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# The Case for Segregated

by David Poole

**A**s a UK private investor in the stock-market, the only certain way of avoiding capital gains tax altogether is by dying. It can, of course, be deferred along the way, and the variety of vehicles or schemes achieving this reflects the acceptance that tax will forever be a major consideration in any long term investment planning process.

But the debate about the extent to which tax should dictate the right investment policy has rarely been more relevant than it is now, following the far-reaching changes to capital gains tax which Gordon Brown, the UK's Finance Minister, has introduced in his recent budgets.

The measures have been well covered in the financial press, and there is no need to revisit them here in anything more than a summary. Indexation of gains has been replaced by tapering relief, effectively penalising those who buy and sell shares within a ten year period.

With more punitive rates applying in the early years, (but no worse than before the budget), and reducing to 24 percent after ten years, the instinctive reaction from much of the financial community is that the only way forward is to invest in pooled vehicles, (investment or unit trusts), where such restrictions do not apply within the funds, thereby enabling the investor to benefit from gains rolling up over a long period.

IFAs and fund managers with long stables of unit trusts have long cautioned the investing public against being conditioned by tax when struc-

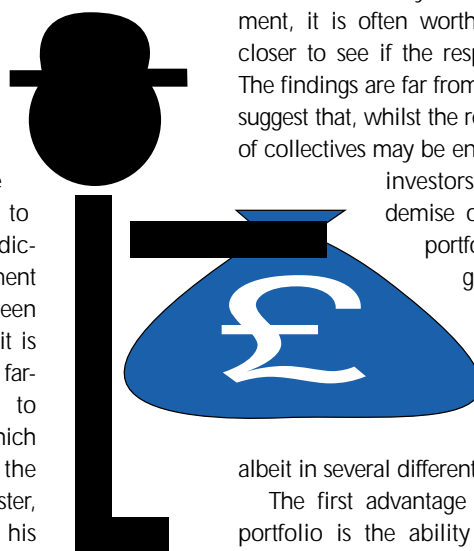
turing their portfolios. It is a little curious, if not hypocritical, that the new proposals, (perhaps through their complexity), now seem to encourage them to do this.

## Greater Flexibility

But when so many seem to be in agreement, it is often worth looking a little closer to see if the response stacks up. The findings are far from conclusive, and suggest that, whilst the relative attractions of collectives may be enhanced for some investors, so has the demise of the segregated portfolio been exaggerated. Their advantages can be summarised in one word: "flexibility", albeit in several different facets.

The first advantage of a segregated portfolio is the ability to move assets from one manager to another in the event of repeated underperformance. Individual shares can be transferred 'in specie' to a new manager as often as desired. If an investor is locked into a pooled vehicle, the only way to transfer to another manager is to sell the units, triggering a potential liability. Obviously a move to another manager with a segregated portfolio is likely to involve some restructuring at the new house, but this is a much more positive approach than holding on to underperforming units, just because to do so would reduce the capital gains tax in later years. The greatest merit of the segregated portfolio is that the investor retains control over asset allocation and the underlying assets themselves. As one of, perhaps, many thousand holders in any particular unit trust, no such freedom exists for an unexpected change of circumstances.

A UK investor committing funds to a



pooled vehicle with an object of long term capital growth, will be more hampered by tax than one in a segregated portfolio if his requirements should change and he should then need to skewer his portfolio towards a higher income. A unit holder will have to sell outright, triggering a taxable gain, and start again in a another fund, whereas any segregated portfolio, tailored from the start to the investor's long term goals, ought to be able to withstand a modest reorganisation without incurring huge tax liabilities.

The bulk of the portfolio can be left undisturbed, but the investor's objectives can be met by increasing his weighting in fixed interest, making full uses of annual allowances and any losses. Whilst annual allowances are available to all, losses within a pooled vehicle are not.

A sudden need for cash takes this theme a little further. An investor in a pooled fund is 100 percent committed and his entire investment is potentially taxable in such an event. A typical segregated portfolio, however, will almost certainly contain between 10-20 percent in tax free assets, such as UK gilts (UK government bonds) or cash. Combined with the use of any losses, the segregated portfolio ought thus to be able to provide a greater degree of liquidity, with significantly lower tax liabilities.

Although perhaps a less important consideration, fees are generally more flexible within a segregated service. Pooled portfolios tend to be more expensive. Internal charges of between 1 - 1.5 percent are typical, whereas a segregated fund could be up to 0.5 percent lower, even on a 'clean fee' (no commission) basis. There is also the ability to exclude significant levels of cash or inactive gilts from the fee. In contrast, the fee scale in a fund is fixed, regardless of the assets and levels of activity.

## Long Term Investing

The UK government's express intention, when introducing the new CGT rules, was to encourage long term investment (i.e. over more than three years), although quite why successful investment should

be any more desirable in more time rather than less is open to question.

The pooled fund route clearly allows this imposition to be circumvented. Managers of such funds can trade actively every day without regard to the tax consequences of their actions. Quite apart from this not being the intention of the new rules, use of these funds presupposes that their managers can add value relative to the market after the cost and spread of each share is taken into account.

The growth in the popularity of index tracking funds suggests a rather different story, however. The efficiencies of markets in larger companies has made it difficult to add value by trading regularly in the likes of Shell or Marks & Spencer, so the incentive to buy and hold for the



long term within a segregated portfolio is strong. To adopt this approach, whilst benefiting from all the associated flexibilities at the same time, is to make use of a most valuable asset: an interest free loan from the government (tax due on gains), repayable not at the lender's behest, but at the borrower's: i.e. the fund manager on behalf of his client.

The power of compounded gains is a little acknowledged phenomenon too often overlooked by some fund managers who continue to operate as if all assets are within a gross environment, buying and selling over the shorter term with little regard to the devastating consequences on the value of their funds.

But maybe private client fund managers have a better understanding than is perceived. Over the past few years the return of a private client portfolio, whether biased towards capital growth or income or just balanced has consistently outperformed the total average return of managed pension funds. The tax considerations begin to be less burdensome.

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Undoubtedly, the complexity of the new rules will drive many to despair, and large houses with the resources to promote their retail funds will prey on this in promoting the simplicity of the pooled fund. But investors would do well to question the emphasis here and ask to what extent this is a convenient disguise to pedestrian performance. The notion that it is very hard to outperform a pooled vehicle because of its friendly tax structure is flawed.

Segregated funds, therefore, will continue to provide a valid investment approach for those who already have existing portfolios, as it will for those who wish to retail flexibility of asset allocation, are sceptical of fund managers' ability to add value through trading, or are fee conscious.

For his part, the segregated manager must be disciplined: run the winners, take the losses to refresh the portfolio, invest (not trade) for the very long term, remembering that his charge is a net investor and that the power of compounded equity dividend interest on an infinite non-recallable loan from the government is of inestimable value to his client.

