

SII Masters in Wealth Management – Applied Wealth Management - Sample questions

SECTION A

- 1 What ‘risk-sensitive’ policies and procedures must be established under the Money Laundering Regulations 2007 (MLR 2007) and what would be the outcome if these measures were not implemented? (5 marks)**

Customer due diligence measures and ongoing reporting
Internal reporting

Record – keeping procedures (for five year period)
Internal control

Risk assessment and management

Compliance monitoring, management and communication of the policies and procedures

Recognition of suspicious transactions and reporting procedures (including appointing a Money Laundering Reporting Officer)

Staff training programmes

Criminal offence if not implemented punishable by a maximum of two year’s imprisonment, or a fine, or both. 5 marks (½ per point)

- 2 What are the key differences between unit trusts and single premium life assurance bonds? (5 marks)**

Unit Trusts	Single Premium Bonds
Restricted range of investment subject to FSA rules	Wider range of investments possible
Income distributions subject to income tax	Annual withdrawals up to 5% not immediately subject to tax, only on final maturity of the bond
Encashment of units subject to CGT	Encashment may be subject to income tax, but top-slicing relief available
No CGT payable by unit trusts	CGT payable by the life fund, reducing performance
More involved administration for the investor	More straightforward administration for the investor
More difficult to switch between unit trusts, involving more costs and a disposal for CGT purposes	Possible to switch between different funds within the bond, possibly incurring a switching charge

5 marks max, 1 per difference

3 What is the taxation treatment of Open-ended Investment Companies (OEICs) and of their investors? (5 marks)

Dividends not taxed at source will be subject to a 20% corporation tax charge.

Interest, rent and foreign dividends will suffer no further tax other than 10% deducted at source

Capital gains within the OEIC are exempt from CGT

Dividends to investors are paid with a tax credit of 10% that satisfies the tax liability for basic and lower rate taxpayers

Higher rated tax payers are liable to an additional 22.5%

Fixed interest funds pay interest with 20% deducted

Higher rate taxpayers must pay 20% more and starting rate taxpayers can reclaim 10%

Non taxpayers may reclaim tax on interest distributions but not equity distributions

OEICS holdings outside a tax wrapper will pay capital gains tax on disposals

An offshore OEIC will not be taxed internally on distributions 5 marks (½ per point)

4 What are the main features of Contracts for Difference (CfDs)? (5 marks)

Buying CfDs does not confer ownership of the underlying asset. Investors can take positions on the price of a great number of different instruments.

The price of the CfD tracks the price of the underlying asset, and so the holder of a CfD benefits, or loses, from the price movement in the stock, bond, currency, commodity or index etc.

CfDs are margin-traded so an investor or fund manager can use CfDs to buy exposure to market movements using only a fraction of the capital they would require in the cash market. The investor then has a geared position relative to the capital deposited.

CfDs allow the investor to benefit from downward movements in a share or other price if they choose. This has the effect of adopting a position of 'short selling' the stock. This flexibility, and the possibility of margin trading, means that CfDs can be used flexibly either for hedging or speculation.

The costs of CfDs comprise a cost built into the spread of the CfD price, together with a funding charge.

CfDs have the advantage that there is no stamp duty or stamp duty reserve tax (SDRT) to pay, although the holder will be liable to capital gains tax on gains.

Can be risky because of the gearing.

5 marks

SECTION B

- 5 a) Evaluate whether a Real Estate Investment Trust could provide them with both income and growth in a tax efficient manner. (6 marks)

A REIT is a company that owns and manages property on behalf of shareholders and can encompass either commercial or residential property, or both. In the UK, 'UK-REIT' status exempts the company from corporation tax.

REITs, distribute nearly all of their taxable income to investors to obtain exemption from capital gains tax and from corporation tax. A minimum of 90% of the REIT's profits from the ring-fenced letting business must be distributed to investors.

Investors pay tax on the dividends and capital growth at their own marginal tax rates, thus avoiding the double taxation that would otherwise affect investors in UK property companies. This is of benefit to Michael and especially Susie who is a non-tax payer at present

REITs are designed to securitise the income from rented property assets in a tax efficient way and to ensure that the return from investing in a property company is more aligned with direct property investment.

