AFM

Focus on the Client

Recommendations for suitable investment advice and asset management

The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fair and transparent financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. The AFM promotes the conscientious provision of financial services to consumers and supervises the honest and efficient operation of the capital markets. Our aim is to improve consumersq and the business sectorqs confidence in the financial markets, both in the Netherlands and abroad. In performing this task the AFM contributes to the prosperity and economic reputation of the Netherlands.

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Summary

Room for improvement in the provision of investment services

This year, the AFM conducted an exploratory review of the quality of the investment services provided by 13 banks and investment firms. From its review, the AFM concludes that the services provided could be improved in a number of respects, especially with regard to obtaining a better understanding of the client's situation and objectives, and incorporating these more explicitly in the service provided.

This Guideline is willing with the purpose of encouraging banks and investment firms to optimise the investment services they provide.

More attention should be devoted to the skills of advisers

The review reveals that the focus of expertise at many banks and investment firms is primarily on investing. The development of professionalism among advisers . with regard to acquiring the skills necessary to get properly acquainted with the client during the interview process and to properly inform the client . are given a lower priority. The AFM's opinion is that banks and investment firms should devote more attention to developing these skills. The way in which the adviser obtains information with regard to the client determines whether a complete and in-depth understanding of the client's situation can be obtained.

The investment policy sets the preconditions for the service to be provided

The AFM expects banks and investment firms to apply an investment policy which includes their target group, their investment strategy, the asset classes eligible for investment, the principles of the strategic asset allocation and the criteria for the selection of financial instruments. The establishment and maintenance of such a policy requires a clear vision. Not every investment firm has such a vision. When establishing the investment universe, it is important to ensure that a proper in-depth process for the selection of financial instruments is followed. The decision of whether to use active or passive investments is also a part of this selection process. In this context, it is also important for the bank or investment firm to take the risks associated with the various financial instruments into consideration.

An appropriate investment solution requires better understanding of the client's situation

In order to be able to recommend an appropriate investment solution, the adviser needs to properly understand the client's situation and objectives. This means the adviser needs to have information on matters such as the client's income and financial position, and the risk that he can and is willing to take. Most clients have an objective of some kind that provides the motivation for them to invest, and therefore this objective should be the central consideration in the provision of the investment service. The adviser should define and quantify the objective, in order to tailor his advice accordingly.

Financial instruments should be appropriate for the client

Once the adviser has established the level of risk the client is able and willing to bear, it is important that he recommends an investment portfolio that reflects this level of risk. This means that the link between the risk of the portfolio and the client's risk appetite should also be quantitatively established. This is not yet normal practice at some investment firms. By giving equal weight to the client's risk appetite and his target return, disappointments that are foreseeable can be avoided. Inherent contradictions between an ambitious return target and a low risk appetite must be discussed. The level of risk that the client can accept is an important precondition that the adviser must take into account in his recommendation. Some financial instruments involve particular risks. In order to ensure

that the investment portfolio he proposes is appropriate, the adviser must determine, for each client individually, which financial instruments are suitable for that client.

Higher priority for the client's objective in the monitoring of the investment portfolio

The adviser must continually ensure that the investment portfolio is still appropriate in the light of changes to the client's situation, his objective, the (maximum) risk that he is able and willing to accept, and the other agreements made. In practice, this usually involves a periodic check to establish whether the portfolio is still within the bandwidths agreed for the strategic asset allocation. This practice is intended to fulfil the duty of monitoring the risk in the investment portfolio. It is important to take the quality of the investments and the associated risk into account when making adjustments. The AFM, however, expects monitoring of the investment portfolio to also involve a consideration of the degree to which the client is achieving his objective. Many investment firms could increase their efforts in this respect. If it turns out that the objectives are not feasible, the adviser should initiate further dialogue with the client with regard to the principles used to select his investments. In other words, adjustments should also be made in order to make the client's objectives feasible.

1 Introduction

1.1 Rationale

The AFM has provided increased guidance regarding the provision of investment services in the last two years. We published the Guideline ±*Appropriate advice for wealth accumulation*q in 2009, which set out a number of general principles for suitable advice on capital accumulation. The Guideline ±*Information on risk profiles*q published in 2010 gave further guidance on the provision of information with regard to risk profiles.[1]

This past year, the AFM decided to carry out a market-wide assessment of the quality of the services provided by investment firms, and accordingly conducted an exploratory review at 13 investment firms. These firms vary widely in terms of size, service methodology and client target group. During the review, we assessed how these firms structure their investment policy, how their advisers obtain information about their clients, how this is then translated into an appropriate client portfolio, what considerations the adviser includes in this process, and how advisers monitor the portfolios on an ongoing basis.

Across the entire market, the AFM sees room for further improvement in the provision of investment services. For this reason, we have decided to give some recommendations to investment firms and their advisers. In order to test its findings and opinions in practice, the AFM has consulted with various industry organisations, market participants and experts prior to publication.

1.2 For whom is the Guideline intended?

This Guideline is intended for investment firms and their advisers[2] who offer *investment advisory* and/or *asset management* services to clients. Reference in this Guideline to investment firms includes banks which offer investment services. The focus is on investment services to clients[3] who do not qualify as professional investors. The examples mostly apply to higher-net-worth clients, although this does not mean that the recommendations do not apply to less wealthy clients. The recommendations especially apply in complex situations where the client significantly depends on the capital invested. In less complicated situations where this dependence is low, not all the recommendations are relevant. This Guideline applies to both investment firms that offer customised services and those firms which use a more ±standardisedq approach in their advisory or management services.

In the provision of investment advisory or asset management services, there is usually some degree of personal contact between the client and the adviser at the investment firm. The recommendations in this Guideline apply equally to situations in which there is less or no personal contact, such as forms of online investment services.

The AFM is aware of the wide variety of investment firms and the clients that they serve, but nevertheless has decided to publish a general guideline for investment firms and their advisers. Most

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[1] For an explanation of the links between the guidelines on the provision of investment services published by the AFM, see www.afm.nl/vermogensopbouw.

[2] The term ±adviserq is used in this guideline to refer to the person or persons responsible for the interviews with the client in relation to their investments and/or assets, who make recommendations to the client in this respect or who manage the client¢s assets. Reference in this guideline to investment advice or recommendations also refers to asset or investment management.

[3] Reference to ±clientsq includes both retail clients and private banking clients.

of the principles and examples described in this Guideline apply to all advisers, regardless of the nature of the investment firm for which they work. Activities described in this Guideline as carried out by the adviser may in practice also be carried out by other persons at the investment firm.

Sections 4, 5 and 6 of this Guideline are also relevant for financial services providers that give advice in relation to asset accumulation products with an investment component.

1.3 Purpose of the Guideline

This Guideline presents the AFM's recommendations for good practice with regard to advice that can support investment firms in their efforts to improve the services they provide. Investment firms and advisers can use this Guideline to assess whether there is room for improvement. In addition, the recommendations and examples described in this Guideline provide focus points for the practical implementation of improvements.

The recommendations mainly concern investment advisory and asset management services. This Guideline is a supplement to the previously published view in the Guideline '*Suitable advice on asset management*' published in 2009.

1.4 What is the status of the Guideline and what does the AFM expect from investment firms?

This Guideline does not have the status of legislation or regulation. The views described are not necessarily the only way to provide suitable advice. The translation of the principles in this Guideline into daily practice will have to be made by the investment firm and the individual adviser. The investment firm or adviser is free to choose other ways of following the recommendations in the Guideline. The same applies to the examples that are given.

The examples are intended to illustrate certain principles. They are a simplified version of reality, and are only intended to clarify one specific issue. The examples are partly fictitious. The names mentioned are not real. The facts and circumstances of each individual case determine whether the advice given is appropriate or inadequate. The AFM does not expect investment firms to implement the examples literally in the conduct of their business. In 2012 or 2013, the AFM will again perform a review of the quality of the investment services provided, and will assess the extent to which there has been improvement in this respect.

1.5 Structure

The Guideline comprises six Sections.

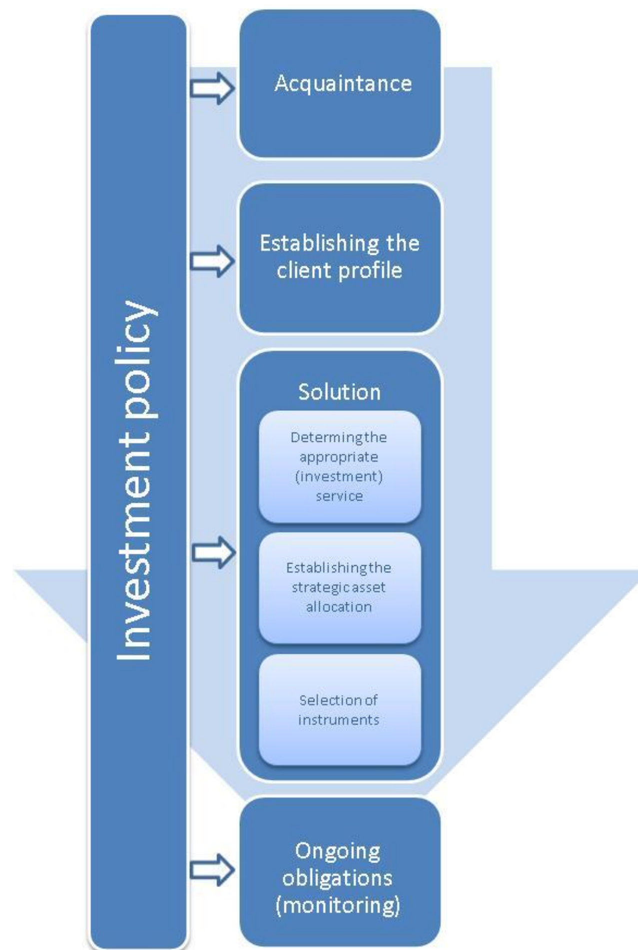
- *Section 1* is an introduction in which the rationale, purpose and status of the Guideline is explained.
- *Section 2* describes the phases of the investment service process and explains a number of important preconditions, namely investment policy and expertise.
- *Section 3* deals with the precondition of the investment policy in more detail and the choices made by the investment firm in this respect. For example, in its investment policy the investment firm makes choices with regard to its investment strategy, its target group, the way in which its strategic asset allocation will be determined and the asset classes in which investments are to be made. This Section also lists the criteria that an investment firm should use in its selection of financial instruments.

- *Section 4* deals with the gathering of information about the client's situation. Actual examples are given to show what a thorough assessment of the client's situation entails. A complete understanding of the client's situation is essential in order to be able to provide an appropriate investment service to the client.
- *Section 5* describes how this understanding of the client's situation can be translated into an appropriate solution. The adviser has to assess what kind of investment service will suit the client's needs. In order to establish the appropriate investment solution, he must quantify the client's target return and the risk he is able and willing to take. This Section also discusses how the adviser links the features and risks of financial instruments to the client's situation.
- *Section 6* discusses the ongoing obligations that the adviser has, in order to ensure that the client's investments continue to be appropriate. Continuous monitoring should focus on achieving the client's objective while remaining within the level of risk that he is able and willing to bear. For instance, the client should be regularly updated on the development of his portfolio with reference to his objective.

2 The investment service

In this Guideline, the AFM assumes there are four phases that the adviser needs to go through in order to provide responsible, appropriate investment advice or asset management service. These phases are explained and illustrated in this Section.

2.1 Phases in the investment service



Phase 1: Acquaintance

The process begins with becoming acquainted with the client. During this initial interview, the adviser discusses the clientღs needs. He informs the client with regard to the services he can offer, and then establishes agreements with the client in order to be able to give suitable advice concerning the type of investment) service. .The adviser forms a general impression of the clientღs situation in order to determine whether he actually can offer a suitable service. If investing is not suitable for the client, the advice given will be not to invest.

Phase 2: Establishing the client profile

The adviser will already have formed a general impression of the client's situation during the initial interview. This general information will however not be sufficient for him to offer good advice. In the second phase, he must go deeper into the individual issues, such as: what does the client hope to achieve, when does he wish to achieve it, what level of risk is acceptable to him, details of his income and assets, and the knowledge and experience the client possesses with respect to investing. The adviser checks this information with the client, and assigns priorities in the event of contradictory information. This information will ultimately lead to a complete evaluation of the client's situation.

Phase 3: Solution

A full picture of the client's situation has been established in the previous phase. The adviser now has to assess whether an investment service will suit the client's needs and if so, which type of service would be appropriate. The adviser will then establish the strategic asset allocation (or investment mix) of the portfolio. The strategic asset allocation should reflect the client's objectives and the risk he is willing and able to bear. The adviser will select suitable investments in each asset class. Finally, he will select the individual instruments and investment funds or products, if appropriate. The investment policy forms the starting point for the adviser's considerations in the solution phase.

Phase 4: Ongoing obligations (monitoring)

In this phase, the adviser provides the service that has been agreed with the client. Usually this involves the monitoring and updating of the investment portfolio, the preparation of regular reports, the regular updating of client data, and feedback on the feasibility of the objective. Since investment advisory and asset management services are ongoing processes, the adviser had ongoing obligations.

