Client objectives and advice

1. Introduction

1.1. Chapter overview

Most of the chapters in this manual are all about knowledge, but this one is about application. It is likely that you will be given a short client scenario and asked to make a recommendation. Remember that the clues will be in the case study to guide you to the most suitable recommendation. One of the main clues to watch out for is a client's overall risk tolerance.

The end of this chapter brings in some familiar regulatory knowledge, such as the FCA Principles, complaint handling and the approved persons rules. These regulatory areas tend not to appear that often, with the main exam focus being on the rest of the chapter.

1.2. Learning outcomes

On completion of this module you will:

An adviser's duty to clients

- 5.1.1 - Describe and compare different types of investors
- 5.1.2 - Explain the obligations of a firm towards retail clients
- 5.6.1 - Describe the need for advisers to communicate clearly, assessing and adapting to the differing levels of knowledge and understanding of their clients.
- 3.5.23 - Identify circumstances where own authority or expertise is limited and there is a need to refer to specialists

Assessing the needs of the client

- 5.1.3 - Explain the main need for retail clients and how they are prioritised
- 5.3.1 - Explain the importance of the fact find process in establishing a client's current financial circumstances and requirements
- 5.3.2 - Identify the factors shaping a client's circumstances
- 5.2.1 - Explain the importance of establishing and quantifying a client's objectives
- 5.2.2 - Explain the need to prioritise objectives to accommodate a client's affordability

Establishing an investor's risk tolerance

- 5.4.1 - Analyse the main types of investment risk as they affect investors
- 5.4.3 - Analyse the impact of timescale on a client's attitude to risk
- 5.4.4 - Explain the key methods of determining a client's attitude to risk
- 5.4.2 - Explain the role of diversification in mitigating risk

Advice and recommendations

- 5.5.1 - Explain why asset allocation always comes before investment or product selection
- 5.5.2 - Explain the key roles of charges and the financial stability of the provider as criteria within the fund selection process, and the use of past performance
- 5.5.3 - Explain the importance of stability, independence and standing of trustees, fund custodians and auditors in the fund selection process
- 5.5.4 - Identify benchmarks and other performance measures
- 5.5.5 - Explain the importance of reviews within the financial planning process

Legal concepts

- 4.1.1 - Explain legal persons and power of attorney
- 4.1.2 - Explain basic law of contract and agency
- 4.1.3 - Explain the types of ownership of property
- 4.1.4 - Explain insolvency and bankruptcy
- 4.1.5 - Explain wills and intestacy
- 4.1.6 - Describe the main types of trusts and their uses
- 3.2.10 - Explain the purpose and scope of the Trustees Act 2000: the rights and duties of the parties involved, the nature of the trust deed and the investment powers of trustees

The principle agent problem

- 1.8.1 - Explain how capital markets allow the beneficial ownership, and the control of capital, to be separated
- 1.8.2 - Distinguish between beneficial owners (principals) and the various agents involved in the capital allocation process
- 1.8.3 - Explain how conflict between the interests of agents and principals gives rise to the 'agency' or 'principal-agent' problem
- 1.8.4 - Identify examples of agency costs such as: expropriation, perquisites, self-dealing, and higher cost of capital, which arise when the agency problem is known to exist
- 1.8.5 - Identify the main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole

2. An adviser's duty to clients

2.1. Different types of investor

Investors can be broadly divided in to two categories: individual investors and institutional investors.

Individual investors

Individual investors are typically categorised by financial services firms based on their wealth – in order to better allocate products that are affordable – and their knowledge and experience – in order to meet regulatory requirements.

There is no official categorisation of individual clients, but terms such as retail investor, private client, high net worth client and ultra-high net worth clients are common.

The FCA does identify some distinction in individual clients.

- High net worth individual – Income of over £100,000 per year and/or net assets of at least £250,000
- Sophisticated investor – an individual who has been certified by their financial service provider as understanding the products they are involved in

Institutional investors

These include pension funds, insurance companies, collective investment schemes and investment trust companies.

Regulatory classification of all clients

As we saw in the conduct of business rules, all clients will be categorised into three key areas:

- Retail client – deemed to have least knowledge and experience so offered most protection
- Professional clients – deemed to have knowledge and experience so protection is less than for retail clients
- Eligible counterparties – deemed to have the same knowledge and experience as the firm providing the financial service, so receive the least protection

2.2. Obligation of a firm towards retail clients

Throughout the financial regulations section, emphasis was placed on the protection of retail clients and always acting in the clients' best interests. Key, in respect of financial advice, was suitability:

Suitability

All personal recommendations and all investment management decisions must be suitable to the investor. Suitable means gathering sufficient information to assess the following:

- Does the advice meet the client's objectives?
- Is the client able to afford the financial risks?
- Does the client understand the financial risks?

Also very pertinent to the the protection of the retail clients were the six outcomes of Treating Customers Fairly, which will be repeated here.

Treating customers fairly

The FCA's Treating Customers Fairly (TCF) initiative is intended to reinforce Principle 6 (Customers' interests). It is a core part of the FCA's move to a more principles-based approach to regulation. The TCF initiative aims to introduce a step-change in the behaviour of the financial services sector and to deliver six improved outcomes for consumers.

