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CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

Certificate in Private Client Investment Advice & Management

Private Client Investment Advice & Management

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Welcome to the Chartered Institute for Securities & Investment's Private Client Investment Advice & Management study material.

This manual has been written to prepare you for the Chartered Institute for Securities & Investment's Private Client Investment Advice & Management examination.

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20 Fenchurch Street, London EC3M 3BY, United Kingdom

Tel: +44 20 7645 0600
Fax: +44 20 7645 0601
Email: customersupport@cisi.org
www.cisi.org/qualifications

Author:
Christopher Grune

Reviewers:
Samuel Grayland
Kim Holding, Chartered FCSI
Ali Sadreddin

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Learning manual version: 12.1 (December 2025)

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Examinations at level 6 and level 7 are intellectually demanding tests which differ from the CISI's offer at levels 3 to 5 in a number of ways.

The examination will be based on the content of the syllabus. The workbooks are designed to support your learning. At levels 3 to 5 no further reading is expected in respect of the technical content of the syllabus, although regular scrutiny of the financial press will be an advantage. You are expected to be able to apply principles outlined in the workbooks to situations which are not explicitly stated in the workbook, and may be expected to use information from more than one area of the workbook in answering a single question.

At levels 6 and 7, while the official workbook is essential reading, you are expected to read around the subject, and this reading is not prescribed, although for some subjects, there are suggestions at the end of the syllabus. Questions will be set on the whole syllabus, and topical issues may be tested, so candidates are expected to be aware of developments in the relevant area of financial services.

As part of your preparation for all level 6 and 7 examinations you should thoroughly scrutinise past papers for your exam, all of which are available free of charge via MyStudy, and refer to the Examiners' reports, which are also available. Together, these give a detailed insight into the type of questions asked, although they should not be relied upon to predict questions or syllabus areas likely to be tested in future papers.

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Changes in industry practice, economic conditions, legislation/regulations, technology and various other factors mean that practitioners must ensure that their knowledge is up to date.

At the time of publication, the content of this workbook is approved as suitable for examinations taken during the period specified. However, changes affecting the industry may either prompt or postpone the publication of an updated version.

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It is estimated that this manual will require approximately 200 hours of study time.

What next?

See the back of this book for details of CISI membership.

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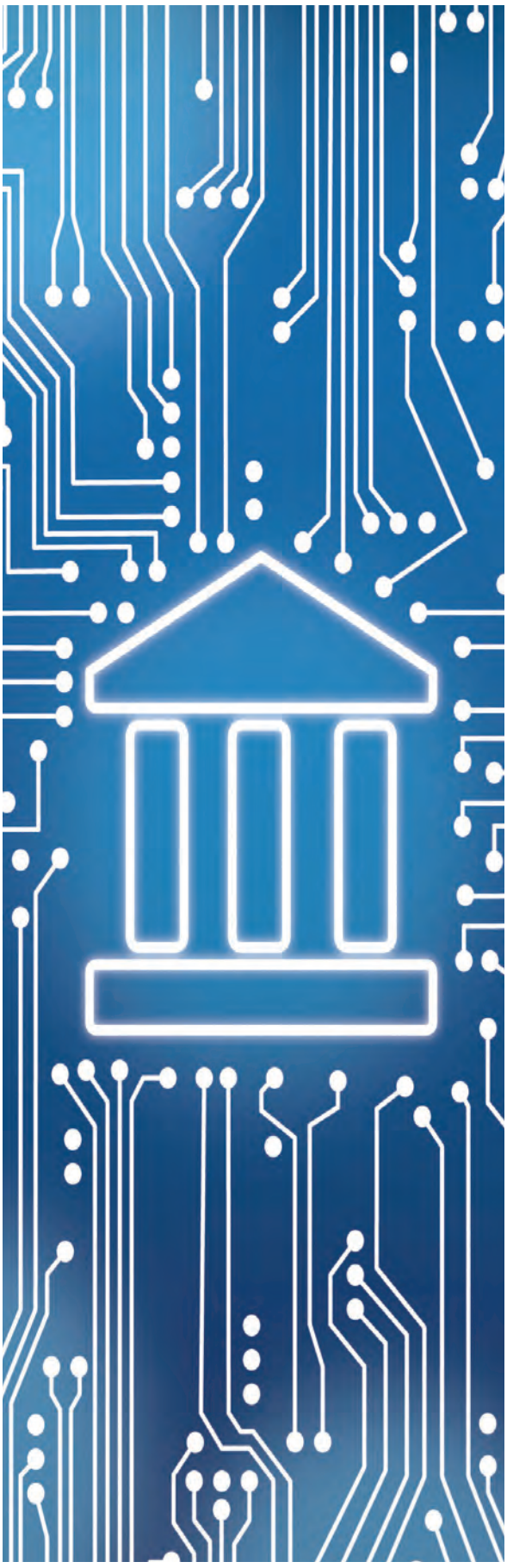
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Chapter One

Financial Advice Within a Regulated Environment

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be building on your knowledge, looking in greater detail at the implications of the UK legal and regulatory framework and how this impacts on the provision of private client investment advice.

Some of the terminology and concepts in this chapter, and the workbook in general, will already be familiar to you in your day-to-day work. We will build upon this knowledge and seek to strengthen your ability to apply the knowledge to real life.

You should continue reading and extending your understanding of the topics covered through additional study since a good understanding of the investment industry and global developments is important.

You will see icons or symbols alongside the text. These indicate activities or questions that have been designed to check your understanding and help you validate your understanding.

Here is a guide to what each of the symbols mean:

? Question

This identifies a question that will enable you to check your knowledge and understanding.

 Analyse

This gives you an opportunity to consider a question and compare your answers to the feedback given.

2. Financial Services and Markets Act (FSMA) 2000 and the Regulatory Bodies

Learning Outcome

1.1.1 Understand the main provisions of the Financial Services and Markets Act (FSMA) 2000 and associated secondary legislation, and assess their implications for the business operations of the private client adviser

1.1.2 Know and understand UK regulatory requirements, and evaluate the effects on the business systems and controls of the private client adviser

1.1.3 Understand the role, regulatory objectives and functions of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA), and how they affect the control structures of firms

2.1 Regulatory Framework

Financial Services and Markets Act (FSMA) 2000 came into force in the UK on 30 November 2001. With the Act came the creation of a single statutory regulator, the Financial Services Authority (FSA), which had statutory powers, a single ombudsman, a compensation scheme and an independent **Bank of England** (BoE, also referred to as the Bank). Combined, these organisations supervised the financial markets, provided guidance to market players, and had the power to sanction those who did not abide by the rules.

It is well known that the global financial crisis of 2007–08 brought about a significant change to the investment industry. From 2001–07, money was abundant, in part due to central banks easing monetary policy following the shocks of the global tech bubble and the 9/11 attacks. UK interest rates ranged between 3.5% and 5.75%, the property market was booming, and mortgage lenders would lend excessively to many borrowers (in some cases, offering 125% loan-to-value mortgages) built on insufficient affordability criteria of mortgagees. The problem did not concentrate just on mortgages, but on debt as a whole.

Almost every single country in the world was affected as the financial markets has largely become globalised and major banks had large exposure outside their home markets. Governments and **central banks** needed to step in and provide quantitative easing (QE), printing more money to keep markets from freezing up and economies from going into steep recessions or even depression. Banks needed bailouts and other types of support from the government as counterparty risk surged and a lender of last resort was needed. The government needed people and businesses to begin borrowing again to keep the economy going. These solutions may be arguable and controversial; however, the banking sector avoided major failures.

As a result of this, and not unexpectedly, His Majesty's Treasury (HM Treasury or HMT, on behalf of the government) completely overhauled the financial sector to prevent this from ever happening again. In 2013, under the **Financial Services Act (FSA) 2012**, the FSA was split into two authorities – the **Financial Conduct Authority (FCA)** and the **Prudential Regulation Authority (PRA)**. Together, the FCA and PRA make up the UK financial landscape. The FCA is responsible for regulating the conduct of both retail and wholesale financial services firms, while the PRA is responsible for higher-level regulation and supervision, including supervising firms and ensuring they have adequate **capital**. The **FCA Handbook** was established with rules and guidance for firms.

In order to improve consumer outcomes from financial advice and to rebuild confidence in financial services, the Retail Distribution Review (RDR) was implemented by the FCA in 2012. The RDR meant that all advisers needed to have passed an appropriate exam at level 4 or higher by this date. Before then, some advisers had never taken a financial exam and had never been independently tested on their knowledge; instead, the adviser could be 'grandfathered in' on the premise that they had worked in the industry for so long that they were deemed to already have an excellent financial understanding. Simply working in the industry for a long time did not guarantee that the adviser was either knowledgeable or up to date on industry standards. The RDR also introduced bans on paying **commissions** for advice and changes in the way charges and services were disclosed to clients.

The global financial crisis affected almost all countries, although some (eg, China, Japan, and smaller, less liquid emerging markets such as countries in Africa and Southeast Asia) were less affected than others. Even so, regulators around the globe re-assessed their existing legislation, amended it where necessary, and created more legislation where gaps were discovered. The whole purpose of the legislation was to prevent another global financial crisis from happening again.

Similarly, other countries overhauled their financial sectors with sweeping reforms and major legislative responses, with the aim of increasing the resilience of banks through stronger capital and **liquidity** buffers.

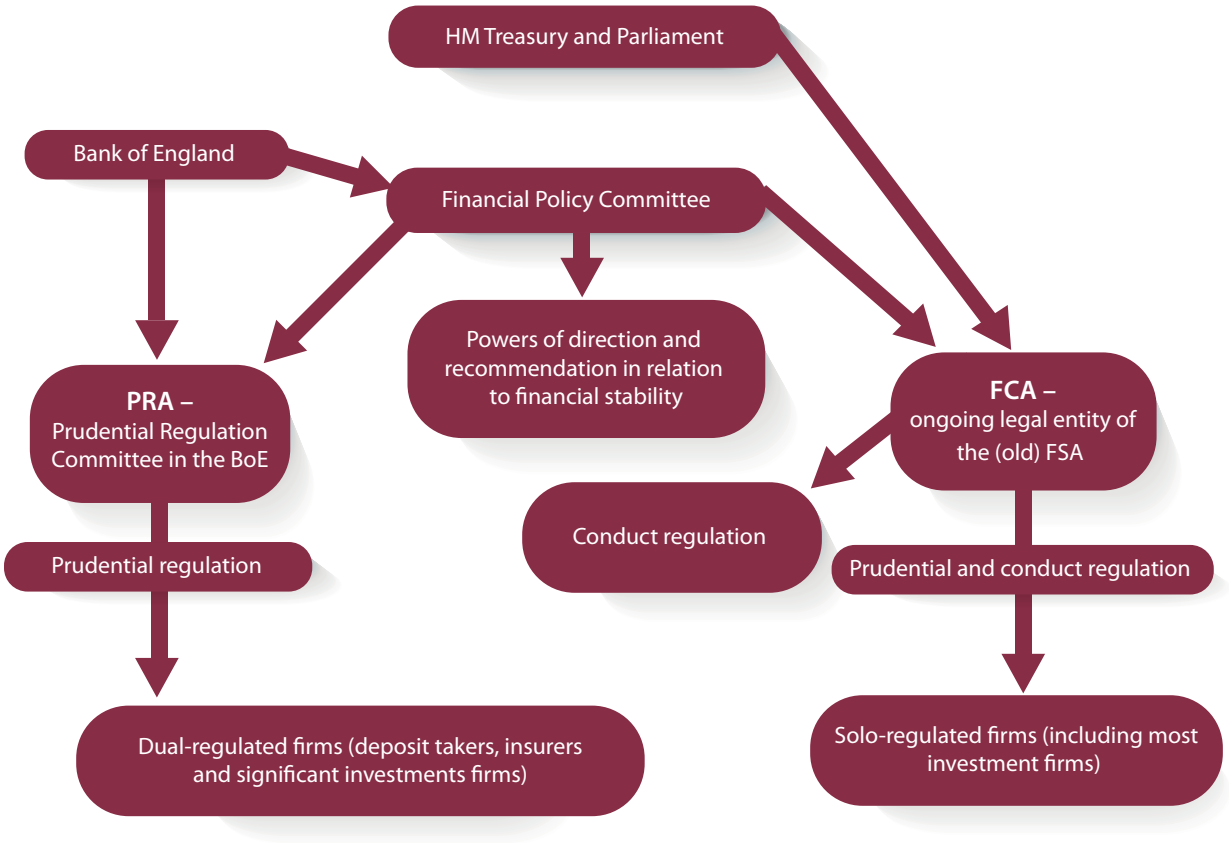
2.2 The Regulatory Structure in the UK

Following a review by HM Treasury, the UK government reformed the UK regulatory system under the Financial Services Act (FSA) 2012. With effect from 1 April 2013, the structure moved to a 'twin peaks' model, whereby the FSA was replaced by the following:

- **The PRA** – covered in section 2.2.3 of this chapter.
- **The FCA** – covered in section 2.3 of this chapter.

This change meant that some (but not all) firms now require dual **authorisation**, and those that do not are solely supervised by the FCA. In addition, the **Financial Policy Committee (FPC)** was established as part of the BoE and charged with the primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective of supporting the government's economic policy.

The BoE oversees the PRA and the FPC, while the FCA is accountable to HM Treasury.



The BoE's primary functions are to produce bank notes and oversee payment systems, work to keep the cost of living stable by adjusting interest rates, and regulate UK banks and other financial firms. These functions, in turn, maintain monetary stability and oversee the financial stability of the UK financial system. The BoE also acts as the lender of last resort and as the custodian of the official gold reserves in the UK.

In 2016, the UK voted to leave the EU (known as 'Brexit'), and the UK officially left on 31 January 2020. The end of the UK's transitional period with the EU (during which, the then existing rules on trade, travel and business for the UK and EU continued to apply) ended on 31 December 2020, and new rules took effect on 1 January 2021.

In July 2022, then Chancellor of the Exchequer Jeremy Hunt introduced the Financial Services and Markets Bill (FSMB) to UK Parliament. This is an important piece of legislation that aims to tailor the financial services regulatory framework to UK markets and updates the powers of the regulators:

> *'to bolster the competitiveness of the UK as a global financial centre post-Brexit and to deliver better outcomes for consumers and businesses'.*

Another landmark piece of legislation – the **Financial Services and Markets Act 2023** – was introduced shortly thereafter. This Act aligns with the Edinburgh Reforms[1] (introduced in December 2022), which are a set of wide-ranging developments aimed at driving growth and competitiveness in the UK's financial services sector, with an explicit focus on consumers. Together, these initiatives aim to enhance the UK's financial services sector, thus making it more competitive and adaptive to global challenges.

1 GOV.UK, December 2022. Financial Services: The Edinburgh Reforms. Retrieved from https://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms (Accessed: October 2025)

These developments fall under several categories, as follows:

- **Maintaining and building a competitive marketplace and promoting the effective use of capital** – for example:
  - A statutory review of the rules that forces banks to ring-fence their retail banking and investment operations, which was introduced during the global financial crisis.
  - The introduction of new secondary objectives for the PRA and FCA – see sections 2.2.3 and 2.3.2 respectively.
  - Repealing and replacing retained EU law on financial services – eg, the CRD and CRR (see section 2.7 of this chapter) and PRIIPs (see section 5.5.1 of this chapter).
  - Reforms to the **Senior Managers and Certification Regime (SM&CR, or SMCR)** – see section 3.2.1.
- **Sustainable Finance** – In March 2023, the UK government published an updated Green Finance Strategy[2], outlining policies for the UK's low carbon future; and a new regulatory regime will be introduced for **environmental, social and governance (ESG)** rating providers.
- **Technology and innovation** – Upcoming plans to support innovation and leadership in emerging areas of finance, such as a UK central bank digital currency (CBDC).
- **Delivering for consumers and businesses** – Reforming the Consumer Credit Act (CCA) 1974. The UK government is currently consulting on proposed changes; and due to the scale and complexity of the legislation, CCA reform is expected to take several years to deliver.

2.2.1 The Monetary Policy Committee (MPC)

The Monetary Policy Committee (MPC) is a committee of the BoE. Its aims are to maintain price stability within the UK, while supporting economic policy, and in a way that helps to sustain growth and employment. It is also responsible for formulating monetary policy, in order to achieve the remit set by the UK government – this includes varying the BoE **base rate** (or the bank rate or base rate for short), the volume of asset purchases, financed by the issuance of bank reserves, and foreign exchange intervention. The base rate is considered the 'risk-free' interest rate for all sterling securities, signifying that all other money market or debt instruments which carry more risk will yield a higher rate (eg, a spread over the base rate).

Each year, the UK government sets a price stability (ie, inflation) target, which is confirmed each year in the Budget, and which the MPC must achieve. Currently, the target is 2% measured by the 12-month increase in the **consumer price index (CPI)**; this target is symmetric (ie, the MPC is required to respond when inflation is too low as well as too high) and applies at all times. If **inflation** moves away from the target by more than one percentage point in either direction, the MPC is required to write an open letter to the Chancellor of the Exchequer providing an explanation.

2 HM Government, March 2023. Mobilising Green Investment: 2023 Green Finance Strategy. Retrieved from https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1149690/mobilising-green-investment-2023-green-finance-strategy.pdf (Accessed: October 2025)

For example, since the end of 2021, UK CPI has been consistently above the official target, peaking in percentage terms at an annual increase of 9.6% in October 2022 (although, the rate of increase has slowed, and by mid-2025 stood at around 4%). The spike was caused by the release of pent-up consumer demand for goods and services as coronavirus (COVID-19) restrictions were lifted, the emergence of supply chain issues caused by the pandemic, extra border costs due to Brexit, and exacerbated by Russia's invasion of Ukraine in 2022 (as both are large exporters of various foodstuffs and other **commodities** including energy). This triggered an exchange of open letters between the MPC and the Chancellor[3], in which the MPC confirmed they would '*take whatever action is necessary to achieve its primary objective of price stability*'.

The MPC is typically made up of nine members, who meet eight times a year. The members are the Governor (who is effectively the chief executive of the group), the three Deputy Governors for Monetary Policy, Financial Stability and Markets and Banking, the BoE's Chief Economist, and four external members appointed directly by the Chancellor to ensure that '*the MPC benefits from thinking and expertise from outside of the Bank of England*' – all are independent. The MPC's work is overseen by the BoE's Court of Directors (which is similar to a board of directors), all of whom are appointed by the UK government.

2.2.2 The Financial Policy Committee (FPC)

The FPC contributes to the BoE's mission to achieve financial stability by identifying, monitoring, and taking action to reduce risks in the financial system and, subject to that, support the UK government's economic policies (including its objectives for growth and employment).

In doing so, the FPC may make recommendations and give directions to the FCA and the PRA in relation to macroprudential measures. It also advises the Court of Directors on the BoE's Financial Stability Strategy.

Of the FPC's 13 members, six are BoE staff – the Governor, four Deputy Governors and the Executive Director for Financial Stability Strategy and Risk. The other seven are external – five members appointed by the Chancellor (selected for their experience and expertise in financial services), the Chief Executive of the FCA, and a non-voting member from HM Treasury. The Committee meets at least quarterly. The FPC publishes a record of its formal policy meeting, and it is also responsible for producing a Financial Stability Report twice a year.

At least once a year, the UK government must make recommendations about the FPC's responsibilities for financial stability, as well as its growth and employment objectives. The FPC must respond to these recommendations or, if it proposes not to follow them, provide reasons for this ('comply or explain').

3 GOV.UK, February 2012 (last updated: September 2025). HMT open letters between the Governor of the Bank of England and the Chancellor of the Exchequer. Retrieved from https://www.gov.uk/government/collections/inflationary- targets (Accessed: October 2025)

2.2.3 The Prudential Regulation Authority (PRA)

Established as part of the BoE, the PRA is responsible for the prudential regulation and supervision of around 1,500 banks, building societies, credit unions, insurers and major investment firms that have the potential to present a significant risk to the stability of the financial system.

Following the passing of the BoE and Financial Services Act 2016 by Parliament, the PRA changed from being a subsidiary of the BoE to being an actual part of it.

The PRA has three objectives:

1. To promote the safety and soundness of the firms that they regulate.
2. To contribute to securing an appropriate degree of protection for insurance policyholders.
3. To facilitate effective competition between the firms that they regulate in the financial services sector.

As mentioned in section 2.2 above, secondary objectives for the PRA have been introduced. Following passing of the Financial Services, Markets Bill in 2023 and a public inquiry[4], new secondary objectives of 'growth' and 'competitiveness' were introduced for both the PRA and the FCA. This, in effect, granted the PRA enhanced rule-making powers, driven by post-Brexit concern over the UK's competitiveness as a global financial centre.

Through regulation, the PRA sets standards and policies that it expects the firms that it regulates to follow, enacted through the PRA Handbook. For example, it requires financial firms to maintain sufficient capital and have adequate risk controls in place. Additionally, the PRA monitors compliance with these standards and policies. The PRA works alongside the FCA in the performance of its role.

The PRA's most significant supervisory decisions are taken by its board, which comprises the Governor of the BoE, the Deputy Governor for Financial Stability, the Chief Executive of the PRA (and Deputy Governor for Prudential Regulation), and independent non-executive members appointed by the Chancellor. The board is accountable to Parliament.

2.3 The Financial Conduct Authority (FCA)

The FCA is the conduct regulator for around 50,000 businesses and the prudential supervisor for over 45,000 firms. However, considering individual traders and appointed representatives, the FCA's regulatory coverage exceeds 200,000. In doing so, the FCA seeks to reduce potential harm to consumers and markets. It also ensures that firms assess the risks posed by their activities and that these risks are adequately managed by senior managers, as well as employees.

In doing so, the FCA aims to:

- drive a healthy and successful financial services system
- drive innovation, productivity and economic growth, and
- protect users from firms that engage in harmful behaviour.

4 bankofengland.co.uk, June 2025. Competitiveness and growth: the PRA's second report. Retrieved from https://www.bankofengland.co.uk/prudential-regulation/publication/2025/june/pra-secondary-competitiveness-and-growth-objectives-report-2024-25 (Accessed: October 2025)

2.3.1 Status and Structure of the FCA

The FCA is a private company limited by guarantee, which is owned by the government and wholly financed by the financial services sector via a fee structure. As an independent regulatory body, the FCA also produces an annual business plan setting out its priorities each year.

The FCA is accountable to HM Treasury through a variety of mechanisms. HM Treasury has the power to appoint or dismiss the FCA's board and chairman. If it is found that there have been any significant regulatory failures, then the FCA must carry out an investigation and report its findings to HM Treasury.

HM Treasury has the power to commission reviews and inquiries into aspects of the FCA's operations. Reviews are to be conducted by someone whom HM Treasury feels is independent of the FCA, and are restricted to considering the economy, efficiency and effectiveness with which the FCA has used its resources in discharging its functions. Such inquiries may relate to specific, exceptional events occurring within the FCA's range of regulatory responsibilities.

HM Treasury can also carry out reviews concerning the FCA's operations and regulation. For example, in 2021, it consulted on the regulation of non-transferable debt **securities** (or mini-bonds). From this, HM Treasury decided that the FCA should regulate mini-bonds in the same way as **shares** as part of its plans to make the UK's **capital markets** more appealing to investors.

2.3.2 Objectives of the FCA

The FCA's strategic objective is to ensure that the relevant markets function well – for individuals, businesses (large and small), and the economy as a whole.

To complement this single strategic objective, the FCA also has three operational objectives:

1. To secure an appropriate degree of protection for consumers.
2. To protect and enhance the integrity of the financial system.
3. To promote effective competition in the interests of consumers.

Since August 2023, the FCA has had a secondary objective:

> *'to facilitate the international competitiveness and growth of the UK economy in the medium to long term.'*

This applies in conjunction with their primary objectives, as stated above – in other words, the FCA cannot pursue this **mandate** if it would conflict with its existing mandates. Strong competition in the UK's financial services sector strengthens firms and enhances the country's appeal as a market, thus bolstering international competitiveness.

The financial services landscape has transformed significantly over the years, more recently driven by the COVID-19 pandemic, Brexit, technology, and the drive to a greener economy. For example, as a result of the pandemic, an increasing number of consumers are today accessing and using financial services digitally; and a number of regulated firms have adopted remote or hybrid working arrangements which, if left unchecked, could adversely impact the management, control and oversight of their businesses or operations, or cause detriment to customers. Further, new products (such as digital assets (eg,

cryptocurrencies)) have captured the interest of millions of UK consumers. While these changes have created new opportunities, they also pose greater operational and market integrity risks, affecting consumer protections and market competition.

The FCA, therefore, recognises that it needs to continue to be a forward-looking, proactive regulator; and in its annual Business Plan, it has historically set out its priorities for the following 12 months or further ahead. Their Annual Reports provide updates on their progress towards addressing their priorities and objectives. In March 2025, however, the FCA acknowledged a need to plan even longer term and launched a five-year strategy for 2025–30.

Protecting Consumers

Authorised firms are expected by the FCA to:

> *'have their customers at the heart of how they do business as well as in the products and services they offer'.*

The Financial Services Act (FSA) 2012 sets out the FCA's 'consumer protection' objective, in the chapter regarding the FCA's General Duties.

The FCA aims to secure an appropriate degree of protection for consumers – regardless of whether they operate in an established or new market – to protect them from firms and individuals in the financial sector that may cause them harm. Such harm can arise in many ways; for example, people and businesses can face limited choice, pay uncompetitively high prices, be advised to buy an unsuitable product, or be treated unfairly by their chosen provider throughout the life of the product.

What is considered to be appropriate will depend on consumers' individual circumstances. The FCA, therefore, takes a risk-based and proportionate approach, and it must strike a balance when deciding what is 'appropriate'. An important part of this approach is establishing, through their policymaking processes, where that balance lies in relation to the many different consumers and categories of **authorised persons** or regulated activities.

Deciding what is appropriate will depend upon the consumers' experience, expertise and capabilities, the degree of risk involved in different kinds of investments or transactions, and the differing expectations that consumers may have in relation to those investments or transactions. The FCA also uses its Consumer Spotlight Tool, which helps it to differentiate between the types of consumers according to their broad circumstances; these groups range from 'retired with resources' to 'hard pressed' and 'starting out', each of which has different financial needs, behaviour, capability and vulnerability. Thus, the groups identify where the risk and impact of potential detriment is greatest.

In 2022, following a consultation, the FCA introduced a new '**Consumer Duty**', which (among other things) refers to the responsibility of financial services firms to protect the rights and interests of their customers. The Consumer Duty is covered in more detail in section 5 of this chapter.

Enhancing Market Integrity

To achieve its 'enhancing market integrity' objective, the FCA ensures that:

- senior management are accountable for their capital market activities
- there is a positive culture of proactively identifying and managing conflicts of interest
- there is orderly resolution and return of **client assets**
- firms' business models, activities, controls and behaviour maintain trust in the integrity of markets
- market efficiency, cleanliness and resilience are delivered through transparency, surveillance and supervision of infrastructure and their principal users, and
- firms put clients' best interests at the heart of their business, and they intervene early in wholesale markets to mitigate the risk of harm being transmitted to retail consumers.

When addressing this objective, the FCA also has a duty to promote effective competition.

Promoting Effective Competition

The FCA has a 'competition objective' to promote effective competition in the interests of consumers in the markets it regulates. It also has a competition duty to promote effective competition when addressing the 'consumer protection' or 'market integrity' objectives.

If the financial services sector is working competitively, then all firms will strive to generate better outcomes for their customers. In addition, healthy firms will adapt and move with changes, including technological changes, in order to promote better outcomes for customers. Firms that do not strive for better customer outcomes or move in line with technological advances will fail or leave the industry.

The FCA has a number of powers to pursue its competition mandate. For example, it can make rules in support of its objective to promote competition to benefit consumers, however, the FCA will only make new rules and guidance should it think this is the most effective and proportionate way to deal with the problems they have identified, typically by carrying out cost-benefit analysis. Alternatively, the FCA can take action against firms that it regulates.

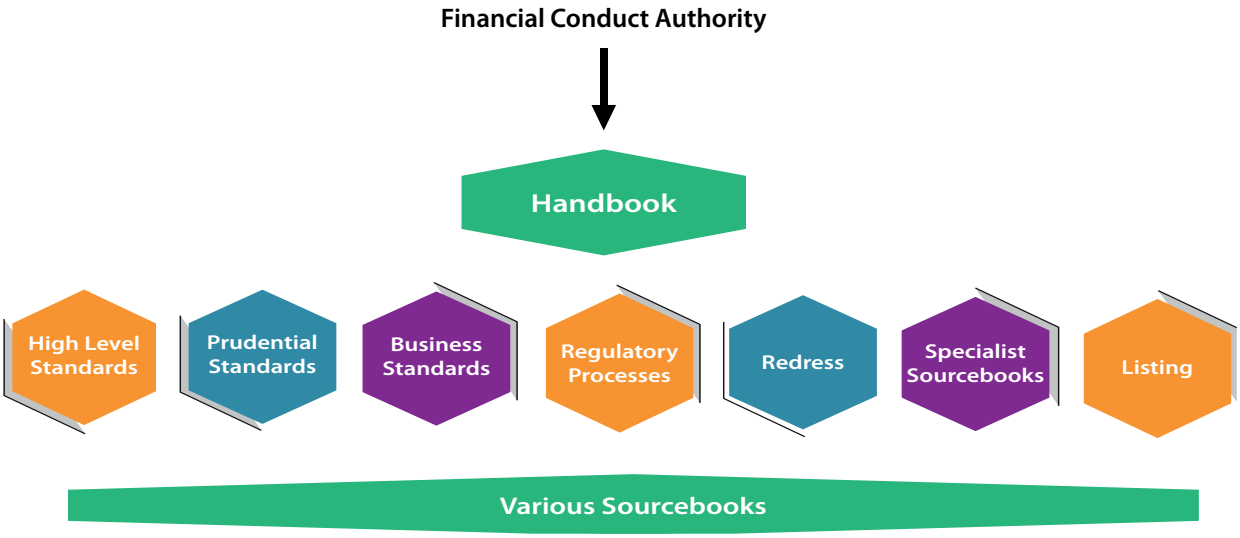
It also has concurrent powers with the **Competition and Markets Authority (CMA)** under the Competition Act 1998 and the Enterprise Act 2002.

The FCA's objectives are intended to bring about the following three broad outcomes:

- Consumers get financial services and products that meet their needs from firms they can trust.
- Firms compete effectively, with the interests of their customers and the integrity of the market at the heart of how they run their business.
- Markets and financial systems are sound, stable and resilient, with transparent pricing information.

2.3.3 FCA Handbook

The FCA and PRA divided the previous Handbook to create their individual handbooks. If printed in their entirety, they are immense, so there are online tools that help firms to create a tailored handbook specific to their particular business (ie, areas of approved activities).



The table that follows includes the sourcebooks which cover the activities of someone who provides investment advice and management to a private client.

It should be noted that this is not an exhaustive list, but it demonstrates the number of detailed rules within the Handbook. Also, depending on your firm's business model and complexity, this list should not be relied upon as regulatory guidance. You must refer to your compliance department/**consultants** for direction.

There are also guides about how to use certain sections of the Handbook. The table below provides examples of some of the sourcebooks in each block of the FCA Handbook[5]; however, this is not an exhaustive list.

Handbook Block	Sourcebook	Reference Code
High Level Standards	**Principles for Businesses** The fundamental obligations of all firms under the regulatory system	PRIN
	Senior Management Arrangements, Systems and Controls The responsibilities of directors and senior management	SYSC
	Code of Conduct The conduct rules for certain approved persons in SMCR firms	COCON
	Threshold Conditions The minimum standards for becoming and remaining authorised	COND
	Statements of Principle and Code of Practice for Approved Persons The fundamental obligations of approved persons (APs)	APER
	Fit and Proper Test for Employees and Senior Personnel The fundamental standards for becoming and remaining an approved person	FIT
	Financial Stability and Market Confidence Sourcebook Rules relating to short selling, including disclosures to the FCA	FINMAR
	Training and Competence The commitments and requirements concerning staff competence	TC
	General Provisions Interpreting the Handbook, fees, approval by the FCA, emergencies, status disclosure, and insurance against fines	GEN
	Fees Manual The fees provisions for funding the FCA, Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS) – see sections 6.6 and 6.7 respectively of this chapter	FEES
Prudential Standards	**General Prudential Sourcebook** The Prudential Sourcebook for banks, building societies, insurers and investment firms	GENPRU
	Prudential Sourcebook for MiFID Investment Firms The prudential requirements for MiFID investment firms	MIFIDPRU
	Interim Prudential Sourcebook for Investment Businesses The prudential requirements for investment firms	IPRU-INV

5 Financial Conduct Authority. FCA Handbook. Retrieved from https://www.handbook.fca.org.uk/handbook (Accessed: October 2025)

Handbook Block	Sourcebook	Reference Code
Business Standards	**Conduct of Business Sourcebook** Conduct of business requirements for accepting deposits, designated investment business and long-term life insurance policies	COBS
	Banking: Conduct of Business Sourcebook Covering the activity of accepting deposits from banking customers	BCOBS
	Client Assets The requirements relating to holding client assets and client money	CASS
	Market Conduct Code of Market Conduct, mainly for wholesale and professional markets	MAR
	Product Intervention and Product Governance Sourcebook Systems and controls that firms must have in place to design, approve, market, and manage products throughout their life-cycle to ensure they meet legal and regulatory standards	PROD
	Environmental, Social and Governance Sourcebook Rules and guidance concerning a firm's approach to ESG matters	ESG
Regulatory Processes	**Supervision** Supervisory provisions including those relating to auditors, waivers, individual guidance, notifications and reporting	SUP
	Decision Procedure and Penalties Manual The FCA's procedures for taking various actions	DEPP
Redress	**Dispute Resolution: Complaints** The detailed requirements for handling and reporting of complaints and the FOS arrangements	DISP
	Consumer Redress Schemes Sourcebook A set of rules under which a firm is required to take one or more steps for consumer redress purposes	CONRED
	Compensation Sets out circumstances in which compensation may be paid	COMP
Specialist Sourcebooks	**Collective Investment Schemes** Provides the detailed framework within which authorised funds operate	COLL
	Investment Funds Sourcebook Contains rules that apply to alternative investment fund managers (AIFMs)	FUND

Handbook Block	Sourcebook	Reference Code
Listing, Prospectus and Disclosure	**Listing Rules** For issuers (and their sponsors) listed on, or seeking admission to, the Official List	LR
	Prospectus Regulation Rules Sourcebook Requirements of a prospectus	PRR
	Disclosure Guidance and Transparency Rules Sourcebook Disclosure requirements for listings	DTR
Handbook Guides	**General Guidance on Benchmark Administration, Contribution and Use** Guidance for benchmark administrators and contributors	BENCH
Regulatory/ Registry Guides	**The Collective Investment Scheme Information Guide** Contains some key facts on the regulation of regulated collective investment schemes (CISs) in the UK	COLLG
	The Enforcement Guide The FCA's enforcement activity against firms	EG
	Financial Crime Guide: A Firm's Guide to Countering Financial Crime Risks Aims to enhance firm's understanding of the FCA's systems and controls in this area	FCG
	Financial Crime Thematic Reviews Reviews of Financial Crime with examples of good and bad practices	FCTR
	The Perimeter Guidance Manual Covers circumstances when authorisation is required, or exempt person status is available	PERG
	The Responsibilities of Providers and Distributors for the Fair Treatment of Customers Detailed rules on how providers and distributors may treat customers fairly in certain circumstances	RPPD
	The Unfair Contract Terms and Consumer Notices Regulatory Guide Information on how the FCA exercises its powers for unfair terms and consumer notices	UNFCOG
	The Wind-Down Planning Guide Guidance on how to wind down a business that provides regulated activities	WDPG
	The MiFID II Onshoring Guide Sets out firms' obligations under MiFID II	M2G

In addition, the Handbook contains a glossary of definitions, and the content in section GEN 2[6] of the Handbook helps readers to interpret the regulatory requirements.

Further information and a guide for navigating the Handbook can be found on the FCA website[7].

The sourcebooks provide eight different provisions, which are indicated by letters next to the text:

R – (Rules) A firm contravening these may be subject to discipline.
E – (Evidential provisions) A rule not binding in its own right, but binding in relation to the rules it relates to.
G – (Guidance) Explains the implications or suggests a possible way to be compliant. A firm cannot be disciplined for failure to follow guidance.
D – (Directions) Binding on those to whom they are addressed.
P – (Principles) Statements of Principle for **Approved Persons (APs)** and binding on all APs.
C – (Conduct) Paragraphs which outline behaviour that does not constitute market abuse.
UK – UK legislative material (Acts of Parliament, statutory instruments (SIs), regulations and orders).
EU – EU legislative material (EU directives and directly applicable EU regulations).

Using this information, and being able to navigate the Handbook, allows you to look in more detail at the regulations, thus becoming more familiar with regulatory concepts and how these impact on private client advice.

2.3.4 Powers of the FCA

FSMA 2000 gave the FCA (and its predecessor, the FSA) the power to issue a number of different notices. The regulator has various tools at its disposal which are designed to enforce the requirements of the rules, regulations and legislation, and these are outlined for firms in SUP, DEPP and EG. Actions can be taken against authorised firms and individuals, so it is important that they are aware of their regulatory responsibilities and what may happen to them if they contravene the rules.

There are a variety of statutory notices which can be issued to firms and/or individuals:

- **Warning notices** provide details of what the FCA proposes to do. In this scenario, the recipients have the right to make representations as to why the FCA should not take that action.
- **Decision notices** give details of what the FCA will do, but also include the right of appeal.
- **Further decision notices** confirm that agreement has taken place after discussion. A further decision notice can only be issued with the recipient's consent, following the issuance of the original decision notice.
- **Notices of discontinuance** inform the recipient that the FCA, after having previously sent warning and/or decision notices, is taking no further action.
- **Final notices** are published on the FCA website and set out the final actions the FCA will take.
- **Supervisory notices** give details of what action has taken place. They are published on the FCA website and must be preceded by a warning or decision notice.

6 Financial Conduct Authority. FCA Handbook | Glossary Terms. Retrieved from https://handbook.fca.org.uk/glossary (Accessed: October 2025)
7 Financial Conduct Authority, Navigating the new Handbook website: new video guides. Retrieved from https://handbook.fca.org.uk/latest-news/news-details/de3c7d93-77bb-4fa6-afce-211286abc1e1 (Accessed: October 2025)

The first we normally see of these actions against firms is a press release that summarises the details that will be included in the attached final notice. As previously mentioned, where possible, the notice will always point to the Principles for Businesses that have been broken because the Principles are given the status of rules (see section 3.1 for details of the Principles).

Disciplinary Measures

The Enforcement Guide (EG) within the FCA Handbook details enforcement activity that the FCA may take against firms. In summary, the FCA has powers to impose three types of sanctions: (1) publish a statement; (2) impose a financial penalty; or (3) impose a suspension, limitation or other restriction.

Looking at these sanctions in more detail:

1. **Private warnings** – a non-statutory tool, these are issued when a person's behaviour may not be in breach of a rule, and/or the matter may be minor in nature or degree, but the FCA may decide that their behaviour is not appropriate.

   The aim of a private warning is to make the person aware that they came close to being the subject to formal action, so it is consistent with the FCA's risk-based approach to enforcement. There is no exhaustive list of the conduct or circumstances which are likely to lead to a private warning, rather than a more serious action.
2. **Variation and cancellation of permission –** the FCA may vary/cancel an AP's **Part 4A permission** if:
   i. the person is failing, or likely to fail, to satisfy the threshold conditions
   ii. the person has not conducted the relevant activity for at least 12 months (or six months, in the case of a full-scope UK AIFM)
   iii it is desirable to exercise the power in order to advance one or more of the FCA's operation objectives, or
   iv. the person has failed to comply with a requirement in Part 5 of the Alternative Investment Fund Managers Directive (AIFMD) UK regulation, or it is for some other reason desirable to exercise the power for the purposes of ensuring compliance with such a requirement.

   The FCA will consider modifying or cancelling a firm's Part 4A permission when it has serious concerns about a firm, or about the way in which its business is being (or has been) conducted. Examples include that the firm appears to no longer be a fit and proper person to carry out a regulated activity, or its material and financial resources appear inappropriate for the scale/type of regulated activity it is carrying out.
3. **Withdrawal of approval** – this prevents an AP from carrying out functions in relation to regulated activities, with the aim of ensuring high standards of regulatory conduct. Where it considers it appropriate, the FCA may also prohibit an AP.
4. **Prohibition of individuals** – the FCA can prohibit individuals from being approved if it appears that they are no longer fit and proper; thus, those individuals will not be allowed to undertake a function in relation to regulated activities. The FCA has the power to make a range of prohibition orders, depending on the severity of the risk posed to consumers/the market, the range of regulated activities to which the AP's lack of fitness and propriety is relevant, and the reasons why the AP is not fit and proper. For example, the FCA may seek to limit the prohibition order to specific functions in relation to specific regulated activities, or it could prevent a person's employment by a firm.

5. **Injunctions –** the FCA may consider an injunction to be the most effective way to deal with their concerns. The court may make three types of order: to restrain a course of conduct; to take steps to remedy a course of conduct; and/or to secure assets. The court may also issue an order to freeze assets, to restrain a person from disposing of, or otherwise dealing with, those assets. The FCA may also ask the court to order the person to pay the FCA's costs.
6. **Restitution and redress** – when deciding to exercise these powers, the FCA will consider the likely amount of recovery, its costs of achieving and distributing any sums, whether redress is available elsewhere and whether the firm is solvent, among other considerations.
7. **Prosecution of Criminal Offences** – the FCA has powers to prosecute a range of criminal offences in England, Wales and Northern Ireland, where this would be consistent with meeting any of its statutory objectives; for example, market abuse, and making misleading statements. In some cases, the FCA may decide to issue a formal caution to the offender, rather than prosecute, in which case a record of the caution will be kept by the FCA and the Police National Computer. (The FCA does not have the power to bring criminal prosecutions in Scotland, although it can carry out investigations with the assistance of Police Scotland and the Scottish courts, and issue civil penalties.)

Additionally, the FCA may make use of its own-initiative power in urgent cases, if it reasonably considers it necessary, whereby the FCA may impose a variation of, cancel permission or issue a requirement so that it takes effect immediately or on a specified date. The FCA will consider exercising powers as a matter of urgency if it has serious concerns about the firm or its business that need to be addressed immediately, or if circumstances indicate it is appropriate for the FCA to immediately prohibit certain activities of the firm. Examples include: information indicates that the firm's conduct has put it at risk of being used for the purposes of financial crime, there is a serious problem within a firm that calls into question its ability to continue to meet the threshold conditions, or there is non-compliance with an FOS award against it.

In deciding what action to take, the FCA will consider all relevant circumstances, and may take into account a wide range of factors (eg, the nature and seriousness of the misconduct, or expected misconduct, whether it has stopped, or is likely to stop, and whether any steps have been taken, or will be taken, to remedy the situation).

Senior members of the FCA generally make decisions surrounding authorisations, supervision and enforcement. However, in more contentious cases, these decisions may be made by the Regulation Decisions Committee (RDC) on the FCA's behalf.

Regulatory Decisions Committee (RDC)

The RDC is a committee of the FCA board, and is part of the FCA. Its members comprise a chair (who is an FCA employee) and one or more deputy chairs, among other members, who are appointed by the FCA for their financial services sector skills and knowledge, as well as for their business and consumer backgrounds. The RDC also has its own legal advisers and support staff, who are separate from the FCA.

While the RDC is generally accountable to the FCA board for its decisions, its decisions are independent of the FCA. This separation of the RDC ensures that FCA staff, who are involved in making recommendations against an individual or a firm, are not involved in the decision as to what action should be taken, thus removing conflicts of interest, and ensuring that the final decision is fair and just.

To begin, the FCA enforcement team will conduct investigations into the individual or firm in question which is then reviewed by an independent lawyer. Subsequently, if it believes that action is appropriate, the FCA will bring the case to the RDC, including recommendations for action, with respect to the following areas:

- Restriction of regulated activities
- Refusal of an application for Part 4A permission
- Refusal of approved AP status
- Making a prohibition order
- The imposition of a financial penalty, public censure or restitution order.

The RDC considers all the evidence gathered by the FCA enforcement team, and whether the recommendations for action by the FCA are the right course to take. Thus, the RDC's process is administrative, not judicial. In straightforward cases, the RDC's chair or a deputy chair can make decisions alone; otherwise, the case is reviewed by a panel of three RDC members (including the chair or a deputy chair). No aspect of the case has been discussed with FCA staff involved thus far unless a representative for the individual/firm is present or they are given an opportunity to respond.

Subsequently, the RDC may then issue a warning notice to the individual/firm. The individual/firm will then have the right to make written and/or oral representations, in which case, the RDC gives the FCA enforcement team an opportunity to respond. The RDC takes all of these representations into consideration when deciding whether or not to issue a decision notice.

Alternatively, if they do not accept the decision, the individual/firm may appeal by taking the matter to the Court of Appeal, or request a new hearing by referring to the Upper Tribunal (Tax and Chancery Chamber).

2.3.5 Powers of Redress on Behalf of Consumers

The power of the FCA to gain redress for consumers, including the ability to claim damages, is granted through FSMA 2000. The legislation in turn sets out the methods of redress in the DISP Sourcebook.

A consumer is any person who has used, or may have contemplated using, a financial service (as listed in section 404E(2) of FSMA 2000), or has relevant rights or interest in relation to any of those services. While a section 404 power is not limited to retail customers only, the FCA may choose to focus consumer redress schemes on retail customers on the basis that retail customers tend to have less experience and expertise than professional customers and eligible counterparties. That said, the FCA will also have regard to the fact that many retail customers are also investors in/beneficiaries of **funds** and pension schemes which may have incurred losses from the failure.

2.3.6 False and Misleading Statements

It is prudent to look through the Financial Services Act (FSA) 2012 to familiarise yourself with the contents of the Act. Of particular importance to private client advisers are Sections 89–94:

1. **Section 89** states that it is an offence to make false or misleading statements, recklessly or intentionally, and to dishonestly conceal any material facts. These apply to statements intended to induce a person to make an investment. This offence only occurs if the statement is made (or concealed) in the UK, the person who is intended to be induced is in the UK, and/or the agreement would have effect in the UK.
2. **Section 90** says that the same applies to misleading impressions, if the misleading impression will create a gain for the person creating that impression or will cause another to make a loss.
3. **Section 91** states that it is an offence to create a false or misleading statement concerning another person relying on a certain **benchmark**.
4. **Section 92** sets out the penalties if a person is guilty of such an offence.
5. **Section 93** provides interpretation of Part 7.
6. **Section 94** provides affirmative procedures for certain orders.

Like false or misleading statements, false impressions must be carried out in the UK for them to fall into the UK legal remit.

Example

A stockbroker tells a potential client that the shares of ABC (a casino company) are very cheap because ABC has just won a contract to build a new casino. If the details of the contract were false, S89–94 of the FSA 2012 could be used to punish the stockbroker for making false and misleading statements to persuade a potential client to purchase shares.

While this is a very simple example to demonstrate the point, private client advisers have to be on their guard to ensure that they do not give false or misleading statements, or overstate the case for an investment. It should also be noted that the law protects not just existing clients, but also potential clients which advisers are trying to impress in order to secure the business.

That said, there are four defences against the charge:

1. The person reasonably believed their act would not create an impression that was false or misleading.
2. The person acted for the purposes of stabilising the price of instruments, and in conformity with the price stabilisation rules.
3. The forecasts were made in line with 'control of information' rules laid down by the FCA. This defence may also include the use of **Chinese walls**/information barriers (see section 4.5.2). In some cases, this may mean the person should not or could not have known information which would then have affected later statements.
4. The conduct was undertaken to conform with the European directive concerning buy-backs and the stabilisation of financial instruments.

A person found guilty of these offences faces up to seven years' imprisonment and/or a fine.

2.4 Regulated Activities and Investments

Under the general prohibition of section 19 of FSMA 2000, no person may carry on a regulated activity in the UK unless they are authorised or exempt.

Those exempt persons are:

- persons exempt as a result of an exemptions order – eg, central banks and the International Monetary Fund (IMF)
- local authorities, charities, and industrial and provident societies (deposits only)
- appointed representatives
- recognised investment exchanges (RIEs) – eg, the London Stock Exchange (LSE) and Cboe Europe ltd
- recognised clearing houses (RCHs) – eg, **Euroclear** UK & Ireland ltd
- recognised auction platforms (RAPs) – eg, platforms on which auctions of emissions allowances are held, in accordance with the UK auctioning regulations, and
- professional persons (eg, accountants) as they are regulated by their own professional bodies.

Recognised overseas investment exchanges (ROIEs), such as Deutsche Börse and **National Association of Securities Dealers Automated Quotations (Nasdaq)**, are also exempt through a recognition order by the FCA, derived from section 295 of FSMA 2000.

Further, while members of Lloyd's are not 'exempt persons' as such, the general prohibition applies to them in certain circumstances.

The list of regulated activities (Regulated Activities Order (RAO) 2001) for which firms must be authorised (Part 4A Permissions) to transact business has expanded since the original list was created, and includes (but is not limited to):

- issuing electronic money
- advising on investments
- dealing in investments as principal or agent
- arranging deals in investments
- making arrangements with a view to transactions in investments
- managing investments
- sending dematerialised instructions in investments, or causing those instructions to be sent
- safeguarding and administering investments
- operating a UK **multilateral trading facility (MTF)** or organised trading facility (OTF)
- providing basic advice on stakeholder products
- advising on **pension** transfers/opt-outs
- establishing, operating or winding up a pension scheme
- managing a UK UCITS/AIF, or acting as **trustee**/**depositary** of a UK UCITS/AIF
- managing an unauthorised AIF, or acting as trustee/depositary of an unauthorised AIF
- establishing, operating or winding up a CIS
- advising on peer-to-peer (P2P) agreements
- advising on regulated mortgage contracts
- effecting or carrying out contracts of insurance
- assisting in the administration and performance of a contract of insurance
- Lloyd's activities, and
- bidding in emissions **auctions**.

The RAO also sets out specified investments within these activities, which include (but are not limited to):

- deposits
- electronic money
- transferrable securities including shares, **bonds** and other forms of indebtedness (eg, certificates of deposit (CDs)), **warrants**, and certificates representing certain securities (eg, depositary receipts (DRs))
- units/shares in a CIS
- **derivative** contracts (for investment/speculative purposes, not commercial purposes) including **options**, futures, forward rate agreements, and **contracts for difference (CFDs)**
- rights under a personal or stakeholder pension scheme
- contracts of insurance (general and long term)
- Lloyd's syndicate capacity and membership
- funeral plan contracts
- regulated mortgage contracts, and
- home reversion plans and home purchase plans (eg, equity release schemes).

It is a criminal offence to carry on investment business in the UK without authorisation. The offence carries a maximum two-year jail term and/or an unlimited fine. In addition, if an unauthorised firm carries on investment business, it cannot enforce any investment agreements made and will have to make good any losses to clients and/or pay any profit from contracts entered into when unauthorised.

2.5 MoneyHelper

MoneyHelper was formed in 2021, following the merger into a single brand of three government-backed financial guidance providers: the Money Advice Service (MAS), The Pensions Advisory Service (TPAS) and Pension Wise. Together forming the Money and Pensions Service (MaPS), these three entities provided independent financial guidance and pension information in order to enhance public understanding and support informed decision-making.

While it was not mandatory for anyone to take such guidance, concerns had been raised about the label 'advice' – those using the service may not have been able to recognise the difference between the guidance offered and advice they could obtain from professional regulated investors. Hence, when MaPS was formed in 2019, the name of the structure made no reference to the word 'advice'.

MoneyHelper's aim as a single body remains unchanged: to provide a free, impartial service to people about their financial matters and retirement savings. Sponsored by the Department for Work and Pensions (DWP), it is funded by levies on both the financial services sector and pension schemes. Further, it engages with HM Treasury, which is responsible for policies on financial capability and debt advice. This consolidation should provide consumers with a better and enhanced experience, and a single source of information and guidance.

2.6 MiFID I & II, Markets in Financial Instruments Regulation (MiFIR) and FSMA 2000 Regulations 2016

The **Markets in Financial Instruments Directive (MiFID I)** is a large piece of legislation affecting all financial firms in the EU and UK. Coming into force in 2007, the main objectives of MiFID I were to increase competition and investor protection, in addition to levelling the playing field for market participants in financial services.

This was significantly amended in 2018 by MiFID II and **Markets in Financial Instruments Regulation (MiFIR)**, which was one of the most complex pieces of regulatory change the financial industry has ever seen, and a full understanding is outside of the scope of this workbook. In brief, MiFID II and MiFIR seek to enhance the protections offered by MiFID I, which has been criticised for not going far enough in order to protect investors. The key difference between them is that MiFID is a legislative goal setting out the goals that EU member states should strive to meet, while MiFIR is a binding legislative act that imposes rules that all countries must follow.

MiFID was transposed into the FCA Handbook upon its implementation. For MiFIR, this framework was transposed and implemented into UK law following the end of the UK's transition period with the EU, under the EU (Withdrawal) Act 2018 (as amended by the European (Withdrawal Agreement) Act 2020), in a process known as 'onshoring'.

Initially, the degree of similarity between UK MiFID and EU MiFID, and between UK MiFIR and EU MiFIR, was high. However, both sides have since been making amendments to their respective MiFID and MiFIR regimes, in order to address any aspects that they identified are not working effectively, such that the regimes have been diverging.

For example, in 2021, the European Commission (EC) published changes relating to information and reporting, research and commodity derivatives requirements, as well as to product governance. This 'EU Quick Fix' aimed to alleviate administrative burdens on firms, thus helping to support the economic recovery from the COVID-19 pandemic, while continuing to safeguard investor protection. These changes were implemented by EU member states in February 2022.

The FCA responded by publishing its own consultation paper shortly after and, in July 2021, the Markets in Financial Instruments (Capital Markets) (Amendment) Regulations 2021 (called 'UK Quick Fix SI') came into force in the UK. This amendment:

- removed the obligation on trading and execution venues to publish reports relating to the quality of order execution obtained on them, and
- made targeted changes to other obligations and requirements related to product governance, payment for research, client information and **best execution** reporting. For example, paper communications to clients are being phased out, and the 10% drop rule (whereby investment firms providing portfolio management services had to inform clients whenever the overall value of their **portfolio** depreciated by 10%) has been scrapped permanently.

Essentially, the UK's approach has mirrored that of the EU, and seeks to address perceived deficiencies in the EU's reform.

Alongside this, the UK's Wholesale Markets Review (WMR) was established to improve the functioning and efficiency of wholesale financial markets. Among a number of other proposals, the WMR sets out to:

- extend electronic delivery as the default method for communications with retail clients
- remove certain restrictions on MTFs, OTFs and systematic internalisers (SIs) to cut unnecessary costs and reduce execution risk, and
- improve the operation of equity markets by removing limits on the amount that can be traded without pre-trade transparency.

These proposals are being implemented through a combination of legislation and regulatory developments – for example, the Financial Services and Markets Act 2023, which introduces key reforms aimed at enhancing market efficiency and investor protection.

While there have been no overarching changes to the MiFID regime since that period, there were a number of modest changes to the MiFID II rules which could be considered as either additional 'quick fixes' or improvements to transparency in 2024. These included:

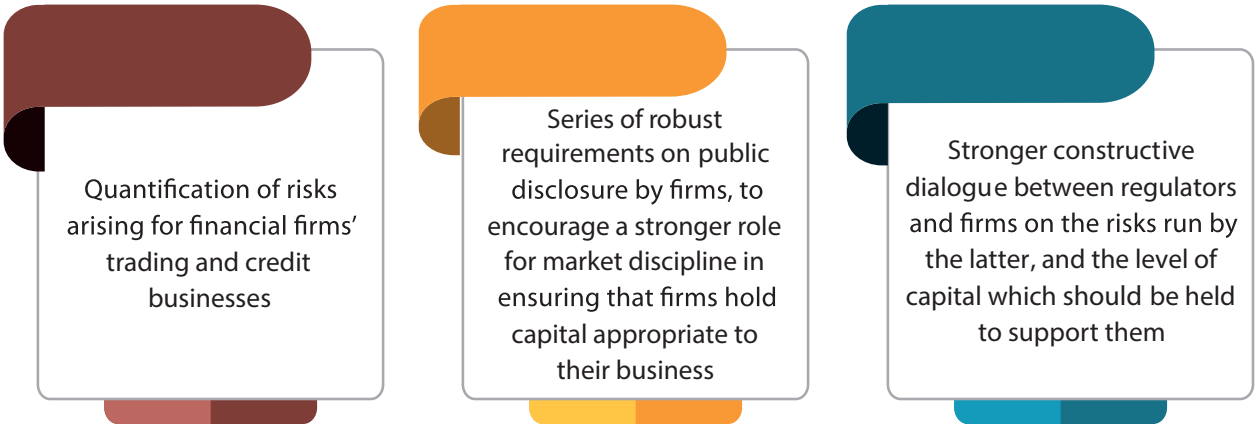
1. relaxing the unbundling of requirements for research on small and medium-sized companies
2. finalising technical standards to move toward a full consolidated tape (CT) for trading in securities
3. changes to how pre- and post-trade liquidity are calculated for non-equity instruments, and
4. tightened requirements for structured products to improve investor protection.

There was also a raft of proposals which are being termed 'MiFID III', but these are still under review and under negotiation among the various EU regulatory bodies.

2.7 Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR)

The **Capital Requirements Directive (CRD)** and the Capital Requirements Regulation (CRR) represent the biggest changes to capital requirements since the global financial crisis. Together, the CRD and the CRR introduce new capital, leverage and liquidity requirements, as well as new concepts, such as capital buffers, and the imposition of new regulatory frameworks. While initially pieces of EU legislation, the CRD and the CRR have been onshored so that they continue to apply in the UK now that the transition period with the EU has ended.

The CRD applies to banks, building societies and most investment firms. It is designed to ensure that these firms hold adequate resources and have adequate systems and controls to manage both their business and its associated risks. The amount of financial resources will depend on the business carried out, the size of the business, its activities and the risks those activities give rise to. Also factored into this calculation are scope, products, and services. This captures what is referred to as the 'three pillars':



The current version of the CRD (CRD VI) and the CRR (CRR II) are together known as the 'CRD-V package', which came into effect in 2024. This so-called 'banking package' makes refinements to reforms that started after the financial crisis, with the aim of strengthening the UK (and European) banking sector and increasing resilience against future financial shocks. This includes extensive changes, such as banks' capital requirements and **leverage** ratios, as well as the way they are structured and how they do business in the long term. As a result, the CRD-VI package has far-reaching consequences for banks and the economy. One important change from the previous regime of CRD-V relevant to UK firms is that, beginning in 2026, non-EU banks will no longer be able to offer core banking services to EU customers, subject to certain exemptions.

In 2022, new rules from the FCA came into effect relating to prudential requirements for MiFID investment firms. This regime largely mirrors the existing CRR II, but has modified certain areas in order to achieve closer alignment with Basel III standards (an internationally agreed set of measures that place minimum capital requirements on banks), thus helping to improve competition between firms and lower barriers for new market entrants. In doing so, the rules 'aim to streamline and simplify prudential requirements for solo-regulated UK [investment] firms, authorised under the [MiFID] regime'; thus, it does not apply to PRA-designated investment firms.

Note from section 2.2 above that the CRD and CRR are due to be revised or repealed. While a timetable for this has not been finalised, the entire process is likely to take several years.

3. FCA Principles for Businesses and Statements of Principles

Learning Outcome

1.1.4 Evaluate the FCA's Principles and Conduct of Business rules as to how they relate to advising clients, managing investments and reporting to customers

1.1.6 Know the extent of an investment adviser's duty to disclose material information about a recommended investment

1.1.7 Identify conflicts of interest and their potential impact on clients and business operations, and understand the compliance requirements that exist to prevent such occurrences

1.1.8 Understand the Senior Managers and Certification Regime (SM&CR) for firms and individuals

3.1 Principles for Businesses

The FCA has set out 12 Principles for Businesses (PRIN) that apply to every firm conducting a regulated activity, extending to 12 when dealing with retail customers. Some Principles apply to all authorised firms regulated by the FCA, and some only apply to firms carrying on specific business (eg, PRIN 9 only applies to firms that are advising clients and/or managing **discretionary** portfolios).

These are a general statement of the fundamental obligations of firms under the regulatory system, and also form the foundation for the 'fit and proper' test for firms and individuals.

	Principle	Description
1.	**Integrity**	A firm must conduct its business with integrity.
2.	**Skill, care and diligence**	A firm must conduct its business with due skill, care and diligence.
3.	**Management and control**	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4.	**Financial prudence**	A firm must maintain adequate financial resources.
5.	**Market conduct**	A firm must observe proper standards of market conduct.
6.	**Customers' interests**	A firm must pay due regard to the interests of its customers and treat them fairly.
7.	**Communications with clients**	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

	Principle	Description
8.	**Conflicts of interest**	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9.	**Customers: relationships of trust**	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.
10.	**Clients' assets**	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11.	**Relations with regulators**	A firm must deal with its regulators in an open and cooperative way, and must appropriately disclose to the FCA anything relating to the firm of which the FCA would reasonably expect notice.
12.	**Consumer Duty**	A firm must act to deliver good outcomes for retail customers.

Under PRIN 12, a product and service will be 'in-scope' if they relate to a firm's 'retail market business'. Note that a firm may not have retail customer clients themselves, but this does not mean they will not be found to have in-scope retail market business; firms must therefore consider whether they have any PRIN 12 obligations. PRIN 12 is considered to impose a higher and more exacting standard of conduct than PRIN 6 and 7; hence, where PRIN 12 applies, PRIN 6 and 7 do not. To comply, firms must assess and provide evidence of how they are acting to deliver good outcomes for their retail customers throughout the life-cycle of the products and services that they provide to them.

If a firm breaches any of the Principles, it will be liable to disciplinary sanctions, which could also result in associated damage to reputation. However, the onus is on the FCA to show that the firm has been at fault.



Which of the above Principles do you think is most important when dealing with clients?

Many people would look at this list and say that the Principles are nothing more than the standards expected by a customer. However, the FCA has found that, over time, many firms have been in breach of these Principles, and in particular in breach of Principle 6 (Customers' interests), hence the FTOC initiative which began to try and encourage firms to 'do the right thing' and, subsequently, the recent implementation of the Consumer Duty (see section 5.3 of this chapter) and introduction of the new PRIN 12.

Try the following exercise.



Look at one of the Principles, and try to think of a positive indicator of that Principle being met and a negative indicator demonstrating that the Principle is being breached. Consider the systems and controls you have in place in your own business, and examples of published cases where firms were found to be breaching the Principles.

3.2 Professional Standards and Culture

FSMA 2000 gave the FCA powers to make rules about the conduct of professionals working in the financial services sector. The expectations of professionals are continuously changing and the FCA informs the industry of new rules and guidance in the Code of Conduct (COCON) Sourcebook. This sourcebook provides details about the Senior Managers and Certification Regime (SM&CR, or SMCR) as well as the high-level Conduct Rules.

3.2.1 Senior Managers and Certification Regime (SM&CR or SMCR)

The SM&CR replaced the Approved Persons regime for the vast majority of regulated firms. It aims to raise standards of governance and increase individual accountability, in turn reinforcing consumer confidence. The responsibilities under the SM&CR are two-fold:

- **Senior Managers Regime (SMR)** focuses on the most senior individuals in firms who hold key roles or have overall responsibility for various areas of relevant firms. It is the firm's responsibility to ensure each senior manager has a statement of responsibility setting out the areas for which they are personally accountable and to produce a firm responsibilities map that knits these together. All senior managers must be approved by the regulators before carrying out their roles.

  Senior managers also have a 'duty of responsibility', which means that they are required to take the steps that are reasonable for a person in their position to take in order to prevent a regulatory breach from occurring. The FCA is very keen to be able to apportion responsibility for a regulatory failure to those in positions of authority within firms.
- **Certification Regime (CR)** applies to 'material risk-takers'. These are staff who could cause significant harm to customers, but who are not senior managers. They are subject to the Dual Regulated Firms Remuneration Code, which is imposed on regulated firms. They include individuals such as those who give investment advice or those who administer benchmarks, for example. The CR requires firms to certify that these staff are fit and proper to carry out their certification function, upon hiring them and annually thereafter.

Firms are responsible for ensuring that senior managers and certified staff are fit and proper to carry out their roles. The FCA will only grant approval to persons whom it deems to be fit and proper (and may withdraw approval if it deems the person no longer fit and proper). If the FCA refuses to grant approval, the matter may be referred to the Upper Tribunal (Tax and Chancery Chamber).

In assessing fitness and propriety, the most important considerations will be the person's:

- honesty, integrity and reputation
- competence and capability, and
- financial soundness.

In addition, the FCA will also have regard for the functions the person is assigned to carry out based on their role.

Approved Person (AP) status must be obtained from the FCA prior to undertaking a regulated or ancillary activity, and the FCA must be informed within seven days if an AP stops performing that activity.

For payment services and electronic money (e-money) firms, regulatory requirements relating to fitness and propriety apply to a very limited number of individuals. Not only can this inconsistency between rules be confusing for firms (particularly for those individuals who hold responsibilities across multiple regulatory environments), but it is harder for the FCA to protect consumers and hold individuals within the payments and e-money sector to account. Therefore, in 2021, the FCA announced its intention to broaden the existing regime, so that the rules extend to this sector.

Before hiring a new employee, a firm needs to ensure that credit and Disclosure and Barring Service (DBS) checks are undertaken. This will hopefully uncover those who are financially unsound or have previously been involved in fraudulent activity.

Note that the FCA and the PRA are reviewing the SM&CR under the Edinburgh Reforms. The discussion period ended in June 2023, and an inital consultation paper was published in 2024 covering ways in which the SM&CR could be improved. This was followed by additional consultation papers published by the Financial Conduct Authority ('FCA') and His Majesty's Treasury ('HMT') in July 2025 (FCA consultation paper CP25/21, July 2025) (HMT consultation paper 15 July 2025) proposing significant reforms to the SM&CR. Some of the primary changes involve changes in definitions and thresholds for what constitutes a senior management function (SMF) and is aimed at streamlining the certification process

3.2.2 Conduct Rules (COCON)

The Conduct Rules apply directly to nearly all staff (apart from ancillary staff not involved in the regulated business functions of the firm – eg, those working in catering or office cleaning). Firms must ensure that staff who are subject to the rules are aware of them and how they apply to their jobs.

There are two tiers to the Conduct Rules: the first tier applies to all individuals, and the second applies only to senior managers:

Tier 1: Individual Conduct Rules	
1	You must act with integrity
2	You must act with due skill, care and diligence
3	You must be open and cooperative with the FCA, the PRA and other regulators
4	You must pay due regard to the interests of customers and treat them fairly
5	You must observe proper standards of market conduct

Tier 2: Senior Manager Conduct Rules	
SC1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively
SC2	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
SC3	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee this effectively
SC4	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice

Source: Financial Conduct Authority[8]

3.3 Training and Competence

3.3.1 Introduction

The rules and guidance concerning training and competence can be found in the FCA Handbook, called TC (training and competence). This sourcebook should be read in conjunction with the SYSC (Senior Management Arrangements, Systems and Controls) Sourcebook, in which it states:

> *'A firm must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them'. (SYSC 5.1.1)*[9]

This covers all firms, and the revised rules relating to training and competence also apply to firms with employees that carry out activities for retail clients, customers or consumers.

3.3.2 Attaining Competence, Appropriate Examinations and Supervision

A firm should not assess a person as competent to carry on any of a specified range of activities until those persons have demonstrated competence and passed each module of an appropriate examination. These activities include certain 'advising and dealing' activities, acting as a broker fund adviser, advising on syndicate participation at Lloyd's, and acting as a pension transfer specialist, among others.

Until such time as the employee is deemed competent, they must be appropriately supervised. Additionally, those supervising employees must have the necessary coaching and assessment skills, as well as technical knowledge, to act as competent supervisors and assessors.

8 Financial Conduct Authority. Code of Conduct (COCON 2.1): Individual conduct rules (last updated: July 2023). Retrieved from https://handbook.fca.org.uk/handbook/cocon2/cocon2s1?timeline=true (Accessed: October 2025)

9 Financial Conduct Authority. SYSC 5.1 Skills, knowledge and expertise (last updated: October 2025). Retrieved from https://handbook.fca.org.uk/handbook/sysc5/sysc5s1?timeline=true (Accessed: October 2025)

3.3.3 Maintaining Competence

A firm must review employees' competence on a regular and frequent basis. The firm must take appropriate action to ensure that employees remain competent for their roles, and specifically take into account:

- employees' technical knowledge and its application
- employees' skills and expertise, and
- changes in products, legislation and regulation.

4. Conduct of Business Sourcebook (COBS)

4.1 Introduction

The COBS Sourcebook (found in the Business Standards block of the FCA Handbook) has wider-ranging rules and guidance on a variety of activities, many of which directly affect the way firms deal with private clients. The COBS Sourcebook is a shift of emphasis from detailed rules to principles, high-level rules and guidance.

COBS applies to firms carrying on relevant activities (see section 4.1.1 below) from an establishment maintained by them, or through an appointed representative, in the UK.

Wherever the rules talk about information being transmitted in a **durable medium**, this means paper or any instrument which allows the recipient to store it unchanged for an appropriate time (eg, on a PC, but not the internet, unless it is held in a storage area with the ability to retrieve it).

A summary of the COBS Sourcebook is provided below.

4.1.1 Activities Subject to COBS

The activities covered are:

- designated investment business (DIB)
- long-term insurance business in relation to life policies, and
- activities relating to the above.

4.2 Client Classification (COBS 3)

Under COBS, clients are generally categorised as one of the following:

- **Retail** – retail clients receive the highest level of regulatory protection. A retail client is any client who is not a professional client or an eligible counterparty.
- **Professional** – professional clients are considered to be more experienced, knowledgeable and sophisticated, and able to assess their own risk, hence they are afforded fewer regulatory protections. They may be either:
  - **elective professional clients** – ie, they have chosen to be treated as such, or
  - **'per se' (Latin for 'in itself') professional clients** – ie, they fall into one of a certain category of clients, such as an entity that required to be authorised/regulated to operate in the financial markets, and institutional investments whose main business is investment in financial instruments.
- **Eligible counterparties (ECPs)** – ECPs will not benefit from the protections afforded by COBS rules. Having said that, many ECPs are large firms who are very familiar with the financial markets, or are themselves large players in the financial markets, and do not need such protection.

Note that the categories are relevant principally in terms of the level of client protection. A firm must implement appropriate written internal policies and procedures to categorise its clients, and they must make a record of the form of each notice provided and each agreement entered into. This record must be retained for the relevant period after the firm ceases to carry on business with clients who were provided with that form.

Recategorisation of Clients

Firms must allow clients to request recategorisation, so as to benefit from the different protections afforded to retail clients (as applicable), or to provide access to a greater range of potential investment solutions for professional clients and eligible counterparties.

In reality, it is today much harder for retail clients to opt up to be professional clients than before these classifications came into force. However, clients can be reclassified on a transaction-by-transaction basis. In all cases, the firm must inform new clients of the classification that they have given to those clients, and the greatest level of protection must be afforded to retail clients.

Elective professional clients are retail clients who have chosen to 'opt up' to be treated as professional clients. To be able to do so, they have to meet certain qualitative criteria and, additionally for MiFID business, meet two of the quantitative tests.

- **Qualitative test** – the firm has assessed their expertise, experience and knowledge and believes that they can make their own investment decisions and understand the risks involved.
- **Quantitative test** for MiFID business – they must meet any two of the following:
  - Average trade frequency of more than 10 significantly sized transactions on the relevant market in each of the past four quarters.
  - Portfolio worth more than €500,000 (defined as including cash deposits and financial instruments).
  - They work or have worked as a professional in the financial services sector for at least one year on a basis which requires knowledge of the transactions envisaged.

Alternatively, a professional client may be treated as an elective ECP if it is a company, and it is:

- a per se professional client (other than one which is only a professional client because it is an institutional investor), or
- it asks to be treated as such and is already an elective professional client (but only for the services for which it could be treated as a professional client), and
- it expressly agrees with the firm to be treated as an ECP.

Recategorisation may be carried out for a client on a general basis or on more specific terms – for example, in relation to a single transaction only. A firm can classify a client under a different client classification for different financial instruments in respect of which they may trade/undertake transactions. However, this will mean complex internal arrangements for firms.

4.3 Communication with Clients (COBS 4)

The FCA has established rules and guidance to govern how financial services firms communicate with retail clients. These rules aim to promote transparency, fairness and consumer protection. We will now outline the key aspects of the FCA rules in this regard.



Can you remember PRIN 6 and 7 from section 3.1? If not, go back and review them and make sure you are confident that you can relate the Principles to the rules outlined in this chapter.

4.3.1 Fair, Clear and Not Misleading

Underpinning the rules relating to advisers dealing with clients is *'fair, clear and not misleading',* which is at the core of the financial promotion rules and the information that is sent to clients. Firms must ensure that:

- if the FCA is named and matters are not regulated by them, it says so
- financial promotions must say if they relate to products or services where the client's capital is at risk
- **yield** quotes must give a balanced view of both short-term and long-term prospects
- if an investment is complex, it must be clearly explained, and
- if communications relate to a **packaged product**, the provider of that product is accurately, fairly and clearly described.

Communications must be easy to understand and read/hear, using plain language. Technical jargon and complex terminology should be avoided or explained in a way that clients can easily comprehend.

If the FCA finds that a firm has provided clients with information that is not fair or clear, or is ultimately misleading (whether those actions were intentional or not), then the firm could face 'serious consequences'; for example, they could be subject to a fine, and contracts could be unenforceable.

The FCA has specific guidelines for firms regarding digital communication and social media. Firms should ensure that their online communications comply with the same standards of fairness, clarity, and accuracy as traditional communication channels.

4.3.2 Information Requirements when Managing Investments

Firms providing portfolio management services must establish a meaningful way of evaluating, and subsequently reporting on, the performance. This should be accessible by the client, and should include appropriate benchmarks based on the clients' objectives and the type of investments used.

- When firms outline past performance, they must make sure that it is not any more prominent than other information, covers at least five years or since launch, and shows the effects of charges and commission.
- With simulated performance, the firm must say that it is simulated and what the simulation is based on.
- With future performance, it must say on what it is based, and there must be a prominent warning that it is not a reliable indicator of future returns.

When managing on behalf of retail clients, firms must:

- state the method and frequency of valuations
- detail any delegation of the discretionary portfolio
- state the benchmarks that the portfolio is assessed against
- state the types of designated investments and the types of transactions which may be carried out, including any limit details or restrictions on the managers' discretion, and
- state the management objectives and the level of risk that may be incurred on the client's behalf.

If firms are holding client money or investments for retail clients, they must provide additional details of who may hold them on their behalf (eg, a custodian), what would happen if the third party became insolvent, and/or if they are likely to be held in omnibus accounts and the safeguards around that.

An omnibus client account falls under CASS. The main two types are:

a. an **account** maintained by a firm at an authorised central counterparty for more than one client of the firm in respect of which the authorised central counterparty has agreed with the firm to provide omnibus client segregation, or
b. an account maintained by a firm for more than one indirect client at a clearing member in respect of which that clearing member has agreed with the firm to provide segregation arrangements that satisfy the requirements of article 4(2)(a) of the L2 requirements of UK European Market Infrastructure Regulation (EMIR).

4.3.3 Risk Warnings and Disclosures

Firms must provide appropriate risk warnings and disclosures to retail clients, especially when promoting or offering financial products or services. Clients need to be aware of the potential risks involved to make informed investment decisions.

Generally speaking, firms have to make sure they do not disguise, diminish or obscure important items, statements or warnings.

4.3.4 Marketing Communications

Any marketing communications, including advertisements and promotions, must be clear, fair, and not misleading. Promotional materials should accurately represent the features, benefits, and risks of the products or services being promoted. Firms should ensure that financial promotions are approved by an appropriate, authorised individual.

