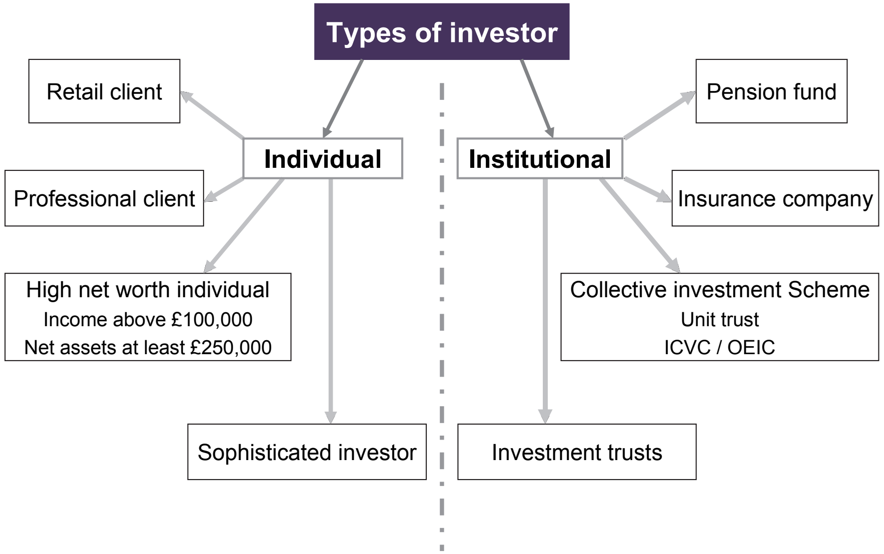
FitchLearning


10-16 Questions

## 2. An Adviser's Duty to Clients



## 2. An Adviser's Duty to Clients

**Obligation of a firm to retail clients**

- Suitability
  - Does the advice meet the client's objectives?
  - Is the client able to afford the financial risks?
  - Does the client understand the financial risks?
- Treating Customers Fairly
  - 6 outcomes to good practice
- The need to refer to specialists
  - Where services go beyond the adviser's knowledge and experience

# 3. Assessing the Needs of the Client

**The fact find process**

- Fact-finding (KYC document)
  - Basic information
  - Current financial situation
  - Current income and outgoings
  - Expected income and outgoings
- Aspirations and goals
  - Matching client needs with solutions
  - Prioritising the needs e.g. protecting the breadwinner, legal requirements
  - Prioritising real future goals vs. pure daydreams

## 3. Assessing the Needs of the Client

**Investment Policy Statement**

- Risk objective – how much risk the client is willing and able to take
- Return objective – the required return needed from the portfolio
- Liquidity needed – at what points withdrawals are intended, e.g. a regular income
- Time horizon – how long the funds are to be invested
- Tax – the tax position of the investor
- Regulatory issues – trusts, charities and pension funds have regulatory constraints
- Other unique circumstances – investor preferences and existing holdings

## 4. Establishing an Investor's Risk Tolerance

**Risk reward connection**

- Risk and potential reward
  - Positively correlated
    - Low-risk investments provide lower expected returns and a lower possibility of loss
    - Higher-risk investments have the potential for higher returns and a greater possibility of loss
- Risk-free returns
  - UK government gilt yield
  - Indicates the benchmark interest rate

**Risk premium**

- Risk premium is the additional return to compensate an investor
  - The riskier the investment, the higher the premium
- Required rate of return
  - Required rate of return = risk-free rate + risk premium



## Further information

**Risk reward connection**

It is important to clearly define which risks are acceptable to investors and the degree of volatility that an investor is prepared to accept.
If an investor wishes to avoid market risk they need to scale down their return expectations to that of the risk-free return. Such investors should also bear in mind that inflation is a hidden risk that erodes the value of their investment.

## 4. Establishing an Investor's Risk Tolerance

**Risks to investors**

- Capital risk
  - Falls in value of the capital invested, or less return than expected
- Income risk
  - Income may fall, cease or not rise as expected
- Currency risk
  - When investing overseas
- Inflation risk
  - Erosion of capital values (good for borrowers)
- Interest rate risk
  - The rate will normally be increased during times of inflation, but this is not always the case
- Shortfall risk
  - The investment does not produce sufficient gains to meet future needs
- Operational risk
  - Mistakes caused by people, processes, systems and external events



## Keeping on target

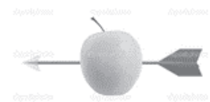
Rebecca Arnold is advising her client with regard to acquiring some Salopian shares as a means of diversifying her client's overseas holdings. Rebecca makes two statements in relation to the risks involved:

1. You will be increasing the currency risk of your portfolio since if the foreign currency appreciates you will suffer losses.

