

## A model for product and portfolio suitability

In CONSULTATION PAPER 325 Product design and distribution obligations ASIC has stated the following:

*The design and distribution obligations are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to designing and distributing products.*

*Issuers will have an increased responsibility to design products that are fit for purpose and deliver good consumer outcomes.*

*An issuer must make an appropriate target market determination for its financial product.*

*A distributor must take reasonable steps that will, or are reasonably likely to, result in its retail product distribution conduct being consistent with the target market determination. Distributors are prohibited from distributing a product unless a target market determination has been made.*

*It will also be useful for the issuer to consider, those for whom the financial product is clearly unsuitable (the 'negative target market').*

ASIC has acknowledged the weakness in the PDS regime to ensure products are fit for purpose, but the above requirements come at a high cost when every product issuer and distributor has to come up with an effective method of ensuring compliance with ASIC requirements.

While ASIC will assist in deeming products, target markets and negative markets it has not provided a model for consistent grading and approaches to product governance and suitability.

The following provides such a model that was developed over eight years, some while working at ASIC but owned by the author through Commissioners approval. (Email 26/09/2014)

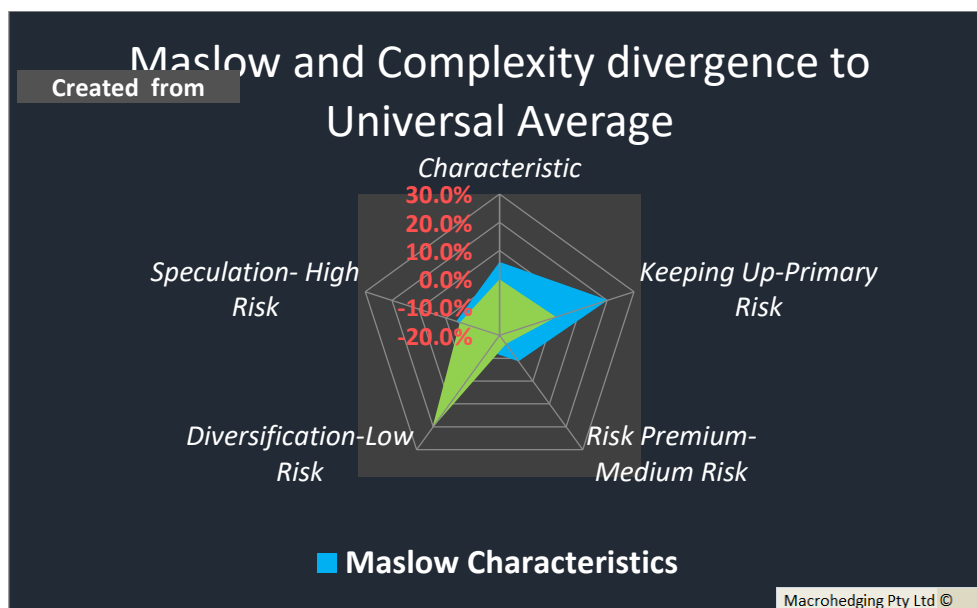
The model was created to try to answer the question of how complex was a certain product, but ended by answering the question, how suitable was a product, and how complex, diversified and suitable was a portfolio?

The starting point was to list and determine product characteristics from a variety of PDS. Twenty classifications such as legal risks, primary risk, product inclusions, counterparty risk, payoff method were determined with two hundred sub-category characteristics such as hedge fund, long/short, path dependent, interposed entity, liquidity, overlay, pooled. Each sub-category was scored for complexity on a 1-10 basis by multiple analysts for 12 categories such as complexity, fees, beta, credit, Sharpe and correlation. The sum of scores determined complexity which was compared to the average of all results.

