Advice Matters

February 2017

Volume 4, Issue 2

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The CPD Solution For Financial Professionals

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ApEx standards

The learning Outcomes and the ApEx Standards can be found at the end of this edition of Advice Matters

Welcome to the February edition of Advice Matters.

This month's edition contains three very different articles. We start off by looking at what 2016 had to offer in the way of enforcement. If the number of fines given to individuals compared to firms is anything to go by, we can say the time of individual accountability has come to pass.

The article on indirect investments is a great refresher, giving a view on some of the benefits and disadvantages of collectives.

And finally the last article for February's edition is on the other relevant industry bodies, some of which you will come across everyday and others that will be less familiar. The article also contains some helpful signposts on things you will need to bear in mind as the year progresses.

As you know we do like to receive your feedback on articles we have included and those articles you would like to read so please keep it coming.

The Advice Matters Team at FSTP

Coming up next month, we will be looking at:

- Your guide to alpha and beta
- Rational pension explanations
- MiFID II – the implications to your business

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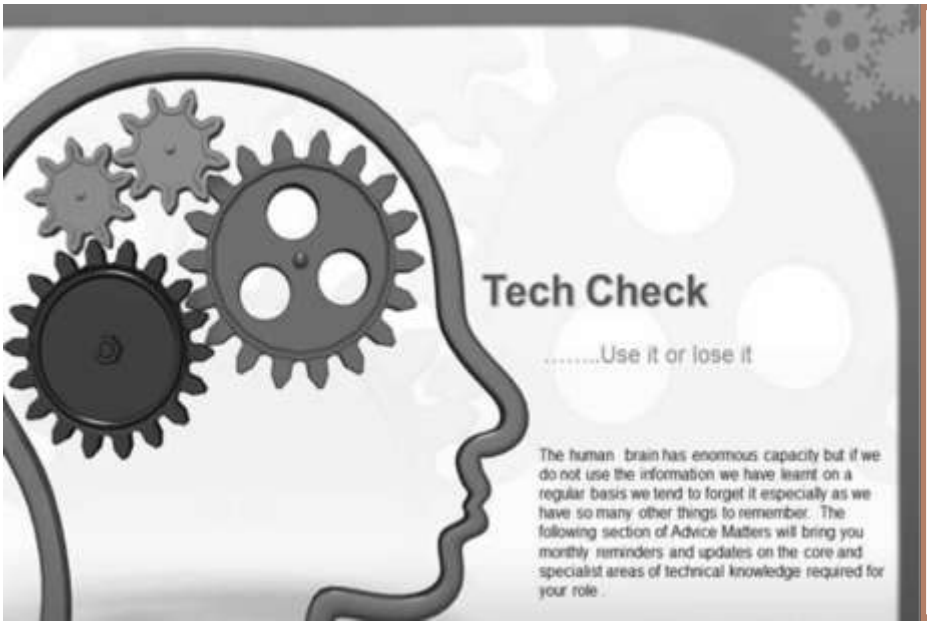

In Tech Check we address aspects of technical knowledge that you need to keep abreast of and that will enable you to have better conversations with your clients.

In this issue we focus on tax efficient saving and investment.

Indirect Investments – do you know enough?

As we all know the timing of investing is not easy – just ask Warren Buffet about Tesco. Do you buy now or wait for a better opportunity? Do you sell now or wait for the market to recover?

Irrespective of the timing decisions an investor has to make, the fundamental decision a potential investor must make is whether to invest directly or whether to invest indirectly via collectives.

Cost is always a consideration – Stockbrokers usually charge a minimum commission of between £5 - £15 per trade for direct investing, so collectives may be cheaper for those that want a fully diversified portfolio.

But as we so often point out to clients - cost shouldn't be the driving factor. Investors come to you because they need help, no longer want to make the decision themselves or haven't got the time to research companies and directly invest. Even if they have both the expertise and the time to research companies and make investment decisions themselves, for some investors using indirect investments as part of their portfolio where they want to benefit , for example, from funds that utilise gearing, indirect investment in collectives may be the better way to go.

There are a number of alternatives to consider when choosing an indirect investment – to help your considerations and conversations with clients we thought a refresher on the advantages and disadvantages of each would be helpful:

Unit Trusts

Set up under a trust deed, they are open-ended collective investment vehicles meaning that the fund can expand and contract in accordance with investor demand.

There are two types of unit trusts:

1. **Distribution funds -** the income is paid out to investors (usually half yearly)
2. **Accumulation funds -** the income is reinvested and used to buy more units.

The majority of funds are actively managed which is an advantage for less experienced investors or as mentioned previously, experienced investors who wish to diversify into markets where they have less expertise.

The value of the units is based on the net asset value (NAV) of the underlying investments unlike investment trusts - see below - which trade either at a premium or a discount to NAV.

Investors buy or sell units via the fund managers. Most unit trusts offer daily pricing; there are some funds which experience a lack of liquidity in adverse market conditions so do not. A good example of this is property unit trusts. They may reserve the right to suspend trading for a period which allows them to liquidate underlying investment properties if there is a demand from investors to withdraw funds.

