



Chapter 7 – Investment Advice

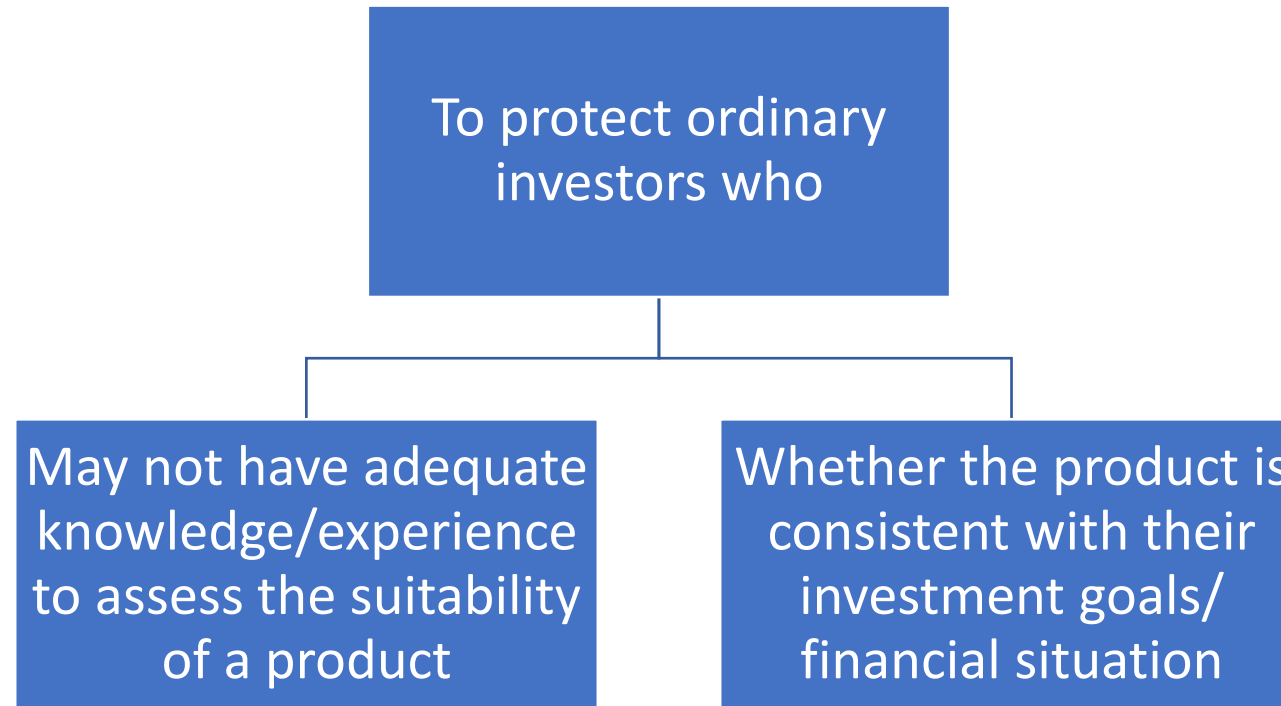
21 Questions



Investment Advice



Client Categorization



Also allows for different rules and approaches for experienced investors who are not in need of such protections



Client Categorization – Country Wise



- Regulations divide clients into two categories: wholesale and retail. Retail clients are the default, while wholesale clients have certain requirements to meet.
- Compliance obligations are less strict for wholesale clients compared to retail clients.
- Retail clients are protected by the Future of Financial Advice (FOFA) reforms, while wholesale clients have access to more investment options but no consumer protections.



Markets in Financial Instruments Directive (MiFID) require clients to be categorized as:

- A retail client – not professional/eligible counterparty and receive the most client protections.
- Professional client – institutions or large entities with sufficient expertise and can opt up to be treated as such but lose regulatory protections for retail clients.
- Eligible counterparties – these are other investment firms that a firm deals with when undertaking activities such as trading and so need the least regulatory protection.



In the United Arab Emirates (UAE), licensed firms are required to classify clients as:

- Professional investors, e.g., regulated financial institutions, listed companies, single family offices or large undertakings.
- Professional investors (assessed), e.g., individuals, special purpose vehicles (SPVs), trusts and other legal entities who meet certain criteria.
- Professional investors (service based).



- Regulations distinguish between two categories – retail and institutional investors.
- Retail investor = individuals
- Institutional investors are large institutions such as investment firms, mutual funds and pension funds.



Client Categorisation



Client's Best Interest

Act in the utmost good faith for the client.

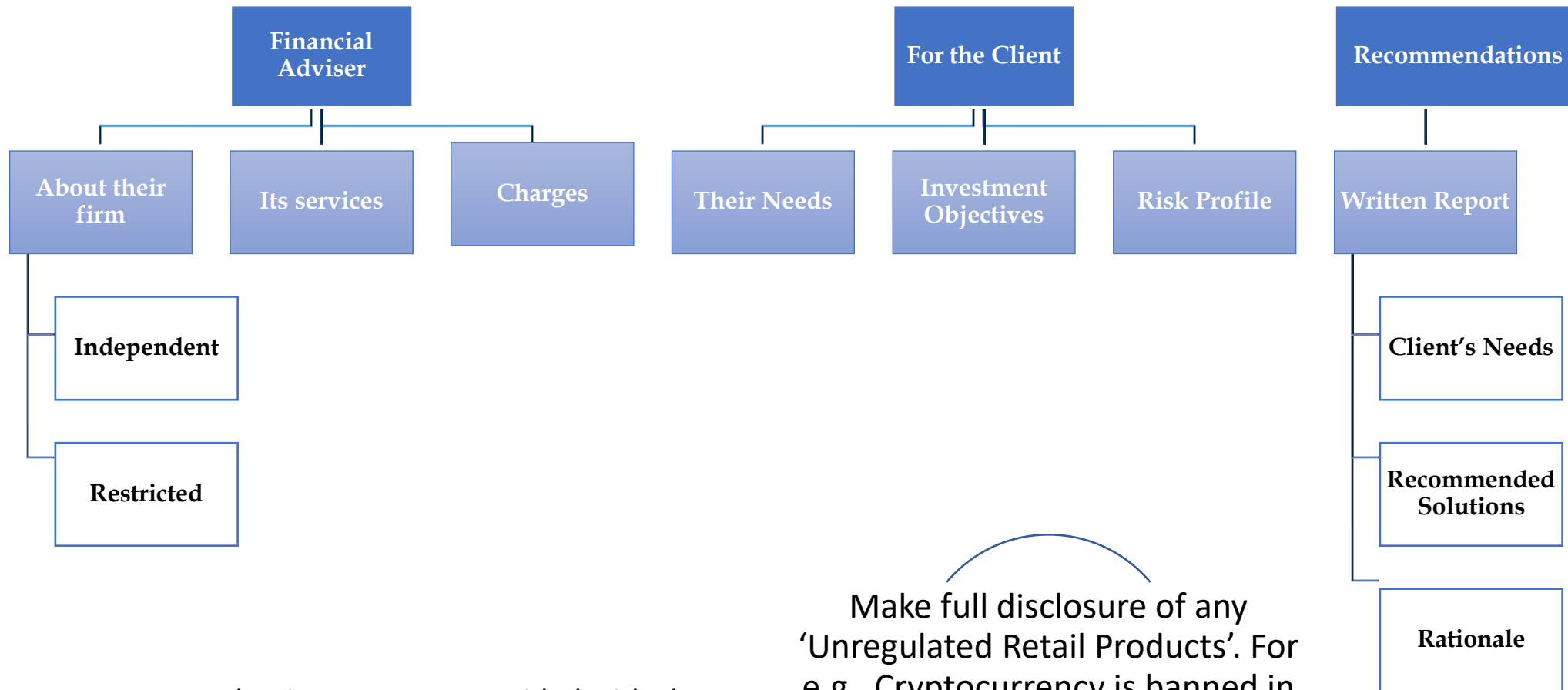
Not make a profit from the trust placed in them.

