

# Part

# I

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## INTRODUCTORY ELEMENTS



# Chapter

# 1



# WEALTH MANAGEMENT

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.....**1.1 INTRODUCTION**

The activities undertaken by staff working in investment administration are essential to the successful delivery of investment services and products.

None of these products can deliver what the client expects if dividends do not arrive on time, trades are not placed correctly, purchases and sales do not settle on time, corporate actions are misinterpreted or shares are not correctly transferred when a new account is opened.

There are a myriad of activities that need to be undertaken for an investment account to function smoothly and it does not matter whether this is for a customer who only has a few holdings in his stocks and shares ISA or it is for a wealthy client with a discretionary managed investment account.

For these to run smoothly requires an efficient investment administration function staffed by a team of knowledgeable investment professionals.

Before we can begin to understand the many and varied functions involved in investment administration, we need to appreciate the range of investment products and services that are offered within the wealth management industry that it supports.

This chapter on wealth management provides an overview of the wealth management market and looks at the key role that investment administration plays in enabling these functions to operate effectively.

## 1.2 WEALTH MANAGEMENT MARKET

Before we look at some key data about the market for retail investment services, we need to undertake a brief review of the role of the financial services industry in order to set the context for products and services that are available.

It is generally accepted that the financial services industry fulfils three core functions within an economy, namely bringing savers and borrowers together through the investment chain, allowing risks to be managed and providing payment systems.

The investment chain links individual savers to firms seeking funds for investment and opportunities for savers to manage their finances. This is achieved through the financial services industry whose function in this chain is the design, manufacture and sale of financial products including such items as:

- banking accounts;
- National Savings investments;
- cash ISAs (Individual Savings Accounts);
- guaranteed growth bonds;
- guaranteed income bonds;
- choice of 2000+ unit trusts
- mortgages;
- life assurance bonds;
- term assurance;
- protection policies.

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As well as products, the financial services industry also aids this function by the delivery of investment services to effectively manage an individual's assets and financial affairs, including:

- financial planning;
- fund supermarkets;
- investment wrappers;
- internet stockbroking;
- execution only share dealing;
- self-select ISAs;
- advisory share dealing;
- discretionary investment management;
- Self-Invested Personal Pensions (SIPPs);
- trusts.

The investment services provided to the retail investment market are usually split according to wealth and can be broken down into three elements, namely mass market, self-directed and wealth management.

The mass market is typically where one-off sales of investment products take place. Beyond straightforward product sales, is the market for investment services. The self-directed element of that refers to the situation where an investor takes control of his own investment affairs either with or without taking specialist advice.

Then there is the market for wealth management services, which are usually classified as mass affluent and high net worth. What constitutes either mass affluent or high net worth is usually based on the value of investable

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assets that a client has available. The wealth management market is usually broken down into four categories based on the US dollar value of assets the client has available to invest:

- mass affluent with assets over \$100,000;
- high net worth with over \$1 million of assets;
- very high new worth with over \$5 million of assets;
- ultra high net worth with over \$30 million of investable assets.

### **1.3 TYPES OF BUSINESS**

The market for wealth management services is huge and is of sufficient size to allow a number of firms to specialise in different sectors, from internet stockbroking to full-service private banking.

In this next section, we will look at some of the types of services that are on offer and the delivery channels.

#### **Financial planning**

Unless the investor self-selects suitable investments, financial planning is at the heart of selecting which investment products and services a client should use.

Financial planning is the methodology that is used to match appropriate investment solutions to client needs. It is about designing a diversified portfolio of assets that

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will deliver medium to long-term investment performance which matches the timeframe and level of risk assumed by the investor.

Financial advice can be divided into five distinct stages:

- Determining the client's requirements.
- Formulating the strategy to meet the client's objectives.
- Implementing the strategy by selecting suitable products.
- Revisiting the recommended investments to ensure they continue to meet the client's needs.
- Periodically revisiting the client's objectives and revising the strategy and products held, if needed.

The investment services and products that are selected will clearly depend upon the funds available to invest, the client's objectives and attitude to risk.

## **Delivery channels**

There is a range of ways in which investors can access financial services, including handling the arrangements themselves directly with the provider, taking advice from a financial adviser and using the services of wealth management firms.

