HE WHO RECOMMENDS IT SHALL BE LIABLE FOR IT

Ben Raven - Director

Last week's edition of Money Marketing featured an article on the FSCS and a potential "shake up" of how redress for bad advice will be paid in future.

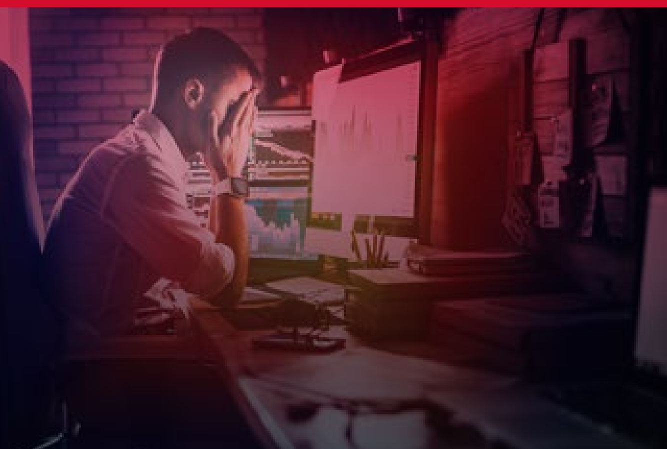
One of the key proposals put out to consultation was whether product providers should be required to contribute around a quarter of the bill that currently falls at the financial adviser's door.

For a financial adviser, recommending a portfolio to a client comes with inherent risks. The adviser agrees the client's attitude to risk (ATR) profile, selects an investment portfolio to meet their needs and then carries the liability. If that portfolio becomes mis-aligned with the client's ATR profile over time, the risks all belong to the adviser.

When the adviser is matching the client's ATR to an investment portfolio, the fund managers are all selling to them. The adviser must ensure the volatility of the portfolio remains appropriate at all times, and owns all the risk if the portfolio does ever deviate. The adviser is liable because they are the ones who recommend it, not the fund manager.

The interests of the adviser and the fund manager are clearly not aligned in this scenario. To this end, the FSCS article contained a quote from the Chief Executive of Investment Quorum. Commenting on the relationship between adviser and fund provider, Lee Robertson said: "Providers are queueing up at advisers' doors with their products, but when they don't perform as expected they are nowhere to be found and advisers carry the can."

Performance is one issue...



...however there are numerous other issues capable of causing advisers serious problems in the years ahead. These could be to do with transparency of information – the total cost of owning a fund for example (see previous blog on **hidden trading charges**). They could be to do with a portfolio becoming misaligned from a risk perspective – e.g. the impact of foreign exchange on portfolio volatility, or the current dynamics of the UK bond market and potential capital losses for those who can least afford them (see previous blogs on **currency risk** and **bond markets**).

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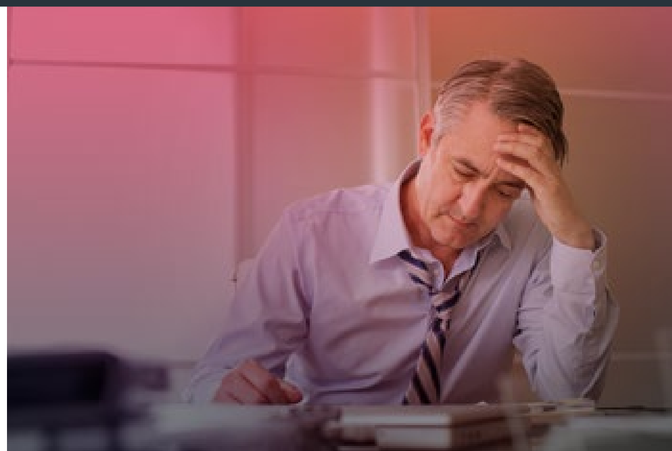
Whatever the issue...

...an adviser's biggest exposure is not fully understanding the portfolios they recommend to clients. For example, do you know exactly what level of currency risk your clients are currently exposed to? Do you know what proportion of their returns over the past decade have resulted from the weakening pound rather than the performance of the various asset classes in the pie chart you speak to clients about during their annual review? Have you spoken to clients about the currency risk they are each exposed to in their globally diversified portfolios?



If you do not fully understand either the concept of currency risk, or the developments in bond markets or the true cost to a client of owning a fund, then you cannot fully understand what you are recommending to them. More importantly, they cannot possibly understand it either.

One potential solution to these issues is seeking the answer from the fund manager. However, allow me to **repeat** myself:

Fund Managers sell to advisers
Advisers make investment recommendations & own the risk if the client complains
The interests of the adviser and the fund manager are not aligned

An adviser may find some of the information they are looking for by asking the fund manager, **but consider this;**

If a fund exposes clients to significant currency risk, and that risk could cause much higher volatility (meaning it could deviate from a client's ATR profile from time to time), do you think the fund manager is going to concede that this is a significant risk to your client and suggest they should invest elsewhere? Of course not! The fund manager will explain how the fund operates within its mandate and that the team's investment outlook is based on the sophisticated research process that encouraged you to recommend the investment in the first place.

Here is where the mis-alignment is most pronounced. A fund manager must protect their own interests first – generating positive returns and increasing the level of assets they manage. This is the business they are in. It is neither their fault, nor is it a new phenomenon. It has always been the case. The fund manager simply has a different priority to the adviser.

1 Bracknell Beeches Old Bracknell Lane Bracknell RG12 7BW United Kingdom www.tavistockwealth.com call : + 44 (0)1753 867000

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The fund manager must make decisions in the best interests of the fund.
The adviser must make decisions in the best interests of their clients.

In order to do this the adviser must fully understand all of the risks involved with a portfolio. Your fund manager may tell you that they are currency hedging the portfolio, but do you know **exactly** how they are doing this? All too often advisers claim they are in the loop with their fund manager on topics like currency risk. The reality is that the adviser has a duty of care to their clients to **fully understand** any risk that is present in a portfolio.

All too often I hear "my manager takes an active view on currencies" or "currency markets even themselves out over the long run" or that "currency trades form a part of my manager's overall macro strategy". **If you ever receive one of these responses you must remember:**

The fund manager does not make decisions based on the needs of your client

YOU are liable for the complaint

INTERESTS ARE NOT ALIGNED

John Maynard Keynes once said ***"the market can stay irrational much longer than you can remain solvent"***. A fund manager may manage their 'risk profile 6' strategy based on a long-term horizon and this may be well within their stated objectives. This may include a view to not hedge overseas currency exposure and still remain within the stated objectives of that fund. **However**, the key point is that these are the objectives of that fund. If you have a risk profile 6 client, and you invest them in this fund, which one day starts taking more risk because the pound starts moving around – this may be fine for the fund manager (who is operating within their stated objectives). Unfortunately, it is not fine for the client who is now being exposed to risk profile 8 volatility and more importantly, exposed to a type and level of risk they were not made aware of and did not sign up to. Complaints..... Liability.....

It is not good enough for advisers to say their fund manager "takes care of it" for them. Nor is it good enough to ask a fund provider a series of questions, accept whatever answers they give and simply attach the notes to the client file.

Whether or not the FSCS review yields any changes in who pays out a client's compensation, advisers need to ensure they are abiding by their duty of care to clients by fully understanding all of the risks of the investment portfolios that they recommend. This is not a one-off exercise, but rather an ongoing process for as long as the clients remain invested in them.

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