These outcomes are:

- Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
- Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
- Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
- Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances
- Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect
- Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

The need to refer to specialists

It is unlikely that an adviser will have total knowledge and experience to answer all client questions. When dealing with clients, if a situation arises that goes beyond the adviser's knowledge and experience they will need to refer to specialists in that area. These specialists are likely to come from within the firm, and advisers must take advantage of these specialist sources of information.

3. Assessing the needs of a client

3.1. The fact-find process

Hard facts

A fact find will cover personal information, such as full name(s), date(s) of birth, state of health, marital status, residence and domicile status, national insurance number(s), address, employment details, family details. These are all examples of hard facts.

Soft facts

In addition to hard facts, the fact find process should involve the advisor listening to the client and asking questions to form a better understanding of exactly what the client is trying to achieve. This information can only be collected face-to-face, and by the advisor asking open questions of the client and listening carefully to the replies.

Letter of authority

Many clients will not have the necessary details within their own files, and it is therefore necessary to collect information from relevant third parties. The advisor will need a 'letter of authority' from the client which authorises the third party to release information regarding the client to the advisor.

3.2. Establishing, quantifying and prioritising objectives

We know that the fundamental principal of financial advice is to find out a client's needs and wants and then to match these needs with suitable solutions.

The Investment Policy Statement (IPS) summarises the client's investment needs and wants into clear objectives and details any investment constraints.

Investment objectives and constraints

An IPS is formulated for each client at the start of the advisor/client relationship. It is developed after a thorough fact-find process and summarises the following client requirements:

- 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

Risk and return

In the IPS the advisor will establish the client's required level of return from the portfolio. The client's required rate of return is important as it will heavily influence the recommendation of asset classes for the investor.

The higher the required level of return, the greater the risk needed to be taken.

The greater the risk needed to be taken, the greater the level of volatility of the portfolio.

Generally speaking, the higher the required rate of return, the greater the allocation to equities.

4. Establishing an investor's risk tolerance

4.1. Risks faced by investors

Capital risk

Think for a moment, in which types of investments is your original capital invested at risk of a potential fall in value?

- Equities can fall in value
- Bonds can fall in value – even ones bought below par if they are traded prior to maturity
- Gilts and bonds bought above par will certainly incur a capital loss if held to maturity
- Property can fall in value
- Most alternative assets can also fall in value

Which investments do not have the risk of a capital loss?

- National Savings and Investments products are backed by the UK Government
- UK gilts bought below par and held to maturity

Notice that Bank and Building Society deposits still have some deposit institution risk as illustrated by the Northern Rock crisis. Experience has shown that should a deposit institution get into financial difficulties and lose the confidence of its depositors, both the institution and the depositors may be at risk of capital losses.

Remember, also, that inflation is the invisible risk to cash deposits. If the cash returns are less than inflation, then the real value of the investment is falling over time.

Shortfall risk

Shortfall risk is the risk that the investment return will literally fall short of the amount required for the investor to achieve their objectives.

- Dividends from equities are not guaranteed as they depend on a company making profits and agreeing to pay some of them to shareholders
- Coupons from corporate bonds are also not guaranteed as they depend upon the issuer being able and willing to pay them – often referred to as issuer risk
- Variable rate cash deposits in Building Societies and Banks have income risk – that interest rates fall reducing the amount of interest payable
- Variable rate National Savings & Investments products also have income risk – such as the investment accounts, easy-access savings accounts, income bonds and direct ISAs

It is also worth mentioning that it is the after tax income that is important for many investors.

Inflation risk

As we know, inflation erodes future values unless the investment earns a return in excess of inflation i.e. a real return. Investors who choose cash deposits as their type of medium- to long-term investment are most at risk from the effects of inflation.

- Equities aim to provide a return in excess of inflation, but aiming is no guarantee to do this every year. Markets can of course fall as well as rise and be prone to periods of high volatility in both directions.
- Index-linked gilts do provide some inflation protection.

It is possible for a country to suffer from deflation risk i.e. falling prices. Japan has experienced a period of falling prices which carries the risk that people stop buying goods and services, waiting for prices to fall further. This fall in demand can be very damaging to an economy.

Interest rate risk

Interest rate risk relates to the fact that the bank base rate is likely to change over time and ultimately feed through to the rates of interest paid on deposit accounts. The rate is set by the Monetary Policy Committee (MPC) of the Bank of England. Normally, the rate will be increased during times of inflation, but this is not always the case.

Currency risk

We have talked about currency risks already in this chapter.

Individuals face the risk that their foreign currency investment depreciates relative to sterling when they convert their investment back to pounds.

UK companies that import goods face the risk that the sterling depreciates, making the cost of the imports more expensive.

One way to hedge currency risk is with forward contracts. A forward contract is a type of derivative that can lock in a forward exchange rate in a foreign currency. Should the foreign currency depreciate, a gain will be made on the forward contract which will offset the loss on the foreign asset.

Hedging has a risk itself. ‘Basis risk’ is the risk that the gain from a hedge will not perfectly match the loss of the portfolio.

Operational risk

Whether we invest in deposits, in equities, in bonds, or in property there is the potential for operational risk. Operational risk covers four areas:

- People
- Processes
- Systems
- External events

Mistakes by financial advisors, investment administrators, banks, buildings societies and investment companies do happen. There is the risk that due to such errors an investor is disadvantaged or, in the worst case scenario, is the victim of an investment fraud.