2.2 Preconditions

In order to be able to provide responsible, appropriate investment advice or asset management service, certain preconditions need to be met by the investment firm. The adviser must have sufficient skills to obtain a proper understanding of the client's situation, and sufficient knowledge of investing to be able to find an appropriate investment solution for the client. In all phases of the advisory process, and especially in the formulation of the investment solution, the investment policy forms an important starting point for the adviser.

Investment policy

In its investment policy, the investment firm establishes what its investment strategy is, under what circumstances an investmentr service is appropriate for a particular client, which asset classes will be used, how the strategic asset allocation will be established, how the selection of financial instruments will be made and how the investment portfolios will be adjusted over time. It is very desirable that the investment policy is regularly evaluated. Particularly in times of high volatility in the markets, it is important that timely adjustments are made. Further details of this are given in Section 3, Investment Policy.

Expertise of the adviser

More attention needs to be devoted to the development of knowledge and skills of advisers

The AFM is of the opinion that more attention should be devoted to the skills and knowledge of the adviser, so that the adviser is in a position to provide investment services in a responsible manner. The review reveals that the focus of expertise of investment advisers at many investment firms is primarily on investing. The development of professionalism among advisers with regard to acquiring the skills necessary to get properly acquainted with the client during the interview process are given a lower priority. The way in which the adviser obtains information determines whether a complete and in-depth understanding of the client's situation can be obtained.

A responsible investment process places high demands on the adviser. In order to be able to give investment advice, it is important that the adviser's expertise is not limited to investing. He must also be able to adapt the way he approaches and deals with clients. The approach required when dealing with an experienced investor with extensive knowledge of investing is different from the approach needed in the case of a relatively inexperienced investor with little knowledge. The adviser will therefore need sufficient skills in either case in order to be able to conduct the interview in such a way that he is able to explain complex material in an intelligible manner. Even more importantly perhaps, the adviser needs to be able to obtain the correct . and the most relevant . information from the client and to persevere in his questions, in order to clarify any potential misunderstandings.

During its review, the AFM observed that the value added by advisers is proportionate to the extent that they obtain a full understanding of the client's financial situation. The adviser is then in a better position to determine how much risk the client can accept and how dependent he is on achieving the objective he has formulated. This does not mean that a comprehensive financial plan is needed to be able to give investment advice or to manage assets. Financial planning can, however, form a good basis for investment advice or asset management. This particularly applies if there are specific objectives, for example objectives that directly affect the client's present or future income, or if the client's situation or wishes are more complicated than the average situations.

3 The importance of a well-considered investment policy

3.1 A clear, consistent investment policy

The investment policy sets the preconditions for the service to be provided

The investment policy of an investment firm largely determines the nature of the investment service provided. Obvious elements of the investment policy include:

- The investment strategy;
- The investment firm's target group;
- The asset classes to be used;
- The strategic asset allocation;
- The criteria for selection of financial instruments in investment portfolios;
- Guidelines for the monitoring of investment portfolios.

The investment firm must ensure that its investment policy is known internally. The advisers use the policy as a precondition for determining the type of investment service for a specific client. Proper recording of decisions can assist the investment firm to establish, at a later date, why certain investment decisions were made.

It is also important that the client understands the various aspects of the investment policy. This will make him aware of what he can and may expect from the service provided by the investment firm. The client should be made aware of the investment policy before the provision of the service commences.

Based on its review, the AFM concludes that the investment policy could be more thoroughly formulated. Furthermore, there is not enough specific information provided regarding the way in which the investment firm selects the financial instruments to be used.

3.2 Investment strategy

The investment strategy should be clear to the client, and to the advisers

The AFM expects an investment firm to include a description of the investment strategy it will pursue in its investment policy[4]. The investment strategy forms the basis for the way in which the investment firm adds value to the client's portfolio. The investment firm should be convinced that the investment strategy it applies will achieve the best risk-return ratio. One element of the investment strategy may be the basis for the selection of financial instruments. Technical analysis is an example of an investment strategy. The investment firm in this case is convinced that it can add value by applying technical analysis in order to select the best-performing instruments. Another example is the value strategy, in which financial instruments are selected because they are considered to be structurally undervalued.

The investment firm must be able to explain its investment strategy to the client, so that the client knows what he can expect. If the client understands how the strategy is related to expected returns and risks, disappointments with regard to the results of investment solutions can to some extent be avoided.

The investment firm should monitor its strategy on a regular basis. If its market view changes, for instance because market conditions change, this may lead to changes in the investment strategy.

[4] *An investment firm may offer several strategies. This should be stated in its investment policy.*

Many investment firms have an investment committee, which regularly evaluates the strategy. Decisions arising from this evaluation and the considerations involved are recorded. These decisions are then passed on to the advisers, so that they are aware of the changes to the strategy and the underlying considerations.

3.3 Target group policy

Defined target group for each type of service

The investment strategy chosen by an investment firm affects the clients that it can serve. It is important that the investment firm determines its target group in advance. If a potential client does not fall within the target group, and his objective, risk appetite, financial position or knowledge and experience are not appropriate to the investment strategy of the firm, this client should not be serviced.

If the client does belong to the target group, the most suitable type of service has to be determined for him (investment advice, asset management or execution only). Not every type of service is suitable for every type of client. It is important that the adviser ensures that the client has sufficient information to make a well-considered choice. In order to support the adviser, it is therefore important that the investment firm applies criteria that assist the adviser in choosing the service that best suits the clientq̧ needs.

3.4 Establishing asset classes

The investment policy states the actual asset classes in which investments will be made

The investment firm determines which asset classes are to be eligible for investment in its investment policy. It is important however that the investment firm uses a more detailed definition of its asset classes, to reflect the fact that the degree of risk within an asset class varies widely. For example, the degree of risk associated with a triple-A rated government bond is very different from that of a corporate bond classified as high yield. Describing both these instruments simply as bonds does not take account of this variation in risk-return profile. A more detailed definition of asset classes will help the advisers provide more accurate information to clients regarding the investments in their portfolios.

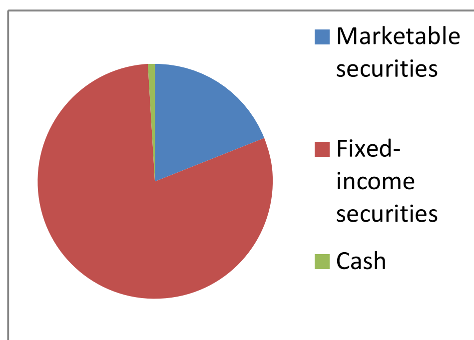
An example of inadequate advice

Mr Boersma (aged 55) intends to have a sum of ” 800,000 managed by an asset manager. Mr Boersma has explained to the adviser that his objective is to provide a pension. In view of this objective, the maximum downside risk Mr Boersma can accept is 5%. The asset manager uses three asset classes, namely marketable securities, fixed-income securities and cash.

In view of Mr Boersmaq̧ objective and the other information, the asset manager applies the following strategic asset allocation:

- *20% marketable securities (shares);*
- *80% fixed-income securities (bonds);*
- *1% cash.*

The quarterly report sent to Mr Boersma states the following:



Asset mix	*Mix*
Marketable securities	*19%*
Fixed-income securities	*80%*
Cash	*1%*

Further analysis of the portfolio shows that the fixed-income (or bond) portion of the portfolio comprises the following[5]:

Asset class	*Mix*	*Standard deviation*
Government bonds EUR AAA-AA	*6%*	*3.5%*
Government bonds non-EUR A and lower	*5%*	*7.5%*
Government bonds non-EUR emerging markets	*6%*	*10%*
Investment-grade corporate bonds EUR	*3%*	*5%*
High-yield corporate bonds EUR	*16%*	*15%*
High-yield corporate bonds non-EUR	*17%*	*16%*
Real estate private indirect Europe (real estate bonds)	*12%*	*7.5%*
Perpetual loans (shares mature markets)	*15%*	*17.5%*
Total	***80%***	

The marketable portion of the portfolio (the part in shares) is composed as follows:

Asset class	*Mix*	*Standard deviation*
Mature markets shares	*4%*	*17.5%*
Emerging markets shares	*15%*	*22.5%*
Total	***19%***	

If one only looks at the three asset classes used by the investment firm, the portfolio risk is 5%. This assumes that the bond portfolio consists of a mix of 20% European investment-grade bonds and 60% European government bonds rated AAA-AA. However as expressed by the standard deviation, the risk of Mr Boersma's investment portfolio on the basis of the specification is 9.2%. So Mr Boersma's portfolio risk is higher than it superficially appears to be, and is also higher than the level appropriate to his situation. This is because the investment firm is only using three very generally defined asset classes.

The asset class of fixed-income securities includes instruments that have a widely divergent degree of risk. For example, European high-yield corporate bonds have a higher risk than European government bonds rated AAA. In addition, perpetual loans are included in the asset class of fixed-income securities (or bonds), when on the basis of risk they should be counted as emerging markets shares. This means that a larger part of the portfolio is exposed to a (higher) risk. Using a more

[5] *This uses the 17 asset classes proposed by the VBA (the Dutch Association of Investment Analysts) with the associated standard deviations.*

specific definition of asset classes will provide better information regarding the risk associated with the asset allocation. The desired portfolio composition can be determined on this basis. The reports will then also provide the client with adequate information regarding the risk associated with his portfolio.

3.5 Establishing the strategic asset allocation

The strategic asset allocation is a crucial element in the investment policy

The strategic asset allocation is the distribution of the capital to be invested across various asset classes on the basis of long-term objectives and obligations. The object of the strategic asset allocation will be to achieve an optimal balance between risk and return. The strategic asset allocation is an important factor for the risk and return of an investment portfolio, and forms the starting point for constructing the investment portfolio. Within the bandwidths of the strategic asset allocation, the investment firm usually has the discretion to make choices with regard to the actual asset allocation. This is known as tactical asset allocation. The tactical asset allocation may involve temporary deviation from the strategic asset allocation. By means of tactical asset allocation, the investment firm can take advantage of short-term expectations, for instance with respect to the returns expected in certain asset classes.

The investment firm may decide to determine the strategic asset allocation individually for each client, or to establish standard strategic asset allocations suitable for certain groups of clients, known as risk profiles. If the investment firm uses risk profiles, this will usually mean that the strategic asset allocation is formulated centrally. If the investment firm decides to formulate the strategic asset allocation individually for each client, this places more responsibility on the adviser. The investment firm will in this case decide how much discretion the adviser should have and how it can ensure that the adviser follows the established procedure. In other words, the more decentralised the formulation of the investment strategy, the higher the demands with regard to the quality of the conduct of business at the investment firm.

Efficient portfolios

When establishing the strategic asset allocation, the investment firm's objective should be to establish a portfolio that will lead to the highest possible return for a given degree of risk. The reverse also applies, that the portfolio risk should be as low as possible for a given return. This is described in Markowitz's 'Modern Portfolio Theory'[6]. Markowitz's principle is that investments should not be selected on an individual basis, but that account should be taken of the relative features of investments compared to other investments, and the relationship between these investments. By considering the investments in context, one can strive to achieve a portfolio that realises the highest possible return with the lowest possible risk. These are known as efficient portfolios. The theory does not state which of these efficient portfolios should be selected. This depends on the risk appetite of the investor. The results of these efficient portfolios depend on the assumptions regarding the returns and risks of asset classes, and the correlations between asset classes. If the actual market circumstances differ from these assumptions, there is a chance that these efficient portfolios will not give the best results. This chance increases in the event of extreme market conditions.

In order to identify efficient portfolios, it is important to determine the expected risk-return ratio for each asset class. The expected return of the strategic asset allocation can be determined in several ways. For instance, the investment firm can make a conservative estimate of the expected return for each asset class on the basis of historical data. In the case of a short-term investment horizon, the

[6] *Source: Markowitz, H.M., 1952, "Portfolio Selection", Journal of Finance 7 (1), 77-91.*

investment firm will have to be cautious when estimating returns, since volatility then has a greater effect.

Investment firms are free to choose the way in which they quantify risk. One possible way of quantifying risk is to calculate the standard deviation of the investment portfolio[7].
Standard deviation can be used to estimate the interim fluctuations that may occur in the portfolio. The advantage of this measure is that it is widely applicable and its calculation is relatively simple. The measure does have its limitations; for instance it involves the assumption that returns will be normally distributed, while this is not always the case in reality[8]. Standard deviation also only takes account of market risk, while an investment portfolio entails other significant risks that are not reflected in the standard deviation, such as liquidity risk and debtor risk. This should be taken into account when using standard deviation to measure portfolio risk or to establish the suitability of an individual investment portfolio for a specific client. The adviser should make it clear to the client that the portfolio risk could develop in a way other than predicted in future.