2. You will also be increasing the political risk of your portfolio, as there is the risk of the Salopian government taking actions to damage the prospects of local companies, or of civil unrest in Salopia.

Which statement(s) is/are correct?

A: Neither statement
B: Statement 1 only
C: Statement 2 only
D: Both statements



## 4. Establishing an Investor's Risk Tolerance

**Ability and willingness to take risk**

- Ability
  - Existing wealth
  - Time horizon and liquidity requirements
  - Existing and future commitments
  - Age and family circumstances
- Willingness
  - Views, feelings and preferences
  - Responses to a questionnaire
  - Previous investment experience
- Assess an overall risk tolerance

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### Hints

There are broadly two ways of determining a client's attitude to risk:

- Examine existing investments
- Ask specific questions

**Answer to the question on the previous slide:**
C: Statement 2 only

## 4. Establishing an Investor's Risk Tolerance

**Portfolio risk**

- Systematic risk
  - Risks that affect the market as a whole
    - Interest rate changes, inflation, currency movements
- Non-systematic
  - Specific to the company, asset class or sector

**Reducing portfolio risk**

- We can diversify a portfolio in the following ways:
  - Increasing the number of holdings
    - Different asset classes
      - E.g. equities, bonds, gilts, property, commodities
    - Different industries
      - E.g. aerospace, health, media, travel and leisure
    - Different countries

## 5. Advice and Recommendations

**The planning process**

- The financial planning process should ideally adopt the following sequence:
  - Identify and quantify the client's financial objectives
    - Risk and return
  - Collect data to establish the client's current circumstances
    - Differentiate between hard facts and soft facts
    - Letter of authority could be used
  - Analyse different options to meet any identified shortcomings
  - Prepare a report and arrange a meeting with the client
  - Implement the plan
  - Review regularly



## Further information

A letter of authority is needed to collect information from relevant third parties.

## 5. Advice and Recommendations

**The importance of asset allocation**

- Asset classes – historical returns
  - Cash – low-risk
  - Fixed interest – low- to medium-risk
  - Equities – medium- to high-risk
- Attitude to risk and asset allocation
  - Cautious – deposits, NSI, gilts at/below par
  - Medium – balanced approach, deposit, fixed income, equities
  - Adventurous – increased equities, other investments also
- Investing in funds
  - Variety of risk/reward profiles and objectives

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## Keeping on target

Which of the following is most likely to be an appropriate asset allocation for a life insurance company offering whole of life policies?

A: A substantial high quality fixed income element with any surplus in equity
B: A substantial low quality fixed income element with any surplus in equity
C: A substantial high quality equity element with any surplus in fixed income
D: A substantial low quality fixed income element with any surplus in high quality fixed income

## 5. Advice and Recommendations

**Comparing charges**

- Explicit fees can include:
  - Advisor fees
  - Broker fees
  - Initial and management fees of the product providers
  - The bid/offer spread on an investment
- Implicit fees can include:
  - The cost of dealing within a fund
  - Capital gains tax issues for actively managed funds
- Other costs can include:
  - Stamp duty reserve tax
  - PTM levy on the London Stock Exchange to fund the Takeover Panel



**Answer to the question on the previous slide:**
A: A substantial high quality fixed income element with any surplus in equity

## 5. Advice and Recommendations

**Benchmarks**

- Specified in advance
  - Comparison with a relevant bond or stock market index
  - Comparison with similar funds or fund universe
  - Comparison with a custom benchmark

**Importance of portfolio reviews**

- Reassessing client attitudes
  - Changes in client circumstances or in the financial environment
- New products and services
  - Maintaining suitability
  - Administrative changes or difficulties
- Investment related changes
  - Assessing return, portfolio rebalancing, benchmark reviews



## Keeping on target

A client asks for advice and provides the following objectives to his financial advisor: to retire at 55 years of age, to provide protection to his family in the event of death and to repay his mortgage as quickly as possible.

