

Preparing for Fund Manager Selection

No one can deny that it is important that private individuals, their trusts and pension funds should research thoroughly their structure and objectives before examining the strengths and weaknesses of the fund managers who they may wish potentially to employ. After all, the large pension funds, who are probably the most sophisticated users of fund management services, devote as much effort to the selection and monitoring of their fund managers as they do to asset and liability modelling. Private clients, their advisers and their trustees should aspire to the same rigorous approach.

What this article seeks to describe is the process leading up to the issue of the investment brief, the core document in determining which type of fund management is required and who should be on the manager shortlist.

Identifying the Ownership Structure

The first stage should be to analyse which elements of the private client grouping should own which investment assets. In a typical case there would be one spouse who starts with the majority of the liquid funds, the other spouse, their children and probably a self-invested pension plan. Often there may be onshore trusts, deceased estates or offshore trusts. Each of these will have different degrees of flexibility and different tax profiles. Private individuals have complete flexibility as to the type of investment to be selected.

Children's assets are normally held in trust and each trust needs to be considered in terms of its investment powers and vesting provisions. Private individuals tend to be taxable, their pension funds and offshore trusts tend not to be.

Identifying the Liabilities

It is important in any family grouping to be able to identify the amount of cash and investments which are to be considered for long term investment. The starting point is to identify not just the current liabilities, such as taxation falling due, or money to be spent on housing, but also longer term liabilities of which the classic example is school fees. Money to meet the short term liabilities should normally be held in cash, or short term bonds, to avoid investment risk before settling the debt.

When referring to cash, this does not mean simply handing it to your bank, because superior rates of return ought to be available from researching the cash market. This is what good private bankers should be doing for their clients.

For longer term liabilities such as school fees a degree of financial modelling is recommended. It is a good idea to draw up a projection of the total school fee exposure and calculate the present value of those liabilities. The amount to be set aside can then be segmented and placed progressively along the efficient frontier curve, essentially the bond/equity mix, as you deal with the fees due in the later years. Some clients may have sufficient dependable income to be able to settle all school fees out of this cash flow on an

arising basis, in which case that form of liability modelling will not need to apply.

Identifying the Risk Profile

In many ways this is the most challenging part of the analysis process. It is in part a technical analysis and in part a human perception of the level of risk which the client is happy to bear to obtain the investment returns which are sought.

From a technical standpoint the two key elements are the time horizon and lifestyle protection. In order to invest in equity markets you need to have a time horizon of at least three years, preferably at least five years. History and research tell us that over most statistically significant periods of time - and apart from the recent strong performance of long dated bonds - equities will outperform other asset classes. Equities, however, are more volatile than cash and bonds and investors must expect setbacks on the path to investment glory.

One of the most frequent problems with private client investing is confusion over the time horizon between good times and bad times. Too often when equity markets have been surging private individuals will invest for the certainty of a gain on money which they need to use within a relatively short horizon.

Equally, when markets fall sharply, as they did last autumn, private individuals can tend to sell after a setback and sit in cash while the market recovers unless they are reminded that they

are in this for the long term. Bear in mind that the first and most dramatic leg of a bull market is normally over by the time that investors have realised what has happened.

The second important feature of risk profile planning is to seek to insulate the client against short term market volatility. If the portfolio is correctly structured it will be generating income which, together with the clients' other income sources, comfortably covers their annual outgoings. If equity markets fall this will not affect their lifestyle. It is only in extreme economic circumstances that companies start to cut their dividends and bond issuers file for default. As a consequence the private investor should be insulated financially, if not emotionally, against the upset of being worth less on paper than they previously were.

Time horizon has a particular impact on private pension funds and children's trusts. An individual nearing retirement with a defined contribution pension scheme should be reducing the volatility of the pension portfolio to avoid the capital value falling just at the point where he chooses to or is obliged to purchase a compulsory annuity. Where money is set aside in trust for young children or unborn grandchildren there is a strong argument that an all equity asset allocation should be employed as the length of the time horizon implies a high degree of acceptance of investment risk.

Taxation

Correctly analysing the tax position of the different family entities has an important influence on the ownership struc-

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ture as described above. Spouse's and children's nil rate and lower rate bands for Income Tax and Capital Gains Tax should be used wherever possible. Potentially exempt transfers are still available for reducing Inheritance Tax by passing money onto the next generation. Elements of the family grouping will have different characteristics for income and gains. An offshore life interest trust may pay no Capital Gains Tax on investment gains but the UK life tenant would pay income tax on all income as it arises.

On the other hand if there are plans to advance capital to UK resident beneficiaries gains may be very undesirable: they can be matched with capital advances and subject not only to Capital Gains Tax on the beneficiary but a surcharge of up to 24 per cent can apply as well. With this form of structure consideration should be given to converting investment gains into income either by using non distributor funds or possibly interposing a single premium life bond.

There are taxation as well as investment advantages to be gained by using collective investment funds for private individuals and their trusts. As well as the investment advantages deriving from greater diversification and liquidity, there is significant added value from the ability to defer Capital Gains Tax.

A unit trust or offshore fund pays no Capital Gains Tax and the holders will only be liable to tax when they eventually sell the units. This enables all the money which would have passed out of a segregated portfolio by way

of annual tax payments to be reinvested for the benefit of the investor. Since the Finance Act 1998, taper relief has become a major influence.

A UK resident investor who holds a unit trust or offshore fund for 10 years will ultimately pay 24 per cent tax rather than the full 40 per cent when he sells the investment. Investment management fees are taken from gross income rather than net income and do not bear VAT which effectively halves the cost when compared with a directly invested segregated portfolio.

The issue of whether to buy individual stocks and shares or to use the unitised approach is a key decision to be taken before selecting a fund manager. There is a further structural decision to be made as to whether distributing or non distributing funds should be used. Generally speaking, distributor funds have the major advantage of taper relief but there

are certain circumstances when an accumulating fund may be appropriate. Examples of this would be for certain types of offshore trust - largely depending on the domicile or residence of the settlor - and for individuals who currently pay higher rate tax, but who may pay only basic rate tax in future years, because they retire, or no tax at all, because they move abroad.

The fund management companies tend to provide private client services in a relatively structured way. It is therefore important to match the structure required with managers who deliver on that basis.



Paterson: advocates thorough research into managers

a private investor moves from cash into his chosen bond/equity mix. The period over which this should be spread and the percentage with which you start should depend on market conditions at the time. There is no great science to be applied to this, rather more common sense.

The Investment Brief

All of the above considerations should be reviewed and determined in creating a comprehensive investment brief. It is only then that you can really consider who out of the universe of fund managers is technically capable of meeting the brief - and it is only fund managers who meet those criteria who should be invited to attend a beauty parade.

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Timing of Investment

Do not believe anybody who tells you that they can add consistent value by timing when to go in or out of the market! There are always hundreds of reasons for not investing now: these range from the market being too high - and must therefore be due for a correction, to the market sinking too low, because it must be about to fall lower.

Many private investors believe that they will be able to spot the market moving decisively upwards before investing from cash and getting in at the right moment. They are likely to be disappointed. Most private clients lose more money being out of the market at the wrong time than they ever do from being in the market at the wrong time.

Nonetheless, it is generally considered sensible to spread the period of time over which