



**SECURITIES & INVESTMENT INSTITUTE MASTERS IN WEALTH
MANAGEMENT
SUMMER 2009**

**CHIEF EXAMINER'S REPORT-
APPLIED WEALTH MANAGEMENT**

This was the second time this paper was sat. Thirty – eight candidates sat the examination. There was a mark range of 43% between the lowest and highest score. Candidates still need to ensure they familiarise themselves with the meaning of the level descriptors used at Masters level. Please read the rubric carefully and start each section on a new page. Try to write neatly and ensure bullet points are professionally presented. Current market knowledge should be included where appropriate. Please time the paper carefully and ensure answers have enough detail in them. The sections do not need to be answered in any specific order. It would be helpful if all examinees put down the order in which they had answered the questions on the paper on the front of the exam script.

These days it is not often that many people at this level, and/or stage in their career, have to sit and write for three hours non-stop so it would be a good idea for future candidates to practise writing answers. Time management remains an issue for some candidates who do not manage to finish the paper. Also, if a question asks for the advantages and disadvantages of something, candidates need to ensure they answer the question under those headings, please, so the marker is quite clear that candidates are aware of which is which.

SECTION A

Question One

Answered by 20 candidates with an average mark of 2.4. This was poorly answered by many candidates who wasted time writing about hedge funds (which was not called for here). Few candidates mentioned the EEA or the implications of designated territories.

Question Two

Answered by 9 candidates with an average mark of 1.89. An unpopular question and poorly answered by candidates with a lack of accurate detail (eg the timescales involved) provided with the exception of a few candidates who did give accurate , detailed answers.

Question Three

Answered by 31 candidates with an average mark of 3.03. Five excellent answers provided and three good ones but unfortunately some muddled answers also. .Both types of warrants

are traded on exchanges (not over the counter) , calls and puts apply to covered warrants, not just calls, and the fact that no stamp duty is payable on covered warrants was rarely mentioned.

Question Four

Answered by everyone with an average mark of 3.39. Some good answers here with candidates correctly evaluating the lack of information available, lack of liquidity, levels of investment, risk and limited controls for investors. Some candidates spent too long on the types of companies invested in by private equity organisations rather than the characteristics of private equity companies themselves.

Question Five

Answered by 32 candidates with an average mark of 3.28. The majority of candidates made a reasonable attempt at this question and had clearly revised this topic or were aware of the key characteristics required. Weaker answers were less detailed.

Question Six

Answered by 17 candidates with an average mark of 1.82. A few very good answers but this was a prime example of where candidates failed to read the question properly. Many candidates wrote about who is eligible to claim compensation from the Financial Services Compensation Scheme rather than who is not eligible which was what the question asked for.

SECTION B

Question 7

- a) The average mark was 4.2. Most candidates made a reasonable attempt at the question but, as stated above, several wrote down a list of things without making it clear whether they are an advantage or disadvantage. Key point here are that with a purchased life annuity capital is lost and with income shares form an investment trust company capital is at risk. Some candidates wrote that investors would receive both income and capital appreciation which is highly unlikely.
- b) The average mark was 4.5. Again it was not always clear which was an advantage or disadvantage. A handful of candidates wasted time suggesting alternative portfolios, which was not required. Sensible comments were made about inflation and low annuity rates and low gilt yields although very few pointed out how liquid gilts are.
- c) The average mark was 3.5. Candidates were either familiar with this topic area or they were not and the type types of fund were muddled up. Weaker answers barely mentioned taxation at all and this was specifically required.

Question 8

- a) The average mark was 4.4. This question was answered well, on the whole, although some candidates did not write enough to gain good marks. The key issue here for both investments is liquidity.
- b) The average mark was 2.1 Fairly general, as opposed to detailed, answers were provided here.
- c) The average mark was 3.13. The majority knew the main features of the Enterprise Investment Scheme and gained good marks.
- d) The average mark was 4.32 and the question was well answered on the whole. Several candidates worked out the percentages of the individual holdings, which was sensible. Key points here were tax efficiency, risk (50% in EIS) and the lack of diversification (25% was in property). Some candidates commented on the lack of ISAs and fixed interest securities in the proposed portfolio.

