AF4 2023/2024
Practical issues Part 1

The full title of AF4 is Investment Planning. Advisers establish a client's current situation, identify their objectives and recommend a solution. The first two parts are fairly easy to assess in a written exam but what about the third?

One thing that can be said with certainty is that you will not be asked to construct a portfolio. You can expect are questions that ask you to:

- Comment on the appropriateness of a client's investments
- Comment on the overall structure of a portfolio and recommend how it might be improved or recommend an alternative
- Explain different investment strategies that could be used by both investors and fund managers.
- Evaluate the performance of a portfolio

Most questions will be asked from the point of view of an individual and their adviser but some will be asked from the perspective of a fund manager or an investment company.

Case studies and questions will normally reflect market conditions of the last 6 months

These notes won't cover the process that advisers should follow to ensure they give appropriate advice. This may be tested but candidates' own experience should enable them to answer these. In addition, the first chapter of the AF4 study guide gives an excellent summary of the process.

As questions cover a wide range of topics, we'll split into three parts:

- The different ways of receiving advice
- The main investment strategies
- The principles of portfolio selection and management

The milestones for this part are to understand:

- How current market conditions affect investment decisions
- The dangers of DIY investing
- The main way in which advice can be delivered

Current state of play

2022 was one of the most challenging years for investors. Against the background of the war in Ukraine investors have had to face:

- Rising inflation
- Higher interest rates
- A rise in gilt and bond yields
- A significant fall in the US stock market led by the fall in tech stocks.
- A cost of living crisis in most countries which resulted in consumers having less disposable income, a slower growth rate and a possible recession.

Unfortunately no one knows in summer 2023 what will happen in the next 12 months but history tells us not to be too concerned over a single years performance. Over the long term asset prices tend to rise although as always “the past is not necessarily a guide to the future.”

Types of advice

Whilst advice has a specific meaning under FCA rules, this part will explore the different options for individuals seeking to invest and for firms seeking to offer an investment proposition.

DIY trading

Go on YouTube and you will find hundreds of sites claiming to show how individuals can become full time traders and need never work again. Their presenters claim that they have turned $2,000 dollars into millions of dollars, and you can achieve the same if you follow their strategy.

Recent volatility has spawned an army of day traders using digital platforms like Robin Hood and it’s easy to see why this looks attractive as certain shares have had spectacular rises in the past two years, and also had spectacular losses,

This type of “day trading” is easy with hindsight but extremely difficult without resort to a Tardis and investors face considerable practical problems.

- A large amount of capital is needed to fund them through the inevitable periods when losses are made.
- They don’t have access to the level of research and analysis available to a financial institution and may not even understand what they are investing in
- They incur dealing costs and stamp duty.
- Unlike professional traders they probably aren’t hedging their positions so are very exposed to a big fall in the market.
- Losses could be 100% of your “investment”.

In behavioural finance terms they are probably overestimating their ability and falling for the, “if they can make money, I can make just as much” delusion.

In fact they are not really investing but gambling.

- They back hunches
- They trade often
- They get lucky or get wiped out

Some individuals may not want to go down that route but don’t wish to pay for regulated advice. The growth of investment platforms make it easy to build up a individual portfolio of funds. Some may offer “suggested” funds to match your own perceived risk profile but this is not advice.

The drawbacks to this approach are:

- Lack of diversification in both asset and sector.
- Attitude to risk will be based on a “feeling” rather than on any objective measure.
- The portfolio may not match investor’s need for income or growth
- No target for performance or benchmark will have been set
- No rebalancing may take place.
- Securities may not be in tax efficient wrappers

Investment platforms whether used by individuals or an advice firm have a number of benefits

- All investments in one place
- Available 24/7
- Performance statistics available
- Can transfer assets easily
- Consolidated tax statements

Investing through regulated advice

Getting regulated advice gives investors protection as the advisory firm has to take responsibility if the advice is inappropriate. Because of cost factors and to ensure that there is an element of consistency many firms have developed a **Centralised Investment Proposition (CIP)**

Centralised Investment Proposition

The firm has a selection of ready-made portfolios and mandates which should be recommended to a particular client based on their objectives and circumstances. The adviser normally has no power to divert from this.

It can deliver benefits to the firm in respect of:

- Consistency
- Risk
- Time

It delivers **consistency** as it eliminates the risk of each adviser using a different approach in recommending a portfolio. 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 construct a portfolio 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 can 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. The make up of these portfolios could be outsourced to a specialist firm or done in-house. 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.

Discretionary advice

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 do 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

That concludes this part do you should now understand:

- How current market conditions affect investment decisions
- The dangers of DIY investing
- The main way in which advice can be delivered