4.2. Ability and willingness to take risk

Introduction

Financial advisors need to consider an investor's ability to take risk, as well as their willingness to take risk in establishing the client's overall risk tolerance.

It is very important to spend time getting this right at the start of the client/advisor relationship so that the most suitable advice can be given.

There are broadly two ways of determining a client's attitude to risk: by examining their existing investments and by asking specific questions.

Ability to take risk

Factors to consider that help to establish a client's ability to take risk are:

- The client's level of existing wealth
- The client's level of liquidity needed from the portfolio
- The client's time horizon
- The client's level of financial flexibility i.e. availability of other sources of income and capital
- The client's spending requirements
- The client's level of existing and future financial commitments
- The client's age and family situation i.e. they may have other urgent financial needs

The expression 'only invest what you can afford to lose' is relevant here.

Willingness to take risk

'What do you want from your investment?' asks a financial advisor. 'What level of risk are you prepared to take?'

As individuals we all have our own opinions as to what we want and what we do not want from our savings and investments, and we have our own understanding of investment risk. The trouble is that many private investors have no real knowledge of modern portfolio theory and are making investment decisions based upon their own perceptions rather than knowledge and experience.

A client's willingness to take risk may be better understood from the following:

- The client's views, feelings and preferences
- The client's answers to a risk and reward questionnaire
- The client's previous investment experience
- Whether the client has taken risks in other areas of life e.g. running a business

Agreeing an overall risk tolerance

Often financial advisors aim to match clients into risk categories such as cautious, balanced or speculative. Alternatively other labels can be used such as 'below average', 'average' and 'above average' as an overall risk tolerance.

If a client's willingness to take risk matches their ability to take risk, then the advisor's job is fairly straightforward. But what if a client has a very high willingness to take risk, but has a low ability to take risk? Alternatively a client may have a very low willingness, but a much higher ability.

It is up to the advisor to educate the client and ensure that the client receives the most suitable investment advice for their circumstances. Ultimately the money belongs to the client and they can choose to accept or reject advice given.

It is often the client's overall risk tolerance that drives the next stage in the process - asset allocation.

4.3. Reducing portfolio risk

Introduction

It is well known that holding many assets in a portfolio reduces the overall portfolio risk compared to holding a small number of risky assets.

A typical equity fund may have 80 or more individual holdings, with some funds having considerably more than this. If a particular company held in the portfolio falls on hard times and profits fall, it is only a small proportion of the overall portfolio. If this company was our only holding this could be disastrous.

We can diversify a portfolio in the following ways:

- Increasing the number of holdings
- Investing in different asset classes e.g. equities, bonds, gilts, property, commodities
- Investing in different industries
- Investing in different countries

Modern portfolio theory allows an investor to combine assets together, aiming to optimise the risk return trade-off i.e. to obtain as high a return as possible for a given level of risk.

Systematic and non-systematic risk

When we hold a diversified portfolio what happens to the levels of systemic and non-systemic risk?

- Diversification vastly reduces the level of non-systemic or specific risk within the portfolio
- Diversification does not take away the systemic risks of a portfolio

Scenario 1

ABC plc is one of 100 equities in a UK equity fund. ABC falls on hard times due to losing two important national contracts and also losing a number of key staff to a competitor. As a result ABC's share price falls.

Notice that the specific risk or non-systemic risk of ABC is much reduced as it is only one of 100 equity holdings. Although the drop in ABC's share price cannot be avoided, the effect on the portfolio is small.

Specific risk includes industry risk, management risk and business risk.

Scenario 2

Imagine if the UK economy began to suffer higher and higher levels of inflation. The Bank of England starts to put up interest rates to aim to keep inflation in check. Many UK firms will be affected by higher borrowing costs, perhaps putting off new projects and making cost cutbacks. The majority of the UK equities (including ABC plc) are affected by this systemic risk of interest rates rising. The impact on the portfolio may be large.

Therefore diversification reduces specific risk, but systematic risks remain.

Systematic risk includes interest rate risk, inflation risk and currency risk.

Correlation and diversification

Correlation describes the extent that two assets move together.

- Positive correlation – assets generally move in the same direction
- Negative correlation – assets generally move in the opposite direction

The lower the correlation between assets in a portfolio the greater are the diversification benefits.

5. Advice and recommendations

5.1. Financial planning process

The financial planning process should ideally adopt the following sequence of steps:

1. Identify and quantify the client's financial objectives
2. Collect data to establish the client's current circumstances
3. Analyse different options to meet any identified shortcomings
4. Prepare a report and arrange a meeting with the client
5. Implement the plan

5.2. The importance of asset allocation

Asset classes

Let's start by looking at the range of asset classes:

- Cash
- Government bonds (UK and international)
- Corporate bonds (UK and international)
- Shares (UK, European, US, Asia and other global)
- Property (UK and international)
- Commodities (international)
- Other alternatives (private equity, hedge funds, antiques, timber etc)

Asset allocation

The key decision for the investor and for the advisor is which asset classes to choose and in what combination. Many academic studies have concluded that asset allocation is the single most important factor in determining returns of an investment portfolio.

The client's IPS will assist with this, providing clear requirements such as:

- The required return
- The specified level of risk
- The required level of liquidity to meet spending

Most retail investors' portfolios are often constructed using a mix of shares and bonds. Alternative investments such as commodities and private equity, although attractive, have traditionally been used by institutional rather than retail investors. There is, however, an increasing interest in alternative asset classes in the investment marketplace.

