A *PRIIP* in Time...

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> *to provide investors with a fairer view of potential investment returns, longer pricing histories should be used*

Packaged Retail and Insurance-based Investment Products, known as "PRIIPs", can be complex financial structures which may not necessarily be well-understood by potential investors. To try to address this, EU regulations require every potential retail investor to be provided with a Key Information Document "KID" for any PRIIP they are considering. The aim of the KID is to improve retail investors' understanding of the products they are investing in, as well as helping them compare different products.

There are detailed requirements around the content and layout of the KID and we have worked with a number of clients to provide the illustrative return figures which must be included. The prescribed calculation methods for KIDs have been widely criticised for producing misleading performance scenarios. This has led us to investigate how suitable these methods might be.

Background

Although KIDs must include a variety of different metrics, we are focusing on the performance scenarios which show a range of possible returns as summarised in the table.

Scenario	Representative Return on PRIIP
Favourable	90th percentile
Moderate	Median
Unfavourable	10th percentile
Stressed	Very poor experience

Our analysis focuses on the returns at the end of the PRIIP's recommended holding period. The PRIIPs regulations normally require that the performance scenarios are determined based on the PRIIP's price history. The amount of price history that can be used depends on the frequency at which it has been recorded.

Our Investigation

To determine the 'predictive power' of the performance scenarios, we considered a hypothetical PRIIP tracking a well-diversified equity portfolio.

Using monthly fund prices, the projected scenario returns[1] were determined at a range of past dates, based on an initial £10,000 investment and a 10 year recommended holding period. We then compared these predicted performance scenarios to the actual returns that would have been achieved.

The PRIIPs regulations stipulate that a minimum of five years' price history needs to be used when determining the performance scenarios based on monthly pricing. Had we used daily or weekly data, the requirements would have been different and consequently different results may have been achieved.
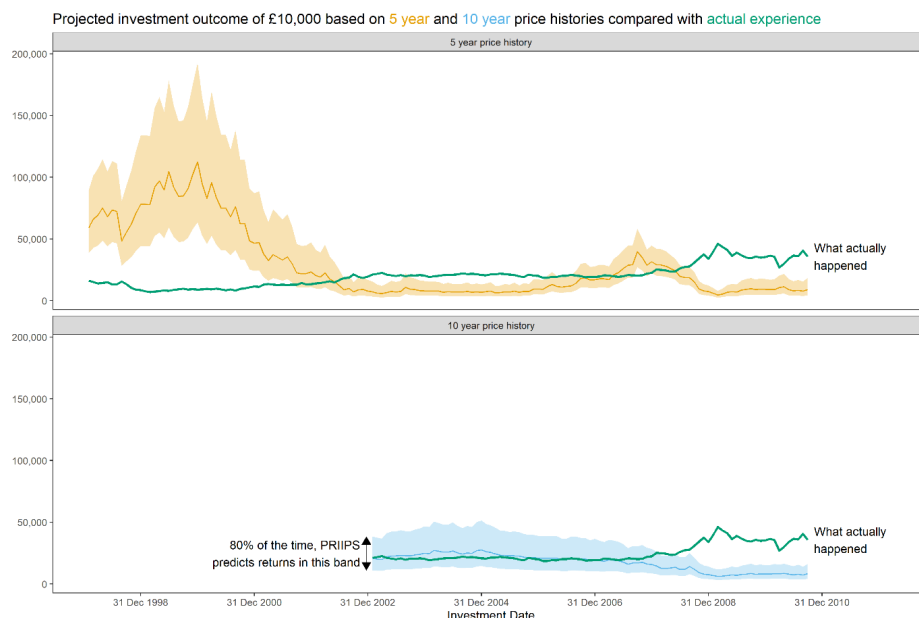
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[1] ignoring any charges

Do actual returns fall in line with the performance scenarios?

The resulting predicted performance scenarios and actual returns are shown in the charts. The first chart shows the performance scenarios based on five years' price history; the second is based on 10 years[2].

The top and bottom of the coloured bands represent the favourable and unfavourable performance scenarios. The coloured lines close to the centre of these bands represent the moderate performance scenario. The stress performance scenarios have not been included[3].

The green lines represent the actual return that would have been achieved on an investment of £10,000 after 10 years and are the same for both graphs.

Projected investment outcome of £10,000 based on 5 year and 10 year price histories compared with actual experience

Analysis of Results

If the methods for determining performance scenarios provide an accurate distribution of actual future returns, we would expect to see 10% of actual returns fall above the coloured bands, and 10% fall below. Consequently, 80% of actual returns should be within the coloured band. Actual returns should fall evenly on either side of the moderate performance scenario line. If actual returns vary significantly from this distribution, this could suggest that the performance scenarios are indeed 'misleading'.

In practice, the actual returns do not fit the intended distribution perfectly. We might have expected this given our relatively small sample of results. A much larger sample size would be needed to demonstrate fully whether or not the PRIIP regulations provide an accurate distribution of returns. Nonetheless, the chart does provide some evidence that the distribution of actual returns better fits the intended distribution when a longer price history is used. That is, the proportion of actual returns between the favourable and unfavourable scenarios is greater when 10 years of price history is used, compared to using 5 years of data.

Go Long!

The chart shows that using a shorter price history provides more volatile performance scenarios. As a result, actual returns are more likely to fall outside of the unfavourable and favourable scenarios. Intuitively, we would expect that using less data provides less appropriate results. However, to understand exactly why this is the case under the PRIIPs' regulations, we must consider what affects the performance scenarios. The main driver is the product's average rate of return as observed in its price history.

Typically:

- Poor past returns will result in poor predicted returns.
- Good past returns will result in good predicted returns.
- The magnitude of the past returns influences the magnitude of predicted returns.

Recent very good or very poor experience can result in overly optimistic or pessimistic long-term performance scenarios when a shorter price history is used. Extreme experience is less likely to be balanced out by more 'normal' experience when shorter time frames are used.

Conclusions

The methods for determining performance scenarios have been criticised for producing misleading performance scenarios. Our findings suggest that this is more likely when shorter price histories are used. Therefore, to provide investors with a fairer view of potential investment returns, longer pricing histories should be used, wherever possible.

We understand that now the UK has left the EU, HM Treasury is reviewing its own regulations for PRIIPs. At the time of writing, however, all British and EU PRIIPs' providers are still required to produce KIDs in line with the EU's regulations. Currently, UCITS[4] funds are exempt from the PRIIPs Regulations. It is our understanding that this exemption will apply until 1 January 2022.

BWCI has experience in producing KIDs for unit-linked and with-profits retail insurance products, as well as other retail investment products. For more information about how BWCI can help providers of PRIIPs to prepare their KIDs, please contact Luke Berry (luke.berry@bwcigroup.com).

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[2] The values are calculated as at each month end between January 1998 and September 2010, and January 2003 and September 2010 respectively.
[3] Actual returns did not fall below the stress performance scenarios.
[4] Undertakings for the Collective Investment in Transferable Securities.