The company will be subject to an interest-cover test on the ring-fenced part of its business, a measure of the affordability of any loans which makes it less risky an investment than some.

REITs can be held within an ISA wrapper but the limit is £7,200 per annum per person at present. It would be much better to put the majority of the holding into Susie's name rather than split it equally to make the most of her currently little used personal allowance.

The timescale for investment is long enough to produce some growth one would hope and obviously should produce income, but this investment will take over ten years to be truly tax efficient.

6 marks

- b) Appraise the advantages and disadvantages of pooled property investment. (3 marks)

Advantages of pooled property investment

The investor is 'buying' expert property management.

The investor can buy into a large, well spread fund. This can be spread according to type, e.g. office, warehousing, retail and geographically, with reduced risk because of this diversification.

Although there is some illiquidity in the pooled funds, particularly in the property fund and the Enterprise Zone schemes, liquidity is greater than with direct investment.

A relatively small amount of money can be invested in a pooled fund. A substantial sum would need to be committed to the purchase of even a modest commercial property.

Disadvantages of pooled property investments

The investor does not have direct control over the properties.

It may be difficult to realise capital quickly particularly from a property bond or Enterprise Zone scheme.

The Enterprise Zone schemes are illiquid and high risk.

3 marks (½ per point)

c) Outline the personal tax treatment to a UK resident of offshore bonds. (3 marks)

Taxation treatment of offshore bonds

Withdrawals of up to 5% of original investment can be made on a tax deferred basis

Investments held in the bond are not liable to UK taxes but are taxed according to the rules of the country in which they are domiciled

Tax deferral advantages – income and gains roll-up free of tax (but are eventually taxable in the hands of the UK resident investor)

Tax payable on gains can be deferred until the investors are in a lower tax bracket

Investment will grow faster because tax not deducted at source

All gains are fully taxable as income and so tax could be due at 40% on encashment – due at marginal
3 marks

d) Critically appraise the main features of a Venture Capital Trust and assess whether it would be a suitable investment for Michael and Susie. (7 marks)

Main features of a VCT

Quoted limited companies that must invest at least 70% of funds in qualifying holdings (shares and securities)

30% by value of qualifying holding must be in eligible shares

No holding in any company (other than another VCT) may exceed 15% by value of the VCRs investments

VCTS may be geared which increases the risk.

VCTS do not pay tax on realised investment gains and these gains can be distributed to investors as tax free dividends – but no tax relief for any losses incurred

Qualifying holdings must be issued to the VCT and unquoted or on AIM

A means of investing in unquoted and AIM securities that are high risk businesses 2 marks

Tax position for investor

Maximum investment £200,000 per annum – can invest more but the excess will not be a tax reducer

Must be 18 and can claim a tax reduction in their tax liability of up to 30% of the amount subscribed

Income tax relief at 40% on qualifying investments of up to £200,000 in a tax year if shares held for 3 years.

Disposals of qualifying shares at a profit are normally exempt from CGT if held for three years

Dividends on shares in VCT tax free income on a limit up to £200,000 by value of VCT shares acquired in one tax year.

Investors must not be connected with the company itself.

Tax relief not given where shares were not acquired for bona fide commercial purposes.

Relief withdrawn if shares disposed of within five years of issue (unless to husband or wife).

Can't defer gains any more but gains exempt CGT if disposes of shares in VCT when issued and still VCT at disposal – although unlikely to make a profit and no allowable loss. Must meet the £200,000 test for tax free dividends.

High risk

Poor track record

Difficult to sell

All these features may negate the tax breaks

5 marks

e) Evaluate their prospective portfolio.

(1 mark)

House £950,000

REIT £220,000

VCT £300,000

Cash £80,000

They want growth. Portfolio lacks diversification, greater majority of assets illiquid and too much risk.

1 mark

SECTION C

a) Outline the main features of hedge funds and structured products and assess their suitability for Gordon and Gail. (10 marks)

Hedge Funds are often based off shore and may be unauthorised. Normally their clientele is restricted to high net worth individuals such as Gordon and Gail.