A spectrum of risk and reward using shares, bonds and cash

Once a client's risk tolerance is established, many companies then tailor a suitable asset allocation to meet the client's objectives using a mix of shares, bonds and cash.

Cash is used to establish an emergency fund for the client and is also a home for short-term planned expenditure. It is essential that the asset allocation takes account of the client's planned and emergency liquidity needs.

The balance of the fund is therefore available for investment according to the client's investment horizon. Changing the mix of shares and bonds can result in a wide spectrum of portfolios that can be suitable for a wide range of clients.

Portfolio managers often use computing power to determine the weights to invest in different assets. The computer program aims to optimise the risk and return relationship i.e. to maximise the return (the mean) and to minimise the risk (the variance). This process is called **mean variance optimisation** (MVO).

5.3. Investing in funds

Retail clients will often choose to hand over the investment decisions to an expert by choosing a collective vehicle to invest in. Examples are unit trusts, investment companies with variable capital and investment trust companies. However, even here there are important considerations, such as:

- Past performance
- Charges
- Stability of the product provider
- Stability and independence of the trustee/custodian

Most of the relevant information can be gained from the fund management group in the form of a Key Features Document (KFD), or, in the case of a UCITS fund, a Key Investor Information Document (KIID).

5.4. Comparing charges

Put yourself in the position of an independent financial advisor (IFA). Assuming two investment funds have a comparable asset mix and comparable performance, how do you choose which is the most suitable fund for your client?

One of the key criterion in making this choice must be to compare the level of and impact of charges in each fund. There are many elements that can impact on charges that could be implicit or explicit.

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

5.5. Impact of borrowing

During a client fact-find, the advisor collects further information about these borrowings to build a more detailed picture of these financial commitments. Typical information collected would be:

- The lender
- The term of the loan
- The repayment method i.e. capital and interest or interest only
- The interest rate and APR
- The monthly repayment
- Check if any early repayment penalties apply – if yes, what level

Many clients do not always consider the cheapest way to borrow and often end up with expensive borrowings, such as high credit card or store card balances charging very high rates of interest. Advisors can assist clients in re-organising borrowings to restructure these kinds of debts and reduce monthly repayments.

Considering repaying or part repaying borrowings

Let's consider the cost of our borrowings for a moment i.e. the interest rates that we pay to the lender. Rates will vary depending upon your credit history, but here is a rough estimate for clients with a clean credit history. Remember also that many lenders also charge fees that have the effect of increasing the APR.

Bank of England base: 0.5% (as at October 2014).

Mortgage rates: 2.5% – 6% (APRs will be higher once we take into account fees).

Unsecured loan rates: 7% – 15%.

Credit cards: 15% – 20%.

Store cards: 20% – 35%.

Consider a client that wants to invest a lump sum but also has some of these borrowings. How should the advisor proceed? Clearly it is quite possible that the return on any investment may be less than the cost of the borrowing. If this is the case the client would be best advised to repay the borrowing.

Other considerations on the repayment of debt

In exploring with the client the option of repaying or part repaying debts, here are some important additional considerations:

- Wanting access to the money in the future – if repayment is made to a mortgage, the client no longer has access to the funds in the future unless they sell the property or raise a new loan

- The client's overall risk tolerance – if the client is not willing to take investment risk then it is likely that repaying debts would be advisable
- Important to avoid paying early repayment penalties
- Useful to firstly repay the debts with the highest rate of interest
- Important for a client to retain sufficient liquid funds for emergencies/unplanned expenditure
- When comparing investment returns with borrowings remember to compare the 'after tax' investment return

To sum up, the advisor and client should explore the option of paying off debt before investing. Where the cost of borrowing is higher than the likely investment return, it is advisable to consider paying off the debt before investing.

5.6. Benchmarks and reviews

Assessing performance

How can we assess the performance of a fund or an investment manager? Investment performance is usually monitored by comparing it to a relevant benchmark.

There are three main ways in which portfolio performance is assessed:

- Comparison with a relevant bond, stock market or custom (composite) index.
- Comparison to similar funds or a relevant sector comparison.
  - Comparable funds should have similar investment objectives and constraints.

Monitoring and review

Financial planning is not a one-off process. In part, this is because of the possibility of change. A client's plans can change because:

- The environment changes, for example, the tax regime or loss of employment
- The client changes their circumstances, needs, wants and aspirations. For example, marriage or divorce, or has a child
- The client changes their attitudes to finance becoming more or less risk-averse

It is also important that people review their investment policy statement (IPS) in order to monitor how well they are sticking to them and how likely the goals are to be achieved.

The adviser should agree early on whether ongoing monitoring and review is going to fall within his remit. If so, the adviser should advise the customer of how frequently he can expect to see an update of the plan and any new recommendations. Periodic reviews to clients should include the up-to-date value of the customer's investments.

The CFA Institute has developed the Global Investment Performance Standards (GIPS). GIPS apply to investment management firms. They are intended to serve existing and prospective clients of investment firms by standardising the format in which performance is communicated to those clients. This enhances comparability.

6. Legal concepts

6.1. Legal terminology

It is useful to start with some legal definitions:

Persons

'Natural person' – is the legal term to describe individuals.