Risks resulting from changing market circumstances

The current volatility in the financial markets involves specific risks. It is important that when constructing and monitoring client portfolios, advisers should continually keep these developments in mind. One example is the risks that are currently associated with bond investments. Whereas previously a government bond offered a high degree of security, this may no longer apply in the current economic climate. Another example is the increasing uncertainty regarding the position of the dollar as a result of the economic situation and political conflicts. These developments underline the importance for an investment firm to continue investing in knowledge with respect to the latest developments and scientific research into investing.
If the original assumptions temporarily or permanently no longer apply, it is important that advisers act in accordance with the new situation. If fundamental changes occur in the principles on which the portfolio composition is based, this could be reason for advisers to change the portfolio bandwidths they have previously agreed with their clients. It is thus important to review the extent to which this is in accordance with the agreement made with the client. If this is not the case, the adviser will need to contact the client and make new agreements.

3.6 The selection of financial instruments

The investment policy includes criteria for the selection of financial instruments

After establishing the strategic asset allocation, the investment firm will also have to decide how the asset classes will be represented. It is important that the investment firm uses criteria in its investment policy for the selection of financial instruments (individual securities, investment funds and other investment products) within a particular asset class. The following points are important:

3.6.1 Who is responsible for the selection of instruments?

The investment firm may decide to select the financial instruments centrally or to allow the adviser to make the selection. It is also possible to use a combination, whereby the investment firm prepares a list of instruments at centralised level from which the adviser can make a selection for each client. In any case, the investment policy should specify how the financial instruments are selected. The decentralised selection of instruments requires additional measures to ensure that the requirements set by the investment firm are met.

[7] Standard deviation is the only risk measure encountered by the AFM in its exploratory review.

[8] See appendix 1 for further explanation of the use of standard deviation.

3.6.2 Will individual securities be used, or investment funds?

Investment firms may have various reasons for deciding to invest in individual securities or investment funds (including Exchange Traded Funds, or ETFs). Choosing investment funds may contribute to better diversification, for example. In addition to diversification, the costs associated with the inclusion of the instruments should play an important role. The firm’s investment policy should specify which solution is appropriate for which situation, with consideration given at all times to whether an alternative is available that offers a better risk-return ratio.

3.6.3 Will actively or passively managed investments be used?

If the investments in an asset class are to be in the form of investment funds, there is the option of choosing either an actively managed fund or a passive investment[9]. An investment firm should make a considered choice between active or passive investing. This decision may be different for each asset class. The AFM published its ‘*Guideline on active and passive investing in the customer’s interest*’ in October 2011, which contained recommendations with respect to making a responsible choice between active and passive investing.

3.6.4 What are the criteria involved in the selection of financial instruments?

Once decisions have been made regarding the type of instruments to be used, the financial instruments themselves can be selected. From its investment universe, the investment firm will select the securities that will add value for clients. It is important here to establish the features of these instruments that the investment firm takes into consideration. Features that in any case will be significant are:

- The mandate of the instrument
- Track record
- Cost structure
- Liquidity
- Counterparty risk
- Risk management
- Structure and personnel

These features are dealt with in more detail in Appendix 2. Not all features apply to all types of financial instrument. Later on in this paragraph, some items of attention regarding the selection of specific financial instruments will be described.

An example of good advice

The investment firm includes investment funds in its client portfolios. Before a fund is included in the portfolio, it is thoroughly analysed by the investment firm. First of all, the firm prepares a wide selection of funds on the basis of certain criteria. It uses information from Internet, factsheets and external research sources, and its own network. The questions the investment firm will ask will include the following[10]:

- *Is the fund’s investment strategy suitable for the investment firm?*
- *What is the fund’s track record and how has it performed in more difficult markets?*
- *What is the reputation of the fund manager, the organisation and the team?*
- *Is the fund registered with the AFM (if applicable)?*

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[9] The term ‘active investing’ refers to the composition of a portfolio that intentionally deviates from its reference index in an attempt to outperform this benchmark. Passive investing means that the intention is to track a particular index as closely as possible, and there is no attempt to construct a portfolio that will outperform the index. Although it is also possible to actively manage investments in individual securities, this is left out of consideration here.

[10] The list is not exhaustive.

The investment firm then makes a further analysis of this wide selection of funds, applying in any case the selection criteria mentioned in Appendix 1. It makes a second selection of funds on this basis. It interviews the fund managers of these funds to gain further understanding of their views and strategies, and assesses whether these are appropriate to the firm and its clients. The investment firm will monitor these funds on an ongoing basis, devoting attention among other things to:

- *Changes made to the investment strategy;*
- *Performance in the last 12 months (absolute and relative) in relation to risk;*
- *The risks the fund is exposed to, including currency exposure, exposure to countries and sectors, and the diversification of the portfolio;*
- *Changes in the fund manager's team;*
- *Assets invested;*
- *Liquidity.*

Selection of proprietary financial instruments

There are investment firms which offer their own financial instruments, such as investment funds. In the same way as for instruments provided by third parties, the investment firm should make it clear when selecting proprietary instruments why the instrument adds value and why it suits the client's needs. The investment firm should take the considerations listed above into account. The investment firm should also explain to the client why the inclusion of a proprietary instrument will add value. In such cases it is important that the investment firm devotes extensive attention to the avoidance of conflicts of interest, such as rewarding its advisers for selecting proprietary instruments. The investment firm should be proactive in informing the client with regard to the risk of a conflict of interest.

Monitoring

An investment firm should base the selection of a financial instrument on the most up-to-date information. New information becomes available over time (such as the publication of quarterly figures, or a report of a fund manager's departure). On the basis of newly available information, an investment firm will have to regularly assess whether there are still good and sufficient reasons for continuing to hold the instrument in the portfolio.

Selection of ETFs

If a decision is made to construct all or part of the portfolio using passive investments, the investment firm has a wide variety of index funds and index trackers, or ETFs, to choose from. ETFs are listed open-end investment funds whose objective is to track an underlying index as closely as possible. This group of investment funds has shown strong growth in recent years. The added value for the client may vary per ETF, and not every ETF is suitable for every type of client. It is therefore important that the investment firm selects ETFs that suit its investment strategy and its client target group. The investment firm can use the criteria listed in Appendix 2. In addition, ETFs have specific features and risks which the investment firm must take account of in its selection[11]:

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[11] The list is not exhaustive. The AFM will devote further attention to ETFs in the near future. This may lead to additional selection criteria being listed.

- *Method of composition*

  Broadly speaking there are two ways of constructing an ETF, either by physically purchasing the underlying securities (physical replication) or by imitating the index using alternative instruments (synthetic replication).

  With synthetic replication, an indexqs return profile is imitated by doing a swap transaction. The counterparty to the swap undertakes to pay the index return to the investors in exchange for the payment made by these investors. Synthetic replication is often used to follow an illiquid market. Swap transactions involve the risk that the counterparty will not meet its obligations. This counterparty risk is difficult to evaluate. Investment firms need to be aware of this risk. Counterparty risk is discussed further in Appendix 1.

  With physical replication, the securities in the index are purchased as far as possible on a one-for-one basis. The ETF thus actually owns these securities. There are two methods used for physical replication, known as full replication, or sampling. Full replication means that all the securities in the index are purchased. Sampling means that a selection of these securities is made. Sampling is often used in cases where the index comprises a large number of underlying securities, or contains a number of illiquid securities. With sampling, there is the risk that the price of the ETF will differ to a greater or lesser extent from the level of the index. When there is no good reason to use sampling but the ETF uses this method anyway, selection of this ETF should be avoided.

- *Stock exchange listing*

  Since ETFs are listed, they can be traded at any time during the day. The price at which they can be traded depends on supply and demand for the ETF in the market. This means that investors in an ETF will not necessarily pay or receive a price that corresponds to the price of the underlying securities. Investment firms need to be aware of this risk.

- *Actively managed (or partly actively managed) ETFs*

  ETFs do not always have the objective to track the index as accurately as possible. Enhanced indexing as an example of a different strategy. With this technique, the investments made are mostly those in the index, however a number of other investments are selected with the objective of realising a return in addition to that of the index. In this case the objective is not to track the index, but to outperform it. A second method, known as leveraged indexing, attempts to use borrowed money to generate a higher return. This method increases the risk of the investments due to the effect of leverage. A third type of ETF, known as inverse indexing, attempts to generate a return that is the inverse of the underlying index. All these three variants have a different risk-return profile from that of a ±normalqETF. The investment firm will have to assess the expected risk and return in each case, and decide whether such instruments are suitable for the client.

- *What is the historical and expected tracking error?*

  The tracking error of an ETF expresses the extent to which the ETF actually tracks the index. The lower the tracking error, the more closely the ETF replicates the index return. Deviations from the index can arise due to transaction costs, sampling and the tax treatment of dividends, to name but a few examples. If the objective of the ETF is to follow the market, then the intention is to achieve as low a tracking error as possible. Information on the historical and expected tracking error informs the adviser regarding the extent to which the fund in question has succeeded (and is expected to succeed) in replicating the index return. A high tracking error means that the return (and therefore potentially the risk) differs from that of the index. This means that the investor will be exposed to a different level of risk than if he had invested in the index.

- *Are ETFs suitable for the asset class in question?*

  ETFs that invest in shares are the most common examples, although there are ETFs available for several asset classes. In the case of some asset classes, there are additional risks that the adviser should be aware of.

  For ETFs investing in bonds, account must be taken of the fact that a market-weighted index of bonds means that the investor is most exposed to parties with the highest debt burdens. This entails additional risk.

  For ETFs investing in commodities (Exchange Traded Commodities), the return from investing in an index is not the same as the return from investing in physical commodities. This is because an index uses futures in order to imitate the return profile. Whether this return will be higher or lower than the return from direct investment cannot be established in advance.

Selection of alternative investments

The term alternative investments is generally used to refer to all investments that are not shares or bonds, for example hedge funds, private equity, real estate and commodities. Alternative investments may have a low or a negative correlation with shares and/or bonds. This means that the inclusion of these instruments in an investment portfolio will reduce the portfolio's volatility. The effect of this varies for each instrument. Since the characteristics of these instruments differ for each type of alternative investment, it is important that this effect is established for each individual instrument. In addition, alternative investments have a number of specific features and risks that must be taken into consideration during the selection process. These include marketability, costs, transparency, roll yield and an underestimation of risk on the basis of volatility. These features are discussed in more detail in Appendix 3.

The investment firm must assess for which clients these features are appropriate. If the investment firm decides to include one or more of the various alternative investments, the adviser will have to ensure that the client is informed with regard to these specific risks and their potential effects. This does not alter the fact that the addition of alternative investments to a portfolio may offer useful diversification of risk.

Selection of structured products

An investment firm or adviser may also decide to select structured products in the composition of an investment portfolio. Many of these products offer a guarantee of the principal sum invested or a minimum return, subject to conditions.

Structured products may have limitations. In some cases the principal guarantee may not be comprehensive, the increase in the associated index or indices may not be fully tracked, or it may be followed only to a limited extent. These limitations are necessary so that the product can offer a guaranteed value. Structured products usually involve high costs, and their marketability may be limited.

When deciding to include one or more structured products in a client's portfolio, it is important that the adviser understands the product and can estimate its added value for the client. This means that the adviser understands the structure of the product, what the risks are and in what situations these will occur. Some of the criteria listed in Appendix 2 will be relevant in this respect. It is also important that the adviser estimates the extent to which the expected returns and upside potential are feasible. In other words, the adviser must be able to answer the following questions:

- What are the factors determining the likelihood that the upside potential will be realised, and what are the risks involved?
- How likely will this return be?
- What is the quality of the guarantee or protection, who is offering it and does it offer value in the light of the productqs cost structure?
- Given the risks and costs, does the product actually offer substantial added value in terms of protection and net return?
- Is it possible to achieve the desired protection in another, cheaper way?

This last question is important because there are several instruments available whereby the level of risk in investment portfolios can be limited, such as individual instruments like zero coupon bonds and options. The limitation of risk by means of including a number of structured products with a nominal guarantee would seem to be a less attractive option, since there are better and cheaper alternatives available to mitigate risk.

An example

In Mr Kuipersq portfolio, the adviser has included four structured products in order to provide partial protection. The structured products track the return of a stock index. 90% of the nominal value is guaranteed. The purpose is to limit the portfoliogs downside risk. Mr Kuipers has actually stated that the maximum downside risk he is willing to accept is 20%. At the time of purchase, the value of the four products together amounts to 15% of the portfolio.

The four structured products collectively guarantee only 13.5% of the value of the portfolio (15% of 90% of the nominal value). It is questionable whether this offers the desired protection for Mr Kuipersq portfolio. Limiting the downside risk is not the same as a nominal guarantee. Constructing a portfolio with a downside risk of 20% can be accomplished in various ways. It is important that the adviser considers the extent to which structured products offer the best and most logical alternative in an investment portfolio. When using structured products, it is also important that the adviser checks the creditworthiness of the party providing the guarantee. Among other things, this determines the guaranteeqs value.