Figure 1.1 provides a stylised view of the range of products and services that are available and the potential delivery routes. It gives an indication of the types of investment products and services that are available and



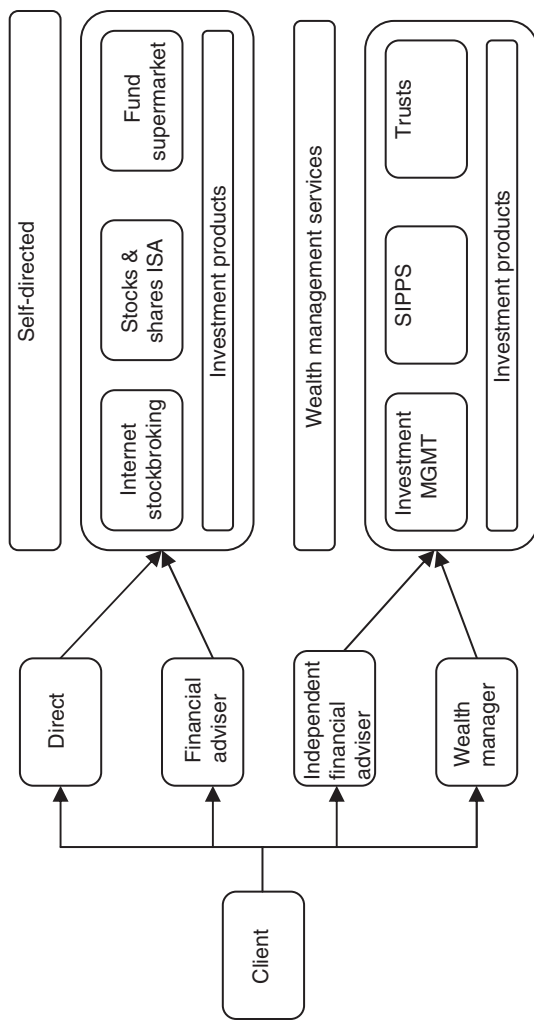


Figure 1.1 Delivery channels

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whether these are likely to be sourced directly or via a financial adviser or wealth management firm.

There is a range of investment-related products and services where investors can self-select the investments they wish to buy and sell, such as internet stockbroking accounts, stocks and shares ISAs and fund supermarkets. They can go direct to the product providers to access these services or do so through a financial adviser.

Although Figure 1.1 shows different routes, in practice there is no reason why an investor might use a wealth manager for one service and self-select another.

Indeed, clients can source financial services either themselves or via an intermediary and the market infrastructure recognises that most clients want an option in this regard. The decision on whether to make your own decisions or to take advice can sensibly be based on the complexity of the arrangements to be entered into. Some services, however, are only available through firms due to either the cost of delivery or the complexities involved in the product.

Wealth management services are targeted at the wealthier and can comprise a wide range of services and products. Typically, investment services such as discretionary investment management, SIPPs and trusts require far larger sums to be invested to either qualify for the service or to make it a viable option. As a result, they tend to be offered by firms in conjunction with their financial planning and other services.

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The providers of wealth management services range from independent financial advisers, to stockbrokers, private client investment managers and private banks. It is one of the fastest growing and most dynamic sectors of financial services and is known by various names including private clients, wealth management and private banking.

What characterises the services it offers is the investment management of liquid funds for its clients. The common feature of each of these services, therefore, is that they are investment vehicles and so each has a need for investment administration of the underlying assets.

## **1.4 INVESTMENT SERVICES AND PRODUCTS**

There is a range of wealth management services available and in this section we will look at the key features of some of the main ones, obviously focusing on the ones where investment administration forms an underlying core activity.

Figure 1.2 shows the potential range of services that a client might need with the wealth management ones highlighted; although that is not to say that a client will not require the other products as well.

The need for each of these varies depending upon client's stage in life and their wealth. Some are ongoing, whilst others are required only occasionally. Some can be done