'Legal person' – is the legal term to describe a collection of natural persons who have gathered together to form a single entity for legal purposes. These persons have rights, such as protections and privileges, and responsibilities, such as legal and tax liabilities, under law. They can also shield their members and shareholders from liabilities, such as bankruptcy and other law suits.

'Partnership' – is a business relationship between two or more parties. Note that a partnership does not have a distinct legal entity, meaning that the partners are individually liable for partnership debts.

'Agent' – an agent acts on behalf of the principal. For example, an independent financial advisor (IFA) is the agent of the client.

'Principal' – gives the legal power to be bound by actions of the agent.

Contracts

'A contract' – a contract is made when an offer stating specific terms and conditions is made and unconditional and willing acceptance is agreed. These could be (and generally are) written or verbal.

'A void contract' – means the contract is unenforceable. Reasons for this could be many, including:

- Lack of intention to create a legally binding contract
- Unclear or ambiguous terms and conditions
- No mutual consideration was included, i.e. there was no apparent benefit for one of the parties

'A voidable contract' – means the contract can continue in force until one of the parties bound by the contract declares it void and decides not to be bound by it.

'Discharge of contract' – this is where the terms and conditions agreed within the contract come to an end. This could be due to several reasons:

- Discharge by agreement – where both agree to terminate the contract
- Discharge by performance – where the terms and conditions in the contract have been met in full
- Discharge by frustration – where external events prevent the contract being fulfilled
- Discharge by breach – where one party does not fulfil their side of the agreement. This can lead to legal disputes

Wills

'Wills' – it is important that everyone has a will to ensure that their wishes are carried out in the event of their death. All parents should ensure that their wills specify who should look after their children in the event of their early death. Also unmarried partners will not be entitled to assets unless they are specified in the will of their partner.

‘Testate’ – having a valid will.

'Intestate’ – not having a valid will.

‘Executors’ – act when there is a valid will to obtain the ‘grant of probate’ i.e. organise the estate of the deceased and arrange to pay any inheritance tax due.

‘Administrators’ – act when there is no will or a will that is not valid. Instead of a grant of probate they obtain ‘letters of administration’ and again arrange to pay any inheritance tax due.

‘Letters of administration cum testamento annexo’ – means ‘with the will annexed’ and is needed when a will was left but, owing to a small defect probate, could not be given its full authority.

Property

‘Real property’ – refers to land, buildings and rights over property: hence the term ‘real estate’. Real property can also be thought of as immovable property.

‘Personal property’ – refers to moveable property such as personal possessions.

Personal property is also known as ‘personalty’.

Trusts

‘Trust’ – is a legal arrangement governed by a trust deed. A trust is not a separate legal entity. Trusts are used in IHT planning and to make gifts to people.

‘Settlor’ – monies are settled into a trust by the ‘settlor’, for the benefit of the trust.

‘Beneficiaries’ i.e. those who benefit from the trust's funds.

‘Trustees’ are charged with managing and distributing the fund's assets to the beneficiaries according to the terms of the trust deed.

6.2. Contracts

Capacity to contract

A financial advisor must ensure that each client has the capacity to enter into a binding contract. Capacity to contract is a legal term meaning the client has the power to enter into a binding contract.

Individuals

The law protects certain people from entering into binding contracts when they are deemed unable to make important financial decisions.

Examples of people unable to enter certain contracts are as follows:

- A bankrupt person
- A mentally incapable person
- A drunk person
- A minor (someone under 18)

Note that the Mental Capacity Act 2004, which came into force on 7 April 2005, states that it is possible for a person to be mentally incapable for some purposes but not for others.

Companies

Companies sometimes have defined powers to enter into contracts in their Memorandum and Articles of Association. Alternatively, they can be given very wide powers by the same documents. Counterparties with companies will often require copies of board meeting minutes, giving the power for the company to enter into a binding contract.

6.3. Ownership and title documents

Title documents: background

A **document of title** is evidence that an investor has legal ownership of an asset, e.g. land, real estate or financial securities.

The title document may be held in different forms, as described below.

Registered

A registered document is one whose ownership is recorded on a central register.

This is the case for cars, real estate and most securities, where the asset is registered in the owner's name. Registration denotes **legal** ownership.

The Driver and Vehicle Licensing Agency (DVLA) record the registered owner of cars, the Land Registry registers real property and a company maintains a register of shareholders.

Bearer

Bearer instruments are **anonymous** and freely transferable. They do not show the owner's name, no register is maintained of legal title and proof of title is in physical possession.

Most bearer instruments have intrinsic value of their own; for example, gold or diamonds. However, there are many bearer documents in the financial world, such as eurobonds, depositary receipts and bank notes.

Although bearer instruments are not registered in the name of the legal owners, they are typically registered in the name of the issuer: a five pound note, for example, is registered in the name of the Bank of England. Even items like gold and diamonds come with a stamp or certificate of authenticity.

Nominee accounts

Traditionally, investments are registered in the name of the investor and the investor's name appears in the register of members. However, to reduce the burden of administering these, it has become increasingly common for investments to be held in the name of a **nominee company**.

With shares held in this way, the nominee appears on the register of members as the **legal** owner. However, the investor retains **beneficial/equitable** ownership, and it is the beneficial owner who receives the rights in relation to a share (e.g. voting and dividends).