4.4 Advising and Selling (COBS 9)

Rules on suitability apply when firms make personal recommendations relating to designated investments and when they manage investments. They exist to ensure that firms take all reasonable steps to establish that recommendations, or decisions to trade, are suitable for the client.

Suitability consists of three elements, all of which must be obtained in order to establish it:



Suitability does not apply to **execution-only** business. Additionally, if the client is a professional client, firms can assume that the client has the necessary knowledge in this area, although carrying out an appropriateness test should be seen as standard practice now.

4.4.1 Suitability Reports

Once suitability is established, a suitability report must be provided to retail clients. The purpose of a suitability report (which is often in the form of a letter) is to explain why and how a particular product or products have been recommended as suitable to meet the customer's needs and objectives. How a firm uses it may depend on their business model and the services that are provided.

They have to be used (regardless of whether or not the transaction occurs) in the following cases:

- Regulated collective investments
- Life policies
- **Investment trusts**
- Personal or stakeholder pension policies
- Pension transfers, conversions or opt-outs.

The suitability report must be written in plain English, be fair, clear and not misleading, and written by a person who is authorised to advise on the recommended products. It must at least:

- specify the client's demands and needs
- explain why the recommendation is suitable in regard to the information provided by the client, and
- explain any possible disadvantages of the transaction for the client.

There may be additional content according to the complexity of the personal recommendation – for example, income withdrawals and any ethical considerations.

Consideration should be given to the following additional points when compiling a suitability report. It should:

- be tailored to the customer
- highlight the risks associated with the recommendations
- explain any costs, charges and potential penalties attached to the products, including any loss of benefits or exit penalties – even if they are percentage based, these figures should be included in monetary terms whenever possible. If they cannot be precise, a realistic example to the case concerned should be used
- where replacement business is involved, compare existing and new arrangements
- confirm the client's attitude to risk, risk descriptions and capacity for loss
- provide a balanced view
- highlight any objectives which have been omitted
- emphasise how the customer will be advantaged or disadvantaged by the advice, and
- contain a statement about the importance and confirmation of the review process and the cost of advice (if not previously agreed).



Some customers do not wish to disclose all of their financial information. This can make it difficult to understand whether the recommendation is truly suitable. What do you need to do in these cases?

If an adviser does not obtain the necessary information to assess suitability, they should not make a personal recommendation (investment advice) or take a decision to trade. However, a customer can always ask the adviser to undertake the transaction based on limited information. The customer must give instructions to the adviser in writing (this type of client is referred to as an 'insistent client'). In these circumstances, they will need to make it clear that any advice they offer will be based on the information that has been provided.

In addition, the adviser will need to advise the customer that their recommendation will not take into account any information not disclosed. For example, if a client who has 10% already invested in a high-risk category does not disclose this, they may be overexposed in their overall risk profile.

In the UK, the FCA does not accept blanket disclosure as acceptable across all customers. Disclosure does not make a case suitable. They should also bear in mind the 'clients' best interests' rule and, if relevant (for non-advised transactions), the appropriateness test.

In some jurisdictions, the obligation on a firm to provide a suitability report may not apply in certain circumstances. An example is a UK firm that is making a personal recommendation to a client who is habitually resident outside of the UK, and who is not present in the UK at the time of acknowledging their consent to the recommendation (under COBS 9.4.3).

Note that the content of suitability reports is not prescriptive, but they must at least specify the client's needs and objectives, explain why recommendations are suitable for the client's needs, and set out the advantages and disadvantages of the transaction.

4.4.2 Record-Keeping

A firm must make appropriate records to demonstrate compliance with the rules in this sourcebook, and keep them for the following periods after an employee stops carrying on the activities:

- at least five years for MiFID business, a life policy, a personal pension scheme or a stakeholder pension scheme
- indefinitely for a pension transfer, conversion, opt-out or free-standing **additional voluntary contributions (AVCs)**, and
- three years in any other cases.

If a client does not proceed with a recommendation, however, then the firm does not need to retain its records relating to suitability.

4.5 Dealing and Managing (COBS 2, 9, 11, 12)

An important aspect of the rules for dealing and managing investments is captured in the SYSC Sourcebook, which says that firms must take all reasonable steps to identify conflicts of interest.

4.5.1 Conflicts of Interest (SYSC 10)

Firms are obliged to take all reasonable steps to identify conflicts of interest between:

- the firm (including managers, employees, appointed representatives/tied agents and parties connected by way of control) and a client of the firm, and
- between one of its clients and another.

Under these obligations, firms should:

- maintain effective organisational and administrative arrangements, designed to prevent conflicts of interest from adversely affecting client interests
- for those producing 'externally facing' investment research, have appropriate information controls and barriers to stop information from these research activities flowing to the rest of the firm's business (eg, Chinese walls – see section 4.5.2 below)
- if a conflict of interest cannot be managed away, ensure that the general or specific nature of it is disclosed
- prepare, maintain and implement an effective conflicts policy
- provide retail clients and potential retail clients with a description of that policy, and
- keep records of those activities where a conflict has arisen.

4.5.2 Chinese Walls (Information Barriers)

A Chinese wall is an information barrier implemented within a firm to separate and isolate persons who make investment decisions from persons who are privy to undisclosed (non-public) material information which may influence those decisions, such as research departments. This is a way of avoiding conflict of interest problems. SYSC requires firms to establish Chinese walls if an employee holds information which must be withheld from other parts of the business. Similar to the conflicts policy, the details of this are not prescriptive, so smaller firms may have far less detailed policies than larger, more complex firms. An example of groups that should be separated is the investment banking department, which has information on an upcoming deal that will affect the price of a stock, and the proprietary trading desk that could profit based on this knowledge.

4.5.3 Investment Research and Recommendations

When a firm produces research, it must ensure that it is labelled or described as investment research or is otherwise presented as an objective or independent explanation of the matters contained in the recommendation.

If the recommendation in question is made by an investment firm to a client, it does not constitute the provision of a personal recommendation. In this instance, investment research is defined as research or other information recommending or suggesting an investment strategy, explicitly or implicitly, concerning one or several financial instruments or the issuers of financial instruments. This includes any opinion as to the present or further value or price of such instruments intended for distribution channels or for the public.

4.5.4 Inducements and Investment Research

One area in which a conflict of interest can arise relates to investment research. For example:

- A firm may produce independent investment research that is (or likely to be) disseminated to the firm's clients or to the public. The analysts producing that research may have responsibilities to the companies that they are researching, which could conflict with the interests of the individuals who receive the research.
- A firm may allow its employees to deal ahead of the publication of its independent investment research, known as front running. Front running has long been considered improper and unethical, since it takes advantage of knowledge of the order and its likely impact on the trading price. Thus, it may amount to **insider dealing**, and is prohibited under the Code of Market Conduct.
- Where a firm is in receipt of inducements and commissions (other than the standard commission or fee for that service) from a third party, or by the firm's own remuneration and other incentive structures, this may impair compliance with the firm's duty to act in accordance with the best interests of its clients.

Firms are required to take all appropriate steps to identify, prevent and/or manage (as a last resort) conflicts of interest that arise in the course of providing any investment and ancillary services.

Under COBS rules, an investment firm must not pay to/provide or accept/receive from any party (other than its client, or a party acting on behalf of its client) any fee, commission or non-monetary benefit in connection with the provision of any investment or ancillary service. These rules only apply:

- to firms carrying on designated investment business, which is MiFID business as well non-MiFID business, and
- where a firm provides independent advice, restricted advice and portfolio management services to retail and professional clients; therefore, investment firms undertaking **eligible contract participant (ECP)** business will not be subject to the detailed inducement provisions.

Where any such fees, commissions or non-monetary benefits are received by firms, they must be returned and the client must be advised.

Notably, this prohibition does not apply to any fee, commission or non-monetary benefit that:

- is designed to enhance the quality of the relevant service to the client; and does not impair compliance with a firm's duty to act honestly, fairly and professionally in the best interests of the client, or
- enables, or is necessary for, the provision of an investment service by the firm (eg, custody costs, settlement and exchange fees, regulatory levies or legal fees); and which, by its nature, cannot give rise to conflicts with the firm's duty to act honestly, fairly and professionally in the best interests of the client.

Additionally, this prohibition does not apply if the benefit can be categorised as a minor non-monetary benefit. According to the FCA[10], a minor non-monetary benefit is one which:

- is reasonable, proportionate and of a scale that is unlikely to influence the firm's behaviour in any way that is detrimental to the interests of the relevant client, and
- consists of:
  - information or documentation relating to a financial instrument or an investment service, that is generic in nature or personalised to reflect the circumstances of an individual client
  - written material from a third party that is commissioned and paid for by a corporate issuer or potential issuer to promote a new issuance by the company
  - participation in conferences, seminars and other training events on the benefits and features of a specific financial instrument or an investment service, and
  - hospitality of a reasonable *de minimis* value, such as food and drink during a business meeting or a conference, seminar or other relevant training event.

The payment is only permitted if it satisfied the following three tests:

- **Disclosure test** – the payment is clearly disclosed prior to the provision of the relevant service to the client.
- **Enhancement test** – the payment is capable of enhancing the quality of service provided to the client.
- **Compliance test** – the payment is of a scale and nature that it could not be judged to impair the firm's compliance with its duty to act honestly, fairly and professionally in the best interests of the client.

10 Financial Conduct Authority. COBS 2.3A Inducements relating to MiFID, equivalent third country or optional exemption business and insurance-based investment products (last updated: October 2025). Retrieved from https://handbook.fca.org.uk/handbook/cobs2/cobs2s7?timeline=true (Accessed: October 2025)

For all MiFID business, firms must keep full records of such payments/benefits made to other firms, for all MiFID business. For non-MiFID business, firms will have to comply with the compliance test; the other two tests (disclosure and enhancement) do not apply.

Retail non-MiFID business in respect of the sale of packaged products is subject to the disclosure requirements of the inducement provisions. The extension of the provision does not, however, expect firms to disclose details of reasonable non-monetary benefits for non-MiFID business.

Research

Firms which produce research must apply a separately identifiable charge to the research when providing it to regulated firms that provide portfolio management services or independent financial advice.

On the other hand, regulated firms may only receive research if it pays for it:

1. directly from its own resources, or
2. via payment from a research payment account (RPA) controlled by the firm funded by a specific charge to its clients.

However, these provisions do not apply to certain entities (such as corporate companies, central banks, and banks) and regulated bodies that produce research, and regulated firms that consume research.

Firms' communication shall be deemed to be 'research' if it comprises research material or services:

- concerning one or several financial instruments or other assets
- concerning the issuers or potential issuers of financial instruments, or
- is closely related to a specific industry or market such that it informs views on financial instruments, assets or issuers within that sector

and which:

- recommends/suggests (either explicitly or implicitly) an investment strategy, and provides a substantiated opinion as to the present or future value/price of such instruments/assets, or
- contains analysis and original insights, and reaches conclusions based on new or existing information that could be used to inform an investment strategy.

Further, the information is relevant and capable of adding value to a client's decisions on behalf of their clients. More importantly, research providers must implement appropriate controls to ensure that they do not provide unsolicited research free of charge.

On implementing the MiFID II text into its Handbook, the FCA gold-plated some of the requirements. However, it has not applied the requirements to authorised investment funds (AIFs) and collective investment schemes (CISs) whose core investment policy does not generally involve investing in MiFID financial instruments. This means that **private equity** business and collective investment funds investing in commercial property would not be captured by the prohibition on receiving research for free.

In 2022, new rules on inducements and research came into effect, some of which are as follows:

- **Exemption from the inducement rules for small and medium-sized enterprise (SME) research** – research on companies with a **market capitalisation** below £200 million will be exempt, meaning that UK-based fund managers do not have to pay for this research.
- **Exemption for FICC Research** – the FCA has applied the exemption of Fixed Income, Currency and Commodity (FICC) research based on underlying financial instruments and not in relation to an investment strategy that primarily relates to FICC instruments.
- **Independent research providers** – there is an exemption for research to be paid for when it is provided by research providers who are not engaged in execution services, and is not part of a financial services group that includes an investment firm providing execution or brokerage services. The list of minor non-monetary benefits has been updated, although the word 'independent' was removed.
- **Openly available research** – research that is openly made available to firms and the general public can be received free of charge by UK asset managers. The aforementioned list of non-monetary benefits has been updated to reflect this.

Further, in April 2024, the FCA proposed amending MiFID rules on how firms pay for investment research, thus reversing a longstanding policy that prevented them from 'bundling' these fees with their trading costs. The aim of this change is to energise the UK's capital markets, as it is expected to encourage more research on small- and medium-sized companies and entice more businesses to list in London.

4.5.5 Best Execution

Firms must take all reasonable steps to obtain the best results for clients. Careful consideration must be given to:

- the characteristics of the client (ie, are they retail or professional?)
- the characteristics of the client order (taking into account the many types of orders and special instructions)
- the characteristics of the instruments involved, and
- the characteristics of the execution venue.

Price **considerations** need to include the cost of the venue, all expenses, and **clearing** and **settlement** costs. This includes the costs of dealing on different venues where the firm has more favourable terms with one venue than another, and this must be taken into consideration when selecting the venue for the client's deal. However, care must be taken that a firm does not discriminate against one venue over another.

Firms are required to advise clients of their order execution policies, which will include a list of the financial instruments for each venue that is likely to be used and the factors that will affect the choice of venue. The firm must explain the reasoning behind the choice of these venues, the factors affecting the choice of the venues, and how the venues will secure best execution for the client. This will need to be reviewed at least annually. Firms do not have to receive explicit client consent, and only have to advise them of the policy.

4.5.6 Client Order Handling

Comparable client orders implement procedures and arrangements which provide for the prompt, fair and expeditious execution of clients orders, relative to other orders of trading interests of the firm.

The procedures and arrangements must allow for the execution of client orders in a way that is the same as other comparable assets.

COBS 11.3 rules say that:

- orders must be executed promptly and accurately allocated
- comparable client orders must be carried out sequentially and promptly, unless market conditions mean this is impractical or the client interests require otherwise, and
- firms must inform retail clients of any material difficulty relevant to the proper carrying out of orders promptly.

Once a firm has agreed to execute a current client order, it must do so as soon as reasonably practicable...	… but the firm may postpone the order where it has taken reasonable steps to ensure that it is in the best interests of the retail client.

Firms must also take all reasonable steps to ensure that the trade settles and **stock**, funds and/or cash are delivered to the client account.

Firms must not misuse the information relating to client orders and must take all reasonable steps to prevent it being misused by others.

4.5.7 Aggregation and Allocation

Where a firm aggregates client orders with its own, the firm must ensure that:

- the client is unlikely to be disadvantaged by the **aggregation**
- the aggregation is disclosed to the client, and
- an order aggregation policy is established.

An order aggregation policy must provide for the fair **allocation** of aggregated orders and transactions, including how the volume and price of orders determines allocations along with the treatment of partial allocations.

Firms can only aggregate their own accounts deals with clients, or aggregate two or more clients' orders if:

- it is likely that the aggregation will benefit each of the clients whose orders have been aggregated, and
- the client has been notified that it may sometimes work to their disadvantage.

The firm must have an order execution policy in place.

4.5.8 Compliance for Investment Managers and Firms Receiving and Transmitting Orders

Firms and senior managers in firms need to have systems, controls and reporting mechanisms to ensure that:

- **investment managers** act in their clients' best interests when placing orders for them, and
- **firms** receiving or transmitting orders for clients must act in their clients' best interests.



When considering the conflicts that may arise, how might a client be disadvantaged? Could a conflict of interest benefit certain clients?

4.6 Rules on Cancellation and Right to Withdraw (COBS 15)

As part of the product disclosure rules (outlined in section 5.5.1), there will be references to the client's right to cancel if they wish. In all cases, records will need to be retained indefinitely for pension transfers and free-standing additional voluntary contributions (FSAVCs), five years for life policies or pension cases and three years for any other investments.

Contract	Cancellation period
• A life policy (including a pension annuity, a pension policy or within a wrapper). • A contract to join a personal pension scheme or a stakeholder pension scheme. • A pension contract. • A contract for a pension transfer. • A contract to vary an existing personal pension scheme or stakeholder pension scheme by exercising, for the first time, an option to make income withdrawals. • A non-distance contract to open or transfer a lifetime individual savings account (LISA).	30 calendar days
• A contract for a cash deposit ISA.	14 calendar days
• To buy a unit or share in a regulated CIS, including within a wrapper or pension wrapper. • To open or transfer a child trust fund (CTF). • To open or transfer an ISA (other than a LISA) or Junior ISA (JISA). • For an enterprise investment scheme (EIS) or **seed enterprise investment scheme (SEIS)**.	14 calendar days
• Accepting deposits. • Designated investment business. • Issuing electronic money.	14 calendar days

The cancellation period begins either:

- from the day of the conclusion of the contract (except in respect of contracts relating to life policies where the time limit will begin from the time when the consumer is informed that the contract has been concluded), or
- from the day on which the consumer receives the contractual terms and conditions and any other pre-contractual information required under COBS 15 or the UK PRIIPs (packaged retail and insurance-based investment products) regulation, if that is later than the date referred to above.

Candidates should also note Article 186 of the Solvency II Directive and Article 6(1) of the Distance Marketing Directive, regarding consumers' rights to cancel distance contracts without penalty and without given reason, and the cancellation periods.

4.6.1 Disclosing a Right to Cancel or Withdraw

Firms must disclose to consumers the existence of their right to cancel or withdraw, its duration, and the conditions for exercising it. This includes information on the amount which the consumer may be required to pay and the consequences of not exercising it, as well as practical instructions for exercising it and indicating the address to which the notification of **cancellation** or withdrawal should be sent.

This disclosure must be made in good time before the consumer is bound by the contract which they can withdraw or cancel, and in a durable medium.

Furthermore, if the firm offers to pay adviser charges, then this must be disclosed at the same time as the information concerning the right to cancel or withdraw. Alongside this, firms must disclose to the consumer the effect on the payment to the adviser if they withdraw the contract; for example, whether any refund to the consumer will include an adviser charge, or whether the consumer may be liable to pay these charges upon cancellation.

These rules only apply if they have not already been applied due to other rules.

4.7 Reporting to Clients (COBS 16)

4.7.1 Occasional Reporting

The rules on occasional reporting require firms, other than those managing investments, to give adequate disclosure to clients regarding any orders carried out on their behalf. A firm must:

- provide the client, in a durable medium, with the essential information concerning the execution of the order
- for a retail client, send the client a notice, in a durable medium, confirming the execution of the order and such of the trade confirmation information as is applicable:
  - as soon as possible and no later than the first business day following that execution, or
  - if the confirmation is received by the firm from a third party, no later than the first business day following receipt of the confirmation from the third party, and
  - supply a client, on request, with information about the status of their order.

4.7.2 Periodic Reporting

Firms managing investments are required to provide periodic statements in a durable medium, unless such statements are provided by another person. This should happen at least every six months, but the client can request them every three months (and the firm must inform retail clients of their right to cancel the provision of periodic statements every quarter) or to receive information about executed transactions on a transaction-by-transaction basis. If the portfolio is leveraged, a statement must be sent monthly.



Why is reporting important for (a) clients, and (b) the firms?

For clients, it means that they can compare and contrast the performance over a period – this may prompt them to contact the adviser.

For the firm, it provides them with information about the performance and allows them to monitor their activities. For example, is there a connection between any decline or increase in clients depending on the performance of their advisers? Is there a correlation between statement production and increased complaints, or rise in assets under management (AUM) or new client recommendations? This data, called management information (MI), allows the company to better understand the current state of its business (see section 5.5.3 of this chapter for more information on MI). Thus, reporting can be a crucial monitoring tool for firms' business activities.

5. Fair Treatment of Customers (FTOC) and Consumer Duty

Learning Outcome

1.1.5 Apply the Consumer Duty principles: products and services; price and value; consumer understanding; consumer support

5.1 The FCA's Journey with FTOC

The requirement on firms to treat customers fairly is central to the FCA's work in ensuring that customers receive a fair deal and is firmly rooted in their Principles for Businesses (PRIN 6). PRIN 6 states that the underlying principal motive for the **Fair Treatment of Customers (FTOC)** initiative is:

> *'A firm must pay due regard to the interests of its customers and treat them fairly'.*

The FCA expects firms to base their business models, culture and how they run their businesses on the principles of FTOC. It is the responsibility of the senior management of firms to deliver this and, according to the FCA, '*all firms must be able to show consistently that fair treatment of customers is at the heart of their business model*'. The FCA also says: '*Above all, customers expect financial services and products that meet their needs from firms they trust*'.

Under FTOC, the FCA sets out six customer outcomes, which they use to guide policy and principles when making rules, preparing and issuing codes, and giving general guidance.

- **Outcome 1** – Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- **Outcome 2** – Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3** – Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4** – If consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5** – Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- **Outcome 6** – Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

FTOC is not about standardising client services and products across industries; rather, it is about firms being able to demonstrate good conduct through their dealings with consumers, each other, and the market. Firms need to ensure that they take steps to positively address the known behaviours and traits consumers may exhibit, rather than trying to exploit them. They should also fully consider the needs of potential consumers when they develop a product or service and aim to develop smarter and more effective ways of communicating with consumers (eg, by shortening their terms and conditions to make them more accessible). The FCA is not providing detailed rules for businesses because it will be different for every type of business and business model.

As outlined above, the FCA has a duty to promote effective competition when addressing the consumer protection objective. The main aim is for consumers to have a choice to 'shop around' for the best deal, as effective competition will produce better outcomes for consumers in terms of price, quality, range, service and innovation.

In a similar way, market integrity is an essential prerequisite for effective competition since consumers need to feel able to trust the financial services sector in order to find the best solution for their needs. Lack of market integrity and trust will prevent consumers from doing this, and the FCA will have failed in not only its integrity objective, but also its objective of protecting consumers.

FTOC also requires firms to have a structure in place if an eligible customer wants to complain, and to make the process as easy as possible for them. We will look at who is an eligible complainant in section 6.3 of this chapter.

5.2 Examples of Consumer Outcomes Being Delivered

What firms need to do is consider these outcomes and demonstrate how they deliver them from their business model to clients. The FCA does, however, help firms by providing suggestions of what the outcomes may look like.

Outcome 1 – Example

1. Reporting and analysing information from staff appraisals demonstrates that behaviours match the firm's customer-centric culture, as expressed by senior management.
2. The firm analyses staff remuneration. The remuneration policy includes measures around the fair treatment of consumers. Analysis of this demonstrates positive staff behaviours.
3. The firm collates feedback from a representative sample of staff, to understand staff views on customer fairness and to capture any recommendations and improvements. The results of this feedback drive change and the firm can evidence these actions.

Outcome 2 – Example

1. The firm has identified points within the product life-cycle where the cancellation of a product could result in customer detriment. It is able to demonstrate consistently high persistency levels at these times and, if performance varies, reasons are understood and do not indicate consumer fairness issues.
2. The firm has articulated what it expects the customer profile will be for its products and analysis of actual customer profiles indicates that this expectation is consistently being met. If there is variation, the firm establishes why, and reasons do not impact on customer fairness. This is tracked over time and trends are monitored.

Outcome 3 – Example

1. When planning a marketing campaign, the firm uses customer panels to check the information is appropriate for the target market. The firm assesses the effectiveness of these panels using post-sale customer feedback. The results demonstrate that customers understand and are able to articulate what they have bought, know the action that they need to take and are aware of the benefits and risks of taking action. This has helped the firm to establish that communications are fair, clear and not misleading.
2. The firm has documented plans in place setting out the timing, purpose and means of planned customer contact activity. It has a record showing evidence of customers consistently receiving appropriate, timely communications, allowing them to make informed decisions.

Outcome 4 – Example

1. A central specialist team assesses the quality of advice. They apply a sound approach, checking the evidence that has been gathered and the appropriateness of the recommendations made. These assessments indicate very low levels of poor advice and when these do occur, prompt action is taken to improve performance.
2. The firm reviews the mix of advised sales by product type and provider, and checks the degree of concentration of sales to identify any potential sales bias. These reviews show an appropriate mix of products and providers, and the firm can demonstrate no sales bias exists.
3. The firm expects a certain percentage of recommendations to be made where the fee is not contingent. The actual proportion of such recommendations is tracked at an adviser level and is in line with expectations.

Outcome 5 – Example

1. The firm has set standards for the quality and speed of service, has communicated these to customers, and monitors delivery of these standards. Results demonstrate that standards are being met. If there are any variations, the firm understands why, and these do not indicate customer fairness issues.
2. Product performance is as customers have been led to expect, or if not, the firm takes appropriate action to improve it and/or customers are kept informed of reasons why. In practice, this can involve measuring performance against the terms of the product and comparing performance to alternative products, benchmarks or competitors over an appropriate period of time.

Outcome 6 – Example

1. Any barriers can be justified and are in line with customer expectations (eg, exit fees are understood by the customer and are only applied in the stated circumstances). The firm measures the application of barriers to ensure they are applied fairly.
2. The reasons for and volumes of complaints received are in line with expectations. The firm conducts root cause analysis and takes corrective actions where appropriate. Feedback about the complaint process indicates there are no barriers to making and resolving complaints.

5.3 Consumer Duty

While the FCA recognises that consumers have responsibility for the decisions they make, consumers cannot always be expected to have enough financial knowledge, information and understanding of complex products, or of the risks associated with them, to decide the best financial course of action for them. The FCA, therefore, wants to see a higher level of consumer protection in the retail financial market. Therefore, in July 2022, following a consultation, the FCA introduced the Consumer Duty. This is underpinned by three 'cross-cutting' rules that set out how businesses should act to deliver good customer outcomes:

1. Act in good faith toward retail customers.
2. Avoid foreseeable harm to retail customers.
3. Enable and support retail customers to pursue their financial objectives.

The Consumer Duty requires firms to consider what outcomes consumers should be able to expect from their products and services, act to enable (rather than hinder) these outcomes, and assess the effectiveness of their actions. While the Consumer Duty reinforces PRIN 6 (Customers' Interests) as well as PRIN 7 (Communications with Clients) which are covered in more detail in section 3.1 of this chapter, note that PRIN 6 and PRIN 7 will not be removed from the regulatory landscape altogether.

Under the Consumer Duty, the FCA has four outcomes[11]:

- **Products and services** – firms must ensure that all products and services for consumers are: fit for purpose; designed to meet their needs, characteristics and objectives of a target group of customers; and distributed appropriately.
- **Price and value** – firms must ensure that all consumers receive fair value; this is more than just the cost. Firms must evaluate their products and services holistically to ensure a reasonable balance between the price that consumers pay and the overall benefits that they receive.
- **Consumer understanding** – firms must ensure that their communications support and enable customers to make informed decisions about financial products and services. This requires providing them with the necessary information at the right time, and presenting it in a way that is clear and understandable.
- **Consumer support** – firms must provide a level of support that meets consumers' needs throughout their relationship with the firm. This involves helping consumers to realise the benefits of the products and services they are purchasing, and ensuring that consumers are supported in pursuing their financial objectives.

These rules apply to new and existing products and services that are open to sale or renewal, as well as to closed products and services.

5.4 Fair Treatment of Vulnerable Customers

The FCA's Principles for Businesses (PRIN) require firms to treat clients fairly, and the regulator expects firms to take particular care with vulnerable consumers. This is necessary because much consumer protection legislation is designed for the average or typical consumer; in contrast, vulnerable clients may be less able to represent their own interests, may have different needs, and may have more behavioural biases that negatively impact their decision making. Consequently, vulnerable clients are especially susceptible to harm – for example, they are more likely to be partially or fully financially excluded, buy inappropriate products and services, and be exposed to misselling, scams and financial abuse, among other things.

The four key drivers of vulnerability are as follows:

1. **Health** – serious or terminal illness could impact on a client's ability to make decisions. Additionally, illness could lead to a loss of **income** and extra expenses and could reduce the client's financial resilience.
2. **Resilience** – a client with a low resilience (eg, low or erratic income, low savings, low emotional resilience and/or high levels of debt) are less likely to be able to withstand financial or emotional shocks.
3. **Life events** – events such as divorce, bereavement and redundancy could impact a client's ability to make decisions because they may be forced into dealing with more complex financial situations than they are used to.
4. **Capacity** – a client who has learning difficulties or is illiterate might be vulnerable. Others may struggle to assess financial products or find it difficult to shop around, while some may have fallen into debt which might have been avoidable if they had been able to understand their options better.

11 Financial Conduct Authority, July 2022. Policy Statement PS22/9: A new Consumer Duty, Feedback to CP21/36 and final rules. Retrieved from https://www.fca.org.uk/publication/policy/ps22-9.pdf (Accessed: October 2025)

Other factors can also make clients vulnerable or indicate they require special consideration. For example:

- **The client may have reliance on another (eg, a friend or family member)** – this suggests a client's inability of making their own decisions. Advisers should consider whether the third party is applying undue influence on the client.
- **The client may display unusual behaviour** – this may indicate a cognitive (eg, dementia) or mental health issue (eg, depression), which impairs their ability to make decisions. Other examples are as follows:
  - Multiple, unusual withdrawal requests in a short period of time may indicate that a client is being defrauded or pressured into passing on money, or they may have forgotten they made previous requests.
  - A very elderly client who requests to fully encash their investments – the adviser should consider whether there is any coercion or undue influence, in which case they may have to inform their compliance/financial crime department for assistance.
- **The client may be unresponsive** – when a client is not responding, uncontactable or unusually quiet, this could signal they are struggling with finances generally, or they are experiencing difficult external events which are a barrier to them.
- **The client may have difficulties filling in forms clearly and correctly** – this may indicate illiteracy or problems (eg, early dementia) that are making it difficult for them to complete such forms.

It is the adviser's responsibility to decide whether a client should be treated as vulnerable. It is important to note that vulnerability can be permanent or temporary, and it may change over time. For example, a client with a permanent disability will be permanently vulnerable, but one who has recently been made redundant may only be vulnerable temporarily.

5.4.1 Interacting with Vulnerable Clients

When interacting with vulnerable clients, advisers should deal with them in a manner which encourages them to be open and honest about any difficulties they may have. Advisers should then adapt their approach to accommodate the clients' needs. Specifically, advisers:

- must provide tailored and suitable advice in a format that the client can access and understand, and which is fair, clear and not misleading
- should discuss having a trusted family member/friend present at meetings, which must be arranged beforehand
- must ensure there is appropriate authority on file (eg, power of attorney (POA)) before discussing matters with a third person and if the client does not have a POA, this should be discussed with them
- must document matters and refer to their compliance/financial crime department if they believe or suspect that the client is under duress, and
- must ensure that partially sighted clients, or those with hearing difficulties, are aided and supported.

5.4.2 Documenting Advice to Vulnerable Clients

To demonstrate that advisers have considered a client's circumstances, they must document the following:

- Any identified vulnerability and the steps that should be taken to accommodate the client's needs.
- Details of a trusted family member/friend who should be present at meetings.
- Details of the client's medical history, including an indication of the severity of any illness.
- Detail of any impairment (eg, sight, hearing and illiteracy).
- Details of any advice which is not proceeded with, and the reasons why the client has not done so.

5.5 Know Your Customer (KYC)

In the regulated environment, it is important that advisers are as certain as they can be that they have done a good job for clients. Advisers who are unable to evidence the collection of sufficient KYC data will find it difficult to show that they have acted in the client's best interests, even if they have.

As there is no set structure for obtaining this information, it is the skill of the adviser in ascertaining the client's particular circumstances that is most important. The client must feel trust in the same way as the skilled adviser demonstrates empathy. During the course of initial discussion to establish suitability of a portfolio or product, an adviser must gather the following:

- **Personal information** – name, address, date of birth, marital status, any spouse/partner, children and other dependants, and basic health information.
- **Employment** – occupation, employer's details and benefits, or details of self-employment.
- **Income** – from all sources.
- **Expenditure** – all outgoings, including debt and credit card repayments.
- **Assets** – property, valuables, savings, investments.
- **Liabilities** – all financial obligations, including mortgages, loans and credit cards.
- **Nationality, residence and domicile** – for tax purposes, and available tax allowances.
- **Objectives** – what the client is hoping to achieve, for how long they wish to hold the portfolio or product.
- **Attitude to risk** – how much risk they are prepared to tolerate.
- **Capacity for loss** – how much risk they can afford to take.
- **Investment preferences** – restrictions, ESG/ethical considerations, legal **constraints** and personal preferences.

5.5.1 Product Disclosure (COBS 13 and 14)

Firms and advisers of authorised FCA funds who provide advice or personalised information about packaged products to a customer must provide written details of the **key features** of the product they are recommending. The type of documents that funds have to provide depend on whether they fall under the **Undertakings for Collective Investments in Transferable Securities (UCITS) Directive** or **Packaged Retail and Insurance-based Investment Products (PRIIPs)** regulation.

UCITS is a European directive that provides a regulatory framework to allow funds that are managed and domiciled in the EEA to be marketed and sold to retail investors. The principal advantage is that a fund authorised in one EEA member state can be marketed and sold in another EEA state, without the need

for further approval (a process known as '**passporting**') as those funds adhere to common standards for risk and fund management.

PRIIPs was introduced in 2014 in response to surveys and consultations conducted by the EC. These surveys found that retail investors across the EU often did not understand the associated risks and costs in their investment decisions, resulting in them suffering unforeseen losses. By creating a new standard common disclosure document for retail investors, PRIIPs aims to support the European single market, enhance comparability with UCITS funds, and improve the overall comprehensibility of financial products for retail investors. The EU introduced PRIIPs regulation in 2018 and, in December 2020, it was transposed into UK law.

Under UCITS regulation, UCITS-authorised funds must produce a **key investor information document (KIID)**, while funds that are subject to the PRIIPs regulations must provide a **key investor document (KID)**. KIIDs and KIDs are very similar in principle, in that they are standardised documents to be issued to investors pre-sale, containing key features of the product including its charges, risk rating and investment profile. Additionally, KIIDs and KIDs must be written in a concise manner and in non-technical language, as well as drawn up in a common format to allow investors to compare one product with another.

There are, however, some key differences. For example, KIIDs contain six sections while KIDs contain eight, and the information on charges, among other factors, may differ substantially due to the calculation methods involved.

In addition to a KID, under PRIIPs regulation, funds must also produce a key features illustration (KFI). The KFI must include appropriate charges information, information about any interest that will be paid to clients on money held within a personal pension scheme bank account. If it is a packaged product, the following apply:

1. It must include a standardised deterministic projection. The contents of this projection are set out in the Handbook. Note that this can be obtained from a combination or average of a stochastic projection – eg, one showing a summary of results from repeated simulations using an investment model, where the model uses key financial parameters which are subject to random variations and are projected into the future.
2. The projection and charges information must be consistent with each other so that:
    - the same intermediate growth rate and assumptions about regular contributions are used
    - a projection in nominal terms is accompanied by an effect of charges table and reduction in yield information in nominal terms, and
    - a projection in real terms is accompanied by an effect of charges table and reduction in yield information in real terms.
3. It may also include stochastic projections if there are reasonable grounds for believing that a retail client will be able to understand the stochastic projection except that the most prominent projection must be a standardised deterministic projection.

In recent years, the FCA has introduced new rules for the UK's version of PRIIPs, asserting that these rules better suit the UK market. Changes include requiring firms to provide narrative information on performance in the KID instead of performance scenarios, and new rules to clarify the scope of the PRIIPs regulation for **corporate bonds**. This signals a divergence from EU PRIIPs regulations.

Following consultations, the UK government published a draft statutory instrument in November 2023 to replace retained European PRIIPs regulations post-Brexit. This draft introduces 'Consumer Composite Investments' (CCIs), which are similar to PRIIPs but allow the FCA to set rules for firms (whether domestic- or overseas-authorised) providing CCIs to UK retail investors. Regulations for CCIs fall under a new Designated Activities Regime (DAR), established by the Financial Services and Markets Act 2023. The FCA closed its consultation in March 2025, soliciting draft rules and exploring interim solutions to mitigate short-term impacts on the investment sector. The FCA now plans to publish a final policy statement on CCIs in late 2025.

In the UK and Europe, UCITS firms do not have to comply with PRIIPs requirements until 31 December 2026. However, from 31 December 2022, PRIIPs firms have needed to comply with UCITS requirements, meaning that cross-border funds have to produce two separate documents – a UCITS KIID for UK investors, and a PRIIPs KID for EU investors.

Costs and Charges

COBS 6.1ZA sets out the mandatory Costs & Charges disclosure requirements for firms: ex-ante (done at the outset, based on forecasts) and ex-post (done at least annually, based on actual costs for the previous period).

Investment firms that:

- recommend or market financial instruments to clients, or
- provide any investment service which requires them to provide clients with a UCITS KIID or PRIIPs KID

are obliged to provide full ex-ante disclosure of information about the aggregated costs and charges in connection with the product or service provided, 'in good time' before a client makes an investment decision. Where costs and charges that are calculated on an ex-ante basis, the firm must use actually incurred costs as a proxy for the expected amounts (where actual costs are not available, reasonable estimations should be used). Additionally, these investment firms must provide ex-post information about costs and charges in connection with the product or service, at least annually.

Investment firms that do not recommend market financial instruments to clients, or are not required to provide clients with a KIID/KID, must inform clients about all costs and charges relating to the investment and/or ancillary service they provide.

5.5.2 Adviser Charging

The Retail Distribution Review (RDR) was launched by the FSA in 2006, and the rules came into force in 2013. These rules are amalgamated into the FCA Handbook in various parts.

The aim of the RDR was to establish a more resilient, effective and attractive retail investment market that consumers had confidence in and trusted. It made several significant changes to the way that investment products are distributed to retail consumers in the UK. For example, the RDR raised the minimum level of adviser qualifications, changed the way that charges and services are disclosed to consumers, and banned the use of commission to pay for advice.

The main effects of the rules are as follows:

- The requirements widened the scope of investment products that can be advised on within the scope of the regime for **retail investment products**.
- A firm must not present itself to a retail client as acting independently unless the only personal recommendations in relation to retail investment products it offers to that retail client are based on a comprehensive and fair analysis of the relevant market and are unbiased and unrestricted (whole of market).
- Advisers who are not 'independent' are classified as 'restricted'. They must describe this restricted service to consumers, with a short description to help consumers understand the service that is being provided to them.
- A **restricted adviser** is an authorised person who can only recommend certain products, product providers or both. Therefore, they might only offer products from one company, or just one type of product, or focus on one particular market, for example.
- A firm must disclose in writing to a retail client, in good time before the provision of its services in respect of a personal recommendation or basic advice in relation to a retail investment product, as to whether the advice will be independent or restricted advice. This can be done in advance or, depending on the stage in the process, perhaps at the first meeting.

A firm that provides independent advice in respect of a relevant market that does not include all retail investment products must include in its disclosure to the retail client an explanation of that market – including the types of retail investment products that constitute that market. If a firm provides restricted advice, its disclosure must explain the nature of the restriction. If a firm provides both independent advice and restricted advice, the disclosure must clearly explain the different nature of the independent advice and restricted advice services.

Disclosure must be made in a durable medium or through a website. A firm is able to provide the disclosure by using a 'services and costs disclosure' document or a combined initial disclosure document.

If a firm provides restricted advice and engages in spoken interaction with a retail client, the firm must disclose orally, in good time before the provision of its services in respect of a personal recommendation, that it provides restricted advice and the nature of that restriction.

Advisers are prohibited from receiving commission from the product provider, called 'trail commission', when making a personal recommendation to a consumer. It is always the case that the adviser and the consumer agree the charge, prior to the service being provided by the adviser. However, there are still some products where commission can be payable, such as life assurance products.

5.5.3 Management Information (MI)

MI is a term that encompasses all the data that a firm can use to better understand the current state of its business.

MI can come in many different forms. Some common types are: new business register, business persistency, training and competence records, file reviews, customer feedback, and compliance reports. It could cover customers, calls, visits, meetings and much more.

Notably, MI is not just about numbers – product reviews, direct customer feedback or complaints can also form an important part of MI. Negative feedback or negative MI can often reveal more about the firm and its culture than compliments will.

Controls and formal procedures must always be used by senior management as it is very important in analysing trends, helping to forecast the future while solving and identifying problems.

It may be appropriate for firms to consider a risk-based approach to MI gathering, where areas of service are monitored more closely when they involve riskier products or solutions.

Standard information may be analysed differently. For example, to gauge what it shows about FTOC, rather than the firm's financial performance.

It is very important that firms use the MI they gather to improve their services, as it provides evidence of a firm's compliance with FTOC requirements. The FCA looks at MI (evidence of process, the logic behind it and that it is being implemented and measured) and ensures that it is being challenged.



What kind of MI do you think a group could collect to support the premise that it was treating customers fairly?

This will depend on the nature of the business and what is proportional to that business.

Can you think about examples that you would use to demonstrate that the customers' outcomes were manifestly being delivered from within an organisation?

6. Complaints Handling

Learning Outcome

1.1.9 Understand the fiduciary responsibilities of intermediaries, the rights of aggrieved customers, and the rules for handling complaints

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In its Handbook, the FCA defines a complaint as any expression of dissatisfaction, whether oral or written, and whether justified or not, from, or on behalf of, an eligible complainant about the firm's services.

6.1 Right to Complain under FSMA 2000

If a customer is unhappy, the place for them to start is to complain to the firm themselves to see if these issues can be rectified directly. If not, the customer may ask the **Financial Ombudsman Service (FOS)** to get involved. If the customer is still unhappy, they can take matters further and go to court.

6.2 Internal Complaints Handling Procedures

A firm must have in place, and operate, appropriate and effective internal complaints handling procedures for handling complaints. These procedures must be written down and must be readily available for customers or potential customers to see at every branch or office of the firm.

In general, the internal complaints-handling procedures should provide for:

- receiving complaints
- responding to complaints
- the appropriate investigation of complaints, and
- notifying eligible complainants of their right to go to the FOS, where relevant.

In particular, a firm's procedures must make provision for:

- appropriate staff to investigate the complaint
- those staff to have the authority to settle complaints (or have ready access to someone who can), and
- the response by the firm to address the complaint adequately and to offer appropriate redress.

In addition, with any complaint made, firms must think about not only dealing with the complaint as being valid, whatever the situation, but also have in place procedures to carry out root cause analysis to make sure that there is no potential for similar complaints, as per the FCA guidelines.



How are customers or potential customers informed of your internal complaints procedure? How does your firm organise its complaints handling?

We must remember that one of the outcomes of FTOC and the new Consumer Duty is the ability of customers to be able to make a complaint without barriers (see section 5 of this chapter). Eligible complaints can be oral or written. Is every member of staff aware of the procedure to ensure that complaints are handled correctly and in a timely manner?

6.3 Eligible Complainants

An eligible complainant is a person who is, or has been, a customer, or is a potential customer of the firm, and is, at the time that the complaint is raised:

- **a consumer** – a retail or professional client (ie, any natural person acting for purposes outside of their trade, business or profession)
- **a micro-enterprise** – an enterprise with fewer than ten employees, and turnover or annual balance sheet not exceeding €2 million
- **a small business** – an enterprise (not a micro-enterprise) with an annual turnover of less than £6.5 million (or currency equivalent), and:
  - with fewer than 50 employees, or
  - a balance sheet total of less than £5 million (or currency equivalent)
- **a charity** with an annual income of less than £6.5 million, or a trustee of a **trust** with a **net asset value (NAV)** of less than £5 million

- **a trustee of a trust** with a NAV of less than £5 million
- **a credit 'buy-to-let' (CBTL) consumer**, or
- **a guarantor** (ie, a person that provides a guarantee).

A claim of financial loss may relate to either actual loss or possible future loss (eg, as a result of a missold pension or **endowment policy**). However, complaints solely about investment performance will not be eligible for review by the FOS, as they are deemed to be ineligible for compensation *(caveat emptor)* unless it is accompanied by the suggestion that the firm was not following the mandate, the performance is due to incompetence or poor systems and controls, and this can be evidenced.

6.4 Record-Keeping and Reporting

Under DISP 1.5, records regarding complaints must be kept for a minimum of three years from the date that the complaint was received. These records must include the name of the complainant, the substance of the complaint and details of any correspondence between the firm and the complainant.

The FCA requires twice-yearly reports on the number of complaints, broken down into categories (eg, 'unsuitable advice', 'disputes over sums/charges' and 'delays/timescales'). Where a complaint could fall into more than one category, then the firm should report it in the category that, in its view, forms the main part of the complaint. This report should also include details of the number of closed complaints, and those outstanding at the end of the period. These reports are made public, so customers and potential customers can see the complaints against the firm.

6.5 Role of The Financial Ombudsman Service (FOS)

The FOS was established in 2000 and given statutory powers under FSMA 2000, to consider claims against a firm by its customers. It acts to resolve complaints against regulated financial services providers, including banks and building societies, if these cannot be sorted out between the customer and the firm directly.

The FOS will investigate the complaint, looking at evidence from both the customer and the firm, and make a decision, which is then binding on the provider – see section 6.5.2 on redress for more details.

The FOS operates independently of the FCA, with a board of directors appointed by the FCA (subject, in the case of the chairman, to Treasury approval). They must prepare an annual report for the FCA, on the discharge of its functions.

6.5.1 Procedure and Jurisdiction

The FOS will only accept cases where the complainant has first approached the firm concerned.

The FOS has two jurisdictions:

Compulsory Jurisdiction

The FOS will only consider a complaint under compulsory jurisdiction regarding regulated and ancillary activities of authorised firms. Through the FOS, and in accordance with FSMA 2000, resolution must be sought via investigation and must be determined by what is 'fair and reasonable'.

Voluntary Jurisdiction

In essence, this operates in a similar manner to the compulsory jurisdiction. The main elements are:

- the firm must be a 'willing participant'
- the complainant must be eligible
- the complaint is with regard to business not covered by compulsory jurisdiction and in respect of lending money secured on land, or financial services activities covered by a different scheme previously in existence, and
- although voluntary, the parties must still submit to any investigation deemed necessary by the FOS.

6.5.2 Redress

The FOS will decide the amount and type of any award. There may be:

- a money award as compensation, and
- a direction to take appropriate action.

The amount of compensation that the FOS may award depends on when the acts or omissions occurred, and when they were referred to the FOS. The maximum the FOS can award, in monetary terms, is:

Date of act or omission	Date of referral to the FOS	Limit that applies
On or after 1 April 2019	On or after 1 April 2024	£430,000
Before 1 April 2019	On or after 1 April 2024	£195,000

Source: Financial Ombudsman Service[12]

If appropriate, the FOS may also decide for the firm to cover the complainant's costs.

If the complainant is dissatisfied with the outcome, they may seek a remedy in a court. Complainants who accept the FOS' decision cannot then issue court proceedings for any more money. Complainants can take a provider to court without reference to the FOS – this is a less common strategy among private individuals, while the use of litigation for group claims is on the rise.

As already outlined, firms must have explained to customers that they have the right to approach the FOS, and must enclose details of how to do this, normally using the booklet that the FOS produces on how to use their services.

12 Financial Ombudsman Service, March 2024. Increase to our award limits. Retrieved from https://www.financial-ombudsman.org.uk/news/increase-award-limits-2024-25 (Accessed: October 2025)

6.6 Financial Services Compensation Scheme (FSCS)

The regulator has also set up the **Financial Services Compensation Scheme (FSCS)**, a deposit protection scheme which deals with compensation claims from eligible claimants in the event of default by a UK-authorised firm or an appointed representative of a UK-authorised firm.

Those who have protected claims are also able to seek compensation from the FSCS. Protected claims are claims made in respect of deposits, insurance and investment business. Protected investment business means designated investment business, the activities of the manager/trustee of an authorised **unit trust** and the activities of an authorised corporate director (ACD)/depository of an investment company with variable capital (ICVC).

Those that are not specifically mentioned as eligible complainants for compensation via the FSCS are:

- authorised firms (other than a sole trader firm, a credit union or a small business whose claim arises out of a regulated activity for which they do not have a permission)
- overseas financial services institutions
- supranational institutions, governments and central administrative authorities
- provincial, regional, local and municipal authorities, and
- large companies or large mutual associations.

6.6.1 Structure and Compensation Payable

The FSCS is funded by the financial services sector through an annual levy paid by every firm registered with the FCA.

The level of compensation is limited and the FSCS will only pay out for actual financial loss. It also depends on the product and when the claim was made. The current limits are as follows:

- **Deposits** – up to £85,000 per person, per authorised firm (£170,000 for a joint account), and up to £1 million for up to six months for temporary high balances (eg, proceeds from a property sale or compensation for a personal injury claim). This limit is the sterling equivalent of €100,000 and is rebalanced every five years, therefore, is subject to change.
- **Investments and home finance (including mortgage advice)** – up to £85,000 per person per firm.
- **Insurance business** – 100% protected for compulsory insurance, liability subject to professional indemnity insurance or certain claims for death or incapacity, 90% of the claim for other insurance.
- **Debt management** – up to £85,000 per person per firm.

The ceiling on compensation available through the FSCS leads some investors to consider spreading their capital among a number of banks and building societies in order to reduce the overall default risk. However, care needs to be taken that the chosen banks do not form part of the same banking group (thus, share a banking licence), as the FSCS will treat them as one bank – to give an example, Lloyds Bank, Halifax and Bank of Scotland share the same banking licence, so cash deposits held across all three would be limited by the £85,000 cap. The benefit of spreading the risk in this way should be weighed against the possible disadvantage of lower rates of interest that may be earned because of the investor missing out on higher rates offered for larger deposits.

Eligible investors in crowdfunding and peer-to-peer (P2P) lending schemes may have recourse to the FSCS for any losses they may incur, up to £50,000, providing they received unsuitable advice from an authorised firm on or after 6 April 2016, and the firm no longer has sufficient assets to meet a claim for compensation. On the other hand, cryptocurrencies (eg, Bitcoin) are not protected under the FSCS, should individual investors incur losses as a result of scams, hacks and/or theft.

Candidates can find more detailed information and updates on the FSCS website[13].

While the FSCS does not cover deposits in the Channel Islands or the Isle of Man, this is not to say that these deposits are unprotected. Jersey, Guernsey and the Isle of Man, for example, have their own deposit protection schemes, which secure the first £50,000 per person. Typically, these schemes protect deposits regardless of the individual's or entity's residency or nationality, and irrespective of the currency in which they are held. That said, it is important to check their eligibility for compensation, based on their personal circumstances and the type of account they will be depositing into, before opening an account or making a deposit.

6.7 The Fiduciary Responsibilities of Intermediaries

In financial services firms, intermediaries (eg, financial advisers, brokers and agents) often have fiduciary responsibilities towards their clients. Fiduciary duties are based on trust, loyalty, and acting in the best interests of clients. The specific fiduciary obligations can vary based on legal and regulatory requirements, as well as the nature of the client relationship.

- **Duty of loyalty** – Intermediaries have a duty to make recommendations and decisions that are aligned with the client's goals, risk tolerance, and financial circumstances; and they must act solely in the client's best interest.
- **Duty of care** – Intermediaries are expected to exercise a high degree of care and diligence in their dealings with clients. They should possess the necessary knowledge, expertise and competence to provide suitable advice and services.
- **Duty to disclose information** – Intermediaries have a duty to disclose all relevant and material information to clients. Full transparency helps clients understand the risks, costs, benefits, and potential conflicts associated with a transaction or investment.
- **Duty to avoid unauthorised transactions** – Intermediaries should not engage in unauthorised transactions or make decisions without the client's explicit consent. They must obtain proper authorisation and ensure that clients understand the implications of their actions.
- **Duty of confidentiality** – Intermediaries are expected to maintain the confidentiality of client information and protect client privacy. They should not disclose confidential or sensitive information to third parties without proper authorisation, unless required by law or regulatory obligations.
- **Duty to monitor and review** – Intermediaries have a responsibility to monitor and review the client's investments, accounts, and financial situation on an ongoing basis; and to make necessary adjustments based on changing client circumstances or objectives.
- **Duty to manage conflicts of interest** – Intermediaries must identify and manage conflicts of interest appropriately.

Note that fiduciary duties can vary across jurisdictions and specific financial regulations. Intermediaries should understand and comply with the applicable legal and regulatory requirements governing their fiduciary responsibilities to protect clients' interests and maintain trust in the financial services sector.

13 Financial Services Compensation Scheme. Retrieved from https://www.fscs.org.uk (Accessed: October 2025)

7. Firms' Responsibility for Combating Financial Crime

Learning Outcome

1.1.10 Understand the principal measures to combat financial crime (insider dealing, market abuse, money laundering and terrorist financing) and evaluate their impact on the firm, the private client adviser, and the process of advising and managing private client investments

Financial crime threatens the safety and soundness of markets worldwide, and countries around the world help each other to combat financial crime by way of organisations such as Interpol.

In addition, financial crime opposes the FCA's consumer protection and market integrity objectives (see section 2.3.2 above), so the FCA is ready to take action in relation to financial crime risk in the sectors or markets it regulates. There are therefore strict requirements for policies and procedures to be implemented by firms to help combat financial crime.

As well as the distress that financial crime can wreak on markets, it can also cause significant harm to individual consumers. The FCA policies and procedures are set out so that it is more difficult for criminals to commit financial crime, with the aim that criminals will be deterred from attempting to target UK financial firms for the purposes of crime.

7.1 Insider Dealing

Also known as insider trading, insider dealing is defined under the **Criminal Justice Act (CJA) 1993** as '*dealing in securities on the basis of inside information*'; in other words, '*information that is not yet publicly known and which would affect the price of securities if it were made public*'. Inside information is also sometimes referred to as 'material non-public information'.

Article 8 of the UK Market Abuse Regulation (UK MAR) describes insider dealing as where a person possesses inside information, and uses that information by acquiring or disposing of financial instruments to which that information relates, either for their own account or for the account of a third party, directly or indirectly.

7.1.1 Who is an Insider?

An insider is a person who is in possession of price-sensitive information because:

1. they are an inside source
2. they have access to the information by virtue of their employment, position or profession, or
3. they have received information, directly or indirectly from a person who is either of (1) or (2).

7.1.2 Offences Under CJA 1993

The CJA 1993 states that a person is guilty of insider dealing if they:

1. **deal** in price-affected securities on the basis of inside information
2. **encourage** another person to deal in those securities in relation to that information – this is an offence even if the other person does not deal, or
3. **disclose** the inside information to another person, unless no dealing is expected.

These offences can only be committed by an individual; however, encouraging a company to deal could also be deemed to be an offence.

7.1.3 Securities Listed in CJA 1993

Under CJA 1993, price-sensitive securities include:

- shares
- debt securities (including **gilts**)
- warrants
- **depositary receipts (DRs)**
- options, futures and CFDs on securities, and
- an **index** based on a basket of securities.

A professional intermediary is a person carrying on a business dealing in securities, and may not be knowingly party to any criminal activity.

The Insider Dealing (Securities and Regulated Markets) Order 2023 harmonises aspects of the CJA 1993 with UK MAR. Previously, the CJA's definition of securities and markets had not been updated for some years – hence, many of the markets listed in Schedule 2 of the CJA were either no longer in operation or operated under a different name. The list of securities included under insider trading rules has been expanded to currency options, certain swaps and **exchange-traded funds (ETFs)**.

7.1.4 Defences

The three general defences against a charge of insider dealing are:

1. did not expect to make a profit
2. information was sufficiently widely held, and
3. would have dealt without the information.

In addition, the three special defences against a charge of insider dealing to ensure that legitimate market activities are not curtailed are:

1. acted in the course of normal market making
2. market information – it was reasonable for the person to deal despite having the information, and
3. acting in accordance with 'price stabilisation' rules.

7.1.5 Penalties

The FCA is empowered under FSMA 2000 to prosecute under CJA 1993. The maximum penalties are:

- **Crown Court** (conviction on indictment) – ten years' imprisonment and/or an unlimited fine, and
- **Magistrates' Court** (summary conviction) – six months' imprisonment and/or a £5,000 fine.

As an alternative to a prosecution for insider dealing, the FCA may take civil action under the market abuse regime.



What are the ways in which a firm can protect itself from insider dealing, either on its own shares or by its employees?

7.2 Market Abuse

7.2.1 Offences

The following table contains the seven offences under UK MAR.

Offence	Examples
Insider dealing	See section 7.1.
Improper disclosure	X, an analyst employed by an investment bank, telephones the finance director at B plc and presses for details of their profits and losses from their latest unpublished accounts. X is guilty of the offence of encouraging market abuse.
Misuse of information	Z, an employee of D plc, is aware of contractual negotiations between D plc and a customer. Transactions with that customer have generated over 10% of D plc's turnover in each of the last five financial years. Z knows that the customer has threatened to take their business elsewhere, and that the negotiations (while ongoing) are not proceeding well. Z sells their shares in D plc. Z is guilty of the offence of misuse of information.
Manipulating transactions	Effecting transactions which: 1. give, or are likely to give, a false or misleading impression as to the supply of, or demand for, investments, or as to the price of one or more qualifying investments, or 2. secure the price of one or more such investments at an abnormal or artificial level. A fund/portfolio manager's performance is measured on the basis of the value of the fund/portfolio at a particular time. The manager buys a large quantity of one of the holdings just before that time, to drive the price up. The manager is guilty of market abuse.

Offence	Examples
Manipulating devices	Effecting transactions or orders to trade which employ fictitious devices or any other form of deception.
Dissemination	Dissemination of information, by any means, which gives a false or misleading impression as to a qualifying investment, by a person who knew, or could reasonably be expected to have known, that the information was false or misleading. This includes false trade reporting (if reckless), misleading information on bulletin boards, and misleading written articles. This also includes: • '**pump and dump**' (ie, artificially inflating the price of a stock through false and misleading information, before selling it at a higher price), and • '**trash and cash**' (ie, circulating damaging information about a recently sold share to buy it back at a lower price).
Misleading behaviour and market distortion	Behaviour likely to give a false or misleading impression to a regular market user (RMU) as to the supply of/demand for, or price/value of, a qualifying investment (eg, moving empty cargo ships). An RMU is defined as a hypothetical reasonable person, familiar with the market in question. Would they regard the behaviour as acceptable in light of all the relevant circumstances?

7.2.2 Defences

There are two general defences against the charge of market abuse, whereby the individual concerned:

1. had reasonable grounds to believe that their behaviour did not, in any way, amount to market abuse, or
2. took all reasonable precautions and took the necessary steps to avoid behaving in a way that would leave them vulnerable to an allegation for being involved (in any way) in market abuse.

7.2.3 Penalties for Insider Dealing and Market Abuse

Insider dealing is a criminal offence, but could be prosecuted as market abuse which is a civil offence.

The maximum penalty for the criminal offence (as covered by the CJA 1993) is an unlimited fine and up to seven years in prison; whereas for the civil offence (under FSMA 2000), it is an unlimited fine but no custodial sentence.

The civil offence under the FSMA 2000 requires a lower burden of proof than the criminal offence, thereby making it theoretically easier for the authorities to gain a successful outcome.

7.3 Money Laundering and Terrorist Financing

Anyone who works within the financial services sector must comply with requirements that prevent **money laundering** and terrorist financing. The two areas are also known as anti-money laundering (AML) and combating the financing of terrorism (CFT) rules, or AML/CFT.

Money laundering (ML) is defined as:

> *'the process by which criminals seek to conceal the true origins and/or ownership of the proceeds, or benefits, of criminal activity'.*

Criminals use financial institutions as major conduits to assist in hiding the proceeds of these activities (which are often large sums), thus avoiding prosecution, conviction and the confiscation of those funds.

Terrorism is defined as:

> *'the use of violence or of the threat of violence in the pursuit of political, religious, ideological or social objectives'.*

While terrorist financing (TF) is intrinsically linked to money laundering, there are two key differences between them which make terrorist financing particularly challenging to identify:

1. Often, only small sums of money are required to commit terrorist acts.
2. Where legitimate funds are used to fund terrorist activities, it is difficult to identify when the funds become 'terrorist funds'.

There is a significant amount of legislation (eg, the Proceeds of Crime Act (POCA) 2002 and the Terrorism Act 2000) of which firms need to be aware. However, most firms will leave the interpretation to the firm's money laundering reporting officer (MLRO). Anyone working in the regulated sector must report to the MLRO if they know or suspect, or have reasonable grounds for knowing or suspecting, that another person is engaged in money laundering or the financing of terrorism. If an MLRO is concerned that the source of funds may be illegitimate, they must report these suspicions to the appropriate law enforcement agencies (eg, the National Crime Agency (NCA)).

That said, it should be noted that senior managers of firms take ultimate responsibility for their firms complying with legislation and ensuring they are doing everything they can to avoid being used to launder money.

7.3.1 Stages of Money Laundering

There are three stages of money laundering:

1. **Placement** – introducing the criminal funds to the financial system.
2. **Layering** – moving money in a series of complex transactions to mask its origins.
3. **Integration** – removing the money for the benefit of the ultimate beneficiary, who appears to hold clean funds.

7.3.2 Offences

The most serious offences under POCA 2002 are:

- concealing
- arranging
- acquisition, use and possession
- failure to disclose
- tipping off, and
- assistance (this covers concealing, disguising, transferring, acquiring or using the proceeds of crime if the person knows or suspects that the proceeds came from serious criminal misconduct).

The maximum penalty is 14 years' imprisonment and/or an unlimited fine.

7.3.3 Defences

The following are defences to money laundering:

1. The individual concerned had a reasonable excuse for not making a report (note that this defence applies only in relatively extreme circumstances – eg, duress and threats to safety).
2. The individual concerned did not actually know or suspect money laundering had occurred, and they had not been provided by their employer with the training required (in which case, this is an offence on the part of the employer).
3. It is known, or believed on reasonable grounds, that the act in question occurred outside the UK, and is not unlawful under the criminal law of the country where it is occurring.

One example of point 3 is the proceeds of bullfighting, which is illegal in the UK; thus, the income of a UK-resident Spanish bullfighter from their professional activities would be regarded as the proceeds of crime in the UK and the bullfighter would be guilty of money laundering. In Spain, though, these activities are perfectly legal. It is for this reason that this defence is known as the 'Spanish bullfighter' exception.

However, just because an activity is lawful in the country where it is occurring, does not mean that this defence will always apply. For example, since 2018, the passing of the Cannabis Act means that the use of cannabis for both recreational and medicinal purposes is legal in Canada and many parts of the US. Despite this, UK investors that hold shares or **invest** in Canadian or US companies whose business activities involve the cultivation or sale of cannabis (or related products) are likely to be at risk of committing a criminal offence.

7.3.4 Joint Money Laundering Steering Group (JMLSG) Guidance

Most firms will build their internal procedures relating to the prevention of money laundering and terrorist financing upon JMSLG Guidance. However, firms must be using a risk-based approach which is proportionate to their client base and their business model. This is designed to ensure that hurdles are created for those who are trying to break the law, but it is not meant to be overly burdensome for honest clients or risk putting smaller firms at a disadvantage because of heavy compliance costs.

The guiding principles are:

- obtaining proof of client identities and verifying this proof
- staff training and understanding of the issues
- recognition that individual staff are responsible for reporting suspicious activity
- summarising the group's approach to assessing and managing ML and terrorist financing risks
- summarising the firm's procedures for appropriate identification and monitoring checks, and
- summarising the appropriate monitoring of policies and procedures.

The money laundering rules and JLMSG Guidance requires firms to obtain proof of the client's identity and source of wealth and funds.

1. For clients not covered by an exemption and for those that present a standard level of risk (eg, those who are permanently resident in the UK with a transparent source of income), prescribed **customer due diligence (CDD)** applies.
2. **Simplified due diligence (SDD)** can be applied if there is a low risk of money laundering or terrorist financing by the business relationship or transaction (eg, children's accounts, such as JISAs).
3. In higher-risk cases, the firm should undertake **enhanced due diligence (EDD)**. Examples of higher-risk clients include politically exposed persons (PEPs) and clients linked to higher-risk countries or business sectors. It also includes those who are not present at an initial meeting – as no face-to-face meeting has taken place, there is scope for the firm to be at risk of being used for money laundering or terrorist financing.

 The JMLSG Guidance places a lot of emphasis on the firm's KYC policy. Why do you think this is?

In the event of an investigation, firms will be required to provide details of their clients and money received from them. These records, coupled with the further in-depth information you should collect as part of KYC, may well hold vital information. Remember, ML involves the funds from any criminal activity and that includes tax evasion. Senior managers must be satisfied that they have robust internal procedures and that all advisers are adhering to them.

7.4 The Impact of Financial Crime

7.4.1 The Impact on the Firm and Private Client Advisers

Financial crime has a significant impact on financial services firms and advisers in various ways.

Firstly, as we have seen, financial services firms operate under strict regulations and are subject to regulatory oversight. Instances of financial crime can trigger investigations by the regulatory authorities, resulting in increased scrutiny, fines, and other penalties. These penalties can be substantial and have a direct impact on the firm's financial position.

Financial crime can also lead to legal action, including civil lawsuits or criminal prosecutions. The legal costs associated with defending the firm or compensating affected parties can be substantial; and in some cases, individuals within the firm may also face personal legal liability.

In addition to financial penalties, firms found to be involved in financial crime may face restrictions on their operations. Regulatory authorities can impose limitations on business activities, such as suspending specific services or restricting the firm's ability to enter new markets, all of which can hinder growth prospects and limit revenue streams.

From a non-financial perspective, financial crime can severely damage the reputation of the firm. Public trust and confidence in the firm can be eroded, leading to a loss of customers, decreased market value, and difficulties in attracting new clients.

If a firm fails to adequately identify and manage the above-mentioned additional risks that financial crime introduces, this can weaken their financial position and overall stability.

7.4.2 The Impact on the Process of Advising and Managing Investments

To combat financial crime, financial services firms need to invest in robust compliance systems, processes, and personnel. Implementing adequate anti-money laundering (AML), combating the financing of terrorism (CFT) and know-your-customer (KYC) procedures, conducting thorough due diligence, and monitoring transactions can be resource-intensive and costly.

Firms are responsible for conducting thorough due diligence and risk assessments before recommending or managing investments for their clients. Financial crime introduces additional risks that need to be carefully evaluated; and firms must implement robust processes to identify and mitigate these risks, in order to protect their clients' investments.

In this regard, financial crime regulations, such as AML and CFT laws, impose strict compliance obligations on firms. These requirements necessitate enhanced CDD, ongoing monitoring of client transactions, and reporting suspicious activities. Compliance obligations can add complexity and time-consuming processes to the investment advisory and management functions.

Financial crime can influence the design and availability of certain investment products. Firms may need to evaluate the risks associated with specific investment opportunities and exclude those that have a higher likelihood of involvement in illicit activities. For example, investments in sectors with higher vulnerability to money laundering, such as shell companies or offshore jurisdictions with weak regulatory oversight, might need enhanced due diligence or be avoided altogether.

Chapter Two

Investment Taxation

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In the UK, there are different types of taxes:

- **Direct taxes** – which are imposed directly on the taxpayer. Examples of direct taxes are income tax, CGT, IHT and national insurance (NI). As these taxes help to reduce inequalities in an economy, they are designed to be progressive (ie, the proportion of tax increases as income, wealth or expenditure rises).
- **Indirect taxes** – which are charges levied on consumption or expenditure; hence, they are also referred to as consumption taxes. Examples of indirect taxes (and there are many of them) are value-added tax (VAT) and financial transaction taxes (FTTs) – eg, stamp duty land tax (SDLT) and **stamp duty reserve tax (SDRT)**. These taxes are considered to be a form of regressive taxation (ie, the proportion of tax decreases as income, wealth or expenditure rises) as they are not based on an 'ability to pay' principle.

In this chapter, we will be building on your existing understanding of the UK tax system and the main direct taxes, specifically looking at **income tax**, **capital gains tax (CGT)** and **inheritance tax (IHT)**. We will also consider how these are collected.

This chapter is also closely linked with chapter 5, which looks at financial instruments and products, where the key features include the taxation of these products.

1.2 Exam Information Sheet

In the sections below, we have provided the main tax rates and allowances in the UK for 2025–26, to help you understand how income tax, CGT and IHT are calculated. An information sheet on the prevailing rates and allowances will be provided in your exam.

2. Residence and Domicile

From an investment strategy point of view, tax should not dictate the strategy, but advisers should be aware of any tax implications and be able to relay this information to clients. Furthermore, the fact that investing in higher yielding securities for income could affect a higher or additional rate taxpayer more than a basic rate taxpayer. Therefore, the appropriate tax wrappers should be considered alongside the investment strategy.

When considering an individual's status, the rules applied for each type of tax are affected by two status concepts, of which we need to be aware:

- **Residence**
- **Domicile**.

Globally, each country has its own definition of residence and domicile for tax purposes – this workbook focuses on the definition in the UK. It is important to be able to understand those two concepts and to realise that they could have an impact on the type of security recommended, such as onshore and **offshore funds**, especially with regard to IHT. There are also certain rules from host countries with regard to what their citizens can invest in or how much they can move offshore (eg, some countries have capital controls or other rules which must be considered).

2.1 Residence

Residence is a short-term concept that is determined for each tax year in isolation, reflecting where an individual lives. Also referred to as the fiscal year or the year of assessment, the tax year is a period of 12 consecutive months that ends on any day of any month (except in December, when the tax year must end on 31 December). In the UK, it runs from 6 April for one year to 5 April the following year – eg, the fiscal year 2025–26 ends on 5 April 2026.

In the UK, a statutory residence test (SRT) applies to determine an individual's residence status for UK tax purposes.

The usual way to establish residency in the UK depends on how many days a person spends in the UK in the tax year.

To establish residency under the SRT, a person is subject to three tests, as shown below. Each tax year must be considered separately, and the tests applied to it in order. Once an individual satisfies a test's criteria, later tests do not have to be considered. Notably, from these tests, a person may have more than one residence or no residence at all.

The Automatic Overseas Test

This determines if an individual is automatically a non-UK resident. This usually depends on how many days they spend in the UK in the tax year.

An individual is automatically a non-UK resident if either:

- **First automatic overseas test** – they were resident in the UK for one or more of the three tax years before the current tax year, and they spent fewer than 16 days in the UK in the current tax year.
- **Second automatic overseas test** – they were not resident in the UK for any of those three tax years before the current tax year, and they spent fewer than 46 days in the UK in the current tax year.
- **Third automatic overseas test** – they work abroad full-time (averaging at least 35 hours a week) and spent fewer than 91 days in the UK in the tax year, of which fewer than 31 were spent working (either employed or on a self-employed basis).

The Automatic UK Test

This determines if an individual is automatically a UK resident. An individual will be automatically a resident if either:

- **First automatic UK test** – they spend at least 183 days in the UK in current tax year.
- **Second automatic UK test**
  - If they have (or have had) a home in the UK, they must have had that home for at least 91 consecutive days, of which at least 30 days must fall in the tax year.
  - In addition, they have been present in their UK home for at least 30 days at any time during the tax year (not necessarily consecutive).
  - If they also have (or have had) an overseas home, they were present in that home for fewer than 30 days in the tax year.
- **Third automatic UK test**
  - They work full-time in the UK for any period of 365 days, which falls in the tax year.
  - Of the days in this 365-day period, considering only the days on which they work for more than three hours, at least 75% of those days must have been worked in the UK.
  - There must be at least one day of the 365-day period that they have worked in the UK for more than three hours.

The Sufficient Ties Test (STT)

This test applies if the individual has not met either of the above two tests.

The STT broadly determines residency based on a combination of various factors, generally surrounding the time they spend in the UK and the number of ties they have. For example, individuals who have a property or immediate family members in the UK (eg, a spouse/civil partner, children or other dependants), or who spend more time in the UK than in any other country, will satisfy the STT.

When a person moves in or out of the UK, usually the split-year treatment is applied. This means that the tax year is usually split into two – a non-resident part and a resident part. UK tax is paid on foreign income, unless the resident qualifies for Foreign Income and Gains (FIG) relief; this relief is based on the length of time they were in the UK.

The number of days that an individual spends in the UK per tax year will determine the number of ties required to be considered UK resident for tax.

2.1.1 Liabilities of UK Residents

Broadly speaking, if an individual is classed as a UK resident, and UK domiciled (or deemed 'domicile'), they must pay tax on their **earnings** and investment income, no matter where in the world that income originated (ie, an arising basis).

The tax regime for UK residents who are not-domiciled in the UK had a separate set of tax rates and allowances, but the 2024 budget abolished these which took effect in April 2025. Some of the key elements of the new residence-based system include the following:

- Individuals are taxed on worldwide income and capital gains in the same manner as UK domiciled persons, effectively doing away with the remittance basis rules.
- New arrivals will receive tax relief for four years (which will apply if they have not been a UK resident in the past ten years), after which the new rules will become effective.
- Individuals who were non-domiciled as of April 2025 may be able to utilise some transitional relief options.

2.2 Domicile

The status of domicile is a more permanent one than that of residence.

Broadly speaking, an individual is domiciled in a country where they have their permanent home. However, an individual can often retain their domicile for the whole of their life, even if they live abroad. Although it is possible for a person to be resident in more than one country or have dual nationality, they can only have one domicile at any one time.

There are four types of domiciles that can apply in the UK:

- **Domicile of origin** – this domicile is acquired at birth.
    - Normally (in England and Wales), an individual will take on that of their father.
    - Children who are born outside of marriage or a civil partnership, or those who are born after the death of their father, take on their mother's domicile.
    - Adopted children take their domicile from their adopted father or, if there is no adopted father, the domicile from their adopted mother.
    - Individuals who were adopted by a same sex couple, where the partners' domiciles are different, may wish to seek advice regarding their own domicile.

  On this basis, just because someone is born in the UK does not necessarily mean that they will have a UK domicile.
- **Domicile of choice** – it is possible to try to establish a domicile of choice by moving to a new country with the intention of living there permanently. There are no strict rules for acquiring this change of domicile; instead, several factors are taken into account, such as voting in the new country, establishing a business there, making a locally valid will there, or acquiring citizenship or nationality.
- **Domicile of dependency** – a child under the age of 16 will have the same domicile as the parent from whom they acquired their domicile of origin. Additionally, women who married prior to 1 January 1974 adopted the domicile of their husband from the date of marriage; for marriages that took place thereafter, this domicile of dependency no longer applies.

- **Deemed domicile** – any person who is domiciled outside the UK will be treated as a UK-domiciled person for IHT purposes. HMRC will treat individuals as UK domiciled if, at the date of any transfer of any assets, they were:
    - domiciled in the UK during the three years before making the transfer, or
    - resident in the UK for at least 15 of the 20 previous income tax years of assessment ending in the year the transfer was made.

  If the individual leaves the UK and ceases to be a resident, they will lose their deemed domicile status for IHT after three years. For income tax and CGT, the individual will cease to be resident after six consecutive tax years.

  If the individual leaves the UK and ceases to be resident, they will lose their deemed domicile status for IHT after three years. For income tax and CGT, the individual will cease to be resident after six consecutive tax years. It is, therefore, important to recommend the most appropriate investment vehicles and wrappers to fit in with these tax rules and keep up to date with clients' intentions or any changes. The timing of the sale of investments could also be important, as by waiting until after the six tax years have passed, individuals would not be subject to pay CGT on disposal.

Any individual who is UK domiciled or deemed domiciled is liable for IHT on their worldwide property. If someone is non-UK domiciled (ie, 'non-dom'), they are only liable to IHT on their UK property.

For individuals who were deemed domiciled on 6 April 2017 and have previously used the remittance basis, they will be able to rebase any overseas assets to their market value as at 6 April 2017, thus removing any gains that occurred during the period. However, this will not benefit those who have incurred a capital loss.

Also, where a UK residential property is owned through an offshore company, the owners of the shares in the company will be liable to UK IHT when they die, on the shares attributable to the UK residential property.

In the Fall Budget of 2024, the UK government finalised the decision to abolish the non-dom tax regime with effect from April 2025. It means that individuals who are UK resident for tax purposes but whose domicile is outside the UK will not pay UK tax on money that they make elsewhere in the world. For individuals coming to the UK on a temporary basis, a new, residence-based scheme will be introduced.

3. Income Tax

Learning Outcome

2.1.2 Understand when and how income tax is applied to earnings, interest and dividends

2.1.4 Apply the main rules relating to allowable deductions, personal allowances and reliefs, marriage and civil partnerships and their breakdown, and the tax liabilities of minors

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Income tax is the main public levy on the UK's working population. Due to the variety of taxable earnings bands, portfolio managers must invest clients into income-generating assets with care and full knowledge of their total taxable income.