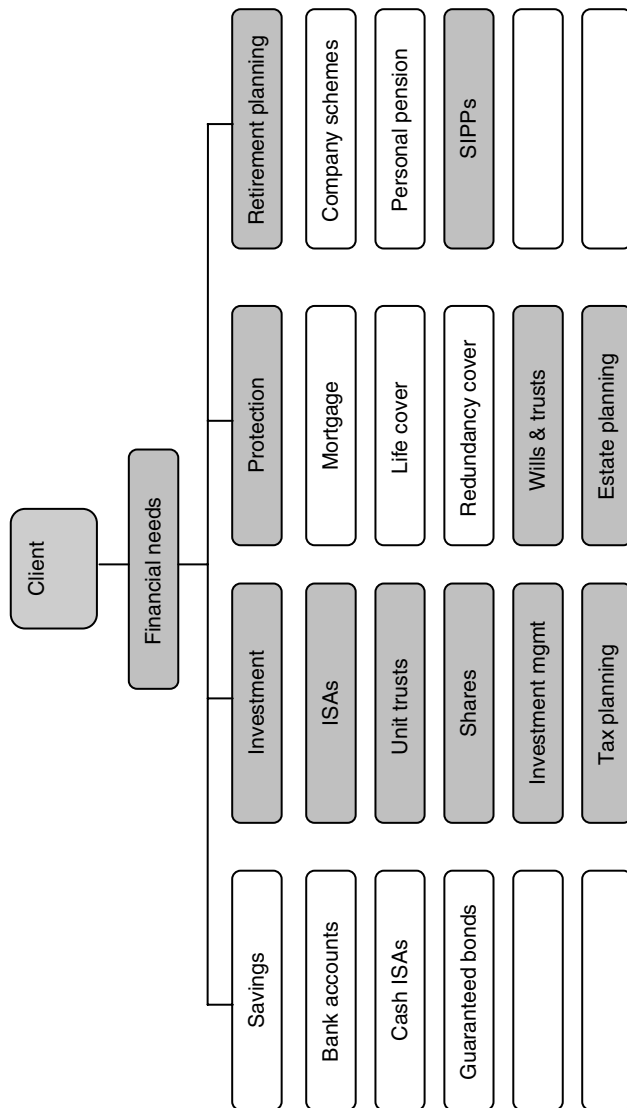


Figure 1.2 Range of services

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by the client themselves, whilst others require professional advice. Equally, some are generally available and others only to a firm's clients.

## **Stocks and shares ISA**

An Individual Savings Account (ISA) is an investment wrapper that can be used for cash and for stocks and shares. It can be offered as a standalone product but can also be offered alongside a stockbroking account and as an integral part of discretionary and advisory investment management.

A stocks and shares ISA carries tax advantages and as a result the rules surrounding ISAs are made by HM Revenue & Customs. Any gains made on the investments held in a stocks and shares ISA are free of capital gains tax, making them an attractive vehicle to build up capital in a tax-free environment.

Due to their tax advantages, there are limits on the amount that can be subscribed each year and on what type of investments can be held.

## **Collective investment schemes**

There is a bewildering range of collective investment schemes – that is unit trusts, OEICs (Open Ended Investment Companies) and investment trusts – available to

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investors. This makes the selection of the right fund difficult for investors and there are both self-select and managed services available to help investors make the right choices.

Fund supermarkets are designed to make dealing in investment funds easier and cheaper. They are generally internet-based platforms that give investors access to performance data on a range of different types of funds and which then provide an electronic method of buying, holding and selling funds.

To make their services attractive to investors they will usually discount the initial charge that a fund group would otherwise charge. From an investor's viewpoint, they offer the attractive combination of discounted initial fees and ease of dealing and administration.

The alternative is a managed portfolio of unit trusts. This is where a firm uses its expertise to select and manage a diversified portfolio of investment funds. It will do this on a discretionary basis and make changes to the composition of the underlying funds as its view on markets and prospects changes.

The initial investment for this type of service will vary but is usually in the range of £30,000 to £150,000. The firm will apply an annual charge for its management of the portfolio but as this is in addition to the charges for the underlying funds, they will usually negotiate heavy discounts for both initial and annual charges.

## Share dealing

Stockbrokers have for years provided a service whereby ordinary investors can trade in bonds and equities. This is the traditional role of a stockbroker, that is acting as an agent for an investor, whether they are buying or selling and involves them taking the order from the client and finding a counterparty offering the best price.

This core service is often referred to as execution-only stockbroking in order to differentiate it from the discretionary and advisory investment management services that a stockbroker will also offer.

In recent years, most stockbrokers have moved on to offering this execution-only service through an internet-based platform. This allows the firm to gain efficiencies by offering automated services and allows the client to gain access to speedier execution.

An internet stockbroking account will involve a client entering into a formal agreement with the provider and the service offered will target those investors who undertake only occasional trades as well as frequent traders. The service will also usually enable any investments purchased to be held in dematerialised form to enable clients to view their portfolio online and trade electronically via the internet.

