The Case For Pooled

by Jonathan Bell

If God were to give us the gift of perfect foresight, we would not only definitively know which investments to hold but the right way to hold them too. In 1996, the majority of private clients at Newton invested through segregated portfolios. Five years later most new clients choose to invest through a pooled rather than segregated portfolio. Has our investment approach changed? In short, it has not. We are still thematic global stock pickers, choosing to invest directly in companies we like irrespective of where they are quoted.

We manage clients with similar benchmarks in a consistent manner whichever individual manager looks after them. As a result, we have many clients with almost identical portfolios and realised that if these clients pool their investments and hold units in the pooled fund they will have virtually the same underlying exposure. However, given the significant advantages of investing in an authorised pooled fund, we might reasonably expect the same investments in a pooled fund to produce close to a 1% per annum better return than an identical segregated portfolio.

There are four principal reasons normally cited in favour of investing through a managed pooled fund:

Tax Advantages: CGT, Income Tax and VAT

The best known of the tax advantages is the capital gains tax (CGT) difference between the segregated and pooled routes. For the segregated investor every sale may give rise to a taxable gain and the larger the investment portfolio the greater the chance that the gains realised will exceed the annual exemption (currently £7,200). Sales within a pooled fund are exempt from CGT so it is only when units are disposed of that a taxable event occurs. If, for example, units are held continuously for 10 years they qualify for the full tapering relief of 40%, whereas only those individual shares held within a segregated portfolio for the full 10 years qualify for the full relief. In addition, when CGT is paid on the disposal of an individual equity in a segregated portfolio that money is no longer working for the portfolio.

Other advantages include the different treatment for VAT, which is charged on segregated investment management fees but not on pooled fees. Likewise, unit trust management fees can be paid out of income partly earned gross effectively reducing the income tax payable, whereas segregated investors can not offset their expenses against their taxable income.

Costs

Much, but not all of the difference in costs relates to the different tax treatment of the two routes as illustrated above. The tax savings mean that if you have a pooled fund and exactly the same investments held through a segregated portfolio, the pooled fund client should outperform on a net basis. This is comparable to two world class sprinters competing in a 100m race but with one allowed to start 10 metres down the track.

Given that a pooled fund should lead to cost savings for the manager the total fees charged including the extra administration should (in theory) be lower than for a segregated portfolio. For illustration, the total expense ratio on the Newton Bridge Fund, designed for clients with £500,000+ to invest, is slightly lower than our segregated management fee for clients of the same size. The initial cost is also lower.

Risk Control

Investing through a pooled fund can reduce risk in three ways. First as the underlying holdings are not encumbered by capital gains tax there is no disincentive to reducing a holding that, through good performance, has become too large. Second, by investing through a pooled fund many investors will obtain greater diversification than through a segregated portfolio. Third, it can be quite a leap of faith to hand over considerable amounts of money to someone you may have only met once or twice. It is even more of a step into the unknown if that person is unable to provide a clear indication of how they might have performed for you in the past. Private client investment managers have been able to hide their investment performance behind the issue of client confidentiality, because no two clients are the same. In contrast, for pooled investors externally verifiable performance numbers are easily available and prospective clients can be provided with previous reports to see how the performance was achieved.

Performance

Paying lower fees and less tax should contribute to improved net performance but there are three other reasons why in the long run pooled funds should also have the edge on performance. As there is no CGT within the fund the manager is free to take investment decisions on their own merit. Too often individual clients can not sell holdings they would otherwise wish to because of large tax liabilities. A pooled fund removes these constraints.

Fund management firms may have highly expensive computer systems to make it easy to transact for all clients at the press of a button. Nevertheless, the manager will need to consider the relative merits of the investment decision for each segregated client before proceeding. Within the pooled fund one

transaction for all clients needs just one decision. If you believe in active management, as I do, anything that helps that management should be beneficial.

In response, the traditional defence of segregated management focuses on flexibility although in the long term the flexibility of a portfolio that may become constrained by CGT must be questioned. Without perfect foresight, we cannot be certain whether a client will be better off investing through a pooled or segregated portfolio. However, we can build different model scenarios to compare the outcomes (Ceteris Paribus) for pooled and segregated investment to see which are likely to meet the clients needs more efficiently. The number of scenarios is endless and the following are just for illustration. In each of them you should assume that the investments, fees and commission charges in the segregated and pooled portfolios are identical:

Client A invests his money for the long term, is happy with the management of his portfolio and dies leaving the investments to his heirs.

Verdict: He will likely benefit from investing through a pooled fund given the inherent CGT, VAT and income tax advantages.

Client B starts with a standard growth portfolio that performs well but after 3 years she chooses to invest entirely along ethical guidelines.

Jonathan Bell of Newton

Verdict: Given that the entire pooled fund will need to be sold, whereas only those companies from the segregated portfolio that breach the ethical guidelines must be sold, it is likely that the segregated portfolio will be more tax efficient.

Client C invests for a number of years without changing the investment brief and then liquidates the portfolio.

Verdict: She will likely benefit from investing through a pooled fund given the inherent CGT, VAT and income tax advantages.

Client D invests for 4 years before sacking his manager and moving to another firm with a similar brief.

Verdict: Given that the entire pooled fund may be sold, whereas only some of the holdings in the segregated portfolio may need to be, it is likely that the segregated portfolio will be more tax efficient.

Client E has a few very large holdings with significant capital gains and some cash she invests for a number of years.

Verdict: Almost certainly she will benefit from investing through a pooled fund. If the spare money was invested in a segregated portfolio it would soon become encumbered by CGT considerations. By opting for the pooled route she will be able to take her annual allowances from the CGT encumbered holdings , the new holdings can be managed flexibly within the fund and benefit from the inherent CGT, VAT and income tax advantages.

In summary, we have found that those clients who anticipate needing to make sudden changes to their portfolios in the early years may sometimes find the segregated route more efficient. In contrast, those investors that do not anticipate needing to make sudden and unexpected changes will be better off investing through a pooled route. In practice, many clients such as those able to make evolutionary rather than revolutionary changes to their investment policy or those with existing CGT constrained portfolios may be best served by investing through a mixture of the two routes.

As the above scenarios illustrate the case for and against pooled management is not clear cut and the investor's circumstances need to be fully considered before the most appropriate route is selected. In our experience, most long term investors will achieve better performance through the pooled route.

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