# An IFA can broaden your investment horizons

## Introduction

Although the idea of investing to provide for your future financial security is gaining wider acceptance, for the would-be investor, finding the most appropriate investment can be a daunting prospect.

Consulting an Independent Financial Adviser (IFA) will be an obvious first step for many, particularly those who are looking at the various types of collective investment vehicles available rather than planning to invest directly in shares.

Most of us now recognise the need for some kind of retirement funding, but there is an increasing emphasis on the need for the individual to take out some kind of private provision across a broad range of areas, from healthcare to education.

But while retirement funding is obviously a basic need, a pension plan need not be the only route to providing for your future.

As well as savings vehicles designed for specific purposes – such as school fees provision – there is also a whole range of opportunities open to the investor wishing to generate extra income or build up a capital sum for the future. Additionally, the investor can address the need to provide for dependants in the event of an unexpected loss of earnings.

## Direct investment

All the forms of investment open to UK investors can, broadly speaking, be split into two main categories – direct investments, such as stocks & shares, or collective investment schemes.

Firstly, direct investment. For the majority of UK investors, this generally means shares or bonds or gilts. Although the spread of share ownership has widened considerably in Britain since the early 1980s, and with it public awareness of what share ownership means, it is worth reiterating the basic principles.

The price of a company's shares is determined by the value of its assets and its potential to generate further revenue. If shareholders begin to see the estimates of future revenue as unduly optimistic, or if the value of the company's assets declines, they are likely to sell their shares and this may cause the share price to fall. If the reverse happens, demand from buyers will increase – thus pushing the share price up.

The trade in stocks and shares, facilitated by market makers whose role is to quote both a buying and selling price for listed stocks and shares, is known collectively as the stockmarket.

Public Limited Companies (PLCs) in the UK are listed on the FTSE All-Share index, with the 100 largest listed on the FTSE 100. Companies wishing to issue shares but lacking the financial muscle for a full market flotation, or new start-up companies, may opt for the Alternative Investment Market (AIM), which means that, in most cases, companies listed on

AIM carry higher risk than those listed on the main stockmarket. For the investor, the drawback to investing in AIM stocks is their lack of liquidity. Market makers will constantly quote buy and sell prices for FTSE stocks, but as trading volumes on AIM are much lower, transactions are conducted using a process known as "matched bargain". This means the buyer or seller approaches the designated broker who finds a counter party for the deal. However, this in turn means the price agreed by the broker may be some way off the last quoted trading price.

**Bond and gilt investment**

The second principle form of direct investment is bonds and gilts. Bonds are basically chunks of debt. In buying a bond, the investor is effectively lending money to the bond's issuer. The investor knows in advance what sort of return they will get on their investment and bonds are generally regarded as a much lower risk category of investment than shares.

Gilts are bonds issued by the UK government – the name derives from the term "gilt-edged stock" – so by buying gilts the investor is lending money to the UK government. As the UK is regarded as a safe bet to honour its commitment to buyers of its government stock, gilts are in turn regarded as one of the safest forms of nvestment. The issuer – in this case the government – is guaranteeing to repay your capital at the end of the bond's term, (if there is a redemption date) and you also get a guaranteed coupon return throughout its life.

A bond with a face value of £100 will also pay a pre-set figure in interest every year to the holder – the coupon rate. When the rate is set it must be competitive with current interest rate levels but these may change, thereby rendering the return on your bond relatively less attractive than cash deposits. So bonds are traded in the market to reflect this. For example, a bond may be issued at a time when 6 per cent is an attractive interest rate return and as a result your £100 bond may pay a coupon rate of 6 per cent. So you have paid £100 to get £6 per year plus your original investment back at the end of the bond's term.

But if interest rates jump to 9 per cent your coupon rate starts to look a bit weak. You therefore sell your bond in the market, but no-one will pay £100 to get only £6 a year so you have to sell at a lower figure that builds in the difference in rates.

Of course you can take comfort from the knowledge that you will get your capital

back at the redemption date, in this case from the UK Treasury.

But it is not just governments who issue bonds. Corporate bonds work in a way that is broadly similar to government bonds – they are issued by companies as a way of raising money from investors. Again, they pay a coupon rate coupled to a pledge to repay the capital at the maturity date. Like gilts, they can be traded on the market if investors want their capital back before the maturity date.