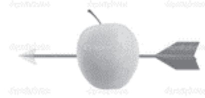
If the advisor believes meeting all of these objectives is not currently possible, which of the following is true?

A. Regulations state that the advisor needs to persuade the client to be more realistic

B. The FCA state that life insurance objectives must be met before pension requirements

C. In exercising the client's best interests rules, the advisor should recommend that the pension takes priority over other investment

D. Regulations do not dictate which objectives should take priority, it is down to investor choice



## 6. Legal Concepts

**Ownership and title documents**

- Registered securities
  - Legal title determined by the name on the register
- Bearer securities
  - Legal title determined by the holder
- Nominee accounts
  - Pooled nominee
    - Investor's shares pooled with those of other investors
    - Broker's name appears on the register of members
  - Designated nominee
    - Investor's shares held in separate pool
    - Investor's designation appears on the register of members



## Further information

Legal vs. Beneficial ownership

Beneficial or equitable ownership provides the right to live in and use a property where you may not be the legal owner, and the right to share in the proceeds of any sale. Beneficial owners are the ones who have the power to control a sale of land or buildings.

*Real vs. personal property*
Real property – land, buildings and rights over these. Real estate.
Personal property – moveable property, such as chattels, furniture and personal possessions. Personality.

**Answer to question on previous slide**

D: Regulations do not dictate which objectives should take priority, it is down to investor choice

## 6. Legal Concepts

**Ownership and title documents**

- Joint ownership
  - Joint tenancy
    - Each owner has a 100% interest in the property
    - On the death of one party, total ownership is transferred to the other parties
  - Tenants in common
    - Each owner has a specified percentage share in the property
    - On the death of one party, their share is passed



# Further information

*Joint ownership:*

*Joint tenancy*
All owners have an identical interest in the property (i.e. they each own 100% of it). If one owner dies, their remaining interest passes to the remaining owner(s).
For instance, if a joint tenant owner of a bank account died, the other owner would have complete ownership of the contents of the account.

*Tenants in common*
Each joint owner owns a separate share of the property. On the death of one owner, their share passes into their estate with their other assets.
For instance, if a tenant in common owner of a bank account died, the other owner would not automatically receive ownership of the half of the account belonging to the deceased. Instead, it would form part of the estate distributed according to their will.

## 6. Legal Concepts

**Contract**

'A contract' – a contract is made when an offer stating specific terms and conditions is made and unconditional and willing acceptance is agreed.

'A void contract' – means the contract is unenforceable.

Discharge of contract – reasons for this could be many, including:

- Discharge by agreement
- Discharge by performance
- Discharge by frustration
- Discharge by breach



### Further information

*Legal persons:*
Natural person
Company
Partners of a partnership
Trustees of a trust

Capacity to contract
Financial adviser must ensure that each client has the capacity to enter into a legally-binding contract. The law protects the following from being bound by a contract:

- A bankrupt person
- A mentally incapable person (can be a specific incapacity)
- A drunk person
- A minor (someone under 18)

## 6. Legal Concepts

**Powers of attorney**

- These powers often include:
  - Power to sign documents
  - Power to make purchases
  - Power to dispose of property
  - Power to handle financial affairs
- Types of power of attorney:
  - Specific – only gives very specific powers to the power of attorney
  - General – gives more general discretionary powers to the power of attorney
  - Lasting – replaced enduring powers of attorney in 2007
    - Made when a person is in sound mind for a time when/if they become incapable
    - Registered with the Office of the Public Guardian



## Further information

*Types of lasting power of attorney*

Property and affairs LPA – Gives power over financial affairs
Personal Welfare LPA – Gives power over healthcare, residence etc.

*Revoking a PoA*
A PoA is immediately revoked if:
- The donor loses mental capacity (except lasting PoA)
- The donor dies
- The donor actively revokes the PoA
- The donor becomes bankrupt
- Any time limit specified in the PoA expires

## Keeping on target

In relation to property, which statement is true?

