Figure 5.12: Annualised Sharpe Ratio for non-unitised and unitised portfolios



Note: The sample includes 100 unitised and 196 non-unitised portfolios from adviser platforms, as well as 88 unitised from D2C platforms.

Source: FCA analysis

38. Our analysis examined the relationship between charges and returns, adjusting for risk by using the Sharpe ratio. Another approach to risk adjustment would be to assess portfolio performance against their benchmark. However, due to the lack of benchmarks and large inconsistency among portfolios that disclose their benchmarks, we have not pursued this approach at this stage and may consider it for further analysis.

39. Three-year performance has been used in this analysis since most model portfolios have only been around for less than five years. It is, therefore, important to note the potential time-period bias, ie since 2012/13, the economic and financial environment has been very stable with low interest rate, positive GDP growth and no significant foreign exchange shock for major 3 currencies (except around Brexit). This may have an impact on returns of portfolios with different risk levels, for example high-risk portfolios may exhibit lower returns in an economic downturn. However, it is not clear what direction this may change our findings given that there is a wide range of charges among portfolios within a specific risk level.

Conclusion

40. We found that model portfolio risk naming conventions are unlikely to allow consumers to use these names to compare model portfolios offered by different platforms and comparable firms. Comparison is made more difficult when benchmarks and information about asset allocations is not available. Consumers may therefore also be investing in portfolios with a different risk level than they would expect.

41. Overall, we found a wide range of charges for the portfolios in our sample. We also found that consumers who pay higher charges are more likely, on average, to receive lower net risk-adjusted returns than those investing in portfolios with lower charges. This finding also holds when we considered net returns of unitised

portfolios, which tend to have higher average charges, and non-unitised portfolios, which tend to have lower average charges.

42. To follow up from our work presented in this annex, we plan to do further analysis in two areas. First, we would like to understand whether consumers would be able to assess the risk levels of portfolios without the naming conventions, such as 'cautious', 'adventurous' and 'balanced'. Second, given the wide range of charges, the next step is to identify the main drivers of the difference in charges for model portfolios by platforms and comparable firms.

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