Not place themselves in a position where their own interests conflict with their duty to the client.

Refrain from misusing confidential information for their own advantage or the benefit of a third person without the fully informed consent of the principal.



Disclosure of Material Information



Make full disclosure of any 'Unregulated Retail Products'. For e.g., Cryptocurrency is banned in certain countries

Regulatory Principle

Ensure that investors are provided with clear information about financial products and services so that they can make an informed decision as to whether the product or service is suitable for them



Factors to Consider When Providing Financial Advice - KYC

The adviser must 'know' the client before being able to provide appropriate advice. Indeed, regulators make this an essential requirement in many countries – the 'know your customer' (KYC) process.



This is done through the process of 'fact-find'.



The fact find is crucial to the investment advice process and many firms use electronic ways of collecting client information and risk attitude to improve the quality and consistency of the firm's advice process.



Purpose

- Gather sufficient information about a client so that financial plans can be devised and appropriate recommendations can be made

Information needed

- Personal details
- Financial details
- Objectives
- Risk tolerance
- Liquidity and time horizons
- Tax status
- Investment preference

Relevance

- Assess appropriateness and suitability



Exercise – Client Information Needed

Information Needed	Why Needed?
Personal details – name, address, age	
Health status	
Details of family and dependents	
Details of their occupation, earnings and other income sources	
Estimates of their present and anticipated outgoings	
Assets and liabilities	
Any pension arrangements	
Any other protection policies	
Potential inheritances and any estate planning arrangements	



Financial Advisory and Discretionary Management

Discretionary Management Service

The client gives discretion to the investment firm to manage their investments.

Investment manager manages and makes changes to the portfolio without referring to the client, but within the constraints of the client's objectives/strategy.

Fund Portfolios

Managed Portfolios

'Bespoke' Portfolios

Advisory Management Service

Clients who do not want to give up decision making and want to remain actively involved in their portfolio's management.

Investment manager suggests changes to a client's portfolio and gives reasons for the changes. The client then decides whether to accept or reject the advice

Execution Only – No advice is given, and the firm simply undertakes the transaction.



Wealth Management Charges

Types of Charges

An initial charge for investment in the product or fund based on a percentage of the amount invested.

Ongoing charges for managing the underlying investment portfolio along with the costs that arise from trading and administering the portfolio.

Performance fees may arise based on the investment performance of the fund.

Exit charges - payable for certain funds or where an early exit from an investment product is permitted.

These are normally paid from within the investment itself.

Fee Disclosure

The total price to be paid including all related fees, commissions, charges and expenses, and any taxes payable via the firm.

If these cannot be indicated at the time, the basis on which they will be calculated so that the client can verify them.

The commissions charged should be itemized separately

If any costs or charges are payable in a foreign currency, what the currency is and the conversion rates and costs

If other costs and taxes not imposed by the firm could be payable, how they will be paid or levied



Conflicts of Interest

Definition

- Where someone in a fiduciary position has personal or professional interests that compete with their duty act in the client's best interest

Examples

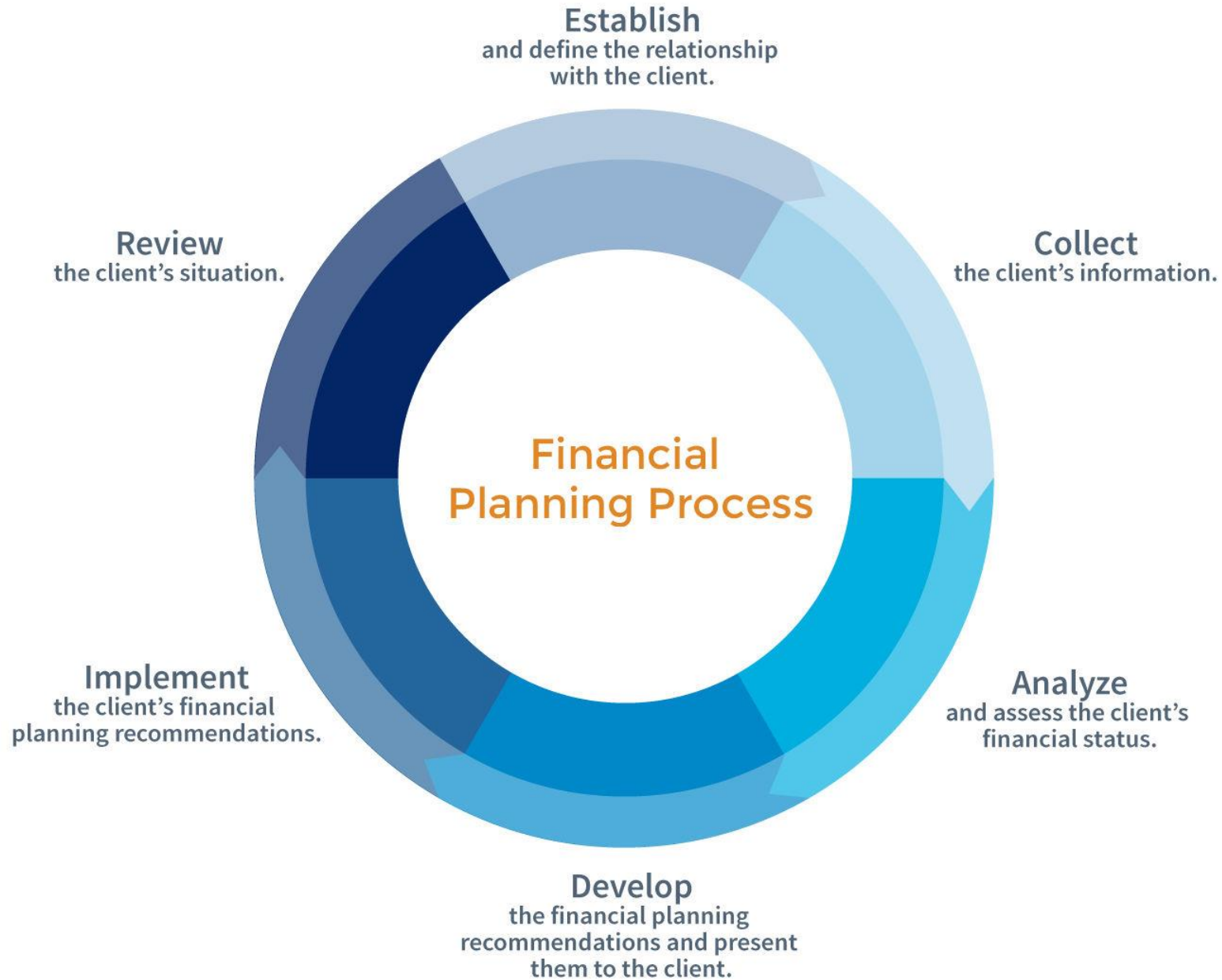
- Recommending products with higher commission rates
- Front running