The charges made will usually depend upon the volume of trading activity that takes place but intense competition between the main providers has driven these down.

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Although described as execution only, many firms provide additional services as well and will often give access to research material to its clients in order to aid them in identifying suitable investment opportunities.

**Investment management**

Provided an investor has sufficient funds, they can use the services of an investment firm to construct and manage a portfolio of stocks and shares to suit their investment objectives.

The portfolio will usually be linked to one or more of the firm's investment models with elements of the construction customised around the investor's attitude to risk, tax position and objectives. This allows the firm to manage a portfolio at an omnibus level and so ensure performance objectives are met, whilst still allowing for client-level adjustments to be made.

The service offered can be either discretionary or advisory. With a discretionary managed portfolio, the firm constructs an initial portfolio to meet the client's objectives, which will often be agreed with the client. Subsequently, it will make changes as and when it believes appropriate and report back to the client periodically on how the portfolio is performing. With an advisory portfolio, the same investment management takes place but any change to the portfolio will require the client's prior approval.



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The entry level for discretionary investment management services will vary from firm to firm depending upon which part of the market it is targeting but will usually be in the range of £150,000 to £250,000. There is significant competition for this type of business and as a result, the fees charges are competitive and often in the range of 0.75% to 1.25%.

The minimum investment level for advisory portfolios and the costs may well be higher in recognition of the increased cost that is involved in managing an advisory portfolio.

**Self-Invested Personal Pensions**

A SIPP or Self-Invested Personal Pension scheme is as its name suggests a pension fund where the investor can direct how the funds are invested instead of having to invest in one of the range of funds available from an insurance company.

Many firms offering SIPPs are stockbrokers and they will construct their product offering in such a way that the administration of the pension element of the plan is outsourced to a specialist pension provider. This can then leave the investor able to choose to manage the underlying portfolio using an internet stockbroking facility.

Although the title refers to self-invested, it does not mean that investors have to undertake the investment management themselves. They can appoint an investment

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management firm to undertake discretionary or advisory management of the portfolio.

As with ISAs, a SIPP offers tax advantages and as a result, HM Revenue & Customs also sets maximum contribution levels and defines permissible investments.

As there is a pension plan element to be administered as well as the underlying investment portfolio, costs will typically be higher than other investment management portfolios. There are also usually set-up fees involved and as a result, the usual recommendation is that the level of fees means that the minimum investment fund needs to be around £150,000 for this route to be economic.

## **Trusts**

A trust is a legal arrangement where one person holds assets for another. It can be used in variety of scenarios – for example to hold funds for young or disabled children; for charitable gifts; and in order to minimise tax liabilities

Trusts are subject to a wide range of complex rules and are used for a variety of purposes. Each may therefore vary considerably but within most trusts is an underlying investment portfolio.

## **Tax and estate planning**

It is virtually impossible to undertake wealth management without giving due consideration to an individual's tax position.

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As a result, most wealth management firms will also offer tax and estate planning services. The objective of these services is to organise the client's affairs in such a way as to minimise their liability to tax.

The tax services provided can satisfy needs ranging from constructing portfolios to maximising tax allowances to managing capital gains tax on substantial holdings. The services can also be one-off or ongoing and the charges depend on complexity of the client's affairs.

Estate planning is designed to ensure assets go to those intended on death with the amount of tax payable minimised. It can take many forms from drafting tax-efficient wills, making inter vivos gifts, creating trusts, to administering the estate of the client once they die.

## **1.5 INVESTMENT FIRMS**

There is a variety of investment firms that operate in the wealth management market from small privately owned firms to subsidiaries of major international banks.

Firms can be classified generally under the following headings:

- execution-only stockbrokers;
- full-service stockbrokers;
- private-client firms;
- private banks;
- international private banks.

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Each will offer a range of investment services from arranging deals, managing investment portfolios to full wealth management. Private banks will typically service fewer but wealthier customers, whilst the others will look to target the mass affluent market.

One of the biggest differentiators between them is the extent to which they use bespoke services to fit individual clients. So at one end of the range, private banks will offer a greater range of personalised services compared to the standardised services offered to execution-only stockbroking customers.

There is also a wide variation in minimum investment levels for investment management services. The sort of minimums levels that might apply are:

- stockbrokers £100,000
- private clients £150,000–£200,000
- UK private banks £1 million
- international private banks £5 million

**Execution-only stockbrokers**

An execution-only stockbroker is a firm that arranges to buy and sell stock-market securities on behalf of investors. In doing so, it does not offer advice on what stocks to buy or sell.