Income tax is payable by all individuals and trusts resident in the UK which, for this purpose, does not include the Channel Islands (Guernsey, Jersey, Alderney, Sark and Herm) or the Isle of Man. In addition, any non-UK resident individual or trust must pay income tax on any income derived from the UK. For charities, most of the income they receive is exempt from income tax and corporation tax, provided the money is only used for charitable purposes.

3.1 Taxable Income

Taxable income relates to virtually any income that an individual or trust receives, unless it is specifically defined as being exempt income.

3.1.1 Allowable Deductions and Reliefs

There are several allowance deductions that an individual is allowed to make from gross income before tax is payable. Some reliefs are also available, whereby taxpayers can deduct an amount from their tax liability before calculating their final liability. These are either allowances or charges on income.

- **Contributions to a personal pension plan or a company pension scheme** – subject to certain limitations, contributions made to a personal pension plan or corporate pension scheme are permissible deductions from total income prior to arriving at taxable income.

  Pension contributions from gross salary (called a 'net pay arrangement') reduce an employee's taxable income. Therefore, employees implicitly attract tax relief at their marginal rate (20% for a basic rate taxpayer, 40% for a higher rate taxpayer, and 45% for an additional rate taxpayer).

  If an individual makes contributions from their net salary (ie, after tax has been deducted), the amount paid should be grossed up by basic rate tax (ie, by dividing by 0.8). The gross amount is then added to the statutory limit where taxable income is taxed at the basic rate (ie, basic rate extender). The effect is that more of the individual's other income will be taxed at the basic rate rather than the higher rate, therefore effectively providing 'higher rate tax relief'. This relief is then claimed through their Self-Assessment tax return (for England, Wales and Northern Ireland; the rates in Scotland differ) – see section 3.7.

- **Charitable donations** – charitable donations made by individuals are fully deductible. Individuals get tax relief if they donate through Gift Aid or straight through their wages or pension, through Payroll Giving (also known as Give As You Earn (GAYE)).

  Similarly to pension contributions above, if an individual makes a charitable donation from their net pay, then the amount paid should be grossed up by basic rate tax (ie, by dividing by 0.8), which then extends the individual's basic rate tax band. Again, this relief is claimed through their Self-Assessment tax return – see section 3.7.
- **Maintenance payments** – this relief is only available where one or both parties were born before 6 April 1935. In such cases, maintenance payments to a divorced or separated spouse made under a court order, by binding written agreement or by a maintenance assessment of the Child Support Agency (CSA) (but not payments made on a voluntary basis) are eligible as a charge on income. They are paid gross.
- **Trading losses** – self-employed individuals can carry forward trading losses from one tax year and offset them against profits in a future tax year. Doing so is likely to reduce the income tax that would otherwise be due. This relief only applies when the losses are offset against profits from the same self-employment.
- **Property loss relief** – this relief may be available to individuals or businesses when they suffer a loss on a property letting. When this occurs, they may be able to offset the loss against their other taxable income in the same tax year, or carried forward to offset against future income. There are specific time limits for claiming property loss relief – generally, claims need to be made within four years from the end of the tax year in which the loss occurred.
- **Double taxation relief (DTR**) – An individual's liability to income tax (as well as to CGT and IHT) may be affected by any double taxation agreements (DTAs).
  Individuals that are liable to pay income tax on overseas earnings may be able to claim double taxation relief (DTR). As its name suggests, DTR helps to protect individuals from being taxed twice on the same income – once by the foreign country and again by the home country. For DTR to apply, the two countries in question must have a DTA between them.

  To prevent income being taxed twice, there exist a number of DTAs with most countries of the world. Examples of countries with DTAs include the UK and China, the US and Malta, and India and Japan. Generally, DTAs stipulate that tax will be imposed only by the country in which the income is earned, the capital gains are realised, or the foreign property is situated respectively.

  A list of the current UK tax treaties in force can be viewed on the GOV.UK website[1].

3.1.2 Exempt Income

Some income is tax-free, including the following examples:

- Premium bond prizes.
- Interest on National Savings Certificates and Children's Bonus Bonds.
- Income from ISAs.
- Gambling and National Lottery wins.
- Generally, the first £30,000 of a payment made as compensation for loss of employment (eg, redundancy pay) under the Income Tax (Earnings and Pensions) Act 2003, section 403.
- **Dividends** on **ordinary shares** of a **venture capital trust (VCT)**.

1 GOV.UK, July 2014 (last updated: 2025). Tax treaties. Retrieved from https://www.gov.uk/government/collections/tax-treaties (Accessed: October 2025)

Investments in **enterprise investment schemes (EISs)** and seed enterprise investment schemes (SEISs) may permit income tax reliefs for the tax year that an investment is made, either in the tax year in which the investment is made or the year prior.

3.2 Income Tax Rates, Tax Bands, Allowances and Exemptions

HMRC calculates the income tax payable on three different kinds of income sources:

- **Earned income** – income received as pay for work performed such as wages, salaries, commissions, tips, and net earnings (ie, earnings less expenses) from self-employment.
- **Non-dividend savings income** – income from bank/building society savings accounts, interest from government and corporate bonds, rental income, interest from loans made through peer-to-peer lending platforms, and other similar sources (other than dividends).
- **Dividend income** – payments to investors by a company as a reward for owning shares in that company.

The rates, tax bands, allowances and exemptions (after the deduction of the personal allowance) for 2025–26 are as follows:

	Non-taxpayers	Basic rate taxpayers	Higher rate taxpayers	Additional rate taxpayers
Tax band	£0–£12,570	£12,571–£50,270	£50,271–£125,140	Over £125,140
Earned income	0%	20%	40%	45%
Savings income	0%	20%	40%	45%
Dividend income	0%	8.75%	33.75%	39.35%
Chargeable gains on life assurance policies	0% (20% tax paid in fund, non-reclaimable)	0% (20% tax paid in fund)	20%	25% (45–20% considered already paid)

Allowance	Rate (£)
Personal allowance	£12,570
Income limit for personal allowance	£100,000
Blind person's allowance	£3,130
Maximum amount of a married couple's allowance	£1,127
Income limit for married couple's allowance	£37,700
Minimum amount of married couple's allowance	£4,360
Marriage allowance	£1,260
Personal savings allowance (PSA)	Basic rate taxpayers: £1,000 Higher rate taxpayers: £500 Additional rate taxpayers: £0
Starting rate for savings	£5,000
Dividend allowance (DA)	£500

Source: GOV.UK[2]

(Candidates may wish to note that the tax bands and rates in Scotland differ to the rest of the UK.)

We consider each of these allowances in further detail in the sections below.

3.2.1 Personal Allowance (PA) and Blind Person's Allowance

The personal allowance (PA) enables individuals to earn a certain amount of income each year without it falling within the income tax net. If an individual does not use up their personal allowance in earned income, then unearned income (eg, investment income) may fall within this band.

The PA of £12,570 translates into a tax code (which is used by employers and pension providers to work out how much income tax to take from an individual's pay or pension) of 1257L. However, not everyone is entitled to this amount, so not everyone has a tax code of 1257L – for example, an individual might have 'benefits in kind' which are given a taxable value that is deducted from the standard personal allowance. Tax codes are discussed in more detail below.

Further, the personal allowance is reduced by £1 for every £2 of income over the £100,000 limit, until it is fully exhausted. This reduction applies irrespective of age. See section 3.3 for more information on the income-related reduction to the personal allowance.

Where blind person's allowance applies, this is added to the individual's personal allowance.

2 GOV.UK, April 2025. Income Tax rates and allowances for current and past years. Retrieved from http://www.gov.uk/government/publications/rates-and-allowances-income-tax/income-tax-rates-and-allowances-current-and-past (Accessed: October 2025)

Pay As You Earn (PAYE)

When an individual is employed, their employer deducts their income tax and National Insurance (NI) contributions from their pay and forward the relevant amounts to HMRC.

An employer will deduct the amount of income tax calculated in the individual's tax code as HMRC allocates a PAYE code to each employee. This consists of:

- **A number** – this indicates the amount of tax-free income (usually) the employee is entitled to. The last figure is always removed, and so you must multiply by ten to quantify the full tax-free amount.
- **A letter** – this indicates the type of personal allowance entitlement. There are different letters used to denote the different types of allowances an individual may be entitled to:
  - 'L' refers to a standard personal allowance.
  - 'M' means the individual has received 10% of the personal allowance from their spouse or civil partner (while 'N' means they have transferred it).
  - 'T' shows that HMRC needs to look at other items to calculate the tax code.
  - If a person has more than one job, then this will be made obvious to the PAYE employer via the tax code. For example, 'BR' will tell the employer to tax all of the income from this employment at a basic rate, 'D0' at the higher rate, and 'D1' at the additional rate.
  - The most interesting is a 'K code', as this indicates the individual has no tax-free income – the number given actually represents additional notional income which is added to earnings before the personal allowance is deducted from the tax paid. The 'K' code is typically used where individuals owe tax to HMRC or some other debt and, therefore, the debt is being repaid over a period of time.

You are not required to know the full list of tax code meanings for the exam; however, it is interesting to peruse the full list of tax code meanings at www.gov.uk/tax-codes.

Example

An employee earns £25,000 gross income per year and has a tax code of K900, so their employer will add £9,000 (ie, 900 x 10) to their earnings.

At current rates, the employee would pay around £4,220 in tax and NI contributions if they had a standard tax code. However, since they have a 'K' tax code, an additional £9,000 has been added to their earnings – this means that the employee pays tax and NICs on £34,000, of around £7,220 (ie, an additional £3,000 a year).

Example

A PAYE code of 1257L equates to an annual tax-free income of £12,570, one-twelfth of which would be treated as non-taxable income by an employer each month. The 'L' in the code is the most common, as it represents those eligible for the basic personal allowance.

The PAYE system covers many payments, including wages and salaries, fees, bonuses and commissions, holiday pay, pensions, payments under profit sharing schemes and statutory pay (eg, sick pay, maternity pay, paternity pay and adoption pay).

3.2.2 Married Couple's Allowance (MCA)

The MCA is available to married couples and civil partners, who are living together, where at least one partner was born before 6 April 1935. It reduces the amount of tax that an individual owes (rather than increasing their personal allowance). For 2025–26, the full MCA is £11,270, meaning that the maximum tax reduction available is £1,127 (ie, 10% of the MCA).

Similarly to the personal allowance, the MCA is reduced by £1 for every £2 above £37,700 until it reaches the minimum MCA of £4,360. This results in a minimum tax reduction of £436 for 2025–26.

3.2.3 Marriage Allowance

If both people in a marriage/civil partnership are born on or after 6 April 1935, one partner earns less than the personal allowance, and the other partner is a basic rate taxpayer, then the marriage allowance may be available.

The marriage allowance is similar to the MCA in that it lets an individual transfer up to 10% of the personal allowance to their spouse/civil partner (ie, 10% of £12,570 = £1,260, rounded up to the nearest £10, in 2025–26). This is providing that:

- the individual making the transfer is the lower earner, and
- their income is within their personal allowance.

A rule introduced in the Autumn Budget 2017 allows claims for marriage allowance to be backdated to 5 April 2015, including for eligible widowed claimants whose partners died after this date. The lower-earning partner effectively reduces their own personal allowance to a maximum of £11,313. Therefore, any additional earnings over £11,313 will be liable to tax rather than the original £12,570.

3.2.4 Personal Savings Allowance (PSA)

The PSA is a nil rate tax band. Basic and higher rate taxpayers receive a PSA. For basic rate taxpayers, it is £1,000; however, but if any of their income falls within the higher-income bracket, then the PSA is reduced to £500. For additional rate taxpayers, the PSA is zero.

Interest generated within an **individual savings account (ISA)**, pension or other tax wrapper do not count towards the PSA as they are already tax-free.

3.2.5 Starting Rate for Savings

Separately from the PSA, individuals may also have a starting rate for savings, whereby they do not have to pay tax on up to £5,000 of interest on savings. This starting rate reduces by £1 for every £1 of other income (such as wages, pension, benefits and savings income) above their personal allowance, meaning that it is zero if other income is £17,570 or more (ie, £12,570 personal allowance + £5,000 savings allowance).

For example, an individual earns £14,570 from their employment and £500 of interest on their savings. As their earnings are £2,000 above their personal allowance of £12,570, their starting rate for savings is £3,000 (ie, £5,000 – £2,000). Therefore, they will not have to pay tax on their savings interest.

3.2.6 Dividend Allowance (DA)

Like the PSA, the DA is also a nil rate tax band. The DA is available to anyone who has dividend income, and it is £500 for 2025–26 regardless of the rate at which they pay tax. This means that individuals do not pay income tax on the first £500 that they receive from dividends. Above this amount, dividends are taxed at the applicable rate (after deduction of the personal allowance and any other allowances): 8.75% for basic rate taxpayers, 33.75% for higher rate taxpayers, and 39.35% for additional rate taxpayers.

Dividends on investments held within an ISA, pension or other tax wrapper do not count towards the DA as they are already tax-free.

3.3 Adjusted Net Income, Adjusted Income and Threshold Income

Before we look at a tax calculation, you will need to understand the concept of adjusted net income, adjusted income and threshold income. This is because the amount of these different incomes can have a serious effect on an individual's income tax position (among other types of taxes).

Adjusted Net Income

Adjusted net income is probably the most important as it affects the following:

- **Income-related reduction to the personal allowance** – as discussed in section 3.2.1, the personal allowance is reduced by £1 for every £2 that an individual's adjusted net income is above £100,000, until it is eliminated entirely. The combination of higher rate tax and claw back represents an effective 60% tax rate.
- **High Income Child Benefit Tax Charge (HICBC)** – for people who claim child benefit and with an adjusted net income above £60,000. The charge is 1% for every £200 earned over £60,000. Once income is over £80,000, the benefit is lost entirely.

Adjusted net income is total taxable income before any personal allowances and less certain tax reliefs (see section 3.1.1).

The following steps are followed to calculate adjusted net income:

1. Calculate net income. This involves adding up all taxable income, including income and benefits from employment/self-employment, pensions (including the state pension), interest on savings and investments, dividends from company shares, rental income, and income from a trust.
2. Take off any tax reliefs that apply such as payments made gross to pension schemes (ie, those that have been made without tax relief), or trading losses (eg, trade loss relief or property loss relief) – see section 3.1.1. The result is the net income.
3. The net income is then adjusted by 'grossing up' any pension contributions and charitable donation made from net income, by dividing the amounts contributed/donated by 0.8 – see section 3.1.1 for more detail.
4. Add back any tax relief (up to £100) for payments to trade unions or police organisations.

Example

During the 2025–26 tax year, Drew's total taxable income is £130,000, comprising employment income of £110,000, bank interest of £5,000, and property rental income of £15,000.

Drew also made pension contributions from their net pay of £10,000, which grosses up to £12,500.

Drew's adjusted net income was, therefore, £117,500 (ie, £130,000 – £12,500). This is £17,500 over the £100,000 threshold, meaning Drew's personal allowance is reduced by £17,500 / 2 = £8,750. In other words, Drew has a personal allowance for 2023–24 of £3,820 (ie, £12,570 – £8,750).

Adjusted Income

Adjusted income is calculated as follows:

Total gross income, including salary, bonuses, investment income, interest on cash

+ All pension contributions if paid from net income – All personal contributions

– Any lump sum death benefit subject to tax

Threshold Income

Adjusted income and threshold income impact on the amount of tax relief that can be claimed in relation to pension contributions. The two are very similar, except threshold income excludes pension contributions while adjusted income includes them. This is to provide certainty for individuals with lower salaries, who may have one-off spikes in the value of their employer pension contributions.

Threshold income is calculated as follows:

Total gross income, including salary, bonuses, investment income, interest on cash

– Tax reliefs (eg, pension payments made before tax relief was applied)

– Any lump sum death benefits subject to tax

+ Any salary sacrifice arrangements entered into and associated pension lost

Impact of Adjusted Income and Threshold Income

If threshold income is over £200,000, then there is a requirement to calculate adjusted income to find out by how much the **annual allowance** for pension contributions will be reduced by.

If a person's adjusted income is over £260,000, then their annual pension allowance will be reduced. For every £2 of adjusted income above £260,000, their annual pension allowance will fall by £1.

The minimum tapered annual allowance is £4,000. This means that if a person contributes more than their tapered annual allowance, they will be subject to the annual allowance charge. The rate of the annual allowance charge is not fixed, but will depend on how much taxable income the individual has and the amount of contribution in excess of their annual allowance – see chapter 5, section 15.5.1.

If threshold income is £200,000 or less, the annual pension allowance will not be reduced.

3.4 Income Tax Liability of Minors

The income tax liability of minors (ie, individuals under 18 years of age) is subject to certain rules and exemptions.

Firstly, all UK residents, regardless of age, are eligible for the basic personal allowance. It follows that any minors who are employed are subject to the same income tax rules as adults. If their income exceeds their personal allowance, they will be required to pay income tax on the excess amount, and the tax is calculated based on the applicable tax bands and rates as per above.

Minors may also receive income from savings accounts, investments, or other sources. The rules for taxing this income depend on the source and the amount, as per for adults. There are specific tax rules and exemptions in place for minors to ensure that their savings and investment income is taxed appropriately.

Minors may be eligible to have a **junior individual savings account (junior ISA or JISA)** or **child trust fund (CTF)**, which are tax-advantaged savings accounts for children. The income and gains generated within these accounts are generally tax-free. However, there are limits on the amount that can be contributed each year. JISAs and CTFs are considered in sections 5.1.8 and 5.1.9 respectively of this chapter.

It is important to note that these rules can be complex, and there may be additional considerations depending on the specific circumstances.

3.5 Implications of a Marriage/Civil Partnership Breakdown

In the UK, the income tax implications of marriage breakdowns can involve several considerations.

Firstly, as we have seen, the MCA and marriage allowance allow married couples and civil partners to transfer up to 10% of their personal allowance to their partner, if certain criteria are met. In the event of a breakdown of the marriage/civil partnership, this transfer may no longer be applicable.

Alimony or spousal/civil partner maintenance payments (referred to as spousal/civil partner periodical payments) may be made by one partner to the other following a breakdown of the marriage or civil partnership. These payments are generally treated as income for the recipient and are tax-deductible for the payer.

Note that child maintenance payments are not considered taxable income for the recipient or tax-deductible for the payer.

3.6 Income Tax Calculation

Learning Outcome

2.1.3 Be able to calculate simple tax computations

Now we have looked at the circumstances in which income tax falls due, we will concentrate on calculating an income tax liability. In the exam, you are required to meet the objective of being able to calculate simple tax computations.

There are six steps to an income tax calculation.



Before looking at the six steps listed below, what do you think they involve, and in what order?

1	Calculate an individual's gross income for the year.
2	Deduct certain allowable amounts from the gross income.
3	Deduct personal allowances (if appropriate).
4	Calculate the amount of any payments for which higher rate tax relief is given.
5	Tax the remaining income at the appropriate rate(s).
6	Give credit for any tax paid at source, and deduct any tax reducers.

We will look in more detail at each step and incorporate the following case study as we work our way through each step.

Case Study

Sandra Evans, aged 62, earns £48,500 gross income per year under PAYE, and 5% of that is deducted by her employer as a pension contribution. She also pays £300 per month into a personal pension plan (PPP) herself from her net income. She no longer has a company car, but her company provides her with private medical insurance, which has a taxable value of £800.

In 2025–26, her building society pays £2,000 interest and she receives £2,500 in dividends. Sandra also invested £10,000 in a VCT in June 2018.

3.6.1 Step 1: Calculate the Gross Income

Case Study

Sandra has gross earnings of £48,500. In addition, she receives:

- employee benefit of £800
- interest of £2,000, and
- dividends of £2,500.

Sandra's gross income for 2025–26 was, therefore, £48,500 + £800 + £2,000 + £2,500 = **£53,800**.

3.6.2 Step 2: Deduct Certain Allowable Amounts

As we saw in section 3.1.1, HMRC lets certain allowable amounts to be deducted from gross income before tax is applied.

Case Study

Sandra's employer deducts 5% of her gross salary as a pension contribution. This equates to £48,500 x 5% = £2,425.

This is an allowable deduction from Sandra's gross income of £53,800, to leave £51,375.

We now need to split the income into the relevant parts, so that we can tax it in order, as appropriate.

The correct order for the tax calculation is always:

1. earned income
2. savings income
3. dividend income, and
4. chargeable gains on life assurance policies.

3.6.3 Step 3: Deduct Personal Allowances from Earned Income

As we have seen from section 3.2, the personal allowance can be enhanced (eg, by the blind person's allowance) or reduced (eg, for net incomes in excess of £100,000).

In this step, note that we deduct the personal allowance from the earned income first. That is because the order in which income is taxed is also the order in which allowances are deducted (ie, from earned income first, then savings income).

Case Study

Sandra is entitled to a personal allowance of £12,570.

Earned income	£49,300 (ie, £48,500 + £800)
Less pension allowance (of 5%)	(£2,425)
Earnings income	**£46,875**
Less personal allowance	(£12,570)
Taxable earned income	**£34,305**

Sandra's earnings income is £46,875. Her personal allowance would, therefore, be deducted from this to reach the amount of £34,305.

The other income amounts of £2,000 (interest) and £2,500 (dividends) are added to this to arrive at the total taxable income of £38,805.

3.6.4 Step 4: Extend the Basic Rate Band and Tax the Income (if any)

From section 3.1.1, if an individual makes contributions to pension plans or charitable contributions from their net pay, the amount paid should be grossed up to extend the basic rate tax band.

Case Study

Sandra is also paying £300 pm to a PPP from her net earnings. This means that she is paying a gross contribution of £375 (ie, £300 / 0.8), which is being invested on her behalf each month.

This means that Sandra's basic rate tax band is extended by £4,500 (ie, £375 x 12).

For 2024–25, the basic rate band is £37,700 (see section 3.2). This means that Sandra's revised basic rate band is £42,200 (ie, £37,700 + £4,500), which we can add to our calculation:

Taxable earned income	£34,305
Tax on taxable earned income:	
Basic rate band (£0 – £34,305) @ 20%	£6,861

Following on from this, Sandra has £7,895 (ie, £42,200 – £34,305) of her basic rate band remaining.

3.6.5 Step 5: Tax the Remaining Income

Here, we need to continue to use the income rate bands to determine the tax rate for the interest and dividends that an individual has received.

Case Study

We can, therefore, now add another figure to our calculation:

Taxable earned income	£34,305
Tax on taxable earned income:	
Basic rate band (£0 – £34,305) @ 20%	£6,861
Tax on savings/interest income:	
Basic rate band (next £1,000) @ 20%	£200

Sandra now has £6,895 (ie, £42,200 – £34,305 – £1,000) of her basic rate band remaining.

Tax on dividends:

Sandra has received dividends of £2,500.

We must first apply the dividend allowance of £500, which leaves £2,000 subject to income tax.

As noted above, Sandra has £6,895 remaining in her basic rate band. Therefore, this £2,000 of dividends falls within the basic rate band so should be taxed at the dividend basic rate of 8.75%. We can now add this figure into our calculation:

Basic rate band (next £2,000) @ 8.75%	£175

To summarise:

Tax on taxable earned income:	£6,861
Tax on savings/interest Income	£200
Tax on dividends	£175
Total tax liability	**£7,236**

We have established that Sandra has an increased basic rate band of £42,200 (Step 4), and she is a basic rate taxpayer with a total taxable income of £39,305. This leads to the following computation:

Type of income	Amount	Tax rate	Tax due
Non-savings income (see Step 3)	£34,305	All at 20%	£6,861
Savings income (see section 3.2.4 for PSA)	£1,000 £1,000	At 0% At 20%	£0 £200
Dividend income (see section 3.2.6 for DA)	£500 £2,000	At 0% At 8.75%	£0 £175
	£39,305		**£7,236**

Case Study

Just to clarify, if neither Sandra nor her employer had been paying any personal pension contributions from her net income, the standard basic rate band of £37,700 would have been applied and the calculation would have been as follows:

Earned income	£49,300
Less personal allowance	(£12,570)
Taxable earned income	£36,730

Tax on taxable earned income:

Basic rate band (£0 – £36,730) @ 20% £7,346

Sandra now has £970 (ie, £37,700 – £36,730) of her basic rate band remaining.

Tax on savings/interest income:

Sandra earned £2,000 as savings/interest, which pushes her into the higher rate band. She, therefore, has a lower savings allowance of £500, so the remaining £1,500 is subject to income tax.

Higher rate band (next £1,500) @ 40% £600

Tax on dividends:

After applying the dividend allowance, £2,000 of Sandra's dividend is subject to income tax at the higher rate.

Higher rate band (next £2,000) @ 33.75% £675

The total tax due is now £8,621. You can see, therefore, that saving into a pension has saved Sandra £1,385 (ie, £8,621 – £7,236) of income tax for the 2024–25 tax year, and she has benefitted from growing her pension fund for retirement in a tax-free environment.

At the same time, pension contributions reduce an individual's take-home pay. Additionally, once a contribution has been made then it cannot be withdrawn, for any reason, until the individual has reached a specified age – typically the normal minimum pension age (currently 55), although it can be later (eg, 60 or 65). Such contributions may, therefore, not be suitable for everyone.

3.6.6 Step 6: Give Credit for Tax Paid at Source and Deduct Tax Reducers

We now need to consider whether the individual could benefit from any tax reducers. These are simply amounts that can be deducted from the final tax bill. Tax reducers are not deducted from income so do not have any effect on tax bands or claw back levels. The common examples are:

- **MCA and marriage allowance** – see sections 3.2.2 and 3.2.3, respectively.
- **Enterprise Investment Scheme (EIS)** – an investment in an EIS attracts tax relief at 30% of any contribution paid, up to a limit of £2 million per tax year, if at least £1 million of this is invested in knowledge-intensive companies (KICs). See section 13.2 of chapter 5.
- **Seed Enterprise Investment Scheme (SEIS)** – an investment in a SEIS attracts tax relief at 50% of any contribution paid, up to a limit of £200,000 per tax year. See section 13.3 of chapter 5.
- **Venture Capital Trust (VCT)** – an investment in a VCT attracts tax relief at 30% of any contribution paid, up to a limit of £200,000 per tax year. See section 13.4 of chapter 5.

To benefit from these reliefs, the claimant must have an income tax liability which can be reduced.

Case Study

We have established that £7,236 is the expected total tax liability for Sandra.

As she paid £10,000 into a VCT, Sandra is eligible to a tax reduction of £3,000 (ie, £10,000 at 30%).

Therefore, her tax bill for the year will be £7,236 – £3,000 = £4,236.

Below is the whole tax calculation so that you can follow through the workings.

Sandra Evans	Earned Income	Savings Income	Dividends	Total
Gross income	48,500	2,000	2,500	
Taxable benefit in kind	800			
Less pension deduction (from gross salary)	–2,425			
Total Gross Income	**46,875**	**2,000**	**2,500**	**51,375**
Less personal allowance	–12,570			
Taxable Income	**34,305**	**2,000**	**2,500**	**38,805**

Tax Calculation		Maximum Allowed	Tax Rate	Earned Income	Savings Income	Dividends	Total
Non-savings Income							
Basic rate:							
Tax band	37,700						
Extend by:	4,500						
Extended tax band	42,700	34,305	20%	6,861			
Higher rate			40%				
Additional rate			45%				
Taxable Savings Income							
Starting rate		1,000	0%		0		
Basic rate		1,000	20%		200		
Higher rate			40%				
Additional rate			45%				
Taxable Dividends							
Basic rate		2,000	8.75%			175	
Higher rate			33.75%				
Additional rate			39.35%				
Tax Payable				**6,861**	**200**	**175**	**7,236**
VCT tax reducer	–10,000		30%				–3,000
Total Tax Payable							**4,236**

3.7 Self-Assessment

Learning Outcome

2.1.1 Understand the role of His Majesty's Revenue & Customs (HMRC) and the structure of the UK Self-Assessment tax system

Most employees in the UK do not have to complete a Self-Assessment tax return (unless they have another source of income, such as self-employment, investments and bank interest, or are asked to by HMRC).

The Self-Assessment system of collecting tax was introduced in the UK in the mid-1990s. Anyone who receives any form of income, other than just PAYE, should complete a Self-Assessment tax return (or appoint an accountant to complete it on their behalf). Clients with investments are a good example. The return covers every eventuality, so it is a combination of all earnings and income received.

The direct taxes that individuals pay under Self-Assessment are:

- income tax (on all types of income)
- Class 2 and Class 4 National Insurance (NI) contributions, if they are self-employed and depending on their taxable profits for the tax year, and
- CGT (see section 4).

Self-Assessment calculates whether individuals have paid the right amount of tax in the past tax year, and determines if any extra tax is due, or if a rebate or tax reduction is due.

People who only have one source of income, such as a salary, rely on their company to pay their due income tax on their behalf, which is deducted at source by the firm via PAYE. However, individuals should always check at least annually that they have paid the correct amount of tax. The amount of tax deducted by the company always depends on the tax code assigned to them by HMRC, which is the UK governmental body that collects taxes and who ensures the correct tax is paid at the correct time. HMRC also expect individuals and firms to pay the correct tax to them at the correct times – thus, if an individual believes that their tax code is incorrect, then they should bring this up with their employer, who will contact HMRC.

3.7.1 Filing Dates

While the Self-Assessment process gives taxpayers the option of calculating their own tax payments, they can opt for HMRC to do the calculation for them. There are also different deadlines for filing tax returns online or by paper.

The key dates for completing the Self-Assessment are:

- **31 October** (following the tax year to which the return relates)
  - This is the deadline for filing on paper and getting HMRC to calculate the tax due in time for payment the following 31 January.
  - For the tax year-ended 5 April 2026, if the individual wishes to complete a paper return (ie, complete it on paper and post it to HMRC) then the deadline for doing this is 31 October 2026.
  - Note that the accounting year-ends for limited companies may differ from 5 April.
- **31 January** (following the tax year to which the return relates)
  - This is the deadline for filing online, and for paying any tax owed following the submission of either paper or online tax returns.
  - By following the online process, the amount of tax owing will automatically be calculated.
  - For example, for the tax year-ended 5 April 2026, if the individual wishes to complete their return online, then the deadline for filing the return is 31 January 2027.

HMRC sends notifications to individuals on the Self-Assessment system, reminding them to complete a tax return. However, if someone believes that they should be completing a tax return but have not received any documentation, then they must contact HMRC as soon as possible. Similarly, if a Self-Assessment form is no longer needed, then HMRC must be contacted to withdraw the Self-Assessment and, if they agree, they will withdraw it – otherwise, the individual could be charged a penalty (see section 3.7.3 on penalties).

If tax is due, HMRC allows two payments of the tax to be made: one by midnight on 31 January following the end of that tax year, and the second payment by 31 July. There is then a third payment date of 31 January the following year for any 'balancing payments' due, which is explained in section 3.7.2 below.

Alternatively, if the income tax bill is less than £3,000, the individual already pays income tax via PAYE, and they submitted a tax return by 31 October (for paper) or 30 December (online), then they may be able to pay their Self-Assessment bill through their PAYE tax code. The tax that they owe is then taken from their salary or pension in equal instalments over a 12-month period, along with their usual tax deductions.

3.7.2 Payments on Account

Once the tax liability has been calculated, it must be paid. Rather than receive ad hoc payments, HMRC operates a system where individuals pay their tax due over three dates. The first two payments are known as 'payments on account', with the third being the 'balancing payment'. Balancing payments can be thought of as tax owed for the previous tax year.

The dates of these are:

- **31 January** — First payment on account
- **31 July** — Second payment on account
- **31 January (the following calendar year)** — Balancing payment

This can sometimes appear a bit complex, as HMRC adopts a 'current year' system. This means that the first payment could be due before the end of the tax year in question for a self-employed individual. Let us consider an example to demonstrate this.

Example

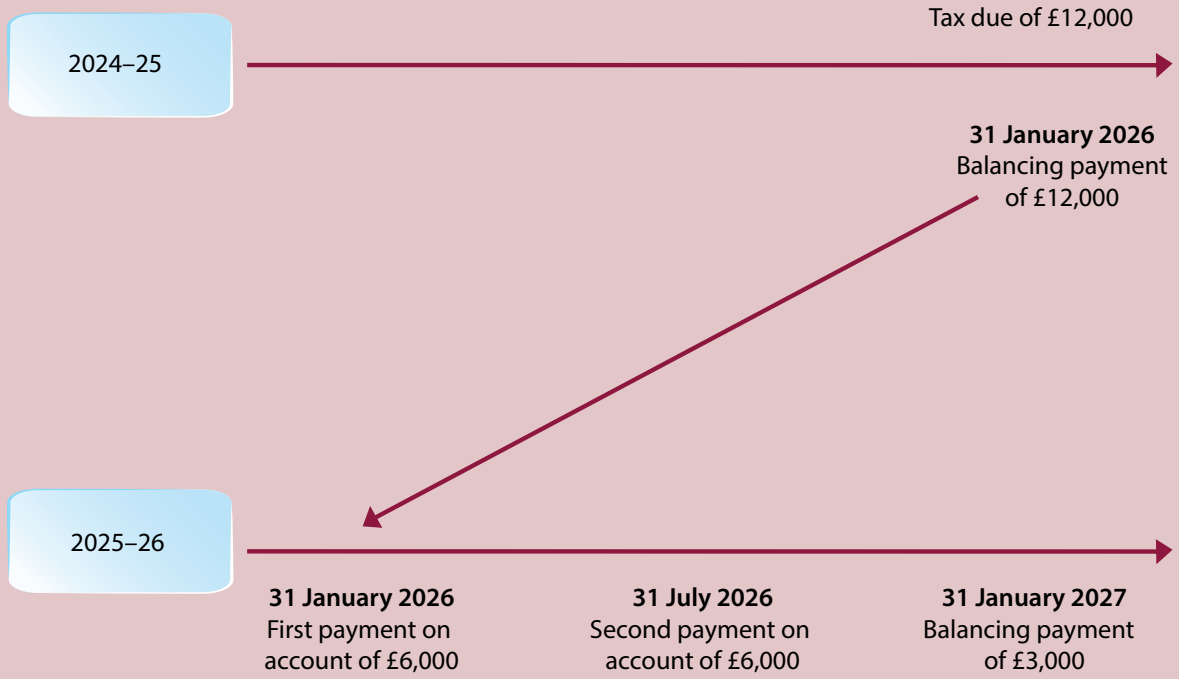
John Robinson has chosen to be self-employed, so he must complete a Self-Assessment form each year. For the 2025–26 tax year, he must do this by 31 October 2025 (if completing on paper) or 31 January 2026 (if online).

From the information that John provides, HMRC calculates that his tax bill is £12,000 for 2024–25. As this is his first year of Self-Assessment, John must pay the full amount by 31 January 2026.

Also on this date, John must pay the first payment on account for the 2025–26 tax year. This will be half of the total amount due for 2024–25 (ie, ½ x £12,000 = £6,000). Thus, altogether, John will pay £12,000 + £6,000 = £18,000 by 31 January 2026.

John's second payment on account for 2025–26 is also £6,000, which is due by 31 July 2026. Thus, for 2025–26, he has paid tax of £12,000 so far.

After the 2025–26 tax year has ended, John completes another Self-Assessment form. From the information he provides, HMRC calculates that John's tax bill is £15,000 for 2025–26. His balancing payment is, therefore, £3,000 (ie, £15,000 – £12,000), which is due by 31 January 2027.



Also, on 31 January 2027, John must pay the first payment on account for the 2026–27 tax year. This will be half of the total amount due for 2025–26 (ie, ½ x £15,000 = £7,500). Thus, altogether, John will pay £3,000 + £7,500 = £10,500 by January 2026; and so on.

? Try this one yourself, before checking your answers below.

Kelly is a self-employed consultant. Her income tax liability for the 2024–25 tax year was £8,400, which she has paid in full and she expects her tax liability for 2025–26 to be about the same. How much, and by which dates, does she need to pay the tax due for 2025–26?

Kelly is able to split the payments into two parts – this means that she will pay £4,200 by 31 January 2026 and the remaining £4,200 by 31 July 2026. If she is actually due to pay more when she comes to do her tax return for 2025–26, then the remaining amount (ie, the balancing payment) will be due by 31 January 2027.

For limited companies, the time frames are different:

- The tax return must be completed 12 months after the end of the accounting period that the return covers.
- The company must pay any corporation tax that they owe, or notify HMRC that they have no corporation tax to pay, within nine months and one day after the end of the accounting period.

The calculation of corporation tax is outside the scope of this module, but candidates should be aware of the above-mentioned differences relative to personal taxation.

3.7.3 Interest, Surcharges and Penalties

When the deadlines described above are not met, HMRC levies a charge. Currently, for individuals, the charge is £100 if the tax return is up to three months late, although it will be more if it is even later or if the individual pays their tax bill late. The charging period begins on the date the return should have been filed or the tax was due, usually 31 January or 31 July; this applies even if no tax is owed. If payment is still not made after 12 months, then HMRC can start court action, including sending bailiffs.

If an error is made in the tax return, then penalties also apply, as a percentage of the extra tax due:

- between 0% and 30% if the error arises because of a lack of reasonable care
- between 20% and 70% if the error is deliberate (eg, intentionally sending incorrect information), and
- between 30% and 100% if the error is deliberate and concealed (eg, intentionally sending incorrect information and taking steps to hide the error).

Interest is charged on both unpaid tax and unpaid penalties. The interest rate is the Bank of England (BoE) base rate plus 2.5%; and overpayments receive interest at the base rate minus 1%, with a lower limit of 0.5% (known as the 'minimum floor'). The interest rates for late and early repayments is available on the HMRC website[3].

Finally, there are also variable penalties that HMRC may levy on individuals (eg, for failing to keep records and documents needed to complete a tax return).

3 HM Revenue & Customs, September 2025. HMRC interest rates for late and early payments. Retrieved from https://www.gov.uk/government/publications/rates-and-allowances-hmrc-interest-rates-for-late-and-early-payments/rates-and-allowances-hmrc-interest-rates (Accessed: October 2025)

4. Capital Gains Tax (CGT)

Learning Outcome

2.2.1 Understand the principles of CGT, and when and how it arises

2.2.6 Understand the tax treatment of cryptoassets

4.1 Definition

In the UK, CGT is a tax on gains arising from the chargeable disposal of chargeable assets by a chargeable person, that a UK resident holds on a worldwide basis. In order to calculate the CGT, we first need to define the terms 'disposals' and 'chargeable assets' (and, following on from this, 'exempt assets').

4.1.1 Chargeable Disposals

A chargeable disposal arises due to a transfer of ownership, the making of a gift, the receipt of a capital sum from an asset, or even the destruction of an asset. However, a disposal is not potentially chargeable to CGT, or allowable as a capital loss, if made between spouses or civil partners, made upon death, or if the asset is itself exempt.

4.1.2 Chargeable and Exempt Assets

Chargeable capital assets for CGT are harder to define.

Indeed, the easiest approach is to list some of the key 'exempt assets'; in other words, those that do not create a CGT liability on disposal. The main exempt assets are:

- an individual's principal private residence (which falls under Principal Residence Relief (PRR) – see section 4.3.1)
- gifts between spouses and civil partners (unless they are separated and did not live together during the tax year)
- gifts to registered charities
- UK government gilts and qualifying corporate bonds (QCBs; ie, a sterling-denominated security that represents a 'normal commercial loan', and it has no rights of conversion to certain shares or other securities)
- premium bonds
- assets held in ISAs, JISAs and CTFs
- most pension investments (however, property can be more complicated, as well as if the pension fund itself holds offshore funds)
- proceeds from most life policies, written in trust or in the hands of the original owner
- a chattel (ie, a tangible moveable object) where the value at disposal does not exceed £6,000
- a chattel which is deemed a 'wasting asset' (basically, an expected life of less than 50 years)
- private motor vehicles
- betting, lottery and pools winnings
- foreign currency, when for own personal use outside the UK

- shares in VCTs (provided the company maintains its VCT status and certain specified criteria have been satisfied)
- shares in EISs and SEISs, as long as they have been held for at least three years, and
- personal injury compensation.

Chargeable assets include:

- property (other than the individual's principal private residence)
- land
- buildings
- leases
- shares and investments
- antiques
- jewellery
- possessions of more than £6,000 in value, and
- business assets such as premises, goodwill and trademarks, if the business is run on a sole trader basis.

Cryptoassets

A cryptoasset is a digital asset that does not require intervention by a middleman and uses decentralised distributed ledger technology (DLT). DLT enables the storage, distribution and exchange of value between users, either privately or publicly.

One example of DLT is blockchain. Since it was the first fully functional DLT, blockchain is more well-known than DLT itself. The amount of blockchain outstanding consistently grows as 'completed' blocks (the most recent transactions) are recorded and added to it in chronological order, and this allows market participants to keep track of digital currency transactions without central record-keeping.

The growth in the use of cryptoassets has largely been driven by individuals and unregulated companies, which raises questions about the level of oversight and proper controls in the cryptoassets market. While these new assets and technologies may present an efficient way of carrying out financial transactions, they also bring an increased risk of fraud, money laundering and the financing of terrorism because the markets for these assets are less regulated than traditional capital markets.

Cryptocurrencies are perhaps the most well-known and longest established form of cryptoasset. Cryptocurrencies (eg, Bitcoin) are virtual or electronic currencies that use encryption techniques to regulate and limit how many units of currency are available.

HMRC considers cryptoassets (including cryptocurrencies) to be a 'chargeable asset', even though they are digital and, therefore, intangible. Most investors will likely buy and sell cryptoassets as an investment activity, just like they would stocks and shares, so any gains on disposal will typically be subject to CGT. Additionally, losses will be allowable (ie, they may be used to offset chargeable gains realised on other assets).

Individuals must report any gains they have made via a Self-Assessment tax return in the tax year after they disposed of the assets. Details of the filing dates for Self-Assessment are covered in more detail in section 3.7.1 of this chapter.

4.1.3 Chargeable Persons

Individuals

Individuals pay CGT on their net chargeable gains (ie, the gains they have made, less any losses realised) in a relevant tax year, less unrelieved losses brought forward from previous years, and the annual exemption (see section 4.2 below).

Trusts and Estates

For trusts, the CGT liability generally falls on the trustees and their representatives, although there are some exceptions to this rule. For example:

- if the settlor, their spouse/civil partner or their minor child/stepchild can benefit from the trust, then it is the settlor who is liable, or
- if the trust is an offshore trust, any gains may fall to the settlor.

Trustees and their representatives are liable for tax on gains at a rate of 24% for all assets.

Estates

For estates, the CGT liability falls on the **beneficial owner**. Each beneficiary has their own CGT allowance and will be taxed at the applicable rates.

Charities

A charity is exempt from CGT on any gains when the proceeds of the disposal are applied for, or to be applied for, charitable purposes, provided that that money is used for charitable purposes only.

4.2 CGT Exemptions

Learning Outcome

2.2.2 Understand the main CGT exemptions and reliefs available including main residence, exempt assets and exemption limits applicable for individuals, trusts and estates

CGT Annual Exemption and Tax Rates

All UK residents are allowed use of an annual exemption, known as the annual exempt amount (AEA) or the CGT allowance. This is a 'use it or lose it' exemption, meaning that no unused element of the exemption from one tax year can be carried forward to the next tax year.

The CGT annual exemption and tax rates for 2025–26 are as follows:

Capital Gains Tax	
Annual exemption (for individuals and some trusts)	£3,000
Annual exemption (for most trusts)	£1,500 (ie, half of the allowance)
Property (excluding main residence)	Basic rate: 18% Higher/additional rate: 24%
Other chargeable assets	Rates were increased, therefore: **From 30 October 2025:** Basic rate: 18% Higher/additional rate: 24%

Source: GOV.UK[4]

Gains can be made up to the CGT allowance with no taxation payable. The allowance can be used against the gain that will be charged at the highest rate.

Where gains have arisen from both residential property and other assets, the annual allowance is first used against the gains that would be charged at the highest rates.

Individuals

For individuals, the CGT allowance is £3,000 for 2025–26. It should be noted that this cannot be transferred between spouses or civil partners.

Generally, the CGT allowance only applies if an individual is UK resident, although there may be some exceptions – for example, individuals who are temporarily non-resident but meet certain conditions. Non-resident individuals should contact HMRC or a tax advisor to determine their specific eligibility.

Trusts

Trusts have an annual CGT exemption depending on the type of trust in question:

- For personal representatives of deceased persons and trustees of certain settlements where the beneficiary is vulnerable, it is the same as for individuals – ie, £3,000 for 2025–26.
- For most others, it is half of this amount – ie, £1,500 for 2025–26.
- It may be even less than this had the settlor established more than one trust – for example, to a minimum of £300 for 2025–26 (ie, £1,500 / 5).

The rate of CGT increased from late 2024 and is now 18% or 24% (basic and higher/additional rate taxpayers and trustees respectively) for all assets. An individual's main residence is exempt from CGT.

4 GOV.UK, June 2018 (updated: May 2025). Capital Gains Tax rates and allowances. Retrieved from https://www.gov.uk/guidance/capital-gains-tax-rates-and-allowances (Accessed: October 2025)

4.3 CGT Reliefs

CGT reliefs are different from CGT exemptions, in that a gain may be wholly or partly relieved against CGT.

4.3.1 Private Residence Relief (PRR)

If an individual disposes of their property that has been used as their only or main home at some point during the period of ownership, then the disposal will attract some amount of PRR (also called main residence relief or principal residence relief). There will be no tax to pay if all of the following apply; otherwise, the individual may have a CGT liability:

- they have one home and they have lived in it as their main home for all of the time that they have owned it
- they have not let out part of the home (this does not include having a lodger)
- they have not used the home exclusively for business purposes (using a room as a temporary or occasional office does not count)
- the grounds, including all buildings, are less than 5,000 square metres in total, and
- they did not buy it solely to make a gain.

Individuals can elect which of their residences is to be treated as their 'main residence', and, therefore, be exempt from CGT – they can only have one main residence at a time for PRR. The election must be made within two years of the acquisition of the additional residence. If no election is made, HMRC can decide which property should be treated as the main residence. Married couples and civil partners who are living together can only claim the exemption for one of their properties.

4.3.2 Business Asset Deposit Relief (BADR)

Previously known as entrepreneurs' relief (ER), BADR reduces the rate of CGT to 14% (increasing to 18% from 6 April 2026) on qualifying gains, subject to a limit on gains of £1 million (ie, a maximum potential tax saving of £100,000) over an individual's lifetime. Once the limit of £1 million has been exceeded, then the normal CGT rate of 24% applies.

In order to qualify for BADR, an individual has to be a sole trader or business partner of a company which they have owned for at least two years. If a business is being closed, then the same conditions apply, and the business assets must be disposed of within three years of the business ceasing.

Qualifying assets include:

- a disposal of the whole or part of a business run as a sole trader
- the disposal of a share in a partnership by a partner
- the disposal of shares in a trading company, where the individual has at least a 5% shareholding and is also an employee of the company
- assets that an owner has loaned to their own business, and
- shares bought through an Enterprise Management Incentive (EMI) scheme, although there are special rules for these schemes.

Even though BADR/ER has faced criticism over the years for doing little to promote business investment, the UK government has ignored calls to abolish the relief entirely for now, as they do not wish to discourage genuine entrepreneurs who rely on it. While BADR is unlikely to be scrapped entirely, further changes could be introduced going forward. For example, potential upcoming changes include stricter eligibility criteria for BADR, a change in the definition of what counts as a 'qualifying asset', and a reduced lifetime allowance (LTA) to restrict the tax benefits on multiple business disposals.

4.3.3 Business Asset Rollover Relief (BARR)

BARR is a form of CGT deferral, which can be claimed by both incorporated and unincorporated businesses when they sell assets used in the business and buy other assets for the business at the same time or soon afterwards. It means that CGT is not payable until the 'new' asset has been sold.

There are a number of conditions for this relief to be available, including:

- the business must be trading
- the new assets must be purchased in a period starting one year before, and ending three years after, and
- the disposal of the old assets and the new assets must be used for the business.

Relief can be claimed on land and buildings, as well as fixed plant or machinery.

There are different rules if the old and new assets are only partially used for the business.

This relief allows a business to expand (eg, into new, possibly larger premises, before selling its existing property and defer the CGT from the sale of its existing property).

4.3.4 Reinvestment Relief into Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) Shares

This relief works along similar lines to BARR. It is used by investors when making a gain on the disposal of an asset. If they invest that gain into shares that qualify under the EIS or SEIS, the CGT is deferred. In short, EISs and SEISs are designed to help smaller, high-risk trading companies to raise finance, by offering a range of tax reliefs to investors. EISs and SEISs are covered in more detail in chapter 5, sections 13.2 and 13.3, respectively.

As with BARR, the investment must be made in a period starting one year before, and ending three years after, the disposal of the asset subject to CGT.

4.3.5 Hold-Over Relief

Hold-over relief is effectively a form of CGT deferral again, being able to 'hold over' the gain on gifts of certain assets. When this relief is claimed, no CGT becomes payable at the time of the gift, but the acquisition cost to the receiver (the donee) of the gift is reduced by the amount of held-over gain.

This relief can only be given if both the donor and donee jointly claim it, and if the donee is resident in the UK (see section 2 of this chapter for further details). Furthermore, it can only be applied to certain assets.

The relief is available on gifts of trading assets, which are:

- assets used in the trade of the donor by the donor's personal company, or
- shares and securities of trading companies, provided they are not quoted on a recognised **stock exchange** or they are those of the donor's personal company (ie, the donor has at least 5% of the voting rights).

Hold-over relief is also available on transfers to trusts that attract an immediate charge to IHT, called **chargeable lifetime transfers (CLTs)** – CLTs are covered in more detail in section 6.3.3.

4.4 CGT Calculation

Learning Outcome

2.2.4 Be able to calculate taxable gains on an individual's net gains for a tax year

2.2.7 Apply the rules to working examples

Just as we saw for the income tax calculation, there are six steps to the CGT calculation.



Before looking at the steps listed below, what do you think they involve and what is the correct order for calculating a possible CGT liability?

1	Determine the disposal proceeds.
2	Deduct the acquisition cost.
3	Deduct any costs incurred when purchasing and selling, and any enhancement costs.
4	Set off any allowable capital losses.
5	Deduct the CGT allowance and any CGT reliefs.
6	Tax the gain at the appropriate rate.

We will look in more detail at each step and incorporate the following case study as we work our way through each step.

Case Study

Jon Carter, aged 46, has a taxable income of £80,000 per year. In May 2025, he sold a holiday home that he purchased in 2018. The sale price was £245,000, and the purchase price £140,000.

Jon has kept all of his paperwork and has calculated that the total cost of the purchase (including stamp duty and legal costs) was £2,600. The legal costs involved with the sale totalled £3,800.

During his time as owner of the property, Jon paid £21,000 on an extension. He also calculates that he has paid £10,000 over the years maintaining the property to a good standard.

Jon has other investments, some of which have performed poorly. He sold some shares a few years ago at a loss of £12,000, which he has not yet offset against gains in subsequent tax years. He has also sold units in a unit trust, incurring a loss of £4,300 in 2025–26.

4.4.1 Step 1: Determine the Disposal Proceeds

The amount treated as the disposal proceeds is usually simply the sale proceeds. However, HMRC has to be satisfied that the sale is on a fully commercial basis. If there is any doubt, then the market value of the asset at the time of the disposal will be used. The 'market value' approach will be used when the disposal is not deemed to be at 'arm's length'. This mainly occurs on two occasions, namely:

- a disposal between individuals with a close connection (eg, close relatives), and
- a disposal that is deliberately at undervalue or a gift between friends. The parties do not have to have a close connection in this situation for the market value to be used.

Case Study

Jon sold the property on the open market and received a fair commercial price. The disposal proceeds are, therefore, set at £245,000.

Disposal proceeds	Acquisition cost	Other costs	Losses	Annual exemption	Gain to be taxed
£245,000					

4.4.2 Step 2: Deduct the Acquisition Cost

The acquisition cost is usually the purchase price, providing the asset was purchased on a commercial basis. If not, the above rules about market value apply. This can be particularly important when dealing with CGT from the sale of an inherited asset, for example, where perhaps an individual inherits the family home which has not been valued for a long time.

An inherited property is valued at the date of death and then again at the date of sale for CGT purposes. That is, unless it is inherited by multiple direct descendants and several of them gift their share to the other descendant(s), in which case, the property would need to be revalued again at the date of transfer and the CGT dealt with accordingly.

If the asset was acquired as a gift, the market value at the time of the gift is used.

An important date to remember for CGT purposes is 31 March 1982. This was when, in a previous regime, the value of all assets were rebased. Therefore, where an asset was acquired before 1 April 1982, the asset's cost is deemed to be the market value on 31 March 1982.

Case Study

Jon also purchased the property on the open market and paid a fair commercial price. His purchase was after 31 March 1982. The acquisition cost is, therefore, set at £140,000.

Disposal proceeds	Acquisition cost	Other costs	Losses	Annual exemption	Gain to be taxed
£245,000	(£140,000)				

4.4.3 Step 3: Deduct any Costs Incurred when Purchasing and Selling, and any Enhancement Costs

Incidental costs involved in the purchase and sale of an asset (such as legal fees, estate agent fees, **stamp duty** and auctioneer's fees) are deductible.

Costs involved in enhancing the asset (but not general maintenance) can also be deducted.

Note that no deductions are allowed for incidental costs of acquisition or enhancement expenditure before 31 March 1982, when values were rebased.

Case Study

Jon can deduct the £2,600 cost on purchase, the £3,800 cost on sale and the £21,000 cost of the extension. He cannot deduct the £10,000 maintenance cost.

The total deduction at this stage is, therefore, £27,400 (ie, £2,600 + £3,800 + £21,000).

Disposal proceeds	Acquisition cost	Other costs	Losses	Annual exemption	Gain to be taxed
£245,000	(£140,000)	(£27,400)			

4.4.4 Step 4: Set Off any Allowable Capital Losses

Allowable losses can be carried forward indefinitely, but must be reported to HMRC within four years from the end of the tax year in which they arise.

First, allowable losses incurred must be set off against any chargeable gains made in the same tax year. This is the case even if the subsequent overall gain is reduced to a figure below the CGT allowance for that tax year. Losses on disposal of exempt assets cannot be offset against gains.

Carried forward losses are then used, if available, even if this means that the individual does not get to benefit from the CGT allowance.

If the gains are insufficient to absorb the loss, the remaining loss can be carried forward to subsequent years until it is fully used.

The CGT allowance then applies if there are no allowable losses or carried forward losses available.

Case Study

Jon has made a loss of £4,300 in this tax year, which must be offset against the gain he has made this tax year. He then has the choice as to whether he wants to use the carried forward losses of £12,000, although given the amount of gain he made on the sale of the holiday home, it is likely he will. Assuming this is the case, the total losses are, therefore, £16,300 (ie, £4,300 + £12,000).

Disposal proceeds	Acquisition cost	Other costs	Losses	Annual exemption	Gain to be taxed
£245,000	(£140,000)	(£27,400)	(£16,300)		

4.4.5 Step 5: Deduct the CGT Allowance and any CGT Reliefs

The exemptions and reliefs for CGT are covered in sections 4.2 and 4.3. It is at this step in the calculation that these apply.

Case Study

Jon will use the annual exemption to bring his gains down to the minimum.

Disposal proceeds	Acquisition cost	Other costs	Losses	Annual exemption	Gain to be taxed
£245,000	(£140,000)	(£27,400)	(£16,300)	(£3,000)	**£58,300**

4.4.6 Step 6: Tax the Gain at the Appropriate Rate

As discussed in section 4.2, different rates apply depending on whether the individual is a basic, higher or additional rate taxpayer. The CGT rates are shown in section 4.2 of this chapter.

We, therefore, need to first establish the individual's income tax status (see section 3.2).

Case Study

With an annual income of £80,000, Jon is a higher rate taxpayer, so the 24% CGT rate will be used when he sells his holiday home.

The amount of tax on the gain is £58,300 x 24% = £13,992.

Thus, from the sale of Jon's holiday home for £245,000, he stands to pay a CGT bill of £13,992.

4.5 Payment of CGT

Learning Outcome

2.2.5 Understand due dates for paying CGT and the use of CGT deferral

Capital gains are reported to HMRC as part of the Self-Assessment system (see section 3.7).

? Returning to the case study of Jon Carter that we have just used to illustrate the CGT calculation process, he sold the holiday home in May 2025. When do you think is the deadline for him to pay his CGT bill to HMRC?

For residential property sales, UK resident individuals and trustees must inform HMRC about any capital gain and pay any CGT due within 60 days from the completion date. This is reported through an online service, rather than through Self-Assessment. Failure to report within this time frame can result in penalties. Special tax rules apply when non-UK residents dispose of property or land in the UK.

Property transactions are the only exception to the general CGT reporting rules. For any other assets, any CGT payable is due on 31 January following the end of the tax year in which the gain was made, and this is paid in full. For example, if Jon had sold something other than property on the same dates, then he would have incurred the liability in the 2025–26 tax year, and he would be required to pay the CGT by 31 January 2027.

4.6 Additional Information

Learning Outcome

2.2.3 Understand the main disposal rules for CGT, including special rules that apply to disposals on death and between spouses/civil partners

This next section covers some of the CGT-related information that you may need to be aware of.

4.6.1 Inter-Spouse and Inter-Civil Partner Transactions

Since the value of assets are rebased on disposal, it is tempting for married couples/civil partners to swap the ownership between them on a regular basis, thereby reducing any potential gains of the value of the asset. This temptation has been recognised by HMRC and, as a result, there are special rules for disposals between spouses and civil partners.

For the duration of a marriage or civil partnership, a transfer of assets from one spouse or civil partner to another does not give rise to a chargeable gain.

When the asset is eventually disposed of by the receiving spouse or civil partner, the tax liability is based on the acquisition cost incurred by the first spouse or civil partner. The transfer between spouses or civil partners is known as a 'no gain no loss' disposal, and is treated as though the recipient of the asset has always owned the asset.

This facility can be used to transfer assets from a higher to a lower rate taxpaying spouse or civil partner. It can also be used as a tax planning opportunity, by ensuring that both spouses/civil partners fully use their CGT allowances before paying any CGT between them.

Note that if the couple separate, either permanently or temporarily (note that this does not mean divorce/dissolution of the civil partnership) and they no longer live together, then they cannot transfer assets on this basis in the tax year following separation. Instead, the 'market value' rule (which was mentioned in section 4.4.1) would apply.

4.6.2 CGT on Death

There is no CGT on the disposal of assets following the death of an individual. The beneficiaries are deemed to acquire the assets at the market value at the date of death. As we will see below, the amount of tax due when someone dies depends on the total value of the assets at current market value and is taxed as IHT.

4.6.3 Chattels

Chattels are tangible, moveable items of property, such as furniture. We noted earlier, in section 4.1.2, that these are exempt from CGT if the value (not the gain) at disposal does not exceed £6,000, or if they are wasting assets (ie, those with a useful life of less than 50 years).

Chattels that are not wasting and are sold for more than £6,000 are, therefore, subject to CGT. For those sold for less than £15,000, however, it is possible to limit the gain to:

$$\frac{5}{3} \times \left(\text{Sale price} - £6{,}000\right)$$

if the result of this calculation is less than the actual gain. If a loss is made then, this can be offset against gains. For chattels sold for over £15,000, capital gains are calculated in the usual way.

? Dominic purchased a painting for £1,000, and he later sold it for £9,000. What gain is assumed for CGT purposes?

Using the above equation leads us to:

$$\frac{5}{3} \times \left(£9{,}000 - £6{,}000\right) = \frac{5}{3} \times £3{,}000 = £5{,}000$$

As this is less than the actual gain of £8,000 (ie, £9,000 – £1,000), this amount can be used by Dominic.

4.6.4 People with Multiple Homes

While an individual's main residence is exempt from CGT under Private Residence Relief (PRR), as discussed in section 4.3.1, it is not uncommon for people to own more than one residential property – whether this is for business, personal or investment purposes.

As noted in 4.2 of this chapter, disposals of additional houses or flats (including buy-to-let) are subject to CGT. Any CGT due must be paid within 60 days of completion (see section 4.5).

4.6.5 Shares

Shares of the same type and **class** can be purchased at different times, creating issues for determining the order of purchase and acquisitions.

Where all shares are sold together, a simple average price is obtained via the purchases. That is, unless they were purchased before 1982, in which case, the rebasing cost of the shares would need to be calculated.

Example

Charlie bought 500 shares on 1 November 2015 for a price of £1.50, costing £750. He bought another 500 shares on 15 October 2018 for a price of £1.25 (costing £625), and 20 days ago a further 500 shares for a price of £1.10 (costing £550). Thus, Charlie bought 1,500 shares altogether, at a total cost of £1,925 (ie, £750 + £625 + £550).

Two days ago, Charlie sold all of his 1,500 shares for £2,000, giving him a capital gain of £75. In this scenario, as they were all purchased after 1982, we calculate the cost per share as £1.283 (ie, £1,925 / 1,500).

This is referred to as 'taking an average cost'.

This is a very simple example, but what if out of the 1,500 shares he owned, Charlie only sold 900 of them two days ago? How would we calculate the base cost to deduct the sale price?

Disposals of shares, or indeed of units in unit trusts, are identified with acquisitions in the following order:

- Acquisitions on the same day.
- Acquisitions within the following 30 days (preventing the use of 'bed & breakfasting').
- Acquisitions in the share pool (which aggregates all other acquisitions not covered above. The average share price of the shares in the pool will be used).

Example

Julie has a shareholding in ABC plc, which she acquired as follows:

- 6,000 shares on 2 September 2013 purchased for £5,000
- 4,000 shares on 26 May 2017 purchased for £4,200
- 2,000 shares on 22 July 2025 purchased for £1,400

Julie sold 8,000 shares on 1 July 2025 for £2,800.

The sale and repurchase in July 2025 are grouped together, as they were made (in that order) within 30 days of each other:

Proceeds of 2,000 shares (ie, £2,800 x 2,000 / 8,000)	=	£700
Cost of the 2,000 shares	=	(£1,400)
Loss		**–£700**

Share pool

Proceeds of 6,000 shares (ie, £2,800 x 6,000 / 8,000)	=	£2,100
Cost (see below)	=	(£5,520)
		–£3,420
Chargeable loss		**–£4,120**

Share pool

	Number	Cost (£)
Purchase 2 September 2013	6,000	5,000
Purchase 26 May 2017	4,000	4,200
Total	**10,000**	**9,200**
Disposal 01/07/25 (9,200 x 6,000/10,000)	(6,000)	(5,520)
Balance carried forward	**4,000**	**3,680**

In this case, Julie has a chargeable loss to set against gains of £4,120.

4.6.6 Shares of Negligible Value

There are occasions where share prices fall so far that they are deemed to have a 'negligible value'. In these situations, HMRC will treat these shares as being disposed of despite the fact that they have not physically been sold. This will allow an investor to crystallise a loss.

HMRC publishes a list of shares which it accepts has become of negligible value[5]. This includes some old investment trusts, shares in a few football clubs and some well-known companies that are no longer in existence such as Northern Rock, department store Debenhams, and centre operator and owner Intu Properties.

5 HMRC, June 2014 (last updated: October 2025). Negligible value claims and agreements. Retrieved from https://www.gov.uk/guidance/negligible-value-agreements (Accessed: October 2025)

5. Taxation of Investment Vehicles

Learning Outcome

2.1.5 Understand the tax treatment of different kinds of investments and the taxation of income arising on overseas investments and when capital gains are taxed as income

2.1.6 Evaluate the tax efficiency of an investment asset within the wider context of suitability for an individual customer

2.4.1 Understand the tax treatment of onshore and offshore funds and directly held assets and be able to apply the rules to working examples

5.1 Introduction

In the previous two sections of this chapter, we looked at the basics of income tax and CGT. In this section, we will examine how these taxes impact on the major investment products and vehicles, as well as examining both the liability for the investor and the liability incurred within the investment vehicle/product. For the purposes of this workbook, the focus is on UK-resident investors.

This will not be a detailed explanation of each product, as that is covered in more detail in chapter 5. We will stick to just the taxation aspects, using a similar format throughout to help you compare each (where possible).

Throughout the explanations:

- 'TP' stands for taxpayer.
- 'BRTP' stands for basic rate taxpayer.
- 'HRTP' stands for higher rate taxpayer.
- 'ARTP' stands for additional rate taxpayer.

There is a starting rate of tax for savings if a person's income from savings is £5,000 or less, which is covered in more detail in section 3.2.5 of this chapter. In addition, the PSA (for savings income and interest) and DA (for dividend income) are available (see sections 3.2.4 and 3.2.6, respectively).

5.1.1 Bank and Building Society Savings Accounts

	Income Tax	Capital Gains Tax
Tax situation within the product	Paid gross	N/A
Tax situation for the investor	Interest, paid gross and taxable; PSA is available	N/A (the only return received is income; no capital gains)
Rate of tax payable	• Non-TP 0% • BRTP 20% • HRTP 40% • ARTP 45%	N/A (no capital gains tax is applicable)
Interest received on cash held in an ISA, pension and other tax wrapper is tax-free.		

5.1.2 National Savings and Investments (NS&I)

This product group is a bit more complicated, as NS&I operates different products with different income tax implications (none of the NS&I's products are subject to CGT).

The following are NS&I's key products, all of which are available as new products:

Tax-free products	Products that are taxable
Premium Bonds	Investment Account
Direct ISA	Direct Saver
Junior ISA	Income Bonds
	Guaranteed Income Bonds (British Savings Bonds)
	Guaranteed Growth Bonds (British Savings Bonds)
	Green Savings Bonds

Source: NS&I[6]

6 NS&I, 2025. All Products. Retrieved from https://www.nsandi.com/products (Accessed: October 2025)

5.1.3 UK Gilts

	Income Tax	Capital Gains Tax
Tax situation within the product	N/A	N/A
Tax situation for the investor	Interest, paid gross and taxable; PSA is available	N/A
Rate of tax payable	• BRTP 20% • HRTP 40% • ARTP 45%	N/A
Any accrued interest on the sale proceeds of gilts is liable to income tax if the individual's total nominal holding of gilts exceeds £5,000. Gilts are exempt from stamp duties on purchase.		

5.1.4 Corporate Bonds

	Income Tax	Capital Gains Tax
Tax situation within the product	Interest payments can be deducted from taxable profits	N/A
Tax situation for the investor	Interest, paid gross and taxable; PSA is available	'Qualifying corporate bonds' (QCBs) are free from CGT – see section 4.1.2. If exempt, profits are tax-free, but losses are not allowable
Rate of tax payable	• BRTP 20% • HRTP 40% • ARTP 45%	N/A
Some corporate bonds are issued as 'deeply discounted securities', where the issue price is over 15% less than the amount payable on redemption, or more than 0.5% per year. One example is zero coupon bonds (ZCBs), which are issued at a significant discount to their face value and do not pay periodic interest. Profits on the disposal or redemption of these securities will be taxed as income, not capital gains.		

5.1.5 Company Shares

	Income Tax	Capital Gains Tax
Tax situation within the product	Corporation tax is paid on a company's profits before dividends are distributed	If a company sells its own shares, this does not create a tax-relevant gain/loss
Tax situation for the investor	Dividends, paid gross and taxable; DA is available	Gains above the annual allowance are subject to CGT; losses are allowable
Rate of tax payable	• BRTP 8.75% • HRTP 33.75% • ARTP 39.35%	• BRTP 18% • HRTP 24% • ARTP 24%
Dividends received on shares held within a tax wrapper (such as ISAs or pensions) will continue to be tax-free income, and any disposals in the wrapper are CGT free.		

5.1.6 Investment Trusts

	Income Tax	Capital Gains Tax
Tax situation within the product	Subject to corporation tax within the investment trust, on its own profits and dividends.	Chargeable gains made within the investment trust are exempt from corporation tax
Tax situation for the investor	Dividends, paid gross and taxable; DA is available	Gains above the annual allowance are subject to CGT; losses are allowable
Rate of tax payable	• BRTP 8.75% • HRTP 33.75% • ARTP 39.35%	• BRTP 18% • HRTP 24% • ARTP 24%
It is important to be able to distinguish between investment trusts, VCTs, EISs and SEISs, for the additional tax advantages for income tax.		

5.1.7 Unit Trusts, Open-Ended Investment Companies (OEICs) and Exchange-Traded Funds (ETFs)

While income payments for unit trusts, OEICs and exchange-traded funds (ETFs) do not have tax deducted at source, the tax situation of these collective products depends on the asset make-up of the products.

Note that when an investor first buys units or shares in a unit trust or OEIC, they may receive an **equalisation payment** as part of the next distribution that the fund pays. As the equalisation payment is a return of the investor's money, it is not liable to income tax; rather, the payment is deducted from the cost of the holding when calculating any chargeable gain on an eventual disposal.

Bond Funds

If at least 60% of the assets are interest-bearing then they are classified as bond funds. Bond funds are treated differently from direct holdings of bonds – income payments are taxed as savings income, at investors' marginal rate of tax; and gains are not exempt from CGT in the event that the individual investor disposes of their units or shares.

	Income Tax	Capital Gains Tax
Tax situation within the product	Paid gross	Exempt on disposals within the fund
Tax situation for the investor	Interest, paid gross and taxable; PSA is available	Gains above the annual allowance are subject to CGT (even if the underlying assets are CGT free or exempt); losses are allowable
Rate of tax payable	• BRTP 20% • HRTP 40% • ARTP 45%	• BRTP 18% • HRTP 24% • ARTP 24%

Equity Funds

If less than 60% of the assets are interest-bearing, then they are classified as equity funds.

	Income Tax	Capital Gains Tax
Tax situation within the product	Paid gross	Exempt on disposals within the fund
Tax situation for the investor	Dividends, paid gross and taxable; DA is available	Gains above the annual allowance are subject to CGT (even if the underlying assets are CGT free or exempt); losses are allowable
Rate of tax payable	• BRTP 8.75% • HRTP 33.75% • ARTP 39.35%	• BRTP 18% • HRTP 24% • ARTP 24%

5.1.8 Individual Savings Accounts (ISAs) and Junior ISAs (JISAs)

An ISA is not a product as such, but a 'wrapper' that makes an existing investment more tax efficient. The extent of effectiveness of this tax efficiency depends largely on the tax status of the individual investor, which can make them an important method of saving for the future.

Due to the tax benefits they offer, the amount that investors can save into an ISA each year is limited. Overall, the contributions to ISAs are limited to £20,000 in total for the tax year 2025–26, although there are some exceptions depending on the type of ISA – see chapter 5, section 12.1.

Although there is no tax relief on contributions made into an ISA, the growth within it is tax-free and income can be withdrawn tax-free.

Therefore, by attaching the ISA wrapper to investment vehicles, the potential for income tax and CGT liability for investors can be removed.

5.1.9 Child Trust Funds (CTFs)

	Income Tax	Capital Gains Tax
Tax situation within the product	Tax-free	Exempt
Tax situation for the investor	Tax-free	Exempt
New CTF accounts were stopped in 2011 and replaced with JISAs. CTFs are exempt from the rule that states a parent is taxable on a child's investment income of more than £100 if the capital came from the parent. CTFs can be transferred to JISAs, and the allowance is the same as that for JISAs. The first CTFs reached maturity in 2020, when holders started to turn 18, and the last will mature in 2029. CTFs are covered in more detail in section 12.1 of chapter 5.		

5.1.10 Derivatives (Futures and Options)

	Income Tax	Capital Gains Tax
Tax situation within the product	No income produced	N/A
Tax situation for the investor	No income produced	Gains above the annual allowance when the contract is closed out are subject to CGT; losses are allowable
In very rare circumstances, transactions may be treated by HMRC as a trading activity and, therefore, may be liable to income tax. If a tax avoidance scheme uses futures or options to produce a return that is effectively guaranteed, the profit is subject to income tax under the Income Tax (Trading and Other Income) Act (ITTOIA) 2005.		

5.1.11 Enterprise Investment Schemes (EISs)

	Income Tax	Capital Gains Tax
Tax situation within the product	Tax-free	N/A
Tax situation for the investor	Dividends, paid gross and taxable; DA is available	CGT free as long as shares are held for at least three years; CGT deferral relief is possible (see section 4.3.4 for details)
Rate of tax payable	• BRTP 8.75% • HRTP 33.75% • ARTP 39.35%	No CGT if held for at least three years. Otherwise: • BRTP 18% • HRTP 24% • ARTP 24%
Investment into an EIS receives tax relief at 30% up to a maximum contribution of £2 million per tax year, if at least £1 million of this is invested in knowledge-intensive companies (KICs). This relief is given as a tax reducer. Income tax relief is withdrawn if shares are disposed of within three years (except to a spouse or civil partner, and the death of the investor also does not count). It is possible to carry back investments to a previous tax year, to receive tax relief in that previous year (as long as the overall maximum limit is not exceeded) – see chapter 5, section 13.2.		

5.1.12 Seed Enterprise Investment Schemes (SEISs)

	Income Tax	Capital Gains Tax
Tax situation within the product	Tax-free	N/A
Tax situation for the investor	Dividends, paid gross and taxable; DA is available	CGT free as long as shares are held for three years; CGT deferral relief is possible (see section 4.3.4 of this chapter for details)
Rate of tax payable	• BRTP 8.75% • HRTP 33.75% • ARTP 39.35%	No CGT if held for at least three years. Otherwise: • BRTP 18% • HRTP 24% • ARTP 24%
Investment into an SEIS receives tax relief at 50% up to a maximum contribution of £200,000 per tax year. This relief is given as a tax reducer. Income tax relief is withdrawn if shares are disposed of within three years (except to a spouse or civil partner, and the death of the investor also does not count) – see chapter 5, section 13.3.		

5.1.13 Venture Capital Trusts (VCTs)

	Income Tax	Capital Gains Tax
Tax situation within the product	Tax-free	Exempt
Tax situation for the investor	Tax-free	Tax- free with no minimum holding period
Rate of tax payable	N/A	N/A
Investments into a VCT receive tax relief at 30%, up to a maximum investment limit of £200,000 per tax year. This relief is given as a tax reducer. Income tax relief is withdrawn if shares are disposed of within five years (except to a spouse/civil partner, and the death of the investor also does not count) – see chapter 5, section 13.4.		

5.1.14 Pensions

	Income Tax	Capital Gains Tax
Tax situation within the product	Tax-free	Exempt
Tax situation for the investor	Up to 25% of the pension pot can be withdrawn as a one-off tax-free lump sum; any income paid out from the remaining 75% is liable to income tax at the individual's highest marginal rate	Exempt
Rate of tax payable	• BRTP 20% • HRTP 40% • ARTP 45%	N/A
Contributions may qualify for tax relief subject to limits, rules and the individual's personal circumstances. Higher rate tax relief is available by extending an individual's basic rate band by the gross contribution (see section 3.1.1 of this chapter).		

5.1.15 Qualifying Life Assurance Products

	Income Tax	Capital Gains Tax
Tax situation within the product	Income tax paid within the fund (deemed to be equivalent to basic rate tax when combined with CGT)	CGT paid within the fund (deemed to be equivalent to basic rate tax when combined with income tax)
For most life assurance companies, the internal taxation is corporation tax which, in reality, is usually lower than the 20% that is deemed to have been paid.		
Tax situation for the investor	• Non-taxpayer cannot reclaim • BRTP, HRTP and ARTP have no further liability	Exempt when in the hands of the original owner
There are several rules that check to see whether a life assurance plan is 'qualifying' or not. The most basic of these rules is that contributions must be paid at least annually, which rules out single premium life assurance products.		

5.1.16 Non-Qualifying Life Assurance Products

	Income Tax	Capital Gains Tax
Tax situation within the product	Income tax paid within the fund (deemed to be equivalent to basic rate tax when combined with CGT)	CGT paid within the fund (deemed to be equivalent to basic rate tax when combined with income tax)
For most life assurance companies, the internal taxation is corporation tax which, in reality, is usually lower than the 20% that is deemed to have been paid.		
Tax situation for the investor	• Non-taxpayer cannot reclaim • BRTP has no further liability • HRTP has a further liability of 20% of the chargeable gain following a chargeable event • ARTP has a further liability of 25% of the chargeable gain	Exempt when in the hands of the original owner

An investor is allowed to take annual payments of up to 5% of the original investment with no immediate liability to income tax, regardless of their tax status. This can be done for a maximum of 20 years (ie, effectively, the investor is having their capital returned in chunks). However, the withdrawals do not have to be consistent as the allowance is cumulative, meaning an investor may be able to withdraw a lot more than 5% of the original investment if they have not taken any previous withdrawals.

