Mifid

Risk, the retail investor and disastrous new rules

Legislation designed to improve transparency is bewildering, says John Kay

John Kay JANUARY 19, 2018

I am a board director of Scottish Mortgage Investment Trust (SMIT), a £6bn investment fund based in Edinburgh. You can receive material about the trust through its newly published key information document (Kid). But please, please, do not Google or download this document, And if you have received a hard copy, burn it before reading. Above all, keep it out of the hands of widows and orphans.

The Kid tells you that if you invest in the shares of SMIT you might in a "moderate" scenario earn more than 20 per cent a year over the next five years, and over 30 per cent in a "favourable" one. Even in "unfavourable" circumstances, you could anticipate an annual return of over 10 per cent.

The Kid document does not explain what "moderate", "favourable" and "unfavourable" mean, but a reasonable person might infer that "moderate" would not be as good for investors as the past few years have been and that "unfavourable" might describe a market downturn — perhaps similar to that experienced in 2000-2 or 2008-9.

And the icing on the cake is that these returns can be expected with only moderate risk. The European Securities and Markets Authority has a scale for the risk associated with investment products. Scottish Mortgage is squarely in the middle of a range from one to seven, with a risk rating of four. Irresistible though the prospect might seem, do not on any account max out your credit card to invest. As any but the most inexperienced investor should understand, the Kid's assessment of risk is thoroughly misleading. In the first part of this article, I describe why this view of risk is misleading and in the second part illustrate what risk really means to the typical retail investor.

Scottish Mortgage Investment Trust is the largest investment trust in the UK and, according to intermediary Hargreaves Lansdown, is the most popular such fund on their platform. The assets are managed by James Anderson and Tom Slater of Baillie Gifford.

In line with the new European regulations for packaged investment products which came into effect at the beginning of this month, Baillie Gifford has produced a key information document.

The objective is to tell potential investors across the EU what they need to know in a short, comprehensible format which they can readily compare with similar documents issued by other funds.Indeed, the required text of the Kid invites you to make such comparisons. Greater

transparency, especially about fees, is needed but it seems impossible to prescribe or calculate a standard formula which makes sense for all products.

The Kid is the product of well-intentioned endeavour. No one can doubt the desirability of such an objective, though some might question its feasibility.

Investment trusts are required to adopt this format from the beginning of this year, and Ucits — the unit trusts and similar funds which account for a much larger share of the retail market — already have Kids but it is proposed to bring their format in line with the investment trust framework in 2019

The concept of the Kid is admirable; unfortunately, its execution is a disaster.

The blame for this does not lie with fund managers. Baillie Gifford has produced this information in accordance with detailed guidelines that leave them with virtually no discretion. And none at all in relation to the calculations of risk rating and prospective returns, which must be made in accordance with complex formulas prescribed by the European Securities and Markets Authority (Esma). A small group of consultants has made a lucrative business of crunching the requisite data.

Key information documents are misleading because, when you wade through the complexity, the prospective returns are little more than a projection of historic returns over the past five years. The calculations that are required involve fitting a probability distribution to the actual recent experience of returns. The various future scenarios that are presented are not projections of what investment yields might be under various economic conditions, but drawings from that hypothetical distribution of past returns.

The recent performance of Scottish Mortgage has been particularly strong, but most investment funds have benefited from bull markets over the past five years. And so you will find a wide choice of funds from which, according to their Kid, you can expect to earn more than 10 per cent a year.

In the past, regulators have rightly emphasised to investors that past performance should not be used as a guide to what they can expect in future. Yet it seems that they have not succeeded in persuading themselves of this important truth.

Some examples are much more extreme than Scottish Mortgage. The Kid for the Bitcoin XBT tracker fund tells you that over one year, a “moderate” performance will net you a cool 150 per cent return. Some highly leveraged funds apparently lead you to expect even higher returns. At least the Bitcoin XBT tracker fund document has the good sense to warn you that an investment linked to bitcoin is high risk. But this warning does not reflect any recognition of the madness that has inflated the price of an asset without fundamental value.

The measure of risk used in the Kid is essentially the historic volatility of weekly returns. Or to put it another way — if the fund managers had been stealing your money, an investment with them would be described as “low risk” so long as they were stealing it at a more or less constant rate.

If you are to give advice to retail investors, you need to start by understanding what they mean by risk. And until the dichotomy between what regulators mean by risk and what investors mean by risk is bridged, the risk classification contained in the key information document is as misleading to investors as the prospective returns.

Your investment adviser may recently have confronted you with an elaborate questionnaire designed to ascertain your "risk appetite". He or she is then required to match your risk appetite to the risk ratings contained in the new generation of key information documents.

The model which lies behind this approach measures the cost to you of bearing risk — in other words, the amount you should set against the expected return — by multiplying your "risk appetite" by the riskiness of the proposed investment.

