Summary of how portfolios presented to the Government Actuary's Department were derived from consultation responses and from material requested from the Wealth Management Association

29 September 2017

Risk profile of personal injury (PI) claimants

The majority of consultation responses stated that, for the purposes of setting the discount rate, the assumed investment risk profile of PI claimants should either be 'very risk averse', or 'low risk', with a slightly higher proportion choosing a low risk approach.

The 'very risk averse', or 'risk free' (Wells v Wells), categorisation corresponds with the existing approach to calculating the discount rate. GAD has already included analyses in relation to this benchmark.

Low Risk

For the 'low risk' (a mixed portfolio balancing low risk investments) categorisation, several independent financial advisers (IFAs) and wealth managers (WMs) provided in-house scales of investment risk as part of their consultation responses, each attached to explicit portfolios. Recognising that this term is difficult to define objectively, we identified those portfolios corresponding most closely with the concept of 'low-risk', based on descriptions provided by the IFAs and WMs, and asked GAD to assess the average return such a portfolio might achieve over the next thirty years, together with the associated risks.

Higher Risk

For comparison, we also asked GAD to consider a higher risk portfolio constructed by a similar method, but selecting benchmarks that represent what we have interpreted as being the highest risk IFAs and WMs say they would recommend or have recommended for PI claimants. Again, this is to an extent a subjective exercise, but the aim here is to provide a broad understanding of the associated risk/reward profiles of the types of portfolios recommended to PI claimants, rather than focusing simply on the characterisation of the risk levels attached to them. It is also noted that some of the riskier portfolio recommendations have been made based on an award calculated using the previous 2.5% discount rate, where a lower compensation amount may have led PI claimants to take on higher investment risk to match their income requirements.

Wealth Management Association (WMA) questionnaire

The portfolios used as a basis to construct these two representative asset allocations include, among others provided by consultees, those provided by four member firms of the WMA offering bespoke investment advice to personal injury claimants. This was in response to a MoJ questionnaire, in relation to three representative personal injury cases, with compensation awards calculated based on three different assumed discount rates. The focus of this analysis was on severe personal injury cases, with all four firms having significant experience in advising on Court of Protection cases.

Representative Portfolio Construction

The table on the next page(s) includes a description of all of the 34 different portfolio mixes considered in the analysis described above, together with the risk categorisations assumed to derive the two representative asset allocations, and commentary on how this was done. Note, some portfolios were not considered suitable for either of the two representative asset allocations. As mentioned above, there is some subjectivity in these classifications, but this should be considered against the broad context of gathering illustrative risk/reward information on portfolio recommendations for PI claimants, and the fact that these portfolios are being averaged to arrive at a representative overall aggregate allocation.

The representative portfolios were constructed by calculating a simple average of the asset allocations for each of the portfolios identified to be included in the 'low risk' and 'higher risk' profiles, respectively. It is noted that by taking an average of a sample of portfolios may not result in the aggregate portfolio being balanced or optimised. However, it provides a way of pooling and summarising all the portfolios identified as having a particular risk profile, and some 'sense checks' have been performed on them (see below).

The portfolios derived (see Final Aggregate Portfolio mixes) were based on a broad set of asset types identified, based on all the different portfolio recommendations provided. In order to keep the number of asset types to a sensible level, some of the asset class descriptions included in various portfolio recommendations were mapped to one (or more) of the broad list of asset types used. We have provided a list to GAD of the mappings used for review.

Alternatives

Many of the portfolio allocations provide in the responses include a weighting to alternative investment strategies. Based on information provided in the responses, these are described variously as:

1) Includes infrastructure, commodities, property, actively managed trading strategies - used as diversifiers
2) Multi-Strategy funds, Long/Short Equity Funds - aimed to produce absolute returns, independent of market conditions - low volatility and low correlation with main asset classes
3) Hedge funds, commodities, precious metals and structured products. The purpose of this asset class is generally to provide returns that have a lower correlation to the other main assets classes.
4) Absolute return funds - often used to create diversification that traditionally would be held in fixed interest securities

We have asked GAD to allocate this asset class into whichever investment(s) they consider to best broadly reflect these descriptions, for the purposes of their analysis.