If an investor takes more than the 5% allowance, there may be a personal income tax liability if the gain, when added to their other income for the year, makes them a higher rate taxpayer (remember that 'chargeable gains' is the last item to be taxed).

When an investor cashes in their investment, a calculation is made to determine the chargeable gain and see if there is a further liability for the investor. In both of these situations, an investor who is still in the basic rate band can use 'top slicing' to help them remain in that band and create no further liability. Top slicing is of no use to an investor who is already a higher rate taxpayer before the chargeable gain is added to their income.

Any gain that has not been top sliced will be added to an investor's income at the end of the term, which will then be tested against the £100,000 threshold for income tax. This could result in the personal allowance being reduced (by £2 for every £1 of income above this threshold) or, if high enough, lost altogether – see section 3.3 of this chapter. Forward planning for this is therefore important.

A simple comparison example of this process is given below.

Top Slicing Example

Matt and Ben are twins. Matt earns £33,000 a year after the deduction of his personal allowance, whereas Ben earns £37,000 a year after the deduction of his personal allowance. They both took out investment bonds eight and a half years ago, each investing £100,000.

They have both been taking 5% of this original investment at the start of each year as they have been told there will be no tax to pay on it immediately. The bonds are now both worth £67,000 and they have decided to encash them.

Matt	Ben
Cash-in value £67,000 Add 5% withdrawals of 9 x £5,000 £45,000 Less original investment (£100,000) **Chargeable gain** **£12,000** The gain has been made over eight full years and so can be 'sliced' by eight: £12,000 ÷ 8 = £1,500 per slice. This slice is added to Matt's taxable income of £33,000, making a total income for the year of £34,500. This is within the basic rate band for 2025–26 of £37,700, so the full gain is taxed at the basic rate and Matt has no further liability. Since Matt is a basic rate taxpayer after including the full gain, he qualifies for the personal savings allowance (PSA). However, because no part of the gain is pushed into the higher-rate band, there is no further tax liability on the bond gain, even without relying on the PSA.	Cash-in value £67,000 Add 5% withdrawals of 9 x £5,000 £45,000 Less original investment (£100,000) **Chargeable gain £12,000** The gain has been made over eight full years and so can be 'sliced' by eight: £12,000 ÷ 8 = £1,500 per slice. This is added to Ben's taxable income of £37,000, making a total income for the year of £38,500. The gain has been made over eight full years and so can be 'sliced' by eight: £12,000 ÷ 8 = £1,500 per slice. This is added to Ben's taxable income of £37,000, making a total income for the year of £38,500. This is £800 above the basic rate band for 2025–26 of £37,700, so this amount is taxed at an additional 20%: £800 x 20% = £160. We then need to multiply this back up by the number of full years the bond was in force for: £160 x 8 = £1,280. Ben will have an additional tax liability of £1,280 following the encashment of his bond.This falls above the basic rate band of £37,700, so the excess amount (£800) will be taxed at the higher rate of 40%. Therefore, Ben wouldwill have an additional charge of £320. However, using his PSA of £1000, he also will have no further tax liability.

5.2 Overseas Investments

Learning Outcome

2.4.2 Evaluate the suitability of offshore investments for UK-domiciled individuals

For UK investors, the main attraction of available offshore bonds (of which there are many) is that they are usually established in low-tax countries, so the investment should roll up more or less free of tax; this will depend on the location of the bond and, in turn, the local tax rules that apply. This is known as 'gross roll-up'. However, this fact alone does not mean that an offshore product is automatically better than an onshore product and an investment should never be made for tax purposes only.

5.2.1 Offshore Sterling Deposit Accounts

These are generally situated in tax havens such as the Channel Islands or the Isle of Man, among others. As we said in section 2 of this chapter, UK resident and domiciled (or deemed domiciled) taxpayers are taxed on an arising basis; therefore, whether the interest earned is remitted or not, they are taxed at the same rate as on UK savings income: 20%, 40% or 45% respectively, depending on whether they are a basic, higher or additional rate taxpayer.

5.2.2 Offshore Life Policies

These are issued in countries such as Luxembourg, the Republic of Ireland, the Channel Islands and the Isle of Man, among others.

As all offshore policies issued after 17 November 1983 are deemed to be non-qualifying, the chargeable gain is fully assessed to tax at 20%, 40% or 45% respectively for 2025–26, depending on the individual's tax rate following a chargeable event. If the individual's total taxable income is £18,570 or less for 2025–26 (ie, £12,570 personal allowance + £1,000 savings allowance + £5,000 of the starting rate of savings at 0%), then no tax will be payable. Just as with onshore bonds, top slicing can be used to calculate the liability.

Briefly, this means that a UK chargeable gain can be reduced proportionately for the amount of time that an individual has been resident outside the UK.

Time apportionment relief is available for periods of residence outside of the UK, based on the percentage of time the investor was a non-UK resident during the term of the policy. However, this still means that the whole of the gain is chargeable if the policyholder was a UK resident for the whole of the policy term.

A quick comparison of onshore and offshore bonds for a higher rate taxpaying UK resident is, therefore:

Onshore		Offshore	
Gain in fund	£100,000	Gain in fund	£100,000
Less tax at 20% in the fund	(£20,000)	Investor's tax at 40%	(£40,000)
Net gain	£80,000	**Net gain**	**£60,000**
Investor's additional tax at 20%	(£16,000)		
Net gain	**£64,000**		

The investor hopes that the tax-efficient fund growth in the offshore bond will more than compensate for the difference in personal tax treatment.

5.2.3 Offshore Funds

Offshore funds operate in a similar way to offshore investment bonds as they are generally set up in territories where there is little or no tax, such as Luxembourg, the Republic of Ireland, the Channel Islands and the Isle of Man, among others. They may be suitable for certain investors, in particular those who are non-UK residents, as offshore income and gains are free of tax before they are remitted to UK investors.

The taxation of these vehicles is as follows:

- If there is a capital loss on disposal of the fund, then this loss is deductible from any other CGT gain as usual.
- Of key importance is whether an offshore fund is a reporting or non-reporting fund, as this impacts how it is taxed. We will now look at this in more detail. Note that it is possible for a reporting fund to become a non-reporting fund, and vice versa.

Note that offshore funds are complex and can have unexpected tax liabilities, so investors must always proceed with caution.

The UK government's taskforce aims to combat tax evasion and improve transparency in offshore funds. The UK is part of over 120 participating countries, giving them all access to a greater amount of tax accounts than they previously had. This was named the 'Automatic Exchange of Information' and is an ongoing agreement between countries. For the UK, the legislation means that in offshore funds, performance fees reduce investors' gain on disposal, rather than being deducted from the reported income (as they were previously).

For further information, see the HMRC website on offshore funds and reportable income[7].

7 HM Revenue & Customs, December 2016. Offshore funds: calculation of reportable income. Retrieved from https://www.gov.uk/government/publications/offshore-funds-calculation-of-reportable-income/offshore-funds-calculation-of-reportable-income (Accessed: October 2025)

Offshore Reporting Funds

Reporting funds are those that have been approved by the UK government, and they have certain obligations to HMRC and its investors (eg, they must prepare accounts in accordance with acceptable accounting policy and provide reports on their 'reportable income').

Dividends and interest from reporting funds are treated as gross income. Any excess above the dividend allowance (DA) or the personal savings allowance (PSA) respectively is taxed at the standard rates, depending on the recipient's tax bracket.

Gains from offshore reporting funds are subject to CGT, with the calculation based on standard CGT principles and with the investor being able to use the CGT allowance as normal. If a double taxation agreement (DTA) is in place, then this will need to be carefully considered, as the individual's liability to CGT could be reduced – see section 3.1.1 on DTAs.

Reporting funds are generally preferable for most UK investors due to CGT rates being more favourable than income tax rates. Also, non-taxpayers benefit from receiving the income.

Some offshore reporting funds may be held within an ISA, pension or other tax wrapper, and as such, they are not liable to income or CGT, nor need reporting by the individual investor.

HMRC publishes a list of funds with reporting status, which is available on their website[8].

Offshore Non-Reporting Funds

Non-reporting funds have not been approved, and do not have any obligations to HMRC, although they will still need to meet their normal obligations to its investors.

Like reporting funds, dividends received from offshore non-reporting funds are taxed as income. However, investors cannot use the DA to offset against those dividends, or the PSA against interest.

Any gains made on disposal are treated as income, meaning the CGT allowance cannot be applied to limit this tax liability, and is taxed as an offshore income gain (OIG). All income received from offshore funds are treated separately on the Self-Assessment form.

These rules do come with the following results:

- Investors in non-reporting funds may pay income tax on theoretical income which they have not yet received in practice. This is also known as a 'dry' or 'unfunded' tax charge.
- However, this income will grow in a low tax environment so the investment may grow faster.

Advisers need to make sure that these types of funds can be held by retail clients, given the rules under the Alternative Investment Fund Managers Directive (AIFMD) which covers funds such as **hedge funds**, private equity, real estate and commodities. Prior to the end of the UK's transition period with the EU, these funds needed to have a passport from a European regulatory authority at the very least, in order to be marketed in the UK, however, this no longer applies. Instead, cross-border marketing of AIFs is subject to varying rules between the UK and EU member states.

8 GOV.UK, December 2014 (last updated: October 2025). Approved offshore reporting funds. Retrieved from https://www.gov.uk/government/publications/offshore-funds-list-of-reporting-funds (Accessed: October 2025)

While the AIFMD is a piece of EU legislation, it has been implemented into UK law under the European Union (Withdrawal) Act 2018, with a few modifications made. For example, the functions of the European Commission (EC) and European Securities and Markets Authority (ESMA) have been transferred to HM Treasury and the FCA respectively, and marketing passports no longer apply in relation to the UK. It is possible that UK AIFMD and EU AIFMD will diverge in their approaches over time.

For further information on offshore non-reporting funds, see the HMRC website[9].

Excess Reportable Income (ERI)

ERI is profit from a non-reporting fund that is not distributed to investors, either as dividends or interest. Even though it has not been distributed, it must still be reported and treated as though it had been distributed to investors. The offshore fund manager will inform the investors of the ERI, which is usually six months after the end of the fund's reporting period.

As already mentioned, the gain on the disposal of an offshore non-reporting fund is reported as income.

It is worth reiterating that the tax treatment of offshore funds is a complex area fraught with anti-avoidance taxation provisions, so it is always prudent to consult with a tax expert before investing.

5.2.4 Global Regulations and Standards

Generally, worldwide, it is not illegal for investors to put their money outside their home country; but hiding it is, and civil penalties and criminal sanctions can be severe.

Two policy tools for combating tax evasion through offshore funds are the Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standards (CRS).

Foreign Account Tax Compliance Act (FATCA)

FATCA is a piece of US legislation designed to reduce tax evasion by US citizens and US tax resident individuals, with respect to income from financial assets held outside the US, by inducing foreign financial institutions (FFIs) to report US owners to the US Internal Revenue Service (IRS). Whether or not the motive was protectionism, the Act has made it increasingly difficult for non-US registered fund providers to market funds into the US.

While FACTA is a US law, it does have implications for individuals and financial institutions in other countries (including the UK), since all FFIs are required to report certain information about their US account holders to the US IRS.

Common Reporting Standards (CRS)

CRS, the idea of which was based on FATCA, is a global standard for the automatic exchange of financial account and tax information between governments around the world, in the fight against tax evasion. The CRS was developed by the Organisation for Economic Co-operation and Development (OECD) at the request of the Group of Eight (G8) and the Group of Twenty (G20). It requires authorities in CRS-participating jurisdictions to obtain information from their financial institutions and automatically exchange that information with other CRS-participating jurisdictions.

9 HMRC, July 2019 (last updated: September 2025). Investment Funds Manual. Retrieved from https://www.gov.uk/hmrc-internal-manuals/investment-funds/ifm12300 (Accessed: October 2025)

Over 120 countries have committed to comply with the CRS including the UK, the EU, China, Japan, Saudi Arabia, Brazil, Mexico, Australia and New Zealand. While the US is on the exclusions list, as mentioned above, FATCA legislation already exists as a mechanism for identifying assets held offshore by US citizens and US tax-resident individuals. For this reason, the CRS is often informally referred to as GATCA (Global Account Tax Compliance Act), or the global version of FATCA.

6. Inheritance Tax (IHT)

Learning Outcome

2.3.1 Understand the liability to IHT, and the effects on IHT liability of chargeable lifetime transfers (CLTs) and transfers on death

2.3.2 Understand IHT exemptions and reliefs, excluded assets, potentially exempt transfers (PETs) and gifts with reservation

6.1 Definition

IHT is often thought of as a tax which is levied when someone dies, but in fact this is something of a misnomer, as IHT can, in fact, apply when assets are transferred in a variety of ways; for example, on death and by gifts. If this were not the case, people would avoid it simply by giving away their assets before they died. That said, the gifting of assets to charities and the like are exempt.

More accurately, IHT is primarily a tax on wealth. Usually, this means wealth that is left to someone else on its owner's death, but it also applies to gifts up to seven years before death and to certain lifetime transfers of wealth.

It is the amount that the taxpayer has transferred that is taxed. You can also see this as the amount by which they are worse off. Therefore, if a taxpayer has to pay IHT on a lifetime gift, they will be worse off by the amount of the gift plus the tax; this must be taken into account when calculating the cost of making this gift.

The individual who makes the transfer is known as the donor (or transferor). The individual who receives the transfer is known as the donee (or transferee).

Going back to a topic we covered in section 2 of this chapter, the concept of domicile is crucial for IHT liabilities.



Thinking back, how does an individual's domicile status impact on their IHT liability?

In the UK, donors who are domiciled or deemed domiciled, are subject to IHT on their worldwide property. Donors who are non-UK domiciled are subject to IHT on their UK property only.

6.2 Calculation of the Chargeable Estate and IHT Rates

The chargeable estate is the value of all chargeable assets owned by the individual at the time of death, valued at that date (probate value), minus all liabilities of the individual, minus any exempt legacies, transfers and other allowances, such as the **nil rate band (NRB)** of £325,000 for 2025–26 (which is frozen at this level until the 2029–30 tax year). Therefore, if the value of the estate is below £325,000, there is generally no IHT to be paid.

In 2017, an additional NRB, called the **residence nil rate band (RNRB)**, was introduced. This means that if an individual:

- dies on or after 6 April 2017
- is an owner (or shares the ownership) of a home so that it is included in their estate, and
- passes the home (or their share of the home) to their children, grandchildren or other direct descendant.

then their estate will receive this additional NRB for 2025–26 of £175,000 (which is also frozen until the 2029–30 tax year). However, if the value of the estate is more than £2 million, the RNRB is reduced by £1 for every £2 that the value is over this threshold.

Any unused NRB and RNRB can be transferred to the deceased's spouse or civil partner (see section 6.5).

If the estate does not qualify for the full RNRB, it could benefit from a downsizing addition where the deceased downsized or ceased to own a home, and the former home would have qualified for the RNRB. However, in this event, they need to ensure that the equivalent value is left to a child, grandchild or other lineal descendent.

Notably, most (but not all) assets are included in the estate. The most common exemptions are pensions (in most circumstances), assets transferred to a spouse/civil partner, assets held in trust, and certain types of gifts and transfers made during the individual's lifetime (eg, those made to charities and bona fide political parties). HMRC may also exclude certain assets which they refer to as 'excluded property' from their assessment. However, from April 2027, most unused pension benefits and unclaimed death benefits will begin to be included in the estate for purposes of IHT.

Inheritance Tax	
Nil rate band (NRB)	£325,000
Residence nil rate band (RNRB)	£175,000
Taper threshold for RNRB	£2 million

Source: GOV.UK[10]

10 GOV.UK, August 2025. Inheritance Tax thresholds and interest rates – from 18 March 1986 to 5 April 2030. Retrieved from https://www.gov.uk/government/publications/rates-and-allowances-inheritance-tax-thresholds-and-interest-rates/inheritance-tax-thresholds-and-interest-rates (Accessed: October 2025)

There are three rates of IHT, which are linked to the prevailing NRB:

- **£325,000 and below**: 0% (for any cumulative value of transfers)
- **Over £325,000**: 20% (for CLTs, such as into some types of trust)
- **Over £325,000**: 40% (for transfers on or within seven years prior to death, subject to taper relief – see section 6.3.2, below).

If at least 10% of the deceased's estate is left to charity, a reduced rate of 36% applies on death.

6.3 Types of Transfer

There are four types of transfer that a UK donor can make.



Before looking at the answers below, what do you think these are?

The types of transfer are:

- exempt
- **potentially exempt transfers (PETs)**
- CLTs, and
- transfers on death.

We will go on to look at each of these in more detail.

6.3.1 Exempt Transfers

These are simply transfers from one person to another that will not fall into the IHT taxation regime.

Various exemptions are available:

- Some exemptions apply only to lifetime transfers (including PETs which become chargeable on death within seven years).
- Other exemptions apply to both lifetime transfers and property passing on death.

The following table lists the main exempt transfers, along with relevant details and whether the transfer is exempt if made during the lifetime of the donor only, or during their lifetime and on their death.

Type	Monetary amount (if applicable)	Relevant details
Inter-spouse and inter-civil partner transfers	• Unlimited if the donee is UK domiciled • If the donee is non-UK domiciled, then a tax charge may arise, subject to the IHT limit.	• This exemption can be applied both on gifts made during lifetime and upon death. • Partners have to be married or in a civil partnership and not 'common law'. • Transfers are exempt, even if the spouses/civil partners no longer live with each other (different to CGT rules).
Annual exemption	• £3,000 per tax year	• This exemption can be applied both on gifts made during lifetime and upon death. • If the whole £3,000 is not used in a tax year, the balance can be carried forward for one year only.
Small gifts	• Up to £250 to any person in any one tax year	• Lifetime exemption only. • It can be used as many times as the donor wants, providing it is to different donees. • It **cannot** be used in conjunction with the annual exemption as part of a larger gift.
Normal expenditure out of income (ie, expenditure on someone else)	• No limit	• Lifetime exemption only. • After making the gift, the donor should be able to maintain their ordinary standard of living. • The expenditure must be regular or, if the first in a series, clear evidence of an intention must be ongoing (eg, paying rent or into a pension for their children). • Payments must be made from natural income.
Gifts on marriage or civil partnership	• £5,000 to each child • £2,500 to each grandchild or great grandchild • £1,000 to any other person.	• Lifetime exemption only. • The gift will only be exempt if it is made on or shortly before the marriage or registration of the civil partnership takes place. • Those made after the date of the wedding or civil ceremony do not count. • This exemption can be used in conjunction with other exemptions, except the small gifts exemption.

Type	Monetary amount (if applicable)	Relevant details
Gifts for education and maintenance	• 'Reasonable provision'	• Lifetime exemption only. • Payments are exempt until the child's 18th birthday, or on ending full-time education (if later). • Children born outside of marriage/civil partnership, step and adopted children are included. • Payments must be made out of regular income and not capital.
Gifts to charities	• Leaving gifts to charity in a will. • The donation will either be taken off the value of the estate before IHT is calculated, or reduce the IHT rate, if 10% or more of the estate is left to charity.	• This exemption can be applied both during lifetime and on death. • For this exemption to apply, the charity must be recognised as such by HMRC.
Gifts to qualifying political parties	• Unlimited	• This exemption can be applied on gifts made both during lifetime and on death. • For this exemption to apply, the political party must have had at least one MP (or two in the House of Commons) and 150,000 votes at the last election before the gift was made.
Gifts for the national benefit	• Unlimited	• This exemption can be applied on gifts made during lifetime and on death. • This includes gifts to museums, libraries, universities, the National Trust and housing associations.
Death on active service of armed forces or emergency services personnel	• Entire estate on death. • Any potentially exempt transfers (PETs), as well as any additional tax that arises on immediately chargeable transfers, made within seven years of death.	• The estates of members of the armed forces and emergency services, and humanitarian aid workers, are tax-free, if their death is caused or hastened by injury while on active service.

Notably, there are circumstances when an exempt transfer will no longer be exempt. While this falls outside the scope of this module, candidates who wish to find out further information can visit https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm11092.

6.3.2 Potentially Exempt Transfers (PETs)

A potentially exempt transfer (PET) is a lifetime transfer or gift by a donor to:

- another individual
- a bare trust, or
- a disabled trust.

However, transfers into interest in possession (IIP) and accumulation & maintenance (A&M) trusts are treated as CLTs (see section 6.3.3). It is important to note that these rules only apply to individuals (ie, human beings, and, therefore, not companies). The different types of trusts are covered in more detail in chapter 4, section 5.

No tax is charged at the date of the PET, and the gift does not even have to be reported to HMRC. If the donor survives seven years, the transfer becomes fully exempt and is excluded from any IHT calculation.

7-Year Rule

If the donor dies within seven years of making the transfer, these are called 'failed' PETs. The tax due can be tapered down based on how long the donor lived after making the transfer. The tapering table shown below is based on the tax due, not the value of the PET itself. The donee could be liable to pay any tax due, depending on the circumstances of the overall estate. Any gift made within the NRB will be automatically exempt from any potential tax charges.

The table below explains:

Years between transfer & death	Percentage of taper relief applied	Effective rate of tax on gift
Up to 3	0%	40%
More than 3, but not more than 4	20%	32%
More than 4, but not more than 5	40%	24%
More than 5, but not more than 6	60%	16%
More than 6, but not more than 7	80%	8%
More than 7	100%	0%

'Percentage of taper relief applied' shows the amount of relief that is applicable to IHT on gifts with a combined worth over the NRB, within seven years of the donor's death. For example, if a donor dies within three years of making a gift, no taper relief (ie, 0%) is available. If a donor dies between three and four years after making a gift, then a 20% taper relief is available.

'Effective rate of tax on gift' shows the effective rate of IHT that must be applied to the gift. Following on from our above example, if a donor dies within three years of making a gift (so no taper relief is available), then IHT will be charged at the full rate of 40%. If a donor dies between three and four years

after making a gift (ie, 20% taper relief is available), then the 40% charge to IHT may be reduced by 20%, giving an effective rate of tax of 32% (ie, 40% – (20% x 40%)), and so forth. Generally, for gifts made more than seven years before the donor died, the gift is exempt from IHT; however, in exceptional circumstances, the '14-year rule' could apply (see below).

Example

George gifted £100,000 to his daughter, Zoe, in 2019, to help her buy her first house. He did not make any other gifts during his lifetime. He died in June 2026, leaving an estate of £300,000 which is split equally between George's five nephews. What is Zoe's IHT liability, if any, on the amount she received and the effect of this gift on the estate?

The gift of £100,000 will be added back into the estate, to give a total of £400,000. Zoe herself, will not be personally liable for any tax due since her gift is dealt with first and it is within the NRB of £325,000.

This leaves a new NRB of £225,000 (ie, £325,000 – £100,000).

The estate will, therefore, pay 40% of IHT on £75,000 (ie, £300,000 – £225,000), giving tax due by George's estate of £30,000.

It is important to note from this example that the value is taken from the actual gift made at the date of transfer; therefore, £100,000 is used. This point is made since the value of Zoe's property may have increased or decreased since she inherited the money.

It is possible to use the value of transfers as the date of death, if the asset has fallen since the date of the original transfer. This rule does not apply to chattels deemed to be 'wasting assets' (ie, having a useful life of 50 years or less) nor would it apply here since George transferred cash, not a property. The fact that Zoe bought a property with cash is immaterial to this issue.

14-Year Rule

As we have seen, the NRB is reduced by all chargeable transfers, including PETs made within seven years before death. Gifts made over seven years ago can be ignored; hence, in these circumstances, the 14-year rule does not apply.

However, if an individual made a CLT (see section 6.3.3), followed by a PET less than seven years later (eg, a gift to an individual), and finally dies within seven years of making the PET, then both the CLT and subsequent PET fall back into the estate for IHT purposes.

This occurs because the NRB is applied chronologically to the gifts. Until the first seven-year period has expired, then the donor's NRB has not been 'reset' and, therefore, it is not available to offset against the second gift (ie, the failed PET).

It is for this reason that careful estate planning is crucial, to ensure efficient use of available exemptions and minimise potential tax liabilities.

6.3.3 Chargeable Lifetime Transfers (CLTs)

These are transfers that are not exempt or potentially exempt. The most common transfers are lifetime gifts to trusts, other than to bare trusts and trusts for a disabled person (which we have already established are PETs) and transfers to a company.

Tax on CLTs is payable at 20% on the excess above the NRB at the time of the transfer, with a further 20% payable on death. There will be no further tax to pay if the donor then survives seven years. If they do not, additional tax will be due, based on the higher death rate, although any tax already paid will be offset, and the same tapering table used for PETs can be utilised.

IHT is charged on CLTs upon each ten-year anniversary of a trust (although certain types of trust are exempt from the ten-year charge). The calculation can be complicated but, generally, IHT is charged at a rate of 6% on the net value of any relevant property in the trust above the NRB, on the day before that anniversary.

Example

A trust holding assets valued at £500,000 will pay 6% on £175,000 (ie, £500,000 – £325,000), or £10,500.

This works out as an overall tax rate of 2.1% (ie, £10,500 / £500,000).

The rules that apply to PETs about the value of the transfer being based on the date of transfer, and not the date of death, also apply to CLTs.

In addition, the 'reduction in value' rule also applies; in other words, the value of the CLTs can be reduced by applying the NRB. Any amount exceeding the NRB may be chargeable to IHT.

6.3.4 Transfers on Death

IHT is also chargeable on the death of an individual, with the tax chargeable as if the deceased had made a transfer of value equal to the value of their estate immediately before death. The taxable estate is the individual's assets, less their liabilities. These assets might include the value of life policies payable on the death of the individual.

For non-UK domiciled individuals, certain types of assets that are excluded. For example:

- assets situated outside the UK (eg, foreign currency accounts and overseas pensions), and
- authorised unit trusts (AUTs) and OEIC holdings (if the beneficial owner is a non-UK domicile).

For anyone living or domiciled outside the UK, this is a complex area. For example, they may be liable to IHT in more than one jurisdiction, so double taxation agreements (DTAs) need to be carefully considered (see section 3.1.1). They should, therefore, seek professional advice to minimise any liability to IHT.

6.3.5 Gifts with Reservation

A **gift with reservation** is a gift which is not fully given away by the donor, so the donee either receives the gift with conditions attached, or the donor retains some benefit. Examples where this occurs include gifting the deeds of a house but continuing to live there without paying a market rent, or gifting the ownership of a work of art but still having the work in the donor's property.

The consequences of making a gift with reservation are not very tax efficient and may, in fact, result in a double IHT charge. The gift is treated as a transfer of value at the time it is made, which may be immediately chargeable or become chargeable on the death of the donor within seven years. However, the gift never actually leaves the donor's estate and so, on their death, it is added back into the estate on the basis of its value at death.

An extension of this concept is that of pre-owned assets tax (POAT). Also known as the pre-owned assets charge (POAC), this is an income tax charge on the benefit individuals receive by having low-cost enjoyment or use of certain assets they used to own, or free/low-cost enjoyment of certain assets for which they provided the funds to purchase.

By paying the POAT, the individual avoids possible IHT on the transaction. It is, therefore, sometimes a tough judgement call to decide whether to elect for the asset involved to be subject to IHT on death by opting out of POAT, or to remain paying the POAT income tax charge.

6.4 Cumulation Principle

This is a crucial aspect that applies to the calculation of IHT, whether chargeable during a donor's lifetime or on death. As we have already seen, transfers that are potentially exempt remain in the IHT calculation process for seven years. If the cumulative value of all PETs exceeds the NRB on the donor's death, IHT will be due on the excess. This is when the tapering relief comes into play, although it should be remembered that PETs are set against the NRB in chronological order so, conceivably, the PET that leads to the NRB being exceeded will be the most recent one and, therefore, the taper relief may be limited.

CLTs over a seven-year period are added together, with tax immediately payable once the NRB is exceeded. A transfer drops out of the cumulation once it is more than seven years old. However, even transfers that have dropped out may still be relevant for a PET made within seven years of the original transfer. This is one of the most complex areas applying to IHT and means that it is possible that CLTs made up to 14 years before a donor's death may be included in the cumulation process (see section 6.3.2 on the 14-year rule). There would not be any tax to pay on these old CLTs themselves, but by being included in the cumulation, it is more likely the estate will fall (partly or wholly) above the NRB and be liable to tax.

6.5 Transfer of the Unused Nil Rate Band (NRB)

The NRB can be extended for couples who were married or in a civil partnership at the time of the first death. The change was based on the fact that the NRB on the first death was often wasted because all or most of the property was transferred to the surviving spouse/civil partner. These transfers would fall under the inter-spouse and inter-civil partner exemption anyway.

When the second death occurs, the percentage of any unused prevailing NRB can be carried forward and applied to the NRB at the time of the second death. This amount is then added to the standard prevailing NRB at the time of the second death.

Any unused part of the RNRB can also be transferred between spouses and civil partners, where the first death occurs after 5 April 2017.

It is probably easiest to see how this works via an example.

Example

Laurence and Anne were married in 1961. Laurence died in January 2002 when the NRB was £242,000. He left £60,500 to his son, and the remaining estate of £400,000 to Anne. Anne died in June 2026, when the NRB was £325,000.

At the time of Laurence's death, 25% of the prevailing NRB of £242,000 was used by non-exempt transfers:

$$\left(£60{,}500 \;/\; £242{,}000\right) \times 100\% = 25\%$$

This means that 75% of the NRB was unused, as the remainder of the estate was passed under the inter-spouse exemption. Anne therefore 'inherited' this unused percentage.

As a result, on her death in 2024, her NRB was increased accordingly:

$$£325{,}000 \times 75\% = £243{,}750$$

This is added to Anne's NRB to make the total NRB on her death of £568,750 (ie, £325,000 + £243,750).

This increase applies even if the surviving spouse (Anne in this case) had remarried by the time of her death. However, there is an upper limit of 100% by which the NRB can be increased, so the NRB can never be more than double that prevailing at the date of the second death.

6.6 IHT Reliefs

Just as we looked at reliefs that can apply to CGT, we will now look at the main reliefs that can apply to IHT: quick succession relief (QSR), business relief (BR), and agricultural property relief (APR).

6.6.1 Quick Succession Relief (QSR)

QSR is available where property from the deceased's estate has passed to another by a CLT in the five years before the second death. Therefore, the property has been valued for IHT purposes and QSR is an attempt to limit the same property being fully chargeable twice in quick succession.

The relief is given by reducing the tax payable on the deceased's estate, by referring to the amount of tax payable on the earlier CLT, the benefit that passed to the deceased on that transfer, and the period between the transfer and death.

The rates for relief are as follows:

Years after death	Rate of relief
Up to one	100%
More than one, but not more than two	80%
More than two, but not more than three	60%
More than three, but not more than four	40%
More than four, but not more than five	20%
More than five	0%

Example

Jo dies, leaving her estate of £400,000 to Alison, and IHT of £30,000 was paid. As Alison dies 2.5 years later, Alison's estate increases by £370,000 (ie, £400,000 - £30,000). The amount of tax eligible for tax relief is calculated as follows:

The gross estate less tax = £400,000 – £30,000 = £370,000

Divided by the gross estate = £370,000 / £400,000 = 0.925

Multiplied by the tax paid = 0.925 x £30,000 = £27,750

As Alison dies 2.5 years later, a 60% taper relief is available, so £27,750 x 60% = £16,650

The final IHT charge for Alison's estate will, therefore, decrease by £16,650.

6.6.2 Business Relief (BR)

Previously called business property relief (BPR), BR is a relief for transfers of business property, designed to try to ensure that family businesses (for example) are not crippled by having to pay an IHT bill.

BR is claimed at two rates. The relief is 100% for:

- interests in unincorporated businesses, such as sole traders or partnerships, and
- shareholdings of any size in unquoted and **AIM companies (formerly known as the Alternative Investment Market)**.

The relief is 50% for:

- shares controlling more than 50% of the voting rights in a fully-listed company, and
- land, buildings, plants or machinery used wholly or mainly for the purpose of a business controlled by the donor (or if the donor was a partner).

BR is only available if the donor owned the property for at least two years before death.

There are some assets that do not qualify for BR. For example, if the business is a not-for-profit (NPO) organisation, it is being sold/wound up (subject to certain conditions), or it consists wholly (or mainly) of dealing in securities, stocks or shares, land or buildings, or making or holding investments.

BR cannot be claimed for relief on assets that:

- also qualify for APR (see below)
- were not used mainly for business in the two years before it was transferred, either as a gift or as part of a will
- are not needed for future use in the business, or
- are subject to a binding contract for sale at the time of the transfer.

For example, if a mechanic owns a building consisting of a large workshop and five unused offices above it, then the BR will only be available on the workshop and not the offices.

6.6.3 Agricultural Property Relief (APR)

This relief is available for the transfer, during lifetime or death, of agricultural property in the UK, Channel Islands, Isle of Man or European Economic Area (EEA). Agricultural property includes agricultural land, growing crops and farm buildings, but not animals or equipment. (A way to think of this is if you could pick up the land and turn it over, anything that does not fall, qualifies!)

APR (not to be confused with annual percentage rate, which refers to the rate of interest charged each year to borrowers on loans, such as mortgages and credit cards) is also claimed at two rates. The relief is 100% for:

- owner-occupied farms
- land that is let on a grazing licence, and
- property that is let on a tenancy beginning on or after 1 September 1995.

The relief is 50% for interests of landlords in most other let farmland.

The property must have been occupied by the donor for agricultural purposes for the previous two years, or have been owned by the donor for seven years and occupied by someone else for agricultural purposes for that time. As with BR, the relief cannot apply to property that is subject to a binding contract for sale.

If both APR and BR are available, APR is given first. Often, assets in a farming business will qualify for BR even if they did not qualify for APR.

In the Budget of October 2024, the UK government stated that they will be reforming BR and APR from April 2026. In the meantime, the current rates of relief will continue: the first £1 million of combined business and agricultural assets will continue to attract no IHT, and 50% relief (at an effective rate of 20%) for assets over £1 million. Further, for shares in unquoted and AIM companies, the rate of relief will be 50% (not 100%).

6.7 IHT Calculation

Learning Outcome

2.3.4 Be able to calculate IHT liability based on a straightforward example

2.3.7 Apply the rules to working examples

There are four steps to the IHT calculation.



Before looking at the steps listed below, what do you think they involve and what is the correct order for calculating a possible IHT liability?

1	Identify the assets and liabilities in the IHT estate.
2	Work out the net value of the estate.
3	Take account of any applicable exemptions and reliefs.
4	Calculate the IHT on the resulting chargeable amount, taking account of the appropriate rate.

We will look in more detail at each step, and incorporate the following case study as we work our way through each step.

Case Study

Sheona is unmarried and has assets worth £550,000, which includes her home valued at £400,000. The outstanding mortgage on the home is £50,000. In addition, Sheona has a bank loan of £5,000.

Sheona leaves her home to her adopted son. In addition to her estate, she gifted £150,000 to her niece eight years before her death, and a further £150,000 to her nephew three years before her death.

6.7.1 Step 1: Identify the Assets and Liabilities in the IHT Estate

Case Study

The total value of the assets in Sheona's estate (ie, the gross value) is £550,000.

There are liabilities of £50,000 for the mortgage and £5,000 for the bank loan (ie, £55,000 total).

In most cases, mortgages are deducted from the property's value, reducing the overall estate value for IHT purposes. Note, though, that there may be specific circumstances when the mortgage is not regarded as part of the estate – eg, if there are specific arrangements in place for repaying the mortgage that do not involve the estate. This can vary on a case-by-case basis.

In the event of the borrower's death, the lender has the right to demand the full amount of the mortgage to be repaid (although each lender will have their own policies and procedures in this regard). If this cost cannot be met by the estate or by life insurance policies, then the lender can ask for the property to be sold in order to repay the debt owed to them.

6.7.2 Step 2: Work Out the Net Value of the Estate

Case Study

The net value of Sheona's estate is £495,000 (ie, £550,000 – £55,000).

6.7.3 Step 3: Take Account of any Applicable Exemptions and Reliefs

Case Study

Sheona's estate can be reduced by the RNRB of £175,000, since she left her home to a direct descendant: her adopted son. The RNRB can only ever be deducted against the value of a home. After accounting for the value of the mortgage, the net value of the home is £350,000 (ie, £400,000 – £50,000). Applying the RNRB of £175,000 leaves £175,000 as the home's remaining value.

Sheona also has an NRB of £325,000, which will always first be applied to the main residence, where the RNRB does not eliminate the tax liability. It is then applied to the gifts before any remaining assets within the estate.

Thus, the remaining £175,000 on the main residence can be cleared completely by using the NRB of £325,000, which leaves a remaining NRB of £150,000 (ie, £325,000 – £175,000).

With regard to the gifts, the remaining NRB must be applied in the order of when the earliest gift was made:

- The gift to Sheona's niece was more than seven years ago, so this falls outside the estate.
- The gift that Sheona made to her nephew of £150,000 was made three years before her death, so this needs to be added back into the estate. The remaining £150,000 from the NRB can be deducted from this gift, so the value of the gift is fully covered and there will be no IHT liability.

There is no more IHT threshold available to reduce the estate down any further.

6.7.4 Step 4: Calculate the IHT on the Resulting Chargeable Amount

Case Study

The IHT liabilities are as follows:

Niece: Sheona gifted to her niece more than seven years ago, so there is no IHT liability on this gift.

Nephew: Sheona's nephew's gift is covered by the remaining NRB, so there is no IHT liability on this gift either.

Estate: The £150,000 left in Sheona's estate (ie, £550,000 less the £400,000 for her home) will be charged at the regular 40% IHT rate, and therefore is due to pay £60,000.

6.8 IHT Transactions

We mentioned at the start of this chapter that IHT is charged on certain transfers of property or value. A 'transfer of value' is a reduction in the donor's estate. Therefore, an interest-free loan that is repayable on demand or on death is not treated as a transfer of value. It should be noted that commercial transactions between family members or business partners are closely scrutinised to ensure they are truly commercial!

The 'loss to the estate' amount might not be the same as the actual value of a gift. An example commonly used, for some reason, is that of an individual owning two expensive vases. Together they may be worth £100,000, but individually they are only worth £20,000. If one vase is gifted away by a donor, the loss to the estate is not the £20,000 single value of the individual vase, but £80,000 as the estate is worth £80,000 less after the gift has been made.

6.8.1 Property Valuations

For the purposes of IHT, the value of any property is the price it might reasonably be expected to reach if sold in the open market at the time of the transfer.

Quoted Shares and Securities

The valuation of quoted shares and securities (including investment trusts) is relatively simple. The LSE's Daily Official List (DOL) is a publication that gives the closing bid and **offer prices** of all quoted securities. IHT valuations are made on the basis of the 'quarter up rule', taking the bid (lower) price plus a quarter of the difference between it and the offer price. Therefore, if the closing price for a particular day is 300–304p, the IHT valuation is 300 + (304 – 300) / 4 = 301p.

The other way of valuing securities is to use the marked **bargain** price. Each day, certain trades on the stock exchange will be marked, and the valuer may take the average of the highest and lowest marked bargains, ignoring bargains marked at special prices.

The rule for the valuation of quoted securities is, therefore, to take the lower of:

- the value on the quarter-up rule basis, and
- the average of the highest and lowest marked bargains for the day, ignoring those marked at special prices.

Valuations for transfers on death must be **cum-dividend** or cum-interest, including the value of the right to the next dividend or interest payment.

Unit Trusts

Units in authorised unit trusts are valued at the managers' **bid price** (the lower of the two published prices).

OEICs

As OEICs are companies, they follow most of the same rules as for companies and shares.

Unquoted Company Shares

There is no easily identifiable open market value for shares in an unquoted company. The shares valuation division of HMRC is the body with which the taxpayer must negotiate. If an agreement cannot be reached, the case may go to the special commissioners and the courts.

6.8.2 Interaction between IHT and CGT

Learning Outcome

2.3.5 Understand the relationship between the valuation of assets for CGT purposes, and valuation of assets for IHT-related chargeable lifetime and estate transfers

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There is considerable interaction between IHT and CGT.

A valuation for IHT is not always the same as a valuation for CGT, because for IHT it is the loss to the estate that is measured, whereas for CGT it is the asset that is valued. However, if an asset is valued for IHT on the death of an individual, the same value is used for CGT purposes. This is then treated as the beneficiary's acquisition cost.

For example, if an asset was originally purchased by the deceased for £10,000 and had a probate value of £15,000 (ie, the value of the asset at the date of death for probate purposes), then the cost assigned to the beneficiary's acquisition of that asset would be £15,000.

If a disposal attracts an immediate charge to IHT (eg, setting up a discretionary trust), CGT hold-over relief can generally be claimed as discussed earlier in section 4.3.5 of this chapter. If no hold-over relief is claimed, any IHT liability paid can be deducted when calculating the gain, providing the IHT was paid by the donor.

No CGT hold-over relief will be available for exempt or potentially exempt transfers.

6.9 Administration of Estates

Learning Outcome

2.3.3 Understand the rules governing the administration of estates, grant of probate and registration of probate

The IHT payable on the estate of a deceased person is the liability of the legal personal representatives. The actual tax is due six months after the end of the month in which death occurs. However, if the estate consists of property (or properties), then HMRC are usually willing to allow some reasonable leeway until the assets have been disposed of.

If the deceased had made a will, an executor would already be appointed in the will itself to administer the estate. If no will exists, then the deceased is said to have died intestate, and the executor becomes known as the administrators, who is usually a close friend or relative.

In some circumstances, the court may call on medical evidence to prove that the deceased had mental capacity at the time that any will was written. In a landmark case of Clitheroe v Bond [2020] WEHC 1185 (Ch), involving a bitter family dispute, the High Court ruled that a deceased's will was invalid (ie, they died intestate) on the basis that their mental capacity had been affected by a traumatic personal event shortly before they wrote their will, so they were unable to make decisions. This case, among others, demonstrates the complexities of assessments regarding mental capacity. It also highlights the importance for practitioners to assess whether the decisions that a client wishes to express in their will are rational, and perhaps to obtain a medical opinion, at that time, if there is any doubt that capacity could be challenged later.

When a client dies, all firms holding assets such as investments, or solicitors arranging the sale of a property, will need to see a grant of probate or letters of administration before they can accept instructions from the executors or administrators. These are legal documents that:

- **Grant of probate** – confirms the executors of a will (ie, the people responsible for carrying out the wishes contained in the will) have the authority to deal with the client's assets.
- **Letter of administration** – grants the holder the authority to represent and administer the client's estate where they have not left a will. There are strict rules about who can be an administrator.

While there is no legal time frame for applying for a grant of probate or letter of administration, much of the estate administration will not be possible until this has been registered with the asset holders; until then, the client's assets cannot be accessed or transferred to any of the beneficiaries. There are some exceptions – for example, for some small estates, grant of probate/letter of administration may not be necessary, although this will depend on the amount of assets held.

If assets were owned jointly as joint tenants, then they will pass automatically to the survivor(s), and regardless of any provisions that the deceased may have made in their will. Instructions should, therefore, be taken from the surviving holder(s). If property is held as tenants in common (where each person has a different ownership share in the property, as opposed to both people owning it fully or outright), then the deceased may give away their share of the assets as they wish.

Historically, personal representatives may well have been forced to take out a loan in order to pay the IHT, as they could not access the deceased's assets until the tax was paid. Nowadays, some banks and building societies accept instructions from personal representatives to pay the IHT by electronic transfer out of the deceased's accounts. It should be noted that this facility is not universal, so IHT loans are still used and remain relevant.

If the deceased individual has a will set up to divide the estate between an exempt beneficiary (such as a charity) and a non-exempt beneficiary, the estate is divided before the tax calculation so that the tax burden is on the non-exempt beneficiary.

7. Estate Planning

Learning Outcome

2.3.6 Understand the principles behind commonly used estate planning products such as discounted gift trusts and IHT portfolios

Estate planning (and tax planning in general) is an important element of providing investment advice, but it has been correctly said that the '*tax tail shouldn't wag the advice dog*'. Basically, tax is an important area of advice, but certainly not the only area.

With the NRB and RNRB frozen at £325,000 and £175,000 respectively until 2027–28, an increasing number of people are becoming caught in the IHT net, such that IHT planning is rising up people's agendas.

With this in mind, we will now consider some fairly simple estate planning strategies, conscious of the fact that each approach must be suitable for specific individual circumstances.

7.1 Nil Rate Band (NRB) and Residence Nil Rate Band (RNRB)

As any unused NRB can be carried forward by a spouse or civil partner, the large market in trusts that generated a similar benefit has diminished due to HMRC closing many of the tax loopholes, such as introducing CLTs and a ten-year charge for some trusts.

7.2 Lifetime Gifts

Most IHT planning focuses on reducing the value of an individual's estate by using lifetime gifts. Some of these gifts could be exempt, such as falling under the annual allowance limit, the small gifts limit or the gift limits on marriage or civil partnership. Even gifts that are not exempt may well become exempt when the donor survives seven years, so it is important to start the process early and when in good health.

Gifts can also be made on a regular basis and will be exempt if they come under the 'normal expenditure' rules. This can provide a good way to reduce an estate.

Not everyone is in the position to gift property away (or, even if they are in the position, they may not have the desire to do so), so IHT planning often revolves around finding a way to pay a potential IHT bill. The most common route is that of a joint life second death whole of life policy. It is crucial that this type of plan is written under trust to avoid the policy's benefit falling into the deceased's estate and actually making the IHT situation even worse!

For donees who have received a PET that falls above the NRB, a special decreasing term assurance plan known as a gift *inter vivos* policy can cover their potential liability.

For the potential recipients of an estate that is in danger of falling above the NRB due to a previously gifted PET, a seven-year level term assurance plan can be used to cover their potential liability. After seven years, the PET will fall out of the cumulation calculation and, therefore, the IHT liability on the estate should fall.

These are some of the more basic approaches taken to IHT planning – it can become a very complicated world with providers trying to utilise identified loopholes which, invariably, HMRC then endeavours to remove. As with many elements of financial services, it is a constantly changing area and will undoubtedly remain so in the future.

7.3 Discounted Gift Trust (DGT)

Simply, a DGT is an arrangement whereby an individual (settlor) can make a gift of cash or assets for IHT purposes, while providing the settlor with an income to meet their ongoing living requirements.

DGTs are set up as either a discretionary trust or a bare trust; this is alongside an investment in an investment bond (either onshore or offshore) or an insurance bond. The settlor makes a lifetime gift into the DGT which immediately reduces the value of their estate for IHT purposes.

To determine the value of the gift for IHT purposes, the settlor's entitlement is valued at the outset on an actuarial basis – in other words, it is based on their age, health and lifetime. The younger and healthier the settlor is, the higher the market value of the income stream as they are likely to live longer, hence the larger the discount and, in turn, the greater the potential IHT saving. If the settlor is older and in poor health, the market value and discount are low, thus the potential saving is lower.

The transfer of value for IHT purposes is the sum going into the trust (ie, the amount invested in the bond), reduced by the settlor's entitlement. This is where the concept of a 'discounted gift' comes from.

The settlor will no longer have access to the capital, although they are entitled to receive either an income for life, or a specified cash sum on specified dates (depending on how the trust is set up). However, once this has been set up, the level of income that the settlor receives from the trust cannot be altered. Their entitlement to income payments ceases upon their death, and the investment is then held exclusively for their nominated beneficiaries under the trust.

Example

In July 2025, Yvette creates a discretionary DGT with an initial value of £300,000. In other words, she is placing this amount into the trust for the benefit of her chosen beneficiaries.

Yvette retains a right to receive income from the trust, which is valued at £100,000. This retained income reduced the value of her gift for IHT purposes. Therefore, the 'discounted' value of the gift is calculated as follows:

- Initial value of the trust: £300,000
- Value of retained income: £100,000
- Discounted gift value: £200,000 (ie, £300,000 – £100,000).

Yvette plans to take an annual payment of £15,000 from the trust, which is 5% of the total trust value (£300,000). Because of this structure, Yvette can potentially save IHT – the immediate saving is 40% of the retained income, which is £40,000 (ie, 40% of £100,000).

Therefore, by using a discounted gift trust, Yvette can effectively reduce her taxable estate while still benefitting from the trust's income.

7.4 IHT Portfolios

An IHT portfolio is a portfolio of AIM-listed and/or unquoted companies that qualify for business relief (BR), that is managed by a professional management team. BR is covered in section 6.6.2.

Given the types of companies in which these portfolios invest, they are suited for investors who are willing to take extremely high levels of risk. Furthermore, IHT relief is not guaranteed, since tax rules are subject to change, or if the investor dies within two years of the investment.

In return, IHT portfolios provide investors with 100% IHT relief after only two years, which can compare favourably to other forms of estate planning. They are also easy for investors to gain access to, as investing requires a simple transaction – there are no eligibility criteria regarding the investor's health or age (although, given the levels of risk involved, they may be required to answer some questions about their investment knowledge and experience).

Further, the investment is not locked away, should the investor require access to it, although any money withdrawn will no longer be IHT free. That said, shares in AIM-listed and unquoted companies are typically more illiquid than those listed on the stock exchange, so they may be difficult to sell.

Upon the investor's death, the IHT portfolio can be distributed in one of three ways:

1. It can be liquidated and the proceeds passed on to the nominated beneficiaries.
2. It remains invested for the nominated beneficiaries. For a beneficiary that is a spouse/civil partner of the deceased, the two-year clock for BR is not reset.
3. It can be liquidated and the proceeds used to pay any IHT liability on other assets directly to HMRC.

Example

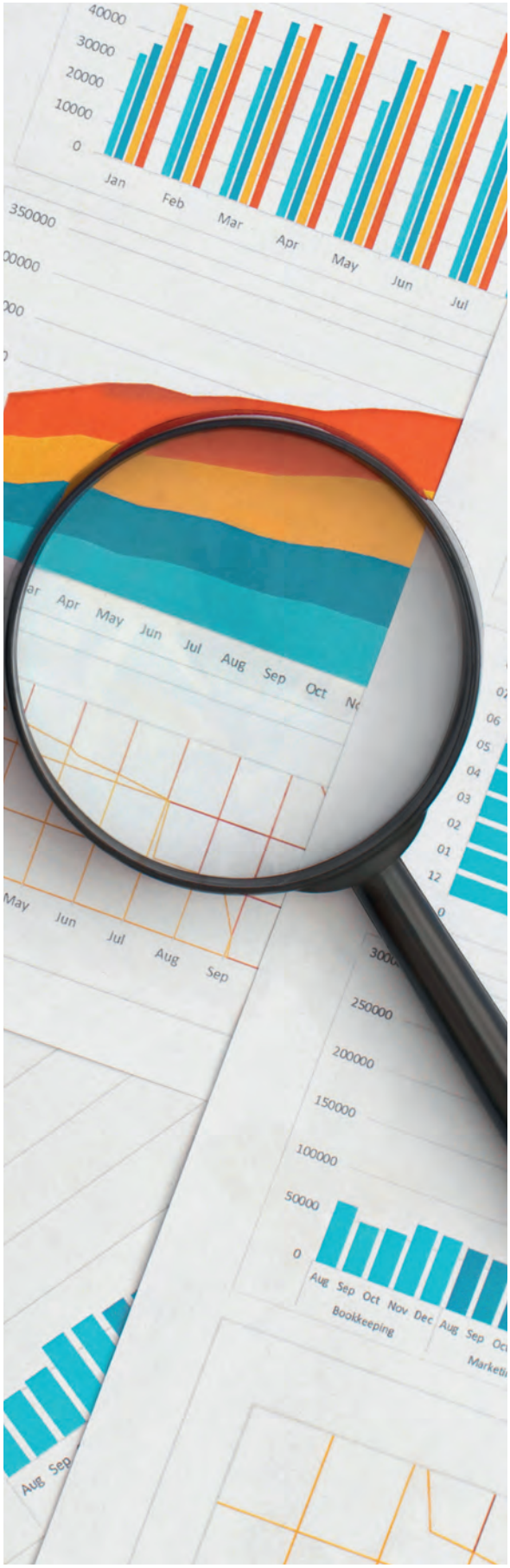
Dale has an estate that includes an equity portfolio worth £1 million, of which £500,000 is invested in an AIM portfolio. Upon his death, providing Dale has lived for at least two years from establishing the portfolio, he is able to pass on an extra £200,000 (ie, 40% of £500,000) to his descendants.

Chapter Three

Financial Markets

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be examining the relevance of market-related factors that can influence investment decisions, processes and advice.

An understanding of market-related factors – such as economic conditions, industry trends, geopolitical events and regulatory changes – is important as they play a crucial role in determining the potential risks and returns associated with different investment options. By comprehending the impact of market-related factors, investors can make informed investment decisions and develop effective strategies that align with their financial objectives, risk tolerance, and other unique factors.

2. World Financial Markets

Learning Outcome

3.1.1 Understand the relative size of world equity markets and predominant sectors within each market

2.1 Size of the World Equity Markets

The size of the world stock markets would seem to be simple to measure, but exact numbers are not always easy to obtain. Since market size is determined by total value (market capitalisation, or 'market cap' for short), the value constantly changes. In addition, many countries have several stock markets, and not all exchanges share data as freely as the most well-known marketplaces.

As of late 2025, the market capitalisation of world stock markets reached over $134 trillion, compared with about $111 trillion in 2021, and below $100 trillion in 2022[1]. 2022 was marked one of the worst years for world equity markets since the global financial crisis of 2007–08, losing about a fifth of their value amidst higher inflation and interest rates. These conditions were driven by the release of pent-up consumer demand for goods and services post COVID-19 restrictions, and the emergence of supply chain issues caused by the pandemic, further exacerbated by commodity price volatility caused by Russia's invasion of Ukraine. The UK also faced Brexit-related hold-ups at ports and allegations of price-gouging by food distributors.

There are many stock markets around the world, some of which are very large like the New York Stock Exchange (NYSE); others are much smaller, such as the Malta Stock Exchange, where only about 30 companies are listed. Some countries, such as Cuba and South Sudan, do not have a stock exchange, while other fast-growing emerging market countries such as Myanmar and Ethiopia have recently launched or soon plan to open securities exchanges. A list of the ten largest stock exchanges by market capitalisation (as at July 2025) is as follows[2]:

Name of Stock Exchange	Market Value $tn
Nasdaq	33.2
NYSE	30.9
Shanghai Stock Exchange	8.0
Japan Exchange Group (JPX)	7.0
Hong Kong Exchange Group	5.7
Euronext	5.6
National Stock Exchange (India)	5.2
Shenzhen Stock Exchange	5.1
TMX Group (Toronto)	4.0
London Stock Exchange (LSE)	3.2

Note that a stock exchange is a marketplace (ie, the infrastructure) that facilitates equity trading. In contrast, a stock market is an umbrella term representing all of the stocks that trade in a particular region or country. Notably, not all stock markets are the same, with each having a different mix of companies and industries, among other factors, as the following table of 'blue chip' indices demonstrates.

1 Trading Economics, World - Market Capitalization Of Listed Companies https://tradingeconomics.com/world/market-capitalization-of-listed-companies-us-dollar-wb-data.html; CompaniesMarketCap.com, Total marketcap history (worldwide) https://companiesmarketcap.com/total-marketcap/ (Accessed: October 2025)

2 Federation of Exchanges. Retrieved from https://www.world-exchanges.org/ (Accessed: September 2025)

	UK	US	Germany	China	Japan
Name of index	FTSE 100	S&P 500	DAX 40	STOXX China A50	Nikkei 225
Number of constituents	100	500	40	50	225
Average market cap*	£2.24T ($3.0T)	$52.5T	€2.1T ($2.5T)	$545B	¥800T ($5.3T)
Largest sector by market value	Financials	Information Technology	Industrials	Financials	Industrials

* The most recent market cap figures available have been shown in local currency (note that the China A50 is a US dollar denominated index), but also converted into US dollars for comparative purposes, based on exchange rates as of October 2025. Note that the UK system has been used, whereby 1 trillion (T) = 1,000,000,000,000 (ie, 1,000 billion, or 1 million million).

2.2 Key Features of Equities Markets

Equity markets play an important role in a market-based economy. As meeting points for issuers and buyers of stocks, they provide important functions such as capital raising, liquidity and investment opportunities, all of which allow economies to grow continuously.

Stocks can be issued in public or private markets; and depending on the type of issue, the trading venue changes. Public issues are listed and traded on the stock exchange (see section 2.4 of this chapter), while private issues are bought and sold in the private market through various channels.

For publicly issued equites, settlement is typically T+2 on a worldwide basis (where T is the trade date and 2 is the number of business days after the trade date that the cash changes hands and the shares' registered title changes). In some countries (eg, the US), the settlement cycle has been shortened to T+1, a shift that aims to reduce counterparty risk and enhance market efficiency.

Once the trade is executed, both the buyer and seller receive a trade confirmation. This provides details of the transaction, including the trade date, settlement date, price, and quantity, among other information.

Trade details are then sent to a clearing house, which acts as an intermediary between the buyer's and seller's financial institutions. The clearing house matches the trade details to ensure accuracy and that both parties have the necessary funds or shares (as appropriate) to complete the transaction. The most common and efficient method for settlement is electronically through a central securities depository (ie, an institution that holds financial instruments) or similar system. However, physical delivery can occur in some cases, particularly in older or less developed markets – this involves the physical delivery of stock certificates from buyer to seller, which can be slower, less efficient, and prone to errors. Further, damage to the certificates or loss is more likely relative to electronic settlement.

Private equity (PE) tends to be limited to institutional investors and high-net-worth individuals (HNWIs), and the shares of funds or individual private companies are typically held for many years (typically at least five years), hence the **secondary market** is relatively illiquid. That said, private equity has become more accessible to retail investors over the years via PE funds, which can be sold in the secondary market to other PE investors. In some countries, PE funds and PE investment companies have been listed on stock exchanges, and some ETFs also offer exposure to private equity.

See chapter 5, section 6 on **equities**, including their general characteristics.

2.3 World Bond Markets

Learning Outcome

3.1.2 Know the key features of global government and corporate bond markets

2.3.1 Size of the World Bond Markets

Also called the debt market, fixed-income market or credit market, the bond market is by far the largest securities market in the world, with a total valuation of nearly US$150 trillion. The US and China are the biggest issuers, which is logical, as the world's two largest economies.

As explained in section 2.1 above, in recent years, inflation worldwide has risen sharply, and today remains above official targets in many countries. This has prompted several central banks to aggressively increase interest rates.

There is an inverse relationship between the prices of bonds and their yields – in other words, as one rises, the other falls. This works on the basis that as interest rates rise, the required yield from investors rises; however, since many bonds pay a fixed **coupon** which remains unchanged over time (see chapter 5, section 4.2.6), the income from those bonds becomes less attractive to investors, so bond prices fall. Hence, in 2021–22, bond markets experienced their biggest drawdown for over three decades. This can also be seen in the context of the time value of money: as interest rates rise, the discounted present value of the series of cash flows from a bond are worth less.

2.3.2 Key Features of Global Bond Markets

The bond markets provide an important way for governments and corporates to raise money.

For governments, this pays for their day-to-day operations or to finance projects such as infrastructure. Modern governments, typically, run a **budget deficit**, which leads to large-scale issues of bonds. This results from the government consistently spending more money than the revenue it collects via taxes.

Governments with high **credit ratings** (such as the UK, US, Germany and China) are able to borrow substantial amounts from global investors with a wide range of maturities (see chapter 5, section 4.1.1 on credit ratings and 4.2.4 on maturities). Due to the relatively high credit ratings of many countries and huge issuances, the sovereign debt markets are the largest actively-traded bond markets in the world.

They are quite a bit larger than the corporate debt market and have the greatest liquidity. Sometimes, the secondary market in government bonds is run on stock exchanges (eg, France, Germany, and the UK) and sometimes outside stock exchanges (eg, the US).

Corporates use the funds raised to pay for large-scale projects such as business expansion, takeovers, new premises or product development. They can be used to replace bank finance or to provide long-term working capital.

Governments, quasi-governments, sovereigns, sub-sovereigns and supranational bodies (eg, the IMF and the World Bank) dominate the bond market generally.

The general features of global government bonds and the markets they trade in vary from country to country. Some examples are listed below:

- Government bonds may be issued by:
  - the country's central bank (eg, the US, Germany, France)
  - the Ministry of Finance (the Netherlands, China, Japan), or
  - by the Debt Management Office (DMO) on behalf of the government (the UK, Ireland, Sweden, Portugal, New Zealand).
- The issue may be to specialist dealers (eg, the US, the UK, France, Germany, Italy) or to syndicates of banks (Switzerland).
- In many countries, conventional bonds make up a majority of all government bond issuance. Conventional bonds are the simplest type of bonds:
  - They pay a fixed coupon, which is payable at regular intervals (half-yearly – eg, the US, UK, Italy and Japan; or annually – eg, France, Germany, the Netherlands, Spain and Belgium).
  - On maturity, the owner of the bond will receive the final coupon and the redemption value.
- Many governments issue inflation-linked bonds (also referred to as 'index-linked bonds' and 'linkers'), where the coupon payments and the principal are adjusted in line with a published index of price inflation such as CPI or RPI.

More generally:

- Bonds may be in:
  - registered form (ie, ownership information is recorded and maintained by a central depository or registrar; eg, the US or the UK), or
  - bearer form (ie, anonymous, with no register of holders).

  Some European, Central and South American countries allow bearer bonds to be sold, but governments are generally cracking down on this due to security issues (eg, tax evasion).
- Most bonds are issued in the form of bullets, where the principal value is paid all at once on the maturity date. Other maturity structures are also present in the bond markets.
- Bond prices may be quoted in fractions (the US, eg, down to 1/32) or decimal (the rest of the world).

See chapter 5, sections 4 and 5 on government and corporate bonds respectively, including their general characteristics.

2.4 Exchange-Traded, Over-the-Counter (OTC) and Alternative Markets

Learning Outcome

3.1.4 Understand and differentiate between exchange-traded, over-the-counter and alternative markets

2.4.1 Exchange-Traded

Stock exchanges (also called securities exchanges or bourses) are places where securities are exchanged against money. They provide a platform on which buyers and sellers of the same security can be matched. Securities include equities (also called shares and common stock) issued by listed companies, bonds and derivatives, among other financial instruments. Such securities are called 'exchanged-traded securities'.

Since the development of the earliest stock exchanges, **open outcry** was the main method used by investors to communicate on the trading floor. This offered a face-to-face auction system, with the trading floor of the stock exchange as a central location. Open outcry trading has been accurately depicted in a number of films – the environment was fast-paced and chaotic, with hundreds or even thousands of people shouting orders across the trading floor, and brokers rushing about to complete their trades. They also used hand signals to transfer information over all the noise.

In 1986, the LSE was among the first major exchanges to switch from open outcry to an electronic trading system. Electronic trading systems are faster, cheaper, more efficient, and less prone to interference and market manipulation by brokers. They also remove geographical restraints (individuals can trade virtually anywhere in the world, almost 24 hours a day), allow continuous multilateral interaction, and can handle higher trade volumes.

Today, very few exchanges still operate an open outcry system. One example is the NYSE, although during the COVID-19 pandemic, it temporarily closed its trading floor and moved fully to an electronic trading. While the trading floor has since reopened, today a majority of the NYSE's order flow is delivered to the floor electronically; therefore, there are proposals to adopt a hybrid structure combining elements of both systems. In the NYSE's case, it is also an iconic location and a tourist attraction, and the ringing of the bell is a tradition which is still performed by CEOs, world leaders and other VIPs when in New York City. Elsewhere, the London Metal Exchange (LME) is Europe's last open outcry exchange – daily official prices are set from the floor, while closing business moved to an electronic system in 2021.

2.4.2 Over-the-Counter (OTC)

Over-the-counter (OTC) is the term describing non-centralised peer-to-peer trading. Many different financial instruments such as stocks, bonds, commodities and derivatives are traded directly between two parties. Also called 'off-exchange', an OTC contract is a bilateral contract in which two parties agree on how a particular trade or agreement is to be settled in the future; in other words, the contract can be

highly customised. Forwards, swaps and exotic options are prime examples of such contracts. Originally, the OTC market was mainly traded by phone, but now it is mostly executed via computer, by direct message, or on dedicated platforms.

OTC trading provides several advantages to investors and traders. For example, they provide a wider range of securities for buyers to access. Decades ago, smaller, risky, early-stage companies were traded via phone calls and negotiation based on printouts ('pink sheets') of the last day's closing price. Since then, growth markets such as AIM and Nasdaq have largely replaced the OTC market in equities. While credit risk is increased, an OTC contract allows market participants to negotiate and tailor their contracts according to their specific needs and requirements. In addition, large orders can be traded discretely, so this may make such trades attractive to large investors compared to more transparent exchanges. The largest market (by volume traded) is the forex market, with as much as $8 trillion traded each day, and most FX trading takes place OTC.

2.4.3 Alternative Markets

Alternative trading systems (ATSs) have risen in importance in several financial markets around the world as an alternative to traditional exchanges, or as a complement to voice broking and OTC trading. Worldwide, ATSs account for much of the liquidity found in publicly traded issues. They have also allowed market participants to adopt new trading strategies, such as posting limit orders or crossing trades. Examples of ATSs include the following:

- **Multilateral trading facilities (MTFs)** – an enabling system that brings together multiple parties that are interested in buying and selling financial instruments (eg, shares, bonds and derivatives). These systems can be crossing networks or matching engines that are operated by an investment firm or a market operator; this is done within the MTF operator's system. The investment firm operating the MTF has no discretion as to how interested parties may interact. The parties form a contract, and the trade is executed under the system's rules or in accordance with the system's internal operating procedures.
- **Organised trading facilities (OTFs)** – a multilateral system that is not a regulated market or an MTF. Within an OTF, multiple third-party buying and selling interests in bonds, derivatives and other products are able to interact in a way that results in a contract. Equities are not permitted to be traded through an OTF; however, since derivatives are permitted, it will be possible to trade equity derivatives on an OTF.

  Many transactions that were previously categorised as 'off-venue' came within a multilateral trading environment following the introduction of OTFs, thus increasing overall market transparency and the quality of price discovery, investor protection and liquidity.

  A key difference between OTFs and MTFs is the ability and requirements on an OTF to use discretion when matching buying and selling interests, provided the use of discretion is in line with fair and orderly trading, and with best execution obligations to clients.
- **Systematic internalisers (SIs)** – a qualifying investment firm which (on an organised, frequent, systematic and substantial basis) deals on its own account by executing client orders outside a regulated market, MTF or an OTF.

  The firm executes orders from its clients against its own book or against orders from other clients. For a firm to become an SI, it must trade on its own account on a 'frequent and systematic basis' when executing client orders outside a regulated market, an MTF or an OTF. The terms 'frequent' and 'systematic' will be measured by the proportion and volume of OTC trades in financial instruments carried out by the firm executing client orders on its own account.

The same legal entity cannot operate both an OTF and an SI. The global financial crisis of 2007–08 and the collapse of several large financial institutions provided a major impetus and pressure by regulators to centralise trading. Now, even many OTC trades are traded peer-to-peer, but are then reported to an information service (greatly increasing transparency) and cleared through a well-capitalised clearing house (greatly reducing counterparty risk). Ironically, or maybe naturally, after the financial crisis, many exchanges created centralised clearing houses for OTC trades.

3. Developed Markets

Learning Outcome

3.1.3 Understand the relative benefits, risks and costs of investing in developed and emerging markets

3.1 Introduction

Markets are categorised as to whether they are developed, emerging or frontier, by large industry players. Two of the most widely recognised providers of global equity indices are Morgan Stanley Capital International (MSCI) and FTSE Russell.

A developed (or advanced) market is one that is more developed in terms of its economy and financial markets. More specifically, they must satisfy specific criteria regarding their market and regulatory environment, **custody** and settlement, and dealing landscape. For example, they are high-income economies (as measured by the World Bank GNI Per Capita Ranking), they have formal stock market regulatory authorities that actively monitor the market, and their debt and equity markets have good levels of liquidity to support sizeable global investment.

Typically, developed markets include countries such as the UK, the US, Canada, Japan, Australia and most European states. Notably, while China is one of the largest countries in the world in terms of land area and total economic output, it is still considered to be an **emerging market**, the reason for which is covered in section 4.1.1.

3.2 Benefits of Investing in Developed Markets

- **Stronger oversight and stricter regulation** – the operations of companies in developed markets are governed closely, and regulatory and market-related institutions have decades of experience, therefore improving the overall transparency of the financial system.
- **Reliable accounting and financial reporting** – due to the above-mentioned oversight and regulation, accounting and financial reporting practices are more reliable. In turn, this increases transparency of the financial system, therefore helping to ensure the safety of any potential investment.

- **Lower risk of unexpected economic and political instability** – economic and political institutions in developed markets are well established and unlikely to change. The government is responsible for making changes in rules, regulations and policies (eg, taxation), which can be instrumental in effectively projecting the continued success of companies. Investors may, therefore, more accurately forecast the future operating conditions for those companies.
- **Lower transaction costs** – high levels of liquidity in the debt and equity markets in the developed world means that investments generally trade with much lower bid/offer spreads.

3.3 Drawbacks of Investing in Developed Markets

- **Increased debt levels** – escalating debt levels in developed economies can lead to slower economic growth. In this scenario, businesses and consumers are likely to spend less, which drives stock markets lower. Among the developed nations, Japan has reported the highest global debt-to-GDP at over 260%[3]. More broadly, high debt levels combined with rising interest rates result in higher debt service costs, which has prompted concerns about the use of leverage in the financial system.
- **Above-average valuations** – valuations in many developed economies often trade above their historical average because of factors such as their stable political environments and strong corporate earnings. This could indicate lower-than-average future returns or, in the event of an unexpected event, could make near-term volatility more pronounced.
- **Efficient pricing** – as share pricing in developed markets is more efficient relative to emerging markets (particularly large companies, which make far more information about their businesses available to investors and which are much more closely monitored by financial analysts), it is more difficult for investors to exploit pricing anomalies.

3.4 Risks of Investing in Developed Markets

While developed markets are considered safer than emerging markets, investment still carries risk.

- **Interest rates** – changes in interest rates can affect investment values in developed markets.

  Following a prolonged period of historically low (and, in some cases, even negative) interest rates, forced even lower in the short term by unprecedented levels of quantitative easing (QE), central banks in the developed world have increased rates in recent years to combat high and rising inflation.

  Higher interest rates make it more expensive for companies to borrow, which can negatively affect businesses that rely on debt financing for expansion or operational needs. Further, higher borrowing costs can reduce profitability and potentially hinder investment and growth prospects, which can impact share prices.
- **Market efficiency** – information is quickly incorporated into stock prices, which makes developed markets generally efficient. Thus, it can be challenging to consistently outperform the market.
- **Volatility** – developed markets can experience volatility due to economic, political and social factors. As mentioned, above-average valuations in the developed world could make volatility more pronounced in the short term, should an unexpected event occur.
- **Economic downturns** – developed markets are not immune to economic downturns and recessions. Such events can lead to reduced consumer spending, lower corporate profits, and overall market decline, which can impact investment returns. Following on from this, it may take time for markets to recover.

3 Trading Economics. Japan General Government Gross Debt to GDP. Retrieved from https://tradingeconomics.com/japan/government-debt-to-gdp (Accessed: October 2025)

- **Political and geopolitical risk** – political stability is generally higher in developed markets than in emerging markets, although political risks can still exist. Changes in government, policy shifts, trade disputes and geopolitical tensions can affect investor confidence and market stability. Examples include the trade war between the US and nearly the entire world, with increased tariffs on a wide range of goods creating uncertainty and disrupting global trade patterns. Another example is the uncertainty created when a national budget cannot be agreed on; in late 2025, this source of disagreement had caused some parts of the US government to shut down and the Prime Minister of France had resigned after less than a month in the cabinet[4].
- **Regulatory and legal risk** – while developed markets have well-established regulatory frameworks, changes in regulations, tax policies and legal systems can affect investments. This can impact specific sectors or industries, potentially affecting investment performance.
- **Currency risk** – investors who are investing in a foreign developed market are subject to currency risks. Any loss incurred on the exchange rate will reduce, and could exceed, the potential gains on the investment capital.
- **Bubble risk** – while there is not a commonly agreed upon name for this phenomenon, developed markets (which are the largest and most liquid, and therefore seen as the safest) have also in the past had periods of irrational exuberance. Risk built up gradually, and many market observers, as well as regulators, assumed that their economies were big enough and sufficiently capitalised, such that they generally scoffed at the chance of a systemic crisis. As we know from the many market crashes in previous decades, developed markets are not immune to crises and sometimes have come close to a complete breakdown.

4. Emerging Markets

4.1 Introduction

The term 'emerging market' can be defined in various ways:

- markets in countries classified by the World Bank as low or middle income, and
- markets defined in various stock and bond indices as an emerging market.

In general, emerging markets are not as advanced as developed countries, but maintain economies and infrastructures that are more advanced than frontier market countries.

MSCI and FTSE Russell have different definitions and methodologies for determining the accessibility of a country's equity market. MSCI has a set of stringent requirements for market accessibility, including criteria related to openness to foreign ownership, ease of capital flows, and stability of market infrastructure. In contrast, FTSE Russell has a more flexible approach, considering factors such as the size and liquidity of the equity market; from this, they divide emerging markets into two categories:

- advanced (which must satisfy fewer of the above criteria than a developed country), and
- secondary (which must satisfy fewer still).

4 GOV.UK. History: Past Prime Ministers. Retrieved from https://www.gov.uk/government/history/past-prime-ministers (Accessed: October 2025)

As a result, the MSCI and FTSE Russell Emerging Markets indices have different constituent countries, to which each provider has different **weightings**. Further, MSCI has a broader coverage of emerging markets include large-, mid- and small-cap companies, while FTSE Russell focuses primarily on large-cap companies. Both providers conduct periodic reviews to determine the composition of their indices, on a quarterly and semi-annual basis respectively. It does not happen often, but countries are sometimes promoted to developed, or dropped down into frontier (Egypt during the Arab Spring protests, for example). Similarly, a frontier market country which shows sufficient development in its economy and markets can be promoted to emerging (Saudi Arabia was a significant example of this).

Frontier markets are a subset of emerging markets that are smaller than emerging markets, and too small in terms of their economic and capital markets development to be classified as an emerging market. As a result, frontier market investments tend to be under-researched and under-owned, with much lower levels of liquidity, so are better suited for investors that can take on higher levels of risk. According to the MSCI Indices[5], there are about 30 countries that are currently classified as frontier markets, compared with about 20 for FTSE Russell[6] – examples in both indices include Kenya, Mauritius and Vietnam.

4.1.1 The BRICS Markets

BRIC is an acronym for Brazil, Russia, India and China, which was coined by Goldman Sachs in 2001. At that time, Goldman Sachs argued that, by 2050, the combined BRIC economies could eclipse the combined economies of the current richest countries of the world. These four countries currently account for more than a quarter of the world's land area and more than 40% of the world's population[7].

The annual gross domestic product (GDP) growth rates in China[8] and India[9], especially, are estimated to be between 4% and 8% a year in the years ahead. Growth forecasts for the G7 countries (the Group of Seven – an intergovernmental political forum consisting of the world's largest advanced economies according to the IMF: the UK, the US, Canada, Germany, France, Italy and Japan) are far less robust, at about 1–2%[10]. This could mean that within 20 years, the top ten economies ranked by GDP will look very different.

The manner in which the momentum for growth in the world economy is shifting is also reflected in the political structures which are emerging. Previously, the semi-annual G7 summits and meetings of the respective finance ministers were the pivotal meetings for global policy coordination. However, the G20 summits (which include all of the BRIC economies, as well as those of the existing G7 and nations, such as Mexico and South Korea) are becoming as important, if not more so, than the G7 gatherings.