Most unit trusts use forward pricing which means the investor will not know the price paid or received for the units until after the deal has been done.

Units are normally dual priced - there is a different price to buy units (the offer price) and to sell units (the bid price). The bid-offer spread is there to cover the commission incurred to invest the money into the fund, stamp duty payable on purchases in the fund and the providers' profit. The bid-offer spread will vary in size depending on the underlying assets points to around 5% for property funds.

Unit trusts will also charge an annual management fee which is typically between 1-2%. They will deduct the annual management fee from the fund commission and other expenses incurred in managing the fund.

Capital gains tax is not paid within the fund which is a potential advantage but CGT is payable on any gains realised on disposal. This is the case even if the investment is in gilts and qualifying corporate bonds which would not be the situation if held by the investor directly (CGT exempt).

If the fund offers different types of units, such as institutional units or units quoted in different currencies the provider would have to set up another trust fund, hence the reason most new funds are now set up as OEICs and a number of unit trusts have converted into OEICs.

Open Ended Investment Companies (OEICs)

Structured as companies OEIC's issue shares not units. An Authorised Corporate Director replaces the role of the Trustees in a unit trust having responsibility for the management and administration of the fund. The underlying securities are held in the name of depositories in the same way that unit trusts hold the underlying units in the name of trustees. This provides protection to the investors.

Because the OEIC structure is umbrella in nature it can issue sub funds unlike unit trusts.

The tax situation for OEICs is essentially the same as for unit trusts. They are open ended so pricing is based on the net asset value of the fund.

Like unit trusts forward pricing is normal for OEICs and the investor does not know the price paid or received for the shares until after the deal has been put through. Investors buy or sell shares directly via the product provider but unlike unit trusts they are normally single priced with entry or exit charges being levied by the OEIC provider.

Investment Trusts

Investment trusts are a company despite the Trust terminology and like a company the Board of Directors are responsible for the management and oversight of the fund.

Unlike OEICs, Investment trusts are closed ended - there are a given number of shares in issue which are then traded on the London Stock Exchange, the same as any other share. Because of this prices will change during market hours as investor's trade.

A bid-offer spread is quoted by the Market Makers for the shares, depending on the liquidity of the fund - typically around 0.4%. Commission will be payable to a stockbroker for buying and selling the funds but online dealing can mean this is as low as £5 per trade. Stamp duty reserve tax will also be payable on purchases at a rate of 0.5%.

Again there is an annual management fee charged by the investment trust – circa 1% per annum.

The share price is determined by supply and demand which means the investment trust can either trade at a premium or a discount to the net asset value of the underlying value of the fund. If the investor buys an investment trust at a large discount to NAV it gives them a good chance of achieving a higher return.

Investment trusts have tended to outperform unit trusts and OEIC's because they can use gearing. Unit trusts and OEIC's are restricted to borrowing up to 10% for short term purposes only whereas investment trusts have unlimited borrowing powers. This can increase positive returns but obviously can also increase losses.

Exchange Traded Products (ETPs)

Generally passive investments ETP's can track a number of underlying assets i.e. Equity and bond indices, commodities and market sub-sectors like water companies.

Technically closed ended, ETP's can create more shares if there is sufficient demand. Shares are traded on the London Stock Exchange and the market maker will charge a bid-offer spread like investment trusts. Unlike investment trusts, no stamp duty is payable on ETPs.

Annual management fees are typically very low for broad based equity index trackers.

The advantage for investors of using ETPs is that they can take a long or a short exposure to a position as both long and short funds exists.

A number of ETPs are leveraged and have shares which aim to return 2 or 3 times the return on the underlying assets.

Whilst there are positives of investing via ETPs there is also risk depending on the type of ETP:

- Physical ETPs hold underlying investments whilst others are what is termed synthetic; they use derivatives to gain exposure to the underlying assets
- Physical ETP's lend out stock for a fee which reduces the overall total expense ratio but that does introduce counterparty risk - the risk that the borrower of the stock defaults on the loan.

Synthetic funds can also carry counterparty risk if they trade derivatives over the counter i.e. - directly with the counterparty. Synthetic funds could also involve 'basis' risk - the value of the derivative changes at a different rate or in a different direction to the underlying asset.

You might see some ETPs structured as Exchange Traded Notes (ETNs) - debt securities issued by the product provider i.e. an investment bank. If the provider goes into liquidation, investors may find their investment either unsecured or secured by collateral that may not be sufficient to cover the investment amount.

Many investors use ETPs as a relatively low cost core portfolio with the hope of delivering market performance using direct investments or active managed funds to deliver outperformance (positive alpha) after costs.

A reminder of the fundamentals and the fact investors have choices is always a good thing but before we ever get to that part of the discussion we need to understand the objectives of the client, the risk profile and the capacity for loss-then we can discuss the potential recommendation whether it be direct or indirect investment or neither!

If you have any problems with this edition of Advice Matters please contact your in-house administrator or FSTP on

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