Guide to Discretionary Investment Management

Rathbones

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Welcome

What is discretionary investment management? What can it do for me? How can I find an investment manager who is right for me?

This guide aims to answer questions like this – whether you're an experienced investor or looking at your choices for the first time.

We have included a glossary of the investment terms highlighted and a list of places where you can find more information.

1. What is discretionary investment management?

Discretionary investment management is a service offered by professional investment managers who specialise in managing individual investment portfolios for private investors and trustees. The professional investment manager will take responsibility for making all the decisions about the investments in your portfolio at their discretion, based on your requirements. This contrasts with a stockbroker, who will only give you advice about investments or act on your specific request.

2. Why might I want a discretionary investment management service?

You may have acquired a reasonable capital sum that you want to invest over the medium to long-term, rather than spend immediately. This capital may come from, for example, the sale of a property or business, a lump sum from a pension plan, or an inheritance.

You may have decided to invest part or all of your capital into something other than a building society or bank deposit account, with the aim of increasing its value. You will also have decided that you don't want to manage your own investments on a day-to-day basis.

If this sounds like you, then discretionary investment management may well be a good option.

3. Why use a professional investment manager rather than manage my own investments?

You may have investment aims that you need help to achieve, such as generating income or managing pension assets (typically in a self-invested personal pension or **SIPP**) to provide income and capital in retirement. Or you may have duties as a trustee which you would like to delegate.

Some private investors do manage their own investments and enjoy doing so. But in practice few people have much time to spend on their investments (or they have other things they'd rather do). Even fewer can monitor the progress of their portfolio consistently and respond to events confidently.

Further, while investment information is much more widely available these days, thanks to the internet, private investors acting alone still don't compete on equal terms.

As well as the practical experience that professional investment managers have built up over long periods, they generally have easier access to more real-time information and detailed research than private individuals.

Investment managers (particularly those with larger firms) can also meet and question face-to-face the people who manage the companies or investment funds they invest in. Few private investors get that opportunity.

Also, investing to meet your personal aims is not just about picking the right stocks or assets – it's about building an overall portfolio with the right mix of risk versus return as well as the right spread between different sorts of investments. These investments might include:

- cash and **bonds**;
- **equities**;
- **funds**; and
- alternative investments, such as **funds of hedge funds** or **structured products**.

This portfolio building is key to a successful service to private investors. So is the need to take account of your tax position, which can strongly affect the choice of investments.

4. How is my money likely to be invested?

Different discretionary investment firms manage their clients' money in different ways, so it's important to understand the different services you may be offered:

- **Funds** – Some investment managers may place all or some of your money in **collective funds** managed in line with a range of common investment strategies, typically classified as *growth*, *income* or *balanced*, depending on what they aim to achieve. They may manage these funds themselves or buy the funds offered by other companies in a **fund of funds**. Some will buy such funds for smaller clients (definitions of small can vary though, from £100,000 to £5 million) but manage larger portfolios on a **bespoke basis**.
- Directly invested – Other investment managers, like Rathbones, manage each of their clients individually, creating a personally tailored portfolio with a range of investments, such as fixed-interest bonds, equities, funds (often from a range of third-party investment funds) and alternative investments. Alternative investments can include funds of hedge funds and structured products, which have become increasingly accessible to private clients in recent years.

You should ask what percentage of your portfolio will be invested in **unit trusts** or other **funds** managed by the firm you appoint (technically referred to as in-house funds) and how well these funds have performed. A responsible firm will only suggest in-house funds if these have a good performance record; otherwise they will try to pick the best external fund in a particular sector.

5. What do you mean by 'alternative investments'?

This is a broad term used to encompass a range of what we call *non-traditional* assets (traditional assets being equities and bonds). In principle they can include everything from art and antiques to fine wine and *collectables* such as sports cars.

In terms of investment management, the commonly used alternative investments include:

- funds of hedge funds and structured products;
- property; and
- commodities funds.

These alternative investments may offer interesting risk-and-return possibilities as part of a balanced investment portfolio.

In recent years, funds and products have been developed that are more attractive for individual investors, with lower minimum investment, shorter investment periods and – importantly – more appropriate tax structures. However, researching this fast-moving market is time-consuming, and professional investment managers can generally buy these investments on more attractive terms than individual investors can, because they have greater buying power.