How managed

- Remove the potential for conflict
- Disclosure
- Customer order priority; personal account dealing rules
- Declining to act
- Compliance policies and checks



Defined by the Financial Planning Standards Board



Determining Client Needs

Establishing Client Relationships

- Identifying the needs of the client, determine whether its in the range of the firm's services and whether the adviser has the skills
- Explain the services the firm can offer
- Determine whether the firm needs lawyers or tax experts

Fact Find

- Gathering personal and financial information of the client
- The fact-find process will need to go beyond just hard facts and elicit views
- Opinions from the client which will allow the adviser to assess the level of risk they are comfortable with and the extent to which family values will affect investment decisions.



Client's Goals and Objectives

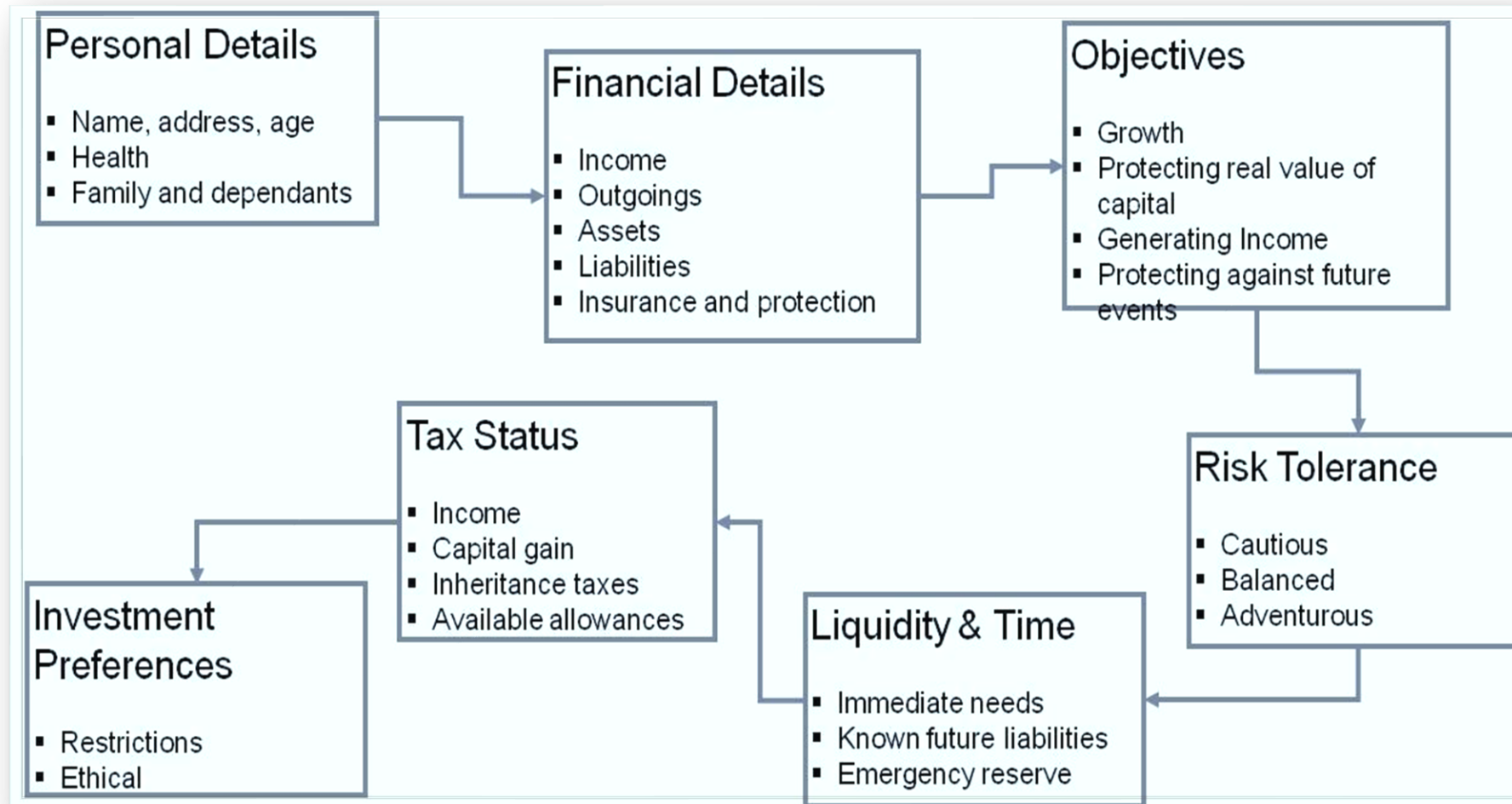
Agreeing the client's investment and financial objectives and identifying any constraints

Collecting the quantitative and qualitative data needed.

