A fresh approach to investment planning – the Skandia Spectrum funds

Guide for financial advisers
Matching clients’ portfolios to their investment goals

Risk-rating with precision

The role you play in providing investment advice for your clients is important – but it can also be complex and difficult. The Spectrum investment planning solution from Skandia can simplify this task, enabling you to meet your clients’ investment goals even more efficiently.

Spectrum is an innovative range of risk-rated funds that bring greater precision to the management of your clients’ investment journey by matching the appropriate fund to an acceptable level of risk.

It works by using the pioneering Skandia Risk Profiler to calculate an investor’s appetite for risk, then matching that calculated ‘score’ directly to the strictly risk-controlled Spectrum fund that has the most suitable risk-return characteristics.

Because it matches a greater number of risk levels, with greater consistency and sophistication than other risk-managed fund solutions, Spectrum can be more closely targeted to your clients’ needs.

Asset allocation and fund selection in a single package

No one can forecast the future with consistency and accuracy, so selecting the ingredients for a portfolio is sometimes regarded as an art rather than a science.

The ability of financial advisers to create ‘bespoke’ portfolios for their clients was enhanced when Skandia pioneered the adoption of powerful web-based portfolio construction tools, covering risk profiling, asset allocation and fund selection.

Until now, however, some challenges have remained:

- Many financial advisers believe the commercial and regulatory risks associated with recommending funds are too high and would prefer to outsource that function to investment specialists.
- Asset allocation is dynamic and allocations representing a particular risk profile can change over time. Without written approval every time, however, non-discretionary financial advisers are only permitted to rebalance to the original asset allocation, which may become out of date.
- Rebalancing within an OEIC/Unit Trust portfolio is a chargeable event for capital gains tax (CGT), adding complexity to the advice process.

‘greater consistency and sophistication than other risk-managed fund solutions’
The Spectrum solution

The Spectrum solution enables you to ‘outsource’ the asset allocation and fund selection process, simply and conveniently, within a single package, allowing you to focus attention purely on your clients’ financial planning requirements.

Spectrum offers a range of six funds, designed to meet the requirements of investors with a Skandia risk level of 3 to 8 (see page 4 the spectrum approach to risk profiling). Each fund has an asset allocation designed to maximise the expected return for a given level of risk. Unlike other risk-rated funds, Spectrum has real volatility targets, which means funds can be matched more closely to clients’ risk levels. For current volatility targets please see the skandia spectrum funds – current asset allocation sales aid.

Advantages of the Spectrum range include:

- With six risk levels, Spectrum can provide a suitable risk managed fund for a wide range of clients.
- A quarterly review of asset allocations ensures the funds continue to reflect the economic outlook, keeping them current and appropriate for each risk level.
- A proven and established risk profiling and asset allocation model developed and supported over six years by leading investment consultancy Towers Watson*.
- The award-winning management expertise of Skandia Investment Group.

Your clients can invest in the Spectrum funds across Skandia’s UK product range:

- Skandia investment bonds
- Skandia pensions

* As an input to Skandia’s asset allocation model, Towers Watson & Co (Towers Watson) conducts a quarterly review of the asset class assumptions used. This review is carried out solely for Skandia under agreed terms of engagement and not for any third party. Towers Watson assumes no responsibility, duty of care or liability to any third party in respect of the Skandia asset allocation model or the Skandia Spectrum Funds.

‘allowing you to focus attention purely on your clients’ financial planning requirements’
How do you calculate attitude to risk objectively?

There are many questions to consider when trying to establish your clients’ risk profiles. What are your clients’ goals and how much capital is required to fund them? How much might their portfolio fall in value in a single year and is that acceptable? What goals are vital, and which are simply ‘nice to have’?

However, attitudes to risk are subjective; they also vary over time depending on a client’s changing circumstances and the prevailing economic conditions. Traditionally, investors have been offered broad-brush investment solutions, eg ‘Cautious’ or ‘Balanced’, which are not matched precisely enough to their true risk profile.

A more sophisticated solution is required that better serves the needs of today’s investors and financial advisers.