6. What about the use of more traditional assets?

Fixed-interest bonds (issued by governments and companies), equities (shares in companies listed on recognised stock exchanges) and funds all continue to form part of most private-client portfolios. Even if you are generally unfamiliar with investments, you will recognise many of the company names whose shares might be included in your portfolio, such as high-street banks and stores.

7. What happens if I have ethical investment concerns?

Because many discretionary investment management firms offer a bespoke service, they may be able to manage your portfolio to specific criteria you may have, such as ethical concerns.

These may range from merely avoiding companies whose activities you disagree with, such as the arms trade, alcohol and tobacco, to seeking out companies with positive policies towards things like climate change, fair trade and sustainable transport.

If this interests you, you should ask how far a firm can meet your ethical interests in these areas, or whether it has any recognised specialist expertise and in-house research resources.

8. If I choose discretionary investment management, what is my role?

You will need to discuss your requirements with your discretionary investment manager. Requirements may include a need for income from your investments, your attitude to risk, and your wider financial circumstances and future plans. Some investors seek investments that reflect their own values and contribute to a better society (see question 7). Your investment manager will take all your concerns into consideration when building your portfolio.

9. Will I really get a personal service?

Yes and no. All firms offer, and all clients expect, different amounts of personal contact. You should make sure you set the terms and that everyone is clear about what is expected.

Do you want a relationship directly with the person who will manage your investments, or are you happy to deal with a middle man (commonly called a client relationship manager)? Make sure you know what everyone's role is.

If you have doubts about the individual you meet, say so and feel free to ask them about their background and the way they work.

Are you content with their experience and the person who'll cover when they are unavailable? What qualifications do they have? Will you always deal with the same person or are they likely to change?

If you'd like to meet regularly face to face, say so. You should certainly meet an investment manager before deciding to invest. In any case, you'll need to meet to complete the paperwork (see question 12).

10. What will it cost me?

There are broadly two ways of charging for investment management services:

- fees (based on a percentage of the funds you hold); and
- dealing charges, which arise each time an investment is bought or sold on your behalf.

  Most discretionary investment managers will charge:

  a) an annual management charge or fee plus dealing charges; or

  b) a (higher) annual management charge or fee alone.

Many firms may offer both options (a) and (b), and you should ask. Charges are usually tiered – the rate goes down for larger portfolios.

There may be other charges too. They are often small in relation to the main fees and charges, but you should make sure you know what they are. By law, the discretionary investment management firm must explain these properly, so do ask if you are not clear.

11. What else should I find out if I'm trying to choose the right investment manager to look after my portfolio?

Ask as many questions as you want – investment managers are used to explaining what they do and how they do it, and should be happy to answer any queries.

Some common questions to ask include:

- how large is the firm?
- how long has the firm been in business?
- can you see a copy of its latest report and accounts or other similar documents?
- does it have an office nearby? Will an investment manager travel to meet you (and your financial adviser, solicitor or accountant if required)?

You can check whether a firm or individual is registered with the FSA at **www.fsa.gov.uk/register/**.

Other information sources are listed at the end of this guide under **'Further information'**.

12. How do I become a client of a discretionary investment management company?

You'll need to agree two key things with your chosen investment manager:

- your investment requirements (see question 8); and
- the process of setting up the portfolio – for example, are your assets held in cash or other investments, or are you looking to transfer funds from an existing investment manager?

You'll need to:

- complete an initial information form;
- sign an investment management agreement (you'll be guided through both documents and shown how to fill in the various entries); and
- provide documents such as your passport and a utility bill. This is because the law to prevent money laundering requires firms to check that all new clients are who they claim to be and that their money has not come from criminal activity.

Your investment manager will generally hold your investments in the firm's nominee company. This will enable them to handle all the administration associated with your investments, such as dividend claims, transfers and rights issues.

You remain the beneficial owner of the assets in your portfolio, even though the company register for each asset in your portfolio will show the investment manager's name instead of yours. Rathbones has its own nominee company for all UK trades and uses the Bank of New York Mellon for overseas trades. Other investment managers will have broadly similar arrangements.

13. What information will I receive to keep me informed about my investments?

You'll receive an initial valuation when your portfolio is set up and regularly thereafter, usually six monthly or three monthly. Feel free to discuss how often you'd like one. Before becoming a client, you can ask to see the format in which investment managers issue valuations – they should have a sample to show you. The key things a valuation should include are:

- a breakdown of the assets in your portfolio;
- details of transactions; and
- performance measurement against a range of benchmarks (you may even require a tailored benchmark).

