Unit 12: Investment Process

https://quizlet.com/gb/901750722/unit-12-investment-process-flash-cards/?i=24ef59&x=1qqt

Five factors in Client Agreement

1. Advice v Discretionary
2. Remuneration
3. Duration
4. Review frequency
5. CIVIC?

Advice Agreement: What is it/ who does it suit.

Needs client approval prior to transaction.

More knowledgeable clients who have an opinion on investments.

Discretionary Agreement

Can do transaction within certain limits without prior approval.

Less knowledgeable/ opinionated clients or time poor.

Advice v Discretionary Agreement: Which has higher costs?

Discretionary

Ongoing fee must have an…

Ongoing service.

Review/ Report etc.

Hard Facts

Age, income - closed questions.

Soft Facts

Aims, goals, onions : open-ended questions.

Attitude to Risk – Key points

General attitude/ thoughts.

Subjective and can change over time.

Tolerance to Risk

Physiological ability to cope with losing money.

*‘How much of a shortfall could you withstand?’*

Tolerance to Risk: When does this vary?

Type of investment: Capital growth/ Income.

Source of funds: Windfall vs Life savings.

Capacity for Loss

Objective measure.

How much they could afford to lose without having a material impact on day to day life.

Capital Preservation: Real terms or absolute.

Could be in real terms or no capital loss at all.

Capital Appreciation

Long term real terms growth.

Growth assets.

Current income: What type of assets?

High dividend firms.

Bonds

Annuity.

Total Return Strategy: What is it?

Balanced return from capital and income.

Income re-invested- accumulation units.

Pound Cost Averaging

Prevents risk of investing a lump sum then value dropping.

Pound Cost Averaging: When does this work?

Regular contributions into fund that moves with market.

Pound Cost Averaging: When doesn’t work?

Cash investments – no capital risk.

If prices are increasing: fewer shares are bought.

Sequencing Risk/ Pound Cost Ravaging

Taking money from fund when market takes a dip.

Have to sell more units to get same amount.

If less than 5 years to investment goal?

Cash better option.

No time to recover investment losses/ fluctuations.

Positive screening

Fund managers pick firms that’s actively do good.

Renewables etc.

Positive v Negative screening: Which is easier to achieve?

Negative screening takes more research.

Some firms may appear good but actually not.

Light Green Funds

Ethical focus but may still invest in some ‘bad’ industries.

Positive screening.

Focused Green Funds

Focus on a few areas: Climate change, health etc.

‘Sin Stocks’

Alcohol, tobacco, firearms.

Dark Green Funds

ESG is core of investment strategy.

Use negative screening to exclude firms that don’t meet set standards.

Sometimes exclude sovereign bonds.

Sharia Funds

Negative Screening: booze, pork, weapons.

Impact Investing

Positive outcomes most important.

Slightly different to ESG/ +- Screening.

ESG: Social Factors

Human rights.

Employee & community relations.

ESG: Governance Factors

Quality of MGMT

Board independence

Transparency

ESG vs +- Screening.

ESG boarder approach.

Incorporates into investment decisions/ not just a filter.

‘Life-styling’ Funds

Funds ‘de-risk’ 5-10 years before retirement.

Target Date Funds

Form of de-risking.

More active MGMT- asset allocation not automictically switched.

Two Asset Allocation Approaches

Theoretical and Pragmatic

Theoretical Asset Allocation

Based on Modern Portfolio Theory (MPT)

Mathematical approach: Efficient Frontier Graph etc.

Negatively correlated assets.

Theoretical Asset Allocation: Pros/Cons

In theory, should optimise portfolio.

However, often only works in ‘lab conditions’.

Pragmatic Asset Allocation

Uses past data on returns to make future projections.

Pragmatic Asset Allocation: Pros/Cons

Returns/ Volatility should average out over time.

Unconscious bias: can use favoured assets.

Strategic Asset Allocation

Keep % allocation the same over time.