4 Client profile: a full understanding of the client's situation is crucial

4.1 More effective gathering of information

In order to be able to give suitable investment advice or to manage assets properly, it is essential that the adviser has the fullest possible understanding of the client's situation (the client profile)[12]. The client profile should be as current and as specific as possible, both qualitatively and quantitatively. The current situation in practice is that the client profile in many cases is too superficial to serve as the basis for constructing an appropriate investment portfolio. This Section uses examples of both good practice and inadequate practice to illustrate the information that the adviser needs in order to obtain a thorough client profile. The advisory service described mainly involves wealthier clients, although this does not mean that the recommendations do not apply to less wealthy clients as well. Much of the information described in this Section will be relevant to the provision of suitable recommendations, especially when the client's situation is complicated, or in situations where the client is heavily dependent on the capital invested. In addition, it is important to ensure that the information obtained is of sufficient depth. If the client's situation is relatively simple, the depth of the information needed will be reduced accordingly.

The client profile must in any case answer the following questions[13]:

- What knowledge and experience does the client possess, and to which financial instruments does this relate?
- What is his education and profession?
- What is the client's objective?
- When does the client hope to achieve his objective(s)?
- How much money does the client need to achieve his objective(s)?
- Does the client plan to make further investments, or interim withdrawals? If so, how much money will be involved?
- Does the client have other long or short term objectives that could be relevant?
- Does the client have sufficient spare capital to invest in order to achieve capital growth?
- How dependent is the client, in financial terms, on being able to realise his objective(s) (now and in future)?
- How much risk can the client bear in the light of his income and capital position, now and in future?
- Can the client accept losing his investment? If so, what is the maximum sum he is willing to lose?

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[12] *According to Section 4:23 of the Financial Supervision Act (Wft), before giving investment advice or providing asset management services, information must be gathered with regard to the client's knowledge, experience, financial position, objectives and risk appetite. For investment firms, these requirements are further elaborated in Sections 80a, 80b and 80c of the Market Conduct Supervision (Financial Institutions) Decree (hereinafter, 'Bgfo'). The requirements for the provision of execution-only services are less stringent than those for investment advice and asset management. For execution-only services, the investment firm only has to conduct a suitability test in the case of investing in complex financial instruments to check that the client has adequate knowledge and experience of the product in question to understand the product and its associated risks. In the case of advice and asset management, a further suitability test has to be conducted to establish whether the service is appropriate to the client's personal situation.*

[13] *This list is not exhaustive. If necessary, the adviser will need to ask additional questions to gain the best possible understanding of the client's situation. Information necessary for the provision of advisory or management services may also be obtained by other means.*

- What chance of failing to achieve his objective is the client prepared to accept?

Failing to obtain an adequate client profile could lead to a client being recommended an investment portfolio that is not appropriate to his situation, risk appetite and objective(s). In many cases, this could lead to disappointment and possibly even financial problems for the client. If the client is not willing to give information (or not enough information) regarding his personal situation, the adviser will have to decide whether he is in a position to offer the client advice. And if he decides that this is not the case, the adviser must say goodbye to the client.

Based on its review, the AFM concludes that the client profile actually obtained could, in many cases, be more complete. In particular, the adviser often fails to obtain a complete enough picture of the client’s objectives and financial position (in both qualitative and quantitative terms).

4.2 The importance of the client’s ‘knowledge and experience’

Knowledge and experience are important for establishing the degree of communication

Understanding the client’s knowledge and experience of investing in specific financial instruments will assist the adviser in estimating how much information he should give the client. Only then can he put the client in a position to understand the risks associated with certain investments. The client will also be in a better position to understand why the adviser gives particular recommendations, or why his assets are managed in a particular way. Information on the client’s knowledge and experience also helps the adviser to interpret the client’s answers more accurately.

If the client has no knowledge or experience of investing, this does not necessarily mean that he should not invest. It is, however, important that the adviser ensures and establishes that the client understands the risks associated with investing and the consequences thereof. This goes further than simply asking whether the client has knowledge or experience with regard to a certain instrument. The adviser should establish the level of the client’s knowledge so that he can adjust the information provided accordingly. It is important that the client understands the adviser.

The lack of knowledge and experience does not automatically have to mean that a client should be excluded from investing in certain asset classes[14]. It may well be the case that particularly complex products with a high degree of risk are less suitable for clients who have no knowledge and experience of investing. Of course, all this must be seen in the context of the client’s financial position, risk appetite and objective(s).

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[14] In a survey of pension administrators, Netspar notes that, in a number of cases, knowledge and experience have an important – and even a decisive – role in establishing the risk profile. Accordingly, the lack of knowledge and experience in some cases automatically means that the risk profile assigned is defensive (savings only). This approach would for example exclude younger employees from more aggressive risk profiles and therefore prevent them from realising a reasonably desired return. According to Netspar, the emphasis should be more on raising clients’ awareness of risk than on pure investment advice. Netspar, ‘Risicoprofielmeting voor beleggingspensioen’ [Measuring risk profiles for pension investing], April 2011, p. 30.

4.3 Targeted investing

The adviser establishes the clientqs objective in sufficiently clear, practical and measurable terms and takes this as the starting point for the service to be provided

In order to construct a suitable investment portfolio, the adviser must consider the reason why the client wishes to accumulate capital or generate income:

- *What does the client need the capital for?*
- *When does the client hope to achieve his objective(s)?*
- *How much money does the client need to achieve his objective(s)?*
- *Does the client plan to make further investments, or interim withdrawals? If so, how much money will be involved?*
- *Does the client have other long or short term objectives that could be relevant?*

Not all clients have an actual objective they can state in defined terms. However, most do. Investing is a means to an end, not an end in itself. The adviserqs job is to properly identify the clientqs motivation for accumulating capital through investing. This could be the desire to achieve a higher return than can be realised in a savings account. It is thus important that the adviser obtains a good understanding of how much additional return the client expects to achieve for the risk he takes.

An example of good advice

The adviser has discussed with Mr and Mrs Bakker (aged 40 and 41 years) what their objective is for the capital they wish to invest of ” 130,000. They want to build up capital so they can continue to travel when they retire. The adviser has established that Mr and Mrs Bakker are accumulating enough money in their pensions to meet their fixed expenses. Mr and Mrs Bakker do not need the money they wish to invest for their living expenses. In addition to the sum they want to invest, they have savings of ” 100,000.

Over 25 years, Mr and Mrs Bakker want to accumulate approximately ” 300,000. The adviser has calculated that this will require a net annual return of 3.5%. The adviser takes account of expected inflation at a rate of 2%. He also takes account of the full asset return tax at 1.2%. Taking all this into consideration, the adviser calculates that the net return required to meet the objective is 6.7%. Mr and Mrs Bakker will pay the costs for the service from other funds.

The adviser has accurately established the clientsqobjective. He has calculated the return the clients are expected to need in order to reach their objective. The adviser has expressly taken account of inflation and tax implications. He uses this information as the basis for his advice.

In order to be able to translate the clientqs objective(s) into a suitable investment portfolio, it is important that the objective is properly defined. The target capital and/or expected return should thus be specified as accurately as possible. It is important that how matters such as inflation expectations, tax implications and the costs of the service will be dealt with is also discussed.

In his advice, the adviser takes account of inflation, tax implications and the costs of the service

An example of inadequate advice

Ms De Wit (aged 49) wants to invest a sum of ” 50,000. From the client profile form that Ms De Wit has completed, it appears that she will have this sum available for a period of %8 to 12 years+. Ms De Witqs stated objective is %to supplement my pension income+.

Ms De Witqs objective is too vague to offer advice on this basis. It is not clear from what date Ms De Wit wishes to supplement her pension, or by how much. In order to be able to determine this, we need to know her situation as regards capital and income. The adviser needs to know what income she wants to receive when she retires, and what pension income she has already accrued. Since this information has not been obtained, the adviser cannot establish what the target capital is or

what the expected return needs to be. This means there is no clear basis on which the adviser can construct a securities portfolio. The adviser has no specific investment objective, he cannot estimate the client's risk appetite, and the investment horizon is unclear. Despite the relatively small sum that Ms De Wit wishes to invest, in view of her pension objective it is important that sufficient further information is obtained. As a result of the lack of specific information, there is a good chance that the client will be disappointed during the management of the portfolio.

4.4 How much risk is the client able to bear?

The adviser has enough information to determine how much risk the client is able to bear

The client's risk appetite comprises both the financial risk he is able to bear and the risk that he is willing to bear. Since these elements may contradict each other, they will have to be assessed separately. A client may be prepared to accept a high level of risk, but if he is too dependent on the assets invested it may be extremely unwise from him to incur a high risk. The answer to the question of how much risk the client is able to bear will be decisive in most cases.

In order to determine the risk the client wishes to take it is important to know his limits. The extent to which he can bear risk depends to an important degree on his financial position and objective(s). The adviser has an important role to play in establishing these parameters.

In order to assess the level of risk the client is able to bear now and in the future, it is necessary to understand his current situation with regard to income and capital. The adviser forms a picture of this situation, in as far as possible, on the basis of the client's current and future income, expenses, assets and liabilities. Furthermore, the client's personal situation with regard to his age, career and future prospects is obviously also important.
Based on this information the adviser can assess:

a. Whether the client has sufficient spare resources in order to accumulate the capital for his objective(s). Will he need this money for other necessary purposes, either now or in future?
b. The extent of the client's dependence on achieving his future objective(s). Will he have enough money to redeem his mortgage for example, or will his income or pension be too low and have to be supplemented?
c. The minimum capital the client needs for his objective(s).

Based on the results of these enquiries, the adviser will discuss with the client the various scenarios that could lead to his target capital being achieved, and will explain the risks that are involved and the feasibility of the scenarios.

An example of good advice

Mr and Mrs Jansen have ” 600,000 to invest. The Jansens are currently both 50 years old. They have told the adviser that Mr Jansen wants to retire at the age of 65. Mr and Mrs Jansen want to supplement their income out of their investment. Mrs Jansen does not work.

The adviser has assessed the extent to which Mr and Mrs Jansen depend on the proceeds of the capital and how much risk they can bear. This is one of the factors that will determine whether the uncertainty associated with investing will be suitable in Mr and Mrs Jansenqs case. The adviser has listed Mr and Mrs Jansenqs income and expenditure, assets and liabilities. He has also asked for details of Mr Jansenqs pension scheme and his UPO (Uniform Pension Statement). Since Mrs Jansen has never worked she will only receive AOW (state retirement pension) when she reaches pensionable age. Their financial situation is currently as follows:

Mr and Mrs Jansenqs current net annual income is ” 100,000. Their total expenditure is ” 90,000 per year. Besides the sum they wish to invest, they have ” 150,000 in savings. They do not own property and have no debts. Mr and Mrs Jansen want to keep their savings as far as possible for their children and grandchildren.

From his analysis of their pension situation, the adviser has established that from the age of 65 onwards, Mr and Mrs Jansen will have a total net annual income of ” 50,000. They want to maintain the same standard of living as before their retirement. After they retire, their expenditure is expected to fall to around ” 80,000. The adviser has calculated that after reaching retirement age, Mr and Mrs Jansen will need to supplement their income by ” 30,000 per year for 30 years. Mr and Mrs Jansen will invest their capital of ” 600,000 for 15 years without making any withdrawals.

The adviser has discussed with Mr and Mrs Jansen what the consequences will be if they fail to achieve a sufficient return to make the intended withdrawals. In this case, they can resort to the return on their savings, or the savings themselves. They would also have the option of reducing their spending by travelling less.

In this example, the adviser has obtained extensive information on the clientsqfinancial position. He is not only aware of their situation as regards their current income, he also knows what will happen when they retire. On this basis, the adviser concludes that investing offers a suitable solution for Mr and Mrs Jansen. The adviser has also obtained information regarding the clientsqobjective and the degree of risk that they are able to bear.

An example of inadequate advice

Ms Brouwer has savings of ” 50,000 available to invest. In 10 yearsqtime she wants to pay off part of her mortgage. From the questionnaire used by the adviser, it appears that this ” 50,000 comprises %26% - 50% of her total assets excluding the value of her house+. The questionnaire also includes a question asking how important it is for her to achieve her objective. Ms Brouwer has indicated that achieving her objective is %easonably important+.

The adviser does not have sufficiently specific information regarding Ms Brouwerqs income or capital position. He has no actual information regarding her income and expenditure, or her assets and liabilities. The adviser needs this information in order to be able to determine the extent to which Ms Brouwer depends on being able to accumulate capital to pay off her mortgage. The adviser also needs this information to assess the degree of risk she is able to bear. This assessment could result in the conclusion that investment is not a suitable solution in her case. The fact that Ms Brouwer has indicated that the capital proceeds are ±easonably importantqto her does not alter the fact that the adviser must make his own assessment of the risk she is able to bear.