14. What about information for my tax return?

You should ask your investment manager what information they will supply at the end of the tax year. Will they produce a tax pack detailing:

- all the income received from the portfolio;
- all purchases and sales of investments; and
- the capital gain or loss on any sales for the tax year in question?

15. What other information should I receive regularly?

Usually, when your investment manager buys or sells an investment in your portfolio you will receive a 'contract note' showing completed transactions. Some firms don't send contract notes but provide a statement of transactions, often attached to their six monthly or three monthly reports.

Some investors are happy to leave their investment manager to manage their portfolio and may phone them only occasionally. Others prefer to talk or meet more often. Many firms produce a regular newsletter to tell clients about relevant news and views.

You should agree with your investment manager how, and how often, you want to hear from them.

Glossary of investment terms

Alternative investments

Alternative investments generally include investments that don't trade publicly on an organised exchange. Examples include partnership funds, which focus on private equity and hedge funds and can include any non-traditional asset class, including works of art, horses, antiques, classic cars and fine wines.

These are generally regarded as higher risk and you should seek higher levels of expertise and advice before buying them.

Two alternative assets that have become increasingly attractive for investment managers looking after private clients are structured products and hedge funds or funds of hedge funds.

- **Structured products** – There is no universal definition for this term, as it covers many different types of investment. Broadly, structured products aim to provide the investor with a preset and expected return based on various assumptions about how markets will perform in future. To do this, they often use futures and options. Most structured products have a fixed life so investors know when they will mature. Many will have some degree of inbuilt capital protection, typically promising a minimum return of 100% of the original investment made at the time of issue. Some will fix a return of less than this but should, therefore, offer greater potential for high returns.
- **Hedge funds** – The term 'to hedge' means to manage risk. To do this the underlying hedge funds can employ techniques such as shorting (selling stock they do not own), leveraging (using borrowed money to buy investments) and the use of futures and options. They can also invest in different markets such as currencies, commodities and loans. Their main aim is to produce an overall return that is not closely correlated to, and is less volatile than, that of traditional assets such as equities or bonds.

Benchmark

A benchmark provides a standard against which the performance of an investment strategy or portfolio can be measured. Benchmarks are compiled by a range of financial institutions and trade bodies to cover specific markets, investment types and so on. The appropriate benchmark to measure a portfolio's performance against will depend on the strategy of that portfolio and the type of assets within it. For example the FTSE-100 or FTSE-All Share benchmarks are common for UK equity portfolios. For private client investment portfolios it is common to use the FTSE/APCIMS Private Investor Indices or benchmarks. These benchmarks incorporate a range of asset types – equities, bonds, even 'alternative investments' – that would typically make a private client portfolio. There are several Private Investor Indices for various portfolio models (growth, balanced and income) and they are published every weekend on the Databank page of the Financial Times' Money & Business section. Rathbones' growth, income and balanced models are all compared against the FTSE/APCIMS[1] Private Investor Indices.

Where there is no pre-existing benchmark appropriate for an investor's strategy, it may be necessary to develop one based on combining a number of pre-existing benchmarks.

Beneficial owner

A legal term where the specific property *rights* of an asset belong to a person even though the legal *title* of the property belongs to another person. This often applies where the legal title owner has implied trustee duties to the beneficial owner. In the case of nominee accounts this means that the investments are held in the *name* of Rathbones nominees but the investor retains the rights.

Bespoke portfolio management

If your portfolio is managed on a bespoke basis, then your investment manager is choosing and buying or selling a range of individual assets for your portfolio, based on their view of what is appropriate for you after discussing and agreeing your needs, risk profile, time horizon and so on. It means your portfolio will differ from other portfolios managed by your investment manager and from those managed by their colleagues. The alternative often is to have an investment manager place your portfolio in a single or a combination of a small number of collective investments.

Collective investments/funds

These are investment funds (sometimes referred to as managed funds or mutual funds) such as unit trusts, open-ended investment companies (OEICs), or investment trusts that pool the money of many investors. They invest in a spread of stocks and shares to give investors a well-diversified, professionally managed portfolio. This means they are generally lower risk than individual shares, and they are particularly useful in enabling you to invest in more specialised areas, notably overseas markets and smaller companies.