Hedge funds have a range of investment strategies and may invest in almost any type of financial instrument eg gold, cocoa, currencies, interest rate future or other derivatives. In addition they often take short positions in stocks by using, for example, CFDs.

Performance amongst the funds is very variable – some are extremely successful while others have gone out of business. They tend to be more successful in volatile markets but that has not stopped several going under recently.

Types of fund include:

Event- driven funds

Merger-arbitrage funds

Macro funds

Fund of hedge funds

They are highly geared and not regulated by the FSA.

Usually they require a minimum investment of £100,000 for small funds and £500,000+ for larger funds. Fees consist of an annual charge of between 1 and 2% and usually a charge of a further 20% is levied on profits made for the investor.

Gail and Gordon could certainly afford this type of investment but they need to be aware that the greatest risk is at the start-up stage and that, very often, there is a lock up period of funds for 1 -2 years.

The risks would need to be explained very carefully and it would be unwise of them to place all of the share option proceeds into hedge funds. They would also need to be talked through the various hedge fund approaches and would need specialist advice before they invest anything.

Structured products are securities that provide investors with an amount on redemption which may provide either full or partial capital protection plus a certain type of return.

The return may be promoted through the buying and selling of options or other derivatives and thus are geared and incur transaction costs of option trading.

May be located offshore

Can be index-based

Often fixed period to the investment

Can be fixed interest structured products (FISPS) with debt instruments as the underlying

Might use zero dividend preference shares with the balance as derivatives

Can be very complex and highly risky

1 per 2 points Max 10 marks

b) Rearrange the couple's portfolio (including the net house proceeds and the shares) to provide the income and growth they require. Provide calculations to show how it meets their objectives and give reasons for your choices. Ignore transaction costs. (25 marks)

Current portfolio:

Shares	£7,600,000 (assuming a share price fall to £3.80 - approximately half way between £4.50 and £3.00)
House	£600,000
Equity ISAs	£63,000
Bank	£8,000
Cash	£2,500,000
Total	£10,771,000

Suggest leave the £63,000 in equity ISA

Income return required $350,000/10,771,000 = 3.25\%$

Suggested portfolio **which is indicative only**

	Gordon	Gail	Income
Equity ISAs	70,200	7,200	
Corporate Bonds eg UBS Active Bond 4.9%		1,000,000	49,000
Fixed rate cash account 6.5%		2,000,000	130,000
Easy access account 1.25%	100,000	100,000	3,000
Gilt fund eg CIF Strategic Gilt A 7.3%		2,000,000	146,000
Index linked Gilt fund:			
G M&G Real Yield A 15.1%		200,000	30,200
Sub total	170,200	5,307,200	358,200
Fund of funds hedge fund	1,000,000	1,000,000	
Global Growth ITC	1,000,000		
Emerging markets ITC		1,000,000	
Zero dividend prefs	615,300	618,300	
National Savings Certs	30,000	30,000	
Total	2,815,500	7,955,500	
Grand Total		10,771,000	

Reasons for choice:

Cash (running a boat is expensive) better rate fixed term but need access also – put most of cash in Gail’s name as current pays much less tax than Gordon.

ISAs tax free

Income provided by gilt funds and corporate bond

Risk but potential growth from fund of funds hedge fund

Better diversification across the globe (although could be currency risk)

Zero dividend prefs for growth and Nat Savings Certs tax free and secure

Could substitute unit trust for UTCs and have accumulation units

25 marks

c) What issues do Gordon and Gail need to consider before they draw up their next wills?

(5 marks)

Are they really sure about cutting out their children?

Are the children likely to contest the wills and have they been told?

Are there any other close relatives?

Who would be the executors?

Are they going to make use of their annual exemptions?

What if they have grandchildren?

If they were to change their minds about this would they take out a policy to cover IHT?

Do they wish to make gifts to charity?

Are they in good health?

Have they thought through the tax implications if the second of them were to die and also what would they wish to happen to the money then?

1 per 2 points 5 marks