4.5 How much risk is the client willing to bear?

The adviser has discussed what risk the client is willing to take that he will not achieve his objective

The client's attitude to risk is one of the most difficult aspects of the client profile. What does risk mean to him? How does one quantify risk? The question of whether the client will have sleepless nights if the market drops 25% does not generally tell one much about the risk the client is willing to take in the light of his objective. It is important that risk is quantified. Expressions such as 'some', 'average' or 'significant' risk are too vague.

For the client, the biggest risk of investing is the risk that he will not achieve his objective. The adviser in any case has to establish whether the client can accept losing all or part of his investment, and if so, how much he is willing to lose. To put it another way, what is the minimum that he wants to retain? It is moreover important to establish what degree of probability that the objective will not be achieved is acceptable to the client[15]. Questions regarding declines in value in the interim may be useful to some extent, but will not provide full understanding on this point.

The adviser can determine the client's attitude to risk by proposing various scenarios to illustrate the financial consequences of realising a lower or higher capital sum on the end date. This will help the adviser establish the degree of risk the client considers to be acceptable.

Many advisers state that in practice the degree of risk that clients are willing to bear only becomes clear after the event. They find it difficult to accurately estimate the client's risk appetite. There is thus much room for improvement in this respect. Making the effect of price fluctuations clear by means of different scenarios can contribute to a better understanding of the actual risk appetite.

An example of inadequate advice

Ms Pietersen has completed a questionnaire provided by her investment firm. The adviser uses her answers to construct an investment portfolio. Ms Pietersen has stated:

- *A capital loss of 20% in the first year would not be acceptable; the maximum loss I am willing to bear in one year under normal circumstances is 12.5%.*
- *A capital loss of 6% in the first month would be disappointing, but I would be confident that the markets would recover.*
- *I would rather have a lower return than take on too much risk.*

The adviser does not have sufficient detailed information to establish how much risk Ms Pietersen is willing to take. The answers she has given do not give enough information to understand her attitude to risk. To what extent is she willing to lose part of her investment on the end date? What does she think about the risk that she will not achieve her objective?

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[15] Netspar recommends that pension administrators measure risk appetite in terms of the objective rather than in general terms. In the Netspar survey, this is the risk appetite with respect to forming capital for a pension. The two decisive factors here are the objective and the date on which the pension becomes payable. Netspar, 'Risicoprofielmeting voor beleggingspensioen' [Measuring risk profiles for pension investing], April 2011, p. 38.

A good example

The following questions are included in a risk profile in order to measure a clientqs risk appetite.

Question 1: Which of the following would you prefer?

Option 1:	*or*	*Option 2:*
A definite + ” 200		*50% chance of + ” 650 and 50% chance of - ” 200*
Option 1:	*or*	*Option 2:*
A definite + ” 200		*50% chance of + ” 900 and 50% chance of - ” 350*
Option 1:	*or*	*Option 2:*
A definite + ” 200		*50% chance of + ” 2000 and 50% chance of - ” 600*

Question 2: value of the investment portfolio

Assume you have an investment portfolio of ” 10,000. And assume that the answers below describe the potential development of the value of this portfolio after one year. Which answer (or risk appetite) best reflects your attitude? The risk you bear is that after one year the portfolio will have a value of between:

” 9,500 and ” 11,500 (- 5% + 15%)

” 9,000 and ” 12,500 (- 10% + 25%)

” 8,000 and ” 15,000 (- 20% + 50%)

” 0 and ” 30,000 (with this option you would risk losing your entire investment).

- ” 5,000 and ” 40,000 (with this option you would risk losing more than your initial investment and ending up with a debt to pay).

There has been much research into the problem of establishing how much risk a client is willing to take that has focused on identifying indicators that will measure a clientqs risk appetite. The research shows[16] that one of these indicators is the aversion to losses. The kind of questions used in this example are useful in measuring a clientqs aversion to losses. The investment firm will have to translate the answers to these questions into a degree of risk. Of course, asking these questions alone will not be enough to accurately establish a clientqs risk appetite. The point here is only to measure how much risk the client is willing to bear. He still also has to establish how much risk the client is able to bear.

[16] *F. van Raaij, B.Schuurmans, H. Vos, ±Verbeteringen in het bepalen en het gebruik van risicoprofielenq [Improvements in the determination and use of risk profiles], B&E April 2011.*

4.6 Are the client's objective(s) and his risk appetite mutually consistent?

The adviser considers whether the objective and the risk appetite are mutually consistent, and asks further questions if there are inherent contradictions

Once the adviser has established how much risk the client is able to bear and is willing to bear and has understood his objective, he has to reconcile this information in order to give appropriate advice.

If the answers given by the client are contradictory, the adviser must discuss this with the client. If achievement of the objective is only feasible by accepting a higher level of risk, it is important that clearly considered choices are made in this respect.

The combination of the objective, the risk the client is able to bear and the risk the client is willing to bear can lead to the conclusion that the likelihood of achieving the objective on the basis of realistic return expectations and the volatility of the chosen investment portfolio is extremely low. The adviser will have to discuss this with the client. Generally, there are three options in situations where the objective and the degree of risk are not mutually consistent:

1. reducing the objective;
2. increasing the investment; or
3. increasing the risk.

The adviser has to identify which of these options the client prefers and which is the most suitable in his case. If for instance the adviser's opinion is that the client cannot take on a higher risk, he should strongly advise against increasing the risk of the portfolio. It is important that the client understands the return expectation associated with a particular risk profile and what this means for the risk of the investment portfolio.

A scenario analysis can be a useful tool for understanding the link between the investment and the chosen level of risk and the client's objective.

An example of inadequate advice

The adviser has obtained information regarding Mr De Haan's objective and the amount of risk he is willing to take. The adviser is sufficiently aware of Mr De Haan's financial situation to estimate the degree of risk he can accept. Since the amount of risk Mr De Haan is able to take is less than the amount he is willing to take, the adviser bases his calculations on the first measure. Based on this information, the adviser carries out a scenario analysis for the various risk profiles used by the investment firm. Using this analysis, the adviser selects the profile that meets the risk restrictions of Mr De Haan and at the same time offers the best chance of achieving the objective. The profile selected by the adviser has a level of risk that is close to the maximum that Mr De Haan can responsibly accept. The chance of achieving the objective in this scenario is 30%.

The adviser has obtained all the important information regarding the client. By means of a scenario analysis, he can assess this as a whole. He recommends a solution that is the most suitable within the parameters the client has indicated. The scenario analysis however shows that within the parameters of the objective and the risk appetite there is only a 30% chance that Mr De Haan will achieve his objective. The low probability that the objective will be realised should lead the adviser to reconsider his current recommendation.

An example of good advice

Mr Zwart has told his adviser he has ”200,000 to invest. The interview reveals that Mr Zwart hopes to purchase a boat in 10 yearsq time. He needs approximately ”250,000 for this. Mr Zwart is not especially dependent on this money, since he also has ”700,000 in savings. His income from his business is more than sufficient to meet his fixed expenses. Mr Zwart has stated that he does not wish to take on too much risk with regard to the capital to be accumulated.

The adviser has established that on the basis of his financial position Mr Zwart can bear a high degree of risk. However Mr Zwart is only willing to accept a limited degree of risk. Based on a detailed questionnaire and the review of a number of answers, the adviser and the client together have come to the conclusion that the neutral risk profile is the most suitable of the risk profiles in use for this clientqs situation.

The adviser will then check to establish how realistic a chance Mr Zwart has of achieving his target return with the chosen risk profile and asset allocation. He has carried out a scenario analysis for this purpose. On the basis of the various risk profiles used by the investment firm, the adviser illustrates how the capital sum would be expected to develop in a positive, a realistic and a negative scenario, and what chance there would be in each case that the objective would be realised.

The scenario analysis shows that the portfolio reflecting a neutral profile would generate proceeds of around ”435,000 in a positive scenario and around ”185,000 in a negative scenario. The final capital sum is expected to amount to approximately ”300,000. The chance of achieving Mr Zwartqs objective with this portfolio is approximately 65%.

The adviser discusses the results with Mr Zwart. It turns out that the objective is most likely to be achieved with the neutral profile, and this is appropriate to Mr Zwartqs risk appetite.

The adviser can use the scenario analysis to explain to the client the potential effects on his capital accumulation of various combinations of investments. He can do this once he has established the level of risk the client is able and willing to bear. The adviser can then calculate the feasibility of the objective with the selected asset allocation. This will help the client to get an idea of how likely it is that he will achieve his objective. Scenario analysis can assist the adviser in explaining the risks that the objective will not be achieved. If there is only a remote possibility of achieving the objective with the recommended asset allocation, the advice must be to reject it.

4.7 Using questionnaires to define the client profile

Advisers use a questionnaire as a means to an end, not an end in itself

Investment firms frequently use a questionnaire to define or to assist in defining the client profile. The questions generally relate to factors such as financial position, knowledge and experience, investment horizon and risk appetite. The adviser determines the composition of the investment portfolio on this basis. Such a questionnaire should be seen as a means to an end, and not an end in itself. The adviser will have to check whether the completed questionnaire gives a clear picture and actually reflects the clientqs profile. The interpretation and evaluation of the information requested from the client is an element of the adviserqs expertise.[17]

In the case of online services, where there is little or no personal contact with an adviser, a good questionnaire is even more important. The investment firm must be confident that the completed questionnaire will lead to a recommendation that is appropriate to the client. In any case, this means that there must be no inconsistencies in the answers given.

[17] See also the guidance consultation of The Financial Services Authority (FSA) ±Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selectionq January 2011, p. 14.

This paragraph describes several items of attention that apply to the use (or partial use) of questionnaires to define a clientœ profile.

The questions

The questions in a questionnaire must be clearly formulated, so that the client has no doubts regarding their meaning. This may also apply to standard (multiple choice) answers. If the question is ±*What is the total of your freely available assetsq* clients could have doubts as to what this means. Moreover, in order to identify how much risk the client can take, specific information on his financial position is required.

In addition, the questions asked should be relevant to the clientœ objective. If for instance the client wants to provide a pension for himself, his future financial position will have to be taken into consideration. In the case of a younger client who wants to accrue capital for his retirement, his expected future income will have to be taken into account.

The use of scores in establishing the Í risk profileÎ [18]

An important disadvantage of a questionnaire that uses previously assigned scores is that the significance of the answers is determined in advance. The significance of the answer is thus not determined according to the individual client. There is a risk that relevant information may be lost as a result of averaging the answers[19]. This is specifically the case if the client has given contradictory answers. If the contradictions are not discussed and simply included in an aggregate score, these points will be neutralised and thus ignored. This could lead to an inappropriate investment portfolio, and for this reason it is important that the adviser reviews the answers to the questionnaire.

An example of inadequate advice

The following questions and scores are used to determine a client profile. Not all the questions have been included below. The client is assigned a ±isk profileqon the basis of his total score.

1. *What is your experience of investing in shares?*
   - *No experience* *0*
   - *1 - 3 years* *1*
   - *3 - 7 years* *2*
   - *7 . 10 years* *3*
   - *More than I0 years* *4*
2. *Do you think you will need part of your investment for other purposes in the next 3 years?*
   - *No* *3*
   - *Yes, up to 20%* *2*
   - *Yes, between 20% and 40%* *1*
   - *Yes, 40% or more* *0*
3. *How many years do you have available for investment?*
   - *Up to 1 year* *1*
   - *1 to 4 years* *2*
   - *4 to 6 years* *3*
   - *more than 6 years* *4*

[18] *In order to establish the desired level of risk in the investment portfolio, some investment firms classify their clients according to various ±isk profilesq A fixed strategic asset allocation is established for each risk profile. This can prevent a client with several objectives having several risk profiles (and investment portfolios).*

4. *The value of investments may fluctuate widely; how much of a decline in value can you accept at any time?*
   - *0% to 3%* *1*
   - *3% to 5%* *2*
   - *5% to 10%* *3*
   - *10% to 15%* *4*
   - *15% to 25%* *5*
   - *25% or more* *6*

There are two important observations to make regarding this questionnaire:

1. The clientq experience of investing in shares is taken into consideration in the determination of his risk profile. The question of how many yearsqexperience he has is given too much weight. The length of experience normally has no effect on the clientq objective, and most likely only a limited effect on his risk appetite.
2. The *method* of scoring used here means that different types of client are assigned the same risk profile. This is not desirable.

   To illustrate this point, we give two examples of different types of client below, A and B. They differ in essential respects, however they would be assigned the same risk profile on the basis of the questionnaire above.

   - Client A, who has more than 10 yearsqexperience of investing in shares, but now wants to invest for his pension and therefore the maximum decline in value he is willing to accept at any time is from 5% to 10%, and Client B, who has 1 to 3 yearsq experience of investing and is willing to accept a decline in value of more than 25% at any time. Both score 7 points on questions 1 and 4.
   - Client A, who has an investment horizon of 10 years and can accept a decline in value of between 0% and 3% at any time, and client B, who wants to dispose of all his capital within 4 years and can accept a decline in value of more than 25% at any time (8 points on the basis of questions 2, 3 and 4).