The Spectrum approach to risk profiling

The Skandia Risk Profiler is the first step of the portfolio construction process and aims to complement your normal fact find. Already an integral part of Skandia’s award-winning investment tools, the Risk Profiler uses a carefully constructed and detailed questionnaire to define the client’s investment objectives and attitude to risk. It then quantifies the client’s requirements by means of a risk score, with 1 being the least risky and 10 the most risky. Clients’ risk scores are then mapped to specific bands of volatility (see the Skandia spectrum funds – current asset allocation sales aid). More than 95% of investors fall within risk profiles 3-8, which is why Spectrum solutions have been built to match these profiles.

It’s a fundamental truth that clients don’t mind about risk when the outcome is in their favour. What they do care about however is the potential to lose money. A client’s risk requirement can therefore more accurately be described as their loss avoidance level.

Applying the Spectrum solution, an investment can be constructed so as to behave according to the client’s preferred level of loss avoidance, aiming to meet both their risk and return requirements.
Challenge 2 – strategic asset allocation

How volatile might the portfolio be, and does that fit the risk profile?

Strategic asset allocation seeks to utilise a mathematical formula by which assets can be combined in order to achieve the investor’s goals over the life of the investment. Individual asset classes are combined into a bespoke investment portfolio via a process known as ‘Mean Variance Optimisation’, or MVO. This process is an integral part of Modern Portfolio Theory (MPT).

Skandia employs such a process to determine the asset allocation for different risk levels. The components driving the asset allocation tool are reviewed quarterly by Towers Watson. This ensures suggested allocations are consistent with current thinking. The risk score is matched to the appropriate set of asset allocations, as calculated by the MVO process. Skandia also provides optional automated portfolio rebalancing which ensures that each client’s portfolio retains the asset allocation adopted at the outset.

One issue that needs addressing however is that over time the asset allocation for each risk profile will change, reflecting changes in the economic outlook. The ideal scenario would therefore be to rebalance to the current asset allocation rather than that adopted at the outset. For this to happen, however, there needs to be written client confirmation of the proposed changes or a discretionary agreement in place.

The Spectrum approach to strategic asset allocation

The Spectrum solution provides a range of asset allocated funds, using the MVO approach. This helps you to achieve your clients’ investment goals by strictly controlling the volatility of the portfolio, matching the risk tolerance of the investor.

Skandia has designed the Spectrum solution to ensure that fund asset allocations always reflect current thinking. Rebalancing is undertaken within the fund, which is more efficient for both financial advisers and investors, and for OEIC investors it means that there will be no potential CGT liability until encashment.

The asset allocations for Spectrum are similar but not always identical to those of Skandia’s asset allocation model. There are a number of factors which go into building optimal asset allocations, including assumptions about asset class returns, their volatility and correlation. These assumptions will be consistent for Spectrum and the Skandia model except that those for Spectrum include an allowance for the manager’s ability to add excess return through fund manager selection. However, because with Spectrum the assets are held within a fund, other elements such as fees and tax rates are likely to be different and will result in differences in the asset allocations. For example, the impact of tax on allocations ceases to apply when the portfolio is provided through a single multi-asset fund, such as a Spectrum fund. This is because the fund as a whole is taxed either as a dividend distributing fund or an interest bearing fund, not a combination of both.

What is modern portfolio theory?

A fundamental principle of Modern Portfolio Theory is that the risk of the portfolio should be considered as a whole, rather than as individual assets. The correlation between the assets in the portfolio is most important. The price of one asset may not move up and down in line with the price of another, so significant diversification benefits may be gained as the peaks and troughs of the respective assets cancel each other out. The aim is to optimise that cancelling out process so as to achieve the highest expected level of return for a given level of risk. However, it is important to remember that even when using a mathematical process, it is essential to review the components that drive that process regularly in order that the asset allocations reflect the current economic outlook.

For more information on Modern Portfolio Theory and asset allocation please see the Spectrum – Optimised Asset Allocation guide.
Challenge 3 – fund selection

How can you focus sufficiently on fund selection and still have enough time to service your clients?