SECTION C

Question 9

- a) The average mark was 5.24. A straightforward question which was well answered by the majority.
- b) The average mark was 5.34. A straightforward question which was again well answered by the majority.
- c) The average mark was 2.34, less confidently answered. There was a strong hint in the storyline that Martin was not a suitable person to place in charge of money and would thus probably not make a suitable trustee. Only two candidates picked up on the point that guardians would need to be appointed for the children.
- d) i) The average mark was 5.47. Some candidates thought it was necessary to provide £60,000 of income although in reality only £30,00 was needed. Most used the ACPIMS benchmarks to apportion the portfolio which was a reasonable thing to do. Two candidates included weightings in AIM stocks but the lack of liquidity, wide spreads, lack of transparency and recent scandals means they are very risky.
ii) The average mark was 7.32. Many good, detailed explanations of why the assets had been allocated as they had.

The following information is provided solely for the guidance of candidates and should not be read as providing a model answer, nor, in some instances, as the only possible response.

SECTION A

1. Funds categorised as Undertakings for Collective Investments in Transferable Securities (UCITS), which are constituted in other European Economic area member states. These are automatically recognised by the FSA

Funds authorised in designated territories ie non-EU countries such as the Channel Islands, Bermuda and the Isle of Man. The FSA recognises that certain countries in which investments are based offer a similar regulatory authority and investor protection to that offered to the UK investor onshore.

Individually recognised overseas schemes funds. The FSA provides for the recognition of overseas schemes on an individual basis.

Non regulated and non recognised funds are subject to severe marketing restrictions in the UK. Prospectuses and details can only be forwarded to investment professionals such as stockbrokers and IFAs. **5 marks**

2. The property must:
 - be situated in the UK.
 - be run on a commercial basis.
 - be furnished.
 - be available to let for not less than 140 days per fiscal year.
 - not normally be occupied by the same person/people for more than 31 days for at least seven months within a twelve-month period. **5 marks**

3. Covered warrants are warrants over the shares of a company other than the securities house issuing them. Technically, a warrant can only be issued by the company itself, since it gives the investor the right to buy new shares in the company. The securities house issues a long-dated **option** into the security and this is referred to as the covered warrant. In order to cover its position, the securities house may own shares in the relevant company or warrants on the company's shares.

Covered Warrants	Warrant
Not necessarily for new shares (typically cash settled)	Usually for new shares
Can exist as calls/puts	Call version only
No stamp duty	Stamp duty
Trade on regulated exchange	Trade on regulated exchange

Covered warrants are unlike ordinary warrants in that they are issued by financial institutions and are based on an underlying asset which may be a share or an index. Covered warrants give the holder the right but not the obligation to buy (call) or sell (put) the underlying asset at a specific (strike) price. Settlement can be in the form of the underlying asset or for cash (particularly for indices, as there is no specific underlying asset).

5 marks

4. High entry levels. Private equity investment is primarily for wealthy investors and a fund may typically require an initial commitment of around \$1m which may be drawn at the discretion of the manager over the first few years of the fund

Unfunded commitments. Managers may not draw all fund committed by the investor, if the firm cannot identify suitable investments

Investment risk. Private equity investments, particularly those in venture capital fund, carry a high level of risk, with an associated potential for high returns

Generally limited control by investors. Most investors are passive and rely heavily on the managers

Low liquidity. It is very difficult for investors to realise their interests before the managers realise their interests in the portfolio. Funds can be locked up for as long as 12 years and distributions are generally only made when investments are sold by the managers

5 marks

5. To be appropriate for benchmarking purposes, an index must be indicative of the performance that could realistically have been achieved.