5 MSCI, Market Classification Framework. https://www.msci.com/indexes/index-resources/market-classification (Accessed: October 2025)
6 FTSE Russell. Equity Country Classification. Retrieved from https://www.lseg.com/en/ftse-russell/equity-country-classification (Accessed: October 2025)
7 World Population Review, BRIC/BRICS Countries 2025. Retrieved from https://worldpopulationreview.com/country-rankings/bric-countries (Accessed: October 2025)
8 The World Bank in China. Retrieved from https://www.worldbank.org/en/country/china/overview (Accessed: October 2025)
9 The World Bank in India. Retrieved from https://www.worldbank.org/en/country/india/overview (October 2025)
10 International Monetary Fund, Major advanced economies (G7). Retrieved from https://www.imf.org/external/datamapper/profile/MAE (Accessed: October 2025)

Investing in these economies places investors at considerable risk, however. Following Russia's invasion of Ukraine in 2022, among other sanctions, MSCI and FTSE Russell pulled Russia from their widely tracked emerging market indices, which led to significant market disruptions and investors reallocating their capital. In recent years, China has suffered significant crashes in its stock market (eg, in March 2022, primarily due to difficulties in implementing the nation's 'zero-COVID' strategy). Further, Brazil has experienced recessionary pressures over the years.

While China is today considered to be a global economic superpower and is the world's second largest economy, it is still classified as an emerging market. This is due to criteria set by the World Bank relating to standards of living, whereby the threshold for **gross national income (GNI)** per capita for 2026 is $13,935[11]. However, according to the latest data, China's GNI per capita is below this threshold and is classified as an Upper Middle Income country[12].

In 2010, the acronym was expanded to BRICS with the addition of South Africa, a decision that was based on several factors:

1. It was the largest and most sophisticated economy in Africa at the time, making it an important player on the continent.
2. It possesses significant natural resources and had a well-developed financial sector.
3. It has a history of political stability and democratic governance, which distinguishes it from some other African countries.

By including South Africa, the BRICS group aims to enhance its engagement with the African continent and strengthen its global influence.

Other acronyms have since been coined. For example, Mexico, Indonesia, Nigeria and Turkey (MINT), which were predicted to be within the top 20 contributors to global GDP by 2050; and Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa (CIVETS), favoured for their diverse and dynamic economies and their young, growing populations (although they also share challenges such as unemployment, corruption and inequality).

4.2 Benefits of Investing in Emerging Markets

- **Faster economic growth** – developing nations tend to grow at a faster rate than those countries that are developed as they try to catch up in terms of living standards and, in the process, develop their infrastructure and financial systems.
- **Savings rates** are usually higher in less developed countries. Foreign direct investment (FDI) will have a positive benefit on the economy, leading to rapid economic growth. This will lead to a rapid growth in profits.
- **Inefficient pricing** – it is possible to exploit pricing anomalies in less developed economies, where analysis and research on companies are not so well advanced.
- **Industry representation** – there may be the opportunity for investors to gain exposure to different types of industries, not possible in other well-developed countries.

11 The World Bank. World Bank Country and Lending Groups. Retrieved from https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups (Accessed: October 2025)

12 The World Bank, Atlas method – detailed methodology. Retrieved from https://datahelpdesk.worldbank.org/knowledgebase/articles/77933-what-is-the-world-bank-atlas-method (Accessed: October 2025)

- **Attractive valuations** – historically, emerging markets have traded at a discount to developed nations.
- **Low correlation of returns** – historically, there has been a low correlation between the fortunes of developed and emerging markets. This provides the investor with an opportunity for **diversification**.

4.3 Drawbacks of Investing in Emerging Markets

- **Restrictions on foreign ownership** – some less developed countries impose restrictions on foreigners owning shares in certain companies.
- **Foreign exchange restrictions** – due to restrictions imposed by the emerging nations, it may not be possible to repatriate funds to the UK once the investor has disinvested.
- **Lack of transparency and information** – there is likely to be a lower quality and transparency of information from emerging markets compared to countries that are well developed.
- **Corporate governance** – there could be a lack of **corporate governance** and corporate law to protect investors and shareholders.
- **Taxation** – while double taxation agreements are in place with most (if not all) developed nations, there may be local taxes imposed by developing nations that are not covered by existing treaties, thereby adding to the tax burden.
- **Additional costs may be incurred** – for example, commission on foreign currency, costs of transferring the money, **nominee** costs and possibly translation or legal costs.

4.4 Risks of Investing in Emerging Markets

- **Political** – emerging markets tend to be less politically stable. This could have a devastating effect on foreign investment. For example, new laws could be passed which outlaw the holding of certain investments by foreign persons, inhibit the ability to repatriate funds or impose high levels of taxation.
- **Volatility** – emerging markets are more volatile than developed ones and are prone to banking or other crises. Lack of information can result in a 'herding' of foreign investment into a small number of companies, which will see a sharp rise in their stock prices; but this could be followed by an equally sharp fall if foreign investment is withdrawn from one of these companies in the future.
- **Liquidity** – emerging markets are more concentrated (ie, less liquid and have a less developed financial system than developed markets). Investments are generally less marketable and, therefore, tend to trade with much wider spreads.
- **Safekeeping of assets** – custody and settlement may be far more difficult to arrange, and the potential for fraud may be increased with less developed regulatory protection and problems with translation. Understanding a contract in English can be difficult enough without the added complication of interpreting complex terms in a foreign language.
- **Currency risk** – historically, emerging markets have tended to have weaker currencies, which are far more susceptible to sudden movements following the withdrawal of foreign investment. Any loss incurred on the exchange rate will reduce, and could exceed, the potential gains on the investment capital.

Example

Alex invests £50,000 in an emerging market, Westonia. At this time, the exchange rate with the Westonian dollar (W$) is £1:W$1, meaning that Alex has invested W$50,000 in local currency terms.

The investments have done well for Alex, but the political climate is changing: an election is due and the people in the know think that the opposition will seek to restrict the withdrawal of foreign investment should they get to power.

Alex, therefore, decides to encash their investments, which are falling in value due to the political uncertainties, and they withdraw their investment with a gain of 10% on their initial investment in local currency terms; in other words, they sell for W$55,000.

However, Alex now has to repatriate the funds and they are staggered to discover that the pound is now 30% stronger against the local currency than it was when they invested their capital in Westonia (ie, an exchange rate of £1:W$1.30). This means that Alex's W$55,000 is worth £42,307.69 (ie, W$55,000 / W$1.30).

Alex has, therefore, made an overall loss of 15.4% (ie, (£42,307.69 – £50,000) / £50,000). This illustrates the importance of foreign exchange rates when investing in emerging markets.

5. The UK Markets

Learning Outcome

3.2.1 Understand the main organisations and processes for transacting, clearing, settling and safekeeping UK financial securities

5.1 Transacting UK Financial Securities

The London Stock Exchange (LSE) is a recognised investment exchange (RIE) and, as such, is answerable to the Financial Conduct Authority (FCA).

The LSE has a responsibility to promote and maintain high standards of integrity and fair dealing in the carrying on of regulated activities. Its main responsibilities include:

- providing a primary and secondary market for equities and fixed-interest securities
- supervising member firms
- regulating the market
- recording all deals, and
- disseminating price-sensitive information received via its Regulatory News Service (RNS).

5.1.1 Member Firms of the LSE

All member firms are broker-dealers. As such, they can act in one of two capacities:

- Act as agent on behalf of the customer where they take a commission (broker).
  - Here, they will receive an order from a non-member client and will arrange the trade with another member firm for a commission.
  - Alternatively, they may have an order to purchase, and a matching order to sell, from another client. They can act as agent to an agency cross-transaction, charging a commission to both parties but offering the same price to both parties.
- Act as principal where they trade their own **book** (dealers).
  - They will be selling shares held on the firm's own books to the client.

Market makers provide liquidity to the market by making a two-way price (bid/offer or bid/ask spread, where the bid price is the price that the buyer is willing to pay for a security, and the offer or ask price is the price at which the seller is willing to sell), using a screen-based system to display their prices. Broker-dealers can see the prices being offered and place their orders based on the quoted prices.

Most equity and some fixed-interest dealing is conducted via a range of electronic systems hosted by the LSE: SETS, SEAQ and SETSqx. Note that while a majority of bonds are listed on exchanges such as the LSE, they are primarily traded OTC.

Stock Exchange Electronic Trading Service (SETS)

The **Stock Exchange Electronic Trading Service (SETS)** is an electronic, order-driven service trading FTSE 100, FTSE 250 and the FTSE Small Cap Index constituents, as well as other securities.

SETS also provides market maker support for all stocks deemed to be liquid under MiFID II definitions.

SETS allows buyers and sellers to be matched, thus avoiding the need to go through a market maker who would charge a spread. It matches orders based first on price, and then on the time the order was placed.

Normal trading hours on SETS are 8:00–16:30 local time every day, except weekends and holidays declared by the exchange in advance.

Order Book

The following types of order are permissible on the order book:

- **At best** – this specifies the number of shares to be bought or sold, and is executed immediately at the best possible price. The main problem that can occur is if the market for the stock is very thin (illiquid), the spread may widen considerably, particularly at either end of the trading day. As the bargain is executed whatever the price, an 'at best' order may secure a very poor price for the client.
- **Market** – this is an 'at best' order which is held on the order book during an auction call period (ie, a set time during which the buyer sets the maximum acceptable price to buy, and the seller the minimum satisfactory price to sell the security). These deals are given top priority for matching at the end of the auction period, according to the time they were submitted.

- **Limit** – these are the only orders which remain on the screen. The client will specify the number of shares required to be bought or sold and the maximum (purchase) or minimum (sale) price they are prepared to accept.
- **Execute and eliminate** – these orders have a quantity and limit price. If it cannot be filled in its entirety, then the deal can be partially filled, but the remaining part of the deal is abandoned.
- **Fill or kill** – these orders may be limited to a particular price; and if not filled in full, then the entire deal is abandoned. It is possible to leave the price open, in which case the order will rely on the depth of the order book.
- **Iceberg** – these orders allow clients to enter large orders with only a certain specified portion of the order visible to the market. The order must have details of the total size of the order and the specified amount to be made visible to other market participants. Once the peak is entirely dealt with, the system automatically keeps reintroducing orders until the entire amount is dealt.
- **Hidden limit orders** – these are limit orders where both the price and volume are hidden. Unlike **iceberg orders**, where the peak is continually refreshed and displayed, other market participants will have no idea if there is any remaining order or not. They are only available for large orders meeting certain threshold conditions.
- **Hidden pegged orders** – these orders allow clients to peg their order to the best bid, offer or **mid-price**.

An example of an order book is as follows:

Buy			Sell		
Price	**Time**	**Volume**	**Price**	**Time**	**Volume**
360	11:10	4,000	361	11:18	3,000
360	11:15	2,000	361	11:24	2,000
359	11:06	1,000	362	11:04	5,000
359	11:08	2,000	362	11:09	3,000



What would the order book look like if a limit order to sell 8,000 at no worse than 360p was submitted at 11:25?

The answer is as follows:

Buy			Sell		
Price	**Time**	**Volume**	**Price**	**Time**	**Volume**
359	11:06	1,000	360	11:25	2,000
359	11:08	2,000	361	11:18	3,000
			361	11:24	2,000
			362	11:04	5,000
			362	11:09	3,000

The order would have been partially filled with 6,000 shares being sold at 360, leaving 2,000 shares on the order book. The order book can be seen by any market participants, and a yellow strip on the SETS screen will display the best prevailing buy and sell prices for each security. Orders that are put through the order book must be executed at best price. Both member firms are given notification of the trade once it is settled, and the deal is automatically reported to the LSE.

Only LSE firms and SETS participants (including investment banks, brokerage firms, institutional investors and market makers) can input orders. Individual retail investors may also participate in SETS through their brokers or online trading platforms.

A central counterparty (CCP) service exists for all deals executed on SETS, which enables trades to be conducted anonymously and guarantees trades, removing counterparty risk. Participants can use either LCH ltd (formerly LCH.Clearnet ltd) or SIX x-clear AG ltd as their CCP for SETS trades.

Trades are normally settled through the **CREST** system, operated by Euroclear UK & Ireland. All deals on SETS are settled on a T+2 basis.

Orders outside the order book are permitted, providing that they are satisfied by the best bid or offer price on the order book. If they cannot be settled at that price, they must be settled at the volume-weighted average price or better.

Stock Exchange Automated Quotation (SEAQ) System

The **Stock Exchange Automated Quotation (SEAQ)** system is for securities in the fixed-interest market, and AIM securities not traded on SETS or SETSqx. Like SETS, SEAQ is a quote-driven, screen-based system for trading.

This means that member firms can act as market makers and compete with each other, by making two prices in stocks in the hope of attracting business from other members (known as broker-dealers – see section 5.1.4, below). Since all market makers must quote real-time two-way prices in all market conditions and act as willing counterparties to trades, they are often required to commit their own capital when there is a lack of market liquidity.

The quotes must appear between the mandatory period of 8:00am and 4:30pm, and apply to any deal no greater than the historic size of the average institutional trade in the applicable shares, known as **normal market size (NMS)**. This is shown on SEAQ as the minimum quote size (MQS).

Throughout the day, the best prices are shown by the yellow strip and are referred to as the 'touch'. This is the price at which a broker-dealer is obliged to transact, subject only to size, in order to fulfil 'best execution' requirements. Deals outside the NMS would need to be negotiated with the broker-dealer. The minimum permitted price change is called the 'tick size' (generally 0.1p, 0.25p, 0.5p or 1p, depending on the price and liquidity of the security):

- If the best bid price is equal to the best ask price, it is called a '**choice price'**.
- If the bid price is greater than the ask price, it is called a '**back'** or a '**backwardation'**.

The SEAQ system offers a screen that changes colour depending on the last price movement of the security: blue for an upward price movement, red for a downward movement and green for an unchanged price.

As this is a quotation system, not a dealing system, then a firm must telephone the market maker to arrange the transaction if they want to place an order in those securities.

To ensure a transparent market, all trades conducted within the mandatory quote period are reported to the LSE by market makers within three minutes. This is known as 'trade reporting'.

The LSE publishes the size and price of trades up to six times the NMS on SEAQ immediately, a process known as 'publication'. Trades greater than six times the NMS have delayed reporting for one hour. Very large trades (over 75 times the NMS) can be withheld from the market for up to five days, to enable the market maker to unwind a large position without the market going against them. Market makers can deal anonymously through specialist firms known as inter-dealer brokers (IDBs) to facilitate this, who can borrow stock from stock borrowing and lending intermediaries (SBLIs) to help preserve market liquidity.

SETSqx

The Stock Exchange Electronic Trading Service: Quotes and Crosses (SETSqx) is the trading platform used for securities that are less liquid than those on SETS. It is a hybrid system combining elements of SETS and SEAQ, with some additional electronic order book functionality.

SETSqx combines the features of the SEAQ market maker model and supports it with some additional electronic order book functionality.

There are two types of order book model for SETSqx:

- **SETSqx with Market Makers** – This type combines an electronic order book with standalone non-electronic quote-driven market making. Market makers have obligations that are similar to those on SEAQ, whereby they must provide continuous prices throughout the trading day. The mandatory quote period is slightly different though, and market makers have the option to participate in the electronic auctions.

  In addition to trades being executed through market makers, there are five auctions 'uncrossings' that take place daily at 8:00am, 9:00am, 11:00am, 2:00pm and 4:35pm. During these auctions, the system works like the order book, and matches as many orders as possible.

  At other times during the day, the system continues to work as a quote-driven system.

- **SETSqx with No Market Makers** – For this type, the order book moves into the next auction call phase following the previous uncrossing. Orders are, therefore, visible on submission until they are executed, cancelled or expired.

Because of the limited liquidity in the securities traded on SETSqx, iceberg and market orders are not supported, although different types of limit orders are.

5.1.2 International Order Book (IOB)

The IOB, offered by the LSE, offers easy and cost-efficient access for traders looking to invest in fast-growing economies.

The service is based on an order-driven, electronic order book similar to SETS, but with the added option for member firms to display their identity pre-trade by using 'named orders', offering greater visibility in the market. Deals are quoted in US dollars, with trading available from 8:00am until 3:30pm.

The market has grown rapidly since its inception in 2001, offering depositary receipts (DRs) from over 30 countries, including those in Central/Eastern Europe, Asia and the Middle East. See section 5.1.6 on DRs.

5.1.3 International Retail Service (IRS)

The IRS (not to be confused with the Internal Revenue Service, a US government agency responsible for collecting federal taxes and enforcing tax laws) is a service provided by the LSE that allows UK investors to trade in overseas stocks quoted in sterling without having to worry about exchange rates through the CREST system. This allows shares to be held in dematerialised form.

Not all international equities are listed on the IRS. There are currently around 330 large-cap (blue-chip) equities available, primarily European and US companies.

	International Order Book	International Retail Service
Market type	Order-driven	Quote-driven
Securities Traded	DRs from over 30 countries	US and European large-cap equities
Currency	US dollars	Sterling
Market Makers	No	Yes (committed principals – CPs)
Settlement	Euroclear Bank	CREST depository interests (CDIs)
Trading	8:00am to 3:30pm Opening/closing auctions; continuous trading in between	8:15am to 5:00pm Mandatory quote period for most European stocks 8:15am to 4:00pm

5.1.4 Trading in UK Government Bonds (Gilts)

Gilts are traded in a similar way to the quote-driven trading of equities. There are three major groups of participants that facilitate trades in the government bond markets:

- Primary dealers
- Broker-dealers
- Inter-dealer brokers (IDBs).

Primary Dealers

Primary dealers are banks and other financial institutions that have been approved to trade securities with a national government, with the intention of selling those government securities on to others. Thereafter, primary dealers provide liquidity to the government bond market by quoting two-way prices under all market conditions throughout the normal trading day – in other words, they act as market makers (note that primary dealers usually operate in over-the counter (OTC) markets, while market makers generally operate on a stock exchange).

In many countries, primary dealers are the only entities that can make bids for newly-issued government securities; thus, they are essentially underwriting new government debt, and act as a market maker in government securities.

Once accepted as a primary dealer, the firm is obliged to make a market in all conventional government bonds at a size deemed appropriate by the issuing agency.

In the UK, primary dealers in the gilts market are gilt-edged market makers (GEMMs). Once vetted by the DMO and registered with the LSE, GEMMs become primary dealers and are required to provide two-way quotes to their clients and other member firms of the LSE throughout the normal trading day. There is no requirement to use a particular system like the SEAQ for making those quotes available to clients, and GEMMs are free to choose how to disseminate their prices.

A firm can register as a GEMM to provide quotes in:

- All gilt-edged securities.
- Gilt-edged securities excluding index-linked gilts.
- Index-linked gilts only.

There are exceptions to the requirement to make two-way prices to clients including the members of the LSE. The obligation does not include quoting to other GEMMs, fixed-interest market makers or gilt IDBs.

Broker-Dealers

Also called agency brokers, broker-dealers are individuals or firms that, as their name implies, perform a dual role in carrying out their responsibilities: as brokers (or agents), they buy or sell government bonds on behalf of their clients; and as dealers (or principals) for their own account. Examples of broker-dealers include traditional financial services firms and large commercial banks.

In their role, broker-dealers perform several vital functions – they facilitate the free flow of government bonds on the open market; and by buying and selling government bonds in their own accounts, they ensure that there is a market in those securities for their clients.

When acting as a broker, broker-dealers will be bound by the 'best execution' rule (ie, to get the best available price at the time, taking into consideration factors such as speed and likelihood of execution). In the UK, the rules on best execution are contained within the FCA's Conduct of Business Sourcebook (COBS), and implemented by the requirements of the Markets in Financial Instruments Directive (MiFID).

When seeking a quote from a primary dealer, the broker-dealer must identify at the outset if the deal is a small one – in the UK, this is defined as less than £1 million nominal.

Inter-Dealer Brokers (IDBs)

IDBs arrange deals anonymously between primary dealers. They are not allowed to take principal positions and the identity of the primary dealers using the service remains anonymous at all times. The IDB will act as agent, but settle the transaction as if it were the principal. The IDB is only allowed to act as a broker between primary dealers, and has to be a separate company and not a division of a broker/dealer.

The Gilt Repo Market

Repo is short for 'sale and repurchase' agreement. One party agrees to sell gilts to another party, but with a formal agreement to buy equivalent securities from them at an agreed price and on a specific date. It is therefore a form of secured borrowing, with the gilt itself used as **collateral**.

The interest rate generated by the difference between the sale and repurchase prices is the repo rate.

All participants in the gilt market are free to utilise repo transactions.

A 'reverse repo' occurs when gilts are purchased first, with an agreement to sell back in the future (ie, the same transaction, but from the buyer's perspective, not the seller's). This allows market participants to go short in the market.

Agreements to repurchase at a specific date are known as 'term repos'. There are also:

- **'open repos'**, where there is no set **redemption date**, and contracts roll over on a daily basis until one of the parties decides to cancel the deal, and
- **'overnight repos'**, which, unsurprisingly, apply to any repo where the settlement date is the next day.

Gilt Strips

Separate Trading of Registered Interest and Principal of Securities (STRIPS) are certain gilts that can be separated into their individual **cash flows** of interest and principal payments. They are explained further in chapter 5, section 4.7.2.

Only a GEMM, the DMO or the Bank of England (BoE) can strip or reconstitute a strippable gilt, although, once done, anyone can trade or hold strips.

5.1.5 Trading in the UK Fixed-Interest Market

This market includes local authority bonds, listed corporate bonds and some **eurobonds**, but excludes gilts. As a result, it is smaller than the gilts market.

The DMO is not involved in this market. Dedicated market makers are registered with the LSE, which imposes the dealing obligation for market makers to buy and sell up to a marketable quantity of stock at a firm price. This marketable quantity is determined by the LSE. Apart from the absence of the DMO, the overall operation of the market is very similar to that for gilts.

Established in 2010 by the LSE in response to growing demand from private investors, the electronic Order book for Retail Bonds (ORB) provides a more liquid and transparent market for a number of gilts, supranational organisations and UK corporate bonds. Investors can enter orders on the order book either directly (if a sophisticated investor) or via a broker who offers direct market access (DMA).

The Prospectus Regulation (PR), which is an EU legislation that was onshored as UK law following the end of the UK's transition period with the EU, distinguishes between wholesale issues and retail issues. The UK however is transitioning to the set of regulations known as Public Offers and Admissions to Trading Regulations (POATRs) 2024. The FCA published the final rules in Policy Statement PS25/9 which go into effect in January 2026. The primary goals of the change were to simplify the listing process, reduce costs and enhance the UK's competitiveness as a financial centre. One of the most significant changes to the rules is an increase in the threshold for requiring a prospectus for add-on issuances, from 20% to 75% of existing share capital and up to 100% for closed end investment funds. The FCA's Prospectus Regulation Rules sourcebook will be replaced by the new sourcebook, '*Prospectus Rules: Admission to Trading on a Regulated Market (PRM)*'.

The market operates with an opening auction phase between 08:00 and 08:45 and closes at 16:30, during which time market makers provide two-way prices. The normal settlement timing for trades in the UK fixed-interest market is T+2.

5.1.6 Depositary Receipts (DRs)

One of the ways that investors can trade on the international markets is via depositary receipts (DRs), which represent a specific number of shares in a company. DRs are typically issued by a depositary bank (ie, a financial entity that facilitates investment in securities markets), and are traded on a stock exchange, which may be local or overseas to the issuer of the DR.

Investors buying shares in a foreign company need to exchange their money into a foreign currency, open a foreign brokerage account, and then purchase the shares on a foreign stock exchange through that brokerage account. With a DR, the process is much more straightforward, in that investors simply need to contact a broker at their local (depositary) bank. The broker will then purchase the shares on the local exchange on which the shares trade. Alternatively, the broker will purchase the shares on the foreign stock exchange via a broker in a foreign bank (called a custodian bank), who will group the shares into packets and then issue to the depositary bank as a DR. The broker will then deliver the DR to the investor in exchange for a fee.

The risks involved with DRs relate both to the underlying share and to the bank issuing the DR. At the same time, they can also reduce some of the risks of investing directly in overseas countries; for example, an investor can invest in Nissan via its ADR listed in the US, rather than on the Japanese stock market.

American Depositary Receipts (ADRs)

One of the most common types of DRs are American depositary receipts (ADRs)**.** ADRs are US dollar-denominated negotiable instruments in respect of non-US-listed shares that have been lodged with the bank.

ADRs were originally designed to enable US investors to invest in overseas shares without the high dealing costs and delayed settlement associated with overseas investment. However, they are today also used by institutional investors wishing to purchase shares listed on their domestic markets. In the UK, this means that investors avoid stamp duty; stamp duty reserve tax (SDRT) is paid on creation of the ADR, not on subsequent dealing.

Up to 20% of a company's voting share capital may be converted into ADRs. In the UK, many companies have used ADRs as a means of raising capital. Sometimes, more than one share is deposited to make up one ADR (for example, one ADR = ten shares).

Dividends are paid to the holding bank in the currency of the overseas company, and paid to the holder of the ADR in US dollars.

ADRs are traded on the NYSE and Nasdaq, and are also traded in the UK through SEAQ.

Other Depositary Receipts (DRs)

Other types of DRs include European depository receipts (EDRs), Chinese depositary receipts (CDRs), Japanese depositary receipts (JDRs) and South African deposit receipts (SADRs), which similarly represent ownership in the shares of a company that is not domiciled in the named country, trades on that country's local exchanges, and is priced in local currencies.

Global depositary receipts (GDRs) – also known as international depository receipts (IDRs) – are issued in more than one country. Again, shares are deposited in a bank which issues the GDR.

GDRs are often listed on the Luxembourg Stock Exchange, the Frankfurt Stock Exchange and on the LSE, where they are traded on the International Order Book (IOB) – see section 5.1.2 above.

5.2 Clearing and Settlement of UK Financial Securities

We will now consider the clearing and settlement procedures for UK domestic financial securities. The process of clearing and settlement involves several stages.

5.2.1 Confirmation

The details of the deal are confirmed. This involves both sides of the transaction being compared to ensure they match.

5.2.2 Clearing

The LSE allows a choice of central clearing parties (CCPs) for trades on SETS and SETSqx market. These CCPs are either LCH ltd, SIX x-clear ltd or European Central Counterparty (EuroCCP). It does not matter whether the trading counterparty is using the same or a different CCP.

5.2.3 Settlement

The securities are transferred into the name of the new owner, against payment. This system whereby the securities are only transferred against simultaneous payment is known as **delivery versus payment (DvP)**. The converse of this is that the buyer will not release the cash unless it is against the simultaneous transfer of the securities. From this perspective, it is described as 'cash against delivery (CAD)'. This system of settlement provides security for both the seller and the buyer of the securities.

A system for delivery free of payment is also available.

The UK markets operate a rolling settlement system. For UK equities and corporate bonds, the normal settlement period is T+2; and gilts are settled at T+1.

In certain cases, investors may be able to request a different settlement period. For example, same-day settlement (allowing for faster completion of trades), and settlement extensions beyond the standard T+2 or T+1 cycles, as listed above. Note that non-standard settlement periods can impact on the cost and overall investment process, however; and in the case of longer settlement periods, the greater the exposure to counterparty risk. It is therefore important for investors to carefully evaluate the potential costs, risks, and operational implications associated with non-standard settlement periods before engaging in such investment transactions.

5.3 CREST

Euroclear UK & Ireland is the central securities depository for the UK markets and Irish stocks. More specifically, Euroclear UK & Ireland operates an electronic settlement system, CREST, settles transactions in equities, corporate bonds and **commercial paper (CP)**, gilts and **Treasury bills**, money market instruments, certificates of deposit (CDs) and a range of international securities; in pounds, US dollars and euros.

CREST can also physically hold stock certificates on the behalf of customers. By holding securities as well as maintaining an electronic clearing system, CREST can provide for same day clearing of securities transactions if needed. Its overall ability to provide a fast transfer of title for the securities it handles is its most important advantage to investors.

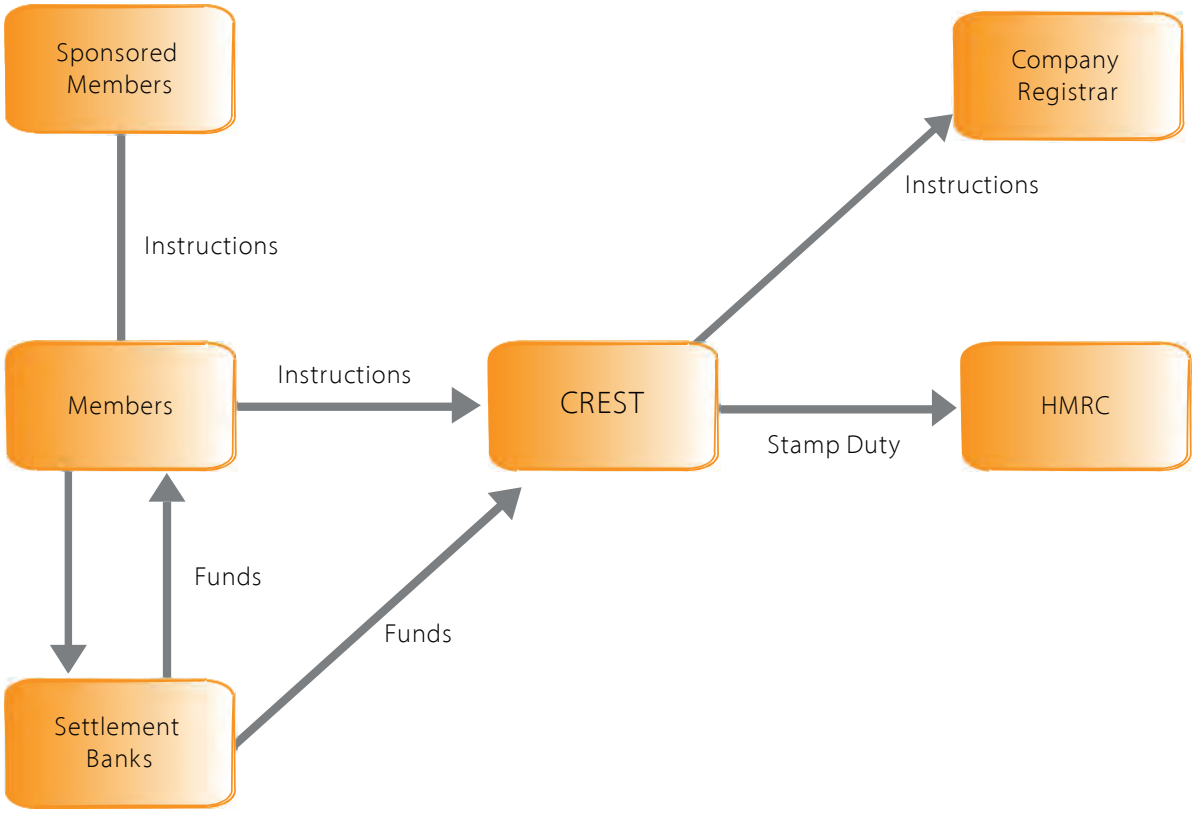
CREST offers investors the opportunity to hold their shares in dematerialised form (where there is no certificate issued evidencing ownership, only an electronic record), either in their own name within CREST, or in the name of their nominee company. Additionally, deals can be settled through CREST, and paper certificates held outside the system.

Trades are normally settled through the CREST system, operated by Euroclear UK & Ireland. All deals on SETS are settled on a T+2 basis.

How Does the CREST System Work?

- **Structure**
  Members have securities in accounts in CREST (much in the same way as we have money in a bank account). There are different types of members depending upon their technical ability to interface with the system.

  Individuals wishing to hold stocks in CREST are known as CREST-sponsored members. However, they can only do so through an institution that has the technical ability to interface with CREST, known as a CREST member (eg, a stockbroking firm). The individual beneficial owner will appear on the company register as the recorded legal owner of the shares that it has in its CREST accounts. Balances are dynamic (ie, they continually change as settlement occurs).



- **Settlement Banks**
  Each member must have a contractual arrangement with their bank, guaranteeing the settlement of their CREST transactions up to an amount known as a 'debit cap' (think of it as akin to an overdraft limit).

  CREST records each member's obligations (purchases/sales) on a **cash memorandum account (CMA)** on a real-time basis throughout the day. At the end of the day, the net position must be settled by the member's settlement bank with CREST.

  Settlement banks maintain liquidity balances with the BoE specifically for the settlement of CREST liabilities. The amount of unused facility (credit) at any point during the day is known as the 'headroom'. Using our overdraft analogy, it is the unused portion of our overdraft limit.

- **Company Registrars**
  Company registrars are required under the Companies Act 2006 to maintain a list of their shareholders. As trades settle, CREST issues a register update request (RUR) to the company registrars, instructing them to update their shareholder register. It may take companies some time to update their records, so it is worth noting that ownership legally passes at the point of payment, even if the records are not updated until later in the day.

- **Revenue Authority**
  CREST acts as collector of transfer tax (eg, SDRT) for the relevant tax authorities.

The CREST Process in Order

Trade date:

- The trade and price are agreed through the exchange.
- Each member (the buying and selling members) creates a settlement instruction, and sends it to CREST.

On or just after the trade date:

- CREST compares both settlement instructions and ensures that the details are correct and match.

Settlement date:

- CREST sends details of the trade to its single settlement engine (SSE) for settlement.
- The SSE checks that the seller has sufficient securities, that the buyer has sufficient headroom, and that the buyer's bank has sufficient liquidity with the BoE.

If so, the transaction is settled:

- The securities are simultaneously moved from the selling member's account to the buying member's account.
- Funds are transferred from the buying settlement bank to the seller's settlement bank.
- The CMA of the buyer is debited, and the CMA of the seller is credited.
- The SSE sends confirmation that the trade has settled to CREST.
- CREST sends a RUR to the company registrar, to update the register of shareholders.

Each business day between 5:00 and 16:30, CREST attempts to settle transactions. This can be done provided the transaction has reached its settlement date and there are sufficient resources available to allow the transaction to settle.

5.4 Custody and Safekeeping Practices

The primary responsibility of a custodian is to ensure that the investor's assets are fully protected at all times, in order to minimise the risk of their theft or loss. Hence, it must provide robust safekeeping facilities for all valuables and documentation, ensuring that investments are only released from the custodian's care in accordance with authorised instructions from the client. By law, registered funds are required to use a custodian.

Many unregistered alternative funds also use a custodian. In the case of hedge funds, the custodian is a trust company or similar financial institution, who is responsible for holding and safeguarding the assets held by the hedge fund. By using a third-party custodian and separating the hedge fund manager from the physical assets, this helps to reduce the risk of fraudulent activity.

As well as safekeeping assets, custodians also provide the following services (among others):

- Making appropriate arrangements for delivery and receipt of cash and securities to support settlement of the investor's trading activities in that market.
- Collecting dividend income, interest paid on debt securities and other income payments in the local market.
- Monitoring and managing entitlements through **corporate actions** and voting rights held by the investor in the local market.
- Managing tax reclaims and other tax services in the local market.
- Ensuring that securities are registered and that transfer of legal title on securities transactions
- proceeds effectively.
- Ensuring that reporting obligations to the regulatory authorities, and to other relevant bodies, are discharged effectively.

6. How UK Securities are Issued

Learning Outcome

3.2.2 Know the methods by which UK securities are issued and brought to market

6.1 Gilts

Established in 1998, the DMO is the issuing agency for the UK government and is an executive agency of the Treasury, making new issues of UK government securities (gilt-edged securities or gilts). The DMO's primary objective is to carry out the UK government's debt management policy of minimising financing costs over the long term, taking account of risk, while ensuring that the debt management policy is consistent with the objectives of monetary policy.

The UK's budget deficit is officially known as the **public sector net cash requirement (PSNCR)**, which is the difference between government revenue and government expenditure. It is equal to the sum of:

- the central government net cash requirement (CGNCR)
- the local government net cash requirement (LGNCR), and
- the public corporations net cash requirement (PCNCR).

The PSNCR should not be confused with the national debt (ie, the total amount outstanding that is owed by the UK government; effectively, a sum of all PSNCRs borrowed over successive years to date).

The DMO issues new gilts each week by auction, and they publish details of issuance each year in their Annual Report and Accounts[13]. The level of gilt issuance varies, depending on the fiscal needs and economic conditions – it will typically be lower during periods of economic growth and reduced deficits, and increase in times of economic downturns or increased public spending. The Office for Budget Responsibility (OBR) plays a key role in forecasting these economic conditions, and providing independent analysis of the government's fiscal strategy. For example, issuance in 2009–10 reached a new (at that time) all-time high of £227.6 billion as the UK government sought to stabilise the economy and support financial institutions during the global financial crisis. Another record was set in 2020–21, with issuance reaching £485.8 billion due to substantial government borrowing to provide financial support for individuals, families and businesses impacted by the COVID-19 pandemic. Issuance has fallen since then and stood at £277.7 billion in 2024–25.

Those years aside, gilt issuance has averaged about £150 billion a year. That said, it has been rising in recent years – reaching levels higher than the global financial crisis – in part because of higher benefit payments such as cost-of-living support.

13 United Kingdom Debt Management Office. Publications. Retrieved from https://www.dmo.gov.uk/publications/ (Accessed: October 2025)

Green Gilts

In 2021, the UK government published its green gilt framework, which detailed the types of expenditures that green gilts will finance. This framework was developed in accordance with the ICMA Green Bond Principles (GBP), which are voluntary guidelines that promote integrity in the development of the green bond market by clarifying the approach for issuance of a green bond.

The UK government raised £10.9 billion in the 2023–24 fiscal year via green gilts and retail Green Savings Bonds[14] to help meet its green objectives. The money raised is being used by the UK government to fund clean transport, climate change adaption, renewable energy, energy efficiency, pollution prevention and control, and living and natural resources. Concurrently, areas such as fossil fuel exploration, weapons, tobacco, gaming and palm oil industries will be excluded.

Additionally, green retail savings products are now available through NS&I. See chapter 6, section 9.3 for more information on ethical investing.

6.1.1 Auction Process

The UK government sets the terms and conditions of the bond offering, including the interest rate (coupon), maturity date, and the amount of bonds to be issued.

At gilt auctions, bids can be either competitive or non-competitive:

- **Competitive bids** – any application can place a competitive bid submitted through a GEMM stating the price the investor is willing to pay. A bid through a GEMM or from a client bidder must be for one bid at a **clean price**, expressed as a multiple of 0.01 of £1, for at least £1 million and for multiples thereof. Investors submitting a competitive bid price which is too low, risk getting no stock, or only a proportion of the amount they originally bid for. Those who bid the highest prices will get as much stock as they have subscribed for, unless the issue is heavily oversubscribed, in which case, it may be allocated on a pro rata basis among the highest bidders.
- **Non-competitive bids** – private investors can bid on a non-competitive basis in a gilt auction for a minimum of £1,000 nominal of the particular gilt; the maximum they can bid for is £500,000. The fact that they bid on a non-competitive basis means that any application will be met in full. That is, the investor gets as much stock as they requested, at the average accepted bid price for that particular auction (ie, the weighted average price paid by successful competitive bidders). This means that someone sending in a non-competitive bid has to accept that they will be allocated stock at whatever this price turns out to be. They do not know it in advance.

For conventional gilts, options are multiple price auctions, but index-linked gilts are auctioned at the uniform price.

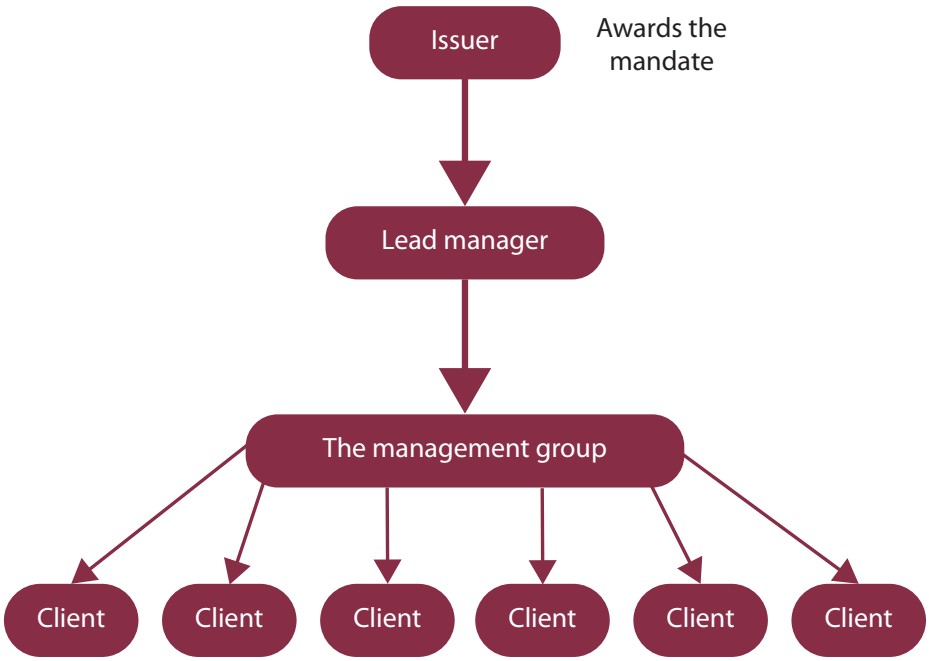
Rarely, but occasionally, gilt auctions fail. If this happens, the stock becomes a 'tap stock' and it is then released slowly when the price reaches predetermined levels.

'When issued' trading is allowed on the stock exchange. This occurs between the announcement of the auction, and when the gilts are actually issued (ie, at the auction itself). Once a gilt is issued, it can be traded in the secondary bond market.

14 GOV.UK, Policy paper: UK Government Green Financing: Allocation Report, October 2024. https://www.gov.uk/government/publications/uk-government-green-financing-allocation-report-2024 (Accessed: October 2025)

6.1.2 Syndication

Syndication is another method of bond issuance in the **primary market**, where a group of banks is appointed to manage the sale of the bond on behalf of the issuer (in the UK's case, the DMO). Very large corporate bond offerings also frequently build a syndicate to successfully issue debt.



A traditional method is for the issuer to appoint a lead manager and award them the mandate. With such a mandate, the lead manager is empowered and obligated to issue the bond on the issuer's behalf and ensure that the issue is taken up. A failed placement could do serious damage to both the issuer and the lead manager.

The lead manager and issuer will agree terms, including the coupon and the maturity. In normal issues, the lead manager has the ability to amend the terms of the issue as market conditions dictate.

Instead of an issuer relying on the best efforts of the lead manager, the issuer could get the commitment from the lead manager to purchase the entire issue of bonds or shares, known as a bought deal. This process transfers the risk of being unable to sell a whole issue at the offer price from the issuer to the lead manager. By putting the issue on to its own statement of financial position, the lead manager takes on the underwriting risk.

The lead manager may create a management group, called a syndication, that includes other banks or **issuing houses** and then each one receives a portion of the deal, as agreed with the lead manager. They are obliged to place their commitment to the deal by getting buyers for the deal from their own client bases. However, the lead manager may choose to run the complete book alone, and exclude the other members of the management group.

A variation to this is a fixed price re-offer, whereby the members of the management group are not permitted to sell the bonds in the secondary market at below the issue price until the syndicate terminates. The syndicate will break when the lead manager believes the majority of the issue has been placed.

Details of all gilts in issue (including recent offerings) and their issuance method are available on the DMO website[15].

6.2 How Equities are Issued

There are two types of companies: public limited companies (plcs) and private limited companies.

Only plcs can issue shares to the general public and have their shares publicly traded on a recognised stock exchange. In practice, only a proportion of plcs choose to do so. Some choose to be listed on the LSE's AIM, rather than seek a full listing.

6.2.1 Full Listing

There are strict criteria, known as listing rules, for private companies to gain a full listing (eg, those firms trading on the main board).

These rules are laid down by the FCA, which acts as the competent authority for listing in the UK via its 'primary markets function'. The FCA maintains the official list, detailing all the companies listed on the LSE.

These rules include the following requirements. Companies can have a premium or standard listing. The former has more stringent governance requirements, over and above that required by legislation. The principal rules are as follows:

- Minimum market capitalisation (MMC, or market value) of at least £30 million with at least 10% of shares freely available to the public (known as the '**free float**').
- Market value of any bonds to be listed must be at least £200,000.
- There cannot be any restrictions on the sale of the shares (this is to avoid the situation of family companies who sometimes place a restriction on selling shares in the company).
- No one can have more than 30% of the voting rights.
- There must normally be three years of audited accounts available.
- The directors must have appropriate experience and expertise.
- There are slightly less stringent rules for companies in certain sectors (eg, scientific, research-based activities), providing they have the requisite three years' trading experience.
- Pre-vetting of the **prospectus** by the FCA.
- A targeted form of dual class structures (DCSs) is allowed within the premium listing segment to encourage innovative (and often founder-led) firms to enter public markets sooner. This reflects the 'changing nature' of businesses looking to list, while maintaining high standards for UK public markets.

15 United Kingdom Debt Management Office, June 2024. Gilts in issue. Retrieved from https://www.dmo.gov.uk/data/gilt-market/gilts-in-issue/ (Accessed: June 2024)

The Public Offers and Admissions to Trading Regulations 2023 establish the legal basis for a new UK Prospectus Regime, distinguishing between the rules governing the admission of securities to trading on UK regulated markets and those governing public offerings of securities. The FCA plans to consult on these regulations in 2024, with the new UK Prospectus Regime expected to take effect in 2025 (at the earliest).

Proposed changes include reducing information requirements for any further issues of shares, and providing the FCA with new responsibilities in terms of making rules on admission to trading.

6.2.2 Listing on AIM

Gaining admission to AIM (formerly known as the Alternative Investment Market) is far less onerous, since the minimum **capitalisation** level, free float and trading record are not required. As a result, most AIM companies are in their early stages of development, having the intention of seeking a full listing at a later date. Nevertheless, there are some well-known and established companies on AIM, such as Boohoo and Fever-Tree Drinks.

AIM has grown in popularity over the years due to the tax advantages offered for investors. For example, an ability to gain business relief (BR) in investment in AIM shares (ex-financials) provided they have been held for at least two years; hence, an advantage for companies to list on AIM to raise share capital.

The requirements for seeking a listing on AIM are as follows:

- A **nominated adviser (NOMAD)** must be appointed. Their role is to advise directors of their responsibilities under AIM rules, and the content required in the prospectus that they must issue, in order to be admitted to AIM.
- A **nominated broker** must also be appointed. Other than providing information about the company to interested parties, their role is primarily to make a market and facilitate trading in the shares of the company.

6.3 New Issue Methods

Worldwide, if a company wishes to raise more capital through their listing or admission, for equities this is done via an **Initial Public Offering (IPO)**. The process whereby a company's shares are offered on the stock market for the first time is called a **flotation**.

There are several types of IPO, which are also known as marketing operations. We have included here the main types that are used in the UK, although they are also used in other jurisdictions outside the UK.

6.3.1 Fixed Price Offer

- The company (or an **underwriter**, such as an investment bank, acting on its behalf) offers its shares to investors at a fixed price, rather than on a tender basis (ie, inviting bids) or some other method that takes particular buyers into consideration.
- This is set just below the price at which they expect the offer to be fully subscribed in order to ensure an active secondary market.
- The company informs investors of the price (and before the public are notified), and investors must pay the full share price when they apply in order to participate.

- Demand for the shares is only known when the issue is closed.
- If, as is usually the case due to the price setting criteria, the issue is oversubscribed, the shares are allocated by either a scaling down or by a random selection from the applications received, as detailed in the offer document.

Pricing the offer is a difficult task, since there is a delicate balance between encouraging an active secondary market while avoiding an excessive oversubscription, which may indicate that the company has not raised as much capital as it could have done. In addition, market sentiment could change between the date of the offer and the closing date for applications. For this reason, some companies may prefer to issue the shares on a tender basis.

6.3.2 Tender Offer

- Rather than fixing a price, invitations for **tenders** are sought from prospective shareholders.
- Normally a minimum price is stipulated, and investors subscribe for a given number of shares at a price they are prepared to pay.
- When the offer is closed, a strike price is determined. This will normally be set with a view to achieving an active secondary market, and all bidders at or above this price will be satisfied.
- All successful bidders pay a uniform striking price, unlike an auction.

Although this form of offering is more attractive in terms of achieving the best result for the company, the administrative complications involved have made this a less popular option in practice.

6.3.3 Offer for Sale

- This involves the company selling either new or existing shares (eg, family shareholdings) to prospective investors.
- The issuing house invites applications from the general public, based on a detailed prospectus known as an offering document. For a share listing other than on the main market, such as AIM in the UK, a less detailed prospectus may be necessary. The prospectus is prepared by the directors, but assessed by an independent sponsor (usually either a solicitor or an accountant).
- The independent sponsor must also provide a letter to the listing authority (eg, the FCA in the UK), confirming working capital adequacy. This normally accompanies the prospectus.
- An advert will also be placed in a national newspaper detailing the flotation. This is known as a 'formal notice'.
- The offer price will be slightly higher than the price paid to the company.
- The offer can be on either a fixed or tender price basis.

6.3.4 Offer for Subscription

- Offer for subscription is mainly used for new investment trusts.
- It is similar to an offer for sale, in that a company (or someone on their behalf) invites the public to subscribe to shares not yet in issue (ie, new shares) or allotted (eg, existing shares).
- A key difference is that for an offer for subscription, a minimum subscription level (eg, value or number of shares) must be met if the offer is to be successful; otherwise, the offer is withdrawn.
- The risk is that if the offer for subscription is not successful, time and resources have been wasted.
- A detailed prospectus and advertisement are required for a full listing, but nowadays they are usually published electronically on the company's or sponsor's website, with hard copies also available.

- An issuing house fully underwrites the issue for an agreed commission, ensuring the company sells all the shares on offer. Usually, this is conditional upon the company achieving a minimum subscription level.
- This kind of IPO can also be offered on either a fixed or tender price basis.

6.3.5 Placing (Selective Marketing)

- This involves a company offering its shares to selected clients (hence the alternative term for a **placing**: 'selective marketing'), typically institutional investors.
- The company markets the issue via a broker, an issuing house or other financial institution.
- The advantages of this method are as follows:
  - the prospectus does not need to be so detailed
  - underwriting is not required
  - advertising is not required, unless a full listing is proposed, and
  - as a result, this is a cheaper alternative for the company seeking a listing.
- The disadvantages of a placing are:
  - the company will have a narrower shareholder base, resulting in lower levels of liquidity in the secondary market, and
  - if existing shareholders do not take up their right to buy the shares, their shareholding is diluted.

In the UK, most AIM companies issue their shares using this method.

6.3.6 Introduction

Companies can also achieve a listing on the stock exchange by means of an introduction. These are not IPOs since no new capital is raised. This method is available to those companies already listed on an overseas exchange or demutualised companies like former building societies. The benefit of a full listing is to make the shares more accessible to UK investors, which could aid any capital-raising activities which may be required in the future. This is also sometimes done where founders and early investors want to realise some gains by placing the shares in the market. Note that in this case, no new shares are issued and no new funds are raised by the company.

7. Indices

Learning Outcome

3.1.5 Understand how indices are constructed, and the purposes and limitations in using them

7.1 Introduction

Indices aggregate a great deal of information. For example, periodically checking the price of a few stocks might give a certain impression of how the market is performing. A well-constructed index can tell an investor how the entire market is doing and how it has done over time.

Indices require a base period, or starting point. The components (members) of the index are given a particular weight and a starting value for the index is chosen (for example, 100). The prices of the components will vary continuously, and for most indices, their weight in the index will also vary over time. Future changes to the index value can then be compared with the base value or subsequent values, to present a picture of long-term performance.

Index numbers are very useful for comparing how the value of a basket comprising many different items changes over a period of time. These indices are called composite indices. Inflation indices such as the **Retail Price Index (RPI)**, the Consumer Price Index (CPI) and the harmonised index of consumer prices (HICP) in the EU are examples of composite indices, which indicate the level and growth (or reduction) of inflation in an economy.

The level of these indices will be interpreted by the market in terms of economic outlook, which may have profound implications for both bond and stock prices. In addition, there will be a tangible effect on the value and coupon of certain index-linked securities (eg, ILGs).

7.2 Stock Market Indices

There are thousands of stock market indices worldwide, some of which track the performance of a single market, and others which cover a sector, region or combination of markets.

Stock market indices have many uses, including:

1. acting as a barometer for the market
2. aiding portfolio measurement (eg, serving as a benchmark)
3. assisting with **asset allocation** decisions, and
4. acting as the basis for certain other investment products, eg, index-tracking funds, exchange-traded funds, index derivatives or **structured products**.

We will examine the use of indices in terms of portfolio performance and review in chapter 7.

7.3 Types of Equity Index

There are many different methods of constructing an index (eg, geometric, arithmetic, weighted or unweighted). We will look at the most commonly used methods below, but before doing so, let us consider the thought processes which should be followed before constructing an index from scratch.

When considering how to construct an index, the following points should be borne in mind:

- Which markets or sectors to track.
- The basis for inclusion of its constituents.
- How to combine or average the relative prices of the various constituents (eg, for responsible and sustainable indices, environmental, social and governance (ESG) criteria and scores).
- Whether and how to weight these constituents.
- How changes to constituents are going to be handled.
- Whether to include or exclude dividend income.
- Whether to include taxes from purchase/sales.

There also needs to be consideration for the potential user of the index, as follows:

- Does it satisfy the needs of investors?
- Is it taken from a broad enough base?
- Can it be replicated for portfolio performance measurement, or by product providers for index-related products?
- Are there any restrictions on holding any constituents?
- Is it transparent in terms of composition and calculation?

The most commonly used indices are as follows.

7.3.1 Price-Weighted Arithmetic Indices

A price-weighted arithmetic index is one where the constituents are weighted in proportion to their price per share. This means that the higher the share price, the greater the impact it will have on the overall index value compared to those with a lower share price.

These indices assume that an equal number of shares are held in each of the constituents. It follows that those constituents with the higher share price will have a greater impact on the overall index value compared with those constituents with a lower share price.

While this type of index is relatively easy to administer, the disadvantage of weighting in favour of the more expensive stocks is considerable. In addition, there is no account taken of the number of shares in issue of each constituent, which may make the index unrepresentative of the true market performance.

Example

If a US index consisted of two stocks, one of which was worth $9 and the other $1, although the constituent with $9 has substantially fewer shares in issue it will have a greater impact on the index. The index in this case would be $5 (ie, [$9 + $1] / 2). If the $9 stock increased by 10% (to $9.90) and the $1 stock decreased by 50% (to $0.50), the index would move to $5.20 (ie, [$9.90 + $0.50] / 2). This illustrates a reason why price weighting methodologies are not widely used; the impact of various stocks are arbitrary and not based on economic fundamentals.

This makes a price-weighted arithmetic index unsuitable as a performance measurement benchmark, or as a market barometer.



Can you think of an example of a price-weighted arithmetic index?

The Dow Jones Industrial Average (Dow or DJIA) is a price-weighted arithmetic index, and has survived despite the shortcomings highlighted above.

Unweighted Geometric Indices

With these types of index, the geometric mean is used to calculate the value of the index.



What is the difference between arithmetic and geometric mean?

Arithmetic mean is what most people understand by the word 'average' in that a set of numbers is added and the sum is divided by the count of numbers in the set, n.

The geometric mean is similar, except all the numbers in the set are multiplied and then the n^{th} root of the product is taken.

Example

Take two numbers, 2 and 8.

The arithmetic mean is 2 + 8 = 10, divided by 2 = 5.

The geometric mean is the square root of 2 x 8 =16 which is 4.

The disadvantages of this type of index are as follows:

- It always understates the price rises and overstates the price falls, compared with a price-weighted arithmetic index.
- It collapses if the value of a constituent falls to zero, since anything multiplied by zero is zero.

For these reasons, unweighted geometric indices should not be used to measure portfolio performance or as a market barometer.

 Can you think of an example of an unweighted geometric index?

An example of this type of index is the FT 30, which is based on the share prices of 30 UK companies from a wide range of industries. While it is a rarely used index, it can offer insights into the broader trends of the UK stock market.

7.3.2 Market Value-Weighted Arithmetic Indices

The constituents of these types of indices are weighted in terms of their relative market capitalisation. In addition, the constituents are usually drawn from a broad base of the market being represented.

This makes them more suitable for performance measurement, asset allocation and for pricing index-related products. They still have a disadvantage in that, if dominated by a handful of large-cap companies, they may not offer the diversity needed for comparison with portfolio performance, or an index-based product. Despite the occasional concentration risk of certain companies and industries, this is the most popular methodology for computing indices.

 Can you think of an example of a market-value-weighted arithmetic index?

Examples include the FTSE 100, S&P 500 and the Hang Seng.

7.3.3 Free Float Indices

The 'free float' is the proportion of a company's securities available to outside investors. It usually excludes shares held by strategic investors or government holdings in large, privatised companies. Some overseas companies limit the number of shares available to non-resident investors.

Free float indices adjust weightings in their indices according to the free float. This makes the indices more useful as a measurement of performance since it reflects more closely what fund managers can actually buy.

The range of indices developed by FTSE Russell (eg, FTSE 100, FTSE Developed Europe, FTSE Japan) and MSCI (eg, MSCI World, MSCI USA, MSCI China) are examples of free float indices.

7.3.4 Capped Indices

Capped indices have upper limits on the weight of any security, category of securities or asset class, thus allowing investors to monitor the impact of reducing the size of the largest companies within the underlying index or indices. Such indices must be rebalanced regularly (eg, quarterly) to re-establish their weightings. They can target specific geographies, regions or sectors, among other criteria.

FTSE Russell, MSCI and Dow Jones have developed their own ranges of capped indices. For example, the FTSE UK Capped 5% Index Series is based on the underlying constituents of the FTSE 100 and the FTSE All-Share index. As its name suggests, constituents are capped at 5% of the total index.

Another example is the MSCI World SRI 5% Issuer Capped Index. Based on the MSCI World SRI Index, it captures large and medium-sized companies with outstanding ESG ratings across over 20 developed countries, with a maximum weight to any company of 5%. UCITS rules have specific concentration limits, so the popularity of UCITS funds have actually driven an entire new class of indices based on the UCITS restrictions.

7.4 Limitations of Using Indices in Portfolio Measurement

- They (usually) do not take into account the effect of costs and taxation, and in any case, they will not match an individual investor's true costs.
- Most track price movement and do not include dividend (for equities) or coupon (for bonds) reinvestment. If total returns are quoted, often the dividend/coupon is assumed to be reinvested at the **ex-dividend (xd)** date, and not the payment date.
- They assume that the investor is fully invested in constituent companies at all times.
- There is a 'survivorship bias' (ie, only issues that have continued to meet the criteria of the index remain in it, whereas other issues that have failed to meet the criteria or that have declined and either removed early or have been acquired by other firms will have left the index). This may not replicate the situation in a real portfolio.
- The weighting by market capitalisation often leads to a high covariance portfolio, where favoured sectors are overly represented in the index, leading to potential instability should the bubble burst.

We will look at the main stock market indices in greater detail in chapter 7.

8. Contract Notes

Learning Outcome

3.2.3 Be aware of the purposes and requirements for issuing contract notes

3.2.4 Understand the applicability of value-added tax (VAT), stamp duty and stamp duty reserve tax (SDRT) to transactions in UK financial securities for UK firms

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In the UK, the rules regarding **contract notes** are to be found in the FCA Handbook, specifically the Conduct of Business Sourcebook (COBS) 16.2.1R.

With the exception of where an adviser is managing investments for retail clients, the contract note must be sent out to them 'in a durable medium' as soon as possible, and no later than the first business day following that execution.

COBS 16 Annex 1R details the information which must be included in the contract note, where applicable:

- The identification of the firm.
- The name or other designation of the client.
- The date and time of trade.
- The type of order (eg, limit order or market order).
- The venue identification.
- The instrument identification.
- The buy or sell indicator (or the nature of the order, if not buy or sell).
- The quantity.
- The unit price.
- The total consideration.
- The total sum of the commissions and expenses charged.
- The rate of exchange obtained (where currency conversion is required).
- The client's responsibilities in relation to settlement of the transaction (eg, time limit for payment or delivery).
- If the client's counterparty was the firm itself, in the firm's group, or another client of the firm, record the fact that this was the case, unless the order was executed using a system which facilitates anonymous trading.



Can you obtain a contract note? Look for the features we have mentioned. How does it compare with others you have seen?

COBS also states that firms must retain copies of contract notes for a minimum period of five years for MiFID business or three years for non-MiFID business.

8.1 Stamp Duty

In the UK, stamp duty applies to transfers of stock and marketable securities in paper (or certificated) form, and to certain transfers of interest in partnerships. It is charged at a rate of 0.5%, rounded up to the nearest £5, usually only paid by the buyer.

Instruments transferring stock or marketable securities with consideration of less than £1,000 are exempt from stamp duty. It is also not charged on gilts, public authority securities, UK corporate bonds, bearer stocks, transfers to registered charities and foreign-registered securities, including most exchanged-traded fund (ETFs), and AIM securities.

Similar financial transaction taxes (FTTs) are levied on specific types of financial transactions worldwide, although the rate itself and the circumstances in which they are charged (if at all) differs significantly across countries.

8.2 Stamp Duty Reserve Tax (SDRT)

Alongside stamp duty, the UK imposes another tax that affects financial transactions: SDRT.

SDRT is a transaction tax charged on 'agreements to transfer chargeable securities', unlike stamp duty, which is charged upon documents. The rate is also 0.5% and the same conditions listed above for stamp duty also apply to SDRT, apart from the rounding up of SDRT to the nearest 1p. Paperless transactions are outside the scope of stamp duty.

SDRT accounts for the majority of taxation collected on share transactions effected through the UK's exchanges. The majority of this taxation is collected automatically through the CREST system, although payments are also collected for transactions that are affected outside of CREST (referred to as 'off-market' payments), or inputted incorrectly through CREST. This is done either by way of a cheque or the Clearing House Automated Payment System (CHAPS). This process eliminates the need for a document (ie, a stock transfer form); however, if a paper transaction is drawn up and duly stamped, the transaction will fall within the stamp duty regime, and the SDRT charge is cancelled.

8.3 Panel on Takeovers and Mergers (POTAM)

To cover the running costs of the Panel on Takeovers and Mergers (POTAM), a £1 levy is imposed on all sterling contracts of equities where the consideration exceeds £10,000. This is imposed on both purchases and sales.

8.4 Value-Added Tax (VAT)

Value-added tax (VAT) is a consumption tax placed on a product at each stage of the supply chain, from its production to the point of sale to a consumer (ie, whenever value is added).

In the UK, the current standard rate of VAT is 20% – in other words, goods and services are subject to an additional 20% of their net value in tax. That said, certain goods and services may qualify for reduced rates or exemptions, while others are exempt from VAT altogether.

For transactions in UK financial securities for UK firms:

In the UK:

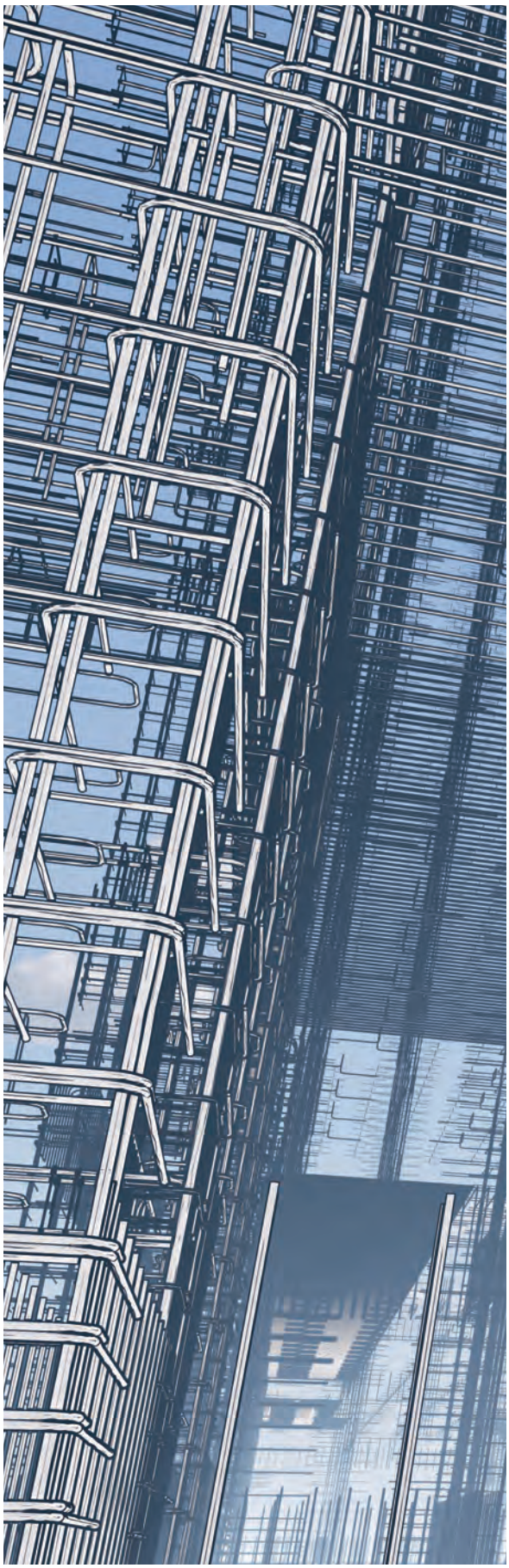
- a stockbroker's commission is exempt from VAT
- investment management fees are generally subject to VAT, and
- some brokers offer a scheme where they charge the client the full rate of commission (with no VAT payable) and offset these commissions against the annual management fee (which is subject to VAT); these are called offset charging schemes and these reduce, or could even eliminate, the VAT payable by the client over the year.

Chapter Four

Trusts and Trustees

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be examining the principles and key features of trusts and the law governing their creation and management.

An understanding of UK trusts and trust law is crucial for various reasons:

1. Trusts provide a powerful tool for asset protection and wealth preservation. By placing assets into a trust, individuals can shield those assets from potential risks, such as creditors.
2. Trusts offer significant tax advantages. With careful planning and implementation, trusts can help minimise income, capital gains and/or inheritance tax (IHT) liabilities. A comprehension of tax rules and regulations surrounding trusts can, therefore, enable individuals to optimise their tax planning strategies, allowing them to pass on more of their wealth to future generations.

However, trust law is a complex and technical area, so a high degree of specialist knowledge is required to ensure that trust is correctly structured and created for the right reasons.

2. Trusts and Trust Legislation

Learning Outcome

4.1.1 Know the key features of UK trusts, including the arrangement, participants and documentation

4.1.3 Understand the key provisions of the Trustee Act 2000 and how these relate to the investment powers of trustees and the trust deed

2.1 History of Trusts

The law of trusts developed in the Middle Ages around the time of the Crusades. Over the centuries since the introduction of Roman law, England had developed a fairly detailed set of rules which the population was obliged to abide by. This was known as common law – common since the rules had to be adhered to by everyone.

The courts enforced common law by following decisions and principles laid down in previous cases very closely. While this served a useful purpose for settling the majority of disputes, at times, the application of the rigid and inflexible rules that had developed through the courts led to problems when dealing with more unusual circumstances. In the 14th century, a system was introduced whereby anyone who found the application of common law to be unfair or 'inequitable' could apply to the king. The king soon delegated his powers to the Lord Chancellor who then established the Court of Chancery. The cases brought before the Court of Chancery were not decided on common law but according to the judge's sense of justice. Over time, the law of equity evolved with its very own rules, principles and procedures.

Candidates need to be aware that the information in this workbook refers to trusts set up under English and Welsh law, which could be different to trusts set up in Scotland and Northern Ireland. It is also worth being aware that other countries may have their own versions of trust law, although the details on this are outside the scope of this workbook.

2.2 What is a Trust?

While there is no statutory definition of a trust, the following summarises the key elements which should be present:

- An individual (settlor)
- Gifts certain assets (the trust property)
- To be managed by a third party (trustee)
- In accordance with defined objectives (the trust deed)
- For the benefit of certain people (beneficiaries).

Some trusts may also appoint a **protector** (ie, a person appointed by the settlor under the terms of the trust deed) to oversee the trustees' actions in relation to their administration of the trust. See section 3 in this chapter for more information on each of these distinct roles.

Trusts are used for many reasons. Some of the more usual reasons include:

- when someone is too young to handle their affairs
- to control and protect family assets
- when someone cannot handle their affairs because they are incapacitated
- when someone cannot handle their affairs because they are serving in a public position and there could be conflicts of interest
- to pass on assets while a person is still alive
- to pass on assets when a person dies (a 'will trust')
- to pass on the proceeds of a life insurance investment bond more quickly on death, without requiring sight of a grant of representation (or confirmation in Scotland), or
- under the rules of inheritance, if someone dies without a will (in England and Wales).

Trusts are often used as part of financial planning arrangements as they can provide flexibility, a level of protection and control over the family assets, or to protect family wealth against taxation/probate. Trusts in a family context are referred to as 'civil trusts' in some parts of the world.

Further, a trust will normally be more confidential than the provisions of a will, which ultimately becomes a matter of public record. That said, under the Money Laundering and Terrorist Financing (Amendment) Regulations 2019, trustees and personal representatives of certain types of trust have been obliged to report information to the Trusts Registration Service (TRS) – this is a government online register to tackle money laundering. This requirement applies to all UK trusts and some non-UK trusts (whether or not the trust has to pay any UK tax), although some exclusions apply.

The Economic Crime (Transparency and Enforcement) Act (ECA) 2022 seeks to ensure that the ownership of property held in the UK is transparent, through measures such as establishing a register of overseas entities and their beneficial owners. Trustees (including overseas entities) who hold land on behalf of a trust will need to register with the UK's Companies House and provide certain prescribed information about the trust. This information must be updated every 12 months. The trust itself may also need to be registered with the TRS. Non-compliance with the rules is potentially punishable by fines and imprisonment.

The TRS register is partially available to the public, thus raising concerns about the erosion of privacy for hundreds of thousands of trustees and beneficiaries. This, alongside reduced tax advantages over the past few decades, could make trusts a less attractive tool for financial planning purposes.

Trusts can also be used extensively in the commercial world. These so-called commercial trusts are often used where:

- client/customer money is held (eg, insurance arrangements)
- there is a dispute, or potential dispute, about the ownership of an asset – the asset can be held on trust, thus preventing the sale of the asset, while the case goes through the courts
- there is an employee incentive arrangement (eg, employee benefit trusts, including pensions), or
- in various collective investment structures (eg, unit trusts).

Whichever type of trust is used, with modern tax rules, professional advice should be obtained to ensure that they do not breach the tax regulations and so fail in their purpose.

2.3 Trust Creation

Trusts can be created by a variety of means including by deed, will, statute or (as we shall see later in section 4.3.2) in secret. They can also come into existence by oral declaration, although the law requires there to be sufficient evidence of the settlor's intention to create the trust (which may be difficult).

We will now look at the methods most commonly used by settlors in the UK, to create trusts for financial planning purposes.

2.3.1 Creation by Deed

This is the most common method of creating a trust. There is no prescribed format, but most solicitors and trust corporations will have tried and tested templates that can easily be adapted to suit the settlor's particular requirements.

The deed will specify:

- the trust property
- the names of the trustees
- the names of the beneficiaries and/or potential beneficiaries (if known, eg, the deed may state 'any children or remoter issue of the settlor', or similar)
- the name of the protector (if there is one)
- the powers of the trustees
- the rights of the beneficiaries, and
- any restrictions on the types of investments in which the trust should invest (eg, any sectors/asset classes to be avoided; or it could include an express power to make environmental, social and governance (ESG) investments, with provisions defining what will qualify in this regard, as well as setting out any limitations on those investments).

The deed must be signed by the settlor and is usually also signed by the trustees to confirm their acceptance.

Trusts can also be created over life policies very simply by filling out the life office's trust form.

2.3.2 Creation by Will

A trust can be expressly stated in a will or arise because of a gift to a minor. Even if the will does not include provisions to set up a trust, the executors are effectively holding the entire estate on trust for the beneficiaries until they can fully distribute it.

Clearly, a will trust (also known as a 'testamentary trust') will not come into operation until after the testator has died. Therefore, the trust may not receive any assets until many years after the will is prepared. There is also the possibility that the will may be revoked prior to death, such that the trust never comes into operation.

Some wills avoid the need and possible expense of setting up trusts by giving permission to the parents of any minors to provide a valid receipt for property left to their children, in essence creating a 'bare' trust. That means looking after the assets for somebody else, but not being affected by any tax consequences.

Notably, a will that has been drafted in accordance with the laws of one country may not be considered valid in another, unless it satisfies the laws of the foreign country (among other considerations), which is outside the scope of this workbook.

2.3.3 Creation by Statute

There are many trusts created or implied by statute. The following are examples of such trusts in the UK:

- **Section 33 Administration of Estates Act 1925** – this provides for the **creation** of a trust for sale on intestacy (failure to leave a will upon death). This has been altered by Section 5 of the Trusts of Land and Appointment of Trustees Act 1996, the effect of which is that personal representatives now have a power, but not a duty, to sell land held within the estate.
- **Sections 34 and 36 Law of Property Act 1925** – if a legal estate is held by two or more persons as joint tenants, it is held in trust.

2.4 Legal Requirements for a Valid Trust

2.4.1 The Three Certainties

In order to create a valid express trust, trust law requires that three certainties are satisfied:

1. **Certainty of intention** – words must be used indicating an intention to create a trust. The equitable maxim 'equity looks at the intention not the form' means that no particular form of words is used, but the court will look at the words used in light of all the circumstances. 'On trust for' would be sufficient in this regard.
2. **Certainty of subject matter** – it must be established, with clarity, what property is to be held on the express trust. If the subject matter is not certain, the whole trust fails (although hopefully, if the settlor is still alive, they would be able to clarify the position).
3. **Certainty of object** – it must be clear for whom the trust is intended. This could be a simple case of naming the beneficiaries (eg, 'A and B in equal shares absolutely') or for a class of people (eg, 'any of my children who survive me').

Case Study

In a case called McPhail v Doulton [1971], the rule was tested thoroughly where the will of Mr Bertram Baden included a gift to the employees of his company, Matthew Hall & Co ltd, and their relatives and dependants. The test that was put forward by the House of Lords was to ask whether a trustee could tell, with certainty, whether a hypothetical claimant presenting themselves was (or was not) within the class of beneficiaries. In this case, it was possible to ascertain whether any person presenting themselves was either an employee, a relative or a dependant, so the trust was valid for certainty.

Charitable trusts need not fail for certainty of object, as they can be established for changing beneficiaries or evolving processes over time (eg, providing financial support for the education of underprivileged children in a specific town). Hence, a legal concept called the *cy-près* (pronounced 'sigh-pray') doctrine empowers courts to adjust the charitable trust's terms to accommodate changing circumstances, while ensuring that the assets fulfil the trust's original charitable intent.

2.4.2 Rules against Perpetuities and Accumulations

It has long been considered to be against public policy to allow property to be retained in trust for an indefinite length of time. Similarly, it was decided in Thellusson v Woodford [1799] that if trustees were allowed to accumulate income indefinitely, then in theory, the trust fund would grow with compound interest and could eventually contain a significant proportion of the national wealth. This seems extraordinary now, but it was clearly of great concern at the time.

The rules against perpetuities are contained in the Perpetuities and Accumulations Act 2009, which states that the ultimate interest in a settlement must vest within 125 years if the trust takes effect after 6 April 2010.

For trusts set up before 6 April 2010, an 80-year limit applies. Alternatively, the Perpetuities and Accumulations Act 2009 allows the settlor to select a specified period, after which accumulation of the trust income must cease, including:

1. the life of the settlor
2. 21 years from the death of the grantor, testator or settlor (referred to as the '21-year rule')
3. the minority of any persons living at that time (ie, until they are 18), or
4. the minority of any persons entitled under the settlement.

Each of these participants is covered in more detail in section 3. The perpetuity rule does not apply to charitable trusts or pension schemes.

2.4.3 Constitution of the Trust

Depending on what type of property is involved, certain formalities need to be satisfied before the property is validly transferred, and the general principle is that 'equity will not perfect an imperfect gift'. Thus, in the case of land, there needs to be a deed, and in the case of shares, Sections 182–183 of the Companies Act 1985 provide that in general, a share transfer form must be executed and delivered with the share certificates, followed by entry of the name of the new owner in the company books.