Sense Checks on representative portfolios

The 'low' risk representative aggregated portfolio was compared against all of the 34 different portfolio recommendations and an analysis was performed to check how closely matched the aggregated portfolio was to each of them. The closest match is the portfolio based on the FTSE UK Private Investor Conservative Index (http://www.ftse.com/products/indices/private-investor). The third closest match is the portfolio based on the WMA Private Investor Conservative Index (https://www.msci.com/wma). A comparison is provided (see Final Aggregate Portfolio mixes), but the fact that the 'low risk' representative portfolio is broadly similar to these two indices provides some comfort that it has been constructed in a manner that it is not atypical with reference to respected industry benchmarks.

Categorisation of Portfolios

No.	Source	Name	Risk Allocation	Comments
1	Consultation response A	WMA Private Investor Conservative Index	Low	Identified by report as 'Lower' risk and equated with the 'Low Risk' MoJ category
2	Consultation response A	WMA Private Investor Income Index	None	Has risk level between the Conservative and Balanced Indices, so not allocated
3	Consultation response A	WMA Private Investor Balanced Index	Higher	Identified by report as 'Medium/Low' risk but PI clients separated into 4 categories, of which this is the highest risk benchmark used
4	Consultation response B.1	Low Risk Investor	Low	Identified as a suggested broad asset mix for a low risk investor
5	Consultation response B.2	Defensive Portfolio	Low	Identified as one of 2 options for a low risk investor. The equity allocation of 25% versus 34% for the other option (Cautious see below), suggests that the Defensive Portfolio fits better with a Low Risk approach (also, not a big difference between these 2 portfolios)

6	Consultation response B.2	Cautious Portfolio	None	See comments on Defensive Portfolio above. No reason to suppose it would be suitable as the highest risk benchmark
7	Consultation response B.3	Court of Protection Client	None	Not referred to as Low risk and no evidence to suggest that it is Highest risk. CoP clients can have very low risk approaches, so not included
8	Consultation response B.4	FTSE UK Private Investor Conservative Index	Low	Considered for low risk clients and labelled as Conservative, so best fit for 'Low' risk approach
9	Consultation response B.4	FTSE UK Private Investor Income Index	Higher	Considered for low risk clients but given the 52.5% allocation to equities suggests this would be a higher risk approach for a PI case
10	Consultation response B.5	FE Invest Cautious Model Portfolio	Low	Cautious Investor synonymous with 'Low' risk
11	Consultation response B.5	FE Invest Moderately Cautious Model Portfolio	Higher	Given the 52% allocation to equities (including 5% allocation to UK Smaller Companies) suggests this would be a higher risk approach for a PI case
12	Consultation response C	Typical PI portfolio	Low	Refers to a Cautious approach and that assumed investment risk should be defensive/low risk (a mixed portfolio balancing low risk investments)
13	Consultation response D	Personal Injury Fund	Low	Designed for Cautious investors who cannot afford to take a big loss
14	Consultation response E	Client A	Higher	Risk profile identified as medium (higher risk of 2 medium classifications). A recent actual allocation to a PI client. 74% to Equities, so definitely equates with highest risk the majority of PI clients are likely to take.
15	Consultation response E	Client B	None	Between the risk profiles for Client A and Client D (also potentially not suitable since allocation is from 2009)
16	Consultation response E	Client C	None	Note this is Client C portfolio 1 (Client C portfolio 2 has 46.4% allocated to mixed assets, so have no idea what this might relate to and so omitted from analysis). Between the risk profiles for Client A and Client D (also potentially not suitable since allocation is from 2012)
17	Consultation response E	Client D	Low	Risk profile identified as Low medium (lower risk of 2 low medium classifications). A recent actual allocation to a PI client. 14% to Equities, so looks to equate with low risk approach
18	Consultation response F	Risk Profile 2: Very Low Risk	None	Identified as very low as opposed to low (see below) so not suitable
19	Consultation response F	Risk Profile 3: Low Risk	Low	Defined as such
20	Consultation response F	Risk Profile 4: Lowest Medium Risk	Higher	Report mentions "most claimants were unhappy or uncomfortable with having to take on more risk than level 4 risk profile" – so sensible to assume this as highest risk
21	WMA Firm A	Portfolio 1 (Medium Low Balanced)	Low	Risk is defined as one of: Lower, Medium Low, Medium High, Higher, and investment objective defined as one of: Capital, Income, Balanced (mix)). Assigned the lowest risk of the 2 Medium Low Balanced portfolios so this is close enough to 'Low' risk (lower end of medium low)
22	WMA Firm A	Portfolio 2 (Medium Low Balanced)	Higher	Given that 3 different PI cases have been provided, each with awards calculated based on Discount Rates of -0.75%, 1% and 2.5%, there is a wide enough mix to include the highest risk recommendation for this