The characteristics that are required to render an index suitable as a benchmark are therefore that it is:

- Specified and unambiguous
- Appropriate to the nature of the fund (e.g. a UK blue chip fund may utilise the FTSE 100 Index)
- Appropriate to the currency of the fund
- Investable, i.e. composed of investments that could conceivably be held in the fund
- Measurable, i.e. the return can be calculated on a frequent basis as required
- Representative of achievable performance, i.e. it has an arithmetic weighted composition (remember that the return of a portfolio is an arithmetic weighted average of the individual stock returns)
- Measures the relevant component of performance, i.e. total return indices for total return performance and capital value indices for capital growth

5 marks

6. An ineligible claimant is defined as a claimant who is:

- An individual with a connection to the insolvent firm, e.g. directors
- A large company or large partnership/mutual association. What is meant by a large company and partnership will depend on rules established under the UK Companies Acts, which are amended from time to time
- An authorised firm, unless they are a sole trader/small business and the claim arises out of a regulated activity of which they have no experience, i.e. do not have permission to carry out
- An overseas financial services institution, supranational body, government and local authority

5 marks

SECTION B

Question 7

a) i) purchased life annuity

Advantages

- Guaranteed income - low risk
- Provides income for life/fixed period
- Could purchase escalating income
- Only 'non capital' element is taxable

Disadvantages

- Income target of £14,000 likely to be unachievable
- Capital base 'lost' completely
- No prospect of growth
- No future flexibility as cannot change mind

Suitability

Unsuitable as the sole investment

ii) income shares from split capital investment trust

Advantages

- Will achieve target income
- Can cash at later date
- Can change mind

Disadvantages

- All income taxable
- Capital gain very unlikely - loss almost inevitable
- Level of income not fixed or guaranteed

Suitability

Unsuitable as the sole investment

6 marks

b) Taking pension now

Advantages

- Certain income for life
- Can utilise remaining assets to increase estate, supplement income or 'enjoy life'
- Additional lump sum
- Taxed at 20%, then 40%

Disadvantages

- Annuity rates very low at present
- Better return available from gilts and corporate bonds
- Too young – at current rates lucky to get 4%

Investing other assets in Government Gilts:

Advantages

- Certain income, paid twice a year (gross)
- Safe investment
- Liquid
- Easily available, many to choose from
- No CGT if he needed to sell

Disadvantages

- Capital will be eroded (trading over par)
- Estate to be left to niece will diminish
- Lack of diversification
- All income taxed at 20% /40% (savings)
- Gilt yields low – corporate bonds better but higher risk

8 marks

c) Distributor funds

- Status applied for annually
- Must distribute 85% of income after charges annually
- Restricted in holdings which can have in offshore funds
- Dividends paid as gross income
- Capital gains subject to CGT
- George would pay tax at 40%
- May as well remain in UK

Non-distributor funds

- Many are roll-up funds ie income is accumulated and no dividends paid
- All gains fully taxed as income
- Cannot use indexation, taper relief or CGT exemption
- Can be used to shelter accumulated income
- George could realise profits when tax rate has dropped or become non-resident
- Both highly unlikely thus unsuitable

6 marks

Total 20 marks

Question 8

a) i) property ownership

Advantages

- Taper relief; CGT exemption
- Have as asset which has historically increased in value
- Rental income will be received if property is rented out
- Income could be received tax free if in Jane's name (non-taxpayer)

Disadvantages

- Could have problem tenants
- Property prices currently affected badly by downturns in the market
- Illiquid asset
- High management charges
- Maintenance of property could be expensive

ii) investing in a property bond

Advantages

- Provide access to the commercial property market, which is costly for the individual investor
- Wider range of properties can be contained within one fund – spread of risk
- Could invest in a fund which holds ground rent properties only

Disadvantages

- Rental income and realised gains are subject to tax - no tax reclaim possible
- Bid and offer price spread
- Can be problems with encashment if company chose to place moratorium on encashment
- Potential of higher rate tax on gains following death or surrender
- Valuation of property is subjective and governs the price of the units
- May be liable for higher rates of income tax over and above his investment

Max 6 marks

b) Long-term care insurance plan

Wide range of plans available

Normally pure protection or investment based LTCI plans

Pure protection cheaper but no surrender value – offer financial protection only if client needs long term care at some stage

Also immediate care plans which is either an annuity or funded by equity release

Protection based LTCI can be an optional benefit on a universal whole of life policy or stand alone

Stand alone can be immediate benefit or designed to meet a future need.