Establishing the clients risk profile



Factors Influencing Client Needs



Personal Details

- Name and address
- Date and place of birth
- Residency status
- Domicile
- Tax ID numbers

Health Status

- Health concerns
- Potential longevity



Family, Occupation and Income Details

Family and Dependants

- Details of spouse or partner
- Spouse's assets and tax status
- Previous marriages
- Details of children

Occupation, Earnings and Other Income Sources

- Business or occupation
- Role
- Business plans
- Income
- Benefits



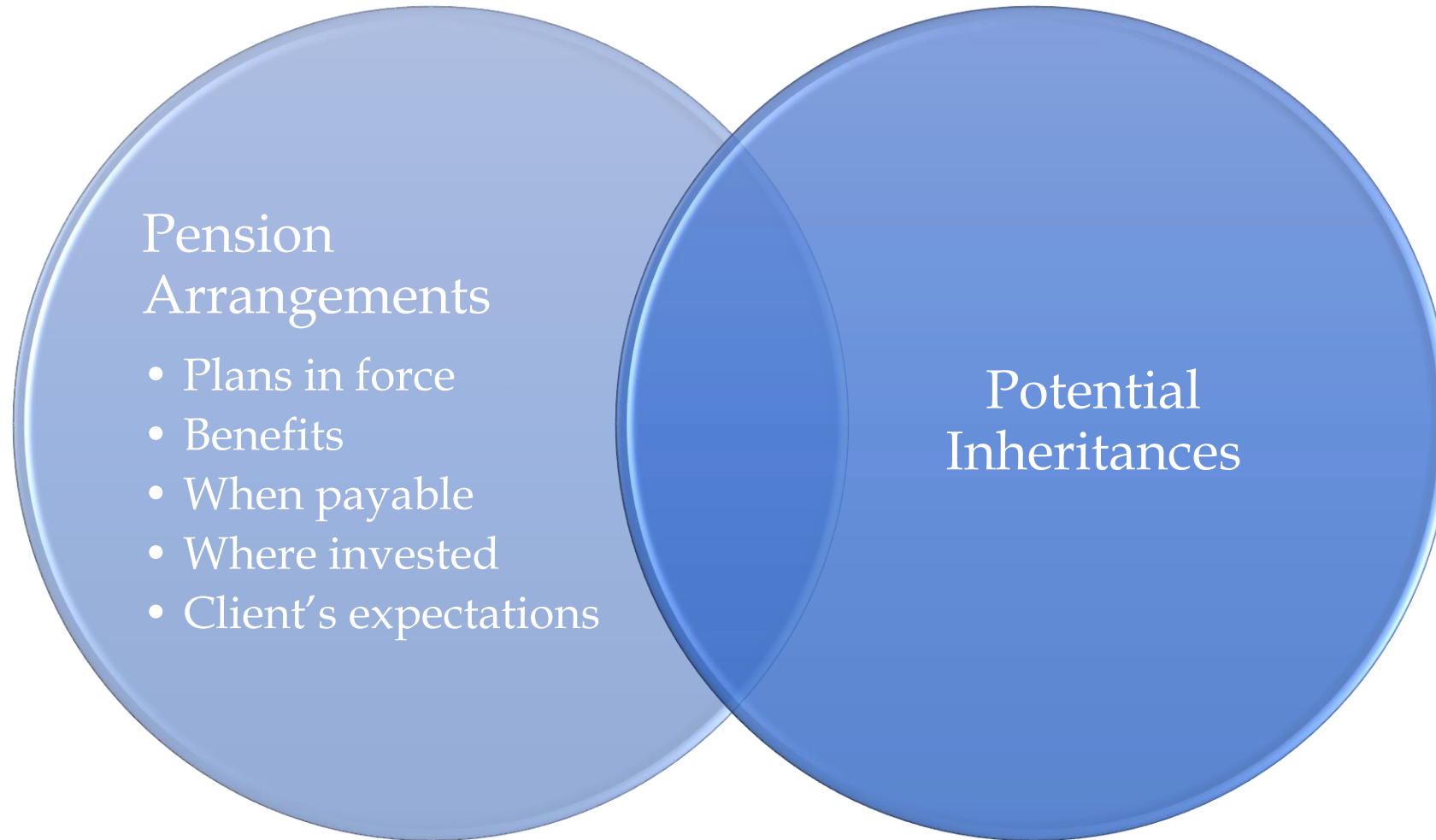
Outgoings

- Income and expenditure plan
- Projected changes in income
- Projected cash outflows
- Cash reserves and emergency reserves

Assets and Liabilities

- Assets
- Source of funds
- Tax details
- Encashment penalties
- Liabilities





Determining an Investor's Risk Tolerance – Risk Capacity & ATR

Objective Factors:-

Timescale - short term - lower risk; long term - higher risk investments

Commitments - may drive different perspective

Wealth - amount available to invest; amount can afford to lose

Life cycle - stage of life

Age

Subjective factors:-

- Attitude - emotional make up; sensitivity to adverse developments; need for certainty
- Experiences - previous involvement; experiences of market volatility

Methods of Assessment:-

- Risk classifications
- Decision trees
- Appropriate questioning by the adviser
- Takes skill and experience



Risk Profiling Tools

Risk Descriptions	<ul style="list-style-type: none">• Identify their investment attitude by comparing it to different types of attitudes.• Method is simple but has a drawback - the terms used to describe risk levels may have different meanings to different people.
Psychometric Risk Profiling	<ul style="list-style-type: none">• Aims to evaluate a client's psychological tolerance/preference for risk, rather than their financial ability.• Uses a questionnaire to create a risk score which is compared to other clients.• It allows clients to carefully consider their attitude towards investment decisions and communicate them to their advisor.• Leads to further discussion about the relationship between risk and different asset classes.• However, the psychological profile is just one factor in the investment decision-making process, and that other factors such as the client's goals should also be considered.
Stochastic Modelling	<ul style="list-style-type: none">• A forecasting tool that estimates the possible returns from different portfolios.• Helps clients select the appropriate portfolio by illustrating the potential outcomes and the probability of achieving them.• Helps educate clients on investment risk, compare different strategies and recommend a suitable portfolio.• Model is based on predictions and assumptions; clients may mistakenly believe the projections are certain.



Investor's Risk Appetite

No risk

- The client is not prepared to accept any fall in the value of their investments. Appropriate investments may be cash-type assets or short-dated government bonds priced below par

Low risk

- The client is cautious and prepared to accept some value fluctuation in return for long-term growth but will invest mainly in secure investments

Medium risk

- The client will have some cash and bond investments but will have a fair proportion in direct or indirect equity investments and, potentially, some in high-risk funds

High risk

- The client is able to keep cash reserves to the minimum, will hold mainstream and secondary equities and be prepared to accept derivatives and other high-risk investments



Investment Objectives & Strategies



Investment Objectives

- Maximising future growth
- Protecting the real value of capital
- Generating an essential level of income
- Protecting against future events




Classification of Investment Objectives

- Income - investors seek a higher level of current income at the expense of potential future growth of capital
- Income and Growth - investors need a certain amount of current income but also invest to achieve potential future growth in income and capital
- Growth - investors do not seek income and their primary objective is capital appreciation
- Outright growth - where the investor is seeking maximum return through a broad range of investment strategies which generally involve a high level of risk