According to Modern Portfolio Theory, each fund within a client’s portfolio should attempt to mirror the characteristics of its particular asset class. However not all funds or combinations of funds may collectively reflect the asset class you are trying to represent and their behaviour may also change over time. This can be difficult to detect without specialist knowledge and information.

The selecting, monitoring and reviewing of funds is complicated and hazardous.

- In the UK retail sector alone there are over 2,500 funds to monitor.*
- You need access to relevant, up-to-date background information.
- Access to fund managers and their teams is not always easy.
- Past performance is no guide to the future. That being the case, how would you pick funds if past performance was not available?
- Star fund managers may move on.
- You have a regulatory requirement to demonstrate due diligence in your fund selection.
- Your clients have high expectations of your investment choices.

*Source: Financial Express Analytics Retail Fund Universe October 2010

In reality you may not always have the necessary time or resources to commit to a detailed research programme. And if you spend too much time on fund selection, it could be at the expense of client servicing.

The Spectrum approach to fund selection

The Spectrum solution means you can bypass the perils associated with fund selection. Spectrum draws on the skills of Skandia’s specialist fund manager, Skandia Investment Group, who takes responsibility for selecting, blending and monitoring the best managers for each asset class.

Skandia Investment Group’s three-step investment process aims to build portfolios that maximise performance and minimise risk in a continuous, virtuous circle.

**Step 1 – selecting the managers**

This means concentrating on finding the right managers for the fund, by looking at the fundamental characteristics of a manager, not simply focusing on past performance.

**Step 2 – blending the managers**

By combining the selected managers with great care, they ensure that each manager works well with others in the portfolio, seeking to minimise risk within each portfolio as a whole.

**Step 3 – monitoring the managers**

Skandia Investment Group continually analyses and reassesses managers to ensure they remain best suited to fulfil their role in the portfolio.

With the involvement of Skandia Investment Group, Spectrum saves you time and money, allowing you to focus attention purely on your clients’ financial planning requirements. At the same time Spectrum funds provide your clients with an efficient vehicle for portfolio management and a greater potential for managing risk.
Challenge 4 – review, reporting and rebalancing

How do you maintain the portfolio’s risk-return characteristics in a changing world?

Asset allocation has to take account of a dynamic economic environment as well as changing client circumstances. Rebalancing is essential in order to maintain the level of risk of a portfolio. The asset allocation for a particular risk profile may also change over time, but non-discretionary financial advisers can only rebalance to the original asset allocation, which may become out of date.

Post-sales support is also an important part of the relationship between you and your client. The three Rs, Review, Reporting and Rebalancing, are all very time-consuming but necessary.

The Spectrum approach to review, reporting and rebalancing

Skandia provides online management tools, such as the market-leading U-Skan, which allow financial advisers to review and report easily on client investments.

In addition, with the Spectrum solution, Skandia Investment Group continues to monitor the managers for each asset class within the Spectrum funds so you don’t have to. It has one of the UK’s largest and most experienced manager research and selection teams, working on your behalf researching, meeting and analysing managers across the globe.

Importantly, each Spectrum fund will rebalance to its most recent quarterly asset allocation target, thus maintaining the fund’s risk-return characteristics within a changing economic environment.
Skandia Investment Group, the fund manager for Spectrum, was founded on the principle that no single fund management group can be the best in every asset class. Rather than manage stocks directly, it concentrates on ‘managing the managers’ by blending together portfolios of high quality investment managers who are experts in their own particular fields.

The aim is to diversify risk within and across investment markets through well-diversified, carefully constructed funds, run by world-class managers, including some who are not available to UK retail investors.

The Skandia Investment Group has grown rapidly and now has funds under management of over £14.4 billion as at 30 June 2011. Its size and strength gives it huge negotiating power and wide access to world-class investment managers from around the globe.

Skandia pioneered the MultiManager investment approach in the UK over 20 years ago and today it is still the acknowledged leader in the field. In 2003, Skandia launched a dedicated investment management business within the group, offering managed investment solutions within an OEIC and unit trust structure for the first time.