Immediate benefit will involve the purchase of an annuity on special terms to take account of a shorter life expectancy. The annuity will be a purchased life annuity

Capital content and investment element – the latter has 20% deducted at sources but HRT would pay another 20%

Future needs plans unit –linked and funded by a single premium which buys units in selected unit linked funds or could be similar to term assurance policy
 Annual reviews when policy holder over 70
 Can also get with profits plan
 Life policy may be a benefit payable on death
 With unit linked policies may be a surrender value
 Term based plans do not have surrender value
 Premiums do not get tax which buys units in selected unit linked funds or could be similar to term assurance policy
 Annual reviews when policy holder over 70
 Can also get with profits plan
 Life policy may be a benefit payable on death
 With unit linked policies may be a surrender value
 Term based plans do not have surrender value
 Premiums do not get tax relief
 Benefits paid to a care organisation will be tax free
 Policies should not be written on a life of another case basis and should exclude cash benefits
 Lot to be said against these policies **Max 4 marks**

c) Main features of an EIS

Income tax relief at 20% on qualifying investments of up to £500000 in a tax year
 Disposals of qualifying shares at a profit normally exempt from CGT if held for 3 years
 Investors must not be connected with the company itself
 Relief withdrawn if shares disposed of within three years (unless to husband or wife)
 Can defer chargeable capital gain by reinvesting gain in shares into EIS
 Suitable means of investing in unquoted securities that are high growth businesses but high risk investment
Max 4 marks

d) Proposed strategy

Pros:

- Sufficient accessible capital
- Good cash management to get a higher rate on cash deposits
- Gains within property fund only taxed at basic rate – Harry is a HRT
- The EIS attracts income tax relief if properly structured
- Gains on EIS will be tax free if held for 3 or more years
- Offshore bond rolls up gross gains – they could be abroad when gains are realised and pay less (maybe no) tax
- Unit trusts give a spread of investments
- UT and property bond are managed

Cons:

- High risk strategy
- EIS is very high risk
- Property bond is once sector only
- Two together make up 70% of capital

No use of Harry's CGT allowance
Jane's CGT allowance unlikely to be used every year

Max 6 marks

SECTION C

Question 9

a) Fixed interest securities vs equities

Advantages:

- Fixed interest give a secure fixed income – equity does not
- Capital amount upon redemption – depends on equity performance
- Fixed interest gives stability to the income from the portfolio. The amount is set up to maturity – not true of equities
- Fixed interest – known term
- Income from fixed interest is normally higher than equity yields
- Value of ISA tax break is greater on fixed interest income as opposed to dividend income
- General economic conditions will not affect fixed interest income stream although will affect yields
- Bonds less systemic risk than equities
- In event of company bankruptcy will be paid before shareholders

Disadvantages:

- Effects of inflation reduces the purchasing power of the income and capital value (still true in a low inflation environment, but as will be more so when investing long term as inflation can still rise).
- The income will not grow – equity yields fluctuate
- Possible capital loss – true also of equities
- Capital value fluctuates during life of the bond – true also of equities
- Investment grade bonds offer higher returns than government gilts but more volatile although not as volatile as equities unlike sub-investment grade
- Restricted choice/availability in comparison
- Early sale gives market price – same as equities
- Return only known if held to redemption
- Gilt yields low at present – some equity yields are high
- Some corporate debt being downgraded at present

Max 8 marks

b) direct vs indirect investment

Advantages

- Direct investment can get good diversification with the amount she has
- Transparency – can see what is owned
- More scope for personal choice
- Often cheaper
- No holding costs
- Can make better/easier use of CGT allowance

Information available if pay for it
Secondary markets – cheaper and targeted
Can invest in companies with small capitalisation (which collectives find hard to do)
Not reliant on skills of fund manager who may in any case change funds