Maslowian Portfolio Theory							
Legal Risk	Primary Risk	Common Name	Product Inclusion	Assets	Strategy	Payoff	Default Claim
Product Disclosure Statement	Underlying	Cash/Change Rate	Asset option	Domestic Equity	Barometer	Path Dependent	Revised Claim
Preposition	Long	Short	Basket option	Commodity	Derivative/Option	Linear	Global Hedging Risk
Liquid	Short	Future	Basket option	Commodity	Static	Linear	Segmented
Limited Investment Company	Contingent	Fixed Income	Binary option	Fixed Income (Australian)	Passive Management	Non-linear	Unit Holder - Pooled
Limited Company	Basic Risk	Managed Fund	Call/Put	Fixed Income (International)	Managed	Exotic	Custody
Trust / Common Fund	Benchmark	Hedge Fund	Cap/Floor	International Equity	Active	Vanilla	Sub-custodian
Company	Leverage	Commodity	Chooser option	Property	Held to Maturity	Physical	Replacement Cost
Managed Investment Scheme	Multiple Leverage	Value	Compound option	Credit default swap	Dynamic Hedging	Synthetic	Subsidiary layers
Schema of Arrangement	Low Level Leverage	Balance	Contingent premium option	Cash	Systemic Risk	Derivative	Interposed entity
Special Purpose Vehicle	Unlimited Assets	Derivative	Digital / Chow Tooth	Infrastructure	Market Timing	Option	Interposed entity chain
Trust/Bare Trust	Private Equity	Exchange Traded Fund	Forward	Infrastructure	Arbitrage	Swap	Roll-over
Capital Security/Managed Account	Research/Thematic	Exchange Traded Commodity	Future	Commodity	Event	Variance Swap	Limited Recourse Loan
Fees	Secondary Risk	Real Estate Investment Trust	Lookback option	Reverse Convertible	Long/Short	Premium Discount NAV	Investment Manager Outbound
Management	Currency	Security/Default	Quanto	Based	Directional	Multi Factor	Specific Risks
Buy/Full spread	Interest Rates	Contact for Difference	Barbell option	Unlevered	Market Neutral	Collateral	Futures Roll
Performance	Liquidity	Warrant	Barbell option	High Yield	Buy and Write	Call	Formula
Hurdle	Tracking Error	Bond	Swap	Basket/Fund of Fund	Managed Futures	Government Securities	Fat Tail
Brokerage/Commissions	Inverse	Index	Swap	Index Related	Macroeconomic	Corporate Bonds	Concentration
Breakability/Expenses	Zero Coupon	Fund of Funds	Credit default swap	Country Risk	Vega	High Yield Junk Bonds	Tranching
Periodic Redemption	Overly	Specialized Product	Credit derivative	Emerging Markets Debt	Counterparty Risk	State	High Frequency Trading
Swap Fee	Model Risk	Hybrid	Credit linked note	Emerging Markets Equity	Header	Equity	Broad Equity
Exit	Netting Agreement	Blue Chip	Total Return Swap	CCIV/COO cashflow/synthetic	Authorized Deposit Taking Institution	Covered Bonds	Investment Manager Risk
SPV	Securities Lending	Capital	Best of/Worst of option	Energy	Settlement	Supranational Sovereign	Net Asset Valuation
Secondary Market	Prepayment Risk	Derivative	Equity default swap	Derivatives	Deferred Purchase	State Government	Initial
Exchange	Rehypothecation	Instalment	Equity collateralized obligation	Emerging or Small Capitalization	Capital Protection	Underlying Assets	Daily
Redeemable	Debt	Capital Guarantee Protection	Accumulator	Ethical	Capital Guarantee	Authorized Deposit Institution	Mark To Market/Related Party
Key	Psychological Needs	Psychological Needs	Range Accrual	Alternative	Secondary Counterparty	Payment	Secondary Market
Retirement & Income	Capital Protected	Safety needs	Geographic	Beta	Subordinated	Interest	Novel /Conflicts
Keeping Up	Capital Return	Belonging	BICS	-1	Secured	Coupon	Variance to Universe
Risk Premium	Front	Esteem	Asian Fund	-0.5	Unlevered	Dividend	0
Diversification	Risk Management	Self-actualization	European Fund	501	Interest Deferral/Termination Clause	Distribution	Complexity Measure
Securitization	Worstful Gain	Self-transcendence	Frontier Market	Negative/Correlated	Equity Credit Conversion	Flaring	0

Three hundred PDS products were reviewed (Gold Coast to Brisbane train) and ranked for complexity. While this assisted with those products deemed too complex for no additional benefit or hidden risks it did not determine suitability.

To determine suitability traditionally theorists and advisors regularly look at two criteria risk and return. Portfolio theory is far too narrow for most investors who often care about other issues such as fees, the environment, safety (income) keeping up with the Jones's (belonging) , diversification (risk management) and trust (risk premium) but also may want the self-transcendence/ windfall nature of speculation for some part of their portfolio. Maslow criteria was overlaid for determining where the 200 sub-categorisations fell to determine the products weighting to the five Maslow categorisations. The words in the PDS would therefore determine the products weighting to suitability criteria based on the needs and wants of the client. In this manner each product could then be checked for Maslow weights to determine suitability within a portfolio based on a target audience such as income, trust, diversification, belonging or speculation. Each of the Maslow criteria then simply needs to be defined across the market (client list). For example, belonging equated to those who prefer a balanced fund for the majority of their portfolio (36% of characteristics on average). An esteem product would equate to use of a product from a fund manager they trust. For example, Colonial and Macquarie have a decade's history of excess returns for their infrastructure funds so choosing a new fund with a successful brand name such as Magellan Infrastructure over them is simply a matter of trust.



