The Warwick Butchart Investment Process and the Sandler Review

The Government announced a "review of medium and long term retail savings in the UK" in 2001, and the subsequent review by Ron Sandler was presented to HM Treasury dated July 2002.

Many of the really important points raised by the "Sandler Review" are already incorporated in the Warwick Butchart Investment Process. This Process is based on detailed quantitative analysis and qualitative research - including many personal meetings and discussions with fund managers and economists. Our experience is enhanced by modern software to help assess each client's risk profile, determine suitable asset allocations, make investment recommendations, and periodically review investment performance.

The following extracts are from the Investment Section, Chapter 7, of the "Sandler Review".

7.12. A widespread consensus exists among investment theorists that, in most circumstances, the asset allocation choice is the critical element in determining long-run overall investment performance. A recent study which surveyed the literature concluded unambiguously that, for the individual investor with a long-term, buy-and-hold investment style the asset allocation decision is by far the most important factor in determining returns.

7.13 In other words, asset allocation allows investors to trade off risk against expected returns to find the combination of asset classes which suits their investment objectives. Historical data shows that corporate bonds have been riskier investments than government bonds, and that equity investments have been riskier still. Higher levels of risk are compensated for by the prospect of higher average returns – the so-called "risk-return trade off".

7.14 A recent study examined historical data on returns on different asset classes in sixteen markets around the world. Figure 7.2 shows the performance, over different lengths of time, of equities, government bonds and cash (short term government bills) for the UK. Each bar in the diagram displays the average inflation-adjusted return from holding an asset category over different periods up to the present day. Over intervals of one to ten decades up to the current time, equities outperformed government bonds and bills in all ten periods considered. Over the last century, equities also outperformed in the other fifteen countries studied.

7.19 Identification of likely future out-performance requires highly sophisticated and time intensive analysis of performance data and fund managers' styles. Only a tiny minority of consumers have access to this sort of analysis. Yet without doing so, simply looking at past performance is of minimal value.

7.47 The evidence suggests that consumers tend to use inappropriately short timescales over which to assess the performance of their investments.

7.59 The relationship between long run prospective returns and asset strategy can be modelled with software tools, which are available on investment websites, or in more sophisticated packages designed for IFAs to use with clients. However, asset allocation software is rarely used.

7.60 As noted above, asset allocation is the key determinant of the long run overall risk and return of an investment portfolio. The observed lack of attention paid to asset allocation by consumers and their advisers tends to be accompanied by a superficial treatment of risk. Qualitative interview evidence suggests that, as described above, IFAs typically determine consumer risk preferences by asking the client to place themselves on a scale of 1 – 10, depending on how much volatility they are comfortable with and how much they can bear to lose overall; the IFA then translates that into a range of products. Such a discussion inevitably glosses over the costs of risk aversion in terms of returns foregone.

7.61 This can lead to what has been termed "reckless conservatism". Analysis suggests that the opportunity costs of conservative strategies may greatly exceed the downside risk of more aggressive strategies. A recent study illustrated this effect by making projections of the likely range of outcomes from investing in low, medium and high-risk funds. It found that the potential opportunity costs of a low risk fund were more than twenty times greater than the possible losses from the high risk fund.

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