Risk Profiler Guide

Risk Rated Portfolio Management

"Where Risk is the Constant"

Margetts' Investment Risk Profiler

Margetts believes that when establishing or reviewing a portfolio, an investor's most important decision is how much risk they are willing and able to take in order to achieve their objectives. This will determine the expected returns for their portfolio.

Margetts has developed a risk reviewing questionnaire, tackling both of these elements of an investor's risk profile. This review provides the adviser with feedback, which can promote further discussion and help to set the risk profile of the portfolio.

This tool is not designed to replace the advisory process or the assessment of suitability and appropriateness, however, it may assist in understanding an investor's risk profile and how to combine it with the Margetts Risk Rated Strategy funds.

For further information on the risk rated scale used by the Margetts Risk Profiler and the Margetts Risk Rated Strategy funds please see our Lessons From History document, available on www.margetts.com.

Risk Assessment – the Ability to Take Risk

The Margetts Risk Profiler can assist in analysing an investor's risk profile, which may help identify achievable objectives over the long term. The Margetts questionnaire splits the investors risk profile into their ability to take risk and their willingness to take risk. An investor's ability to take risk is linked to the following three factors:

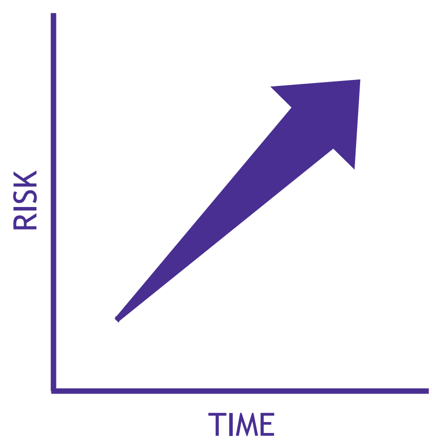
Time considerations – the longer the time frame, the higher the ability to take risk. We view this as the most important factor when establishing a client's ability to take risk. The majority of investments are inherently volatile due to a level of future uncertainty.

However, we believe that investors will be rewarded for taking long only (linked to the market) risk over time. Over the course of several investment cycles, the chance that a portfolio does not meet its goals is reduced.

Wealth and earnings – wealth relates to a client's current assets relative to the cost of their future lifestyle. The higher the level of wealth relative to lifestyle, the lower the required rate of return to achieve future financial goals, and therefore the greater the ability to withstand volatility.

This does not mean that higher levels of risk are required to achieve future financial goals, but it does allow the portfolio to withstand higher volatility.

Higher earnings relative to lifestyle also provide a greater ability to take risk, as losses may be offset against greater levels of saving and pound cost averaging in the future, with less compromise to lifestyle than for an investor with relatively low earning ability.



Risk Assessment – the Ability to Take Risk

Income – withdrawing income reduces a portfolio’s ability to take risk by flattening volatility and making it harder for portfolios to recover following income withdrawal. The opposite is pound cost averaging as portfolios can benefit from inflows during market volatility.

Often there are several stages to an investor’s portfolio: accumulation, income or partial withdrawal and terminal value. The time consideration section focuses on terminal value, and the income section focuses on the income/withdrawal secondary phase of the portfolio.

The shorter the time frame of either phase, the lower the ability to take risk. The aim of this section is to protect the portfolio from volatility and sharp capital falls whilst there is an income requirement.

The ability to take risk section of the Margetts Risk Profiler takes into account the above factors in relation to each other. For example a very long time horizon overrides a lack of wealth and earnings as it is assumed that people will build both as they move through their career.

In addition, over the long term the risk of not achieving the portfolio objective is reduced.

Feedback is provided on each of the above sections at the end of the review to help understand the risk profile and ensure it reflects the investor’s situation. Advisers should read the feedback carefully to ascertain that the Risk Profiler assumptions are relevant to the investor.

NB – The questionnaire does not take into account the level of income or value of a partial encashment. The system makes assumptions to simplify the process which is described in the following section (Risk Profiler Limitations).

Risk Assessment – the Willingness to Take Risk

An investor's willingness to take risk is more subjective. The Risk Profiler is designed to ask questions which challenge an investor's expectations or ask how they would react to certain market conditions, expected returns and range of returns.