(Facebook personality mapping came two years after the Maslow map for a financial product)

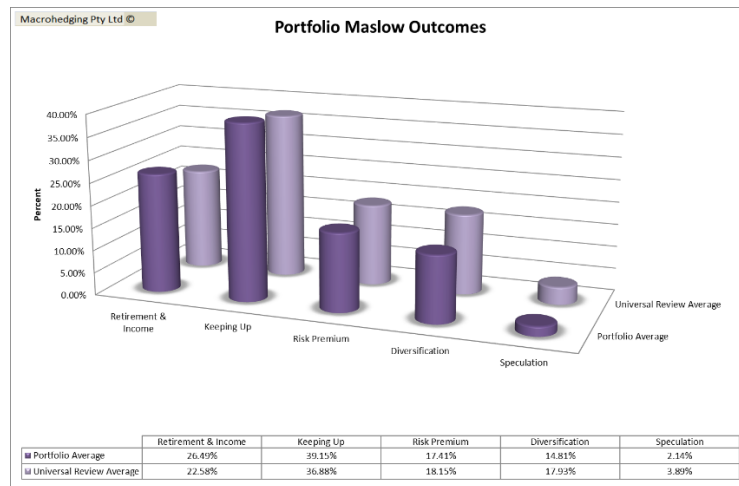
While the suitability and target or non-target can be determined for a product it doesn't balance or diversify a portfolio so there is a conflict in ASIC's requirement at the product level and determination at the portfolio level where products that could be deemed speculative (emerging bonds/Asian property) may have a place for reasons as simple as diversification.

Macquarie International Infrastructure Securities Fund		CFS Global Listed Infrastructure Securities	
Product Characteristics		Product Characteristics	
MACQUARIE INVESTMENT MANAGEMENT LTD		COLONIAL FIRST STATE INVESTMENTS LIMITED	
Active	Redeemable	Active	Residual Claim
Benchmark	Unit Holder -Pooled	Beta .5 to 1	Underlying
Beta <.5		Buy/Sell spread	Unit Holder -Pooled
Buy/Sell spread		Concentration	Unlisted assets
Currency		Distribution	Value
Daily		Global Insolvency Risk	
Distribution		Infrastructure	
Diversification		Interest Rates	
Emerging Markets Equity		International Equity	
Growth		Issuer	
Hybrid		Liquidity	
Infrastructure		Long	
International Equity		Managed Fund	
Long		Managed Investment Scheme	
Managed Fund		Management	
Managed Investment Scheme		Mark To Market/Related Party	
Management		Path Independent	
Path Independent		Physical	
Platform-Master Trust		Product Disclosure Statement	
Product Disclosure Statement		Redeemable	

To create a portfolio, a tool was developed that allowed users to include any one of the 300 funds categorized into 15 asset classes such domestic or international equity or property, income, credit, infrastructure, emerging markets, regional, brand recognition and weighted for asset allocation between 3-7% for each product to determine portfolio Complexity and Maslow scores relative to the average. The portfolio could also be optimized for a number of criteria for asset allocation rather than just the traditional risk (volatility) and return, including criteria such as Fees, Complexity and Maslow score, Strategy, Sharpe Ratio, Expected Return in any ratio. In this manner the suitability of the portfolio can be compared (mapped) to the universe of products (300) for all criteria such as Maslow score and breakdown.