If the investment firm uses a questionnaire, it is important that proper attention is paid to ensuring it is of adequate quality. What type of questionnaire gives the adviser the best support? How can the answers be best converted into input for the advice? Using a dynamic questionnaire, in which certain answers to particular questions lead to specific follow-up questions can help to define the client profile more accurately.

Open questions

If the questionnaire consists of open questions without multiple choice answers (a sort of check-list or guideline for the adviser), it is important that the considerations (and answers) that have led to the advice are recorded in the file. It is important that the adviser records his considerations. This is not always the case in practice, meaning that one cannot refer to the considerations on the basis of which the adviser has arrived at a particular recommendation.

5 Conversion into a solution for the client

5.1 From client profile to solution

An important task for the adviser is to recommend a suitable (investment) solution on the basis of the client profile. A suitable solution is a solution that takes account of the risk the client is able and willing to bear and puts him in the best possible position to achieve his objective.
If investing is the most appropriate solution, the adviser will construct a suitable investment portfolio on the basis of the client profile. In order to find a suitable investment solution, there are several steps for the adviser to consider.

These involve three steps:

1. The first step is to select the right investment service: asset management, investment advisory or execution-only, or an intermediate variant. If an investment firm is not able to provide the service that best suits the client, the adviser should refer the client to another service provider. This consideration may already have been dealt with in the initial interview stage.
2. If the client chooses investment advisory or asset management, the second step is to establish the strategic asset allocation on the basis of the client profile. This means that the adviser makes choices with regard to the allocation of the assets to be invested across various asset classes. This may be directly linked to the client profile that has been established.
3. The third step is the selection of individual financial instruments.

In practice, the link between the investment portfolio and its associated risk and the client's objective and risk appetite is not always clear. At some investment firms, the quantitative foundation for this is lacking.

5.2 Step 1: Determining the appropriate investment service

The adviser determines whether the service is appropriate for the client

The adviser has to determine whether the service is appropriate for the client. If a client wishes to invest, and is able to invest, this does not mean that all forms of investment services are appropriate. The adviser has to determine whether an execution-only service, investment advice service, or asset management service is most suitable. At all times, the adviser must assess whether the service he can offer is appropriate for the client's needs.

Investment firms that offer several levels of investment service will not have to reject potential clients as often as those that offer only one type of service. Investment firms that offer services focusing on very specific investment strategies, for example firms that only invest in options, will have to reject potential clients more frequently. Their service will generally be appropriate for a more limited group of people (see Section 3 Investment Policy).

If no suitable solution or investment service is available, the adviser should refer the client elsewhere

There are also clients for whom it will emerge that investing is not appropriate on the basis of their objective(s) and risk appetite. In such cases, the adviser must advise against investing. If the investment firm does not offer another suitable form of capital accumulation, the adviser should refer the client to another service provider.

It is important that the adviser has asked the right questions in order to be able to decide what type of investment service is suitable for the client, and what are the clientφ intentions and possibilities. One issue for instance concerns the extent to which the client needs or has the time to invest on his own behalf and manage his own portfolio. How much involvement or influence does the client wish to have? The clientφ knowledge and experience are also a factor in this consideration. How much support does he need in finding an investment solution? It is important that the adviser obtains a clear understanding of these issues, and gives the right advice. The decision is of course made by the client, but it is the duty of the adviser to ensure that the decision he makes is well-considered.

An example of good advice

Mr and Mrs De Boer want to redeem their mortgage in five yearsq time. The adviser has held a thorough discussion with Mr and Mrs De Boer regarding their overall financial position. The total mortgage is ” 200,000. They have assets of ” 170,000. The adviserφ calculations show that Mr and Mrs De Boer are heavily dependent on the capital they wish to invest. They have not accumulated capital for the redemption of their mortgage by other means.

In view of their heavy dependence on the capital and the fact that their target capital can be achieved through savings, the adviser advises Mr and Mrs De Boer not to invest. He advises them to place their ” 170,000 temporarily on deposit.

The adviser has assessed the client profile. His first consideration is which service would be suitable. In this case, he concludes that investment is not the right solution. Since the clientsq objective can be reached by other means and they are heavily dependent on the final capital sum, it is foreseeable that investing could lead to disappointment. The adviser understands that the solution is not the priority; the priority must be the clientsq interest.

5.3 Step 2: Establishing the strategic asset allocation

The adviser quantifies the appropriate level of return and risk

The strategic asset allocation is the distribution of the assets to be invested across various asset classes. The strategic asset allocation is one of the most important factors for the risk and return of an investment portfolio.

In order to translate the client profile into a strategic asset allocation, the adviser must quantify the target return and the level of risk that the client is able and willing to take. This should then correspond to the risk and return of the strategic asset allocation.

Quantifying risk and target return

The adviser has information regarding the level of risk that the client is able and willing to take. Based on this information, the adviser can determine what level of risk is appropriate for the client and what the maximum portfolio risk should be. It is important that the risk inherent in the strategic asset allocation corresponds to the risk that is appropriate in the clientφ case. We have already dealt with this point extensively in Section 3.5 Investment Policy.

The expected return of the strategic asset allocation should also correspond with the target return. This is one of the factors that will determine the feasibility of achieving the objective. The adviser can quantify the clientφ target return by analysing the client profile. Many objectives require to consider

inflation, since this will affect the client's financial position in the longer term. The adviser must also take account of tax implications and the costs of the investment service.

The risk and return of the investment portfolio should correspond to the client profile

The adviser must ensure that he recommends a strategic asset allocation to the client that corresponds to the client profile. Many investment firms make agreements with clients regarding the strategic asset allocation that will be applied or the bandwidth within which this allocation can be adjusted. However specific agreements regarding the degree of risk within the investment portfolio are more important.

The risks within an investment portfolio are based on past experience. It is important that the adviser takes account of significant changes in the risks associated with asset classes in the asset allocation as a result of volatility in the financial markets. It may even be necessary to deviate from the strategic asset allocation. If the agreements made with the client do not permit this, it is important that the adviser discusses the situation with the client.

An example of good advice

Mr and Mrs Smits have € 130,000 to invest. They want to withdraw € 15,000 a year (adjusted for inflation) for a period of 10 years as a supplement to their income. The maximum loss Mr and Mrs Smits are prepared to accept in any one year is 20%[20]. The adviser has also asked them what degree of possibility they will not achieve their objective is acceptable to them. They consider a 30% possibility that the objective will not be realised to be acceptable. They have a further € 50,000 in savings, which they can use if things do not go as planned. Mr and Mrs Smits are therefore not heavily dependent on the capital they wish to invest.

The investment firm uses standard risk profiles. The expected risk and return within the risk profiles is raised in steps by adjusting the investment mix. The investment firm calculates the standard deviation using the data in the VBA's report 'Risicostandaarden Beleggingen 2010'[21].

For the expected return per asset class, the investment firm uses long-term historical data from indices selected for each asset class. The expected portfolio return for various investment mixes is then calculated using this data.

Based on the expected return and the maximum volatility per asset class, the investment firm calculates the range of annual returns for each profile with 99% confidence[22]. The investment firm uses the following profiles[23]:

	Expected return	*Expected risk (volatility)*	*Annual range return (with 99% confidence)*
Profile 1	*3.0% – 4%*	*0.0% – 4.1%*	*- 7.1% – 14.1%*
Profile 2	*5.0% – 6%*	*3.7% – 7.0%*	*- 12.6% – 23.6%*
Profile 3	*6.5% – 7.5%*	*5.4% – 8.9%*	*- 17.0% – 29.0%*
Profile 4	*8.0% – 9.0%*	*7.8% – 12.3%*	*- 23.2% – 40.2%*

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[20] One must take account of the fact that it is always possible that extreme situations will occur. The adviser will have to discuss this with the client.

[21] VBA investment professionals (VBA) published this report at the end of 2010. The report contains the standard deviations and correlation matrix for 17 different asset classes. The standard deviation of the portfolio can be calculated by combining the standard deviations and correlation matrix with the weights of the various asset classes in the portfolio.

*[22] The formula is: average return +/- 2.58 * the maximum standard deviation. +2.58 and -2.58 are the threshold values associated with the 99% interval of the standard normal distribution.*

[23] The profiles and asset allocations stated in the example are fictitious.

Profile 5 9.0% . 10% 11.2% . 15.8% - 31.3% . 50.3%

The adviser establishes the right profile for Mr and Mrs Smits by comparing their risk and target return with these profiles. A strategic asset allocation is linked to each profile. The adviser calculates that an average annual return of 3.5% is required to achieve the objective after inflation. The adviser assumes a long-term inflation rate of 2%. This means that the gross return needed is 5.5%[24]*. Mr and Mrs Smits can achieve this return in profile 2 or higher.*

The maximum loss Mr and Mrs Smits are prepared to accept in any one year is 20%. The adviser considers that this risk is acceptable in their case. The maximum losses in profiles 1, 2 and 3 are lower than this.

Using a scenario analysis, the adviser has determined that profile 2 offers a probability of achieving the objective of 53%. The chance of achieving the objective with profile 3 is 72%.

The features of profile 3 are the most suitable in this case. The adviser also assesses the extent to which other specific risks are associated with this profile, such as liquidity risk or debtor risk, and the extent to which these are appropriate for the client. This will also be considered in the selection of the financial instruments.

On the basis of the above, the adviser recommends profile 3. The associated asset allocation is as follows:

Cash	*10%*	*.*	*15%*
Government bonds EUR AAA-AA	*20%*	*.*	*30%*
Investment grade corporate bonds EUR	*10%*	*.*	*20%*
Investment grade corporate bonds non-EUR	*5%*	*.*	*10%*
Mature markets shares	*15%*	*.*	*30%*
Emerging markets shares	*10%*	*.*	*15%*
Indirect private real estate Europe	*0%*	*.*	*5%*
Hedge funds	*0%*	*.*	*5%*

The investment firm continually monitors the progress of the investment portfolio, to ensure that the portfolio risk is still in line with the clientọs risk appetite. The investment firm calculates the standard deviation of the portfolio on the basis of the actual asset allocation and the standard deviations as given by the VBA. This risk is the leading parameter in the monitoring. The bandwidth of the asset allocation is subordinate to this. The investment firm moreover checks periodically to establish whether the clientọs objective is still feasible.

In this example, the investment firm has calculated the expected return and volatility for each risk profile. The adviser establishes a desired level of risk and return on the basis of the client profile, and then selects a corresponding strategic asset allocation. On the basis of the chosen profile, the adviser can select the instruments that are suitable for this asset allocation. The chosen profile with its expected return and volatility provides the adviser with the framework within which he is free to construct an investment portfolio that reflects the clientọs risk appetite.

The adviser continually monitors the investment portfolio, to ensure that the portfolio risk is still in line with the clientọs risk appetite. The fact that an asset class may move out of its bandwidth does not necessarily entail adjustments to the portfolio, as long as the overall portfolio risk still corresponds to the clientọs risk appetite. The adviser takes account of the clientọs risk appetite at all times. The adviser moreover continues to consider whether the clientọs objective is still achievable at all times.

[24] *The clients will pay the fees for the investment service by other means.*

An example of inadequate advice

Mr De Jong (40 years old) has ”600,000 to invest. His target return is 6%. He has stated that the maximum loss he can accept in any one year is 12.5%. The adviser has not made any assessment of the risk that the client is able to take.

The adviser selects the profile and associated strategic asset allocation on the basis of the target return of 6%. The adviser therefore chooses the neutral profile used by the investment firm, for which the expected return is 6%. In this profile, the investment allocation is between 40% and 70% in shares and between 30% and 60% in bonds. The adviser takes no account of the risk that the client is able and willing to bear. Moreover, he has not specified a measure of risk to determine the risk associated with the strategic asset allocation.

The adviser has recommended the following portfolio:

Mature markets shares	*64.0%*
Government bonds EUR AAA-AA	*15.6%*
Investment grade corporate bonds EUR	*18.5%*
Cash	*1.9%*

The standard deviation of this portfolio is 11.5%[25].

Mr De Jong has stated that under normal circumstances the maximum loss he is willing to bear in one year is 12.5%. Assuming normal return distribution, it is possible to calculate the standard deviation for which the loss will be capped at 12.5% with 99% confidence[26]. This results in a standard deviation of approximately 7.9%. It follows from this calculation that the standard deviation of the recommended portfolio **is not appropriate** to the risk that Mr de Jong is willing to bear.

5.4 Step 3: Selection of financial instruments

The adviser knows the features, costs and risks of financial instruments and selects instruments that are appropriate for the client

Once the strategic asset allocation is established, the adviser selects the individual financial instruments. In each asset class, it is decided which instruments are to be recommended or purchased, also taking account of their specific characteristics. The various items of attention in this selection are described in Section 3 Investment Policy and in the appendices.

5.4.1 What are the risks to which the investor will be exposed?

An initial decision is made at the level of asset classes regarding the risk the client will incur with his investment portfolio with the establishment of the strategic asset allocation. The selection of specific individual instruments can involve additional risks for the investor. These risks may also arise through the combination of certain instruments in the portfolio. Some of these risks may also intensify the overall risk. It is important that the adviser takes these risks into consideration.