2.4.4 Foreign Account Tax Compliance Act (FATCA)

As covered in section 5.2.4 of chapter 2, FATCA is a piece of US legislation designed to reduce tax evasion by US citizens and US tax resident individuals, with respect to income from financial assets held outside the US.

Under FATCA, trusts may be classified as a foreign financial institution (FFI). If this is the case, the trustees and/or trust must register as an FFI with the IRS, who will issue the trustees and/or trust with a global intermediary identification number (GIIN). Thereafter, the FFI must report any payments made to or for a US person from the trust. Any FFIs that fail to comply with FATCA will be subject to a **withholding tax (WHT)** penalty on certain sources of investment income.

Pensions and charitable trusts are deemed to be compliant FFIs, so they have no further obligations under FATCA.

2.4.5 Common Reporting Standards (CRS)

Also from section 5.2.4 of chapter 2, CRS is a global standard for the automatic exchange of financial accounts and tax information between governments around the world in the fight against tax evasion.

Similarly to FATCA, the CRS requires financial institutions (including those holding trusts) to collect and report certain financial information about their customers to their respective tax authorities. While the CRS primarily targets individual and entity accounts, it can also have an impact on trusts as well with regard to increased reporting obligations, tax transparency, and trust planning and structures to ensure compliance with reporting requirements. The CRS also imposes additional administrative burdens on trustees, as they may need to gather, maintain, and report accurate and comprehensive information about trusts and their beneficiaries to the relevant authorities.

3. Parties to a Trust

As we have already discussed, every trust has a settlor, trustees and beneficiaries. Some trusts also have a protector. We will look at each of these participants in turn.

3.1 Settlor

Sometimes referred to as a trustor or grantor, the settlor is the person who sets up the trust by transferring money or other property to trustees to hold upon the terms of the trust they are seeking to establish.



Who do you think may be a settlor?

Any legal entity that is capable of owning or transferring property could be a settlor, which could include an individual or a corporation.

Documentation: Trust Deed

The terms of the trust will be laid out in a legal document for gifts during the settlor's lifetime (*inter vivos*), or in the will on death. In England and Wales, this document is usually in the form of a trust deed. The trust deed sets out the terms and conditions under which the trust will operate, the parties involved in the trust (including the settlor, trustees and beneficiaries, the latter two of which are described in sections 3.2 and 3.3, respectively below), the trust property, the purpose of the trust, its duration, and the powers and duties of the trustees, among other components.

The placing of property into trust is effectively a gift of the assets, so the settlor no longer has any control over them. However, some settlors find this unpalatable; therefore, many modern trust deeds include provisions that reserve certain powers for the settlor. Commonly, the settlor will wish to reserve the power to appoint and remove trustees, but they can go further and reserve the power to appoint portfolio managers or, more unusually, retain the investment powers completely.

On a practical point, settlors need to be careful not to retain too much control, since the courts could set aside the trust as a sham in such circumstances. This would mean that the trust is ignored for tax purposes and, therefore, any potential tax benefits of setting up the trusts would be lost. This is far more common with offshore trusts where it may be possible for the settlor to also be a beneficiary.

3.2 Trustees

The trustees are the legal owners of the trust property and, on appointment, the property will be vested in them by the settlor. This process is known as 'constituting the trust'. Trustees can be natural persons (ie, an individual human being, sometimes also referred to as a physical person), a business entity (known as corporate trustees) or a public body (ie, an organisation the delivers a public service).

The original trustees are appointed by the trust deed, sometimes called a 'settlement'. The original trustees of will trusts are appointed in the will. If someone dies intestate (without a valid will), then the administrators will be the trustees of any trust set up as a result.



Who do you think may be appointed a trustee?

Anyone capable of owning a legal interest in property may be appointed as a trustee (even if they are also a beneficiary under the trust), which means that they have to be over 18 and of sound mind (*sui juris*). This also includes corporate entities known as trust corporations, empowered by their memorandum and articles to act as a trustee.

The settlor and/or one or more beneficiaries may be appointed as trustees, which can be beneficial as it allows them to be directly involved in the trust's affairs. However, the trust deed will need to be carefully worded to manage any possible conflicts of interest.

Trustees must do the following:

- Familiarise themselves with the terms of the trust and ensure that the trust property has been transferred into the names of the trustees and is under the trustee's control.
- Comply with the terms of the trust and not act outside their powers (eg, by making or facilitating payments to a non-beneficiary). In fulfilling their responsibilities, trustees must also consider and address ethical, responsible and sustainable investment factors (which will vary, depending on the nature of the trust).
- Administer the trust fund honestly and impartially, not allowing their own personal interests (including any interest they may have as a potential beneficiary) to influence their decisions.
- Consider the needs, circumstances and interests of all of the beneficiaries when exercising powers or discretions.
- Keep records of the trust assets and investments (including payments made out of trust to beneficiaries) and be prepared to account to the beneficiaries on request and for tax purposes.
- Keep a record of any loan repayments made to the settlor (in the case of a loan trust) and ensure that no more than the amount loaned is repaid.

3.2.1 How Many Trustees are Allowed?

There can generally be any number of trustees, although most trusts will have between two and four. If the trust ends up with only one remaining trustee, for whatever reason that may be, then at least one other trustee should be appointed.

If the trust contains land, in order to give a valid receipt for the proceeds of sale, there must be at least two trustees (unless one is a trust corporation) and no more than four.

Whatever the number of trustees, they are treated as a single notional person. In the UK, the residence status of the trustees determines how the trust will be taxed:

- **All trustees are UK resident** – the trust is resident in the UK for income tax and capital gains tax (CGT) purposes.
- **All trustees are non-UK resident** – the trust is not resident in the UK for income tax and CGT purposes. These trusts are called non-resident trusts, the tax rules for which are very complicated and fall outside the scope of this workbook.
- **The trustees are a mixture of UK and non-UK resident** – the trust is resident in the UK, unless the settlor was not resident and not domiciled in the UK at the time that they made (or was treated as having made) the trust, and any time when they added property to the trust.

3.2.2 Duties of Trustees

As we have seen, the job of the trustee is to hold the trust property for the benefit of the beneficiaries in accordance with the trust provisions.

In England and Wales, the trustees' duties are set out in the trust deed and applicable trust law (eg, the Trustee Act 2000, which is set out in section 3.2.6 below). The role carries with it the following principal general duties:

- **Comply with the terms of the trust** – the trustee must be familiar with the terms of the trust and comply with the duties and powers contained in the trust instrument. Any failure in this duty could be in breach of trust and the trustees would have to make good any losses which have arisen as a result of negligence.
- **Take control of the trust property** – the trustee must ascertain the assets of the trust and ensure these are vested in the names of the trustees. For example, they will need to make sure that any shareholdings are registered in the names of the trustees. Failure to do so could result in loss or misappropriation, which would also be a breach of trust for which the trustee would be liable.
- **Act impartially between the beneficiaries** – the trustee must act in the best interests of the beneficiaries, but importantly, must also act impartially between all of the beneficiaries. When considering which investments to purchase on behalf of a trust, the trustee must have regard to the interests of all beneficiaries and not be biased one way or another.
- **Duty to keep accounts** – the trustee must keep clear and accurate accounts of the trust and provide them to beneficiaries on request. There is no duty to have these audited, but the trustee can choose to do so.
- **Duty to provide information** – the trustee must produce information and documents on request of the beneficiaries.
- **Statutory duty to consider financially material factors** – the trustee must disclose 'financially material considerations' in their **statement of investment principles (SIP)**, which sets out the trustees' investment policy. This includes how they have considered ESG factors in their investment decisions, among other considerations. Trustees of certain schemes must also include a statement in their annual report setting out the extent to which they have followed the SIP during the scheme year.
- **Duty of care** – in addition to the above general duties, there has always existed an overarching duty of care that covers all the actions of a trustee. While this has developed over the years from common law, it has now been complemented by the statutory duty of care imposed by Part 1 of the Trustee Act 2000.
- **Common law duty of care** – this has been developed from case law over the years, and interestingly, most of the important cases were concerned with investment-related issues.
    - **Speight v Gaunt [1883]** – a trustee should conduct trust affairs in the same way a prudent person of business would conduct their own. This case centred on the use of agents, in this case a stockbroker, who defaulted on their duties. However, the trustee was not found liable since they had been prudent in seeking expert help.
    - **Re Whiteley [1886]** – in relation to investment, a trustee should use the same diligence as that which a person of ordinary prudence would take in the management of their own affairs, or the affairs of someone for whom they felt morally bound to provide.

- **Re Lucking's Will Trusts [1968]** – this concerned the management of a majority interest in private company shares within a trust. A majority shareholder would be prudent to seek more information than an ordinary shareholder; indeed, they may seek a seat on the board. If they did not do so, they would be lacking in their duty of care.
- **Bartlett v Barclays Bank Trust Co ltd [1980]** – again, this case concerned the management of a private company. The court followed the ruling in Re Lucking's Will Trusts, but also said that a higher duty of care is expected of a professional trustee who specialises in trust management.
- **Statutory duty of care** – the Trustee Act 2000 established a statutory duty of care for trustees. This is found in Part 1, which is reproduced below:

  'Whenever the duty under this subsection applies to a trustee, they must exercise such care and skill as is reasonable in the circumstances, having regard in particular:

  a. to any special knowledge or experience that they have or hold themselves out as having, and
  b. if they act as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.'

As you will see, this legislation imposes a general standard of care as to what a reasonable person would do in the circumstances, but supports the ruling in Bartlett v Barclays Bank Trust Company for professional trustees and those with specialist knowledge or experience.

3.2.3 Limitations of the Statutory Duty of Care

The statutory duty of care will only apply to:

a. exercising the powers of investment
b. acquisition of land
c. using agents, nominees or custodians, and
d. insurance of trust property.

Furthermore, it is possible (under Schedule 1 Section 7 of the Trustee Act 2000) to exclude the statutory duty of care in the trust instrument.

However, the common law duty of care will apply to each and every exercise of the trustees' powers, therefore it will continue to be of great relevance and importance to the activities of trustees.

3.2.4 Exemption Clauses

In addition to being able to exclude the statutory duty of care, trust instruments have, for some time, commonly included exemption clauses whereby the settlor agrees to exonerate the trustees from any liability for negligence. In Armitage v Nurse [1998], an exemption clause of this type was considered by the courts, and it was held that exemption clauses were valid for any breach of trust in the absence of dishonesty. As you can imagine, you will not see many modern trust deeds managed by solicitors and professional trustees without this clause inserted.

3.2.5 Powers of Trustees

The trust deed will commonly confer additional powers to the trustees. These could be specific investment powers or, if there is a life policy held in trust, the power to pay premiums, make claims, exercise options and switch funds.

All trustees must act unanimously in the exercise of their powers.

The Trustee Act 1925 also conferred statutory powers on trustees regarding to the power to apply income (Section 31) or capital (Section 32) to beneficiaries.

3.2.6 Trustee Act 2000

Many sections of the Trustee Act 1925 and the Trustee Investment Act 1961 were repealed by the Trustee Act 2000. The Trustee Act 2000, which came into effect in England and Wales in 2001, brought about the biggest changes to trust law in England and Wales for 75 years – for example, it conferred new statutory powers of investment on trustees; and it gave trustees a statutory power to delegate day-to-day duties to an agent (including the powers of investment). The Act requires the trustees to set out a policy statement stating how the investment management functions should be managed in the best interest of the trust.

The Act also created an express professional charging clause for non-charitable trusts which allows the payment of fees to a trustee appointed in a professional capacity where there is no charging clause in the deed.



What do you think the position is for laypersons acting as trustees?

The general rule is that trustees cannot benefit from their position, therefore laypersons are not allowed to charge for acting as a trustee, but can claim reasonable 'out of pocket' expenses.

The Act also gave the trustees the power to insure 100% of the trust property.

3.2.7 Investment Duties in Equity

Case law through the years has provided a clear framework as to what is expected in equity. In this context, 'equity' in the legal sense means 'fairness' (not to be confused with the use of the word 'equity' meaning 'shares issued by a company', or the market value of a homeowner's unencumbered interest in their property. In the UK, historically, it was administered by the Court of Chancery, in opposition to the strict rules of common law.

Trustees are expected to conduct investment business to the standard of a prudent person in business. If the trustee is a trust corporation, that company owes a higher standard of care. Various court cases over the years (eg, Bartlett v Barclays Bank Trust Co ltd [1980] and Nestle v National Westminster Bank plc [1992]) have led to some general guidelines, including the following:

1. It is not a wise policy to change investments too frequently.
2. A trustee with power of investment should undertake periodic reviews of the investments held in trust. These reviews should be undertaken at least annually.

3.2.8 Investment Powers in the Trust Deed

The trustees must observe the powers granted in the trust deed, ensure that they understand the meaning of the powers, and conform to them strictly.

Modern trust deeds often confer wide powers of investment on the trustees (eg, 'invest as if absolutely entitled'). The trust deed could also give permission to retain hazardous or wasting assets. However, many old trust deeds do not confer any powers of investment on trustees. In the absence of investment powers in the trust instrument, the trustee will have to rely on the investment powers laid down by statute.

3.2.9 Statutory Investment Powers

In the UK, the Trustee Investment Act 1961 defined three ranges of investment which limited the proportion of a trust that could be invested into different types of investment:

- The two limited and risk-averse ranges were both known as the 'narrow range', which were essentially fixed-interest securities.
- The riskier investments were known as 'wide range investments', which were primarily equities.

The Act laid down strict rules as to the percentage split of the portfolio with regard to these ranges. If the trustees had power to retain assets, there was also a special fund in which these assets were held until disposal. At the time, this was welcome legislation, but it was found to be too restrictive in the modern era of portfolio management; hence, the Act was replaced by the Trustee Act 2000.

As we have already seen, Part 1 of the Trustee Act 2000 introduced a statutory duty of care for trustees. However, the most important aspect of this legislation is contained in Part 2 of this Act, which details a new power of investment. This is summarised as follows:

- Trustees now have the right to invest in anything as if they were 'absolutely entitled', subject to the 'standard investment criteria'. Standard investment criteria include:
  - the suitability of the type of investment for the type of trust (eg, age of beneficiaries and life tenancy), and
  - whether the particular investment selected is the most suitable of its type. The assessment of suitability will include considerations as to the size and risk of the investment, the balance between income and capital growth, and will include any relevant ethical considerations as to the kind of investments appropriate for the trust.

  The standard investment criteria cannot be excluded by a settlor in the trust instrument or by including wide powers of investment in the trust instrument.

- There is a need to review investments from time to time to see if they need to be varied. Although the Act does not stipulate how frequently this must take place, updates are typically needed every three to five years, perhaps more frequently (eg, if circumstances change). This will also depend on the trust deed, investment policy statement and investment mandate.
- There is also a need to diversify the investments of the trust to the extent that is appropriate to the circumstances of the trust.
- Trustees are permitted to invest in freehold or leasehold land in the UK (but not overseas). Property can be bought for investment, occupation by the beneficiary or any other reason.
- Since the trustees have powers of an absolute owner, they will also have the power to mortgage.
- A trustee must seek advice before setting up a trust fund, or on review, unless the trustee thinks it is unnecessary in the circumstances (not defined in the Act but is considered to cover situations where there are only small sums to invest). The advice must be from a person whom the trustee reasonably believes to be qualified. This duty to seek advice also applies to express powers given in the trust instrument, not just the statutory investment powers.
- Trustees are also bound by their duty of care, to act fairly between all beneficiaries entitled to income and capital.
- With regard to investment management, it is good practice when managing trust assets to draw up an investment policy statement with the trustees, so all parties are clear as to how the investments are to be run.

Note that the general power of investment does not apply to pension trusts, authorised unit trusts (AUTs) or certain charitable trusts (which are discussed in section 5.7 of this chapter).

3.3 Beneficiaries

The beneficiaries are the persons or objects for whose benefit the trust is created. Beneficiaries can either be named in the trust instrument (eg, 'my children Jenny and Sarah in equal shares') or described by a class (eg, 'all my children in equal shares'). The latter approach would provide extra flexibility if a settlor was intending to have more children. In certain cases, the trustees may be given the power to exercise discretion as to who benefits from the trust.

There are various types of beneficial interest:

- **Absolute vested interest** – the beneficiary has a full equitable ownership, which cannot be taken away. There are three conditions which must be satisfied for an interest to be vested, and these are that:
  1. the identity of the beneficiary is known
  2. any conditions are satisfied, and
  3. the respective shares are known.

  If any of these conditions are not satisfied, the interest is known as a 'contingent interest'.

- **Life interest** – a beneficiary (called the **life tenant**) is entitled to the income on the trust property but not the capital. An immediate right to the income is called an 'interest in possession'. Where there are successive life interests, the person who is not enjoying the immediate right to the income has an 'interest in remainder'.
- **Remaindermen** – these beneficiaries will receive the capital of the trust fund on the death of the life tenant. Until that time, their interest is known as an 'interest in reversion (or reversionary interest)'.

Example

Dave settles money on Julia for life, then to Phillippa for life, and then to Freddie providing he reaches the age of 21 (he is four at present).

Julia has an interest in possession, which is vested.

Phillippa has an interest in remainder, which is vested since there are no conditions. Freddie has an interest in reversion, which is contingent on him reaching 21 years of age.

The settlor can appoint themselves as a beneficiary of the trust during their lifetime. However, they must not be the sole beneficiary – otherwise, the trust would have no purpose. Where the settlor (and/or their spouse/civil partner) benefits from the trust, these are called settlor-interested trusts. These trusts can be interest in possession, discretionary or **accumulation trusts**, which are covered in sections 5.2, 5.4 and 5.5, respectively.

A beneficiary cannot control the trustees, but they do have a personal right to enforce the trust and ensure that the trustees carry out its provisions. For this reason, pets cannot be legal beneficiaries, however, they may benefit from an honorary trust (ie, a trust where there is neither a charitable purpose, nor beneficiaries to enforce the trust).

In certain circumstances, the beneficiaries can terminate the trust. This is known as the rule in Saunders v Vautier [1841]. The conditions that must be present for them to successfully call for an end to the trust are that:

1. all the beneficiaries are ascertained
2. there is no possibility of further beneficiaries
3. they are all of full age and capacity, and
4. the beneficiaries are unanimous.

This rule can be expressly excluded in the trust instrument.

3.4 Protector

Protectors are much more common in offshore trusts than in England and Wales, and their most common role is to veto the proposals of trustees. Unlike trustees, they do not have trust property vested in their name.

The scope of the protector's powers is set out in the trust instrument, and these can be either:

- **Reactive** – the protector reacts to the actions of a trustee (eg, to distribute money to a beneficiary).
- **Proactive** – the protector takes the initiative and instigates an action (eg, to remove a trustee).

Like trustees, anyone who is *sui juris* can be a protector, including a corporate body.

Practical Point

Clearly, the more power given to the protector, the more cumbersome the administration of the trust could become. However, appointing a protector may give the settlor the desired peace of mind that someone will be able to oversee the activities of the trustees, hence the term often used to describe this role is 'settlor's comfort'.

4. Classification of Trusts

Learning Outcome

4.1.2 Know the different classification and types of UK trusts and their individual purposes in terms of what each is designed to achieved

Many different and difficult situations relating to trusts have arisen over the years, requiring the court to recognise and deal with them appropriately. This has left us with many different classifications of trust, which are recognised by the courts as discussed below. Note that these classifications are not mutually exclusive, and a trust can fall into multiple categories simultaneously.

4.1 Testamentary and Inter Vivos Trusts

Testamentary trusts are created through a person's will and come into effect after their death. Here, the settlor specifies the terms and conditions under which the trust assets are to be managed and distributed. It is funded from the assets from the settlor's estate on their death.

Inter vivos trusts are established during the settlor's lifetime. In contrast to testamentary trusts, they become effective and operative immediately upon their creation, and do not require probate upon the settlor's death.

4.2 Revocable and Irrevocable Trusts

All trusts are either revocable or irrevocable. With revocable trusts, the terms (including the trustees and beneficiaries) can be altered, changed or modified after its creation, or the trust can be revoked entirely, whereas irrevocable trusts cannot.

Typically, a revocable trust converts to an irrevocable trust after the death of the settlor.

4.3 Express and Implied Trust

4.3.1 Express Trusts

An express trust is one where the terms are expressly set out, usually in writing but for personal property this could be by a clear declaration. This could be by way of a lifetime settlement, by will or on intestacy. In the latter case, this is also known as a statutory trust.

4.3.2 Implied Trusts

In contrast, implied trusts are created because of what the law infers as being a person's intention. There are two main types of implied trusts:

- **Resulting trusts** – these are implied trusts that arise through operation of law. This involves the transfer of property from the settlor to another person; however, it is presumed that the settlor holds the intention to retain beneficial ownership of the property, either wholly or in part. The trust property is, therefore, said to revert back (ie, 'result') to the settlor. One type of a resulting trust is a mortgage company, whereby an individual buys property or land with the mortgage company's money, but the mortgage company owns the property or land until the individual has paid the money back in full.
- **Constructive trust** – this type of trust is imposed by law, usually to remedy inequitable, unconscionable, improper or unjust conduct. An example would be where someone acts as *trustee de son tort* (ie, they act as though they are a trustee and receive an item of trust property or make a profit at the expense of a trust). In these circumstances, they are legally deemed to be holding the property and profit on constructive trusts for the benefit of the beneficiaries and are accountable to the beneficiaries for them.

Another example of where a constructive trust will be imposed is where there is a 'secret trust', which take effect through the operation of the will. The intention of a secret trust is to obtain confidentiality, since the beneficiaries and the terms of the trust can remain secret. There are strict rules that must be followed for these trusts to be valid. Secret trusts can be fully or half secret:

Fully Secret Trusts	Half Secret Trusts
The will may appear to leave property absolutely to individual A. However, at some point during their lifetime, the testator must have communicated either orally or in writing (or by sealed letter to be opened upon the testator's death) with A, who agrees to hold the property in trust for another or others.	The trust is partially expressed in the will. The word 'trust' can appear in the will but not the terms of the trust or the intended beneficiaries. The purpose of these trusts is again to retain confidentiality, but also to prevent possible fraud by the legatee (a person who receives a legacy). An example of such a trust would be 'to Jayne on the terms I have previously communicated to her'. The rule regarding the communication of half secret trusts is different to that of fully secret trusts in that the communication (written or oral) and acceptance must take place either before, or at the same time, as making the will.

Example of an Automatic Resulting Trust

In Barclays Bank ltd v Quistclose Investments ltd [1970], Rolls Razor was deeply indebted to Barclays. It needed further additional sums to be able to pay a dividend which it had declared. Rolls Razor borrowed funds from Quistclose in order to satisfy the dividend declared. The terms of the loan were such that the funds would only be used for the sole purpose of paying the dividend. The loan was paid into an account with Barclays, and Barclays was given notice of the arrangement.

However, between the time that the loan was advanced and the dividend was paid, Rolls Razor went into liquidation. Barclays Bank claimed that it was entitled to exercise a set-off of the money in the account against the debts that Rolls Razor owed to Barclays. Quistclose claimed that the money had to be returned, as the purpose for which it had been loaned had now failed and was incapable of being fulfilled (as Rolls Razor was now in liquidation).

The House of Lords (with the leading judgement being given by Lord Wilberforce) unanimously held that the money was held by Barclays Bank on trust for the payment of the dividends; that purpose having failed, the money was held on trust for Quistclose. The fact that the transaction was a loan did not exclude the implication of a trust. The legal rights (to call for repayment) and equitable rights (to claim title) could co-exist. Barclays Bank, having notice of the trust, could not claim the money to set off against the outstanding debts that Rolls Razor owed them. Similarly, the liquidator of Rolls Razor could not claim title to the money, as the assets did not form part of the beneficial estate of Rolls Razor. This was a landmark case and henceforth, these types of trusts are often described as Quistclose Trusts.

This ruling was backed up by Lord Millet in a later case which went to the House of Lords, namely Twinsectra ltd v Yardley [2002].

4.4 Charitable and Non-Charitable Trusts

Charitable trusts are established for charitable purposes and must fulfil specific criteria to qualify as charitable entities – see section 5.7 for more details on charitable trusts.

Non-charitable trusts are created for non-charitable purposes, such as family trusts or private trusts.

5. Types of Trusts

We will discuss the taxation aspects of the most commonly used trusts in section 6. In the meantime, let us consider the main features, benefits and possible uses of the following types of trusts. Many (if not all) of these types are used worldwide, although there may be slight variations.

5.1 Bare Trust

A bare trust (also called an absolute trust or a simple trust) is where the trustee holds the trust property for, usually, a single beneficiary (although they may have more than one). However, the beneficiaries have the right to all of the capital and income of the trust at any time if they are:

- 18 or over (in England, Wales and Northern Ireland), or
- 16 or over (in Scotland)

and have full mental capacity. Under Saunders v Vautier [1841], the beneficiaries who hold the whole of the equitable interest may call for the legal interest from the trustee, which will give them absolute ownership property held in trust and, therefore, end the trust.

Example

One example of this would be a life policy on trust for Jimmy (an adult) absolutely.

In this case, the trustee's duty is just to claim the proceeds from the life office and pay it over to Jimmy.

Resulting constructive trusts (see section 4.3.2, above) are usually bare trusts.



In what circumstances do you think bare trusts would be an appropriate solution?

Bare trusts are particularly useful for grandparents who wish to pass on assets to their grandchildren or set aside money for their school fees or university education. The named beneficiaries have an 'absolute entitlement' to the assets that are placed in trust, but they will be held in the name of the trustee until the children reach the age of 18.

This could be useful for settling assets that the beneficiaries could not hold directly (eg, stocks and shares, because minors cannot contract to buy and sell them). Other common bare trusts could be bank accounts for young children and Junior ISAs (JISAs); importantly though, JISAs may only be set up in the name of a parent or someone with parental responsibility for the child, rather than a grandparent, and there is a maximum amount that may be subscribed to a JISA each tax year.

On reaching the age of 18, the beneficiaries will be able to call on the assets. The trustees will have no discretion as to whether to comply with this request. As we shall see in section 6.1.2, the income on a bare trust is deemed to be that of the beneficiaries who will be able to use any unused personal allowance to mitigate, or avoid completely, any income tax on the income arising within the trust fund.

For parents, this type of trust is not so attractive, since any income over £100 would be deemed to be that of the parents for income tax purposes. For grandparents, however, this rule does not apply.

Any growth on the assets held in trust will be outside the estate of the settlor and, providing the settlor survives seven years from the date of creating the trust, there will be no IHT to pay.

Another potential advantage of bare trusts is if property is bought within the trust, following changes to stamp duty rules in 2016. Someone buying a residential property who already owns at least one other must also pay an additional 5% of stamp duty land tax (SDLT). However, by buying the property within a bare trust, and providing the beneficiary of that bare trust themselves do not have any further properties, then this additional charge does not apply. This could be particularly useful for parents wanting to help their adult children get on the property ladder, while retaining full control over the property, for example. However, candidates should note that the rules are complex, so property owners should seek specialist tax and legal advice, which falls outside the scope of this qualification.

The disadvantage of bare trusts is the lack of flexibility – the beneficiaries can get their hands on the funds at 18, which may not be desirable for the settlor if the beneficiary is not good with money, for example. However, considering HMRC, it is important to note that trustees are responsible for paying any tax due on the assets on behalf of the minors (children).

5.2 Interest in Possession (IIP) Trust

Also known as a life interest trust or fixed interest trust, an interest in possession (IIP) trust is one where a beneficiary (the life interest) has an immediate right to receive an income from a trust fund, or use of trust assets. Upon the death of the life interest, another beneficiary (the remainderman) receives the capital of the trust.

IIP trusts are, sometimes established in a will, and are a potentially useful way of providing a safe income for dependants of the settlor, while ensuring that some assets are saved to be passed on at a later date.

UK legislation enacted in 2006 changed the tax treatment of these trusts. Any IIP trusts established before this date are treated as though they are owned by the beneficiary or beneficiaries for IHT purposes; those set up on or after this date are treated in much the same way as discretionary trusts. As such, while an interest in possession trust may well still be a viable option, some settlors will wish to investigate other possibilities, particularly discretionary trusts which provide greater flexibility.

5.3 Power of Appointment (or Flexible) Trusts

Trusts can be fixed interest trusts inasmuch as once they are set up, the beneficial interests cannot normally be altered. However, it is also possible to set up a trust where the trustees are given a 'power of appointment' to appoint or vary beneficiaries or vary the terms of the trust. The settlor has power to change the beneficial interest and appoint new trustees during their lifetime.

The class of potential beneficiaries can be drafted very widely, which can cater for any changing family or personal circumstances like marriage/civil partnership, divorce/dissolution/separation, births, deaths or bankruptcy.

There will be a default beneficiary who has a right to the income (ie, an interest in possession) and possibly capital if the trustees do not appoint any of the other beneficiaries.

 Can you think of a situation where this arrangement could be particularly useful?

These types of trust are commonly used for life assurance policies written in trust. This gives the settlor power to change the beneficial interest and appoint new trustees during their lifetime.

There are other advantages in setting up a life policy under a trust. These are as follows:

- Subject to certain conditions, the proceeds are paid outside of the deceased's estate, and, therefore, avoid any potential IHT charge.
- The trust funds can be paid to the trustees without the need for a grant of representation (outside probate). This means that the proceeds can be paid by the insurance company within a matter of days after production of the death certificate.

5.4 Discretionary Trust

Discretionary trusts (also called fixed trusts), along with bare trusts, have become the family trust of choice. In a discretionary trust, no beneficiary has a right to the income – the trustees have the power to accumulate income, and distributions will be at their discretion.

Depending on the trust rules, the trustees can decide:

1. income or capital
2. how often payments are made
3. the amount of trust income or capital each beneficiary receives, and
4. any conditions imposed with the payment.

An example would be 'on trust for such of my children or grandchildren as the trustees shall, from time to time, appoint'.

 What do you think are the potential uses of a discretionary trust?

The main advantage of discretionary trusts is their flexibility. Again, this can cater for changes in circumstances such as marriage/civil partnership, divorce/dissolution/separation, a surviving spouse/civil partner remarrying/entering a new civil partnership, or the threat of bankruptcy to any beneficiary. Discretionary trusts are also useful to guard against spendthrift beneficiaries who may have access to the capital restricted, and who will only benefit from the income if the trustees so decide.

Placing funds in a discretionary trust can also mean that potential beneficiaries can continue to receive means-tested benefits, which would otherwise cease. For example, this type of trust could prove very useful for providing for beneficiaries who have learning difficulties.

The settlor can advise the trustees, normally by leaving a 'letter of wishes' with the will. Although not binding, this could be a useful guide for the trustees in exercising their discretion during the lifetime of the trust.

There are certain IHT disadvantages of discretionary trusts although, as we shall see in section 6.3.2, since 2006, these are now shared with IIP trusts created after that date. These taxation implications need to be weighed up against the benefits of greater flexibility and control.

5.5 Accumulation Trust

Trustees can accumulate income within the trust and add it to the trust's capital, often until the beneficiary becomes legally entitled to the trust assets or the income produced from them. They can also pay income out, as with discretionary trusts. (These are not to be confused with the old accumulation and maintenance trusts, a special type of discretionary trust intended to make provisions for children and young adults until they reached the age of 25, which stopped in 2006.)

5.6 Mixed Trust

Also called 'hybrid trusts', these are a combination of more than one type of trust. For example, some of the assets may be set aside as an IIP trust, and others as a discretionary trust. Each of the different parts are treated separately and taxed according to the tax rules for each part.

5.7 Charitable Trusts

Learning Outcome

4.2.2 Know the requirements for charitable status, how charities are taxed, and the purpose and rules of Gift Aid

Charitable trusts (also called 'public welfare trusts') are a type of purpose trust in that they promote a purpose and do not primarily benefit specific individuals. They must be of a charitable nature, for the public benefit, and wholly and exclusively charitable.

In the UK, the legal framework and regulations that govern the operation, management and oversight of charitable organisations is provided by the Charities Acts. The history of the Charities Acts spans several decades and involves multiple pieces of legislation aimed at regulating and governing charitable organisations. Of these, the most noteworthy are:

- **Charities Act 1993** – modernised charity law by introducing significant reforms, and established the Charity Commission as the regulatory body for charities in England and Wales
- **Charities Act 2006** – brought substantial reforms to charity law in England and Wales, including changes related to charity registration, fundraising regulations, trustee duties, and public benefit requirements, and
- **Charities Act 2011** – consolidated and updated existing charity law, incorporating provisions from earlier legislation (including the Charities Act 1993 and 2006) with the aim of simplifying and clarifying the legal framework for charities in England and Wales.

- **Charities Act 2022** – further revised the existing charity legislation with an aim of making charitable trust laws easier to navigate, and reduce the administrative and compliance burdens on trustees. Since coming into effect, it has been implemented in three phases, which were as follows: Royal Assent (the Act received Royal Assent on 24 February 2022), the initial changes (starting with the less complex changes, on 31 October 2022), and the Act's ongoing implementation (all remaining changes should have taken effect by May 2025).

In the UK, for tax purposes, HMRC states that the definition of a 'charitable trust' is a trust established for charitable purposes only.

Under the Charities Acts, there are 13 purposes, and they are:

1. the prevention or relief of poverty
2. the advancement of education
3. the advancement of religion
4. the advancement of health or the saving of lives
5. the advancement of citizenship or community development
6. the advancement of the arts, culture, heritage or science
7. the advancement of amateur sport
8. the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity
9. the advancement of environmental protection or improvement
10. the relief of those in need, by reason of youth, age, ill health, disability, financial hardship or other disadvantage
11. the advancement of animal welfare
12. the promotion of the efficiency of the armed forces of the Crown; or the efficiency of the police, fire and rescue services or ambulance services, and
13. any other purposes charitable in law.

It is not automatically assumed that an organisation with a stated aim that falls within one of the above descriptions of purposes is charitable.

In England and Wales, prospective charities must apply to the Charity Commission to claim charitable status, and thereby the tax benefits connected with a charity. In Scotland, charities are regulated by the Office of the Scottish Charity Regulator (OSCR); and in Northern Ireland by the Charity Commission for Northern Ireland (CCNI).

5.7.1 The Benefits of a Charitable Trust

Generally speaking, charitable trusts are subject to the same rules as private trusts, but they enjoy a number of advantages over private trusts, some of which are particularly relevant when considering the management of investments on behalf of the trustees.

The Perpetuity Rule

We discussed in section 2.4.2 above that the perpetuity rule prohibits settlors from tying up their property indefinitely. Charitable trusts are the exception to this rule, since they will be valid even though they may last for an infinite period of time.

Tax Advantages

As you would expect, charitable trusts and charities enjoy significant tax advantages, and this is the main motivation for bodies seeking charitable status.

For the charities themselves, they benefit from preferential tax treatment. In the UK, the investments of charities are:

- exempt from income tax
- exempt from CGT on disposals by the trust, and
- exempt (or eligible for relief) from stamp duty, stamp duty reserve tax (SDRT), and stamp duty land tax (SDLT) in specific circumstances.

Donors too also receive tax benefits. For example, in the UK:

- no CGT is payable on gifts by individuals to charity (this is an exempt disposal)
- no IHT is payable on outright gifts by individuals to a charity
- charities benefit from a mandatory 80% business rate relief for the premises that they occupy; the further 20% is discretionary and may be awarded by the local authority to whom the rates are payable, and
- gifts to charitable trusts may qualify for income tax relief under Gift Aid (or a Payroll Giving scheme, also called Pay As You Go (PAYG)) as described in section 5.7.2, below.

5.7.2 Gift Aid

Introduced in 1990, Gift Aid is a scheme that enables UK-resident individuals and companies to gift money to charity tax-efficiently. Individuals donating money to certain UK, charities and community amateur sports clubs (as well as organisations in the EU, Norway, Iceland and Liechtenstein that meet the UK tax definition of a charity) may be able to claim tax relief on donations they have made through their Self-Assessment tax return if they are a higher or additional rate taxpayer. Additionally, UK charities may reclaim basic rate income tax on eligible donations, thus increasing the value of those donations.

The scheme applies to any donation, whether large or small, recurring or one-off. There is also no monetary limit as to the size of the donation; however, to qualify for Gift Aid, the donor must have paid enough tax to cover the amount that is payable to the charity.

How it Works

Charities take the donation, which is money that has already been taxed, and reclaim a basic rate tax from HMRC on its gross equivalent (ie, the amount before the basic rate tax was deducted).

Basic rate tax for 2025–26 is 20%, so this means that a gift of £10 using Gift Aid is worth £12.50 to the charity.

Higher and additional rate taxpayers can claim the difference between the higher/additional rates of tax (40% and 45% respectively) and the basic rate on the total (gross) value of the donation to the charity on their Self-Assessment forms.

Example

Georgina is a higher rate taxpayer. She donates £100 to charity, but the total value of her donation is £125. She can also claim back 20% of this (£25) for herself. She will need to make this claim via her Self-Assessment tax return.

Gift Aid Rules

Donations will qualify for tax relief as long as they are not more than four times the amount of tax that a donor paid in the tax year (6 April to 5 April).

To satisfy the Gift Aid conditions, donors must give the charity a Gift Aid declaration, which should include:

- their name
- their home address
- the charity's name
- details of the donation, stating that it is a Gift Aid donation, and
- confirmation that they have paid UK tax (to cover the tax that the charity will reclaim).

A declaration can be made to cover individual donations or a series of donations, and can cover donations made during a specified period or to cover all future donations. They can also be backdated for up to four years prior to the date of the declaration.

5.7.3 Limitations of Becoming a Charity

There are restrictions on what charities can do. These are determined by the Charity Commission, both in terms of purpose and operations. This is primarily to ensure that all money raised, and any surpluses, can only be distributed in accordance with the charitable objectives of the organisation. It is essential to think carefully before applying to become a registered charity. In the UK, the following is required:

- Charity trustees cannot be paid, other than for reasonable expenses. This could restrict the professional assistance that the organisation might otherwise be able to engage.
- Charity law also demands that trustees avoid any situation where charitable and personal interests might conflict.
- Charities are not allowed to undertake political campaigning.
- Being a charity restricts the type of trading activities that the organisation is allowed to undertake.

6. The Taxation of Trusts

Learning Outcome

4.2.1 Understand the concept of chargeable lifetime transfers (CLTs) and be able to assess the income tax, CGT and IHT consequences of different scenarios relating to each type of trust

The way in which trusts are taxed can be complex, depending on the type of trust under consideration, the types of assets in which it is invested, the residence of the trustees (and, to a lesser extent, the settlor at the time that the trust was created), the beneficiary's circumstances, and so on. Therefore, unless otherwise specified, the sections below describe how trusts are taxed under UK tax legislation.

6.1 Income Tax

In the UK, trustees are subject to tax under Self-Assessment. The date by which new trusts must be registered with HMRC depends on the type of taxes for which the trust is liable. For income or CGT, the deadline is 5 October of the tax year after the trust starts to receive any income or has capital gains, and becomes potentially liable for income tax or CGT. If it is liable for other taxes (eg, IHT, SDRT, or SDLT, land and buildings transaction tax (LBTT) in Scotland), then the deadline is 31 January of the tax year after the trust becomes potentially liable. Trustees then receive a Unique Taxpayer Reference (UTR) enabling them to complete the tax returns.

Thereafter, the deadlines for filing tax returns online or by paper for the previous tax year are the same as for the self-employed (see section 3.7.1 of chapter 2).

Although similar to the Self-Assessment forms, the trustees must complete a 'Trust and Estate Tax Return'. Similar to other Self-Assessment taxpayers, trusts may have to make interim payments on account.

All trustees are jointly liable for any outstanding tax and are personally liable for any penalties which may be incurred. The income tax treatment of trusts varies depending upon the individual circumstances and nature of the trust.

6.1.1 Income Tax Payable by the Settlor

There are certain occasions when, regardless of the type of trust (other than a trust for 'vulnerable' beneficiaries, which includes disabled persons and bereaved minors), the income is deemed to be that of the settlor and is taxed accordingly (even though it may not have been distributed to them).

This applies in three circumstances:

- when either the settlor, their spouse or civil partner retains an interest in the trust (but this does not include a widow, widower, or separated spouse or civil partner)
- where the settlor has absolute entitlement to the income from the trust, or
- where the trust is for the benefit of a minor unmarried child of the settlor.

The settlor can reclaim any tax payable on trust income from the trust since, in effect, it will have been paid twice. However, since the rate of tax is likely to be higher for the individual settlor than that paid in the trust, it is not good tax planning for this situation to arise.

We will look at each of the main types of trust in turn. Further information on this topic is available on the GOV.UK website at https://www.gov.uk/trusts-taxes/trusts-and-income-tax.

6.1.2 Bare Trusts

Income arising within the trust is deemed to be that of the beneficiary, who must include it in their Self-Assessment forms and pay tax on it personally. They will be able to use their personal allowance against this income.

6.1.3 Interest in Possession Trusts

Tax is payable within the trust on income at a rate of 8.75% for dividends and 20% for all other income. The trust is not entitled to a personal allowance since it is not an individual person. Beneficiaries who receive the income must declare the income and tax already paid on their Self-Assessment form.

There is no higher rate tax within the trust and the trustees are personally responsible for paying the tax. The beneficiary may be liable to additional tax on receipt of the trust income, which may take the beneficiary into the higher or additional rate band. In view of the above, trustees will often mandate the income directly to the beneficiary without paying any tax beforehand.

Beneficiaries receive tax vouchers showing the net income, and this will be broken down into the sources of income (ie, savings, dividends and other income). Management expenses are not allowed to be deducted from the income for interest in possession trusts; otherwise, this would interfere with the income due to the beneficiaries. Instead, they must be taken from the capital.

6.1.4 Discretionary or Accumulation Trusts

Trustees are responsible for declaring and paying income tax on income received by the trust.

In both discretionary trusts and A&M trusts, where total income is less than £500, then there will be no income tax to pay. If total income is above £500, then the whole amount (not just the amount over £500) will be taxed at the 'trust' rate of 39.35% for dividends and 45% for all other income (eg, rental income and savings interest). These rates are equivalent to the additional rate for individuals.

The £500 allowance can be reduced if the settlor has created multiple trusts. It is divided by the total number of trusts established by that settlor, with a minimum reduction limit set at £100. If trusts are settled jointly (ie, there is more than one settlor), then the reduction is based on the highest number of trusts created by any one settlor.

Beneficiaries are taxable only on income that has been distributed to them by the trustees, or applied by the trustees for their maintenance, education or benefit, at their own marginal rate on the gross distribution.

Non-taxpayer	Basic rate taxpayer	Higher or additional rate taxpayer
Can reclaim some, or all, of the tax suffered.	Can reclaim 25% of the income falling within the basic rate band.	No further tax to pay.

If income has been accumulated instead of distributed, then there is no further tax to pay.

Trustees of a discretionary or an A&M trust have the power to make discretionary payments and therefore need to make sure that they have paid enough tax to cover the tax credit given to the beneficiary. They do this by using a 'tax pool', which keeps a record of all discretionary income payments they have made and the tax they have paid.

6.2 Capital Gains Tax (CGT)

CGT is assessed on the trustees of UK resident trusts in a very similar way to that of individuals who are higher rate taxpayers (covered in section 4 of chapter 2). Tax payable by trustees is 24%. This applies irrespective of the income of the trust or beneficiaries, except for bare trusts. Tax is due by 31 January in the year following the end of the tax year of disposal.

However, there are a few notable differences when dealing with trusts, as shown in the sections below.

Further information is available on the GOV.UK website at https://www.gov.uk/trusts-taxes/trusts-and-capital-gains-tax.

6.2.1 Annual Exemption

The normal CGT annual exemption available for trustees is half of that available to an individual. For 2025–26, this is £1,500 (ie, half of £3,000).

However, the trust exemption has to be shared between any trusts set up by the settlor since 6 June 1978, to a minimum of one-fifth per trust (ie, a minimum of £300 for 2025–26), as follows:

One Trust	Two Trusts	Three Trusts	Four Trusts	Five Trusts or more	Bare trusts and trusts for disabled persons
£1,500	£750 each	£500 each	£375 each	£300 each	£3,000 per beneficiary

Bare trusts and trusts for vulnerable persons (eg, where the beneficiary is a disabled person or whose parent(s) has died) are entitled to the same annual allowance as an individual (ie, £3,000 for 2025–26, per beneficiary). If there is more than one beneficiary and only one of them is vulnerable, the higher CGT allowance may apply.

6.2.2 Hold-over Relief

The creation of a trust by the settlor is a disposal for CGT purposes and the market value of the assets at the date of creation of the trust will be used to calculate the amount of any gains payable by the settlor. However, it may be possible to claim hold-over relief to avoid a potential tax liability arising at that time (see section 4.3.5 of chapter 2).

From 22 March 2006, hold-over relief is available under most circumstances, for any assets placed into trust. In this case, only the settlor would need to claim the relief and advise the trustees accordingly.

In addition, hold-over relief may be claimed when trustees transfer assets to beneficiaries. Under these circumstances, the relief must be claimed jointly by the beneficiaries and the trustees. The beneficiaries will effectively acquire the assets at the trustees' acquisition cost, which may enable them to defer the disposal to use their individual annual exemption or partially dispose of the assets each year, again using their individual annual exemptions, to potentially avoid a CGT charge altogether.

For the gifting of business assets (eg, land and buildings used for the purposes of a trade) into a trust, not only would hold-over relief apply but also, upon the death of the settlor, no IHT would be payable. This could therefore be a useful tool for business owners wishing to reduce their tax liabilities. However, the amount of reliefs available may be restricted (eg, if only part of the asset was used for the purposes of trade; or if, for some time during the settlor's ownership, it was not used for the purposes of trade). The rules on this are complex (eg, what qualifies as a business asset to begin with; and while the settlor is still alive, the beneficiary must keep the assets as a going concern to retain the reliefs). Business owners should therefore take specialist legal and tax advice in connection with this, which falls outside the scope of this qualification.

6.2.3 Deemed Disposals

In addition to actual disposals within a trust, a CGT charge may arise on other occasions within a trust.

An example of this would be if an interest in possession ends on the death of a life tenant, and the property passes to the **remainderman**. For pre-2006 trusts, since CGT does not generally become payable on death, this often results in a free uplift of values.

Another example of a deemed disposal is where a beneficiary becomes absolutely entitled to trust property on achieving a contingency (eg, on their 21st birthday). Once the beneficiary has become absolutely entitled, the trustees will be holding the assets as bare trustees.

It may be helpful to consider each of the main types of trust in turn.

6.2.4 Bare Trusts

Any gains are treated as the beneficiary's gains and any liability will be payable by them. Any subsequent transfer of assets to the beneficiary will be disregarded for CGT purposes.

Bare trusts for minors continue to have CGT advantages, even if the trust was set up by a parent. Unlike other forms of trust, the gains on bare trusts for minors (if the parent has settled the assets) are chargeable to the minor, not the parent. This means that they will have their full annual exemption available and not the lower trust annual exemption. They are also less likely than the settlor to need their annual exemption for other purposes.

6.2.5 Interest in Possession (IIP) Trusts

To summarise what was discussed above, the position on the death of a life tenant is as follows:

Pre-22 March 2006 Trusts

- No CGT on death of life tenant – free uplift in acquisition values.
- Held-over gains are chargeable on the death of the life tenant.

Example

Jimmy created an interest in possession trust in 2005 with an asset valued at £100,000. He has owned the asset for 20 years, originally valued at £50,000. The gain of £50,000 was held over to the trustees.

The life tenant died on 21 January 2025 and the asset was worth £300,000 at that date.

The gain of £200,000 will not be chargeable to CGT, but the trustees will now be liable for the held-over gain of £50,000.

Trusts commencing on or after 22 March 2006

- No CGT on death of life tenant – no uplift in acquisition values.
- Held-over gains are chargeable on the death of the life tenant.

In addition, if the trustees allow a beneficiary to occupy a property held in the trust for their main residence, it should be possible to claim principal private residence exemption provided hold-over relief was not claimed when the property was placed in trust.

6.2.6 Discretionary Trusts

Pre-22 March 2006 Trusts

- Hold-over relief could be claimed by the settlor for business assets or family company shares only.

Trusts Commencing on or after 22 March 2006

- Hold-over relief can be claimed by the settlor for all assets.
- Hold-over relief is not available where the settlor has, or may acquire, an interest.
- Transfers to beneficiaries are deemed disposals for CGT purposes but hold-over relief is available to the trustees in the same way as it was available to the settlor.

6.3 Inheritance Tax (IHT)

The Finance Act 2006 drastically changed the tax treatment of trusts.

The creation of a trust is a transfer of value for IHT purposes: the amount of the gift will be assessed as the reduction in the value of the donor's estate, not necessarily the market value.

Once again, we will look at the main types of trust and consider the IHT implications of each one in turn.

6.3.1 Bare Trusts

- The creation of a bare trust is a potentially exempt transfer (PET).
- The trust will only be taxable if the settlor dies within seven years.
- If the beneficiary dies, the trust will be included in their estate for IHT purposes.

6.3.2 Interest in Possession (IIP) Trusts and Discretionary Trusts

The IHT rules for discretionary trusts also apply to most IIP trusts.

There are three elements:

Creation of the Trust

- This will be a chargeable lifetime transfer (CLT) with tax payable at 20% if it takes the settlor's cumulative total over the nil rate band (NRB).
- Some trusts may utilise the residence nil rate band (RNRB), but not all. As the RNRB only applies where residential property is passed to the deceased's direct descendants, careful consideration must be taken as to the type of trust a settlor creates, and how it is set up (see chapter 2, section 6.2).
- If the settlor dies within seven years, the full 40% rate of IHT will be payable.

Periodic Charges (also known as the Principal Charge)

- Periodic charges apply to the trust, not the settlor and arise when the trust reaches its tenth anniversary, when it must be assessed as to whether any IHT is due. This calculation can be complex.
- They will apply whether or not the settlor is alive.
- This will occur on every ten-year anniversary of the trust creation.
- The charge is 30% of the current lifetime rate. The current lifetime rate is 20%, thus the maximum charge is 6% of the value of the trust fund (ie, 30% of 20%).
- The seven-year IHT cumulation of the settlor immediately before the creation of the trust is taken.
- Any capital distributions within the previous ten years also need to be taken into account.

Exit Charge (also known as the Proportionate Charge)

- This charge applies to capital leaving the trust.
- It is taxed at 30% of the effective rate from the start of the trust, or if it is after ten years, the effective rate from the last periodic charge.
- If there was no IHT to pay on creation due to the amount being within the NRB, the effective rate would be nil so there would be no **exit charge**.
- It is then time apportioned by the number of complete successive quarter years since the last periodic charge (expressed as n/40^{ths}).

Candidates should note that business relief (BR) and agricultural property relief (APR) may be used here – see chapter 2, sections 6.6.2 and 6.6.3 respectively.

Example

Freida made a transfer of £248,000 to a discretionary trust on 1 October 2015 (when the NRB was £325,000). Freida had made no other gifts prior to setting up the trust. A capital payment of £33,000 was made from the trust to a beneficiary in January 2026.

The value of the trust on 1 October 2026 was £405,000.

The tax position is as follows:

- There is no charge on creation since there are two annual exempt amounts and also the NRB covers the amount.
- There is no exit charge on the capital payment since the effective rate was nil.

Periodic Charge

Value of the trust at 10th anniversary	£405,000
Plus capital disbursement of	£33,000
Total amount subject to IHT	£438,000
Less current NRB	(£325,000)
Taxable amount	**£113,000**
£113,000 x 6%	£6,780

Further example: A further capital payment of £30,000 is made from the trust to a beneficiary on 21 April 2031.

Exit Charge

The effective rate from the last 10th anniversary: £6,780 / £405,000 = 1.6741%.

£30,000 capital distributed on 21 April 2030: £30,000 x 1.674% = £502.20.

Time apportionment: 1 October 2026 to 30 April 2031 = 4 years 6 months = 18 quarter years = 18/40.

£502.20 x 18/40 = £225.99 payable by the recipient.

6.3.3 Trusts for Minors

Rules were introduced by the Finance Act 2006 to replace accumulation and maintenance (A&M) trusts. Two types of trust were created by the death of a parent, step-parent or someone with a parental responsibility (by will or intestacy) or under the Criminal Injuries Compensation Scheme (CICS): trusts for bereaved minors, and 18 to 25 trusts. These trusts allow the accumulation of income but do not incur the full application of the periodic or exit charge rules.

Trusts for Bereaved Minors

- These trusts must provide an absolute interest to a child (who has lost at least one parent) at 18 years of age.
- Until then, the trust is treated as the child's own for IHT purposes (in a similar way to pre-2006 IIP trusts).
- There is no periodic charge or exit charge at 18.

18 to 25 Trusts

- These trusts must provide an absolute entitlement to a beneficiary by the age of 25.
- The trust is treated as the beneficiary's own for IHT purposes until they reach 18 years of age.
- An exit charge is payable on their absolute entitlement, based on the period since the beneficiary's 18th birthday.

Note, there have been changes to IHT with respect to business property and agricultural property relief, which will come into effect in 2026. Clients should consult with their tax advisers to understand any necessary changes to their trust planning.

Chapter Five

Financial Instruments and Products

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be building your product knowledge so that you have a good understanding of the different types of investment **asset classes**, financial instruments, and products and schemes available in the UK. This understanding is important as it will allow you to make informed decisions about where to allocate a client's financial resources and potentially grow their wealth.

2. Bank and Building Society Savings Accounts

Learning Outcome

5.1.1 The different types of bank and building society accounts

Savings accounts are financial accounts that are maintained by financial institutions, such as a bank or building society. Deposits into, and withdrawals from, the account are allowed, which the financial institution records.

Various types of accounts are available, which are classified into commonly understood types, although financial institutions do also use their own names. The terms and conditions for each type of account are set by the financial institution. Individuals are allowed to hold accounts of different types with various financial institutions; and potentially in different currencies and countries, depending on where the account holder resides.

We will now look at some of the most common account types that are available.

2.1 Account Types

2.1.1 Current Accounts

Current accounts are instant access accounts through which most individuals conduct their day-to-day banking requirements. Banks and building societies also offer a range of current accounts for which the customer pays a fee to receive a package of added benefits. Some accounts pay interest, although rates tend to be low which is a trade-off for instant access. There may be a service charge, but this is often waived if the account has a balance above a certain level.

They are the base account for a range of additional products, features and services, including:

- cheque books
- overdrafts
- standing orders and direct debits
- debit cards
- telephone and internet banking facilities, and
- credit cards.

2.1.2 Savings Accounts

Savings accounts come in several forms, such as branch-based, postal, telephone operated, and internet-only versions (including via smartphone apps), as well as a combination of these.

The amounts of interest payable on these products are often (but not exclusively) linked to the cost incurred by the bank or building society of operating that product. For example, a branch-based account requires high street premises, whereas the other extreme is an internet-only account which can be run from the head office by a limited number of staff. As internet-only accounts are cheaper to run, they often pay better rates (but not always) of interest than branch-based accounts.

Interest payable sometimes gives an indication of risk, and the bank or building society's need for additional capital, as was seen in the global financial crisis of 2007–08. Higher rates can tend to indicate higher risk to the depositor.

Instant or easy access accounts, as the name implies, means that depositors can withdraw their money without having to give any notice of their need to withdraw funds. These accounts typically offer the lowest rates of interest. They are particularly useful for holding a reserve of cash for instant access in case of emergencies.

Notice accounts require investors to give a minimum number of days' notice before being able to withdraw funds. In exchange for the notice arrangement, the accounts pay a higher rate of interest. Notice periods vary between financial institutions, but usually start with a minimum of 30 days needing to be given, with 60, 90 and 120 days' notice accounts also being quite common. Investors usually have the ability to forgo the notice period and obtain immediate access to their money, but there will be a financial penalty such as a loss of interest.

Term accounts are those that pay a set rate of interest and run for a set period, normally between one and five years; normally, the longer the period, the better the rate. There will always be a penalty for withdrawing early and this can be prohibitive.

Regular savings accounts can offer relatively high interest rates to savers who are prepared to commit to save an amount each month. In the UK, the amount which needs to be paid into the account is usually between £10 and £500 per month and time limits often apply, which means that the higher rate of interest applies for a predefined period of time and then reverts to an instant access account, paying a lower rate of interest. These accounts often stipulate that the higher interest rate is only provided if there are no withdrawals in that time frame, and any withdrawals will forfeit the higher rate.

Savings bonds are also offered by many banks and building societies. With these products, investors tie up their savings for a given period (say one, three or five years) and earn a fixed rate of interest for the life of the bond. Additional deposits and withdrawals may be heavily restricted or not allowed at all. These products are often available for limited periods only.

Depending on the type of savings account, interest may be paid at the end of the term, annually or more frequently. Interest rates may be variable, fixed or tiered, where the higher the level of cash, the higher the rate of interest. Access to some savings accounts is dependent upon having a minimum amount to deposit and some are also limited to a maximum.

As a rule of thumb, better rates of interest can be obtained by tying money into a savings product for a minimum period, but savers should be careful to consider the position should they need to access their money before this period ends. Some accounts do not allow for access before the end of the agreed period at all, and the saver may find they are worse off than if they had merely used an instant access account, since penalty costs may be charged for early withdrawal.

It is crucial that retail investors ensure they have a sufficient amount of accessible cash to cover any emergency needs, that will not incur any penalties.

2.2 The Advantages and Disadvantages of Cash Investments

Learning Outcome

5.1.2 The advantages and disadvantages of cash investments

5.1.3 The deposit protection scheme

When considering the types of investments that may be suitable for a client, it is important to consider the advantages and disadvantages from the client's perspective. These products are probably quite familiar to you, so try the following exercise.


Analyse

Think of as many advantages and disadvantages of cash investments as you can. When you have a list, compare it to the answers below.

Advantages	Disadvantages
• Where a deposit protection scheme is in place (eg, the UK's Financial Services Compensation Scheme (FSCS) – see section 6.6 of chapter 1), they provide a high level of security for investors' money. • The capital on deposit is not exposed to investment risk. • Immediate access accounts provide a good home for holding short-term emergency monies. • Foreign currency deposits provide an opportunity for investors to take advantage of exchange rate movements or, if they have liabilities in a country other than the one in which they live, to manage exchange rate risk.	• The only returns are in the form of interest payments, which can be low. • The real value/purchasing power of the capital may be eroded by inflation, especially if held over longer periods. • Uncertainty of income for the investor. If the interest rate is variable, it will fall and rise with interest rates generally. • There is no potential for capital growth. • The company offering a cash product might not be covered under a deposit protection scheme. • Any penalties on encashing deposits early may reduce returns to investors. • In certain countries, capital controls may be imposed, either by the government (to restrict flows of capital out of, or into, a country) or by the banks (to prevent a run on the bank); in which case, investors may not be allowed to move their money freely. • Amounts larger than the insured limit under a deposit protection scheme will not be guaranteed in the case of a bank's insolvency.

3. National Savings and Investments (NS&I)

Learning Outcome

5.2.1 The characteristics of different NS&I investments

5.2.2 Their suitability for different tax status investors

5.2.3 The terms and penalties for early surrender

In the UK, National Savings and Investments (NS&I) are considered to be one of the safest types of investment because they are guaranteed by the UK government. They can be purchased either online, over the telephone, through post offices or by post.

NS&I aims to set its interest rates at a level in line with its competitors and helping to strike the balance between the needs of its savers, taxpayers and broader market stability. The returns on these investments are typically low; however, the trade-off is that they offer 100% security since the products are backed by the UK government.

The below information is a summary of the NS&I products that are currently available. Further details are available on the NS&I website[1].

3.1 Taxable Products

3.1.1 Investment Accounts

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Postal only savings account for those aged 16 and over. • Minimum balance £20, maximum £1 million per person. • Variable rates of interest. • For children under 16, parents, guardians and grandparents can open an account.	• Interest taxable, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• Not applicable.

1 NS&I, 2025. All Products. Retrieved from https://www.nsandi.com/products (Accessed: October 2025)

3.1.2 Direct Saver

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Savings account for those aged 16 or over. • Withdrawals online or by phone. • Minimum balance £1, maximum £2 million per person.	• Interest taxable, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• Not applicable.

3.1.3 Income Bonds

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Provide a monthly income. • Variable rate of interest, calculated daily. • Investments may be between £500 and £1 million per person.	• Interest is taxable, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• No withdrawal restrictions; can be encashed early without penalty. • At least £500 must remain to keep the account open.

3.1.4 Guaranteed Income Bonds (British Savings Bonds)

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Provide a guaranteed monthly income for one, two, three or five years. • Fixed rate of interest, calculated daily. • Investments may be between £500 and £1 million per person.	• Interest is taxable, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• Money cannot be withdrawn until the bond reaches the end of the term.

3.1.5 Guaranteed Growth Bonds (British Savings Bonds)

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Provide a guaranteed return for one, two, three or five years. • Fixed rate of interest, calculated daily. • Investments may be between £500 and £1 million per person.	• Interest is taxable in the tax year in which the bond matures, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• Money cannot be withdrawn until the bond reaches the end of the term.

3.1.6 Green Savings Bond

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Savings contribute towards green projects. • Rate of interest is fixed for three years, calculated daily and paid annually. • Investment may be between £100 and £100,000 per person.	• Interest is taxable, but paid gross. • Taxpayers may need to declare the interest to HMRC, depending on their circumstances.	• No withdrawals until the end of the term.

3.2 Tax-Free Products

3.2.1 Premium Bonds

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• Minimum £25 investment and maximum £50,000. • Lump sum or monthly investment. • Prizes paid each month ranging from £25 to £1 million with a 21,000:1 chance of winning for each £1 unit. • No interest or dividends paid so capital remains static.	• Prizes are tax-free: no income tax or CGT payable. • Cannot be held in joint names. • Can be purchased for a child under the age of 16 with a nominated parent or guardian looking after the bonds for them.	• Bonds can be encashed at any time without loss of capital.

3.2.2 Direct Individual Savings Accounts (ISAs)

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• NS&I's version of the cash individual savings account (ISA). • Investment between £1 and £20,000 for 2025–26. • Variable rates of interest.	• Tax-free, no income tax or CGT payable. • Not for individuals who want to invest their full allowance in a stocks & shares, innovative finance or flexible ISA (see section 12 below).	• No withdrawal restrictions; can be encashed early without penalty.

3.2.3 Junior ISAs (JISAs)

Product Characteristics	Tax Status/Suitability for Investors	Terms/Penalties for Early Surrender
• NS&I's version of the cash JISA, a long-term savings account for children aged up to 18. • The account can only be opened by someone with parental responsibility for the child, providing that the child does not already have a Child Trust Fund (CTF). • Investment between £1 and £9,000 for 2025–26. • Earns a variable rate of interest.	• Tax-free: no income tax or CGT payable.	• Withdrawals cannot be made until the child is aged 18, at which time the account will automatically be transferred into an adult cash ISA.

4. Bonds

The terms 'bonds', 'fixed-income securities', 'fixed-interest securities' and 'debt securities' are given to securities that pay a pre-specified or fixed return in the form of income, and potentially capital growth. Following the more widely adopted usage, such securities are also collectively called 'bonds'.

This derives from the original use of the word: a tie or commitment (as in the saying *'my word is my bond'*). This is because a bond represents a promise to repay the capital borrowed at some defined point in the future; and also, in most cases, a certain amount of interest paid by the issuer to the lender in the intervening period.

A bond is essentially an IOU issued by a borrower (known as the issuer) in return for the money lent to it by the buyer (known as the holder) for a fixed period and usually with a fixed rate of return or interest.

Bonds are issued by issuers as a means of raising finance. There are several types of bonds according to the issuer:

- **Government bonds (also called sovereign debt)** – issued by governments.
- **Corporate bonds** – issued by companies.
- **Supranational bonds** – issued by international organisations such as the World Bank and the European Investment Bank (EIB).
- **Public authorities bonds** – issued by government agencies.
- **Asset-backed securities (ABSs) and mortgage-backed securities (MBSs)** – securities whose income payments, and hence their value, are derived from and collateralised ('backed') by a specified pool of underlying assets (a collection of mortgages, in the case of MBSs).

These bonds can be further categorised into various subtypes – for example, investment grade and high yield, and domestic and foreign currency issues. One of the key characteristics of bonds is that they tend to be higher up in the capital structure of the issuing entity (eg, repayment of bonds is prioritised over redemption of other issued securities such as equity, especially in the case of insolvency).

4.1 Sub-Categorisations of Bonds

4.1.1 Investment Grade and High Yield

Learning Outcome

5.3.10 Structure and relevance of credit ratings in the evaluation process

'Investment grade' and 'high yield' refer to the quality of an issuer.

Investment grade issues offer the greatest safety and liquidity. Issuers have a solid financial standing, stable cash flows, and a good track record of meeting their debt obligations, all of which make them less likely to default on their interest payments or principal repayment. Investment grade bonds are usually favoured by investors when economic conditions are deteriorating.

For high yield (also referred to as non-investment grade, speculative and **junk**) bonds, there is a higher probability of the issue defaulting on either the interest payments or the capital repayment. Because of this, they tend to trade at lower prices and offer higher coupon rates (ie, higher default premiums) compared to more secure debt issues to compensate investors for assuming this default risk. In turn, as their name suggests, their yields (assuming the interest payments can be kept up) are significantly greater than comparable maturity bonds with higher credit ratings.

There are several independent credit rating agencies that assess and report on credit ratings, although there are three in particular that are heavily relied upon by institutional investors, hence their ratings affect the price of the bonds: Moody's, Standard & Poor's (S&P) and Fitch.

When a bond is issued, the issuer will pay for one or more of the credit rating agencies to evaluate the credit risk attached to the bond, and rate the bond accordingly. Credit ratings are given for each individual bond issue. Different bonds issued by the same issuer may have different credit ratings, since the bonds can have very different terms and conditions. For example, a secured bond is likely to have less credit risk than a bond issued by the same company without the benefit of any security. The two bonds are likely to have different credit ratings.

The credit rating agencies consider a range of information, including financial performance, operating policies, risk management strategies, business environment, levels of assets and liabilities, strength of the management team, the sector and environment in which the company operates and more.

Moody's, S&P and Fitch use similar methods to rate issuers and individual bond issues. They assess whether the cash flow generated by the borrower will comfortably service and, ultimately, repay the debt. The table below provides an abridged version of the credit ratings available from the three agencies:

	Moody's	S&P	Fitch	Description
Investment Grade	Aaa	AAA	AAA	Gilt-edged quality, prime and maximum safety
	Aa	AA	AA	High grade with high credit quality
	A	A	A	Upper medium quality
	Baa	BBB	BBB	Lower medium grade
High yield/Junk/Speculative	Ba	BB	BB	Lower grade, speculative
	B	B	B	Highly speculative
	Caa	CCC	CCC	Substantial risk in danger of default
	Ca	CC	CC	Highly speculative, maybe in default
	C	C	C	Extremely speculative
		D	DDD	In default
			DD	
			D	

Generally, a bond with a long-term credit rating of BBB (Fitch, S&P) or Baa (Moody's) and above are considered worthy of investment grade, while high yield bonds have a credit rating of BB/Ba or below.

The agencies all have their own rating systems, but as you can see from the table, they are generally quite similar. As well as this combination of capital and lower-case letters, the credit rating agencies may also use pluses and minuses (eg, AA+, BBB-) or numbers (eg, Aa1, Baa3) as indications of sub-gradings within a broad sliding scale or rating band.

Bonds issued by governments are generally regarded as the most secure. That said, it is not unheard of for governments to default on their debts – Argentina and Venezuela, as two examples, have defaulted on their sovereign debt numerous times in their history.

A change in credit ratings can impact borrowing costs for an issuer, particularly if the issuer is re-rated from investment grade to high yield or vice versa. Bonds downgraded to high yield have been perceived as having an increased risk of default, so issuers need to pay higher yields to attract investors; this results in higher interest rates for the issuer. The opposite applies when bonds are upgraded to investment grade: as they have a lower risk of default, the interest rate demanded by investors typically falls.

Greece's credit rating migration in the aftermath of the global financial crisis is a good example of a solid credit-rated sovereign issuer that has seen its credit status dramatically lowered to speculative debt. In 2007, Greek sovereign debt was rated by Moody's as A1 (upper-medium grade)[2], thus Greece was deemed to have low credit risk. At the same time, Germany was rated at Aaa[3], with minimal credit risk. As Greece's inability to meet its debt obligations increased, its rating was downgraded and, by 2012, it stood at C (the lowest rating awarded by Moody's). The spread between Greek and German government bonds widened as a result, from 0.36% to a peak of about 18% in 2015[4,5], – this reflected the fact that investors deemed Greek debt as a very high risk compared with German bonds, for which they demanded adequate compensation (through a higher yield spread).

It is worth noting that spreads continuously expand and contract as underlying economies and financial markets change over time.

Some portfolios (particularly for trusts, charities, or institutional clients) may have specific 'sell' triggers that explicitly require a bond to be sold if it is downgraded from investment grade to high yield. To avoid them from becoming forced sellers immediately following a downgrade (thus, being unable to obtain a price considered as satisfactory), advisers/managers should be aware whether such mandatory triggers are included in the IPS so they can be alerted to the possibility ahead of time. They should also carefully monitor issues they regard as potentially vulnerable to downgrades. One method of monitoring bonds of concerns may be to see how their yield spreads compare with other similarly rated credits, as higher spreads may indicate higher levels of perceived risk.

The Relevance of Credit Ratings in the Evaluation Process

Corporate bonds are subject to credit risk, so most private investors do not have sufficient knowledge or expertise to be able to adequately assess the credit risk on individual bonds, there needs to be a system that looks at this aspect for them.

Credit ratings are a standardised and concise way of communicating the opinion of the credit ratings agency on the ability of the issuing company to be able to meet its financial obligations. It does not constitute a recommendation to buy the bonds.

2 Trading Economics, Greece – Credit Rating. Retrieved from https://tradingeconomics.com/greece/rating (Accessed: October 2025)

3 Trading Economics, Germany – Credit Rating. Retrieved from https://tradingeconomics.com/germany/rating (Accessed: October 2025)

4 World Government Bonds, Greece 10 Years Bond – Historical Data. Retrieved from http://www.worldgovernmentbonds.com/bond-historical-data/greece/10-years/ (Accessed: October 2025)

5 World Government Bonds, Germany 10 Years Bond – Historical Data. Retrieved from http://www.worldgovernmentbonds.com/bond-historical-data/germany/10-years/ (Accessed: October 2025)



Analyse

Credit rating agencies have received criticism (mostly in times of economic stress) that their methods of analysis are too inflexible and that credit ratings have not necessarily given a true picture of the credit risk posed by a bond, either due to their system being slow to react to real world events, or through having a conflict of interest as they are remunerated by the companies whose debt they rate.

Since the global financial crisis, governments worldwide have been pressing for new laws that improve their conduct, including the quality of credit ratings that they provide, in order to protect investors. For example, in the UK, credit rating agencies must comply with The Credit Rating Agencies (Amendment etc) (EU Exit) Regulations 2019; and in the US, the existing Credit Rating Agency Reform Act was reformed and revised in 2014, to protect against another repeat of the global financial crisis. Recall from above that to receive a credit rating, the company itself must pay the credit rating agency and, hence, there could arise a conflict of interest.

This having been said, even if the actual rating is not changed, a bond may receive a 'negative outlook' warning which alerts the market to the fact that the rating may be downgraded in the near future.

In addition, investors always take the final responsibility on the principle of *caveat emptor* ('buyer beware'). This can be seen in operation in the bond market. It has, for example, been possible to find an AAA-rated bond issued by a large well-known institution, trading on yields more comparable to those available on bonds many notches lower in the credit ratings system. This is due to the market pricing in the information and views it has on the issuing company and effectively ignoring the published credit ratings. A bond that is initially classified as investment grade, but experiences a sudden downgrade to non-investment grade is known as a '**fallen angel**'.

It should, therefore, be borne in mind that while they remove a lot of the work for investors, published credit ratings are not the only source of information which should be considered when investing in bonds and, although they are generally considered to be of lower risk than equities, default risk can change rapidly in times of market stress. In extreme cases, the volatility of some bonds at the lower end of the credit ratings scale may make them just as volatile as equities.

4.1.2 Domestic and Foreign Currency Bonds

Further, bonds can be either domestic or foreign currency bonds. In terms of currencies, there are broadly three classifications of bonds that may be issued by governments or corporates: foreign bonds, eurobonds, and global bonds.

Domestic Bonds	Foreign Bonds
• A bond in which the nationality of the issuer, the denomination of the bond and the country of issue are the same. • For example, a Japanese yen-denominated bond issued in Japan by a Japanese company).	• Issued in a domestic market by a foreign entity, in the domestic market's currency. • For example, a bond issued by a US company in Canada, in Canadian dollars. • Often, foreign bonds bear names that reflect the country in which they are issued – eg, bulldogs in the UK, yankees in the US, and samurai in Japan. There are many more examples.

Eurobonds	Global Bonds
• Denominated in a currency other than the home currency of the country or market in which the bond is issued (eg, a bond denominated in renminbi in the UK). • Contrary to the name, eurobonds do not have anything to do with the euro currency, nor do they have to be denominated in euros. Rather: ◦ they can be issued in any major currency, and ◦ they are not limited to one domestic market, but are usually traded in several financial centres. • This means that eurobonds can be held by investors in almost any country. • Regulation is less stringent than with purely domestic bonds.	• Also called international bonds. • Eurobonds are a subset of global bonds. While there are similarities between them, global bonds can also be traded and issued simultaneously in the country whose currency they are issued in, as well as in other markets, and consists of tranches denominated in multiple currencies. • For example, a global bond could be denominated in Chinese renminbi, but unlike a eurobond, could be offered in both the UK and China.

4.1.3 ESG and Non-ESG Bonds

ESG bonds are fixed-income financial instruments issued by governments, corporations, or other entities to raise capital for projects that align with specific environmental, social, and governance (ESG) criteria. These bonds are designed to finance initiatives that promote sustainability, ethical practices, and responsible investing.

The following table shows the characteristics associated with ESG bonds:

Green Bonds	Green bonds are issued by private firms and public entities to raise funds to finance projects that have a positive environmental impact, such as renewable energy and the green construction of buildings. For investors, the attraction is that they allow investment that contributes to social and environmental impacts.
Blue Bonds	Blue bonds are similar to green bonds, but the funds raised are to support projects related to sustainable water use, ocean conservation and marine projects, such as promoting biodiversity. Their focus may also be wastewater treatment, prevention of water pollution and water-related climate change adaptation.
Impact Debt	Impact bonds are designed to fund prevention and early intervention. Impact debt is designed to be responsive to the needs of vulnerable groups to improve their lives.
Social Bonds	Social bonds are issued for the purpose of using funds raised for projects with positive social outcomes. The focus is, but not limited to, affordable basic infrastructure (eg, clean drinking water, sewers, sanitation, transport), health, education and vocational training for persons living below the poverty line, marginalised populations and vulnerable groups such as displaced persons, including as a result of natural disasters or conflicts.
Sustainable Bonds	Sustainable bonds raise finance for a combination of both green and social projects.
Sustainability-linked Bonds	Sustainability-linked bonds whose characteristics are tied to sustainability/ESG initiatives.

4.1.4 *Sukuk*

Sukuk are Islamic financial instruments, similar to bonds, which are required to comply with Islamic religious law. *Sukuk* were developed as an alternative to conventional bonds which are not considered permissible by Muslims. This is because Islam sets out specific requirements in Islamic law (Shariah) with regard to investment, with an overarching principle that all forms of interest are forbidden. The Islamic financial model works on the basis of risk sharing: the customer and the bank share the risk of any investment on agreed terms and divide any profits between them.

Sukuk are instruments of equal value representing a common share in the ownership of an underlying asset, that comply with Shariah law. Examples of underlying assets are real estate plots, utilities or services; or the assets of a specific project or investment activity.