In addition, it takes into account how they have accumulated their wealth to gauge how much risk they have been comfortable with in their past.

Investors who would become distressed with volatile returns may not tolerate higher levels of risk, despite their ability to withstand the volatility.

In relation to expected returns, the questionnaire makes investors consider a range of returns (positive and negative); therefore forcing the investor to accept more volatility for higher levels of return.

This question is hypothetical and should not form a basis for the expected returns, which will be linked to the market. However, it can provide a useful insight into a client's expectations given a range of returns.

Investors who have taken risk in other areas of their life or in financial markets are more likely to have a lower risk aversion and therefore a high risk portfolio may be appropriate.

The questions are designed to ask similar, related, questions in different ways to reduce the risk of misunderstood questions and outlying responses. Each answer is given a risk rating from cautious to adventurous. The system takes an average of the responses to define the willingness to take risk profile.

The system is designed to highlight when investors choose significantly different answers to questions than the ones expected based on answers to previous questions. This is to ensure that they are deliberate and that the question has been understood.

In addition, there are three questions that will ensure that investors unwilling to accept losses are not given a risk profile higher than cash or cash alternatives. These questions are: is the client unwilling to wait six months to recover losses, is the expected return in a bad year 0% (not negative) and is the client unwilling to accept fluctuations in the value of their investment.

Risk Assessment - Summary

The system provides an overall risk profile, which is the lower of an investor's willingness and ability to take risk. In addition, the system asks the client to consider what they imagine their risk profile to be on a scale of 1-10. If this is significantly different to the generated profile then the system will highlight this fact in the feedback.

The system is not designed to replace an adviser, but to be a tool to understand risk tolerance and create a document for discussion. Feedback on an investor's risk profile is provided in order that the investor and adviser can confirm that the statements reflect their situation and are appropriate (or not) to their circumstances.

All investors are different and therefore the adviser will still need to make a personal assessment of the client and the suitability of the recommended investment.

Risk Profiler Limitations

The Risk Profiler has been designed to provide and help interpret feedback based on investors' responses to questions about their ability and willingness to take risk.

The questionnaire is designed to meet the needs of clients with reasonably straightforward financial circumstances. An adviser's assessment of a client, their needs, objectives and the suitability of investments is a complex and human assessment that cannot be entirely replicated by a risk profiling tool.

The questionnaire therefore focuses only on a client's ability to take risk and their willingness to take risk. Assumptions are made to simplify the process. Therefore, feedback is provided at the end of the report which is designed to promote discussion. The adviser will need to factor in the personal circumstances of the client in order to ascertain whether the assessment is accurate. For complicated cash flow planning the questionnaire may not be suitable.

The questionnaire has been designed based on the Margetts risk scale. Our scale of risk may be different to the scale used by advisers or other product providers. Users should familiarise themselves with the intended risk scale before assessing the suitability of the profile and any products recommended.

The questions are designed to be straightforward and be understood by the average investor. The adviser should ensure that the questions are understood and that the answers accurately reflect the investor's view. This may require a discussion following completion of the questionnaire. We have added warnings if answers to some questions deviate significantly, which should prompt a discussion if there is a misunderstanding, however it remains the responsibility of the adviser to ensure that the questions are understood and that they are satisfied that the responses meet their own assessment of the client.

Risk Profiler Limitations

The questionnaire does not take into account the level of income or value of a partial encashment. The questionnaire assumes a level of income which is significant, but could be achieved from the average expected growth of a cautious portfolio (eg. 3-6%). The Risk Profiler assumes that the portfolio objective during the income phase is to preserve capital.

If income is being taken, the ability to take risk profile is automatically reduced to cautious (2-3 on a scale of 1-10, where 1 is cash) on the assumption that the objective of the portfolio is to maintain capital whilst withdrawing income. If the client does not intend to maintain capital, the income is higher or lower than assumed, or the client cannot withstand any volatility, the Risk Profiler may not be suitable during this phase.

If the questionnaire is used for a pension (first question) then it is assumed that income will be withdrawn at retirement and that at this point the time frame is short due to the pension switching from a depositing savings phase to a withdrawing income phase. Therefore, the ability to take risk reduces to cautious at retirement.

However, this does not reflect every circumstance. For example, some people may not need to take an income from the investment and may wish to maximise the value of their investment before inheritance.