In any case, the following risks must be evaluated:

- **Concentration risk**
  This risk results from a lack of diversification within an asset class. This does not apply to diversification across different securities, but also across sectors and regions.
- **Liquidity risk**
  This risk arises if the investments in financial instruments (within a fund) are not readily marketable. The client may encounter problems if he wants to sell, or is forced to sell.
- **Counterparty risk**

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[25] Based on the calculation from the VBA publication mentioned above.

*[26] The formula is: Maximum loss with 99% certainty = expected return . 2.33 * standard deviation. -2.33 is the threshold value associated with the unidirectional 99% interval of the standard normal distribution.*

If several financial instruments are combined in a (new) product or a product that involves derivatives, the investor runs the risk that the counterparty will fail to meet its obligations. This risk is called counterparty risk and arises for instance with structured products, synthetic ETFs and insurance policies with an investment component. This also includes the risk incurred by the investor that coupon interest will not be paid or that he will lose his investment.

- **Currency risk**

  If the investor purchases investments denominated in a currency other than the euro, he is exposed to currency risk. This means that the portfolio may be more volatile than would be the case if similar investments had been made in euro-denominated securities. For some financial instruments the currency risk is hedged, but this does not apply in all cases.

Trends: Investing in gold

Investors are sometimes driven very strongly by emotions. In some markets, trends can be observed in which it is not clear whether the trend is due to a fundamental change in demand or the result of a large group of investors following a trend. For instance, the strong rally in the gold price and the motivation for investing in gold have attracted much attention recently.

It is important that investment firms and advisers follow developments in the financial markets closely and form their own independent views with regard to these trends. They should consider the extent to which these trends are suitable for their clients. The associated investments should only be included in a client's portfolio if the investment firm is convinced they will add value for the client.

If the firm or its advisers are of the opinion that certain instruments are not suitable for their clients or are not appropriate to the investment strategy, the adviser must be able to present good arguments to this effect. How one deals with clients who wish to include such instruments in their portfolio on their own initiative is thus an important issue. The adviser must in this case at least be able to explain why he advises against such instruments. If the client decides within the context of an advisory relationship that he still wishes to include gold or gold-related investments in his portfolio, he has in any case been warned.

5.4.2 Funds or individual securities

In selecting the instruments within an asset class, the adviser has the option of either investment funds or individual securities. The choice that is made may vary for each asset class and also within an asset class, and may depend on market circumstances. The choice the adviser makes will also have to match the client profile. The advantage of an investment fund is that a client with less capital to invest can do so with better diversification. The disadvantage may be that some funds do not pay dividends or coupon interest. This could be important in the case of a client who wishes to generate income from his portfolio. The point to consider is always what is in the client's best interest, and what will achieve the best risk-return ratio.

5.4.3 Actively or passively managed financial instruments

If a decision has been made to use investment funds, the adviser will then make a choice between actively and passively managed financial instruments. This decision should also be made by the adviser on the basis of the client profile.

The adviser must be able to demonstrate that he has made a thorough consideration of the choice between active and passive investing in the advisory process, and must be able to explain the reasons why he has chosen active, passive or a combination of the two. The adviser should also inform the client, both in advance regarding the considerations underlying his decision and afterwards regarding the effects thereof.

An example of good advice

Mr and Mrs De Vries are very interested in private equity. They have heard from a neighbour that this can generate a high return, and are keen to invest a large proportion of their assets. However the adviser has established that over the next 15 years Mr and Mrs De Vries will need to withdraw funds from their portfolio in order to supplement their pension income. He therefore recommends that they choose liquid investments. Private equity usually involves a high degree of liquidity risk. This could mean that the investments cannot be sold, or at any rate cannot be sold at a good price. In the adviserθs view, these investments are not really suitable for Mr and Mrs De Vries.

The adviser recommends that a large part of the portfolio should be invested in bonds. This will enable Mr and Mrs De Vries to generate the income they need.

The adviser has taken account of the clientsq objective. He has chosen instruments that will meet their need to generate income. When selecting the bonds, he will of course take account of the clientsqrisk appetite. He also explains why investing a large part of the portfolio in private equity is not suitable in their case.

An example of inadequate advice

Ms Visser has invested capital of ” 60,000. She has no other assets. The maximum loss she can accept in one year is 5%. The capital is invested using an active stock selection strategy, whereby individual stocks are selected on the basis that they are undervalued in the assessment of the investment firm. If the price of these subsequently increases after the purchase, the investor can make a profit. In order to limit transaction costs, the number of shares purchased increases as the capital invested increases. The result for Ms Visser is that she has invested in nine individual stocks, with allocation percentages of 7% to 15%. Investing 15% of her capital in one stock means that Ms Visser is exposed to high risk if any one of these stocks suffers a heavy fall in price.

If a client invests in a limited number of stocks, the level of risk they take is higher than the general market risk. If one of these stocks falls sharply in price, this will mean a heavy loss for Ms Visser.

There is no consensus in the scientific research regarding the minimum number of stocks that should be included in order to make the best use of diversification benefits. One of the first publications on the subject was by Evans and Archer[27]. This study questions the economic justification for including more than ten stocks in a portfolio, since the diversification benefits decline sharply once this number is exceeded. Statman[28] compares the benefits of diversification with the costs, and concludes that the benefits outweigh the costs with a portfolio of 30 to 40 stocks (for various types of investor). In 2004 he made a conservative estimate that the minimum number stocks should be as much as 300[29]. While it is thus debatable what the minimum number of stocks in a portfolio should be, it can certainly be argued that for a defensive investor, a highly concentrated portfolio involves a high level of risk. In this case, better diversification across a greater number of securities, or the inclusion of a diversified investment fund or ETF, could mitigate Ms Visserθs risk. The adviser should also involve the cost element and risk features of these alternatives in his consideration.

[27] Evans, J.L., and S.H. Archer, 1968, Diversification and the Reduction of Dispersion: An Empirical Analysisq Journal of Finance 23, 761-767.

[28] Statman, M., 1987, How many stocks make a diversified portfolio?, Journal of Financial and Quantitative Analysis 22, 353-363.

[29] Statman, M., 2004, ‘The Diversification Puzzleq Financial Analyst Journal, 60, 44-53.

5.5 Recording and explaining the advice

The adviser records the advice, the underlying considerations and the other agreements made with the client

The adviser must properly record the client profile and the advice given, devoting sufficient attention to the considerations underlying his advice. These considerations should explain the reasons for the choice of a particular profile, a particular asset allocation and/or particular financial instruments that the adviser has made. The adviser uses the client profile as his starting point. He must also explain this to the client. The client will thus understand clearly why the adviser has given a particular advice. The considerations involved should preferably be recorded in a report, so that the client can review the original decision made over the course of time.

It is also important that the adviser records all agreements made with the client. If the client's wishes change or the agreements change, reference to the previous agreements should be made in the record. This will avoid a situation in which several possibly inconsistent agreements are made without being clear which agreement should prevail. This can prevent problems in the future. The adviser needs this information for his monitoring of the portfolio, and moreover this information will be needed in the event that a client gets a different adviser.

6 Ongoing obligations

6.1 Ongoing monitoring of risk and objective of investment portfolios is needed

Ongoing obligations focus on the question of whether the client is achieving his objective with a level of risk that is commensurate to the risk he is able and willing to bear

The investment advice or asset management service does not end with the signing of the management agreement or the provision of the advice. The adviser must continually ensure that the investment portfolio is still appropriate to the client϶s goal, his objective and situation, the (maximum) risk that he can and is willing to accept, and the agreements made with him. This is an essential part of a responsible investment process, since it means that foreseeable disappointments can be avoided. In today϶s situation with highly volatile markets and a high degree of uncertainty, the importance of proper monitoring has only increased. The central focus of the monitoring process should be the client϶s objective. Our exploratory review reveals that investment firms could devote more attention to this issue.

There are various forms of monitoring. Some investment firms choose to monitor the investments at the level of individual portfolios. Others use an automated monitoring system. It is important to ensure that the monitoring process does not focus exclusively on the investment portfolio; the situation of the client should also be updated on a regular basis. Changes to the client profile moreover can be reason to adjust the investment portfolio.

The client should be provided with regular updated information regarding the development of his investment portfolio in relation to his objective. This is done by means of periodic reports stating data such as the value, composition and return of the portfolio. The investment firm should also provide information on the total costs and dividends received. In the case of asset management, reporting is mandatory[30]. Depending on the type of service, the investment must, in addition, provide other information during duration of the contract[31]. In addition to the information required by law, this provides a good opportunity for the investment firm to include additional information for the client. This is discussed in paragraph 6.3.

6.2 Monitoring

In a responsible advisory process, monitoring encompasses the portfolio risk, the client϶s objective and any agreed investment restrictions. The adviser should keep the client up to date with the various aspects that are monitored.

Monitoring the objective

The adviser monitors the feasibility of the client϶s objective

The most important risk for a client who is being provided investment advice or asset management service is that he will not achieve his objective. This is particularly the case if the client is heavily dependent on achieving the objective, for instance if it involves the provision of income, pension or the possibility of repayment. But in other cases as well, failure to achieve the objective can lead to serious disappointment. The adviser thus monitors the development of the client϶s capital in the light of the intended objective. The adviser updates the portfolio or gives recommendations in order to increase the likelihood that the objective will be achieved. This of course must be within the frameworks (portfolio risk and any investment restrictions) that have been agreed with the client. If it emerges that there is only a very low chance that a client϶s objective will be achieved, the adviser should contact the client and discuss the situation, and confirm this discussion in writing. In this

[30] *The information an investment firm must provide by law in the case of asset management is stated in Section 70 Bgfo.*

[31] *See for example Sections 69, 71, 71a Bgfo.*

situation, either the client will have to adjust his objective or assume a higher level of risk (if he is willing and able to do so), or he will have to increase his investment. If it looks as though the objective will be achieved faster than expected, this of course also means that the portfolio risk can be reduced, or the realised returns can be turned into cash.

An example of good advice

Each year, the adviser checks to see how the capital of Mr and Mrs Smits has developed in the light of their objective. The objective is to generate annual income of ” 15,000 over a period of 10 years. This requires an average return of 5.5%. As a result of disappointing performance by the investments, the likelihood that Mr and Mrs Smits can realise their objective has declined significantly. The adviser therefore contacts them to discuss the situation, and the actions they could take to still be able to generate the income they need. In such a situation the options are: to increase the investment, to increase the portfolio risk or to downwardly adjust the target capital. The adviser discusses these options with Mr and Mrs Smits. Since on the basis of their financial situation they are unable to increase their portfolio risk, they have a choice between increasing their investment or adjusting their target capital to a lower level.

The adviser has given timely notice to the clients that the development of their capital has not been sufficient to reach their objective. He discusses this with them and explains the various possibilities available to them in order to still generate the income they need.

Monitoring the risk

The adviser ensures that the portfolio risk continues to correspond to the clientœs situation

The monitoring of the portfolio entails the performance of ongoing checks by the adviser to ensure that the portfolio risk is still appropriate to the risk that the client is able and willing to bear in his investment portfolio. For this purpose the investment firm will have to use a measure of risk with a certain bandwidth.[32] Monitoring risk simply on the basis of the allocation to asset classes is not sufficient. Market developments can, as a matter of fact, lead to changes in the risks within specific asset classes. A decline or increase in value of a particular asset class may also lead to a change in the proportion of the portfolio invested in each class. This in turn may change the portfolio risk, in some cases to the point that this risk is no longer within the acceptable risk bandwidth. It is therefore important that the adviser monitors the actual risk in the portfolio.

An example of good advice

The investment firm uses six risk profiles. For each of these profiles, the expected return and risk (on the basis of volatility) are determined in advance. Using the standard deviation of the investment portfolio, the adviser checks to establish whether the risk still corresponds to the risk that the client is able and willing to bear (established in his risk profile). The adviser also assesses whether there are other risks that can affect the clientœs portfolio, such as interest-rate risk in relation to the bonds in his portfolio. If the risk does not correspond to the client profile, the adviser takes action accordingly.

The investment firm uses a measure for risk. On this basis, the adviser makes a periodic assessment as to whether the clientœs portfolio risk is still commensurate with the risk he is able and willing to take. The adviser also takes account of other risks. In case of deviations, he takes appropriate action.

32 See paragraph 5.3.

Monitoring investment restrictions

Advisers may also make specific agreements with a client regarding the asset classes and instruments in the investment portfolio. For instance, it may be agreed that certain asset classes or instruments within an asset class, such as particular regions or themes, will be excluded. These agreements are usually recorded in the agreement concluded with the client, or in an annex thereto if the agreement is made at a later date. The adviser continually monitors the portfolio to ensure that these agreements are complied with.