We will see this split between legal and beneficial ownership many times. With collective investment schemes we see the trustee as the legal owner of assets, but the unit holders as the beneficial owners. We will see it again later in the section on a more personal level when discussing trusts.

Joint ownership

It is important to realise that, in law, assets can be held jointly in two legal ways:

- Joint tenancy
- Tenants in common

Each method has a different legal implication on death of one of the joint owners.

Here is what happens on death for each legal method of joint ownership:

Joint tenants

Imagine a jointly held deposit account held on a joint tenancy basis. On death of one of the joint holders, the deceased person's interest in the account automatically passes to the survivor.

This means that the survivor now owns all the proceeds of the account.

Most joint accounts are automatically set up on a joint tenancy basis unless specifically changed. Inheritance tax planning often involves changing the ownership basis to tenants in common.

Tenants in common

Using the same scenario, let's now assume that the joint account is held in a tenants in common basis. This time, on death, the deceased person's interest does not go to the survivor but instead goes to their estate and is distributed according to their will.

6.4. Powers of attorney

A power of attorney is where a donor gives powers to a donee to act on their behalf. It must be signed by deed and in the presence of two witnesses.

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 POA.

General – gives more general discretionary powers to the POA.

Lasting – replaced enduring powers of attorney in 2007, implementing changes outlined in the Mental Capacity Act 2005.

A lasting power of attorney (LPA) is made by a person in sound mind to appoint an attorney to handle their affairs if and when they become incapable of making their own decisions. Notice that this must be made in advance, when the donor is in sound mind, and must be registered with the Office of Public Guardian to be effective.

A difference between an enduring power of attorney and the new lasting power of attorney is that a lasting power of attorney has wider powers to make not only financial decisions (property and affairs LPA) but also decisions concerning the donor's personal welfare (personal welfare LDA).

A power of attorney can be revoked in the following circumstances:

- The donor dies
- The donor revokes the POA
- The donor becomes bankrupt

6.5. Insolvency, bankruptcy and individual voluntary arrangements

Insolvency

Insolvency relates to companies and is the term used when a company cannot pay its debts. We often talk about the solvency of a company being the excess of its assets over its liabilities. If a company is insolvent it has more liabilities than assets i.e. it owes more than it owns.

When a company is insolvent there are a number of alternative approaches:

- **Liquidation** – the courts rule the company should be wound up; its assets sold and creditors paid back
- **Company voluntary arrangement (CVA)** – a formal agreement to make repayments is established by the court
- **Informal arrangement** – as above, but in an informal context i.e. not via the court
- **Administration** – the courts grant an order to give a company some temporary breathing space i.e. protection from creditors until a plan can be put in place

Bankruptcy

Bankruptcy relates to companies and individuals as defined in the Insolvency Act 1986. Bankruptcy applies when a person is unable to pay their debts when they fall due and is unable to pay them in the near future. The minimum level of debts involved is £750.00.

Bankruptcy is intended to be a fair process to distribute whatever assets the individual has to their creditors. This process will be administered by the official receiver.

Not everyone can be made bankrupt. Here are some examples:

- A deceased person
- An infant
- A spouse of a bankrupt person is treated as a separate individual, meaning the creditors have no claim over their assets

Individual voluntary arrangement

An individual voluntary arrangement is a less expensive alternative to bankruptcy for individuals. The debtor will formally agree a repayment plan with creditors.

6.6. Wills

Having a will is very important as it:

- Specifies how you want your assets to be distributed
- Specifies who you want to be responsible for your children
- Specifies who you want to benefit from your estate

The will must be:

- In writing
- Willingly made
- By a person of mental capacity
- By a person over 18 years of age
- The person must not have made it as a result of pressure from someone else
- Signed and witnessed

Terminology

The terminology is very important in this area:

- Died **testate** – having a valid will
- Died **intestate** – not having a valid will or not having a will at all
- **Executors** – carry out the terms of the will and obtain the ‘grant of probate’. Probate is the agreement from the tax authorities to release the estate to the beneficiaries. Probate is only granted once any IHT that is due has been paid
- **Administrators** – carry out the administration when there is no will. They have the same role as executors but rather than obtain a grant of probate they obtain letters of administration
- **Letters of Administration** Cum Testamento Annexo (with the will annexed) – a will is left, but due to a small defect it is not valid. The deceased is considered intestate, so administrators will be appointed by the courts to distribute the assets. However, the invalid will is annexed to the letter of administration for reference.

In the event that an individual has died intestate (without a valid will) the National Intestacy Rules apply. These rules dictate how the deceased person's estate is to be divided up.

Deeds of variation

Some wills are not very inheritance tax efficient. Deeds of variation can change the will of a deceased person to save the family thousands of pounds in inheritance tax.

This can only be done if all the family members who would have benefited agree, and if there is no financial consideration involved. A deed of variation must be completed within two years of death.

The deed must be signed by all parties, who must be over 18 and of sound mind.

National intestacy rules

An important part of inheritance tax planning is making sure a client has a valid will. Not having a will can cause many problems:

- The National Intestacy Rules rather than you dictate how your assets are to be distributed
- The courts rather than you decide who is to be the guardian of your children

This clearly causes delays in distribution of assets and uncertainty for family members.