There are several structures of *sukuk*, one of the most significant being *Ijarah*. *Ijarah* involves the sale or transfer – and, if applicable, lease-back – of a tangible asset for a specific period of time against a specified consideration. Other structures include:

- ***Intifa'a*** – the right to utilise, own or develop any asset, or other legal rights of utilising or holding such assets.
- ***Salam*** – a seller undertakes to supply certain goods to the purchaser at a future date in exchange for a price paid in full in advance.
- **Perpetual *sukuk*** are *sukuk* without a specific maturity date, but may be redeemed or amortised wholly or partially at any time at the discretion of the issuer or within specific periods. They may be issued as long as the issuer meets all standards and requirements related to capital adequacy, as well as further resolution or instructions issued by regulatory bodies. Government, ministries, public authorities and institutions may issue perpetual government *sukuk*.
- **Convertible *sukuk*** gives the holder the right to convert the *sukuk* into the issuer's shares at a later date. These may be issued if approved by a resolution issued by the obligor's extraordinary meeting, which is based on a reasoned proposal by the board of directors containing the rules for conversion. The price of the *sukuk* issued may not be below the **par** value of the shares; and the total par value of shares that the *sukuk* are proposed to be converted into, plus the par value of shares issued, may not exceed total authorised capital. The proposal needs to ensure the period of conversion is permissible and detail the eligibility of *sukuk*-holders to recover the value of sukuk if they do not wish to convert them.

4.2 General Characteristics of Bonds

Regardless of who the issuer is, bonds are likely to share a number of general characteristics (regardless of issuer, credit rating, the currency in which it is denominated, and so on), which we will now consider.

4.2.1 Nominal Value

All bonds are issued with a fixed principal amount or **nominal value** (NV; also known as face value or par value), which remains with the bond for its life. For example, the NV is normally £100 on UK bonds. Typical NV is $1,000 on US bonds, and 100 yuan in China; therefore, bond prices in each of these regions are quoted on this basis. The NV facilitates the calculation of yield (ie, coupon payments as a percentage of the nominal value). The NV is also the amount at which the bond will be redeemed by the issuer when it matures, hence it is also referred to as 'redemption value'.

It is important to note, though, that not all bonds **denominated** in a specific currency have a fixed NV. While many bonds in various currencies adhere to a standard NV, others may differ. For example, in the US, bonds may have an NV of $100, rather than $1,000. Whatever the denomination, the NV remains constant throughout the bond's life, and is used as the basis for calculating bond prices and yields.

4.2.2 Price

Learning Outcome

5.3.4 Calculation of accrued interest

The bond price is quoted in terms of the amount that an investor would have to pay in order to buy nominal value of the bond. The price is quoted in pounds and pence in the UK, dollars and cents in the US, and so on.

Compared to its fixed par value, the price may be trading above par (at a premium) or below par (at a discount). The market price is based on the market's assessment of the fair value and is set by the supply and demand for the paper in the marketplace. The cash flows that an investor will receive from the bond are capitalised with the market's expectations about the future pattern of interest rates. These rates are referred to as the term structure of the bond.

The quoted price is called the clean price and this excludes the accrued interest that is due to the seller of the bond. The **dirty price** of the same bond is the total price payable by the buyer and is the clean price plus the accrued interest, which we will now consider.

4.2.3 Bond Pricing and Accrued Interest

We have seen so far that bonds are priced per nominal amount of bond (eg, £100 on UK bonds), but the bond market also adopts a 'clean' and 'dirty' pricing system.

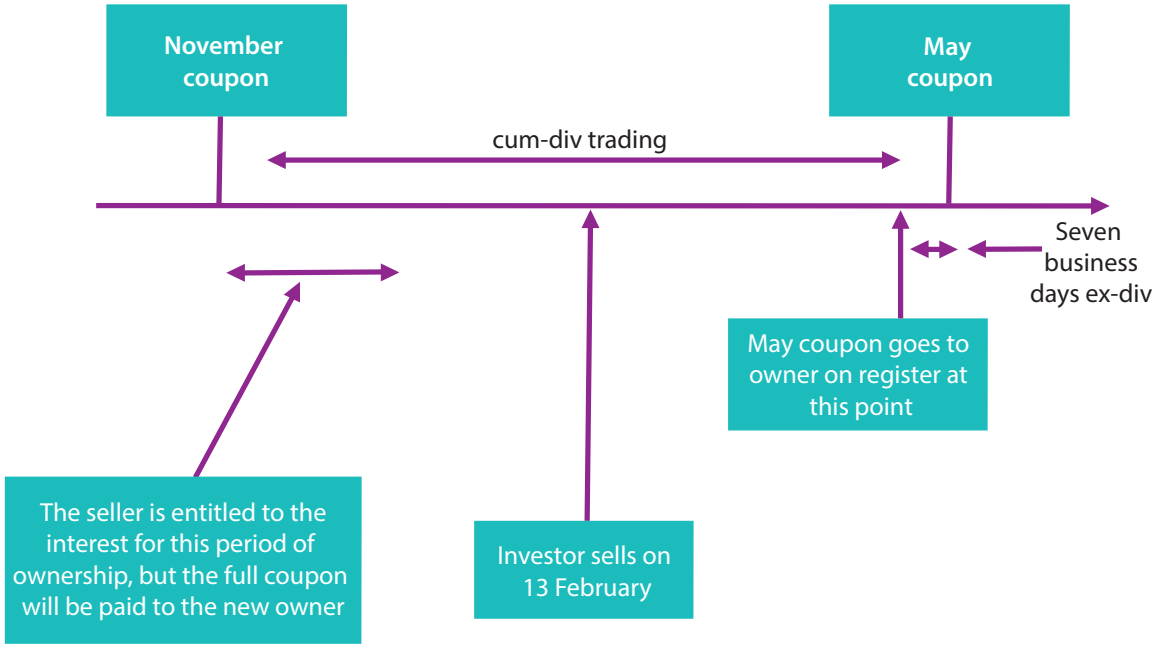
If an investor wishes to buy a bond, they will be quoted the clean price. The clean price is the price that is quoted in the financial press.

However, when they actually come to pay for the bond, they will pay the dirty price. This comprises the clean price plus an allowance for accrued interest, which is an element of the coupon that will need to be paid over to compensate the seller. The new buyer will be entitled to the whole coupon payment, although they would not have necessarily held the bond for the entire coupon period. Therefore, the new buyer must compensate the seller on a pro rata basis. Except for coupon payment ex-dates, the dirty price will be more than the clean price.

This is how it works:

- Seven business days before the coupon payment is due, the identity of the registered owner of the bond is established. The coupon payment for the whole half-year is paid to that investor on the coupon payment date.
- The owner of a bond, who sells it between coupon payments, will be entitled to interest which will be paid to the new holder on the next coupon date. When buying a bond, the purchaser must therefore compensate the seller for the interest that was accrued during the seller's period of ownership.

The following diagram illustrates the point:



The clean price plus (or minus) the accrued interest makes up the dirty price.

During the cum-div trading period, the accrued interest is added to the clean price to compensate the seller for the interest accrued, which will be paid to the new holder.

During the ex-div period, the accrued interest is deducted from the clean price to make up the dirty price. If a gilt is sold during this period, the purchaser will have owned the gilt for a few days before the coupon payment is made. As such, they will be entitled to the accrued interest for the number of days that they owned the gilt, before the coupon payment date. As the coupon for the entire half-year will be

paid to the seller, the seller must rebate the purchaser the accrued interest that the purchaser is entitled to. The purchaser therefore pays the clean price for the gilt, with the value of the accrued interest owed to them by the previous owner, deducted from the cost.

Accrued Interest Calculation Example

Julia sells a 5% Treasury bond 2040 on 27 November (settlement on 28 November). The clean price is £128.60 and the coupon payment dates for this particular gilt are 7 March and 7 September. What is the dirty price paid to Julia by the purchaser of the gilt?

Step 1: Calculate the number of actual days that Julia has owned the gilt since the last coupon payment date:

8 September (day after coupon payment date) to 28 November (settlement days) = 82 days

Step 2: Calculate the number of actual days in the coupon period (from 8 September, the day after the last coupon was paid; to 7 March, when the next coupon falls due):

Sep 23 days (8^{th} – 30^{th})
Oct 31 days
Nov 30 days
Dec 31 days
Jan 31 days
Feb 28 days
Mar 7 days (1^{st} – 7^{th})

Total = 181 days

Step 3: Calculate the proportion of the half-yearly coupon payment for which the purchaser must compensate Julia:

$$£100 \times \left(\frac{1}{2} \times 5\%\right) \times 82/181 = £1.13$$

Step 4: Calculate the dirty price:

$$£128.60\ (\text{clean price}) + £1.13\ (\text{accrued interest}) = £129.73$$

4.2.4 Maturity

Learning Outcome

5.3.3 Redemption dates and the use of sinking funds

The maturity date is when the nominal value of most bonds is repaid by the issuer. Prior to that date (and to the redemption of the principal), it can be traded on a secondary market.

Single-Dated Bond (Bullet Redemption)

Most bonds redeem on a single date, called a bullet redemption. To give an example, the UK government's Treasury Gilt 1.125% 22/10/2073 matures on 22 October 2073, on which date the final coupon payment and the whole par value will be paid to the investor.

Callable Bonds

Callable bonds may be redeemed at the issuer's option, usually on or after a particular date during the term of the issue. One reason that an issuer may call a bond and redeem it early is if interest rates are lower in the market than under the terms of the issued bond. A call provision would enable the issuer to redeem the more costly bond early, and potentially re-borrow the money at lower rates.

Puttable Bonds

A bond with a put provision enables an investor to insist that a bond is redeemed early at a pre-specified rate. Given the relationship between interest rates and bond prices, this operates to the investor's benefit should interest rates rise, as it effectively acts as a floor on the price/value of the bond.

Dual-Dated Bonds

A particular type of callable bond is a double-dated bond, which is issued with two maturity dates. The issuer can give notice and choose to redeem the bond on any day between the first and final maturity dates.

When the issuer chooses to redeem will depend on whether these bonds represent cheap or expensive borrowing for the issuer. In the example of 7¾% Treasury Loan 2012–15, as rates were lower in the marketplace when 2012 arrived, the government redeemed the gilt at the earliest opportunity because it could re-borrow the money at lower rates. If rates are higher in the markets, the government is likely to redeem these gilts at the latest possible date.

Note that the UK government does not currently have any dual-dated gilts in issue.

Undated Bonds

Also called irredeemable or perpetual bonds, these bonds have no maturity date. The issuer is under no obligation to redeem the principal sum, although they do have the right to do so if they wish. If the bond is not redeemed, the coupon will be paid into perpetuity.

Sinking Funds

A **sinking fund** makes a provision for the repayment of the capital outstanding under a bond, and, therefore, reduces the default risk of the bond.

They usually work in one of two ways:

- A counterpart fund can be established, where the issuer of the bond puts money aside each year in readiness for **redemption**.
- Alternatively, the issuer may repay a set proportion of the bond at set intervals. For example, 1/15th of a bond's outstanding value may be redeemed every year for 15 years.

The method of selecting the bonds to be redeemed will be specified in the terms of issue, and may be by way of lottery, whereby serial numbers of the bonds to be redeemed are drawn at random. If, however, it is agreed in the terms of issue that the bonds will be redeemed at par and the bonds are trading at less than nominal value in the markets, the issuer may choose to purchase bonds in the market with a total nominal value equal to the amount that is to be redeemed.

There is usually a period during the initial life of a bond where the sinking fund does not operate. In the example above, for instance, the bond may be a 20-year issue with no redemptions during the first five years, and 1/15th of the bond is redeemed annually thereafter.

The existence of a sinking fund may reduce the risk associated with a particular bond.

Maturity Classifications

Bonds are classified in terms of how long they have to run before they are redeemed (ie, before the issuer repays the capital). In the UK, there are two different conventions used:

	Financial Times	DMO
Shorts	Under five years to run to redemption	Under seven years to run to redemption
Mediums	Five to 15 years to redemption	Seven to 15 years to redemption
Longs	Over 15 years to redemption	Over 15 years to redemption

The Financial Times (FT) method is probably more familiar to retail investors who use the publication to follow prices, while the Debt Management Office (DMO) classification is used by professionals.

Other countries and organisations may have their own classifications – in the US, for example, shorts, mediums and longs mature in under three years, between four and ten years, and over ten years respectively. Note that the exact definition used by certain ETFs and for delivery in the futures markets can be slightly different.

Over time, longs eventually become mediums and then shorts, as maturity nears. In more recent years due to a low interest rate environment, some governments and companies have issued bonds with maturities of 50 and even 100 years. These 'ultra-long' issues are categorised along with the 'longs' as they do not have a separate category all to themselves. Similarly, 'ultra-short' issues (ie, those maturing within one year) are categorised with the 'shorts'. For double-dated bonds, the later date is used for the categorisation.

Other bonds are perpetual (ie, there is no maturity date) – these are also called irredeemable bonds or undated bonds. The issuer is under no obligation to redeem the principal sum, thus the coupon is paid into perpetuity; however, they may have the right to do so if they wish.

Bonds generally cannot be encashed before the final redemption date (ie, investors cannot ask the issuer to repay the debt early), but they can be bought and sold in the secondary markets.

4.2.5 Coupon

Learning Outcome

5.3.1 Features and redemption terms of fixed, floating and index-linked bonds

5.3.6 Break-even inflation rates

The coupon is the amount of interest that an investor will earn each year on the nominal value of a bond. When calculating the return on investment (ROI) on their price, the general market convention is to talk about bonds in terms of their nominal value. How often the coupon is paid is determined at issue – the frequency is typically every quarter, six months or once each year.

The vast majority of bonds are issued with a predetermined, fixed value for the coupon; hence they are known as 'fixed-interest' securities, 'fixed-rate' securities, 'straights' or 'conventional' bonds. However, some pay coupons that fluctuate in line with a broader index (eg, a rate of interest or inflation). Others do not pay a coupon, but are instead issued at a discount for their nominal value (known as **zero coupon bonds (ZCBs)**). The basis for the determination of the coupon is set before issue, although this does not mean that the value is known at that date.

The investor's income tax liability on the coupons will depend on their other sources of income and the availability of any statutory allowances in their country (or countries) of residence. In the UK, for example, coupons are classed as savings income. In other words, if the income received falls within an individual's personal savings allowance (PSA), then there is no further tax to pay; otherwise, it will be taxed at their marginal rate (see chapter 2). One exception to this is ZCBs, which we will explain in a moment.

Tax is not normally deducted from the coupon payment, and this is referred as to being a gross coupon. That said, investors may be able to choose to have income tax deducted from the payment of their coupon, which is referred to as 'electing for withholding tax (WHT) to be deducted'.

For example, in the UK, if an individual holds £100 NV of a 6.5% semi-annual bond and elect to have tax deducted (which would be at the basic rate of 20%), their next coupon will be reduced to 80%, as follows:

$$\text{Next coupon} = £100\ \text{NV} \times \text{Coupon rate} \times {}^{6}\!/_{12} \times 80\%$$

$$= £100\ \text{NV} \times 6.5\%\ \text{x}\ {}^{6}\!/_{12} \times 80\% = £2.60$$

Thus, the gross coupon is £3.25 (ie, half of £6.50) and the net coupon is £2.60.

4.2.6 Conventional Bonds

This is the simplest type of bond. They pay a fixed coupon, which is payable quarterly, semi-annually or annually, depending on the market convention in the country in which the bond is issued (eg, in the UK, bonds typically have semi-annual coupon payments, and eurobonds are conventionally issued with annual coupons). On maturity, the owner of the bond will receive the final coupon and the redemption value.

Convention in the market is to quote bond prices as the price an investor must pay to purchase the nominal value (also called face value or par value), and is a clean price excluding any accrued interest (see section 4.2.3 on clean price). Accrued interest is quoted separately as '+' or '–' a certain number of days. The current market price at the time the investor buys the bond may be more than or less than the nominal value:

- If the current market price of a bond is above the nominal value, the bond is described as trading 'above par' and the investor will make a capital loss on the bond when it is redeemed.
- If the current market price of the bond is below the nominal value, the bond is described as trading 'below par'. An investor who buys the bond for less than the nominal value will make a capital gain if they hold the bond to maturity, which may be exempt from CGT (eg, if it a gilt or qualifying corporate bond (QCB)); but at the same time, losses are not allowed, so cannot be offset against any gains realised elsewhere.

Bonds are described in terms of the percentage coupon they pay and the maturity date, so a bond paying a 4% coupon and maturing on 15 April 2040 would be described as:

4% Bond 15/04/2040

The amount of coupon paid is the quoted percentage of the nominal value of the bond and not of the purchase price. For example, an investor paying £118 for £100 nominal of bond will therefore receive a coupon payment of £4 per year (4% x £100), split into two equal instalments of £2 each.

4.2.7 Floating-Rate Bonds

Price fluctuations of a bond are driven by the coupon rate relative to the market rate of interest for a similar maturity instrument. With conventional bonds, the coupon is fixed. However, certain types of bonds reset the coupon according to a commonly accepted index or other (usually short-term) interest rate. These are called floating-rate notes (FRNs) or floaters. These securities set the coupon (usually at a given spread) based on a short-term market-rate benchmark – with the most popular being **sterling overnight index average (SONIA)**, euro short-term rate (€STR) or secured overnight financing rate (SOFR). The coupon is then adjusted regularly (eg, at one- to six-monthly intervals). Thus, FRNs are popular during periods of increased volatility in interest rates, when lenders are reluctant to lend funds cheaply at a fixed period for a fixed rate, or in other situations such as when macroeconomic factors might be seen as unfavourable for bonds.

The coupon on FRNs consists of two parts, namely:

1. the reference or index rate, and
2. a quoted margin or **spread** (ie, the rate above the reference of index rate that must be paid) which is defined at the outset and indicates the borrower's credit ratings and size of the issue, in addition to the market conditions at that point.

An example of this is a five-year bond with a coupon of a benchmark rate (the index rate) plus 25 basis points (the quoted margin). A basis point (BPS) is equal to 0.01%, so 25 bps would be equal to 0.25%. If the benchmark rate is 6% per annum over a six-month period (it is usually worked out as an average), then the FRN will pay 6% pa plus the 0.25% spread, or 6.25% pa in total over the period.

Other conditions may be included, such as an interest rate becoming fixed if it falls to a specified level, known as a drop lock or **floor**. It is also possible for the issuer to protect the FRN with a ceiling or a cap on the rate so that if interest rates rise, the coupon also rises, but not beyond the ceiling. A **collared** FRN with a floor and a ceiling is known as a mini-max bond.

As the coupon moves in line with market interest rates, floating-rate bonds tended to trade close to nominal value.

4.2.8 Inflation-Linked Bonds

At other times, these fluctuations may be in relation to a particular measure of inflation, called inflation-linked bonds (ILBs) (also linkers and index-linked bonds). Here, the quoted coupon is increased in line with the inflation rate over the time since the bond was originally issued. The coupon payments are therefore 'real' rates of return and the income from these bonds is, for the most part, inflation-proofed (ILBs are not completely inflation proof because they typically have a lag in adjusting their principal value and coupon payments in response to changes in inflation, as discussed below).

A similar process applies to the redemption value. This too is increased in line with how much inflation has occured since the bond was issued, and protects the investor's capital against inflation, although it is not growing in real terms.

To use the technical term, the coupon payments and redemption value are 'uplifted'. Conceptually, in the UK, there are several measures of inflation – of these, the measure of inflation used to calculate the uplifting is the retail price index (RPI). The RPI considers a basket of goods and services purchased in UK households from month to month, and measures the average change to the total cost of this basket over time to determine the inflation rate.

Following a consultation, the UK government has announced that the way in which the RPI is calculated in the UK will be reformed by 2030, such that it will be more in line with the consumer price index (CPI) including housing costs – this measure is called the CPIH. There are also some key differences in the way in which the RPI and CPI (including the CPIH) are calculated:

- The RPI is an arithmetic mean, while the CPI is a geometric mean.
- The RPI includes a range of costs, such as mortgage payments and rents, while the CPI does not.
- Vice versa, the CPI includes some items that are not in the RPI, such as unit trust and stockbroker charges, university accommodation costs and student tuition fees.
- The CPI covers all private households, whereas the RPI excludes the highest earners and pensioner households, who derive most of their income from state benefits.

All in all, this leads to a disparity in the rates over time – indeed, statistics show that the RPI is typically about 1% higher than the CPI every year. Therefore, this change from the RPI to CPIH will likely result in a fall in the value of ILBs as they will be linked to a lower inflation measure.

Note that ILBs may not have a deflation 'floor' – in other words, their final redemption payment could be less than the nominal value if there is a general fall in the level of prices in the UK. For bonds with a deflation floor, investors still receive the full nominal amount at maturity if deflation drives the principal amount below par. For example, for a 20-year ILB issued today with a deflation floor, the deflation floor would only take effect if the level of inflation to which the bond is linked, is in 20 years' time, below that of today's level.

It would be logical for the inflation uplifting to take account of the increase in inflation for the exact period from the date of issue to the date of payment of the coupon/redemption proceeds. Unfortunately, this is not the case. For most global ILBs and index-linked gilts (ILGs) issued after September 2005, the allowance for the inflation uplifting is calculated with a three-month time lag.

The methodology for calculating the coupons and redemption values uses an index ratio to measure the growth in inflation since the ILB was originally issued. The general formula is:

$$\text{Interest payment}_{\text{Interest payment date}} = \text{Coupon}/\text{n} \times \text{Index ratio}_{\text{Interest payment date}}$$

With the index ratio calculated as:

$$\text{Index ratio} = \text{Reference RPI, 3 months before the coupon date} / \text{Reference RPI, for month before the issue date}$$

where n is the number of coupon payments in a year.

Example Calculation

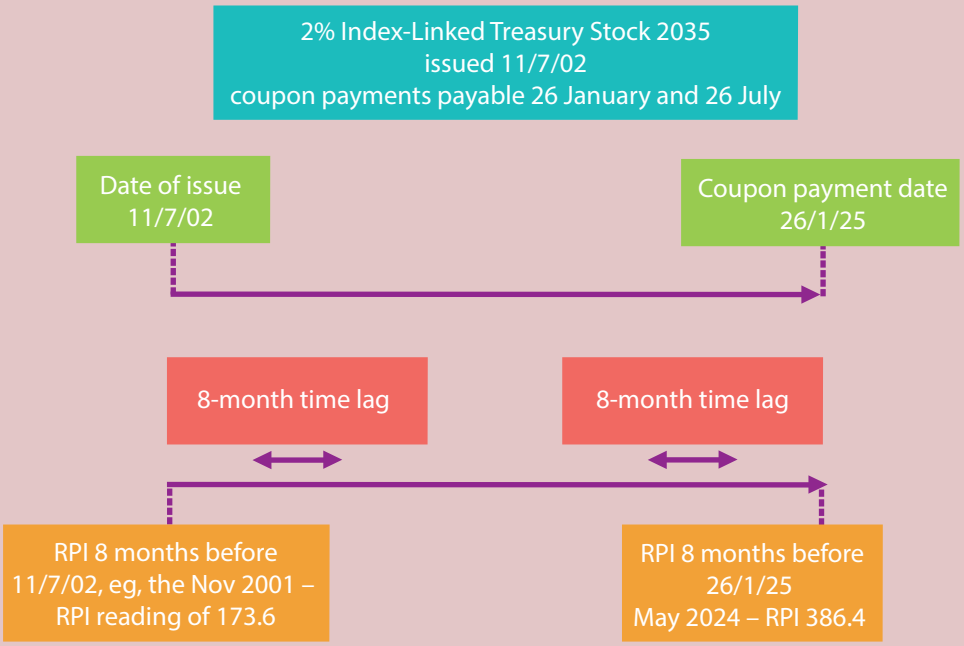
1 1/8% Index-Linked Bond 2037
issued 22/5/2007
Coupon payments payable 22 May and 22 November

$$\text{Interest payment for 22 May 2025} = \frac{1.125}{2} \times \frac{364.5}{203.1} = £1.0095$$

RPI (among other inflation) data is available on the ONS website[6].

One exception is index-linked gilts issued before September 2005, where the allowance is calculated with an eight-month time lag. The methodology for calculating the coupons and redemptions values is different from the above, as the example below shows.

Example Calculation



6 Office for National Statistics, September 2025. RPI All Items Index: Jan 1987 = 100. Retrieved from https://www.ons.gov.uk/economy/inflationandpriceindices (Accessed: October 2025)

Formula for calculating the January 2025 coupon payment:

$$\left(2\% / 2\right) \times \left(386.4 / 173.6\right) = 2.2258\%$$

Assuming our investor owns £15,000 gilts, the coupon payment would be:

$$£15{,}000 \times 2.2258\% = £333.87$$

The break-even rate represents the average rate at which inflation must be over the remaining life of an ILB for the investor to see equal returns by buying the ILB, as opposed to having bought a conventional bond of similar maturity date. This will depend on the investor's tax rate as the inflation uplift of the index-linked repayment is free of CGT.

If inflation rises above the break-even rate, the ILB will provide a better return. If inflation falls below the break-even rate, the ILB will provide a lower return.

4.2.9 Zero Coupon Bonds (ZCBs)

There is also a variety of bond known as zero coupon bonds (ZCBs), or simply 'zeros', which pay no coupon. Instead, the investor makes their return by virtue of the fact that the bond is issued at a discount (usually a price well below) its eventual redemption price, which is generally its face value. For example, a ZCB may be issued at £60 per £100 nominal, with an eventual redemption price at £100 per £100 nominal. This capital appreciation reflects the return on holding the bond.

On the face of it, the return looks more like a capital gain than an income stream. However, in most cases, tax authorities will deem the investor to have received a notional amount of income each year and tax them on that, in order to avoid the possibility of investors abusing zeros as a way of obtaining the certainty of return of a fixed-interest instrument, without the income tax liabilities.

ZCBs have some intriguing properties that are much valued by pension funds and risk managers who use them to get more effective immunisation against interest rate risks, especially in asset/liability management (ALM) applications. The duration of a zero is the same as its maturity.

4.3 Calculating and Interpreting the Returns on a Bond

Learning Outcome

5.3.7 The calculation and interpretation of flat yield and redemption yield

Yields are a measure of return expressed as a percentage of the purchase price of the investment. You should know how to calculate and interpret three types of yield in relation to bonds: flat yield, **gross redemption yield (GRY)** and net redemption yield (NRY).

4.3.1 Flat Yield

The flat yield (which is also known as the running, interest or income yield) merely looks at the income received by way of coupon, and expresses it as a percentage of the amount paid for the bond. It is useful for an investor seeking income and not expecting to hold the bond until maturity:

$$\text{Flat yield (\%)} = \text{Gross annual coupon} / \text{Clean price}$$

However, the flat yield has a number of drawbacks:

- It only considers the return by way of coupon, not capital, and is therefore an incomplete measure of return. If the bond is held to redemption, the investor may also make a profit/loss on their capital depending on whether the purchase price was above/below par (eg, £100, $1,000, 100 yuan).
- If the investor is a taxpayer, they will be liable to pay income tax on the coupon received. This measure also ignores the investor's tax status.

? Using the formula above, calculate the flat yield for the following bond: A US corporate bond is paying a 5% coupon and is priced at $128.60. The bond redeems in ten years (ie, 2034). You can check your answer below.

This would give a flat yield of $5 / $128.60 = 0.0389 or 3.89%.

4.3.2 Gross Redemption Yield (GRY)

The GRY, also referred to as the yield to maturity (YTM) or discount rate, is a far more accurate way to calculate the return on a gilt, because it takes both the income and potential capital gain (or loss) at maturity into account.

A simple way of calculating a rough approximation of the GRY is shown below.

Example

5% Corporate Bond

Maturing in 10 Years

Clean price €128.60

Step 1: Calculate the flat yield:

$$\text{Flat yield} = €5 / €128.60 = 0.0389 \text{ or } 3.89\%$$

Step 2: Calculate the annual percent return on the profit or loss element:

$$\text{Annual percent return} = \left(\text{Redemption value} - \text{Current price}\right) / \text{Years to redemption}$$

$$= \left(€100 - €128.60\right) / 10 = -€28.60 / 10 = -€2.86 \text{ a year}$$

Step 3: Divide this by the current price:

$$-€2.86 / €128.60 = -0.0222 \text{ or } -2.22\%$$

Step 4: Total the return from both parts of the calculation:

$$3.89\% - 2.22\% = 1.67\%$$

In summary:

$$\text{GRY}\left(\%\right) = \text{Flat yield} + \left[\left(\text{Redemption value} - \text{Current price}\right) / \text{Years to redemption}\right] / \text{Current price}$$

Although this above example demonstrates the concept, in reality the calculation is more complex and incorporates the time value of money. In practice, a financial calculator will give a more accurate result. In the above case, the more accurate GRY would be 1.85%, assuming semi-annual coupon payments.

In conclusion, bonds priced below par have a GRY which exceeds the gross flat yield. Conversely, bonds trading above par (common nowadays) produce a GRY below the gross flat yield.

4.3.3 Net Redemption Yield (NRY)

The net redemption yield (NRY) takes the GRY a step further and calculates the after-tax redemption yield for an investor, taking into account their personal tax status.

In the UK, generally, the tax status of bonds is:

- profits on redemption of gilts and qualifying corporate bonds (QCBs) are exempt from CGT (see section 4.1.2 of chapter 2), and
- coupon payments are subject to income tax at the investor's marginal rate.

The return from the coupon must therefore be reduced by the amount of tax payable, to give an investor's after-tax return.

Continuing the example above:

Example

Step 1: Calculate the flat yield:

$$€5 / €128.60 = 0.0389 \text{ or } 3.89\%$$

Step 2: Reduce this by the tax rate of the investor:

Tax Status	BRTP (20%)	HRTP (40%)	ARTP (45%)
Gross flat yield	3.89%	3.89%	3.89%
Less tax payable	20% of 3.89% = –0.78%	40% of 3.89% = –1.56%	45% of 3.89% = –1.75%
Net flat yield	3.11%	2.33%	2.14%

Step 3: Add the annual return from the capital profit (or subtract the loss element), to calculate the net redemption yield:

Tax Status	BRTP (20%)	HRTP (40%)	ARTP (45%)
Net flat yield	3.11%	2.33%	2.14%
Loss to redemption	–2.22%	–2.22%	–2.22%
Net redemption yield	0.89%	0.11%	–0.08%

In the case of the additional rate taxpayer, the yield is actually negative. While a more accurate calculation will be achieved on a financial calculator, nevertheless; it illustrates the tax inefficiency of this bond for an additional rate taxpayer.

4.4 The Yield Curve

Learning Outcome

5.3.8 The features and determinants of the yield curve

In bond markets, much reference is made to the yield curve.

The **yield curve** is a graphical representation of the GRYs for bonds of equal credit quality (typically government bonds), plotted over a range of maturities. When the yield for each maturity has been plotted on the graph, a line of best fit is drawn through the points, and the yield curve, also known as the term structure of interest rates, is created.

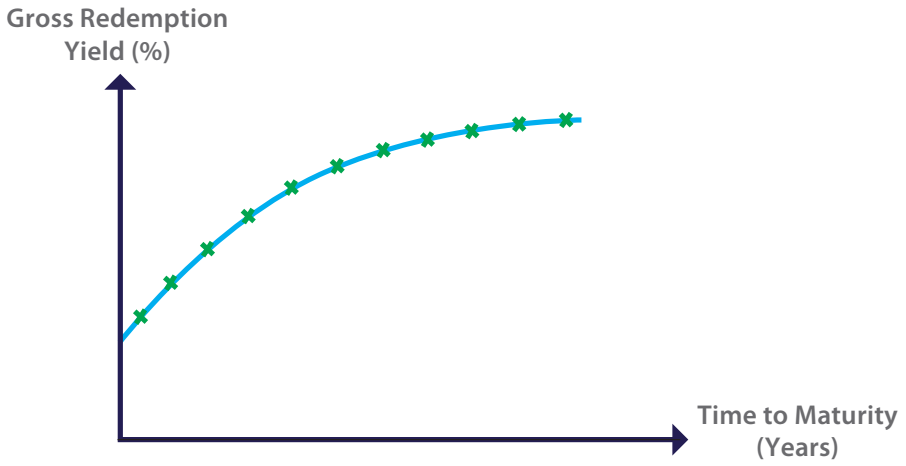
The shape of the yield curve changes over time. Although there are many different theories to explain these changes, the shape of the 'real world' yield curve is always likely to be influenced by a combination of economic, monetary policy, inflationary and market sentiment factors, although some factors may be more significant in different situations.

Note that the bond market is actually a collection of different bond markets. This is highlighted in times of market stress, when higher-quality issues become dissociated from lower-quality issues as investors seek low-risk bonds as a safe haven (eg, AAA-rated government issues) and shun poorer-quality issues. When discussing the yield curve, it is important to understand which yield curve is being referred to.

The normal yield curve is upward sloping, to the right, although it can be down sloping (inverted), horizontal (flat), humped or a mixture of shapes along different parts of the curve.

More often than not, the yield curve is described as being 'upwards sloping', in that it displays a positive slope. This is known as a normal yield curve, as it depicts the commonly observed relationship of long-term interest rates being higher than short-term interest rates.

Normal - Upward Sloping Yield Curve



Some of the main theories that explain the possible shapes of the yield curve are explained in the text that follows.

4.4.1 Liquidity Preference Theory

This theory suggests that an investor who invests in longer-dated bonds has to wait longer for their money to be repaid to them and, therefore, take additional risk which requires a greater return. It therefore explains the shape of the upward sloping normal curve.

Shorter-dated bonds return the investor's money sooner and therefore represents a lower risk, and the points plotted on the yield curve for these are correspondingly lower.

4.4.2 Pure Expectations Theory

This theory states that long-term yields are the geometric average of expected short-term rates. The yield curve therefore becomes a reflection of market expectations of interest rates.

When the yield curve is inverted, as seen in the following diagram, short-term interest rates are higher than long-term rates.

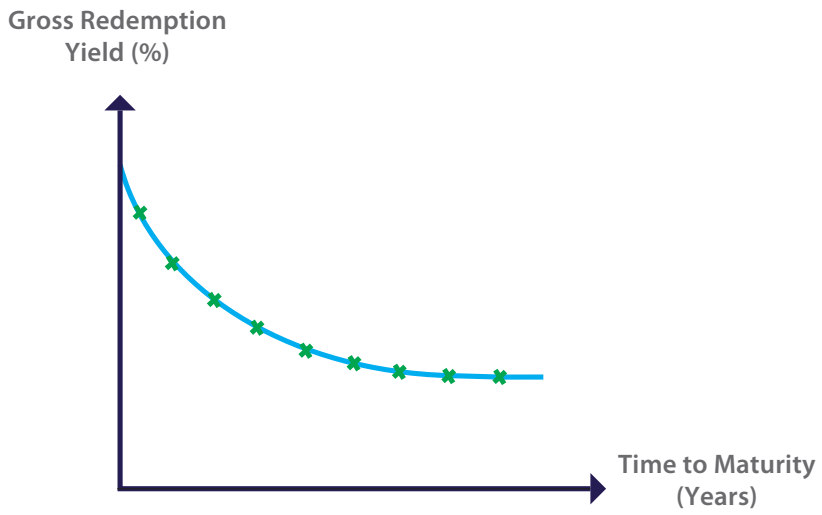
Given the inverse relationship between bond prices and interest rates, if the market expects yields at the longer end of the curve to increase, interest rates are likely to increase and bond prices will fall. The theory predicts that in anticipation of this movement, bond traders will sell long-dated bonds.

If market expectations are that long yields will fall, then interest rates will fall and bond prices will rise; in which case, the theory predicts that bond traders will buy long-dated bonds.

There is often an **inverted yield curve** just before a recession, because interest rates tend to be reduced to kick-start the economy and investors buy at the long end of the yield curve in order to profit from the anticipated fall in bond yields and corresponding rise in bond prices.

Inflation expectations also have a bearing on the prices of bonds – although this is much more significant at the longer end of the curve. If it is anticipated that there will be a period of high inflation, then the real value of the return obtained from the bond will fall the longer it is held. Consequently, the yield needed to reward investors for holding the bond to maturity needs to be higher for longer maturity bonds.

Inverted Yield Curve



4.4.3 Segmentation Theory (or Preferred Habitat)

This theory considers the short, medium and long-dated bonds on the curve to belong to different markets, with differing forces of supply and demand to take into account.

Pension funds, for instance, have a preference for investing in longer-dated bonds to match their liabilities, whereas banks and insurance companies have a need to maintain liquidity in their investments, therefore, they have a preference for investing at the short end of the curve. You may sometimes see discontinuities or anomalies in the curve where there is a gap between two such influences or a change from an influence in one part of the curve to a different influence in another part of the curve.

4.4.4 Government and Central Bank Policy

In order to control the economy, governments and central banks use the supply of and demand for government bonds as a tool for stimulating or cooling economic growth. It is also sometimes used to manage market liquidity and wholesale short-term rates.

A central bank may offer to buy back a government's debt, and although this has previously been done on a regular basis using funds in existence, various governments worldwide have used this method in more recent years to boost their economies in what is called quantitative easing (QE). This has differed significantly from the usual government bond buy-backs in that the governments in question have electronically created more of their own currency to pay for the bonds they are buying back, and on a massive scale, giving rise to fears of high (or even hyper) inflation. While, theoretically, purchasing bonds should push down the yield curve (which it has at the shorter end), the expectation of future high inflation did not appear until more recently. Actual inflation readings have been rising for a variety of reasons, and the long end of the curve has moved higher.

More recently, for example, the level of borrowing by governments around the world (in particular those in the West) surged during the coronavirus (COVID-19) pandemic, with substantial liquidity provided to businesses and households to help alleviate the impacts. Alongside this, various central banks made emergency decisions to cut interest rates, to provide further economic support – in 2020, the Bank of England (BoE) cut rates to 0.25%, and shortly thereafter to 0.10%, the lowest ever in its 325-year history; and the US Federal Reserve to near zero. While the European Central Bank (ECB) decided not to cut interest rates, it instead announced measures to support bank lending and expanded its asset purchase programme. Similar emergency monetary policy easings were taken by Japan, South Korea, Australia and New Zealand. Certain countries, which were fighting particularly strong deflationary forces including Japan and Switzerland, imposed negative interest rates, a phenomenon seen for the first time.

QE has been the biggest monetary policy experiment in modern times, with central banks implementing large scale asset purchase programmes from 2008 to 2022.

Note that a green QE programme is different to conventional QE. With green QE, central banks buy bonds that have been issued by governments or firms that intend to fund projects on energy efficiency, renewables and any other type of environmentally- friendly investment. Unlike conventional QE, which aims to enhance economic growth, green QE contributes to the fight against climate change, since it tilts the central bank's balance sheet towards the sectors that are helping to address climate change.

Quantitative tightening (QT) – also called 'quantitative hardening' or 'balance sheet normalisation' – is the opposite of QE. It involves the central bank selling its balance sheet assets, thus reducing the money supply floating around in the economy. QT is, therefore, a form of contractionary monetary policy applied by central banks to decrease the amount of liquidity within an economy.

QT will have an impact on the markets, not only in relation to how they undertake this exercise, but in the pace of the unwinding and how this is communicated to the market. In 2021–22, for example, the BoE, the ECB and the Fed started to reduce the pace of their asset purchases, termed 'the Great Unwinding' due to the scale of the task.

In addition to this, more recently, central banks have been increasing interest rates once again to combat high and rising inflation caused by the release of pent-up consumer demand for goods and services as COVID-19 restrictions were lifted and due to the emergence of supply chain issues caused by the pandemic. The situation was exacerbated by Russia's invasion of Ukraine in 2022, as both are large exporters of various foodstuffs and commodities.

As QT is only now being ramped up, there is considerable uncertainty as to the magnitude of its impact. One of the anticipated issues with QT is that it raises risks for markets.

By tightening liquidity conditions, QT puts upward pressure on interest rates. Modern governments run on budget deficits; and easily obtainable, cheap mortgage finance has boosted the residential property market. In a highly leveraged economy, the rising cost of credit could weaken demand, thus triggering an economic crisis on a global scale. This, in turn, could create a bearish investor sentiment – especially towards equities and other 'risk-on' assets which are particularly sensitive. There is also the risk of a crash in the bond markets, as pressure builds for yields to move higher in a rising interest rate environment, leading to lower prices.

4.5 Other Determinates of the Yield Curve

As seen earlier, in the UK, the coupon on bonds is liable to income tax, but any capital gain on them is free of CGT (except for ZCBs). For higher and additional rate taxpayers, it is more beneficial to invest in bonds paying a lower coupon and generating a capital gain on maturity. This increases the attraction of ILBs, particularly for higher and additional rate taxpayers.

Note, though, that bonds can be bought above par. In other words, investors may bid a higher price than the bond's face value. For those investors who buy such bonds and hold them until maturity, they will realise a capital loss, and such losses are not allowable for CGT purposes.

Why, then, would investors purchase above-par bonds? One reason is that a negative yielding bond can deliver a positive real return if there is deflation; hence, they can act as a deflationary hedge. Also, investors can sell their bond before maturity in the secondary market – depending on the sentiment towards the issuer, the investor may be able to sell the bond for more than the price they paid (although it could also be less).

Another reason is that, above all else, it is important that bonds match the actual mandate. For example, pension funds have liabilities (payments) to make, so would rather have the certainty of bonds to equities if liabilities are due soon.

Bond investment strategies (like equity investment strategies) revolve very much around market timing and security selection. Market timing techniques involve predicting changes in interest rates and yields, which result in the prices of bonds falling or rising, and security selection techniques involve looking for underpriced and overpriced securities. Hedge funds that engage in fixed-income arbitrage attempt to eliminate overall directional risk in interest rates, instead seeking trades where spreads between two issues will narrow or widen. Managers running speculative strategies also often make leveraged bets on how the shape of the yield curve will change. For example, if they expect long rates to rise relative to short rates, they will sell long-dated bonds or bond futures, and buy short-dated securities or interest rate futures. Passive and active investment strategies are covered in chapter 6, section 8.

4.6 Bonds and Duration

Learning Outcome

5.3.9 Duration and modified duration, and their determinants and usefulness as measures of price volatility

Interest rates have an influence on bond prices due to market forces (eg, if an investor can receive a 3% return on cash, why would they buy a bond with the same level of risk only to receive a 2.8% yield?). Therefore, if interest rates available on cash change, bonds have to remain competitive by offering a similar yield after accounting for risk differences between the two (remember that bond dealers tend to talk about yields rising/falling, not prices falling/rising). As interest rates have an effect on the bond market:

- If interest rates go up – bond yields go up – bond prices go down.
- If interest rates go down – bond yields go down – bond prices go up.

This volatility in bond prices translates into risk for an investor. The problem is that not all bond prices change by the same amount if interest rates change.

As a general rule, all other things being equal:

- **Longer-dated bonds are more volatile than shorter-dated bonds.**
  Consider two different bonds. One has 10 years until maturity and the other has only just over a year to go until maturity. Interest rates increase. As a result, both bonds are less attractive than they were the previous day, compared with cash.

  The price of both bonds will fall. The price of the longer-dated bond will fall by a higher amount because the reduction in the price needs to compensate buyers for receiving what is now perceived to be a less attractive coupon for a longer period. The price of a short-dated bond only has to alter a small amount to compensate the investor for a short period of holding the investment before they receive the redemption proceeds and are free to invest elsewhere.

  As bonds approach maturity, the price at which they change hands gets closer and closer to nominal value due to this effect. This is known as ‘pulling to redemption’.

- **Low coupon bonds are more volatile than high coupon bonds.**
  The coupon payments are cash flows into the account of the investor, followed by the redemption payment. If two bonds have the same time to redemption, the one which represents the greater risk is the one with the lower coupon payments as a greater proportion of an investor's cash being returned a long way in the future. The higher coupon bond is paying a larger proportion of the total cash flows much sooner, and although the biggest cash flow still comes at redemption, the fact that it pays more cash back to the investor sooner means that it represents less of a risk.

As a rule of thumb, we can see that investors seeking to minimise risk (price sensitivity) should be buying higher coupon bonds with shorter maturity dates, but which of the following bonds is the most volatile:

- a low coupon bond with a short time until maturity, or
- a high coupon bond with a long time to maturity?

To know which, we would need more details in order to calculate specifically which is more volatile.

A measure called **Macaulay's Duration** (also sometimes known as 'relative duration' or just duration) measures the sensitivity of the price of a bond to a change in interest rates. In technical terms, duration is the weighted average of the timing of the bond's cash flows, using the present values of those cash flows as weights.

In more general terms, it can be thought of as the elasticity of bond prices with regard to interest rates, or a measure (in time) of how quickly a bond will repay its true cost.

You are not required to be able to calculate duration for the exam, but you need to know the determinants of the calculation. It is useful to have a look at how the calculation is done, and its components.

Example

5% Coupon Bond
3 years until maturity
Gross Redemption Yield 7%

Year of payment	Cash flow (£)	Present Value (£)		Present Value x Time in years until payment (£)	
T_1	5	$5 / 1.07^1 =$	4.67	4.67 x 1 =	4.67
T_2	5	$5 / 1.07^2 =$	4.37	4.37 x 2 =	8.74
T_3	105	$105 / 1.07^3 =$	85.71	85.71 x 3 =	257.13
Totals			**94.75**		**270.54**

Final Step: 270.54 / 94.75 = 2.86 years

We see in this example that the average weighted time taken to receive the returns from this bond is 2.86 years.

4.6.1 Using Macaulay's Duration

The bond with the highest duration is the bond whose price will move the most, for a given change in interest rates.

4.6.2 The Determinants of the Calculation

The calculation takes into account the following:

- **Coupon rate (which determines the size of the cash flows)** – the higher the coupon, the lower the duration – there is an inverse relationship between the two.
- **Time to maturity** – an increase in maturity will increase duration and vice versa. Duration varies directly with the time to maturity. As the remaining life of a bond shortens, so does its duration.
- **Yield (which determines the present value of each cash flow)** – if the yield increases, the present value of each cash flow will decrease. As the present value of each cash flow is multiplied by time, proportionally the values in the future are reduced at a greater rate, thereby lowering duration. There is an inverse relationship between the two.

4.6.3 Modified Duration

If we had a list of bonds and calculated the Macaulay duration for each, we would be able to identify the bond price that will move the most when interest rates change.

What the measure does not do is quantify by how much a bond price will change.

This is where '**modified duration**' comes in. In technical terms, it calculates the percentage change in the price of a bond for a one percentage point change in interest rates.

The formula for calculating it is:

$$\text{Modified duration} = -\text{Macaulay duration} \,/\, \left(1 + \text{GRY}\right)$$

The minus sign indicates that the relationship is inverse; in other words, as interest rates rise, the price of the bond will fall, and vice versa.

For the above example:

$$-2.86 \;/\; 1.07\% \;=\; -2.67\%$$

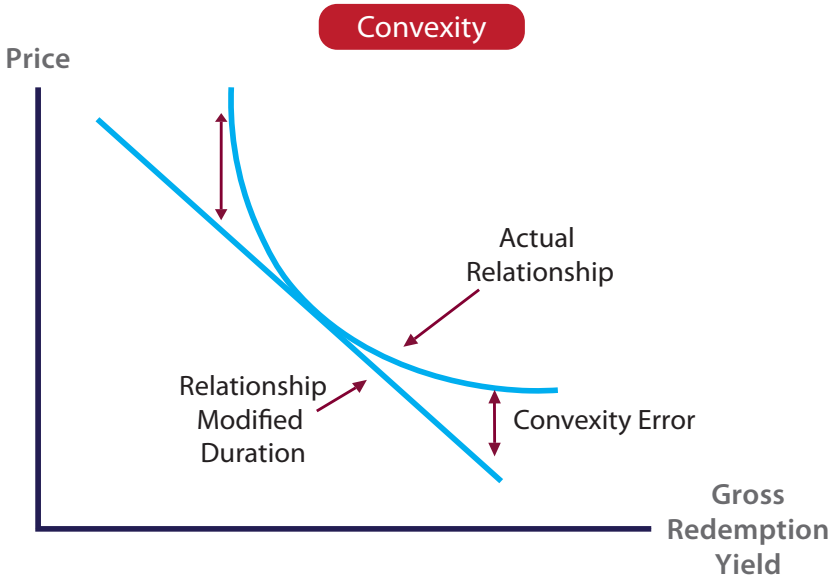
4.6.4 Interpretation

For every one percentage point change in interest rates, the bond's price can be expected to move up/down by 2.67%. Therefore, for every one percentage point rise in interest rates, the bond's price will fall by 2.67%, and vice versa.

4.6.5 Usefulness as a Measure of Price Volatility

Modified duration gives an approximation of the amount a bond's price will change, and is only useful for small changes in interest rates.

The formula we have seen suggests that there is a straight-line relationship between changes in market interest rates, the yield of that particular bond and bond prices. In the example above, we estimated that for every one percentage point change in interest rates, the bond's price will change by 2.67%.



In practice, this is not the case. The actual relationship between yield and price is convex as shown in the above diagram. Convexity is beyond the scope of the syllabus, so it is not covered in detail in these notes. Suffice to say that because of the concept of convexity, modified duration (especially for larger changes in yield) will:

- overestimate the fall in a bond's price, and
- underestimate the rise in a bond's price.

4.7 Government Bonds

Learning Outcome

5.3.2 Strips and strippable bonds

5.4.1 Types of securities issued by central government and local authorities

4.7.1 Issues by Central Governments

If a government spends more money than it collects through taxes, this is known as the budget deficit or, if the opposite is true, a budget surplus. A balanced budget is where the amount spent equals the amount collected. The budget deficit/surplus is used as an indicator for a country's financial health. (A budget deficit is not to be confused with 'national debt', which is the total amount of money that the government owes its creditors at any given time; in other words, national debt is the accrual of deficits.) A significant proportion of this shortfall is funded through the issue of government bonds.

A government bond, put very simply, is effectively a tradeable (securitised) IOU from a government, acknowledging that they owe the owner of the government bond some money. In common with most situations when money is lent by one party to another, interest is payable on the borrowing, and the borrowing has to be repaid.

In the UK, the budget deficit is officially called the public sector net cash requirement (PSNCR); and government bonds are usually known as gilt-edged securities, or 'gilts' for short.

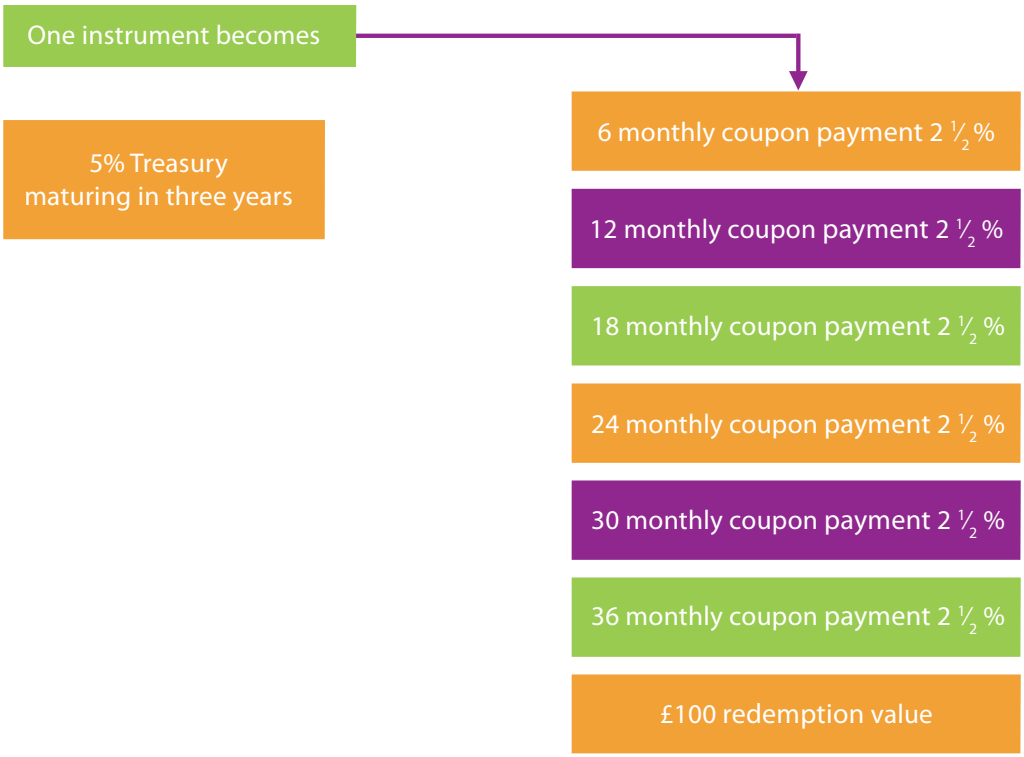
Differently named gilts have been issued over the years. Recent issues have been named '**Treasury Stock**', but previous issues have been named 'Exchequer Stock', 'Conversion Stock', 'Consolidated Stock' and 'War Loan'. Although the name indicates the purpose or features of the original issue of the stock, there is now little practical significance in the name as they are all obligations which HM Treasury is liable to repay, hence the name 'Treasury'.

The UK government issues conventional gilts; and since 1981, has been issuing index-linked gilts. These account for about 80% and 20% of all the gilts in issue respectively, and in terms of the sterling amount outstanding[7].

4.7.2 STRIPS

The acronym 'STRIPS' stands for separate trading of registered interest and principal of securities. The stripping of a bond involves taking a standard interest-bearing bond and splitting it into its individual cash flows, ie, coupons and redemption, which can then be bought and sold separately.

Let us look at a UK gilt as an example.



Each instrument then becomes a ZCB which does not pay the investor any interest during the period it is held. The holder merely receives the nominal value of the strip on maturity.

7 United Kingdom Debt Management Office, Gilts in Issue. Retrieved from https://www.dmo.gov.uk/data/gilt-market/gilts-in-issue/ (Accessed: October 2025)

STRIPS instruments have a duration equal to the term of the single cash payment, and they trade at a discount to their nominal value until maturity, to reflect the time value of money.

This process is not confined to the UK. For example, US, German and Japanese government bonds have also been stripped. Not all government bonds are 'strippable'; rather, only those government bonds that have been designated as 'strippable' are eligible for the STRIPS market. Those government bonds that are stripped have separate registered entries for each of the individual cash flows that enables different owners to hold each individual strip and facilitate their trading.

In the UK, for example, the Debt Management Office (DMO) designates which gilts are strippable and only designated gilt-edged market makers (GEMMs), the BoE or the Treasury are able to 'strip' gilts.

Advantages of Investing in STRIPS	Disadvantages of Investing in STRIPS
• Single cash flows can be matched against known future liabilities. • There is no reinvestment risk when investing in STRIPS (ie, the risk that an investor is unable to reinvest a coupon paid out, at the same rate of coupon as the original bond.)	• STRIPS can be subject to price volatility, particularly if there are changes in interest rates and inflation. If not held to maturity, it may realise a loss. • The market for STRIPS is relatively small and less liquid compared to other investments.

4.7.3 Issues by Local Authorities

In addition to the central government raising finance through the issue of bonds, local government has the power to do the same.

In the UK, historically, local authorities issued bonds to raise money to finance the building of infrastructure in local cities. There is no legal constraint on local authorities still doing so, but it has been actively discouraged since the 1980s when a more centralised approach to economic control was adopted.

Since 2004, for example, Transport for London (itself designated as a local authority) has raised funds through the issue of local authority bonds, to finance improvements in the transport infrastructure – for example, refurbishing and enhancing various Tube and Overground stations, and the introduction of electric buses to reduce emissions and improve air quality in London.

The UK Municipal Bonds Agency (UK MBA) sells municipal bonds on the capital markets, and it then lends the funds it raises to local authorities. In doing so, this allows local authorities to raise money for projects (eg, schools, care homes and recycling centres) at more favourable rates of interest than they would otherwise receive. The UK MBA provides funding through three lending programmes:

- **Pooled loans of at least £1 million, for maturities exceeding one year** – these loans are proportionally guaranteed; in other words, local authorities are only liable for their share of the borrowing. In the event that a local authority defaults on its payments, the amount in default is distributed proportionately among the other authorities providing the guarantee. Local authorities do not need a credit rating to obtain this type of loan.

- **Standalone loans to a single local authority for at least £250 million, for maturities exceeding one year** – these loans are fully guaranteed by the local authority for which the bond is being launched, who must have a credit rating from one of the major rating agencies (see section 4.1.1) to obtain this type of loan – the credit rating that the local authority receives will influence the pricing of the loan.
- **Short-term pooled loans (ie, maturities of less than one year)** – these loans fall outside of the proportional guarantee. Again, local authorities do not need a credit rating to obtain this type of loan.

Even though the UK MBA was established in 2014, it issued its first bond in 2020, on behalf of Lancashire County Council, raising £350 million for five years. Similar municipal bond agencies (also called 'bond banks' or 'local funding agencies' exist in other countries such as the EU, the US and China.

For investors, the return on local authority bonds tend to be higher than that on government bonds, as the risk is perceived to be higher. They are not government guaranteed in the same way as central government bonds.

4.8 Trading Government Debt

Learning Outcome

5.4.2 Methods of trading government debt including relative merits and disadvantages

Government bonds can be traded in both the primary and secondary markets.

In the primary market, newly issued government bonds are sold directly by the government to investors via auction or syndicate – see chapter 3, section 6.1.1.

After they are issued, government bonds can be bought and sold in the secondary bond market. This market provides liquidity and allows investors to adjust their bond holdings based on changing market conditions.

Government bonds are traded on various platforms, including the following:

- **Stock exchanges** (eg, the UK's LSE and India's NSE), which provides a centralised marketplace for government bond trading.
- **OTC markets**, which involves direct transactions between buyers and sellers, facilitated by dealers and brokers.
- **Electronic trading systems**, such as Bloomberg and electronic communication networks (ECNs), which enable traders to buy and sell bonds electronically.

Trading Government Bonds through Stock Exchanges

Advantages	Disadvantages
• Stock exchanges provide a transparent marketplace with readily available price information. • They provide a centralised platform where buyers and sellers easily connect, thus increasing the liquidity of government bonds. This liquidity enables investors to trade bonds quickly, often at competitive prices. • Stock exchanges are accessible to a wide range of investors, which enhances market depth and facilitates efficient trading. • Stock exchanges are typically subject to regulatory oversight by financial authorities, which helps to ensure fair trading practices, investor protection and market integrity, all of which instils confidence in market participants.	• Stock exchanges typically operate within specified trading hours, which limits trading in government bonds to specific market sessions. This means that investors could miss out on trading opportunities during non-trading hours or international time zones. • Trading government bonds on stock exchanges may involve additional costs compared to other trading methods (eg, brokerage fees, exchange fees, and other transaction costs), which reduces overall returns. • Bonds issued by the same government on multiple stock exchanges can result in fragmented liquidity and potentially different prices across platforms.

Trading Government Bonds OTC

Advantages	Disadvantages
• OTC trading allows for flexibility and customisation, where buyers and sellers can negotiate terms directly (eg, pricing, quantity, and settlement arrangements). • OTC markets often provide access to a broader range of government bonds, including those issued by smaller governments or less frequently traded bonds. This allows investors to diversify their bond portfolios. • As OTC transactions are negotiated directly between parties, it can be easier for institutional investors (who need to trade large volumes of bonds) to execute sizeable trades without impacting market prices significantly. • OTC trading may involve lower transaction costs compared to trading on stock exchanges, since there may be fewer intermediaries involved.	• OTC markets are generally less transparent compared to stock exchanges. Pricing information and market data may not be as readily available, making it more challenging for investors to determine fair value and assess market conditions. • OTC markets generally trade 24-hours a day (primarily weekdays, but trading may even be possible on weekends), so they can be accessed during many times when exchanges are closed. • With OTC trading, investors bear counterparty risk (ie, the risk that the other party may default on its obligations). • Some government bonds traded OTC may have lower liquidity compared to those listed on stock exchanges, leading to wider bid-ask spreads and potentially impacting execution efficiency. • OTC trading typically has fewer regulatory requirements compared to trading on stock exchanges.

Trading Government Bonds on Electronic Trading Systems

Advantages	Disadvantages
• Electronic trading systems enable fast and efficient execution of trades, thus enhancing price transparency, and improving overall efficiency in the government bond market. • They can increase market liquidity by bringing together a larger number of buyers and sellers, in turn reducing bid-ask spreads. • They enhance price transparency by providing real-time pricing information. This allows investors to make informed decisions based on current market conditions and enhances price discovery. • Electronic trading systems are generally accessible to a wide range of investors. This promotes broader market participation, and allows investors to trade government bonds from anywhere with an internet connection. • Electronic trading systems can automate various trading processes (eg, order routing, trade confirmation, and settlement), which reduces manual errors, streamlines operations, and improves overall efficiency in bond trading.	• Electronic trading systems are reliant on technology, and technical glitches, system outages, or connectivity issues can disrupt trading. This can potentially lead to trading delays, failed transactions, or other operational challenges. • Successful electronic bond trading relies on robust and reliable infrastructure, including internet connectivity, servers, and data centres. In regions or countries with limited or unreliable infrastructure, access may be challenging. • Electronic trading systems can facilitate algorithmic trading and high-frequency trading (HFT) – while these strategies can enhance market liquidity, they can also introduce higher market volatility and potential price fluctuations. • Some bonds, particularly less liquid or less frequently traded ones, may be excluded from electronic platforms, leading to limited market access for certain securities. • Trading on electronic systems may require knowledge of trading software, market data interpretation, and so on. Investors need to invest time and effort in acquiring the necessary skills to navigate electronic trading systems effectively.

In the UK, the DMO offers an 'execution-only' service, operated by Computershare Investor Services on the DMO's behalf, who are members of the DMO's Approved Group of Investors to buy and sell gilts by post. Its commission charges for smaller transactions may be lower than the charges made for buying or selling gilts through a stockbroker or bank.

There is a very active market in gilts, which operates through a system of GEMMs. GEMMs are appointed by the DMO and have a number of rights and responsibilities, one of which is to quote two-way prices throughout the trading day for all gilts, thereby providing liquidity to the market.

The system is dissimilar to that where equities are bought and sold, in that there is no centralised marketplace as such, and the GEMMs can choose the system by which they make their prices known to the market. They deal continuously with major professional investors such as institutional investors and custodians.

4.9 Reasons for Investing in Government Bonds

Learning Outcome

5.4.3 Reasons for investing in government debt

To consolidate all you have learnt, think of, and list, three reasons for investing in government bonds. There are some suggestions below, with which you can compare your answers.

Reasons to invest in government bonds include:

- They are guaranteed by the government. Where they are issued by governments with a high credit rating, they are considered to be a secure investment (virtually free of default risk).
- They provide a regular, stable income.
- Any capital gain is tax-free.
- Index-linked government bonds provide an inflation-protected real return.
- They can be held within a tax wrapper, such as an ISA or pension, also providing a tax-free income (although the tax-free status of these wrappers means the CGT exemption is not useful if a profit is made).
- Their prices tend to be considerably less volatile than those of equities.

5. Corporate Debt

5.1 The Features and Redemption Terms of Different Types of Corporate Debt

Learning Outcome

5.5.1 Features and redemption terms of different types of corporate debt

5.5.4 Relationship with government debt and yield spread

One of the main distinguishing features between government bonds (particularly investment grade rated issuers) and corporate bonds is that investors who purchase corporate debt face a greater risk that the company issuing the bond will fail to pay the coupon payments and/or the redemption value. This risk is described as credit risk (see section 4.1.1 on credit ratings).

From a 'big picture' standpoint, credit risk premiums are very simple to understand. Keep in mind that credit risk can take a lot of forms. It could be corporate debt of all kinds as well as mortgage-backed debt. Each type of credit risk has an associated risk premium. For example, as their name suggests, high-yield corporate bonds will offer a higher yield than an investment grade corporate bond to compensate investors for the added level of risk they are taking on – this difference in yield, called the high yield bond spread, is a credit risk premium.

What is important to understand is that credit risk premiums fluctuate along with the economy. This means that if the economy is strong, companies are more likely to make their debt payments and the market correspondingly assigns a lower credit risk premium during such times.

Conversely, if the economy enters a recession, companies (and other debtors) are less likely to make their payments. As a result, the market assigns a higher credit risk premium during these times. As such, the cycle of risk premiums closely tracks the health of the broad economy, or at least the area of the market in which the debtor operates (eg, mortgages, corporations or municipalities).

When an issuer is upgraded from high yield to investment grade, the spread of its bonds usually tightens markedly – often beyond the level implied by the higher rating – due to intense technical pressure. As a rating upgrade implies an improvement in the borrower's credit risk profile, investors' required rates of return on the debt falls which, in turn, increases the price. (The reverse holds true for a rating downgrade.)

To make some corporate debt attractive to investors, other features can be included, which does have an effect on the company's statement of financial position (also called a balance sheet) and the ability to raise more debt. When companies follow this route, they consider the cost of their debt compared to the cost of their equity shares and where interest rates are likely to be in the future.

5.1.1 Deeply Discounted/Zero Coupon Bonds (ZCBs)

As their name suggests, ZCBs do not generate any interest payments. Instead, the return comes from the discounted price, at which they are issued, compared to eventual redemption (on a specified date) at par. Hence, the capital return on maturity is known, so long as the company can afford to repay the debt. See section 4.2.9 of this chapter for more information on ZCBs.

5.1.2 Warrants

Bonds may be issued with sweeteners attached, such as a warrant. Warrants give holders the right to buy shares in the company at a pre-agreed price at a fixed date in the future. A warrant can be detached from the bond that it is issued with, and be traded separately in the market.

5.1.3 Eurobonds

Recall from section 4.1.2 above that eurobonds are bonds issued in a currency other than the currency of the home country. They are mainly unsecured in nature and historically were issued in bearer form, although some form of electronic registration is increasing, as with nearly all securities.

Interest is usually paid annually against the presentation of the relevant coupon to an appointed paying agent, without the deduction of tax (ie, no WHT). This does not mean that they are tax-free, merely that investors should declare their income from the instruments in the jurisdictions in which they are liable to pay tax.

5.1.4 Eurocurrency Bond

A bond denominated in a currency other than that of the country in which the bond is issued. Examples include:

- **eurosterling** – denominated in UK sterling, issued by a non-UK company outside the UK
- **eurodollar** – denominated in US dollars, issued by a non-US company outside the US, and
- **euroyen** – denominated in Japanese yen, issued by a non-Japanese company outside Japan.

It is important to note that eurocurrency bonds are traded worldwide, not just in Europe. They are subject to fewer regulatory restrictions. For example, an American company may issue a eurosterling bond to attract non-UK sterling investors for its financing needs.

5.1.5 Foreign Bonds

From section 4.1.2 above, these are bonds in the home currency of the country where they are issued, but they are issued by an overseas company; and these bonds have names that are linked to the country of issue (eg, bulldog in the UK, yankee in the US, and samurai in Japan).

5.1.6 Callable and Puttable Bonds

Callable and puttable bonds are explained in section 4.2.4 above. In summary, callable bonds may be redeemed at the issuer's option, while puttable bonds enable an investor to insist that a bond is redeemed early. The reasons for doing so will depend on a variety of factors, mainly related to the interest rate environment.

5.1.7 Coupon Structures

Coupons on corporate bonds are often fixed, although they may be variable and linked by way of a margin above or below a reference rate – see section 4.2.5 above on inflation-linked and floating-rate bonds.

Another coupon structure is a stepped coupon. As the name implies, the coupon rises at preset intervals over the life of the bond. This is advantageous for the company, in that it provides it with cheaper funds during the early years of the borrowing.

5.1.8 Hybrid Debt

Hybrid debt includes characteristics of both debt and equity, thus offering investors the potential benefits of both. It is treated as equity, but it pays a fixed income; and investors do not participate in the profits of the company. The reason that companies offer this type of debt is so they can still go to banks and borrow money and not have their capital structure affected by having in issue more fixed interest or more equity, but hybrid debt.

The yields on hybrids are higher than the issuer's conventional bonds of similar maturity because they are a form of subordinated debt (ie, they rank either equally to or below any subordinated debt should the company go into liquidation). They are, therefore, considered to be high risk.

5.2 Convertible Bonds

Learning Outcome

5.5.2 Convertible bonds, and the effect of conversions on a company and its securities

As well as the above types of corporate bond, companies may issue convertible bonds. A type of hybrid debt, a convertible bond is a bond with an embedded option allowing the bondholder to convert their bond into a pre-specified, fixed number of shares in the company issuing the bond. They are often described as a hybrid security because they are part debt and part equity. Whether or not the bondholder chooses to convert will depend on the share price in the market at the time they are able to convert.

Example

A corporate bond allows the bondholder to choose to have their nominal value of £100 repaid, or can convert this into 20 ordinary shares in the company issuing the bond. This would be the equivalent of paying, for example, £5 for each share if denominated in sterling:

If the share price in the market is above £5 at the point where conversion becomes possible, it is profitable for the investor to convert and receive the higher value shares.

If the share price in the market is lower than £5 it is not profitable for the bondholder to convert.

If we ignore commission charges for the purposes of this example, the investor would be better off by redeeming the bond at £100 and buying the shares in the market at below £5.

This choice has a value for the holder of the convertible bond (and comes at a cost!), because they offer the investor the opportunity to participate in the upside of the equity if share prices rise, and provide the downside protection of a bond.

You will find that if you compare the prices of a straight bond issued by a company and a convertible bond, the convertible bond will be trading at a higher value. The higher cost of the convertible is made up by paying for both parts of the bond, the straight bond and the embedded conversion (call) option.

They are also advantageous for companies, in that by adding the sweetener of the conversion rights, they will probably be able to pay a lower coupon, thereby reducing their borrowing costs, although on conversion the equity in the company will be diluted.

5.2.1 Contingent Convertibles (CoCos)

Contingent convertible bonds (also known as CoCos) are very similar to traditional convertible bonds. The key difference is that a price is set, which the underlying equity share price must reach before conversion can take place (ie, conversion is contingent on the ordinary shares attaining a certain market price over a specified period of time). The main risk to holders of CoCo bonds is that when converting, the underlying equity price may see a sharp decline in value during, or after, conversion.

Contingent convertible bonds (CoCos) are as safe as the issuing bank. The possibility that these perpetual bonds may be converted into equity or coupons (even capital cancelled), depends upon the bank continuing to meet its debts and its prudential requirements, and upon the regulator supervising it to achieve this.

This 'conversion to equity' type is the more common type of CoCo. With 'principal write-down' CoCos, investors contractually agree to absorb losses through the cancellation of their entitlements, either in whole or in part – this occurs even if equity shareholders retain a claim. One real-life example of a principal write-down CoCo is that issued by Credit Suisse. When the bank collapsed in March 2023 (following which it was bought by rival UBS), the Swiss regulator FINMA announced that $17 billion worth of lower tier bonds (ie, CoCos) would be cancelled. Subsequent legal claims were threatened against FINMA and Credit Suisse for failing to protect bondholders, and favouring shareholders ahead of them. Across global bond markets, the move very publicly highlighted the risk attached to this type of debt.

In recent years, CoCos have become a popular form of issuance, particularly from financial institutions. As they are fixed-income instruments that are convertible into equity if a pre-specified trigger event occurs (eg, if the solvency ratios of the institution falls below a specified level), then the bond converts to equity, resulting in an improvement in the institution's solvency ratio.

CoCos are the riskiest bonds in the capital structure, thus attracting a higher return for investors than a conventional bond.

5.2.2 Analysing Convertible Bonds

There are a number of calculations you should be aware of when analysing convertibles.

Consider the calculations for the following example:

Conversion ratio = 50 shares per £100 nominal of the stock
The market price of the convertible is £126
The ordinary share price is £2.15
The ordinary share dividend is 2.5 pence per share
The conversion rights expire in December 2025

Conversion Price

The conversion price is the cost of purchasing each share through converting. The formula is:

$$\text{Conversion price} = \text{Market price} / \text{Conversion ratio}$$

In our example, therefore, conversion price = £126 / 50 = £2.52.

Conversion Premium (or Discount)

This calculation identifies the extra cost to an investor of accessing the shares through converting, compared with purchasing the shares at the current price in the market.

$$\text{Conversion premium} = \text{Conversion price} - \text{Share price}$$

In our example, the conversion premium is £0.37 (ie, £2.52 – £2.15). This means that the investor is paying £0.37 more for the shares via the convertible than they would if they purchased them in the market. This amount may be expressed as a monetary amount or as a percentage premium compared to the current share price.

Percentage premium calculation: £0.37 / £2.15 = 0.172 or 17.2%

If an investor converts before expiry, there is the loss of income under the bond element to consider and loss of option value. How does this compare with the dividend income paid if the shares are owned? This is not a consideration if converted at expiry.

5.3 Capital and Interest Cover

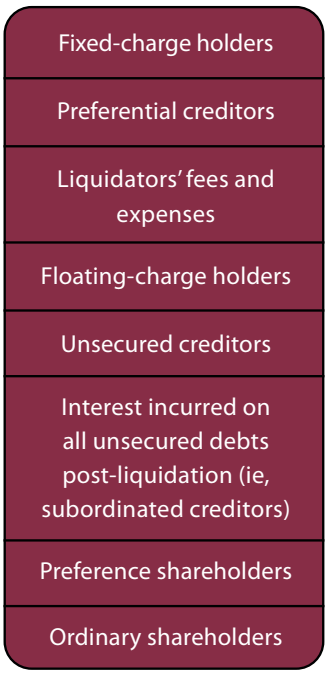
Learning Outcome

5.5.5 Capital and interest cover

We have looked in some detail at the different types of corporate bonds and their characteristics. This particular section looks at ways of evaluating how safe an investor's capital and interest income is for a particular corporate bond.

To understand this section, you will need to know the priority order for repayment of those owed money by a company in the UK, should it go into liquidation (the ordering may differ in other jurisdictions).

Priority order for repayment:



5.3.1 Capital Cover

Capital cover calculates the number of times that the value of a company's assets covers the repayment of a particular priority debt. The higher the cover, the lower the risk, should the company get into difficulties.

To begin the calculation, you will need to know the amounts outstanding to the various categories of creditors. We will use the following example:

- £10 million 5% mortgage **debenture**
- £20 million 6% unsecured **loan stock**
- £5 million 5% (net) cumulative **preference shares**
- £20 million £1 nominal ordinary shares, and
- £30 million ordinary share capital reserves.

Step 1: Rank these liabilities into the order in which they will be repaid, should the company go into liquidation.

Step 2: Calculate the cumulative amount of debt for each level.

Step 3: Divide the total assets available to cover the debt, by each cumulative level.

Liabilities/Security	Amount	Cumulative Amount of Debt	Capital Cover
5% Mortgage debenture	£10m	£10m	£85m / £10m = 8.5×
6% Unsecured loan stock	£20m	£30m	£85m / £30m = 2.8×
5% Preference shares	£5m	£35m	£85m / £35m = 2.4×
Ordinary share capital including reserves	£50m	£85m	£85m / £85m = 1×
Total	**£85m**		

Total Assets ÷ Cumulative Debt

5.3.2 Capital Priority Percentages

This calculation shows the percentage of the company's assets that would have to be used to repay each priority level.

Liabilities/ Security	Amount	Cumulative Amount of Debt	Capital Cover	Capital Priority Percentage
5% Mortgage debenture	£10m	£10m	£85m / £10m = 8.5×	£10m / £85m = 11.8%
6% Unsecured loan stock	£20m	£30m	£85m / £30m = 2.8×	£30m / £85m = 11.8% to 35.3%
5% Preference shares	£5m	£35m	£85m / £35m = 2.4×	£35m / £85m = 35.3% to 41.2%
Ordinary share capital including reserves	£50m	£85m	£85m / £85m = 1×	£85m / £85m = 41.2% to 100%
Total	**£85m**			

Cumulative Debt ÷ Total Assets

5.3.3 Interest Cover

The interest cover calculation takes the profits that a company has made, and looks to see how many times it covers the interest liability on a particular priority debt.

Using the example from above again:

- £10 million 5% mortgage debenture
- £20 million 6% unsecured loan stock
- £5 million 5% (net) cumulative preference shares
- £20 million £1 nominal ordinary shares
- £30 million ordinary share capital reserves, and
- profit before interest and tax £10 million.

Step 1: Rank the interest-bearing liabilities into the order in which they will be repaid, should the company go into liquidation.

