AF4 2020/2021
Portfolio Construction
Part 2 Practical issues

The milestones for this part are to understand:

- How Modern Portfolio Theory can be applied to portfolio construction.
- The difference between a "Top Down" and "Bottom up" strategy
- The difference between an advisory and discretionary service.
- The basics of Discretionary Fund Management
- The issues facing firms drawing up Collective Investment Propositions

An investor's portfolio is made up of different asset classes and securities. It can use exclusively collective investments, exclusively directly held investments or a mixture of both.

The portfolio should:

- Be appropriate for the client's aims and objectives.
- Be diversified through different asset classes, geographical location and industry sectors.
- Use tax efficient wrappers as far as possible.
- Not expose the client to a greater risk than they would be prepared to accept.

Following **Modern Portfolio Theory**, the order in which a portfolio should be constructed is:

- Decide on the asset allocation of the whole portfolio.
- For each class decide the geographical split, For example the share component could be split into 40% UK, 30% US, 20% Europe, 10% Japan
- Then for each one of these split into sectors, e,g, technology, Banks, Retail
- Finally individual stocks are selected.

This is also known as **Top Down** Allocation. The opposite is **Bottom Up** which start with individual shares and is usually found in specialist funds.

Collectives or directly held investments

Most individuals will be recommended to use collective investments. These offer greater diversification but selection of securities and when these should be sold will be done by the manager or by an algorithm in the case of a tracker fund. The individual and the adviser have no say in that decision. This means in a top down approach advice can only be given on the first two parts and possibly the third if specialist funds are used.

The adviser and client will work on an **advisory basis,** that is the advisor makes a recommendation but the client must consent to this. If a fund was performing poorly and the client was recommended to switch this cannot go ahead unless the client agrees.

For a higher net worth client some or most of the assets may be held in individual shares and bonds. This gives the investor greater control of their portfolio but they will probably lack the skill and support to do this themselves.

Firms may offer to deal on a **discretionary basis** rather than an **advisory** one. This allows the firm to buy and sell the client's investments without getting their prior approval.

A strategic approach will be agreed but the manager will be able to take tactical decisions to respond to changes in the market or economy. A DFM can do this because it can act much more quickly than under an advisory service.

If the DFM buys and sells on a frequent basis, these trades will give the investor a CGT liability whereas trades within a collective fund does not. A liability only arises when the investor makes a disposal.

To act as a DFM requires a specific FCA permission so firms may elect to out-source this. If this is done the outsourcing firm must establish what is its relationship with the DFM. This can either be:

- Agent as client
- OR "reliance on others"

Under "agent as client" the DFM's end client is the financial adviser rather than the adviser's client. This means the adviser is responsible to their client for the actions of the DFM. Therefore, if the client has a grievance or complaint about the DFM, the liability is with the adviser.

Under a reliance on others arrangement the liability for the DFM's actions on behalf of the end client remains with the DFM

In selecting a Discretionary Fund manager, account should be taken of their:

- Experience
- Performance
- Structure and style of investment
- Size and resources of the potential manager
- Quality of staff
- Administration
- Costs

Centralised Investment Proposition

Most financial advice firms use a **Centralised Investment Proposition (CIP)** if they only include collective investments in their clients' portfolio. The firm draws up a set of ready-made portfolios mandating which should be recommended to a client based on their objectives and circumstances. The adviser normally has no power to divert from this.

The firm can either prepare these portfolios themselves out outsource this.

A CIP can deliver benefits to the firm in respect of:

- Consistency
- Risk
- Time

It delivers **consistency** as it reduces the likelihood of one adviser using a different approach to another. This is particularly important if the firm operates nationally with many advisers

In terms of **risk**, a CIP should mean there is a demonstratable process for investment selection. Without a CIP it could be difficult to show how the investment was researched and selected.

It saves advisers' **time** as they don't need to fund pick for every client thus freeing up time for other parts of the advice process.

A CIP makes it easier to bring in streamlined client reporting. It also provides a way of reviewing and keeping track of the investments internally avoiding the need to carry this out on a day to day basis.

The drawback to a CIP is that it can "shoehorn" clients into an inappropriate portfolio. In the past a firm might have been able to divide its clients into whether they wanted growth or income and then selected the portfolio on their attitude to risk. This would not meet the requirements of the **FCA's Product Intervention and Product Governance Sourcebook (PROD)**

The purpose of PROD is to ensure that investment products that are recommended to clients:

- Fulfil the need of one or more identified target market
- Are distributed appropriately
- Deliver appropriate client outcomes

This requires firms to identify and segment their potential market and identify appropriate solutions. The FCA could require firms to give written evidence that demonstrates the firm has established market segments, sub segments and has detailed documentation explaining how clients are being matched with investments products. Put another way a firm needs to be able to say:

- This is our target market
- These are our investment solutions, platform selections and services
- Our investment solutions are designed in a specific way in order to work for the target markets we've identified.

For example a firm may split its client base into three age related segments;

- Under 45
- 45 to 60
- 60+

Each of these could be split into sub segments. For example, the under 45 segment might be split into new investors and experienced investors. The 60 plus group might be split into investors who require income and those who wish to protect their wealth aiming to pass it on to children and grandchildren. Each segment will have different portfolios depending on their attitude to risk. Apart from listing the funds in the portfolio the CIP should also detail charges, platforms to be used and frequency of client communications

There should also be a process to deal with "outliers" who have specific needs that do not fit any of the client categories or the proposed portfolio would not be suitable for them.

That concludes this part do you should now understand:

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- The difference between an advisory and discretionary service.
- The basics of Discretionary Fund Management
- The issues facing firms drawing up Collective Investment Propositions