- The rules date back to the Administration of Estates Act 1925 and so many of the figures specified may seem low in today's terms. There are two main variations, depending upon whether the deceased left a spouse or not

6.7. Trusts

Introduction

A trust is a way of holding or managing money or investments on behalf of a beneficiary who may not be ready or old enough to do it themselves.

For example, if a parent wishes to ensure that their child receives certain investments should that parent die, they could place those investments in trust until the child is old enough to benefit fully from those assets. If the parent dies, then the investments would be held in trust by a trustee who would manage the investments until the child reaches a specified age. Once the child reaches a specified age, the investments would pass into their possession.

The terms of this agreement would be set out in a legal document called a trust deed.

Terminology

There are various terms necessary to understand when considering trusts.

Trustees

Trustees are the 'legal owners' of the trust property and must deal with it in the way set out in the trust deed - the legal document setting out how the trust property is managed. They also deal with the trust administration. There can be one or more trustees.

Settlor

The settlor creates the trust and puts property into it at the start - in our example this would be the parent - possibly adding more later. The settlor says in the trust deed how the trust's property and income should be used.

Beneficiary

This is anyone who benefits from the trust - in our example this would be the child. The trust deed may name the beneficiaries individually or define a class of beneficiary, such as the settlor's family. The beneficiaries are the 'beneficial owners' of the investments.

Trust property

This is the property that is put into the trust by the settlor. It can be anything, including land, property, securities, cash, antiques, etc.

Types of trust

Discretionary trusts

These trusts give the trustees the right to distribute the trust property - both capital and income - to the beneficiaries as they see fit. It gives the trustee the flexibility to respond to unforeseen events when considering the distribution of the property.

Interest in possession (life interest)

In this kind of trust the beneficiaries have the legal right to all the income of the property, but not to the property itself. They are said to have interest in possession. After a specified event, such as the death of the beneficiaries, the asset will pass to the reversionary interest or remainderman.

An example of this would be where a settlor leaves the income from investments to their spouse, but the investments to their children once the spouse dies.

Bare trusts

This is where the trustee takes on a nominee role only for the beneficiaries. Although the trustee holds and manages the investments, the beneficiaries are at liberty to take the trust property - both capital and income - from the trust at any time.

Charitable trust

Charities may be established either as legal trusts or as companies (usually limited by guarantee). If a trust, a settlor sets up a trust for charitable deeds. The trustees become responsible for the distribution and investment of the assets.

Charities enjoy a wide range of tax benefits; they do not pay capital gains tax, income tax, inheritance tax or stamp duty. However, they can be liable for value added tax (VAT) on purchases.

In the UK, the Charity Commission, together with the Charity Acts of 1992 and 1993, provide the regulatory structure in which charities operate.

Charities will typically seek investments that give real capital protection and supply income to spend on charitable causes. They are much more likely to be buy and hold investors, than traders. Suitable investments are likely to be income generating shares and property that can be rented or leased out.

6.8. Trustee Act 2000

A trust is a legal arrangement whereby the creator of the trust, known as the 'settlor', puts aside property in the form of cash, real estate etc. for the benefit of others, known as 'beneficiaries'.

The settlor appoints a trustee to act as **legal owner** of the assets while the assets are held 'in trust'.

The trust deed, also known as the trust indenture, specifies trustees' permitted powers of investment.

If the trust deed does not clarify the position, trustees are governed by the Trustee Act 2000.

Under the Trustee Act:

- Trustees have a statutory duty of care in selecting investments
- Trustees are expected to act with a degree of skill and care which is appropriate to their knowledge, experience and professional status. They should take proper advice where appropriate

- Trustees may, subject to these duties, exercise their powers of investment over the same range of investments as they would if they were the beneficial owner of the investments within the trust

Under the act, trustees are given two main powers of investment:

- The general powers of investments: this allows the trust to invest in most types of assets (including shares and bonds) except land
- The specific power to invest in freehold and leasehold land in the UK

Note that the investment powers of trustees as defined by the Act do not apply to:

- Life insurance companies
- Occupational pension funds
- Authorised unit trusts

7. The Principal-agent Problem: Separation of Ownership and Control

7.1. Introduction

We see the separation of ownership and control in many situations. In the financial markets, there are two key areas where this could occur:

- The shareholders of a company (**principal**) and the management of the company (**agent**)
- An investor (**principal**) and a financial firm, such as an adviser or wealth manager (**agent**)

In government, there is also a separation of this sort between the voters (**principals**) and the politicians (**agents**).

7.2. The principal-agent problem

In all of the examples given, the separation of ownership and control can cause a conflict through the division of interests, referred to as the principal-agent (or agency) problem.

- The principal wants to achieve the best overall return from their ownership. This return may be a profitable company, a portfolio that meets specified objectives or a society that allows for a long, happy, productive life
- The agent wants to achieve the most from the agency. Their return may be the salary they are paid, the commissions they generate or the plaudits they receive from policy decisions

These interests are not necessarily aligned, and could be in direct conflict with each other: higher salaries for managers reduce the returns available to the shareholders; higher commissions for advisers can lead to unsuitable recommendations for the investor; policy decisions by politicians could simply be vanity projects that do not benefit society.

Agency costs

Employing an agent to act on behalf of a principal will clearly add an additional layer of cost. However, in addition to the obvious costs, there can be other costs if an agency problem exists.