				firm as representative of the highest risk approach that would typically be recommended.
23	WMA Firm B	Portfolio 1 (Low/Medium risk)	None	Ignored as not close enough to 'Low' risk (and no sub-divisions of low/medium risk classification)
24	WMA Firm B	Portfolio 2 (Medium Risk)	Higher	Given that 3 different PI cases have been provided, each with awards calculated based on Discount Rates of -0.75%, 1% and 2.5%, there is a wide enough mix to include the highest risk recommendation for this firm as representative of the highest risk approach that would typically be recommended.
25	WMA Firm C	Portfolio 1 (Discretionary Portfolio – Lower Risk)	Low	Assigned the higher risk of the 2 "Discretionary Portfolio - Lower Risk" portfolios to 'Low' Risk based on assumption that the lower risk one is very low risk (<15% equities)
26	WMA Firm C	Portfolio 2 (Discretionary Portfolio – Medium Risk)	Higher	Given that 3 different PI cases have been provided, each with awards calculated based on Discount Rates of -0.75%, 1% and 2.5%, there is a wide enough mix to include the highest risk recommendation for this firm as representative of the highest risk approach that would typically be recommended.
27	WMA Firm C	Portfolio 3 (Discretionary Portfolio – Lower Risk)	None	The lower of the 2 lower risk portfolios – so assumed very low risk, so Ignore (<15% equities)
28	WMA Firm D	Portfolio 1	None	These are essentially bespoke portfolios which have been picked based on allocating an amount to cash (for short-term expenditure and liquidity needs) and the rest to either a cautious or moderate risk portfolio. However, since we do not know the relative amounts allocated to the cash and mixed portfolio elements, one cannot easily derive the underlying mixed portfolio allocations – as such, we have ignored all portfolios from this Firm for the purposes of the illustrative portfolios.
29	WMA Firm D	Portfolio 2	None	
30	WMA Firm D	Portfolio 3	None	
31	WMA Firm D	Portfolio 4	None	
32	WMA Firm D	Portfolio 5	None	
33	WMA Firm D	Portfolio 6	None	
34	WMA Firm D	Portfolio 7	None	

Final Aggregate Portfolio mixes

The Table below sets out the aggregate 'low' and 'higher' risk portfolio mixes which have been provided to GAD for analysis, together with a comparison against two industry benchmarks (included in the analysis), showing that the 'low' risk portfolio is broadly comparable.

Asset Class	LOW RISK PORTFOLIO AVERAGE (mean)	HIGHER RISK PORTFOLIO AVERAGE (mean)	FTSE UK Private Investor Conservative Index	WMA Private Investor Conservative Index
UK Equities	12.71%	29.13%	19.00%	19.00%
Overseas Equities	13.31%	27.50%	13.50%	11.00%
ILGS	4.74%	3.31%	5.00%	5.00%
UK Gilts (FI)	13.18%	7.12%	10.00%	20.00%
Overseas Gov Bonds (FI)	2.05%	0.19%	0.00%	0.00%
Corporate Bonds (FI)	22.29%	14.10%	25.00%	25.00%
Cash	9.54%	5.14%	5.00%	5.00%
Property	4.11%	5.19%	5.00%	7.50%

Alternatives	16.86%	7.71%	17.50%	7.50%
Commodities	1.22%	0.25%	0.00%	0.00%
Other	0.01%	0.38%	0.00%	0.00%
TOTAL	**100.02%**	**100.00%**	**100.00%**	**100.00%**

Note: The 'low risk' portfolio is the average of 11 different portfolio recommendations, while the 'higher risk' portfolio is the average of 8 different portfolio recommendations. Hence, 15 portfolios were not selected for either the 'low risk' or 'higher risk' portfolios.