Risk Tolerance



Volatility in the prices of investments or the overall value of an investment portfolio are inevitable

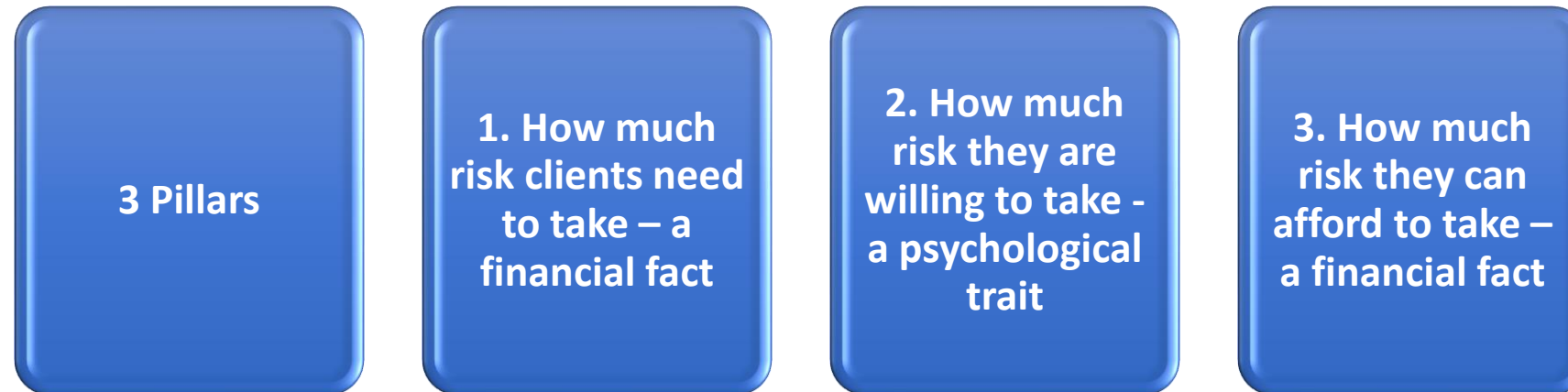
At a personal level this translates into the risk that prices may be depressed at the time when an investor needs funds and will mean that they will not achieve their investment goals

Determining attitude to risk

Describing attitude to risk



Risk Tolerance and Capacity for Loss



Capacity for Loss

This is linked to the level of risk a client can face. E.g. if the only money for investment and to live off is their entire life savings, then this should temper down the level of risk. Consequently, this client has a low capacity for loss as they lack funds to fall back on if their investments perform badly.





Liquidity

Amount of funds a client might need both in the short and long term

Emergency cash reserves

Funding known liabilities



Time Horizons

Period over which a client can invest

Short term

Medium

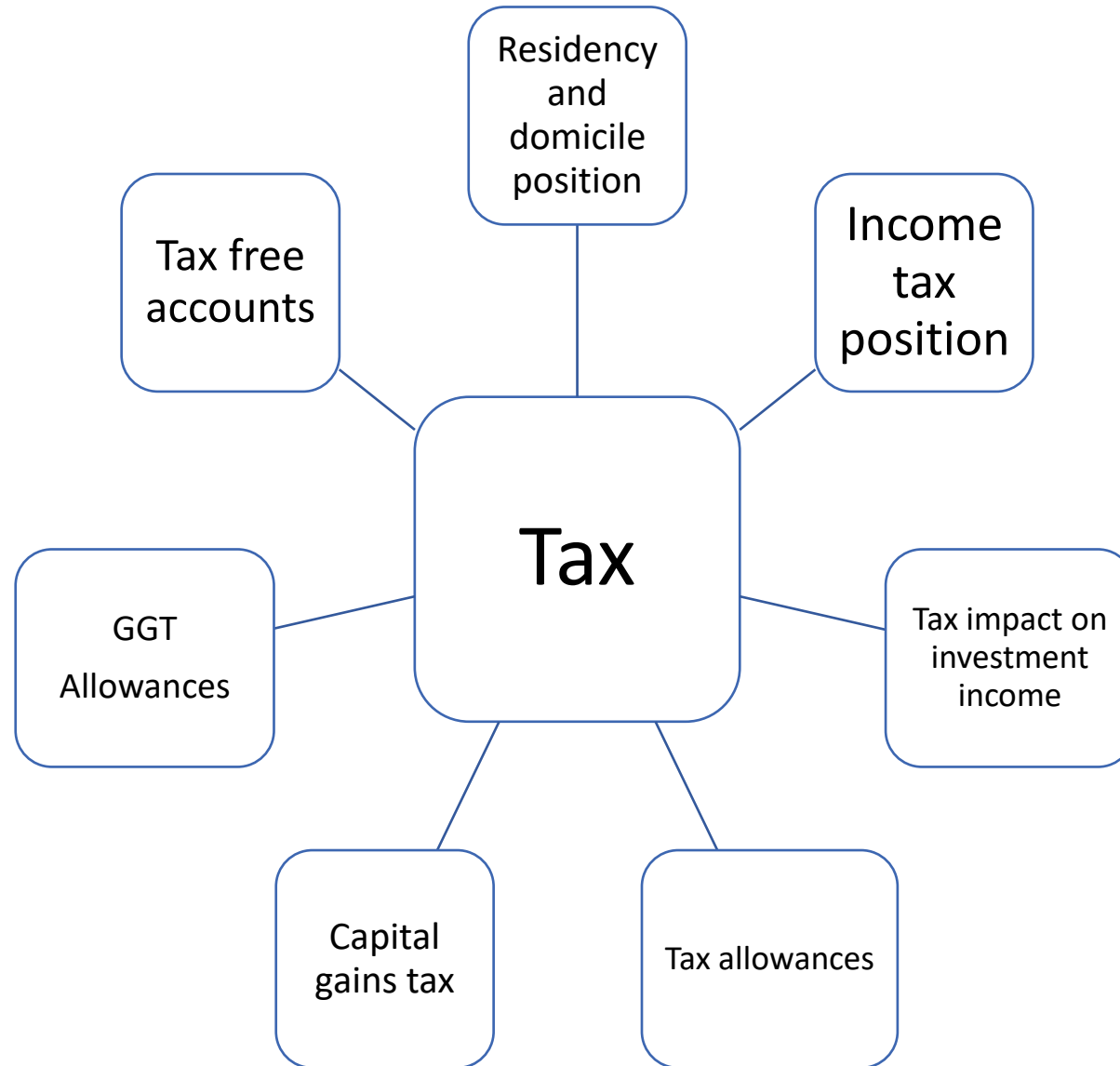
Long term



Implications



Tax Status



Tax Considerations

Tax should not drive the strategy
- client suitability and objectives
that are most important.

The interaction of taxes needs to be fully understood so that the client's assets are suitably invested to minimise the impact that tax will have on either growth or income for the client.

