AF4 2023/2024
Investment products
Part 5: Miscellaneous Products

This final part will look at the remaining products that could be tested.

The milestones are to understand the basic principles of:

- Hedge Funds
- Private Equity
- AIM shares
- Structured Products
- Peer to Peer Lending

Hedge Funds

There is no one accepted definition of a hedge fund but it can best be described as a fund that aims to make money in both rising and falling markets. A traditional fund will buy assets in the belief that they will rise in value. If they fall the fund value will also fall.

Most hedge funds will share the following characteristics:

- High initial investment required.
- It will make use of derivatives.
- It is often highly leveraged. It has borrowed heavily to buy assets
- It uses short selling. This involves paying a fee to borrow shares from a pension fund or other financial institution. It then sells them and hope the price will fall so they can buy them back at a lower price. They will then give them back to the body that lent them and pocket the profits.
- It will take an active position in companies trying to influence management to dispose or acquire parts of the business.
- It may have lock in periods where investors cannot realise their investment.
- High charges including performance fees.

The high charges made by the typical hedge fund has led to comments that the investor take a high level of risk but a large part of the reward goes to the fund's management.

Whilst a hedge fund is unlikely to be suitable for most private investors what are termed **absolute return funds** try to offer something similar. Most collective investments will take a "long" position, that is they buy shares with the aim that these will rise in value. An absolute return fund also does that but in addition has a short selling strategy. Either using put options or borrowing securities that it then sells it aims to make money whether the market is rising or falling. The performance of these funds has been mixed and critics have pointed out that

these managers have got to be good at both identifying which securities will rise and which will fall.

Private Equity

Private equity can be defined as any company whose shares aren't listed on the main Stock Market.

The vast majority of UK companies are structured in this way as there are benefits in being incorporated rather than acting as a sole trader. These need not concern us since the owners of the business have no intention or need to offer shares to the general public.

Some large public companies have turned themselves into private ones. The perceived benefit is that they can operate free from pressures of outside investors.

Other private equity companies have been set up primarily to buy companies that may possibly be struggling with the aim of turning them round and selling them later for a profit.

There are potential problems for investors in Private Equity firms.

- Since the shares are not traded on the market they cannot be easily purchased or sold.
- Most deals tend to be on a matched bargain basis where a potential buyer must find someone who is willing to sell their shares.
- It is difficult to establish the right price for the shares since they aren't traded in a market. The majority of shares are usually held by the owners/directors and other shareholders may find it difficult to have any significant influence in the way the business is run.

There are also some Investment Trusts that invest in Private Equity companies.

Alternative Investment Market

Getting a listing on the London Stock market is a very involved process and businesses need a trading history. This may not be possible for smaller, younger businesses. They can raise capital by issuing shares on the Alternative Investment Market (AIM) which also acts as a secondary market.

- Unlike the main stock market there is no minimum size or trading requirements. Neither do they need minimum trading records.
- There is no requirement for any given percentage of shares to be in the hands of the public
- A company must appoint a nominated adviser (NOMAD) and a nominated broker
- Prospectuses must have a warning that AIM is designed for emerging or smaller companies.

Because these are new companies the risks of failure are higher than a long established business so investment in AIM company shares will carry a higher risk than one listed on the main stock market. Conversely there is greater potential reward in that a company may prosper and go on to be a major player in its field.

They can be held in an ISA and a further tax benefit applying to holdings in unlisted companies is that they qualify for 100% business relief under IHT once held for two years. Effectively this means they are exempt from IHT.

Structured Products

A structured product can be described as one which aims to give a potential return with little or no risk to the initial investment.

The main characteristics of these are:

- They have a fixed term, most commonly for five years to seven years.
- It is usually impossible to access the original investment before the end of the term.
- There is a guarantee of capital or income and sometimes both.
- The minimum and maximum return is usually specified
- Returns are usually based on the performance of an index.

Whilst structured products will vary from one provider to another there are two main types.

- The first offers a return at the end of the term linked to the performance of an index. Typically this would be the FTSE 100 and investors would be offered 100% (or another percentage) of its increase over the term. Therefore if the FTSE grew by 50%, an original investment of £10,000 would return £15,000. If the FTSE 100 is less that it was at the start of the term, the investor will be paid back what they originally put in.
- The second offers a guaranteed income per year and the return of the original investment at the end. However the return is only guaranteed if a selected index achieves a set return. If it fails to do this the amount returned will be less than the original investment.

There may be a “kick out” option which means that on certain dates, if a set growth in the index has been achieved, the issuer will terminate the contract and pay out the benefits to the investors.

Whilst the product may state that returns are linked to the FTSE 100 or another index, investors are not placing their money into shares. Instead the product is usually made up of two financial instruments. These are a zero coupon bond which returns the original capital and an option which will provide the growth.

These products can look attractive especially in times of high market volatility as it appears the investor cannot lose. There are though a number of disadvantages:

- Even if the original investment is returned at the end of the term the investor has lost the income they would have received if they had simply put the money on deposit.
- The fund produces no income as would be the case if the money were invested in a unit trust or OEIC.
- It is usually impossible to access the money before the end of the term
- The term cannot be extended so any gain is crystallised at maturity even if the market is growing
- If the zero coupon bond does not produce the expected return, the original capital may be lost.
- As it uses a derivative to produce the gain there is a counterparty risk.

The tax position on the investor will depend on the structure of the product. Many are structured as non-qualifying life policies so a higher rate tax payer will incur additional 20% income

Peer to Peer lending

This has sprung up partly as a result of the current climate of low interest rates. Rather than lend money to a bank, savers place their money with an organisation such as Zopa. They in turn lend the money out to borrowers and the interest they pay to Zopa is paid to the saver less charges.

The company does the credit checks and normally the saver's money is split between different borrowers to spread the risk.

The saver should get better rates than through a bank but gets no protection from the FSCS and is subject to default risk.

It can be placed into an innovative finance ISA

That concludes this part so you should now understand the basic principles of:

- Hedge Funds
- Private Equity
- AIM shares
- Structured Products
- Peer to Peer Lending

Further Reading

Hedge Funds

https://www.moneyadviceservice.org.uk/en/articles/hedge-funds

Private Equity

https://www.investopedia.com/articles/financial-careers/09/private-equity.asp

AIM shares

https://www.londonstockexchange.com/raise-finance/equity/aim

Structured Products

https://www.fca.org.uk/consumers/structured-products

https://www.moneyadviceservice.org.uk/en/articles/structured-deposits-and-investment-products

Peer to Peer lending

https://www.moneyadviceservice.org.uk/en/articles/peer-to-peer-lending--what-you-need-to-know