Long term view.

Strategic Asset Allocation: When would you amend this?

Client goals change dramatically.

Exceptional market circumstances.

Tactical Asset Allocation

More active MGMT: change % allocation to exploit opportunities.

Allocation will have ranges rather than set amount. e.g. Equities 50-70%.

Tactical Asset Allocation: Pros/Cons

Potential for more growth.

Requires active MGMT- Higher fees

More trading costs

Stochastic Model: What are they?

Predicts future outcomes using set of assumptions/ randomness.

Stochastic Model Pros

Visual

Adaptable

Stochastic Model Cons

Only Projections.

Reliant on assumptions.

Use past data.

Cash Flow Forecast: Pros

Good visual aid for clients.

Can forecast accumulation/ decumulation phases.

Cash Flow Forecast: Cons

Often based on unrealistic steady returns.

Assumption based.

Top Down Management

1. Asset Allocation: Stocks, Bonds.
2. Sector Weightings: Tech, Retail
3. Specific Stocks

Top Down Management: Pros

Looks at macro-economic situation first.

Sector weightings should factor in geographical spread due to higher correlation in global markets.

Bottom Up Management

1. Specific Stocks
2. Sector Weightings
3. Asset Allocation

Bottom Up Management: Pros

Looks at fundamentals of company first to see if worth investing in.

Value Investing

Buy and hold.

Stocks where price lower than intrinsic value.

GAARP Meaning

Growth at a Reasonable Price.

GAARP Pros

Provides a middle ground.

Value stocks can be static.

Growth Stocks can be volatile.

Momentum Investing

Move to ‘hot sector’.

Sector rotation.

Reliant on good timing.

Contrarian Investing

Going against market trends.

Buy when others sell and vice versa.

Active Funds

Try to beat the market – ‘Alpha returns’.

Active Funds: Pros/ Cons

Can be tailored to individual investor.

Higher costs/ higher risk.

Passive Funds: Full v Partial Replicator

Full: All components are purchased. (Less tracking error)

Partial: Stratified Sample of companies.

Tracking Error

Discrepancy between the passive funds returns and underlying investment.

Core/Satellite MGMT

Core of passive funds with

Specialised active MGMT in specialist areas- emerging markets etc.

How to measure financial strength of investment bonds?

Free Asset Ratio.

Discrete v Cumulative Returns

Discrete: Set time period- quarter, year.

Cumulative: Total return over length of investment.

Discrete v Cumulative Returns: If looking to measure consistency?

Discrete

Ongoing Charges Figure (OCF): Components

Annual Management charge (AMC) + Ancillary Ongoing Costs

What is excluded from OCF?

Start/ Exit Fees

Fund switching

Dealing Costs

Performance Fees

Portfolio Turnover Ratio (PTR)

Dealing Costs.

Total Cost of Ownership (TCO)

OCF + PTR + Performance Fees + External Costs

Excess Return

Actual Return – Performance Fee Threshold.

Performance fee will be set amount of excess.

Calculating Performance Fees

Subtract Initial Charge from OG amount.

Performance Fee x Excess Amount

Periodic Portfolio Reporting

At least every 3 months.

Measure performance with a benchmark.

What must FA confirm if there is an ongoing charge?

Service provided.

Charge details.

How can cancel service.

Why do we need to regularly review advice?

1. Client circumstances
2. Market circumstances
3. Regulation/ Tax changes
4. New products

Investment Policy Statement

Outlines an individual’s goals, risk tolerance, strategies.

Must remain up to date.

Investment Policy Statement: When would update?

Marriage/ divorce

Inheritance

Child

Job change/ retirement.

Rebalancing Portfolio

Realigning asset allocation to initial goals > diversification.

Different assets grow at different speeds.

Rebalancing Portfolio: How often?

No official rules.

Mostly annually.

Rebalancing Portfolio: Tax?

May be CGT liability if have to sell assets.