A: Under tenancy in common, all owners have the same interest in the property
B: If a bank account is jointly owned, upon the death of one party the other party would need to liquidate part of the account and transfer it to the estate of the deceased
C: Real property refers to land and buildings
D: Chattels can never be jointly owned

## 6. Legal Concepts

**Insolvency, bankruptcy and individual voluntary arrangements**

- Insolvency:
  - Applies to companies
  - A state of being, in which the company is unable to pay debts
  - Can lead to
    - Bankruptcy
    - Receivership
    - Liquidation
- Bankruptcy:
  - Applies to companies and individuals
  - A process by which assets are liquidated in order to repay some of the debtor's liabilities



# Further information

*Methods of entering bankruptcy*

A *debtor's petition* is where the debtor voluntarily applies to the courts for a bankruptcy order to put his debt problems behind him and begin again.
A *creditor's petition* is where one or more of the individual's creditors apply to the courts for an enforcement order, where the debt is at least £750.
An *individual voluntary arrangement* is an alternative to bankruptcy allowing individuals to make arrangements with creditors without becoming bankrupt – subject to certain rules.

*Bankruptcy:*
Those who cannot be made bankrupt
- Deceased people (though their estate can be 'administered in bankruptcy')
- Minors (theoretically possible, but highly unlikely)
- Mentally incapable (unless the debts were incurred when of sound mind)

A spouse can only be made bankrupt in connection with his/her own separate property

**Answer to the question on the previous slide:**
C: Real property refers to land and buildings

## 6. Legal Concepts

**Wills**

- A will specifies:
  - How you want your assets to be distributed
  - Who you want to be responsible for your children
  - Who you want to benefit from your estate
- Must have capacity to contract
- Executors are granted probate
  - Establish the ownership of the estate before assets are distributed
- National intestacy rules
  - When an individual dies intestate:
    - The national intestacy rules dictate how your assets are to be distributed
    - The courts decide who is to be the guardian of your children



## Further information

National intestacy laws will attempt to distribute to family members, from nearest relatives to the most distant, including:

- Spouse, children and their descendants
- Parents, siblings and their descendants
- Grandparents, parents siblings and descendants, etc

If there are no identifiable heirs the assets are said to be *'bona vacantia',* (ownerless property) and go to the crown, or the Duchies of Lancaster or of Cornwall

## 6. Legal Concepts

**Jargon**

- Trustee
- Beneficiary
- Settlor

**Types of trust**

- Discretionary trust
  - Absolute discretion for trustee to distribute income to beneficiaries
- Interest in possession (life interest trust)
  - Life tenant – income from the trust
  - Remainderman (reversionary interest) – receives capital when life interest ends
- Bare trusts
  - Obeys instructions of beneficiaries
  - Trustee is a nominee only

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## Further information

Typical uses of trusts include:

- Ensuring the financial needs of the settlor's family are provided after death
- Minimising tax burdens on the settlor's estate following death
- Making gifts to people too young or not sensible enough to handle them
- Making gifts of income to one person, whilst reserving capital for another person after the income beneficiary's death
- Qualifying for charitable taxation treatment

## Hints

Charitable trusts benefit from tax advantages, but must be set up for the purpose of charitable deeds. These are defined as the relief of poverty, advancement of religion, the advancement of education or purposes beneficial to the community.

## 6. Legal Concepts

**Trustee Act 2000**

- Dictates what a trustee may invest in in the absence of a specific statement of investment policy
  - Standard investment criteria:
    - The suitability to the trust of an investment
    - The need to diversify investments insofar as it is appropriate to the circumstances of the trust



## Hints

The investment provisions of the Trustee Act 2000 do not apply to occupational pension schemes, authorised unit trusts or certain schemes under the Charities Act 1993.

## 7. Principle-Agent Problem

| | Principal | Agent |
|---|---|---|
| **Companies** | Shareholder | Directors |
| **Investments** | Investor | Adviser or manager |
| **Objectives** | Best return | Salary, fees or commission |

- Solutions to the potential conflict of interests
  - UK Code of Corporate Governance
  - Stewardship code
    - Shareholder activism
  - Retail Distribution Review
  - CFA Code of Professional Practice



## Further information

Implicit costs of agency

- Cost of producing accounts and having them audited
- Short-termism leading to longer-term instability
- Perquisites (Perks) taken by the agents
- Self dealing – appointing third-parties due to self interest
- Expropriation of company assets by agents
- Implementation of regulation to avoid conflict
- Opportunity costs of slow reaction to instructions