Its role is to act as agent for the investor and under the Financial Services Authority (FSA) rules it is required to

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obtain the best price for the trade. To do this, it will use trading platforms provided by the London Stock Exchange and may either deal electronically with a market counterparty or place a telephone trade.

As far as the counterparty is concerned, it has traded with the broker. It will look to the broker to settle the trade and will be uninterested who the broker's client is. There will therefore effectively be two trades to settle, one between the broker and the market counterparty and one between the broker and the client.

The broker may also trade as principal, which means that instead of seeking a market counterparty to trade with, it deals for its own account. If a client is selling, then the broker will buy the stock from the client and add the stock to its book. It may use that stock to meet other client orders or sell it on into the market. Either way, the broker has an obligation to ensure that its client receives the best execution on their trade and to ensure it discloses to its client that it has traded as principal rather than agent.

Other brokers may be part of a larger organisation and have their own internal market maker and may 'internalise' all of their orders. This is the same as when a broker trades as principal, but where they systematically internalise all of their trades. In order to ensure that their clients get the best execution, they will use a price improvement algorithm that identifies the best price that they could have dealt for the client externally and then add an improvement onto the actual price the client deals at.

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Execution-only stockbrokers offer a range of dealing services. They will offer a certificated service where investors place the order with them and sends in their share certificate and stock transfer form for the trade. They will also offer dealing services where they hold the investor's stock in one of their nominee accounts and administer the portfolio, leaving clients free to concentrate on the dealing they wish to undertake.

There tends to be no entry level for these dealing services. Execution-only stockbrokers make their money by charging for trading and so will have a tariff of charges that usually is higher for certificated dealing than dematerialised. Where stock is held in nominee accounts, there will usually be a quarterly administration fee which may be waived where the number of deals exceeds a required level.

Many of these dealing services are offered via the internet. When they first started to be offered, the services were quite basic but they now feature real-time pricing, market reports, graphs and access to research material.

Many execution-only stockbrokers have also expanded to offer discounted unit trust dealing. They are able to use the same systems platforms to administer the unit trusts or OEICs that a client holds and this has enabled them to widen the scope of the instruments their clients can trade.

To make it attractive for their clients and to attract new customers, they usually negotiate discounts on the

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initial charge that a unit trust makes. Initial charges can easily be 3.75% and these are often discounted to 1.5% making it a very attractive proposition for investors.

**Full-service stockbrokers**

A full-service stockbroker will offer a range of investment services from unit trust managed accounts to full discretionary management, as well as arranging deals for their clients. I have used the term full-service stockbroker to differentiate from ones who offer execution-only dealing services.

There is a large number of stockbroking firms around the country who have traditionally been the first choice for an investor seeking to have an investment portfolio managed, either on a discretionary or advisory basis. Stockbrokers vary from large to small firms and many differentiate on local service so they are often regionally located.

Stockbrokers will often have more flexible entry levels than private-client firms, which tend to be subsidiaries of larger organisations. They can also tailor their services to the needs of the geographic area in which they concentrate rather than having to offer a nationwide service.

The entry level will usually be a managed unit trust service which can have minimum investment levels as low as £7000. These are designed for clients who are looking to grow their assets and the funds will be invested in a range of well-diversified funds.

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Where clients have more substantial funds they will be offered managed portfolio services. The entry level for these may be as low as £100,000 and would involve the firm constructing a portfolio of bonds, equities and investment funds around the specific needs and objectives of the client.

They are also likely to offer other types of accounts that utilise other investment managers. These may be called wrap accounts or manager of manager funds. These are designed to give access to institutional fund managers that would not otherwise be accessible to a private investor.

A stockbroking firm will also offer financial advice and other investment products to its clients. The products will include ISAs to hold some of their investments but will often extend beyond that to offering trading in contracts for difference. The range of products and services might also include child trust funds, SIPPs and tax and trustee services.

**Private-client firms**

A private-client firm will usually be a subsidiary or division of a larger firm, such as an investment bank.

The services they offer to clients will also include managed investment accounts and a range of financial services and products. They tend to target investors with larger funds to invest and this is reflected in the



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minimum investment they will accept that can be anywhere in the range of £250,000 upwards.

