



The Challenges of Risk Measurement

Discussion Points for the European Commission Working Group

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The Challenges of Risk Measurement

The Directive and its interpretation

- > Overall statement of risk
 - Definition of absolute loss

- > Description of applicable risks
 - Specific risks (credit, counter-party, liquidity, currency, investment concentration, custody)
 - Additional risks

How much does an investor get from this description .. And how much should the investor understand?

The Challenges of Risk Measurement

Creating a synthetic indicator

- > How do you assign values?
 - Specific risks
 - *How do you define high, average, low? Is there an absolute measure?*
 - *Can you say equity funds have no credit risk (Kmart, Worldcom, Enron)?*
 - *Is real estate a medium risk or a high risk for liquidity*
 - *What about new products like Long-Short funds*
- > Concentration risk
 - *Concentration isn't just about countries and sectors*
 - *What is the normal size of a diversified holding? 100 stocks, 80, 50 .. When does the risk increase*
- > Performance risk
 - Tracking error .. You pay for active management .. Should you settle for passive +
- > Inflation risk?
 - Is there an asset class that is free of inflation risk?
- > From which perspective are we defining risk
 - Currency -- does the investor understand the risk vis a vis the fund or vis a vis themselves
 - When we talk about a target investor are we creating the likelihood of confusion

The Challenges of Risk Measurement

Creating a synthetic indicator

- > How do we create a broad and legitimate definition of specific risks and ensure comparability across funds and fund promoters?
- > Is volatility the right measure?
- > What about VaR?
- > What about stress testing?
- > *If less is more for the retail investor, should index products be the product of choice?*

The Challenges of Risk Measurement

A need to translate risk for the investor

- > Investors need to understand fund products and their risks
- > A synthetic risk measure at the fund level may be an important next step
- > Volatility only tells part of the story
- > Institutional buyers look at peer groups and quartile performance over the longer periods ... is this a potential direction?

The Challenges of Risk Measurement

A need to translate risk for the investor

- > What about the target investor?
 - Should this be part of the simplified prospectus?
 - Fund promoters should find a way to define a fund's level of risk vis a vis the opportunity cost (peer group) but should they define the target investor .. Do they have this expertise?

- > UCITS III is a brand .. And is meant to define a medium to long-term investment range (exception for MM funds)

- > UCITS III true value may lie in its vision of appropriate investments .. The best definition of risk is potentially at the level of investible assets and a maximum level of risk any investor may face

- > The target investor (broadly defined) is a retail investor .. Should fund promoters be expected to go beyond this level in the SP?

The Challenges of Risk Measurement

Next Steps for the industry

- > The fund industry is institutional in nature and product focused
- > The industry should be challenged to define and answer these issues ...
- > BUT it should be done in combination with distributors and investors
- > No one piece of the puzzle will have all the answers and no one document can be all things to all people
- > The simplified prospectus is meant to provide **understandable** information that permits an informed purchase
- > A risk measure may be a tool but it should not substitute for « understandable Information »