When managing tax implications for a client, it is important to appreciate the difference between:

Tax Evasion is a financial crime and is illegal;

Tax Avoidance is organising your affairs within the rules so that you pay the least tax possible.

The latter is a responsibility of the adviser when they are undertaking financial planning.



Consideration for Other Types of Clients



Islamic Finance

- Shariah Law for Investments
- Ijara
- Ijara-wa-Iqtina
- Mudaraba
- Murabaha
- Musharaka



Faith-based Values

- Socially responsible investing
- Screening out of other things germane to achieving those goals
- Looking at social and religious teachings
- Political and societal factors impact individuals



Trusts

- Assets are controlled by trustees
- For the benefit of named beneficiaries/for a specified purpose
- Trustees have a range of power and duties conferred by trust deed/statute
- Have power to invest but liable for losses



Charities

- Use surplus funds to invest
- Run by a board of trustees – responsible for management of funds
- Investments must strike the right balance between:
 - Providing income
 - Maintaining the value of the funds – long term



Investment Recommendations – Developing a Strategy

Client's Financial Position

- Net assets statement
- Cash flow statement
- Tax analysis
- Lifetime cash flow projections

Assess the client's

- Affordability and suitability
- Aims
- Priorities

Development of strategy:

- Assess where action is needed
- Prioritizing what needs to be assessed
- Identify actions that can be done later
- Develop potential solutions to address priorities



Assessing Existing Assets

Determining details of each product

Establishing any issues that may arise in moving these to alternative options

Assessing if the meet client's needs

Factors to consider:

- Relevance to client's needs
- Affordability
- Risk
- Diversification
- Liquidity
- Charges compared to other products
- Income producing or capital growth
- Tax treatment/efficiency
- Performance
- Bonus clauses
- Encashment penalties



There are a range of potential investment solutions to choose from that can cater for different types of client including:

- A preferred fund panel for clients who want execution only services.
- A portfolio of low-cost mutual funds for clients with modest asset levels who required a low-cost ongoing service.
- A model portfolio service for clients with a higher level of assets and investment experience, where the additional costs are appropriate.
- Discretionary fund management for clients who required bespoke investment management solutions.



Investment Funds

Return Focused Portfolios	<ul style="list-style-type: none">• Many investment firms use model portfolios of investment funds to target specific investment objectives such as growth, balanced or income.• Regularly monitored and adjusted based on market movements and changes in fund managers, with the goal of meeting or exceeding a benchmark target.
Risk-Targeted Portfolios	<ul style="list-style-type: none">• Risk-targeted portfolios aim to maximize returns while staying within predefined volatility bands and risk parameters.• A model portfolio is chosen to provide a suitable mix of asset classes and funds that align with the client's risk profile.• The goal is to maintain the risk profile and not necessarily beat sector average performance.• Due to constraints on risk-targeted funds, significant outperformance should not be expected.
Model Portfolios	<ul style="list-style-type: none">• FoFs invest assets in other mutual funds to utilize the expertise of specialist managers in each asset class, while a manager of manager (MoM) approach involves assets being managed on a segregated basis as mandated by the multi-manager fund manager.• A FoF approach can be fettered or unfettered• Multi-manager funds may invest in traditional assets or adopt a more multi-asset approach.• Advisers should understand the component parts of each fund as they may expose investors to different types of risk.



Discretionary Investment Management

Services vary widely and range from managed portfolios at the lower value end of the market to bespoke portfolios that are tailored to the individual client at the other end.

Model or Managed Portfolios

- Standardized portfolios designed around a range of investment objectives and risk approaches
- Constructed of a mix of direct holdings and investment funds and are managed centrally in line with the portfolio's investment objective
- Designed to appeal to a wider audience

Bespoke Portfolios

- Involves constructing and managing a portfolio around the specific needs of a client
- Can be managed on a discretionary or advisory basis
- Investment mandate is agreed with the client
- Investment manager appointed to manage but client has direct access
- Traditional and alternative asset classes used
- Charges negotiated
- Detailed performance reporting and analysis



Investment Policy Statement - IPS

Investment Objectives

Risk Profile

Liquidity Requirements

Time Horizons

Tax Position

Investment Strategy

Asset Allocation

Constraints

Benchmark

Any Other Factors



Review

Reviewing the previous advice in light of any changes to the client's circumstances and revising recommendations where necessary.

Changes to goals and objectives and the amounts targeted.

Reviewing and amending the assumptions used, where relevant, to take account of changing market conditions, investment returns and future inflation rates.

Net worth, income and expenditure.

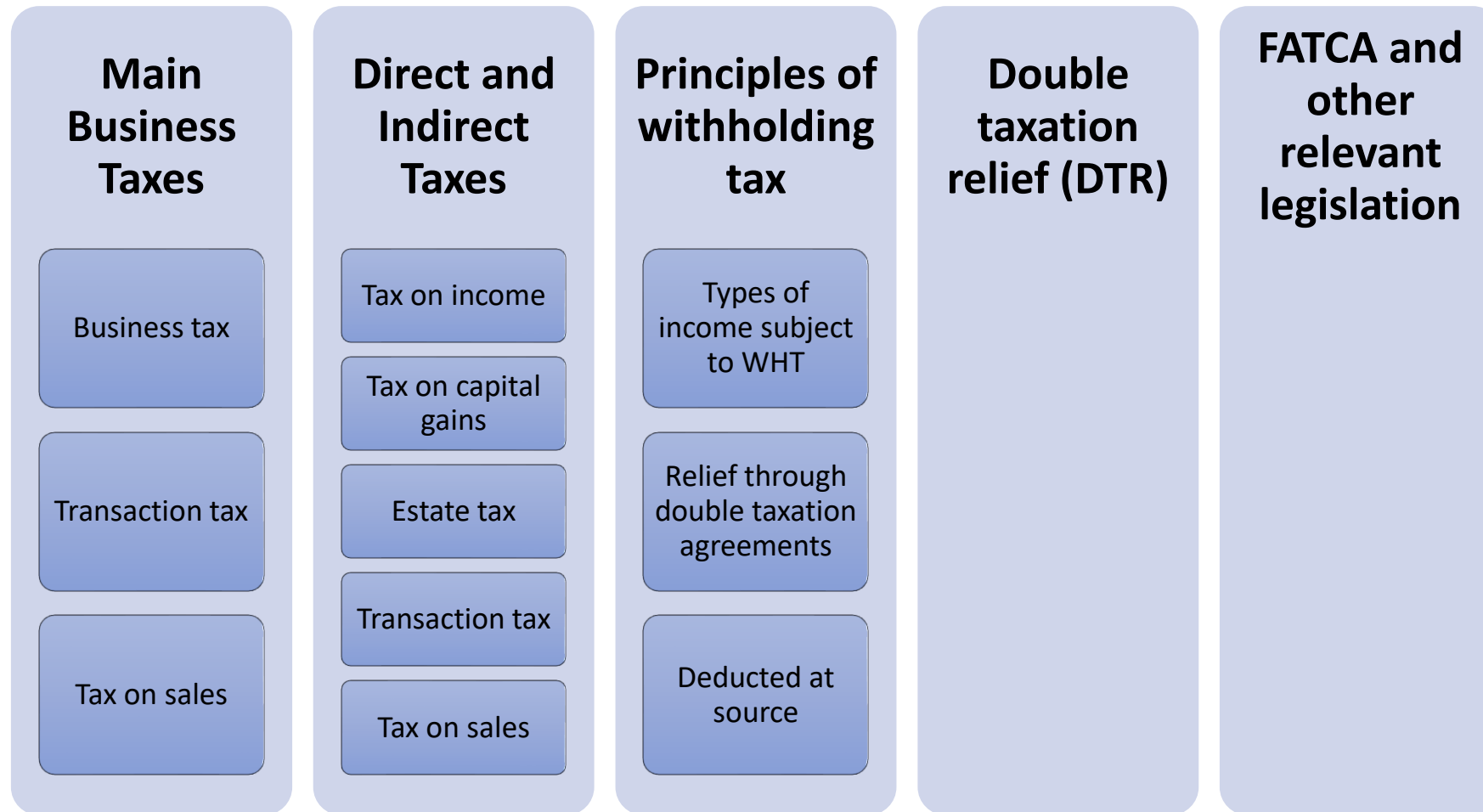
Asset allocation and client risk profiles (including rebalancing portfolios).

