BIOmetric #2: Standard Risk Measure

Recommending financial products to clients has always been a staple of the financial planning process. And while the way we do this and the way we’ve used investment research to support this advice hasn’t changed much over the years, the political and operating environment within which we work, has.

Financial planners have set a clear goal to transition from industry practitioners to ‘professionals’ and at the same time, governments and regulators have reshaped remuneration practices and increased planner obligations around personal financial product-based advice. These influences combined have diminished the relative importance of financial products in the advice process, but... the financial product advice that is given must now be better. Enter Lonsec’s BIOmetrics.

Financial Product Risk

A consensus learning from the GFC was that a retail investor’s understanding of ‘risk’ is misaligned with our industry’s definition. The ‘average’ retail investor considers risk to be the probability of failing to meet their objectives, whereas the asset and wealth management industries define risk as the “historical volatility of annualised monthly capital returns”.

This should be re-examined within the context of the advice process and the asset allocation that flows from it. Lonsec has committed to developing financial product risk indicators for the benefit of financial advisers and investors by launching our Aggregated Risk BIOmetrics which are:

- Standard Risk Measure,
- Risk to Income and,
- Risk to Access (liquidity).

These intuitive and actionable financial product-level risk metrics can be compared and contrasted across product options and against specific product features and benefits, such as capital return potential, income potential and base case liquidity offered.

Our aggregated risk measures are, however, not catch-all metrics. Financial product risk is multi-faceted and, for this reason, we’ll continue to assess funds for their specific risks which should be considered alongside aggregated risk measures.

Standard Risk Measure BIOmetric

Background

The Standard Risk Measure (SRM) is an industry standard measure of investment product risk that super funds are required to report on within their PDSs. The SRM regime is related to other changes to superannuation regulation, including the Shorter PDS regime and the MySuper Product Dashboard requirements.

There are a number of limitations of SRMs which must be understood and accepted by users before relying on them (see section “What it isn’t” below). Further, there are issues of subjectivity (eg each super fund creates their own SRMs) and coverage (whereby only superfund products are covered).

We have now calculated a SRM for all applicable products Lonsec rates and in doing so, we’ve addressed these issues of subjectivity and coverage. The Lonsec-derived SRM measures are:

- derived from one consistent source of inputs, allowing for more meaningful comparisons across funds, and
- applied to non-superannuation and pension products as well as superannuation products.

What It Is

The SRM is a volatility derived measure of the expected frequency of annual losses over any 20 year period.

It is expressed either as a ‘risk band’ between the ranges of 1-7 or as a ‘risk label’ on a 7-point scale from ‘very low’ through to ‘very high’. At the low extreme, a risk band of 1 or a risk label of ‘very low’ translates to an expected number of negative annual returns of 0.5 per any 20 year period. At the high extreme a risk band of 7 or a risk label of ‘very high’ translates to an expected number of negative annual returns of >= 6 per any 20 year period.
Investment risk is complex, and no one measure can ever capture all risks. The SRM is but one measure of risk and it should be viewed as merely one component of investment risk. To this end, the SRM is not:

1. a measure of the anticipated size of future losses
2. a measure of the chance of an adverse statistically rare outcome (‘value-at-risk’)
3. a measure of the chance that a return may be positive but less than expected
4. a measure of the risk to income distributions
5. a measure of the risk to access (liquidity)
6. a measure of the frequency of annual losses over the next 20 year period (the starting position of markets — be they either undervalued or overvalued — is not taken into account within the capital market’s assumptions that underpin the measure).

How to use it
Lonsec suggests users of the SRM take the following approach:

1. For superannuation options, compare the Lonsec SRM to the fund manager’s SRM in the PDS and where a difference is noted, use the more conservative number.
2. Compare the SRM to the fund name — are there any disconnects? A fund with the word ‘Conservative’ in its name should have a risk band of 3 or lower and only carry a risk label of ‘low to medium’, ‘low’, or ‘very low’. Likewise, a fund with ‘Balanced’ in its name but a risk label of, say, 7 would be considerably riskier than the name may suggest.
3. Consider the measure in conjunction with other measures of risk:
   - Where a long track record exists, the maximum drawdown of the fund and time to recovery of that drawdown
   - The level(s) of specific investment risks within the PDS and/or within Lonsec’s research reports

Many of these risks are not reflected in volatility based measures of risk (such as the SRM) yet they are undeniably relevant to assessing the overall level of risk to capital, risk to income, and risk to access.

Summary
The SRM is the beginning of the journey for our industry in providing more reliable, transparent and comparable information about financial products to consumers. The methodology underpinning its key tenets will no doubt be refined and evolve over time. Users must be careful not to place more emphasis on this one risk measure than can be safely ascribed to it, particularly when considering the absolute level of risk inherent in an individual investment. That said, it is still a useful starting point for considering investment risk. Its most beneficial uses are arguably in helping to

1. identify outliers within very broad or varied categories — for example ‘fixed interest’ funds, and
2. identify funds with potentially misleading names.

Lonsec is proud to be the first research house to provide financial planners with super and non-super SRMs calculated with a consistent set of inputs across the whole rated universe of funds. We believe that our SRM BIOmetric will prove to be timely and useful for financial planners as they seek better investment outcomes for their clients.