Explicit costs include:

- Managers are paid a salary for managing a company. If managers' remuneration is disproportionate to their contribution, this depletes the company profits
- Some advisers charge a fee for their advice, giving the investor a clear picture of the cost. Some product providers offer advisers commissions taken from the investor's contributions. The latter can lead to commission bias, where advisers recommend products that do not meet the investor's objectives but pay a large commission

Implicit costs include:

- The cost of producing company accounts to identify the fundamentals of the company
- The need to have financial statements audited by an independent body
- Losses incurred through projects that generate high short-term returns at the expense of long-term stability

- **Perquisites** (perks), such as healthcare, company cars, etc., used as incentives for managers are also a drain on the profits of the company
- Losses incurred through **self-dealing**, for example, managers appointing an uncompetitive contractor because they own a beneficial interest in that contractor
- **Expropriation** of company assets for personal use, such as using company vehicles or labour-force
- The cost of implementing and enforcing regulations for the financial services
- The opportunity cost of slow actions of agents
- The cost of not meeting objectives

All of these increase the costs and reduce the return owed to the beneficial owners.

7.3. Reduction of the agency problem

Companies

From a company perspective, the **Combined Code** and more recently the **Stewardship Code** have highlighted major issues caused by the agency problem and suggested ways of reducing them.

The recommendations range from assessing the remuneration of the managers in the Combined Code, often linking remuneration to the long-term profits of the company by rewarding managers with shares or options on the shares of the company they manage. This aligns the interests of the managers with those of the shareholders. The code suggests that companies appoint executive and non-executive directors that are appropriate to the business. The Stewardship Code advocates active participation of all shareholders (**shareholder activism**), particularly those large institutional shareholders that often passively hold large proportions of a company's shares.

Many exchanges, such as the London Stock Exchange, insist that companies trading on their markets comply with the codes or explain non-compliance.

Financial services

From a financial services perspective, the conduct of business rules govern how the agents should behave. This focuses on the client's best interests and the need to act honestly, fairly and professionally. More recently, there has been the implementation of the Retail Distribution Review, which prohibited the provision of product provider commission and enforced the need for advisers to subscribe to an established code of conduct, such as the CFA Standards of Professional Practice.

How reducing the agency problem can benefit the investment profession and society

Reducing the agency problem increases the trust in the companies, and the financial firms that give people access to those companies. This trust makes the people more willing to invest, allowing those companies access to more capital at a cheaper cost, thus increasing returns. Where there is an alignment of interests between the principal and agent, the cheaper capital can be used more efficiently and effectively, increasing returns further. If shareholders become more actively involved in the decision-making of the company at general meetings, the beneficial owners become more involved in the controlling of the company. This reduces the need for external controls and the cost incurred through their implementation.

8. Summary

8.1. Key concepts

An adviser's duty to clients

- 5.1.4 - Different types of investors
- 5.1.5 - The obligations of a firm towards retail clients
- 5.6.1 - The need for advisers to communicate clearly, assessing and adapting to the differing levels of knowledge and understanding of their clients.
- 3.5.23 - Circumstances where own authority or expertise is limited and there is a need to refer to specialists

Assessing the needs of the client

- 5.1.6 - The main need for retail clients and how they are prioritised
- 5.3.1 - The importance of the fact find process in establishing a client's current financial circumstances and requirements
- 5.3.2 - The factors shaping a client's circumstances
- 5.2.3 - The importance of establishing and quantifying a client's objectives
- 5.2.4 - The need to prioritise objectives to accommodate a client's affordability

Establishing an investor's risk tolerance

- 5.4.1 - The main types of investment risk as they affect investors
- 5.4.3 - The impact of timescale on a client's attitude to risk
- 5.4.4 - The key methods of determining a client's attitude to risk
- 5.4.2 - The role of diversification in mitigating risk

Advice and recommendations

- 5.5.1 - Why asset allocation always comes before investment or product selection
- 5.5.2 - The key roles of charges and the financial stability of the provider as criteria within the fund selection process, and the use of past performance
- 5.5.3 - The importance of stability, independence and standing of trustees, fund custodians and auditors in the fund selection process
- 5.5.4 - Benchmarks and other performance measures
- 5.5.5 - The importance of reviews within the financial planning process

Legal concepts

- 4.1.1 - Legal persons and power of attorney

- 4.1.2 - Basic law of contract and agency
- 4.1.5 - The types of ownership of property
- 4.1.6 - Insolvency and bankruptcy
- 4.1.5 - Wills and intestacy
- 4.1.6 - The main types of trusts and their uses
- 3.2.10 - The purpose and scope of the Trustees Act 2000: the rights and duties of the parties involved, the nature of the trust deed and the investment powers of trustees

The principle agent problem

- 1.8.1 - How capital markets allow the beneficial ownership, and the control of capital, to be separated
- 1.8.2 - Beneficial owners (principals) and the various agents involved in the capital allocation process
- 1.8.3 - How conflict between the interests of agents and principals gives rise to the 'agency' or 'principal-agent' problem
- 1.8.4 - Agency costs such as: expropriation, perquisites, self-dealing, and higher cost of capital, which arise when the agency problem is known to exist
- 1.8.5 - The main reasons why it is argued that reducing the agency problem benefits the investment profession and society as a whole