Suitability of products and product wrappers held and revisiting the risk appetite and capacity for loss of the client.

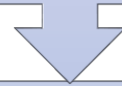
Obtaining any documentation that may be required in the review meeting.

Checking existing terms of business documentation and preparing updated documents, where necessary.

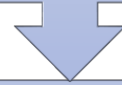




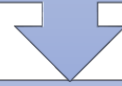
An accounting period starts when: a company first becomes chargeable to corporation tax, or the previous accounting period ends.



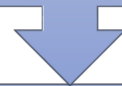
An accounting period ends when the earliest of the following takes place:



the company reaches its accounting date



it is 12 months since the start of the accounting period



the company starts or stops trading.



Value added tax (VAT) and goods and sales taxes (GST)

Is a tax levied on consumption or expenditure as opposed to income/wealth.

Are forms of indirect taxation that are being increasingly deployed across the world

And being applied to an increasing number of items.

Often referred to as consumption taxes - are a form of regressive taxation because they are not based on the 'ability to pay' principle



Financial Transaction Taxes

Are imposed by governments on any sale, purchase, transfer or registration of a financial instrument.

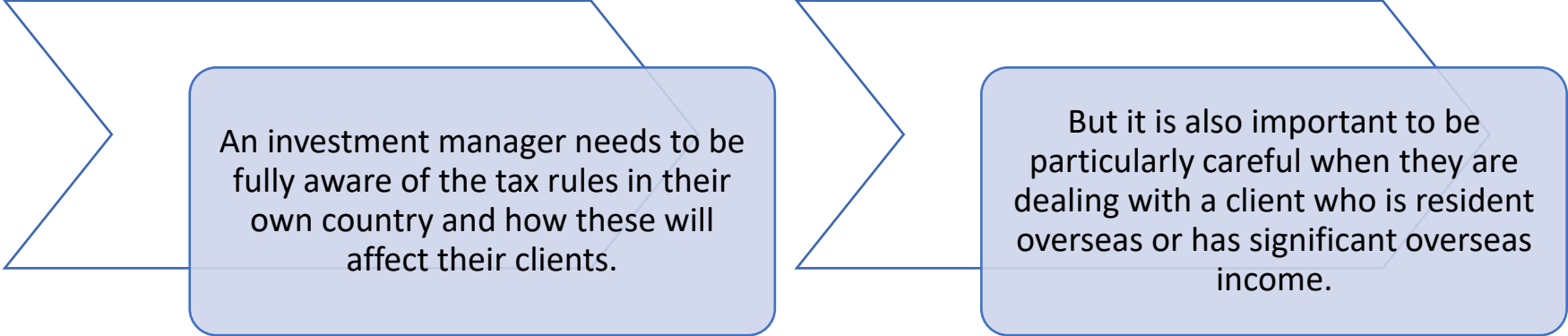
Many G-20 countries currently impose it, and the most common is a tax on the trading of equities in secondary markets.

They are generally *ad valorem* taxes based on the market value of the shares being exchanged - tax rate varying between 10 and 50 basis points.

The trend in share transaction taxes over the past several decades has been downward. E.g. eliminated in US, Germany and Japan.



Personal Tax – Income, Capital Gains and Estate Tax



An investment manager needs to be fully aware of the tax rules in their own country and how these will affect their clients.

But it is also important to be particularly careful when they are dealing with a client who is resident overseas or has significant overseas income.



Income Tax

The amount of income that is subject to income tax is the total that is received in a financial year. E.g. UK tax year runs from 6 April in one year to 5 April in the next.

Often referred to as the year of assessment

Income can usually be grouped into 3 main sources:

- Income arising from earnings.
- Interest income arising from bank deposits, money market accounts and bond interest.
- Dividend income.

Why?

Liable to different tax rates, having certain allowances and in which order they are treated, if there are higher rates of tax payable