Disadvantages

Does not have expertise in managing a portfolio, so discretionary management needed
Direct equity/bond investment can be more expensive than indirect investment with brokers fees, stamp duty on purchases, CGT and possible PTM levy
Some forms of investment cannot easily be achieved from direct equity investment Eg overseas shares
More time consuming if DIY (more paperwork and research needed)
Easier to diversify with unit trusts with smaller sums of money
Uts, ITCs and OEICS not themselves subject to CGT whereas direct equities – income tax on dividend income and capital gains tax on any capital gains
Indirect investment provides a far wider underlying portfolio of shares via the unit trust/OEIC than can be gained, failure/downturn of a single share is minimised as holdings are well diversified.
Less scope for overseas investment
Money is not pooled with other people's funds so less scope for diversification than with collectives and thus there can be more risk
No pound cost averaging
More difficult to specialise in specific sectors
Difficult to invest small amounts of money safely on a regular basis

Max 8 marks

c) Will provisions

The aim of estate planning is to ensure that all the beneficiaries are treated in the way that the deceased would wish.

A well drawn will should ensure that the liability to inheritance tax is minimised.

Recognition of the three main assets which could, in total, be subject to IHT- Fiona currently has:

- the inherited sum
- a house (currently valued at £750,000)
- an interest in a business (value unknown)
- £100k in bank
- pension benefits
- company shares (but these may be subject to BPR)

thus there would be a liability to IHT and a detrimental effect on the estate if the will was not drawn up to minimise the effect of IHT.

A whole life in trust policy, which provides a lump sum on death, could be taken out which would place funds outside the estate. A back-to-back scheme would remove the cost of the annuity from the estate (need to get permitted specialist advice for this).

There is no IHT liability on money left to the surviving spouse but this only removes £200k so Fiona may wish to reconsider.

They need to choose executors. The executors are responsible for ensuring that the terms of the will are carried out.

The children of the second marriage are minors, thus the will needs to appoint a guardian to look after these children in the event of the death of both parents prior to the children attaining the age of 18

When making a will consider leaving money to the two younger children in a discretionary trust until they reach the ages of 18 (or whatever age Martin and Fiona wish to specify) but the IHT will depend on the settlor's cumulative transfers in the seven years before her death and the value of the trust property. Suitable trustees would need to be appointed.

Max 6 marks

d) i) Indicative Portfolio

Total to invest (£900,000 + £100,000) = £1,000,000

Total income required from portfolio £80,000 - £20,000 (pension) - £30,000 (profits) = £30,000 (shortfall)

Required gross yield 3.00% gross

With the required income of £80,000 Fiona will be a top rate taxpayer

Tax efficiency needs to be considered where possible

Investment	Amount £	Gross Yield %	Income
2 High interest bank accounts - liquid cash separately registered with the FSA	100,000	3	3,000
Index linked NSCs	15,000	Nil	-
Current issue fixed rate NSCs	14,800	Nil	-
Investment Grade Corporate Bond funds eg Invesco Perpetual High Income, M&G Corporate Bond, Invesco	250,000	6	15,000
Share ISA	7,200	nil	-
Range of funds, unit trusts, investment trusts etc, eg Cazenove UK Absolute Target Fund, L&G Global 100 Index Trust	500,000	2.5	12,500
Total	<u>1,000,000</u>		<u>£30,500</u>

ii) Reasons

Justification for the 10/30/60 or whatever split is chosen by the student. If a candidate went for 100% equities, the portfolio would cause concern.

10% cash for unexpected expenses so as not to disrupt portfolio

tax efficiency via ISA - no taxable income,

NSCs are tax efficient and guaranteed return over 5 years - no income paid

Corporate bond funds – best bet a present

indirect using a mix of investment trusts/unit trusts/OEICs under 4 to 5 different managers to reduce risk of one manager having a poor year.

Provide professional management and diversification

Could consider an indirect investment in an overseas market to provide further diversification and greater long term capital growth

Could also consider investing part of the equity element into single premium bonds

These are tax efficient, allowing 5% p.a. withdrawals over 20 years, free of tax at time of withdrawal

On encashment these are subject to top slicing, but with good tax planning a phased encashment could mean that tax is not paid at the top slice (top rate - basic rate)

Equity investment (indirect) should have low dividend yield

Equity based investment will provide growth of income and capital in the long term.

Additional investments would be acceptable, for example exchange traded funds

Max 10 marks