They will generally operate a series of investment models that can be used to meet most client objectives. This allows them to focus on managing the top-level model against a series of benchmarks so that investment performance can be delivered. Changes to the models will then be fed down to the client level where some flexibility in implementation can take place to allow for client-level sensitivities, such as investment restrictions, risk tolerance and capital gains tax. The use of ISAs and Personal Equity Plans (PEPs) will usually be integral to the management of the investment portfolio.

The investment service offered will usually be fully integrated with its financial planning and wealth management services. They will therefore usually offer a wide range of services beyond just investment management which might include estate planning, tax planning and pension planning. The range of products available will also be wide and might include SIPPs, small self-administered pension schemes and uniquely negotiated investment bonds.

Although the services offered by private-client firms and stockbrokers may sound similar and the boundaries between what they offer are blurred, it is important to remember that it is a large market and there is plenty of room for different competitors and different offerings.

## Private banks

Private banks will target the wealthier end of the investment market and will look to offer both personalised services and a wider range of services and products designed to meet the needs of their wealthier clients.

The entry level for private banking services is usually at the level of £1 million of investable assets. At this level, clients demand extra service and private banks will focus on the quality not just of its wealth management capabilities but on the quality of its relationship management as well.

As well as investment management, they will also offer a suite of tailored banking services to meet the needs of their clients. They will also offer portfolio borrowing to allow their clients to borrow against their existing portfolio for investment in other assets to create leverage.

They will usually have tailored services that can meet the needs of wealthy investors and which will focus on wealth preservation. By definition, this will make effective estate and tax planning an essential and integral component of the service offered.

## International private banks

International private banks offer services that are designed to be the preserve of the ultra-wealthy. It is a huge market that is dominated by the Swiss banks and the

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major US global banks that are able to leverage their international stance to service the wealthiest.

They are able to offer individual specialist services because of the size of the investable funds and minimum entry levels can be a staggering US\$35 million.

Beyond investment management, their services can extend to art, other collectible assets and buying properties overseas. They will also have tax experts that allow them to advise and construct solutions that take account of the many issues that can arise across different tax jurisdictions.

**1.6 INVESTMENT ADMINISTRATION**

Having looked briefly at the range of investment services and products available, together with the firms who provide these services, we can now turn to see what part investment administration plays.

Investment administration is the core process that underlies many of the wealth management products and services described above and is essential to their effective delivery.

The way in which any of the above firms are organised will obviously vary but they would generally be organised

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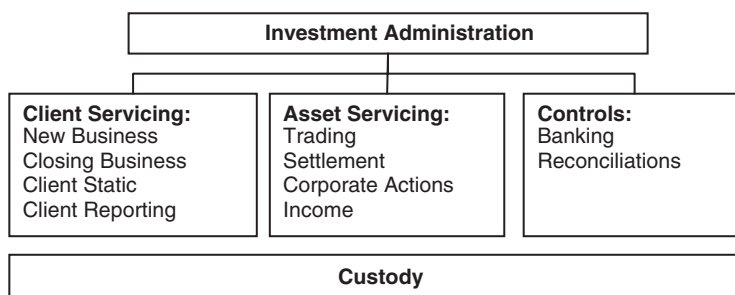


Figure 1.3 Organisational model for investment administration

around the common themes of:

- client relationship management;
- investment management;
- investment administration.

And a firm would typically organise its investment administration area around the core functions that take place as described in Figure 1.3.

The groupings bring together similar functions relating to client or asset servicing, with the control functions separated out.

The client servicing area will deal with new and closing business, which involves all of the activities needed to open or close an account. This encompasses money laundering checks, validating stock, transferring holdings and setting up a myriad of client and asset records so that a portfolio can function effectively. It requires a broad knowledge of financial planning, products and industry processes. It will also deal with issuing detailed investment and transaction reports to the client.

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The asset servicing area will handle all transactions that affect a client's holdings. It will deal with the placing of stock-market trades and their settlement. The corporate actions area will deal with events such as takeovers, rights issues, mergers, dividends and interest payments. A controls area will deal with the banking arrangements necessary for the effective running of a portfolio so that payments can be made and received, trades can be settled and dividends collected. This area will also undertake the essential process of ensuring that its record of client investments can be reconciled at all times with its custodian. All three areas are complex and rapidly changing and require staff with specialist knowledge.

We will look at many of these individual processes in detail as we progress through this book.