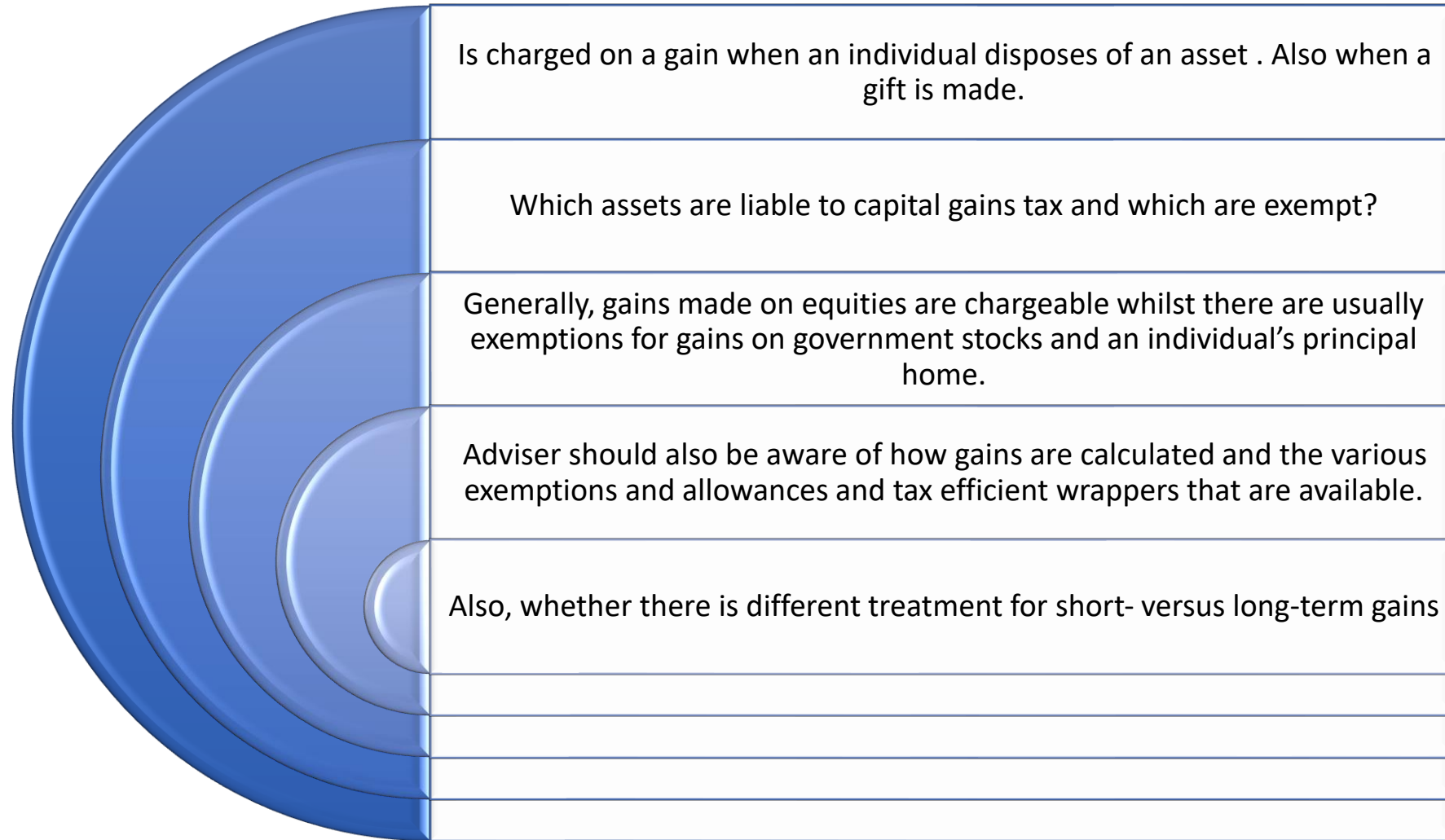
Key concept is the **residence** of the individual, which will determine whether they are liable to tax and, if so, on what sources of income.

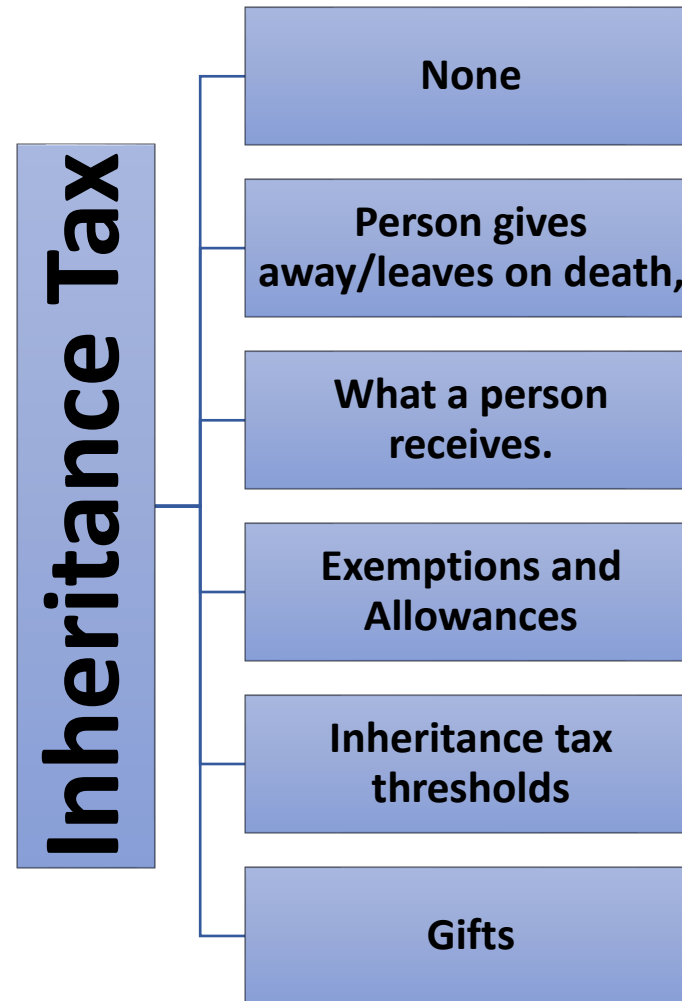
Another is the concept of **gross** and **net** and **grossing up**.

Treatment of accrued interest on a bond purchase or sale - bonds are quoted clean, but settled dirty. Also ZCB – UK and US.



Capital Gains Tax (CGT)







How does the issue of double taxation arise?

Withholding Tax (deducted from overseas dividends) plus income tax (in country of residence)

Double Taxation Agreement

- Relief at source - a reduced rate of withholding tax to be deducted
- Repayment Claim



The Foreign Account Tax Compliance Act (FATCA)

A 2010 United States federal law requiring:

- All United States persons including those living outside the US to file yearly reports on their non-US financial accounts to the Financial Crimes Enforcement Network (FinCEN).
- All non-US (foreign) financial institutions (FFIs) to search their records for anything indicating US person status and to report the assets and identities of such persons to the US Department of the Treasury

Is designed to prevent tax evasion by US citizens using offshore banking facilities.

The law is used to detect assets, rather than income

Does not include a provision imposing any tax.

Financial Institutions who do not agree to provide the required information will suffer a 30% withholding tax on payments of US-source income.



Domicile, Residency & Location of Assets

Domicile

- The country that an individual considers as their permanent home
- **3 types:**
 - Domicile of origin
 - Domicile of choice
 - Domicile of independence

Residency

- Residency is mainly assessed by how many days an individual has stayed in a country and their frequency of visits

Location of Assets

- Country(s) where an individual has assets stored



Why are they important?

Domicile

- Acts as a link to an individual and the set of rules relating to legitimacy and taxation

Residency

- Establishes an individual's tax liability on income/gains while being inside or out of their country of residence

Location of Assets

- Establishes tax implications on assets owned in other countries