This riskiness is the expected volatility of the underlying returns. The "cost of risk" is the amount you would have to be paid to take on a "fair" gamble — one in which, if you repeated the bet very many times, you would neither gain or lose. "Alpha" — the holy grail of the investment world — is expected return, less this measure of the cost of risk.

But this model does not represent what ordinary people mean by risk. According to the Oxford English Dictionary, risk is "exposure to danger, the possibility that something unpleasant or unwelcome will happen". This is very different from the financial economist's equation of risk with volatility.

No one talks about the "risk" of winning the National Lottery, or the "risk" that their favoured horse will be first past the post. They don't even talk about the risk of not winning the National Lottery, because sensible people don't really expect to win.

The modeller's approach confuses certainty and security. The financial economist who knows he is going to be hanged tomorrow has certainty, but not security. He knows that something unpleasant and unwelcome will happen and it is more, not less, unpleasant and unwelcome because it is certain.

For the intelligent investor, the unpleasantness or unwelcome outcome that they fear is that their investment strategy fails to meet their reasonable expectations. And that is the relevant concept of investment risk.

There are two important, and immediate, implications of adopting that everyday view of risk. One is that the meaning of risk depends on your own particular investment objectives. For many people, risk is not being able to maintain their standard of living in retirement. For others, risk is not being able to afford the property they were hoping to buy, or to pay for the education of their children, or to maintain sufficient funds to meet household emergencies. And if risk means

different things to different people, then you can set aside the notion that there is a necessary trade-off between risk and return.

Illiquidity — the inability to realise their savings within a few days — is a risk for some investors. But most have much longer time horizons. If that is true of you, you can benefit from a liquidity premium, since most institutional investors are obsessed by liquidity, and many of them are required by regulation to maintain this obsession.

And for many fund managers, risk is the risk of being fired, which is why they are reluctant to deviate far from benchmark indices. For the retail investor, however, it is absolute return, not return relative to an index, which matters. Cash in your pocket, will pay your bills, "Alpha" will not. Once you are released to disregard indices, you do not have the same requirement as many fund managers do to buy fashionable and large-cap stocks.

An important practical implication of a more considered definition of risk is that in today's environment, long-term investors should not be holding long-term bonds. When people describe bonds as "low risk", what they mean is that bonds have low price volatility and high liquidity.

Many investors, particularly institutional investors, believe (or are instructed) that they need low volatility and high liquidity; but most retail investors can manage without. Retail investors need not — and should not — check the value of their portfolio every day, and need not — and should not — realise that value within the week. If you can turn off your computer and wait a short time to get your money back, you can appraise bonds by reference to their fundamental value.

Which is unappealing. The bond market has been grossly distorted by a decade of quantitative easing. Anyone who is relying on bonds — or the bonds held by their pension scheme — to finance their retirement has certainty but not security. In this case, the certainty of a low standard of living in future. If you can keep that distinction between certainty and security in mind, and have an appropriately long time horizon, you can simply leave these overpriced assets alone.

Another implication of a proper understanding of investment risk is that such risk is a property of an investment strategy taken as a whole, not a property of the individual components of a portfolio. That is why it is not helpful to classify Scottish Mortgage Investment Trust as risk category four — the relevant risk for the investor can only be assessed in the light of that individual's own objectives and other holdings.

The Edinburgh fund is focused on a limited range of stocks, reflecting a conviction that rapid technological change will continue, that long-term global economic growth will be rapid and mostly driven by countries outside North America and Western Europe, and that a small number of companies will benefit disproportionately from these developments.

It would be foolishly risky for anyone to entrust the whole of their savings to an investment in this fund. But for many people it might represent an attractive addition to a diversified portfolio of other investments. In this context, a small holding in a volatile investment may add little to overall portfolio risk especially if the factors that influence the expected return are very different from those that influence the returns on your other assets. In the case of portfolio that is too risk-adverse, it may even reduce risk.

Such diversification is the key to investment success without undue risk. But if your timescale is five years or less, effective diversification has been recently been made very difficult by the evolution of modern financial markets.

Liquidity, government policies and herding behaviour by institutions have tended to push up the prices of all asset classes together. But investors with a long-term perspective can and should ignore the weekly asset price volatility which is central to Key Information Documents and instead plan diversification on the basis of underlying fundamentals.

Over 20 years there is unlikely to be a strong relationship between the performance of German residential property, Chinese internet service providers, and US pharmaceutical companies. The intelligent investor can benefit in the long run from the diversity of the global economic environment, and in the meantime, use key information documents to light the fire.

John Kay is an FT contributing editor. The new, updated edition of his book "The Long and the Short of It: a guide to finance and investment for normally intelligent people who aren't in the industry" is out now from Profile Books with an RRP of £9.99

Letters in response to this article:

Uncorrected, Kid will be to consumers' detriment / From John Hunter, Chairman, United Kingdom Shareholders' Association

For savers, it's a question of tolerance, not appetite / From Prof Andrea Sella, Dept of Chemistry, University College London, UK

Copyright The Financial Times Limited 2018. All rights reserved.

Show 80 Comments