6.3 *Informing the client during duration of the contract*

The adviser informs the client regarding the development of his capital in comparison to his objective

The client receives regular reports on the investment service that update him as to the status of his investment portfolio. The purpose of these reports is twofold. Firstly, there is the reporting, at least in the case of asset management, that gives account of the activities of the investment firms and the added value for the client. Secondly, the reports provide the client with information on his investment results and the situation with reference to the realisation of his objective. The adviser will discuss with the client whether, on the basis of the reports, action is necessary in the light of the objective. Many of these reports currently do not take account of the clientqs needs in an adequate manner. Important opportunities to make the client more aware of the extent to which his objectives are still feasible are thus being missed. The reports are an excellent tool for keeping the client informed with regard to the realised results and the added value of the service.

The AFM considers it to be desirable that clients are in any case informed with regard to the following points. These are separate to the statutory obligations that apply to reporting.

- The investment result, or the growth of the capital in both absolute and percentage terms. The percentage should express the net return, therefore after deduction of all direct and indirect costs;
- Information on achievement of the objective, providing information on the development of the investment portfolio compared to the objective, and the likelihood that the objective will be achieved.
- Allocation of the capital across the asset classes. Reporting only the allocation of the capital to shares, bonds, cash and other investments is not detailed enough. The risks within these asset classes may diverge widely without the client being aware of this. A more detailed classification of the asset classes is more appropriate considering the difference in the risks of the various financial instruments.[33] As seen from the example in Section 3.4, the classification of perpetual loans as bonds gives a different impression than if they are classified as marketable securities.
- Allocation of the capital across various sectors, regions and themes. This informs the client regarding the diversification of his portfolio.
- Portfolio risk (for instance based on standard deviation). This informs the client regarding the risk to which his portfolio is exposed.
- Transactions, deposits, withdrawals, income and expenses. This information explains some of the activities of the investment firm and gives an overview of the clientqs own actions.
- Specification of costs. Costs are relevant to the achievement of the objective. The costs associated with investing are paid out of the return. If the costs are shown only in absolute figures, it can be difficult for clients to see the percentage that has to be deducted from their return to meet them. It is therefore important that costs are shown in both absolute and

[33] *See for example the allocation recommended by the VBA ±VBA Risicostandaarden Beleggingen 2010q*

percentage terms. In order to provide the client with the best possible information regarding costs, it is important that all the various cost items are specified.

6.4 Information on achieving the objective

It is important that the client is kept informed during the period of the service as to whether he is on track to achieve his objective. In this way, the investment firm will manage the client's expectations more effectively.

In order to enable the client to understand this information, it is important that it should include a link between the client's objective and the investment results. This can be done by listing the results against the intended objective (in returns). In situations where there is a target capital sum (a mortgage, pension or consumer spending target), a few scenarios can be used to show the client the extent to which his objective is still feasible. It is a good idea to discuss the link between objective and investment results periodically, in an evaluation interview with the client, and to take action as a result of this if necessary.

6.5 Periodic evaluation of the client profile and the service

The client profile needs to be updated in order to ensure that the investment portfolio continues to be appropriate to the client's needs. The client's situation may change, for example as a result of changes to his income, social situation, separation or death. There may also be external factors that affect the client's wishes (such as a poor year for the stock market). These changes and factors can affect the feasibility of the client's objective and can be a reason to contact him. The adviser should at all times assess whether an adjustment to the portfolio is desirable in the light of the changed circumstances.

At the outset of the service, the adviser should make agreements with regard to periodic contact with the client for the purpose of evaluating the service and updating the client profile. The AFM considers it desirable that an evaluation of the client profile and the service should take place at least once a year.

Appendix 1: Standard deviation

What is standard deviation?

Standard deviation is a measure that expresses the extent to which a variable fluctuates. The standard deviation of returns expresses the historical volatility of the returns and is thus a measure of risk.

Standard deviation gives information on historical volatility. In a diversified portfolio, standard deviation gives an indication of the degree of risk an investor is exposed to, but it is not a perfect measure. When using standard deviation, the following points should be remembered:

- Standard deviation is based on the historical volatility of prices. This gives an indication of future volatility, but no guarantee.
- Standard deviation assumes a normal distribution of returns. In reality, returns are not normally distributed, and the distribution of probability in the tails is greater than would be expected on the basis of a normal distribution. Using standard deviation as the only measure will therefore lead to an underestimation of the probability of extreme results.
- Standard deviation assumes a diversified investment portfolio. A less diversified portfolio will usually involve a higher level of risk.
- Standard deviation assumes a long investment horizon. The shorter the investment horizon (or the remaining investment horizon) and the greater the volatility of prices, the less time there will be for good returns to compensate for poor returns.
- Some asset classes involve other risks that are not expressed in the standard deviation. The investment firm needs to take account of this factor when assessing the level of risk.

Appendix 2: Selection of financial instruments

This appendix discusses a number of important considerations that will assist the investment firm in the selection of financial instruments. The selection of financial instruments can be made at central or decentralised level. The following criteria apply in both cases.

- *The mandate of the financial instrument*

In order to better estimate a financial instrument's potential added value and its suitability for inclusion in the client's portfolio, it is important to know what the mandate of the instrument is.
In the case of an investment fund, for example, the fund's investment strategy is an important factor. From the mandate of the investment fund, the investment firm can assess the extent to which the fund is or may be exposed to certain markets and risks. This includes exposure to certain sectors, regions or currencies, the liquidity risk and other risks and the use of derivatives or leverage.
In the case of an ETF, it should in any case be clear which index the ETF follows. There are also several variations on the theme of replicating an index, such as enhanced indexing, leveraged indexing or inverse indexing. These involve a different of risk, and will produce a different return. It is thus important to establish what the ETF's mandate is, and what implications this mandate entails for the expected return and risk for the investor.

- *Track record*

When selecting a financial instrument, the investment firm expects this instrument to make a positive contribution to the portfolio return, or to reducing the portfolio risk. Future returns can never be predicted. However past performance can be an indication of the extent to which an instrument has succeeded in generating a positive relative return that is proportionate to the risks inherent in that instrument. The results of an instrument in a more difficult market can also give an indication of added value. Indicators such as the information ratio or alpha can be useful in measuring the track record. If an instrument only has a brief history, historical returns are less useful.
The degree to which an ETF has succeeded in tracking the market is shown by its tracking error. The lower the tracking error, the more closely the ETF replicates the index return. Deviations from the index can arise due to transaction costs, sampling and the tax treatment of dividends and cash positions, to name but a few examples.

- *Cost structure*

The cost structure of a financial instrument has a significant effect on the return that the client can achieve, since costs are paid out of the return. The expected return therefore should be enough to make sure that there will be sufficient return remaining after all costs for the fund have been paid.
In order to properly assess this situation, it is important that all the relevant cost items are involved. This concept is known as the total cost of ownership (TCO). To identify the TCO, one can make a distinction between internal and external costs.
Internal costs are all costs and any revenue that are generated within the instrument. In the case of an investment fund or an ETF, the Total Expense Ratio (TER) shows the effect of the main cost items. The TER is calculated ex post, and mainly comprises the management fee, which is known ex ante. Performance fees (if applicable) are also included in the TER, but these depend on the fund's performance and are therefore only known ex post. The third element of the TER is the operating expenses. The TER does not include transaction costs, since these are paid by the fund and therefore belong to the internal costs. In order to obtain an indication of the total transaction costs, it is important to look at the portfolio turnover rate. Any revenue generated from securities lending should be deducted from the internal costs.

External costs are the costs incurred by the investor when purchasing or selling the instrument. Examples of these are trading costs (reflected in the bid-ask spread), costs for the creation or removal/repurchase of securities and broker fees.

- *Liquidity*

The liquidity of a financial instrument is the measure of its marketability. For individual securities or investment funds, liquidity is determined by trading volume. In the case of ETFs, trading volume in the ETF concerned is not the main factor; the level of liquidity is determined by the liquidity of the underlying securities.

If an instrument has a low level of liquidity, there is an increased risk for the investor that he will not be able to buy or sell it at a reasonable price. This can lead to losses for the investor.

- *Counterparty risk*

Counterparty risk is the risk that a counterparty is not able to meet its obligations with regard to a financial transaction. Several financial instruments may involve this risk. In the case of investment funds and ETFs that use *physical replication*, the investor is exposed to counterparty risk if securities lending is used[34]. In the case of ETFs that use *synthetic replication*, the investor is exposed to counterparty risk with respect to the counterparty in the swap transaction. In the case of structured products, the investor is exposed to counterparty risk with respect to the issuing institution.

The creditworthiness of the counterparty is an important determining factor for the degree of counterparty risk. In the case of securities lending or swap transactions, one of the main measures to mitigate risk is the placement of collateral in the form of other assets with the investment fund or the ETF. The extent to which the collateral mitigates the risk depends on its quality (liquidity, risk of decline in value, etc.) and size in comparison to the obligations that have been taken.

- *Risk management*

The investment firm should have made an estimate of the risks to which the financial instrument is exposed and the measures taken to manage these risks. For instance, to what extent is the instrument funded by borrowed money, and what measures have been taken in this respect? Is the monitoring of the instrument adequate?

- *Structure and personnel*

The structure of an investment fund provides information on the potential direct or indirect risks involved in investing in the fund. Issues to be considered include the fund's domicile, its structure (open-end or closed-end, marketability and possibilities that trading in the fund's units may be suspended). Important items of attention with respect to the continuity of the fund (and of its positive results) mainly concern personnel issues, such as the composition of the investment team, employee turnover, dependence on one person ('key man risk'), the knowledge and experience of the fund manager, the fund's reputation and quality of its service providers (its administrator, custodian and auditor).

[34] Securities lending is the temporary lending of purchased securities to other investors. The purpose is to generate additional revenue in the form of the fee paid by the borrowers of the securities.

Appendix 3: Selection of alternative investments

This appendix discusses a number of the risks associated with alternative investments. When selecting alternative investments, the investment firm and the adviser should consider whether these risks are appropriate given the client's situation.

- *Marketability*

Some alternative investments are less marketable than instruments in the traditional asset classes. Hedge funds for instance often apply a lock-up period in which investors are not permitted to withdraw their money from the fund. This can vary from a couple of months to a number of years. In the case of private equity, the investment has to be held for a longer period. There is a secondary market for both these investments. The biggest risk here is that liquidity in this market will dry up rapidly in crisis situations, in which case the client will not be able to sell his investment, or if he can, it will be at a very disadvantageous price.
The marketability of investments in real estate varies, and is determined by various factors. One of the factors affecting the marketability of a real estate fund is whether the fund periodically repurchases units at the request of its investors or not. Real estate funds that invest directly in property usually do not repurchase units on a regular basis because the property investments they hold are not liquid. If a real estate fund does not repurchase units, the only option for the investor is to trade his investment in the secondary market with other investors. The drying up of liquidity in the secondary market is then a risk. Listed real estate funds are generally easier to trade than unlisted real estate funds, but in their case as well, liquidity is a determining factor for price formation.

- *Costs*

The costs of investing in hedge funds and private equity especially are significantly higher than the costs of investing in traditional investment funds. This is because the management fees are on average higher, and because performance fees apply. Private equity and hedge funds also use the 'fund of funds' approach. This offers better diversification, but it adds an extra layer of costs because one is investing in a fund that in turn invests in other funds. Higher costs obviously reduce the returns that can be achieved. In other words, a higher return has to be realised from these investments than from an active or passive share or bond fund in order to realise the same net return. And a higher return involves higher risk. For this reason, the investment firm should take a critical view of alternative investments with respect to their net return and the level of risk that is involved.

- *Transparency*

Hedge funds generally provide little transparency with regard to their investment policy. Moreover, there is generally little publicly available information regarding private equity investments. This limits the adviser's ability to provide substantiation for his recommendation.
In addition, hedge funds pursue a wide variety of investment strategies that can also involve very different levels of risk and return. An investment firm should therefore bear this mind when assessing an investment and be aware of the feature of a specific strategy.

- *Roll yield*

Investments in commodities are usually not direct investments, as this is usually not possible because of storage considerations. For this reason, these investments are made using commodity futures. Normally the most current futures contract (with the shortest possible term to maturity) is chosen. Shortly before the contract expires, the position is sold and the contract with the shortest term to

maturity is purchased again. This process is known as rolling the position. With the passage of time between the moment of purchase and sale, the value of the futures contract can rise or fall. Part of this change in value is not due to a change in the value of the commodity. The positive or negative return that the investor realises in this situation is called the roll yield. Due to the effect of the roll yield, the return on these investments will not completely replicate the price development of the commodity in question. The investment firm needs to take account of this when selecting alternative investments.

- *Underestimating risk on the basis of volatility*

Standard deviation is the most popular measure of risk because it is simple to calculate and intuitive in practice. The risks mentioned above however are not reflected (or at any rate not fully reflected) in the standard deviation. If the investment firm uses standard deviation, it should bear this in mind and make a separate estimate and evaluation of these risks.

The Netherlands Authority for the Financial Markets
T +31(0)20 797 2000 | F +31(0)20 797 3800
Postbus 11723 | 1001 GS Amsterdam

www.afm.nl

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