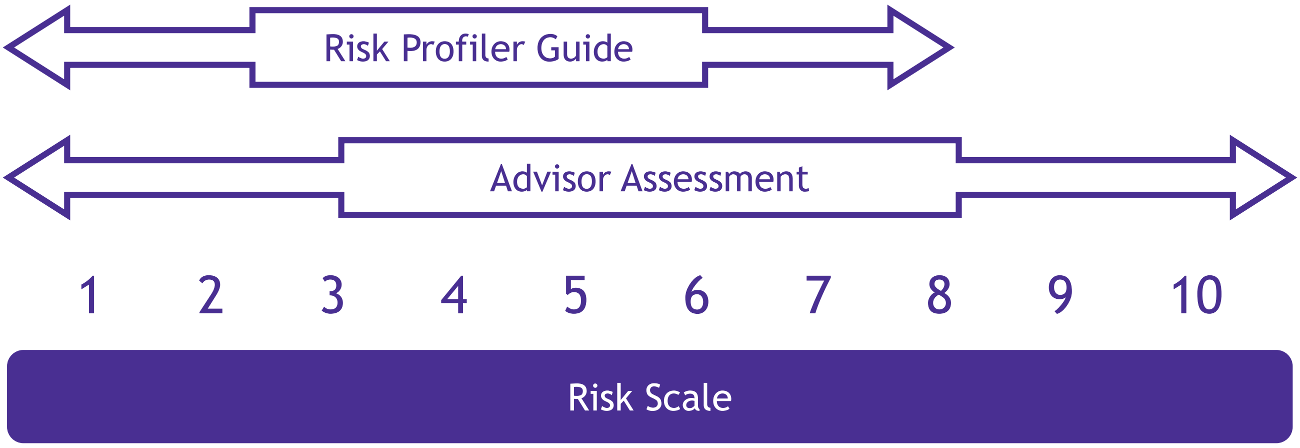
In this instance, the automatic lowering of the ability to take risk by the Risk Profiler would need to be considered by the adviser, who would have a more accurate understanding of the client’s investment goals and personal circumstances.

The Risk Profiler is designed to provide a guide to the overall risk profile of the client. However, a client may have different risk profiles for different investments, depending on their investment goals. (For example, someone may wish to told a low risk pension for themselves, and a high risk investment for their grandchildren). A client in this situation may feel that filling out one questionnaire for each investment is useful, or conversely that the questionnaire is not a useful tool for estimating their risk profile. The adviser would need to apply their own judgement as to the suitability of the Risk Profiler in this instance.

Risk Profiler Limitations

The questionnaire does not cover the extreme high risk categories, as we believe that it is difficult to accurately identify an investor with this ability or willingness to take risk through this type of system.

The adviser will have to combine the result of the Risk Profiler with other aspects of their assessment to adjust the risk profile achieved by the system.



Important Information

The risk questionnaire provides an assessment of the ability and the willingness to take risk based on an investor's simplified current situation and personal preferences. Over time both circumstances and preferences are likely to change. It is therefore important that a review of the investor's profile is undertaken regularly.

The risk questionnaire is designed to help financial advisers assess an investor's willingness and ability to take risk by promoting discussion. It is designed to supplement the advisory process; it is not designed to replace it. The questionnaire can be used as part of the suitability assessment, but does not replace the regulatory requirements for recommending any product or provide an assessment of the suitability and appropriateness of any product.

The information in this guide is designed to illustrate the Margetts risk categories. It is intended to help investors and advisers match their risk profile with an appropriate portfolio and does not illustrate Margetts past performance.

Not all risk scales will be the same. This guide illustrates the scale used by Margetts only. Investors and advisers should not use this guide with any risk profiling tool other than that provided by Margetts.

This information is not meant as investment advice.

The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested. The actual portfolio performance will vary due to charges, manager performance and timing differences.

The guide does not provide any guarantee that losses will not exceed historical losses or provide an expected future return.

We strongly recommend that all investors seek financial advice from a qualified adviser before making any investment.

Award Winners for Investment Performance

www.margetts.com

T 0121 236 2380 **F** 0121 236 2330 **E** admin@margetts.com

Margetts Fund Management Ltd
1 Sovereign Court
Graham Street
Birmingham
B1 3JR