Defaqto Diamond Rating methodology for Risk Bound Fund & MPS families

February 2025

Family Diamond Rating methodology update

The Defaqto Family Diamond Rating methodology has been enhanced to a pure quantitative rating methodology, to aid the selection process, providing an efficient method to help identify the strongest families/ranges of funds and Discretionary MPS portfolios.

Defaqto appreciates that in a Consumer Duty regulatory landscape, being able to explain concepts to clients in a way that they understand is key. Furthermore ensuring consistent approaches to evaluating investment solutions is evermore paramount.

Defaqto has therefore made the following key enhancement to the Defaqto Family Diamond Rating methodology:

Removal of qualitative due diligence assessment:

Previously Defaqto Family Diamond Ratings included qualitative assessments for funds and Discretionary MPS families that were new to the market (less than 5 year performance track record). Defaqto's team of Investment consultants would hold in depth due diligence meetings with the fund and portfolio managers of new multi-asset risk-bound families, covering assessment of investment processes, risk management, resources, philosophy, company structure, fund manager's track record of managing similar solutions, and more.

To align with the Consumer Duty requirements imposed on advisers. Defaqto has made the decision to remove the qualitative due diligence assessment, converting the Defaqto Family Diamond Ratings to a purely quantitative methodology. Therefore, creating a clear separation between quantitative and qualitative assessment methods, avoiding risk of subjectivity and ensuring families are assessed on their own merits, without influence from other established strategies.

Impact of the change:

As a result of these enhancements, Fund and Discretionary MPS families that don't have 5 years' worth of performance history, may experience downgrades in ratings. In large, such downgrades are due to the removal of the qualitative due diligence assessments, from the Defaqto Family Diamond Rating methodology, not a reflection of the asset manager.

For more on these updates, please contact our service desk.

Introduction

Following the introduction of the Retail Distribution Review (RDR) in December of 2012. Defaqto launched an innovative new rating methodology, to assess and monitor risk-bound multi-asset fund families, in response to advisers needing an efficient and effective method to assess Centralised Investment Propositions (CIPs). The methodology was later extended to include Discretionary MPS families.

In scoring risk-bound multi-asset fund and Discretionary MPS families, Defaqto apply a data numeric analysis (DNA) methodology, with each portfolio feature and performance attribute being scored from 1 to 5, where 5 indicates the best characteristics and 1 indicates the worst characteristics.

The sum of the individual DNA scores across the range of criteria provides an overall score, which Defaqto use to rank each family within its respective universe and then assign each family a Diamond Rating of 1 to 5.

Rating criteria

Criteria for the Defaqto Family Diamond Ratings:

Shape

In accordance with Modern Portfolio Theory (MPT), over the long-term, investors expect to be rewarded for taking on additional risks with the potential for higher returns.
Shape measures the conformity of the family of portfolios to this expected correlation between risk and return, with a closer fit to this pattern receiving a higher score.

E.g. an asset manager marketing a family of funds as risk 1, risk 2, risk 3, risk 4, etc, over the long-term should be delivering increasing returns as the funds progress in level of risk.

Defaqto measures Shape as the average of the signs of both annualised return deltas and risk deltas for each solution, in order of the asset managers marketed risk order, using the following calculation steps for each family:

1. Establish the marketed risk order of each investment solution within a family
2. Calculate the differences between the annualised returns of each investment solution in order of marketed risk (return delta)
3. Calculate the signs for each of the return deltas e.g. +1 for positive return deltas, or conversely, -1 for negative return deltas
4. Calculate the differences between the annualised standard deviation of each investment solution in order of marketed risk (risk deltas)
5. Calculate the signs for each of the risk deltas e.g. +1 for positive risk deltas, or conversely, -1 for negative risk deltas
6. Average all signs within family
7. The results are then quintiled against the Shape results for all families, to produce a DNA score

The above process is repeated for 1 year, 2 year, 3 year, 4 year and 5 year cumulative periods (3 year, 4 year and 5 year cumulative for MPS).

Consistency

An assessment of how 'even' the increases in risks are when moving between investment solutions within a family. Calculated as the variance of these changes in risk, with a lower variance (i.e. more even steps in risk) being rated as better.