However, companies can default on corporate bonds, so return of capital is not guaranteed. Corporate bonds are therefore risk-graded, with higher risk bonds paying a higher coupon to attract buyers.

Guaranteed return of capital is clearly an attraction, although it has to be weighed against the potential for higher returns offered by the stockmarket. But while recent years have seen the long-term appreciation of prices in the stockmarket as a whole, the investor cannot rely on every individual company seeing an increase in the value of its shares.

This is the major potential pitfall of direct share investment – any company is at the mercy of conditions in its own particular business sector, and even companies in generally profitable sectors can fall victim to bad times. Correctly identifying which companies to invest in is therefore vital for direct share investment. Warning against putting all your eggs in one basket may seem a little obvious, but relevant in this context.

You should keep a close eye on how your investments are doing. Potential investors often find the prospect of constantly keeping tabs on their share portfolio too daunting and for this reason – as well as those outlined previously – many opt to take their first step into these markets via collective investment schemes rather than direct stocks and shares investment.

## Pooled investment schemes.

In the UK there are three principal types of mainstream collective or pooled investment schemes – unit trust, investment trust and Open Ended Investment Company (OEIC).

All three will take the pooled monies of a large number of investors and put them in the hands of a professional fund manager. He or she will choose a broad spread of instruments in which to invest, depending on their investment remit. The main asset classes available to invest in are shares, bonds, gilts, property and other specialist areas such as hedge funds or ‘guaranteed funds’.

There are key differences between the three types of scheme structure.

### Unit trusts

An investor in a unit trust ‘buys’ a number of units, while an investor in an investment trust or OEIC ‘buys’ shares. Unit trusts are open-ended, which means that units can be issued as demand requires. The price of these units is dependent on the value of the underlying assets, and they can be sold back to the fund managers by the investor. Most UK collective investment schemes are authorised by the Financial Services Authority (FSA).

**Investment trusts**

Investment trusts are structured as companies so their shares are traded in the same way as any other limited company’s shares.

Investment trusts offer a wide range of investments.

**Open Ended Investment Companies (OEICs)**

The OEIC is structured along similar lines to the unit trust, but it differs as it has no bid/offer spread. This means buyers and sellers get the same single price. Additionally, the OEIC has an “umbrella” structure allowing numerous sub-funds investing in different types of assets, so the investor can switch easily between different investment funds.

Given the range of options of unit trusts, investment trusts or OEICs, the choice can be confusing – consulting an Independent Financial Adviser could help simplify your investment choice.

**Index trackers and active management**

Among the various types of fund management, two definite methods have emerged – active management and index tracking.

Proponents of these two approaches debate over their respective merits, but many observers have concluded that a “horses for courses” attitude is appropriate for investors.

Through research and analysis an active manager will seek to identify companies which he or she believes will perform better than their rivals, or whose current share price makes them a bargain buy. Potential returns depend on whether the manager gets it right or wrong.

An index tracker fund tracks a stockmarket index. Having decided which recognised market index is most appropriate for the tracker fund, the manager (often a computer rather than a person) will invest in such a way as to replicate the make-up of that index. In times of good stockmarket performance tracker funds are attractive.

But the critics of tracker funds point to two potential drawbacks. Firstly, if the index falls, the fund must go with it. Secondly, the cost of running the fund – administration fees, management fees, etc, can mean that tracker funds' performance is just below that of the index itself.

Active managers argue that their skills allow them to produce better returns than the market average, and hence the index, as well as to avoid the worst of any market falls by switching away from the worst-affected shares. "Ah yes...", say the trackers, "...but how often do the active managers actually beat the index?"

The debate rages on, but the argument serves to reinforce the importance of getting good independent financial advice.

There are hundreds of collective investment schemes to choose from. The services of an Independent Financial Adviser can greatly simplify the investment process.

**Investment. The profits and perils**

So why should the saver, who has been content to build up a nest egg in a deposit account, move into the riskier area of investment in equity or bond markets? Well, the main reason is the chance of a higher return than can be obtained from deposit accounts. If the investor is prepared to be patient, mainly types of investment are not for the short term, over time he or she should be able to expect a higher return.

The investor must also consider the question of risk. In a low interest rate environment the return on your deposit account may decrease, but there is no threat to your capital. Investing in shares is different. Potential returns can be much greater than those offered by cash deposits. But if the shares in which you have invested were to fall in price, there is a real threat to your capital itself. If you are forced to sell your shares at a time when they are performing poorly, you could actually end up with less money than you started with.