- **Investment trusts** – An investment trust is a company listed on the Stock Exchange. Since it is a listed company, dividends are paid in a similar way as an individual equity. The underlying share price of the investment trust is subject to supply and demand and may not accurately reflect the underlying value of the assets the company owns (which might range from property to other companies' stock depending on the investment aim or objective). These companies can therefore trade on premiums or, more typically, discounts to their underlying assets; ie the share price might rise to a level that values the company (the share price multiplied by the number of shares in issue) at a higher level than the assets it owns (a premium) or they might fall so that the company is valued at less than the assets it holds (a discount). Being a listed company they have the power to borrow (gear) which increases the assets available for investment, but also the risk.
- **Unit trusts/OEICS** – These are similar to investment trusts in that they are diversified portfolios of shares or bonds, but they are known as open-ended. This means that when investors want to buy into the fund, new units are created; and when they wish to withdraw their money, the units are cancelled in exchange for their cash value. The price of each unit is directly linked to the value of the underlying assets and therefore trades at asset value with no discount or premium as in investment trusts.

[1]APCIMS – Association of Private Client Investment Managers and Stockbrokers – it is Rathbones' trade body. See www.apcims.co.uk

Fixed-interest investments

Fixed-interest investments pay a set rate of return agreed at the outset. Their stability means they are often part of the portfolios of an investment manager's clients. They are relatively low risk and predictable, which is helpful for investors looking for income.

- **Gilts or UK government stocks –** These are the safest form of fixed interest since they are guaranteed by the government. Conventional gilts pay a fixed rate of interest until the government buys back the stock on a preset date at a preset price. If held to that date, the return they pay is therefore completely predictable and fixed. Their price, however, can rise and fall in the market, mainly depending on interest rates and inflation. Index-linked gilts are particularly low-risk investments since their return is linked to inflation. The income from them is also indexed but usually modest, which makes them attractive to investors who dislike risk and don't need income.
- **Corporate bonds –** These have similar characteristics to gilts. They are guaranteed by the underlying company rather than the government so are higher risk than gilts but give similar types of return. They'll normally have a higher yield (income return) than gilts, reflecting their higher risk. If a company performs badly or goes bankrupt, the holders of a bond would have priority over ordinary shareholders in receiving repayment or income.

Fund of funds

A fund of funds is an investment fund whose strategy is to hold a portfolio of other investment funds, rather than investing directly in shares, bonds or other securities. In this way it achieves more diversification for investors with the aim of reducing risk.

Futures and options

Futures are a financial contract obliging the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a preset future date and price. They are often used to hedge or to speculate on the price movement of the underlying asset. For example, a producer of corn could use futures to lock in a certain price and reduce risk (hedge). On the other hand, anybody could speculate on the price movement of corn by going long or short using futures. The main difference between options and futures is that options enable the holder to buy or sell the underlying asset at the expiry date, while the holder of a futures contract must fulfil its terms. In real life, few of the underlying goods specified in futures contracts are ever delivered.

Self-Invested Personal Pension (SIPP)

A type of UK government approved personal pension scheme, which allows individuals to make their own investment decisions from the full range of HM Revenue & Customs (HMRC) approved investments. HMRC rules allow for a greater range of investments to be held in a SIPP than in other personal pension plans such as equities and property. Rules for contributions, benefit withdrawal etc are the same as for other personal pension schemes. SIPPs, in common with personal pension schemes, are tax 'wrappers', allowing tax rebates on contributions in exchange for limits on access.

Shares, also known as equities

When you buy shares in a company you become a partial owner of it. The main benefit as a shareholder is to receive a share of the profits of that company, usually as a dividend. If the company performs well and increases its profits, the dividend should rise. The share price should increase as well, giving the prospect of capital gains. Shares are risk investments and their value can go down as well as up, as can the income you get from them (the dividend). You should view shares as a medium- to long-term investment. It is important to spread investment risk across a range of companies, sectors and markets to reduce the risk of losing out if any one company or sector performs badly.

Further information

The Association of Private Client Investment Managers and Stockbrokers has a directory of members (of which Rathbones is one). Write to 112 Middlesex Street, London E1 7HY, call 020 7247 7080 or go to **www.apcims.co.uk**.

The Financial Services Authority regulates all discretionary investment management companies in the UK. It also offers information for private investors at **www.moneymadeclear.fsa.gov.uk**.

Many of the national newspapers have weekly personal finance or money sections that offer advice, and most of their websites also offer information about personal finance.

Rathbone Investment Management

Rathbone Investment Management is one of the UK's largest and longest-established providers of high-quality, personalised, discretionary investment services.

We are part of Rathbone Brothers Plc, which remains an independent company with a listing on the London Stock Exchange.

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