Calculation steps for each family:

1. Establish the marketed risk order of each investment solution within a family
2. Calculate the differences between the annualised standard deviation of each investment solution in order of marketed risk (risk deltas)
3. Calculate the variance of risk deltas
4. The results are then quintiled against the consistency results for all families, to produce a DNA score

The above process is repeated for 1 year, 2 year, 3 year, 4 year and 5 year cumulative periods. (3 year, 4 year and 5 year cumulative for MPS)

Spread

The range of risk available in the family of investment solutions. Calculated as the difference in risk between the maximum and minimum risk solutions within a family. With a wider spread being seen as better, as it indicates more choice.

Calculation steps for each family:

1. Identify the investment solution, within the family, that has the highest annualised standard deviation.
2. Identify the investment solution, within the family, that has the lowest annualised standard deviation.
3. Subtract the lowest annualised standard deviation from the highest annualised standard deviation
4. The results are then quintiled against the consistency results for all families, to produce a DNA score

The above process is repeated for 1 year, 2 year, 3 year, 4 year and 5 year cumulative periods. (3 year, 4 year and 5 year cumulative for MPS)

Performance

Performance is measured within a family, as the average of each investment solution's annualised total return, divided by the expected return for the level of risk taken:

$$\frac{\text{Annualised total return}}{\text{Expected annualised return for the risk taken}}$$

Expected return is determined from the universe of Family Diamond Rating constituents. Each constituent has an associated volatility and return. The risk is plotted on a graph and a curve of best fit is produced. From that curve, there will be an expected return corresponding to a given volatility, and the portfolio's actual return will either be above or below that.

The results are averaged at family level, then quintiled against the results for all families, to produce a DNA score.

This process is repeated for 1 year, 2 year, 3 year, 4 year and 5 year cumulative periods. (3 year, 4 year and 5 year cumulative for MPS)

Number of investment solutions

When selecting a family of investment solutions as a CIP, advisers take into consideration the variety of choice of available investment solutions, within the family.

Therefore, number of Investment solutions within the family is considered as a Family Diamond Rating criterion.

For Funds, a cap of 5 points is assigned where a family has 5 or more investment solutions available. 3 points are assigned for 4 solutions, and 2 points assigned for 3 solutions.

For MPS, a cap of 5 points is assigned where a family has 8 or more investment solutions available. 4 points are assigned for 6 solutions, 3 points assigned for 5 solutions, and 2 points assigned for 4 solutions

MiFID II costs & charges

Cost, whilst implicitly factored into net returns, is a key driver for advisers selecting a family of investment solutions as a CIP.

The total MiFID II costs are calculated for each Investment solution within a family, then averaged. The average is then quintitled against the average total MiFID II costs & charges for all families, to produce a DNA score.

Family AUM

AUM is a consideration that advisers frequently use when assessing investment solutions.

5 points are assigned where the total AUM within a family is greater than or equal to £100,000,000.

Ranking

Defaqto totals the performance and risk criteria DNA scores for each criterion separately for each observation period. The scores are then weighted as follows:

Cumulative observation period	Weight
5 years	33.3%
4 years	26.7%
3 years	20.0%
2 years	13.3%
1 year	6.7%

The results are summed, which produces a total performance and risk score. The sum of the DNA scores of the following criteria are added to the 'total score': 'Number of investment solutions', 'MiFID II costs & charges', and 'Family AUM'.

The final scores are then assigned a rating based on the total DNA.

Peer groups

Defaqto has created three mutually exclusive peer groups of risk-bound families to ensure like-for-like comparisons are being made.

Peer group definitions:

Unit Trust and OEIC fund families

- Must be registered for sale in the UK
- GBP share classes only
- Marketed as a multi-asset range of investment solutions
- Offers different risk/return outcomes e.g. low to high risk

Discretionary MPS – Platform custody:

- Must be registered for sale in the UK
- Platform custody
- Marketed as a multi-asset range of investment solutions
- Offers different risk/return outcomes e.g. low to high risk

Discretionary MPS – Direct custody:

- Must be registered for sale in the UK
- Direct custody
- Marketed as a multi-asset range of investment solutions
- Offers different risk/return outcomes e.g. low to high risk