My PORTFOLIO						
	Income	Property	International	Emerging Markets	Emerging Markets Bond	Cash
Costa-City Asset Limited	Primoval Tech/Infra Trust	Commonwealth Property Securities Fund	Megafund Global Fund	Schwab Global Emerging Markets Fund	Primo-ES2 Wholesale Emerging Markets Bond Fund Class B	Legg Mason Western Asset Cash Plus Trust
Westpac Banking Corporation	Macquarie Income Opportunities	Commonwealth (ES2) Mortgage Income Fund	Platinum International Fund	Aberdeen Emerging Opportunities Fund	Alternatives	Option Related
Insurance Australia Group Limited	Franklin Templeton Global Aggregate Bond Fund	Australian Unity Healthcare Property Trust	Five Oceans World Fund Class A	Walker Scott Emerging Markets Fund	Winton Global Alpha Fund	BT Balanced Equity Income Fund
Telstra Corporation Limited	Bentley Wholesale Global Income Fund	APN AMET FUND	Telstra Global Equity Fund	BT Global Emerging Markets Opportunities Fund	DNV Global Equity Agribusiness Fund	Travis and Partners Australian Buy Write Fund
BSP Billiton Limited	Credits	Vanguard Index Australian Property Securities Fund	Vanguard Index International Shares Fund	Martin Currie Global Emerging Markets Fund	Aspect Diversified Futures Fund-Class A	Regional
ASX Limited	Colonial First State Global Credit Income Fund	Global Property	Aberdeen Actively Managed International Equity Fund	Stability China Fund	Robinson Alternative Trade (Global Trading Strategy)	Platinum Asia Fund
Domestic Alternatives	Macquarie Australian Fixed Interest Fund	AMP Capital Core Property Fund	Grant Smallcap Global Equity	Rubicon India Fund	Credit Suisse Enhanced Commodity Fund	Macquarie Asia New Stars Risk Fund
Eng Griffiths Group Small Companies Fund	Primo ES2 Wholesale Bond Fund	ES2 SGI Global Global Listed Property Securities Trust	AGF Global Risk Premium Trust	All China Opportunities Fund	Debt Hybrid	Pathdown European Fund
Altium Discrete Builder	Primo Australian Fixed Interest	Legg Mason Property Securities Fund	BNY Mellon Global Alpha Fund	Premium China Fund	AGF Energy Index Bond New 2039	Aberdeen Asia Opportunities Fund
Schroder Australian Small Companies Fund	IMB Connect-It Preference Shares	CFS Wholesale Global Property Securities	Schroder Global Smaller Companies Fund	Frontier Markets	Carfax Subordinated Notes 2037	Platinum Japan Fund
Etihad Airways Australian Market Neutral Fund	Bentley Wholesale Synthetic Loan Fund	Premium Asia Property Fund	Acadian Wholesale Global General Equity Funds	Levent Developing Markets Equity Fund	Tobacco Subordinated Notes 2037	
Perpetual Share-Plus Long Short Fund	Infrastructure	Domestic Fund	Peters MacGranger Global Fund	Sea Lake America Equity Fund	Woolacotts Notes 11 2036	Finish
Domestic Micro	CFS Global Listed Infrastructure Securities	Benchmark Australian Equities Fund	CPI related	Theme Equity	Brand Recognition	
Carriage Mortgage Limited	Macquarie International Infrastructure Securities Fund	Investec Value Shares Wholesale Trust	Colonial First State Government Inflation Linked Bond Fund	Adventis-Holdings Group Limited	Platinum International Bonds Fund	
Asahi Micro Cap Fund	New Infrastructure Value Fund Hedge	PLATINUM Australian Equities Trust	Robinson Global Inflation Linked Securities (Hedge) Trust	Platinum Asset Management Limited	BT Global Listed Bond Fund	
Aberdeen Australian Small Companies Fund	Levent Global Listed Infrastructure Fund	Mighty Brown ASX Australian General Equity Fund	Schroder Near Return Fund	Bank Limited	UBS Global Research Preferred Australian Share Fund	

Because the portfolio is simply the average of the individual reviews the portfolio can be checked for: diversification by asset class and strategy, comparing outcomes to universal average of products reviewed, simulate allocation by Yield, Complexity, Fees, Strategy, Maslow, Volatility or any combination.



Another benefit of the scores is that they highlight situations where issuers, who have a reputation in the market for being conservative, issue complex products. This may result in retail investors unknowingly investing in products that are more complex than they realise. The misalignment of the Complexity and Maslow score can/has highlighted where a product has been structured to generate fees or future problems (trust and exit/credit issues).

It is a shame that ASIC doesn't like the current system but wants to leave it to issuers and distributors to spend millions developing models for product suitability which by its nature will need to include portfolio suitability as well when they have themselves rights to pass on the product model known as AIRC (Australian Investment Risk Characteristics) and the sum of its results developed later for portfolios, MY PORTFOLIO model to enable a consistent review method for all product issuers and distributors to follow allowing a database of all products to be built for comparison (issuers review and download) and used as educational tools for the public to increase financial literacy.

By year 10 everyone has done Maslow at school, so I am not sure why there is such a fear of its concepts that correctly framework financial literacy and provide an easy method for classifying suitability for investors in terms they are familiar with.

Standardising complexity and suitability are the means to a financially literate nation.