Skandia was named as Best Multi Manager Provider in the Money Marketing Awards 2005, 2006, 2007 and 2008.

‘Skandia pioneered the MultiManager investment approach in the UK over 20 years ago’
Access to **specialist skills** gives greater chance to outperform

Thanks to the scale and strength of Skandia Investment Group, Spectrum has access to the skills of managers who are normally available only to institutional investors. It can also apply investment disciplines not readily available as part of a portfolio built with retail funds.

### Segregated mandates and retail funds

A ‘fund of funds’ selects from retail funds while a ‘manager of managers’ fund selects from institutional managers usually not available to retail investors. Each approach has its own distinctive advantages, and Spectrum is able to combine both methods to deliver ‘the best of both worlds’. Institutional managers are asked to run a segregated mandate on Skandia Investment Group’s behalf, essentially a written agreement on how Skandia Investment Group wants the investment to be managed. This allows it to control the investment boundaries, including the types of investment and the level of risk it wants each manager to take. By tailoring the mandates, Skandia Investment Group ensures that the managers focus on the areas where they are felt to be most skilled, giving them the best chance to outperform.

### Cash management

Cash is a significant part of the asset mix for some of the Spectrum funds.

It is impossible to hold cash without taking some risk if you want to add value. To minimise that risk, Spectrum only uses cash funds that conform to the following benchmarks:

- Institutional Money Market Funds Association (IMMFA) standards
- AAA rated by leading credit-rating agencies
- Weighted average maturity of less than 60 days
- Traded daily
- Valued at least weekly

Investors are broadly exposed to three risks when holding cash: the counterparty (credit risk), the term of the deposit (duration risk) and the currency of the deposit (exchange rate risk).

Adding value when managing cash is a function of these factors and, when done within a risk-controlled framework, significant value can be added whilst maintaining the core characteristics of the asset.

Money market funds typically add value by extending the term of their deposits and by depositing with a number of counterparties of varying credit qualities.
Spectrum will restrict money market funds to the very high IMMFA standards which require the fund to be AAA rated and have an average maturity of less than 60 days. Given that these funds exploit two of the three opportunities in cash management, it is then attractive to turn to currency-based products in order to continue to add value, yet diversify the risk across all possible opportunities.

Hedge fund replacement

Institutional investors have long recognised that hedge funds have an ‘absolute return’ flavour and that their historically superior risk-adjusted returns and low correlation to traditional assets may be beneficial within balanced portfolios. Institutions have typically gained exposure through ‘fund of hedge fund’ products, yet there are a number of reasons why these investments may have been unsuitable for the retail market. Among them are high fees, monthly or quarterly rather than daily access, a lack of transparency and a lack of regulation.

The goal of hedge fund replacement is to provide a substitute for the typical allocation to hedge funds, with a product which has the same benefits as hedge funds, but without the drawbacks. Such a product aims to provide superior risk-adjusted returns in a transparent, accessible and regulated form (UCITS III) and at significantly lower cost than traditional alternatives.

‘aiming to provide the same benefits as hedge funds but without the drawbacks’
In summary

Spectrum provides clear and easy solutions to the four stages of effective portfolio construction.

Spectrum is:

• A risk profiling solution
• A dynamic strategic asset allocation solution
• A fund selection solution
• A reviewing, reporting and rebalancing solution

It aims to lighten your load by matching your clients’ risk tolerance with a strictly risk-controlled fund, enabling them to meet their investment goals in a consistent, compliant and efficient way.

For more information about the Skandia Spectrum Fund Range please contact your Skandia representative or visit our website www.skandia.co.uk/adviser/spectrum
Skandia provides you with access to its investment platform, known as Skandia Investment Solutions. Within this platform you can open an ISA and Collective Investment Account provided by Skandia MultiFUNDS Limited, a Collective Retirement Account and Collective Investment Bond provided by Skandia MultiFUNDS Assurance Limited and an Offshore Collective Investment Bond, distributed by Skandia MultiFUNDS Limited but provided by Old Mutual International (Guernsey) Limited.

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