An Independent Financial Adviser can help establish what level of risk you should take with your investments.

**Direct investment**

Direct investment in shares is conducted through stockbrokers who will buy or sell shares on your behalf for a commission. Terms will vary from one stockbroker to another but commission will be charged as a flat fee or a set percentage.

If you intend to actively manage your share portfolio by regularly buying and selling different shares then the commissions will start to stack up. The shares which offer the greatest potential for high returns may also present the greatest risk to your capital. So unless you intend to invest directly in a broad range of stocks and shares, you should probably consider a collective investment scheme instead.

**Collective investments**

- Unit trusts and OEICs can be bought directly from the provider of the fund or more commonly, through an Independent Financial Adviser.

- Investment trusts are most commonly bought through a stockbroker, but again an IFA can also advise on their purchase.

Details of funds and fund providers are published in a range of specialist financial publications as well as sections of the national press.

**Investing online**

Use of the internet has opened up another access route for investors. Many providers now offer their funds via websites. However, given the range of investments and the amount of information available it is a good idea to seek professional, independent financial advice before proceeding.

**Tax efficiency**

If you are looking to invest directly in shares or bonds or collective investment schemes, a tax-efficient method of doing so is through an Individual Savings Account (ISA).

An ISA is not an investment in itself – it is a tax-efficient "wrapper" which you may use to hold a range of investments.

As the UK's principal tax-efficient investment plan, an ISA can incorporate a stocks and shares element within which you can invest up to £7,200 for the 2008/2009 tax year. Up to £3,600 of this allowance can be saved in cash with one provider. The remainder of the £7,200 can be invested in stocks and shares with the same or another provider.

Within the stocks and shares element of an ISA you may invest directly in shares or bonds or collective investment funds.

ISAs are explained fully in another IFA Promotion booklet, entitled 'ISA guide'.
It makes sense to take advantage of all the existing tax allowances and your IFA will be able to help you do this.

## Offshore investment

In specific cases, offshore investment may be worth considering. From the UK perspective, offshore funds have traditionally been used mainly by expatriates. Because UK expatriates do not generally pay UK income tax, it makes sense for them to invest in funds based in a low-tax centre such as Luxembourg or the Channel Islands. However, some funds, accumulation funds in particular, can offer a tax efficient use of offshore funds to the UK resident.

If you are a UK expatriate intending to return only on retirement when your tax status will be more favourable, there are benefits in keeping your investments offshore.

Funds based in an offshore centre are generally not covered by the regulations which govern their UK-based equivalents. This means the investor does not always enjoy the same level of protection offered in the UK. Funds based in several of the larger offshore centres are deemed to meet UK regulatory standards where that centre has been granted "designated territory" status by the UK. Such funds can be marketed in the UK, as can funds based in the European Union and approved under the EU's UCITS (Undertakings for Collective Investments in Transferable Securities) regime. If this all begins to look like a minefield, that serves to highlight the importance of getting independent financial advice.

As well as offering tax advantages, lighter regulation in offshore centres means funds can invest in a much wider range of markets than most onshore vehicles – a big attraction for the more adventurous investor.

But do remember that capital and income values may go down as well as up and you may not get back the amount invested, also exchange rate variations may cause the value of overseas investments to increase or decrease. Past performance is no guarantee of future performance.

But the offshore sector presents all manner of pitfalls for the unwary, so for investors considering a move in this direction, getting specialist advice is of paramount importance.

Here the services of an IFA with specialist knowledge of the offshore market can prove invaluable.

## Questions and answers

Whatever the nature of the investments you are considering, the starting points should be the same. An Independent Financial Adviser will be able to help you

identify the type of vehicle best suited to your needs, based on your own preferred balance between risk and return.

Most obvious among the questions you should ask is “How much will it cost?” All collective investment schemes have built-in charges, but these vary, so ask your IFA to explain. For the newcomer, the charges can be difficult to understand so it is important that this is explained properly.

Another key factor is how long you intend to invest. Make sure your IFA understands your wishes clearly when it comes to short, medium and long-term investments. Lastly, make sure you understand all the risks of your chosen investment.

For further information on the subject contained in this guide, please contact your IFA.

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