Step 2: Calculate the cumulative amount of interest payable for each level.

Step 3: Divide the total profits available to cover the interest, by each cumulative level.

Liabilities/Security	Gross Interest Payable	Cumulative Amount of Gross Interest	Interest Cover
5% Mortgage debenture	£500K	£500K	£10m / £500K = 20×
6% Unsecured loan stock	£1.2m	£1.7m	£10m / £1.7m = 5.9×
5% Preference shares	£250k	£1.95m	£10m / £1.95m = 5.1×
Total	**£1.95m**		**£1.95m**

PBIT ÷ Cumulative interest payable

5.4 Security and Borrowing Powers

Learning Outcome

5.3.11 Security and borrowing powers

A company can (broadly) borrow in one of two ways to raise finance for its needs: it can borrow the money from a bank by way of loan or overdraft; or alternatively, it can issue corporate bonds.

As we mentioned in section 4.1 above, one of the main distinctions between government bonds (particularly those that are investment grade rated) and corporate bonds is that there is increased credit risk when investing in corporate bonds. One of the ways in which this risk can be reduced, therefore making the issue more attractive to prospective investors, is for the terms and conditions of the issue to include some form of security or collateral covering the bondholder, should the issuer default.

This gives the bondholders a right to sell the collateral (charged assets) to repay the bond debt, should the company fail to pay either the coupons or capital redemption. Secured bonds are often referred to as debentures (except in the US, where a 'debenture' has the opposite meaning in that it is an unsecured bond). Bonds that have no security attached tend to be described as unsecured bonds.

There are two types of charge on assets that a company can give:

- **Fixed charge** – gives the bondholder a right over a specific company asset, such as its land and buildings or plant and machinery. The company is not allowed to sell the charged asset without first obtaining the permission of the bondholders. Should the issuing company default, the bondholders can take possession of the charged asset and sell it to obtain repayment.
- **Floating charge** – gives the bondholder a right over a 'class' of the company's assets or assets generally, as opposed to rights over a specific asset. The company is allowed to buy and sell these assets as normal, until a crystallising event, such as a default, occurs. At the point of crystallisation, the specific assets that the bondholders have a right to is defined, and the company no longer has the power to sell them.

Pari Passu

Pari passu is a Latin phrase meaning 'equal footing' that describes situations where two or more assets, securities, creditors or obligations are equally managed without any display of preference.

In finance, the term '*pari passu*' refers to loans, bonds or classes of shares that have equal rights of payment or equal seniority. In addition, secondary issues of shares that have equal rights with existing shares rank *pari passu*.

Since secured debts are backed by a particular asset, they are often not fully equal to the other obligations held by the borrower. Since unsecured debts are not supported by a specific asset, the need to be considered equal to other obligations may be greater in instances of borrower default or bankruptcy. Further, a provider of unsecured financing may enact clauses that prevent a borrower from taking part in certain activities, such as the promising of assets for another debt, in order to maintain a position with regard to repayment. This means that if a company issues debt against an asset, then it cannot issue another new debt with the same kind of guarantee for bondholders.

5.5 Permanent Interest-Bearing Shares (PIBS) and Perpetual Subordinated Bonds (PSBs)

Learning Outcome

5.5.3 Building society PIBS and perpetual subordinated bonds (PSBs)

Permanent Interest-Bearing Shares (PIBS) are a special type of security issued by building societies that pay a fixed rate of interest, normally half-yearly. Although they are a type of fixed-interest security, the rate of interest is higher than that paid on gilts and many corporate bonds due:

- to the increased level of credit risk
- increased volatility (as they are undated, they can be very volatile when interest rates change), and
- the fact that they are not covered by a deposit protection scheme – eg, the Financial Services Compensation Scheme (FSCS) in the UK.

PIBS are comparable in many ways with subordinated irredeemable loan stock, hence the fact that the same type of stocks issued by a now demutualised building society are known as **perpetual subordinated bonds** or PSBs (or sometimes Perps). In the UK, Australia and New Zealand, where building societies exist, some have demutualised and become commercial/retail banks, while others have been absorbed in a widespread consolidation of smaller societies over the years.

There is a secondary market in PIBS and PSBs, and they can be bought and sold in much the same way as equities on the stock exchange. This market can sometimes be illiquid, resulting in wide spreads. In the UK, depending on the issue, it is usually only possible to trade in round lots of £1,000 nominal value, or sometimes higher (similar to corporate bonds). The interest payable on a PIBS is subject to income tax. Some are callable, which makes them less attractive to the investor, and therefore require a higher relative yield.

5.6 Tax Efficiency of Fixed-Interest Securities with Comparative Stocks

Learning Outcome

5.3.5 The tax efficiency of comparative stocks

The tax efficiency of fixed-interest securities, and therefore comparative bond issues for investment purposes, revolves around how the income generated and any capital gain on disposal is taxed and its impact on overall returns. The outcome will depend not only on the investor's personal circumstances (eg, their tax bracket and residence status), but also on the jurisdiction in which the investments are held.

Broadly, fixed-interest securities generate interest income that is taxed as 'ordinary' income at the investor's marginal tax rate. This straightforward taxation can make fixed-interest securities less tax-efficient for investors in higher tax brackets compared to other investment options, where comparative tax rates may be lower. For example, in the UK, an additional rate taxpayer is taxed at 45% on interest income from a fixed-interest security, but only 39.35% on a dividend; hence, for every £100 of interest income, the investor is paying an additional £5.65 of income tax.

CGT is another consideration. Most bonds are exempt from CGT when held directly, provided they meet certain conditions; this is in contrast to other types of investment, where capital gains may be taxable. The exemption that applies to fixed-interest securities contributes to their overall tax efficiency. That said, where the security is exempt for the purposes of CGT, it follows that any losses are not allowable. Hence, if investors were to sell the bonds at a loss in the secondary market, or they bought the bonds above par and held until maturity), then this loss could not be offset against other capital gains for tax purposes.

Where a fixed-interest security is taxable, most jurisdictions provide individuals an annual CGT allowance before any tax is due on capital gains; thus, investors can realise gains up to the allowance amount without incurring tax. The rate of CGT to which an investor is subject thereafter will vary depending on their total taxable income and the type of asset sold.

Tax-advantaged accounts, such as pensions and ISA, also play a role in optimising tax efficiency. Income and capital gains generated within these accounts can be tax-deferred or even tax-free, depending on the account type and other considerations. This tax advantage can significantly enhance the overall returns of both fixed-interest securities and other investments within these accounts, making them particularly appealing for long-term wealth accumulation strategies.

6. Corporate Equity

6.1 Features of Ordinary Shares and Types of Dividend

Learning Outcome

5.6.1 Features of ordinary shares and types of dividend

The ownership of shares means that the owner is a member of the company and confers upon the shareholder a number of rights.

Ordinary shares are the most common form of shares issued by companies. Common shares (also called 'common stock') are identical to ordinary shares, except they have no nominal value – this is the preferred legal form in the US, Dubai, Egypt, Greece and Japan, for example.

These shares represent permanent capital for a company. The company does not have to redeem the shares, although investors are free to sell their shares to other investors.

Typically, shareholders have no security, although they do usually have voting rights (normally one share, one vote) and can vote at company meetings on matters such as the appointment of directors and auditors, approval of proposed dividends and takeovers.

Dividend payments to ordinary shareholders are discretionary on the part of the company, and can only be paid out of profits and distributable reserves after the preference shareholders (if any) have received their dividend in full. Globally, most companies pay out dividends either quarterly or semi-annually – this usually takes the form of one or three interim dividends and a final dividend which can be viewed as a balancing payment. Dividends are usually declared with the announcement of the company's interim/half-yearly results, and the final dividend at the announcement of the company's full year-end results. However, payment of the dividend may be delayed for some time after it is declared, although the date on which it is to be paid is usually declared at the same time as the amount.

Dividends are usually quoted in terms of currency (eg, pence or cents) payable per share as the amount that the shareholder will receive gross of tax.

Ordinary shares are considered to be the risk capital of a business, in that they are the last to be paid in the event that the company is wound up (there is typically nothing left in the pot to pay the ordinary shareholders if a company goes into liquidation). This is the risk taken for being a part owner of the company and having the right to share in the profits of the company.

There are a number of variations on the standard ordinary share, as follows.

6.1.1 Non-Voting Ordinary Shares/'A' Shares

As the name implies, owners of these shares do not have the right to vote at company meetings. In all other respects, they are identical to ordinary shares.

They have, typically, been issued by founders of companies, particularly family companies, where the existing shareholders do not want to give away any control.

Shareholders are increasingly reluctant to purchase non-voting shares and they are likely to be traded at a discount to the voting shares, despite being entitled to the same level of dividend.

Similarly, a company can issue shares with restricted voting rights.

6.1.2 Deferred Shares

With deferred shares, the holders are not entitled to the payment of a dividend until a condition has been met, such as:

- a specific amount of time must have elapsed since the shares were issued
- the profits have to exceed a certain level, and
- other classes of shareholders have to have been paid a predetermined level of dividend, before the owners of these shares can be paid.

6.1.3 Golden Shares

These are shares with special voting rights. They may allow the holder to outvote other shareholders in specific circumstances, giving an effective power of veto and often giving the ability to block any one shareholder from acquiring more than a certain proportion of ordinary shares.

Historically, in some jurisdictions, companies that have been nationalised by the government have issued golden shares which have been held by the government, thus giving the government effective control over the nationalised company. This prevents events such as takeovers and controlling holdings going abroad, on the basis that these industries are of national importance. Other governments, such as in Brazil, have used golden shares to retain control overstate-run entities. Golden shares have been mostly banned in the EU, on the basis that it views them to be unjustified and disproportionate to the interests of the company and the economy.

Another use of golden shares is family companies that wish to give a trusted, impartial outsider sufficient powers to help resolve conflicts without involving them in running the company. Some companies have issued golden shares to founders with voting rights at a certain ratio (10x the ordinary, for example) to ensure they retain control of the company, even while raising outside capital.

6.1.4 Redeemable Ordinary Shares

Companies are allowed to issue redeemable ordinary shares, provided the company has at least one other class of shares in issue that is not redeemable. These types of shares may be bought back by the company, at either the option of the company or the shareholder, on a date specified at the time of issue.

6.2 Features of Preference Shares

Learning Outcome

5.6.2 Features of cumulative, non-cumulative, participating, convertible and redeemable preference shares

Preference shares are the second most common form of shares issued by companies, and as with ordinary shares, they come in a variety of forms:

- They pay a fixed rate of dividend unlike the variable/discretionary dividend paid for ordinary shares.
- Preference shareholders are preferred over ordinary shareholders in two respects:
  - a company must pay the preference share dividend in full before it can pay a dividend to ordinary shareholders, and
  - in the event that the company is wound up, the preference shareholders will be repaid the nominal value of their shares before the ordinary shareholders can be paid (assuming that there is sufficient to pay).
- There is no security attached to preference shares.
- They do not usually have voting rights, although there is typically an exception which allows voting rights if the preference shareholders have not received a dividend for five years or more.

When investors buy preference shares, the dividends are fixed, so they will not benefit from any significant increase in the company's profits. Preference share dividends are taxed in the same way as ordinary shares: they are paid gross, and any amount that falls above the dividend allowance is taxed at the investor's marginal rate. Preference shareholders are, however, protected from some of the downside. Variations on the usual form include cumulative, non-cumulative, participating, redeemable and convertible preference shares.

6.2.1 Cumulative Preference Shares

If a dividend is not paid to cumulative preference shareholders because the company makes insufficient profits, the next year a dividend cannot be paid to the ordinary shareholders until any arrears in the payment of dividends to the cumulative preference shareholders has been made up. The rights to be paid a preference share dividend are effectively carried forward. Most preference shares take this form.

6.2.2 Non-Cumulative Preference Shares

With this type of share, if a dividend is not paid, it is lost. The arrears do not have to be made up before a dividend can be paid to ordinary shareholders.

6.2.3 Participating Preference Shares

The owners of these shares have the right to receive additional dividends when the profits of the company exceed a certain level. The additional amount payable is usually expressed and paid as a proportion of the ordinary dividend. Holders of these shares participate more in the risks and rewards of share ownership than normal preference shares.

6.2.4 Redeemable Preference Shares

These are shares that will be bought back by the company at a pre-agreed price on a pre-agreed date. They are identifiable by the fact that they will have a date in their title.

6.2.5 Convertible Preference Shares

Holders of convertible preference shares will, at some point, have the option of converting them into ordinary shares.

Practically, if the company does not do well and the share price falls, they can be held as a fixed income investment, and if the share price rises, the investor can convert.

6.3 Shareholders' Voting Rights and Their Responsibilities

Learning Outcome

5.6.3 Shareholders' voting rights and their responsibilities

Since a company's board of directors has responsibility for the day-to-day management of the company, a mechanism is needed to ensure shareholders can exercise some control over them. This is achieved by a series of shareholder rights as laid down in the relevant regulation (eg, the Companies Act 2006).

Basic rights

- To receive annual accounts.
- To be notified of annual general and extraordinary general meetings.
- The right to attend meetings and vote.
- The right to share in the profits of the company.
- The right to a share of the surplus on winding up after all liabilities have been paid.

Statutory rights

- Companies must hold annual general meetings at least once a year.
- Shareholders with more than a specific percentage of voting rights can call extraordinary general meetings (EGM) – eg, 10% in the UK.
- Shareholders with more than 5% of voting rights can propose resolutions.
- Any shareholder can petition the court because the affairs of the company have been conducted in a manner unfairly prejudicial to the interests of some or all of its members.
- Pre-emptive rights (or rights of pre-emption) – any rights shareholders may have to be offered shares in a company before they are made available to anyone else. They can arise on the allotment, transfer or transmission of shares. Such rights may be important to ensure that a shareholder's proportion of the voting and other rights in the company are not diluted.
- Pre-emptive rights on allotment can arise under the relevant Companies Act or the company's memorandum and articles.

As seen above, the holders of primarily ordinary shares have a right to vote at company meetings.

Voting at these meetings is generally by way of a show of hands where one shareholder has one vote. Larger shareholders can demand a poll, in which case votes are counted in proportion to the number of shares held.

If a shareholder is unable to attend a meeting in person, they can appoint a **proxy** to vote on their behalf.

When sending out proxy forms, companies usually suggest names of directors of the company who will act as proxies, voting as they see fit unless otherwise instructed.

Sometimes, a representative is appointed by corporate bodies as an alternative to a proxy. For the duration of the meeting, the representative has the same rights to speak and vote as a member.

The shareholders' responsibilities for the company's financial liabilities are limited to the value of shares that they own, but have not paid for. This is unlikely to happen in plcs – it is more a private company issue.

6.3.1 Private Companies

Unlike public limited companies (plcs), shareholdings in private limited companies are not readily available to the public. Just as a member of the general public cannot readily buy shares in a private limited company, any shareholder in a private limited company cannot readily sell those shares to a member of the general public.

The unfortunate effect of this is that shareholders are often locked into a company and, although their shareholding may be very valuable on paper, they are unable to realise that value on sale. Even if a buyer can be found, shareholders often then face a number of further hurdles before the sale can proceed.

6.3.2 Pre-Emption Rights

The problems faced in trying to realise the value of a shareholding in a private limited company can be made more difficult by provisions in the company's Articles or (if there is one) in a Shareholders' Agreement. It is very common to find that these documents contain further restrictions on the disposal/transfer of shares. For example, they may provide that only a certain class of individuals can hold shares in the company (such as the relatives of the original shareholders).

Most commonly, restrictions on the transfer of shares take the form of 'rights of pre-emption' whereby the shares which are to be sold/transferred must first be offered for sale to a prescribed class of individuals (normally the other remaining shareholders). This is, in effect, a right of first refusal before the shares can be sold elsewhere or to someone who may be a stranger to the remaining shareholders.

6.3.3 Share Value

A right of first refusal does not present any great problem to a shareholder wanting to dispose of their holding, but the catch often comes in the price to be paid. In a typical right of pre-emption, the price to be paid by those exercising their right of first refusal is expressed to be a 'fair value' (to be independently determined in the absence of any agreement, often by the company auditors).

Unless the shareholding to be sold represents a majority shareholding in the company, a fair value will normally include a very substantial discount on what the owner will normally regard as the real value. This is known as a 'minority discount' and it seeks to reflect the fact that the shareholding is not a majority shareholding and does not, therefore, in itself carry the ability to control the company.

This can lead to seemingly harsh results and substantial undervaluations against what many would regard as the true value of the shareholding. For example, if a 49% shareholder in a £20 million company sells their entire shareholding to the 51% majority shareholder (who else would want to buy?), a crude example of the likely fair value might be:

Company value = £20 million

49% of £20 million = £9.8 million

Minority discount (say 75%) = valuation @ £2.45 million

While the true value to the 51% shareholder might well be seen as something in the order of £9.8 million (or more), they might well only have to pay £2.45 million by reason of the calculation of a fair value.

6.3.4 Non-Registration

A further difficulty sometimes faced in seeking to sell a minority shareholding is that the articles of association for many companies will also contain provisions enabling the board of directors to refuse to register (in broad terms, to recognise or ratify) a transfer of shares on specific grounds or, in some circumstances, on whatever grounds they choose and without giving any particular reason.

6.4 Corporate Actions and Their Effects

Learning Outcome

5.6.4 Bonus and rights issues, buy-backs and their effects

6.4.1 Bonus/Scrip/Capitalisation Issues

A bonus (also called scrip or capitalisation) issue is a free issue of shares to existing shareholders, *pro rata* (ie, based on their existing holding). The shares are issued without cost, and the companies undertaking such an issue are not raising any additional finance. However, the share capital needs to be paid for and comes from the company's share **capital account**.

The main reason for a company undertaking a **bonus issue** is to reduce the price of the shares in the market, increasing demand for the shares and therefore making them more liquid.

The ratio that is applied to bonus issues depends on the country:

- For many (including the UK, Europe, and China, for example) a 5-for-2 (or 5:2) bonus issue means that an investor receives five shares for every two shares they hold in a company. Therefore, an investor that owns 200 shares will end up with 200 + 500 = 700 shares in total.
- For others, such as the US, every two shares held will be converted into five new ones. In other words, an investor with 200 shares will end up with 500 shares. This mirrors the custom used for share splits.

The figures used for a bonus issue can be whatever the company decides.

Unless otherwise stated in this book, assume the former convention. In the real world, you will often have to clarify the convention being used to understand the terms of the issue.

Let us look at an example of how a bonus issue impacts a company's share price:

Example

Terms of the bonus issue 2-for-5
Current price of each share £7.30

For the purposes of the example, we will assume that the shareholder owns the minimum number of shares needed to participate in the issue, ie, five.

	No. of shares	Price €	Value £
Before the bonus issue	5	7.30	36.50
Bonus Issue	2	nil	nil
After the bonus issue	7	5.21	36.50

By dividing the new share value (of £36.50) by the resultant number of shares (ie, 7), this gives a share price of £5.21 after the bonus issue. The total value of the shares is now distributed across a larger number of shares, reducing the market price of each share.

This process is also known as a capitalisation issue, because in accounting terms, it is achieved through the capitalisation of the company's reserves. The impact of a £100 million capitalisation issue of shares at £1 each on a company's balance sheet would be as follows:

Before	
Net assets	£550m
Share capital 300m @ £1	£300m
Share premium account	£100m
Revenue Reserves account	£150m
Shareholders' funds	£550m

After	
Net assets	550m
Share capital 400m @ £1	400m
Share premium account	–
Revenue Reserves account	150m
Shareholders' funds	550m

6.4.2 Rights Issues

A **rights issue** is an issue of new shares to existing shareholders for cash, on a *pro rata* basis for their existing holding. The price of the shares is normally discounted from the current market price. It is a way for companies to raise additional finance to either fund additional investment projects for growth or to repair balance sheets.

Pre-emption rights under UK law require that existing shareholders are all offered the same opportunity to buy shares and, therefore, maintain their proportion of shareholding in the company concerned.

Issues are typically underwritten for a fee by investment banks, who guarantee to buy any unsold shares if the issue is not fully subscribed.

Note that unlike bonus shares, the interpretation of the ratio is more consistent. In whichever country it occurs, for example, a four-for-seven rights issue enables all existing shareholders to buy four new shares in the company for every seven that they already own. As before, the figures can be whatever the company wants.

Let us look at an example of how a rights issue impacts on a company's share price:

Example

Terms of rights issue: four-for-seven
Current price of each share: €4.10
The subscription price of the new shares is €3.30 each

For the purposes of the example, we will assume that the shareholder owns the minimum number of shares needed to participate in the issue, ie, seven.

	No. of shares	Price	Value
Before the rights issue	7	€4.10	€28.70
Rights issue	4	€3.30	€13.20
After the rights issue	11	€3.81	€41.90

The new price is €3.81(eg, €41.90 ÷ 11), known as the theoretical ex-rights price (TERP).

From this, it is easy to calculate the theoretical value of the right; that is, the value of the right, calculated mathematically, between the date that the offer is announced and the date it expires. In the above example, the rights premium will be €3.81 – €3.30 = €0.51. A client holding 350 shares, say, will receive 200 nil-paid shares, which will therefore have a theoretical value of 200 x €0.51 = €102.

After the rights issue has gone through, the average price of all the shares will reduce, because of the number of discounted shares just issued, increasing the total outstanding.

With regard to the actions that shareholders should take when faced with a rights issue, they have a number of choices:

- exercise the rights and buy the shares at the discounted price
- let the rights lapse and do nothing – receive lapsed rights proceeds
- sell the rights **nil-paid** in the market
- **split** the rights, or
- sell some of the rights nil-paid, and use the money generated to purchase the remainder of the discounted shares.

Selling the Rights Nil-Paid

Example (continued)

If the shareholder chose to let the rights lapse and do nothing, they would be out of pocket after the rights issue had gone through. This is because before the rights issue, the shareholder would have owned seven shares worth €4.10 each, with a value for the total holding of €28.70.

After the rights issue, the share price will have fallen. The shareholder will own seven shares, theoretically worth €3.81 each, with a total value of €26.67. The shareholder would suffer a loss of €2.03.

To avoid this loss, the shareholder can sell the right to buy the shares at a discount in the market for a value. This value is known as the nil-paid price, and is calculated as the theoretical ex-rights price (TERP), less the subscription price.

TERP	=	€3.81
Less subscription price	=	€3.30
Each right	=	€0.51

4 rights x €0.51 = €2.04 (the slight difference is down to rounding), this therefore keeps the value of the holding constant.

Splitting the Rights/Maximum Subscription at Nil Cost

If a shareholder has insufficient money to take up the rights, but is still keen to increase their holding in the company, this might be a suitable option. It involves selling some of the rights nil-paid to generate some money, and using that money to purchase some of the discounted shares.

There is a formula that can be used to calculate the number of rights that need to be sold nil-paid:

$$\text{Number of rights to be sold nil-paid} = \left(\text{Number of rights} \times \text{Subscription price}\right) / \text{TERP}$$

Example (continued)

Assume that our shareholder has 7,000 shares, that gives them 3,465 rights to be sold nil-paid to fund taking up the remainder (ie, (4,000 x €3.30) / €3.81).

The sale of 3,465 rights at the nil-paid price of €0.51 will generate proceeds of €1,767.

The shareholder is now free to exercise the remaining rights, and purchase 535 shares (ie, 4,000 – 3,465) at the subscription price of €3.30 each, giving – a total cost €1,765.50 (ie, 535 shares x €3.30).

As the shares are sold at the minimum of nominal value, there is no addition to the share premium account.

The impact of a €100 million rights issue of shares at €1 each on a company's balance sheet would be to increase the share capital and total value of the company by €100 million.

Before	
Net assets	€550m
Share capital 300m @ €1.00	€300m
Share premium account	€100m
Revenue Reserves account	€150m
Shareholders' funds	€550m

After	
Net assets	€650m
Share capital 400m @ €1.00	€400m
Share premium account	€100m
Revenue Reserves account	€150m
Shareholders' funds	€650m

6.5 Share Buybacks and Their Effects

If a company has surplus cash, it can retain the money within the business for future use or return it to its shareholders through either the payment of a dividend or by buying its shares back in the open market.

Shares that have been bought back can be cancelled or retained as Treasury shares. Treasury shares are bought-back shares, which are not cancelled but held in case they need to be resold. They are sometimes used to fulfil share options (issued via an employee share ownership programme, for example) as an alternative to a company having to issue more new shares.

After a share buyback, the profits made by the company are distributed across fewer shareholders (described as 'earnings enhancing'), often leading to the payment of an increased dividend per share.

In addition, if the company believes that the shares are trading at a value below that of the net assets represented by each share, then the buy-back exercise will also increase the value of the company. This is because the laws of supply and demand suggest that if there are fewer shares available in the market, the price will rise. This rise in the share price gives shareholders the benefit of capital gains as opposed to the income they would have received if the company had paid a higher dividend. Shareholders have a choice as to when to realise this capital gain, and can minimise their tax liabilities in a way which they cannot do if there is a mandatory dividend payment.

Share buybacks have been particularly common in the US, as they have been much more tax efficient than paying dividends. Many large US corporations have spent billions of dollars a year to repurchase their own shares. In order to discourage excessive share buy-backs and encourage more productive uses of corporate cash reserves, the Inflation Reduction Act introduced a 1% excise tax on stock repurchases made after 31 December 2022, where the repurchase exceeds 1% of the aggregate fair market value. However, this initial guidance provided a very broad anti-abuse rule, which was narrowed under new regulations issued in April 2024. There is also potential for the excise tax rate to be increased in the future, to further reduce the tax efficiency of share buy-backs.

Example

Company A has a net asset value (NAV) of $5 per share, yet its shares trade at $4 in the market.

The company has 500 million shares in issue:

- total NAV of $2.5 billion
- market capitalisation of $2 billion.

It buys back 100 million shares in the market for cancellation, costing the company $400 million.

- the company then has 400 million shares still in issue
- total NAV = $2.5 billion – $0.4 billion = $2.1 billion.

Now, the new net assets per share = $2.1 billion / 400 million shares in issue = $5.25.

Although the total market capitalisation of the company is smaller, the company has increased NAV per share by 5% (ie, ($5.25 – $5) / $5). One of the main jobs of the directors of a company is to give shareholders a satisfactory return. They need to consider how the cash they have is best invested and it may therefore be that they decide that the best way to provide a shareholder return is to buy back shares below NAV to boost the NAV of the remaining shares, and consequently the share price.

From the company's perspective, if it increased its dividend because it had surplus cash, it would be difficult for it to reduce the dividend in the future as it would be seen as a sign of weakness by the market, and investors relying on a stream of dividends prefer to see stability in the pattern of dividends paid out by a company.

6.6 Risks and Rewards of Investing in Equities

Learning Outcome

5.6.5 Risks and rewards of equity

 Analyse

Think of as many advantages and disadvantages and risks and rewards of investing in equities as you can. When you have a list, compare it to the answers below.

Rewards	Risks
• Shareholders share in the equity and, therefore, profits of the company, via dividends, capital repayments and share price growth. • Returns are not limited to a specific amount. • In the longer term, they can provide capital growth in a portfolio. • Generally speaking, equity ownership gives inflation protection. • Voting rights give an opportunity to influence the direction of the company. • There is a liquid market in the shares of most major quoted companies, giving narrow spreads. • The main stock exchanges are generally well regulated and well established. • Most shares can be bought in tax wrappers such as an ISA or a pension, eliminating income and CGT. Certain shares have other shareholder perks, usually connected with the products of the company.	• Capital invested in shares is at risk. • The dividend income is not guaranteed. It can fall, or may not be paid at all. • Past performance is no guarantee of future performance. • Shares are subject to CGT on gains and income tax on dividends, if not held in a tax wrapper. • Some shares can be illiquid and difficult to sell at a fair value and the liquidity of all shares can change from day to day. • There may be a significant difference between the buying and selling price, meaning if an investor wants to buy and sell quickly, they may do so at a loss, especially in consideration of the fees involved in doing so, as well as the SDRT. • Share prices can be volatile. • Ordinary shares rank below other creditors on winding up and may receive nothing if the company goes into liquidation. • Shares tend to be regarded as a long-term investment suitable for clients with at least a five-year time frame.

6.7 Beta Values

Learning Outcome

5.6.6 Beta values

Beta (β) was introduced by William Sharpe in the **capital asset pricing model (CAPM)** in 1964, which is covered in chapter 7, section 2.3.

It is a 'relative measure of risk' in terms of volatility; in other words, it measures a security's, portfolio's or fund's historic returns relative to a particular benchmark or market index. If the volatility is greater than that of the benchmark, then the instrument is thought to be riskier than the benchmark, and vice versa. Hence, beta can be seen as a security's, portfolio's or fund's sensitivity to movements in the benchmark or market index.

To gauge the general riskiness of a particular investment, one can compare the standard deviation of an investment to that of the market. This is a very rough measure, however, and leaves out some important information. If, for example, the returns are not normally distributed, this number can be misleading. It may also not capture the possible downside if there is a systematic crisis.

Beta effectively describes how a security's returns respond to swings in the market, another way in which it can be calculated is by dividing the covariance (ie, the combined variability) of the security's and market's returns, by the variance of the market's returns over a specified period, as follows:

$$\beta = Covariance\left(R_e, R_m\right) \ / \ Variance\left(R_m\right)$$

where:

R_e = the return on the security
R_m = the return on the overall market

Covariance is covered in chapter 7, section 2.1.4. Another more technical way of calculating beta is to run a regression of the returns of the stock/fund against the benchmark, with beta being the coefficient or slope of the regression line. If, for example, the stock or fund moves 20% more than the benchmark on average, then the regression-derived beta should be approximately 1.20.

The market itself is given an underlying beta of 1, and securities are ranked according to how much they deviate from the market. A security with:

- **β = 1** has the same level of risk as the overall market, so it would be expected to move in line with the overall market. If the market rises 20%, for example, the value of the share will rise by 20%. These shares are described as 'neutral'.
- **0 < β < 1** has less risk, so it would be expected to move in the same direction as the market, but by a smaller amount. If the market falls by, say, 10%, then a price of the share with a beta of 0.8 should fall by 8%. Stocks with a beta between 0 and 1 are often referred to as **defensive stocks**. These shares will likely be bought if stock markets are expected to fall, as the share price should fall less than the market as a whole.

- **β > 1** is riskier than the overall market, so it would be expected to move in the same direction, but by a greater amount. Should markets go up by, say, 10%, a share with a beta of 1.2 should go up by 12%. These shares are described as aggressive or **cyclical**. If stock markets are expected to do well, say as the economy pulls out of recession, shares with a beta of more than 1 should increase in value more than the market.
- **β = 0** is uncorrelated with the market, so there is no clear relationship between the two. For instance, for a given aspect of market risk, the security may go up sometimes and down others.
- **β < 0** moves in the opposite direction to the market as a whole, with the amount by which the price moves given the magnitude. Thus, if the overall market moves up, the price of the asset would move down, and vice versa.

6.7.1 Total Risk

A security's total risk can be broken down into two components:

- **Systematic risk (σ_s^2)** – also called market or undiversifiable, this is a risk that diversification cannot address and is associated with every type of asset. Causes of systematic risk include inflation rates, exchange rates, political instability, war, and interest rate movements. This type of risk is not specific to a particular company or industry, and it cannot be eliminated, or reduced through diversification; it is just a risk that investors must accept. For example, an external market shock could negatively affect the share price performance of good quality equities; or the entire market in Japan could fall due to a tsunami. Investors sell in these cases because they are worried about the impact of macro events on the entire economy and market, as opposed to an individual security. Systematic risk is measured by beta.
- **Unsystematic risk (σ_u^2)** – this type of risk is specific to a company, industry, market, economy or country, and it can be reduced through diversification; hence, it is also called specific or diversifiable risk. The most common forms of unsystematic risk are business risk and financial risk. Other examples include strength and quality of the management team, range of products, and geographic location. Unsystematic risk refers to risks related to just that individual security, such as an equity.

(Note that systematic risk of the market differs from systemic risk, which is broader and represents the possibility that an entire industry or economy could suffer a collapse.)

$$\text{Total Risk} = \text{Systematic Risk} + \text{Unsystematic Risk}$$

Total risk is the risk of that individual securities are exposed to, encompassing both systematic and unsystematic components. What we need to do is combine all the securities together and understand the total amount of combined risk in a portfolio. Ideally, we are looking to reduce the overall levels of risks and at the same time increase the return.

Example

An investor who only had UK banking equities in their portfolio from 2010 to 2020 would have seen the value of their shares drop hugely (about 50% excluding income). If the investor also owned shares in the UK technology sector, only part of their portfolio would have been affected by the large fall in value and would have been offset by the huge (although volatile) rise in value in the technology sector over the same period (about 300% excluding income). Thus, £100 invested in banks alone in 2010 would have resulted in a portfolio worth about £50 in 2020, while an equal combination of both sectors would have resulted in a portfolio worth about £175 (ie, (50% x £50) + (300% x £50)).

That being said, in spring 2020 when the COVID-19 outbreak was labelled a pandemic, the portfolio with an equal combination of both would have fallen in value by about 35% from its January peak to its March trough. This period is a good demonstration of systematic risk as, at this time, most assets fell in value as institutions desperately sold large volumes of stock in a bid to raise cash.

6.7.2 Diversification

Diversification is a risk management technique that removes the 'all eggs in one basket' risk, by investing in a mix of non-correlated stocks, sectors or asset classes. For example, by choosing to buy stocks in the retail sector and offsetting them with stocks in the industrial sector, an investor can reduce the impact of the performance of any one security on their entire portfolio. Most stocks in a given sector usually move broadly together, so allocation across multiple sectors is also important. Ideally, positive performance of one asset in the portfolio will cancel the negative performance of other assets. Thus, to understand diversification, investors need to understand the two main types of investment risk: systematic and unsystematic risk (as described in section 6.7.1 above).

In practice, stocks will tend to vary in their **correlations** to one another over time, depending on changing influences. In practice, therefore, the more uncorrelated or negatively correlated holdings there are in a portfolio, the better the diversification and the bigger the reduction in specific risk: specific risk can be diversified away. This has, however, an exponentially reducing effect, ie, each holding added has a smaller effect on the reduction of specific risk (what is left is systematic risk).

Nevertheless, in times of heightened volatility, diversification might not be able to protect portfolios from losses, as witnessed from the global financial crisis and the COVID-19 pandemic, among others. During these periods, diversification within equities provides very little benefit; thus, diversification across asset classes is also important. The market fallouts, therefore, drove home a clear lesson: diversification of risks in a portfolio should be the critical goal.

At the same time, though, the cost of purchasing and managing a larger number of holdings increases. Different studies have produced different results as to the number that should be held to diversify away most of the specific risk, but it is generally accepted that for practical purposes, it is about 25–30 holdings. Note that diversification can help to decrease risk, but there are diminishing returns from risk diversification, given one cannot diversify away market exposure, only **hedge** it.

6.7.3 Correlation

Correlation measures how the returns from two different assets move together over time and is scaled between +1 and –1. Diversification and risk reduction is achieved by combining assets whose returns do not move in perfect step, or are not perfectly positively correlated, with one another (ie, attempting to achieve correlation of, or close to, zero). Assets with a low or negative correlation are attractive to investors, in that when one asset is performing badly, the other asset is hopefully rising in value.

6.8 Analytical Measures of Equity Valuation, Their Merits and Uses

Learning Outcome

5.6.7 Analytical measures of equity valuation, and their relative merits and uses

There is no one precise way for analysts to value equities; rather, they have a number of techniques at their disposal. Of these, the two main approaches are:

- absolute methods, where discounted cash flow techniques are used to try and value the shares, and
- relative value methods, which provide a multiple which can be used to compare the performance of one company with its peers (eg, those of a similar size, sector and risk).

6.8.1 Absolute Methods

Intrinsic Value

In terms of absolute methods, analysts may use **fundamental analysis** rather than technical analysis to estimate the **intrinsic value** of a company. The intrinsic characteristic is the expected future net cash flows to the company calculated by a discounted cash flow valuation.

An alternative (although related) approach is to view intrinsic value as the value of a business' ongoing operations, as opposed to its accounting-based **book value**, or break-up (liquidation) value.

Gordon Growth Model

Another absolute method of valuing a share is to use the Gordon growth model. This is a simple method of deriving a share valuation or price from a future series of the current dividends, expected dividend growth, and return required.

The formula for calculating the share valuation using this approach is as follows:

$$\text{Share price} = \text{Dividend} / \left(\text{Required return} - \text{Dividend growth}\right)$$

For example, if next year's dividend is expected to be $0.20, the required rate of return is 10% and the expected dividend growth is 5%, the valuation is: $0.20 / (0.10 – 0.05) = $4. Required rate of return is also called the discount rate, which could be looked at as the investor's funding rate plus a risk premium.

The next section contains the ratios specifically listed in the syllabus that you need to know. However, to be able to evaluate equities, there are a number of other ratios of which you should be aware.

6.8.2 Profitability Ratios

These measure the effectiveness of the company at generating profits using the company's assets/ resources.

Return on Equity (ROE)/Return on Shareholders' Funds

Return on equity (ROE) measures the percentage return the company is achieving on the amount of funds provided by shareholders, which come from two main sources:

- the share capital and share premium, being the funds paid by investors for new shares in the company, or
- **retained earnings** (ie, accumulated from profits not paid out as dividends over the years).

$$\text{ROE}\ (\%) = \text{Profit after tax and preference dividends / Shareholders' funds}$$

An ability to earn consistently above average rates of ROE is the most fundamental characteristic of a good company.

Return on Capital Employed (ROCE)

ROCE is a better comparison between companies than ROE, since ROE is heavily affected by differences in the capital structure of companies, some of which have a much higher degree of debt funding than others.

$$\text{ROCE}\ (\%) = \text{Profit before interest and tax / Capital employed}$$

Interest and tax are excluded from the calculation because we are trying to identify how much profit a company has generated from its assets, and different companies have different financial commitments and may be subject to different tax rates.

Capital employed is calculated as:

$$\text{Capital employed} = \text{Equity} - \text{Non-current liabilities}$$

This is money which the company holds from shareholders and debt providers and which it uses to generate profits.

Capital employed can also be calculated using the trading side of the statement of financial position (ie, balance sheet):

$$\text{Capital employed} = \text{Total assets} + \text{Current liabilities}$$

6.8.3 Gearing Ratios

These are useful to those providing finance to the company in assessing the level of risk involved.

Debt-to-Equity Ratio

The **debt-to-equity ratio** is a measure of the risk to shareholders of receiving a lower dividend:

$$\text{Debt-to-equity} = \left(\text{Interest bearing loans} + \text{Preference share capital}\right) / \text{Ordinary shareholders' funds}$$

Note that preference share capital is usually, as here, included on the top line of the calculation, as it closely resembles interest-bearing debt. It also ranks above ordinary shareholders in the priority list for repayment in the event that the company is liquidated.

Interest Cover

The interest cover looks at the same problem from a different angle. How many times over could the interest bill be paid out of current profits?

$$\text{Interest cover } \left(\text{x}\right) = \text{Profit before interest and tax} / \text{Net interest paid}$$

where net interest is interest paid less interest received. Capital and income cover, and priority percentages, provide a more specific breakdown.

6.8.4 Liquidity Ratios

Liquidity is crucial to a company's fortunes. Even with an impressive order book and plenty of assets, companies sometimes fall into liquidation because they do not have enough cash to pay the bills.

Liquidity ratios are therefore watched very carefully by analysts and investors.

Working Capital (Current) Ratio

The purpose of this is to determine if the current assets recoverable within one year are sufficient to cover the liabilities that fall due within one year.

$$\text{Current ratio } \left(\text{x}\right) = \text{Current assets} / \text{Current liabilities}$$

As a general rule, a current ratio of between 1.5 and 2 is most commonly acceptable, although the actual number will depend on the type of business and the economic conditions. A low number may indicate a higher chance of the company falling into liquidation, while a high number may suggest that it has too much inventory or is not investing its excess assets in the most productive and yield-generating manner.

Quick (Acid Test) Ratio

The difficulty with the working capital ratio is that current assets include the inventory of goods which, as we have seen, do not, in practice, always sell easily in times of financial crisis.

The quick ratio (also known as the acid test ratio), measures only those assets which can be quickly and definitely turned into cash.

$$\text{Quick ratio}\left(\text{x}\right) = \left(\text{Current assets} - \text{Inventories}\right) / \text{Current liabilities}$$

Alternatively:

$$\text{Quick ratio}\left(\text{x}\right) = \frac{\text{Cash} + \text{Trade and other receivables} + \text{Short-term investments}}{\text{Current liabilities}}$$

Cash Flow

Most companies will include a cash flow statement in their company accounts which provide a more dynamic view of the money flow within a company. This gives the investor a far better insight into the operations of a company than just relying on the bottom-line profit figure.

When considering cash flow, the following need to be taken into consideration:

- **Increases in assets = a use of funds** – for example, buying machinery (this will be shown in brackets since it is a negative cash flow).
- **Decreases in assets = a source of funds** – for example, selling an asset.
- **Increases in liabilities = a source of funds** – for example, a new loan or an increase in creditors.
- **Decreases in liabilities = a use of funds** – for example, repayment of a loan (this will also be shown in brackets).

Key considerations when analysing cash flow statements will include the following:

- **Cash flow at operating level – is this positive?** If not, the position cannot continue for long. Borrowing may provide a short-term solution, but this cannot continue indefinitely. This is, therefore, of crucial significance.
- **How much cash is being generated from non-operating sources?** This is the money which is being squeezed from working capital; for example, by reducing stock or debtors or from the sale of fixed assets. This is a sound practice but cannot be repeated indefinitely, so cannot be relied upon to cover for cash shortages from operations.
- **What changes to loans have occurred?** The detailed notes within the accounts will provide useful information on relevant aspects of the company's debts, for example the dates of repayment and whether the rate of interest is fixed or variable.

6.8.5 Investors' Ratios

Learning Outcome

5.6.8 Measures of dividend yield, dividend cover, earnings yield, price/earnings ratio and price/book ratio

Earnings Per Share (EPS) and Diluted EPS

This ratio takes the profits attributable to ordinary shareholders that a company makes and divides it by the number of ordinary shares it has in issue. It, therefore, provides investors with a 'profits made per share figure'.

$$\text{EPS} = \frac{\text{Profit attributable to ordinary shareholders}}{\text{Number of ordinary shares in issue}}$$

The profit figure used is the profit after all deductions, except the ordinary dividend (ie, the maximum amount that could be distributed to ordinary shareholders).

Viewed on a year-on-year basis, it is particularly useful for identifying trends in profitability, and it can also be used to compare one company's performance against another.

Note, however, that there are a number of reasons why a company may have to increase the number of shares it has in issue, which would reduce the earnings per share figure. The 'fully diluted' shares outstanding used in the EPS formula will typically include:

- **convertible bond/loan stocks** outstanding if all were to be converted
- warrants in issue, or
- share options issued, but not yet exercised.

The diluted EPS figure looks at a worst-case scenario by increasing the number of shares on the bottom line of the calculation to a maximum.

Dividend Yield

This ratio compares the year's dividend paid out on a share against its current market price and expresses it as a percentage return. It therefore provides investors with an indication of how much they are earning on their shares.

It is calculated as follows:

$$\text{Dividend yield (\%)} = \frac{\text{Dividend per share (DPS)}}{\text{Share price}}$$

Points of note:

- As companies tend to have different policies on how much of their profit they pay out by way of dividend and how much they retain by way of reserves for future use, the **dividend yield** is not always directly comparable between companies.
- For example, **growth stocks** tend to have low (or zero) dividend yields as they reinvest a large proportion of their profits if they make a profit, but having a low yield does not necessarily mean a company will grow. Investors may actually prefer low dividends with such companies in exchange for maximum likelihood of large capital gains.
- A high dividend yield could arise because the company is regarded as insecure, resulting in a lower share price; and the dividend is the investor's reward for the additional risk that they are incurring by investing in the company. Alternatively, it could be indicative of a company with strong cash flows and/or low capital expenditure. Companies operating in defensive sectors (eg, utilities and healthcare companies) also often make higher distributions. These companies are often referred to as 'bond proxies' due to their bond-like characteristics in terms of providing low-risk, higher levels of income.
- Demand for a particular share will drive the price up, therefore lowering the yield.
- From an investor's perspective, a high historical dividend yield is no guarantee that the company will continue to pay those levels of dividend in the future.

Note that dividend pay-outs are not necessarily guaranteed. For example, in the first half of 2020, dividends worldwide were cut by $220 billion in response to the uncertainty caused by COVID-19 pandemic[8]. Banks and insurers were heavily impacted – in the UK, this was in response to pressure from the Prudential Regulation Authority (PRA) for financial institutions to maintain safety and soundness. Banks in emerging market economies faced similar government clampdowns, with regulators instructing them to pause dividends to help preserve capital. Elsewhere, oil and gas companies cut their dividends amid a collapse in the oil price. Other areas and individual names were also affected, with cost-cutting exercises put in place to offset falling revenues.

Dividend Cover

This ratio looks at the ability of the company to maintain the current level of dividend that it is paying out; thus, it is of particular use to income-seeking investors.

It is calculated as follows:

$$\text{Dividend cover } (\text{x}) = \frac{\text{Earnings per share (EPS)}}{\text{Dividend per share (DPS)}}$$

Generally speaking, a **dividend cover** of 2x or higher is considered solid, in that the company is perceived to be able to easily afford the dividend. An unusually high dividend cover implies that the company is retaining the majority of its earnings, presumably with the intention of reinvesting for further growth. This is common among companies which are still in a high growth phase, rather than more mature companies which are often expected to pay regular dividends.

8 Janus Henderson, Press Release. Pandemic caused $220bn of global dividends cuts in 2020, but the decline was less severe than feared. Retrieved from https://www.janushenderson.com/en-it/advisor/press-releases/pandemic-caused-220bn-of-global-dividends-cuts-in-2020-but-the-decline-was-less-severe-than-feared/ (Accessed: October 2025)

A ratio below 1.5x might suggest a less sustainable dividend, however. If the ratio is less than 1x, then the company is paying a dividend which is greater than the year's earnings. The company is funding part of its dividend using earnings retained from previous years (ie, past reserves) and is said to be paying an uncovered dividend. This is more likely to be a cause for investor concern as it signals either that the dividend will be cut or the company will need to borrow; either implies the company is having financial difficulties.

One point of note: it is not necessarily the case that because a company is profitable, it has sufficient cash to be able to pay a dividend.

Investors tend to feel more at ease when a dividend is comfortably covered by earnings, although there are occasions when an uncovered dividend is considered acceptable – for example, if a business is about to win a large contract, and the stock market knows this to be the case.

Price/Earnings (P/E) Ratio

The **price/earnings ratio** (also called price-to-earnings ratio, P/E ratio or PER) is a multiple, which looks at how many times the price of a company's share exceeds the level of profits per share. It, therefore, provides an indication as to the level of confidence that the stock market has in the company.

It is calculated as follows:

$$\text{P/E ratio}\left(\text{x}\right) = \frac{\text{Current market price per share}}{\text{Earnings per share (EPS)}}$$

As a rule of thumb, a high P/E ratio relative to the market/industry average, or the company's own historic norms, indicates that the company is expected to do well and grow, whereas a low P/E ratio may indicate a lower growth, more established company. An extremely low P/E ratio is likely to indicate that investors fear that future earnings will be substantially lower or may occur because the company is undervalued by the market.

It is useful for comparing companies in the same sector, and you will find P/E ratios in the financial pages of newspapers. As with the majority of these ratios, you should note that the P/E ratios that you will see listed in the financial press and on investment websites are usually based on historic figures; the same also being true of dividend yields.

As investors are typically more interested in future dividends and growth prospects, the prospective P/E ratio may be of more use to them. This is calculated in the same way as the historical P/E ratio, but uses forecast earnings for the current year. This, in itself, will have limitations, in that it uses estimated earnings figures and analysts may be incorrect in their forecasts. An average or median among a group of analysts covering the same company (known as the 'consensus' estimate) is usually used, in order to avoid the most extreme forecasts.

As the P/E ratio uses earnings in the way it is calculated, it cannot be used for companies that do not make profits. It also can grow to high values when earnings are very small, so it is generally good to look at more than one year's earnings to see if the current year is an outlier.



Analyse

Have a look in the financial pages of any major newspaper and view the P/E ratios for different sectors. Why do you think that some have a dash?

Earnings Yield

The **earnings yield** is the reciprocal of the P/E ratio expressed as a percentage. It shows the rate of return that an investor would make, if the company paid out all of its profit by way of dividend.

It is calculated as:

$$\text{Earnings yield } (\%) = \frac{\text{Earnings per share (EPS)}}{\text{Current market price of the share}}$$

This calculates the profits the company makes per share as a percentage of the current share price. For instance, a Japanese company that has a share price of ¥3,000 and has earnings per share of ¥150 would have a P/E ratio of 20 and earnings yield of 5%.

The earnings yield is more easily used in comparisons against dividend yields, bond yields and interest rates, but the P/E ratio above is the most commonly used form of the formulae using earnings.

The more risk an investor is taking, the higher a return they would expect.

Price/Book Ratio

The last of the ratios that we need to consider is the price/book (or price-to-book, or P/B) ratio. This ratio provides us with an alternative to the P/E ratio, and can be used even if the company is making losses.

It is calculated as follows:

$$\text{Price/book ratio } (x) = \frac{\text{Current market price per share}}{\text{Book value}}$$

The book value is the net tangible assets per share. It is calculated by taking the company's assets, less intangible assets, less the value of all of its liabilities (ie, its net asset value, or NAV). On the balance statement of financial position, this number is also referred to as shareholders' equity. Dividing this figure by the number of ordinary shares in issue gives the book value per ordinary share.

If the P/B value is less than one, the market is valuing the shares at less than the value of the company's assets. This may indicate that the share is undervalued, that investors consider the assets to be overvalued, or that they perceive some other problem with the company which is depressing the share price.

A high P/B value would suggest that investors are prepared to pay more for the shares because they expect the management team to generate significant profits from the assets the company owns (and they would, therefore, be using other investor ratios), that investors consider the assets to be undervalued or it may be because a company has been making losses which has reduced its retained earnings.

The ratio is a widely used measure, but care should be taken in its application. It is a better indicator with companies with large tangible assets (eg, building firms with large land banks and property companies), and is of less use if the company has more intangible assets such as copyrights, patents or goodwill, which are more difficult to value, or if the company has large amounts of debt which negate the value of the tangible assets in the calculation.

6.9 The Yield Gap and Reverse Yield Gap

Learning Outcome

5.6.9 Relevance of the yield gap and reverse yield gap

Earnings and dividend yields are important to investors as it provides a good clue about the financial strength of a business, and therefore future prospects and performance. The **yield gap** is the difference between the dividend yield on ordinary shares (eg, the UK's FTSE 100, S&P 500 in the US, or China's SSE Composite Index) and the redemption yield on the relevant government bond or bond index (eg, UK gilts, a US Treasury, or a Chinese government bond respectively). It indicates how much equity investors are being rewarded for the additional risk over investing in comparatively risk-free fixed income assets.

You would normally expect there to be a higher dividend yield received from shares than the GRY on a government bond. However, it is possible for the yield gap to reverse, whereby government bonds yield more than the relevant share index, on average. This is likely to occur during periods of high inflation, which undermines the returns on government bonds as the real value of the coupon and capital reduces over time. At the same time, inflation increases company profits, allowing dividends to be increased. This could also happen in periods of extreme exuberance in the equity market (which could be exacerbated by companies preferring stock buy-backs over dividends).

This is important because to invest in equities, investors will look at the risk premium over the risk-free return. In such a calculation, investors will also include dividends from equities and the fact that both should grow in real terms and rise with inflation, whereas bonds and their coupons do not.

The UK and US are examples of where **reverse yield gaps** have occurred. Between 1959 and 2008, it was the norm for gilts and Treasuries to yield more than equities, with arguments justifying this centred on the effect of inflation. From this, it was argued successfully that UK and US government bonds needed to pay a higher yield to compensate investors for the erosion in the spending power of cash flows; and that buying shares with an initial yield that was lower than those bonds was acceptable because the potential for dividend growth would outweigh the risk.

As more investors bought into this argument, demand for equities increased, pushing up prices and lowering yields on equities, thus widening the gap.

After 2008, this trend reversed itself, mainly due to quantitative easing (QE) and lower inflation expectations, which took UK and US government bond yields to unprecedentedly low levels (including, as we saw in section 4.5, the sale of the first ever negative-yielding UK gilt in 2020).

Equity Risk Premium

The size of the **equity risk premium** is determined by two key factors: the market's view on the growth prospects for equities and the perceived risk of owning equities.

Examples of risk factors that drive equity investments include:

- macro-economic
- credit default
- real interest rates
- inflation
- commodity price volatility (certain industries may be more affected than others)
- political risks, and
- liquidity factors.

One way of looking at investments is considering whether equities are cheap, relative to bonds. The yield gap gives us a useful insight into this.

 Analyse

Have a look at *The Financial Times* and compare the yield on equities with the average yields on gilts. What is the current position? Has the gap been closing or widening recently?

7. Financial Derivatives

7.1 Introduction

Derivatives are so-called because they derive their value from the value of something else – for instance, the price of an option on a share is derived, largely, from the price of the underlying share itself. In this workbook, we will mainly focus on exchange-traded derivatives (ETDs), although there are also over-the-counter (OTC) derivatives which may provide exposure not available on exchanges.

7.1.1 Use of Derivatives

There are three main approaches when looking to hedge, **speculate** or conduct **arbitrage** via derivatives are:

1. **Tactical** – short-term exploitation of market opportunities (eg, flattening yield curve).
2. **Strategic** – duration management of a bond portfolio using futures and interest rate swaps (eg, short five-year UK swaps).
3. **Downside protection** – manage overall risk profile (eg, a long equity **put option** and short (risk) five-year credit derivatives).

Hedging

A hedge is an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract. If an investor owns an asset (such as an equity), and is worried about it falling in price but wants to retain it, they can purchase an offsetting position via a derivative (such as a put option or short futures contract). This is based on the expectation that as one asset falls, the other rises; however, because of the cost incurred, this does reduce the overall profit profile.

For the purposes of the exam, we will be looking at four main categories:

- futures
- options
- warrants, and
- contracts for differences (CFDs).

Speculation

Speculation is the act of buying or selling an asset in the hope of generating a profit from the asset's price fluctuations.

Derivative securities can be bought or sold to speculate on the future price of the underlying assets. Derivative securities' prices are dependent on the price of underlying assets and are merely contracts between parties. Speculators do not own the underlying assets; they own the right to buy or sell the underlying asset, in the case of options. These can be on a variety of underlying assets – eg, equities, bonds, currencies and credit default swaps (CDSs).

Arbitrage

Arbitrageurs seek low risk profits by exploiting pricing anomalies, for example, simultaneously selling the underlying asset and buying the future. Although private investors do not usually have the ability to carry out such trades at large enough size or sufficiently low cost to make it viable, the fact that such trades are carried out by professionals helps to keep markets fairly efficiently priced: the act of trading against the pricing anomaly helps to remove that anomaly.

7.2 Futures

A future is an agreement to buy or sell a standard quantity of a specified asset, on a fixed future date, at a price agreed today.

It is, in essence, an agreement where the buyer and seller of an asset agree the terms upon which they will buy/sell the asset concerned, but the actual purchase/sale transaction does not happen until an agreed future date. Once the agreement is made, each side then has an obligation to the other:

- **Buyer** – the party agreeing to buy the asset under the future is described as the '**long**'.
- **Seller** – the party agreeing to sell the asset under the future is described as the 'short'.

Futures are traded on exchanges; and to maintain liquidity in the markets, the terms on which futures are agreed are standardised. The standard terms for each specific type of future are described as 'contract specifications', which include the following.

Standard Quantity

By way of example, wheat futures traded on a futures exchange (eg, ICE Futures Europe or the Chicago Board of Trade (CBOT)) are all for 100 tonnes of wheat. If a buyer wants to buy 500 tonnes of wheat, they buy five wheat contracts. If they want to buy an odd amount of wheat, say 531 tonnes, they cannot do it exactly; they have to round up or down to the nearest whole future.

Specified Asset

It is logical that if someone agrees to buy something in the future, they want to know exactly what they are buying. If, for instance, a buyer agrees to buy oil, they would insist on knowing in advance the specific quality (eg, the type and grade). For this reason, the asset is also clearly defined in the contract specifications.

Fixed Future Date

The actual purchase and sale under the future, which is known as 'delivery', can only take place on specific dates set by the exchange, known as 'delivery days'. The exchange sets the available delivery days and as one date expires, another is added.

Price Agreed Today

The price that the buyers and sellers (under futures contracts) agree to pay or receive for the specified asset is agreed in advance on the date that the future is bought or sold. As with share prices, these are published by the exchanges.

The Obligation

There are two ways that the parties to a futures contract can fulfil their obligation:

- see the contract through to delivery, or
- close out the contract. This is achieved by entering into an equal and opposite contract.

The second option is possible because futures contracts are said to be 'fungible' (ie, each contract has the exact same specifications as every other contract of the same type of futures). In contrast, OTC contracts can be highly customised and may not be easily offset.

Example

A farmer sells five wheat futures for November delivery at a price of 2,000 yuan per tonne, and their crop fails.

This has committed them to deliver 500 tonnes of wheat on a date in November at 2,000 yuan per tonne. To cancel out this obligation, they can enter into an equal and opposite futures contract, which commits them to buy 500 tonnes of wheat for the same November date delivery. In this way, they are agreeing to sell 500 tonnes of wheat and buy 500 tonnes of wheat on the same date. The buy and sell cancel each other out and the farmer does not have to deliver or take delivery of any wheat.

When a futures contract is closed out in this way, the closing contract is entered into at the market price for the day, which means that the farmer may suffer or gain from the price differential.

Our farmer has agreed to sell 500 tonnes of wheat at 2,000 yuan per tonne. If the closing contract to buy wheat is priced at over 2,000 yuan, say 2,500 yuan per tonne, the farmer will have effectively bought wheat at 2,500 yuan per tonne and sold it at 2,000 yuan, causing them a financial loss of 500 yuan per tonne (ie, a total loss of 250,000 yuan).

The reverse is also true. If the price falls, say, to 1,500 yuan per tonne, the farmer is effectively buying the wheat at 1,500 yuan per tonne and selling it at 2,000 yuan per tonne, making a profit of 500 yuan per tonne.

Futures are available on numerous products including individual securities, financial indices and interest rates. The main uses of all futures are hedging, speculation and arbitrage – see section 7.1, above.

- A **long futures position** has the potential to make a limited, although highly geared, loss (ie, a price can only fall to zero), but an unlimited gain.
- A **short futures position** has the potential to make a limited gain (the maximum would be if the price fell to zero), but an unlimited loss (ie, a price could in theory continue to rise without limit).

7.3 Clearing and Settlement

Learning Outcome

5.7.8 Operation and relevance of margin in the clearing and settlement process

Clearing and settlement include the following stages:

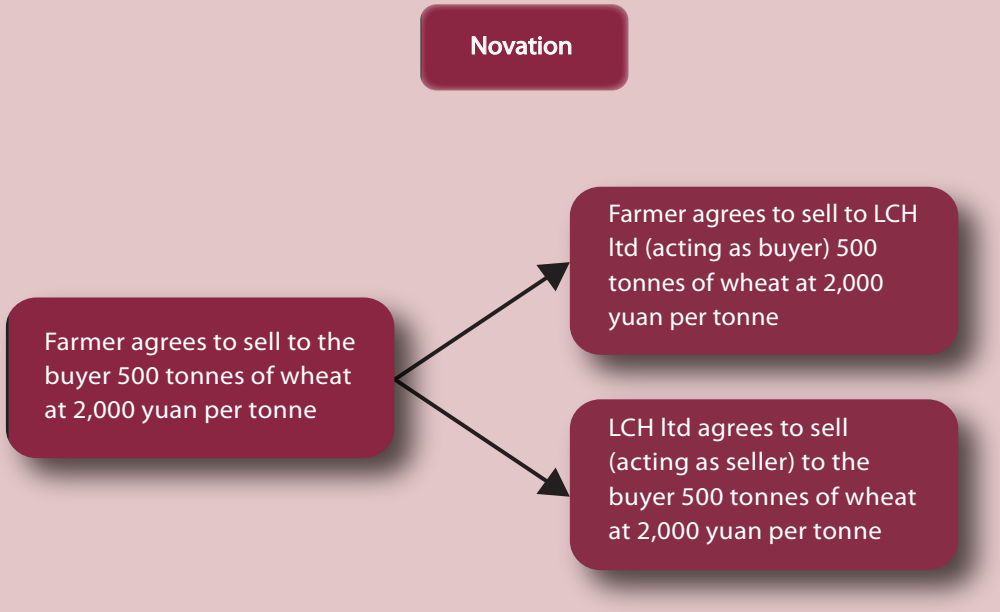
- Matching of the trade details.
- During the life of the future, managing margin payments.
- Arranging for either delivery or cash settlement of the contract on expiry/closing out.

In the way that we have looked at futures so far, the implication is that the buyer and seller deal with one another directly. In practice, this is not the case.

After the trade details have been matched, the clearing house (eg, LCH ltd) becomes the legal counterparty to each side of a futures trade, through a process known as 'novation'. This means that they become the buyer to every seller and the seller to every buyer. From this point forward, they also guarantee that both sides of the contract are fulfilled. In essence, the original contract between the buyer and seller are cancelled and two opposing new contracts are issued between the traders and clearing house, thus the term 'novation' (originating from the Latin *novus*).

Continuing our earlier example with the farmer:

Example



The guarantee:

LCH ltd guarantees that even if the farmer does not sell the wheat to them, LCH ltd will sell the wheat to the buyer at 2,000 yuan per tonne. This could mean that LCH ltd have to go out into the market, buy the wheat at the current market price (which could be more than 2,000 yuan per tonne) to sell to the buyer at 2,000 yuan per tonne, potentially making a loss.

LCH ltd also guarantees that they will buy the wheat from the farmer for 2,000 yuan per tonne, even if the buyer will not buy it from them for 2,000 yuan per tonne. This potentially leaves LCH ltd in the position of buying wheat from the seller at 2,000 yuan per tonne and having to sell it in the market at the current market price (which could be less than 2,000 yuan per tonne), potentially making a loss.

To cover themselves against these eventualities, LCH ltd use a system of margin payments and the creation of a settlement guarantee fund.

7.3.1 Initial Margin

Initial margin is payable when each futures contract is first traded. It is effectively a returnable good faith deposit and is paid by both buyers and sellers of futures and can be paid in the form of cash or acceptable forms of collateral.

It is described as a returnable good faith deposit, because if a party taking a position in a futures contract honours their obligations, the initial margin will be returned to them.

A risk-modelling programme called Standard Portfolio Analysis of Risk (SPAN) is commonly used to calculate the amount of initial margin to be paid, and it equates to the worst probable one-day loss that the buyer or seller of the futures may incur. The more volatile the markets, the higher the initial margin.

In the UK, initial margins are usually payable by 9:00am on the business day following the trade.

7.3.2 Variation Margin

In addition to the initial margin, variation margin is payable if the futures contract that has been bought or sold loses money. It is paid by the loser (through the clearing house) to the winner. The amount of the variation margin payable/receivable equates to the profit/loss on the futures contract each day.

The amount of variation margin payable is calculated at the close of business each day and is payable by the futures trader; in the UK, this is usually by 9:00am on the next business day. If it is not paid by the required time, the amount due is taken from the initial margin paid, and the contract will be closed out, with any surplus being returned to the exchange member.

Example

1 August – bought 1 FTSE 100 Index December future at 6709

At the end of the trading day, the daily settlement price is calculated and is 6699. The buyer has bought a single contract, which needs to go up in value for the buyer to be in profit. It has fallen in value, so the buyer is initially making a loss. Variation margin will be payable by the buyer to cover this daily loss.

In this particular case, the variation margin payable will be £10 per index point, per futures contract bought. The index has fallen by 10 points x £10. Therefore, £100 is payable.

The amount of variation margin payable per index point depends on the futures contract being bought. In this case, per index point, it is £10 for the FTSE 100 index.

This daily margining process ensures that any profits or losses are calculated each evening and realised (paid or collected) first thing the next morning, not just at the expiry or closing out of the future. If the futures price moves in your favour, payment is received. If the futures contract moves against an investor, payment must be made.

The process of comparing the daily price to the futures price, and working out the margin payable, is often described as 'mark to market'.

In practice, to avoid the need for cash to be constantly moving between brokers and their customers, an amount of cash is usually left on deposit with the broker, and payments are credited to, or debited from, the margin account.

Although these are the two main types of margins, other types of margins are used (both in London and on other foreign exchanges) as follows.

7.3.3 Spot Month Margin

This is an extra margin charged to cover additional risk for contracts in certain months (often delivery months).

7.3.4 Intra-Day Margin

Intra-day margin is called in times of high volatility in the price of a contract during a trading day. In such circumstances, if the amount of initial margin originally called for is considered inadequate by the clearing house to cover the additional risk, extra margin is called.

7.3.5 Maintenance Margin

Certain exchanges (particularly some of the US exchanges) operate a different system for calculating initial margin, which results in a higher initial payment needing to be made. No variation margin is then payable unless the balance on the margin account falls below what is described as the maintenance margin level, which is usually two-thirds of the initial margin level. At this point, investors are required to pay sufficient margin to bring it back up to the initial margin level.

7.4 The Relevance of Cost of Carry and Fair Values

Learning Outcome

5.7.7 Relevance of cost of carry and fair value

The next step is to understand how futures are priced.

7.4.1 Contango

The futures market is described as being in '**contango**' if the futures price of the asset is higher than the **spot** price. For physical commodities, this is the normal market condition, which can be explained by the following:

Example

To explain, let us consider the position of a farmer who has some wheat to sell. The farmer can sell it today or at an agreed date in the future. If the farmer agrees to a future sale, they will incur additional financial costs (the farmer may not be able to repay an overdraft – eg, until the wheat is sold – thereby incurring extra interest costs). The farmer may also have to pay to store and insure the wheat. These additional costs are described as the 'costs of carry'.

Put simply, if the farmer is going to agree to sell wheat in the future, they are going to work out how much it is going to cost them, and the price will be calculated accordingly.

$$\text{Fair value} = \text{spot price} + \text{costs of carry}$$

7.4.2 Backwardation

In practice, the futures price is a result of the spot price, the costs of carry and the interplay of several other factors such as supply and demand, market sentiment, practical issues, interest rates and more. Given these additional factors, the futures price is sometimes lower than the spot price. You will find it is also the case for a number of metals if demand is high and supply is temporarily low. It can also occur with equity futures, if dividend yields are lower than interest rates.

When the futures price is lower than the spot price, the market is described as being in 'backwardation'.

7.5 Features of Financial Futures on Equity Indices

The wheat future we saw above is capable of being physically settled (ie, the wheat can actually change hands). Some futures trade the prices of less tangible or more complex types of investments, which would be difficult or impossible for an investor to physically deliver. One such example is that of an equity index. Investors can buy and sell futures based on the value of the index, but it would be difficult

to physically deliver an index (requiring the transfer of every stock in the index in the exact proportion at maturity), so they are settled by paying the cash equivalent of the difference between the buying and selling price, ie, they are 'cash-settled'.

Example

An investor thinks the value of the FTSE 100 index is going to go up (they are bullish about the market), so they buy FTSE 100 futures contracts. Buying at a low value and selling (closing out) when the price has risen will generate a profit.

Conversely, if they think the value of the FTSE 100 is going to fall (they are bearish about the market), then they should sell futures while the value is high and buy (close out) the contract when the price has fallen. In this case, they have still followed the old adage of 'buy low and sell high' to generate a profit; they just did it in reverse order.

The contract specifications for the FTSE 100 Index are:

- tick size = 0.5 point, and
- tick value = £5.

The '**tick**' is the smallest permitted price movement by an exchange for a given futures contract. The 'tick value' is the amount that the exchange will pay out for a one tick price change.

Profit/Loss Calculation

The formula for calculating the profit or loss on a futures contract is:

$$\text{Profit or loss} = \text{Number of ticks} \times \text{Tick value} \times \text{Number of futures contracts}$$

Example

An investor buys a FTSE 100 December future at 6729. In December, the FTSE 100 Index has risen to 6859. Calculate the profit.

The FTSE 100 has moved 130 points. Each half a point is a tick, therefore, 260 ticks.

The investor bought and the index rose, so they bought low and sold high, generating a profit.

Each tick is worth £5.

$$\text{Profit} = 260 \times £5 \times 1 = £1{,}300$$

Example

An investor who has a portfolio of shares worth £100,000 and is expecting the equity market to fall by 20%. If they continue to hold their shares and the market falls, the shares will fall in value to £80,000.

If they went short futures (sold futures, ie, sell high; and buy while low, ie, close out), when calculated correctly, they could make enough profit on the short futures position to make a £20,000 profit, compensating them for the £20,000 loss on their cash equity portfolio.

If the market moves the other way, the investor will make a profit on their shares, but a corresponding loss on the short futures position.

With a perfect hedge, the status quo is maintained.

Market falls	
Portfolio	–£20,000
Profit on future	+£20,000
Equity portfolio	+£80,000
Profit on future	+£20,000
Overall position	+ £100,000

Market rises	
Portfolio	+£20,000
Loss on future	–£20,000
Equity portfolio	+£120,000
Loss on future	–£20,000
Overall position	+ £100,000

Futures are available on a number of indices, from both developed and emerging markets. For example, ICE Futures Europe has futures available on:

- FTSE 100 and FTSE 250
- MSCI Europe Index
- MSCI USA Index
- MSCI Pacific Index, and
- MSCI Emerging Markets Index

and many more, including a selection of more country-specific indices (eg, MSCI China Free Index). Futures on American indices are available through the Chicago Mercantile Exchange group (CME). There are some exchanges outside the US which list single stock futures. At present, there are no futures available on AIM stocks.

When using equity index futures for hedging purposes, to achieve a perfect hedge, the contents of the index must exactly match the contents of the portfolio being hedged. It is important to select the index with care. If the portfolio is made up of UK blue-chip shares, it would not be appropriate to select an index of European mid-caps!

7.6 Features of Contracts for Differences (CFDs)

Learning Outcome

5.7.9 Features of contracts for differences (CFDs)

A CFD is similar to a futures contract which has no expiry date. They are not capable of being physically delivered for settlement and are, therefore, cash-settled.

In effect, CFDs are agreements to pay out the cash difference between the starting price of an index, share, interest rate or the closing price. If an investor buys low and sells high, they make a profit and receive money. If the price moves against them and they buy high and sell low, they make a loss and have to pay out the difference. It is possible to go short the CFD, so the reverse is also true.

CFDs have the following features:

- CFDs can be taken on individual listed companies, not just indices.
- They allow investors to make money (and lose money) on movements in prices, without them having to buy the underlying asset.
- They can be used when prices are rising or falling. They allow investors to go short and potentially make money in a falling market.
- A long CFD position has the potential to make a limited (although geared) loss (ie, a price can only fall to zero), but an unlimited gain. A short CFD position has the potential to make a limited gain (the maximum would be if the price fell to zero), but an unlimited loss (ie, a price could in theory continue to rise without limit).
- Due to the system of margining, investors do not have to pay out the full value of the contract/shares upfront, and the outlay is much smaller.
- CFDs are geared products and will magnify an investor's profits and losses. Investors can control a much larger number of shares for a smaller outlay, compared with actually buying the shares for instance, giving them more profits if the price rises and higher losses if the price falls.
- No stamp duty or SDRT is payable on CFDs.
- For long CFDs on shares, the buyer is also entitled to any dividend paid by the underlying company on which the CFD is based, during the life of the contract. (CFD brokers cover their side of the contract by trading in the underlying shares, to match their CFD obligations.)
- CGT is payable on gains, in the same way as investors would be liable if they made profits trading the shares outright.
- Stop losses are available, and guaranteed stop losses mean that the investor cannot lose more than a predetermined amount, even in a rapidly changing market.

Note that in several countries, such as the US and Hong Kong, CFDs are illegal in order to protect retail investors, amid regulators' concerns about the amount of leverage that CFDs use to purchase the instruments they represent (although Hong Kong residents can still trade CFDs via overseas brokers).

7.6.1 Spread Betting

Spread bets and CFDs are very similar. The key difference is that spread bets constitute gambling, so winnings are free from CGT. They are available over a much more diverse and varied subject matter, but are generally less flexible than their CFD counterparts. For example, they have set expiry dates, whereas a CFD can be closed at any time.

Again, note that spread betting is illegal in some countries, such as the US, in order to protect retail investors.

7.7 Options

Learning Outcome

5.7.1 Features of UK-traded options on individual securities and indices

5.7.2 Terms and timescales of different kinds of traded options and warrants

5.7.3 Valuation and quotation of traded options and warrants

An option is a contract that gives the holder the right, but not the obligation, to buy or sell an asset at a given price on or before a given date.

In the same way as a future, an option allows an investor to purchase or sell an asset at a future time for a price agreed today. The main distinction between the two types of derivatives is that with a future, the parties have an obligation under the contract, but with an option, the buyer has a choice about whether to use it.

The investor's choice will be determined by how the price of the asset in the current market compares with the price they are able to buy or sell under the option. If the price is favourable, the investor will exercise the option. If the price is not favourable, the investor has the right to let it lapse.

7.7.1 Terminology

- **Buyer** – the party purchasing the option is described as the 'long', the 'buyer' or the 'holder'.
- **Seller** – the party selling the option is described as the 'short', the 'seller' or the 'writer'.
- **Intrinsic value**:
  - For a **call option**, the intrinsic value is the current market price of the underlying asset minus the **exercise price**. It is zero if the result is negative.
  - For a put option, the intrinsic value is the exercise price minus the current market price of the underlying asset. It is zero if the result is negative.
- **Time value** – the premium is the sum of intrinsic value and time value. So, time value is premium minus intrinsic value.
- **In-the-money (ITM)** – intrinsic value greater than zero.
- **At-the-money (ATM)** – current market price of the underlying asset equals the exercise price.
- **Out-of-the-money (OTM)** – intrinsic value is zero, premium is made entirely of time value.

7.7.2 Types of Options

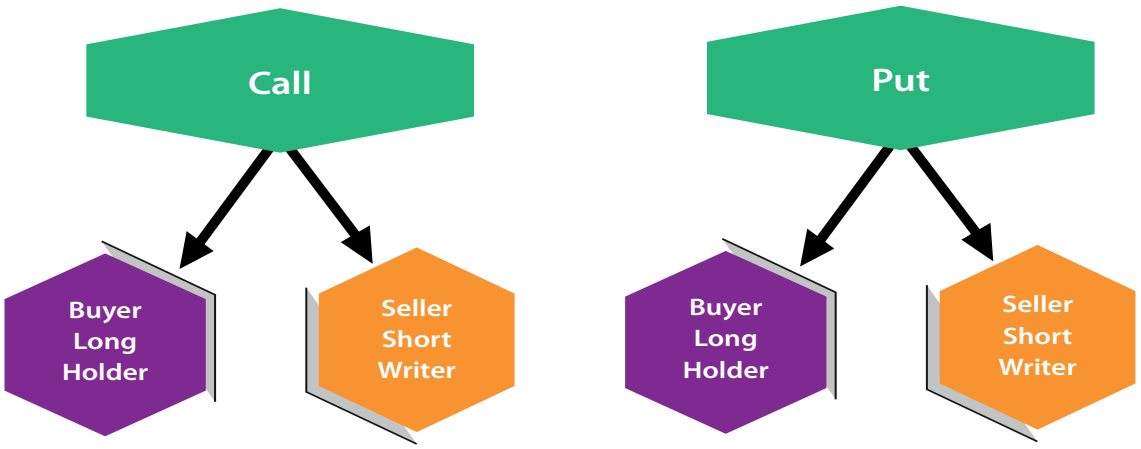
Options may be traded on exchanges, or over-the-counter (OTC), and they come in two types:

- **Call options** – give the buyer (the long position) the right to buy the underlying asset if they choose to do so. If the long decides to do so, the seller of the option must sell (deliver) to the buyer the underlying asset at the agreed price.
- **Put options** – give the buyer (the long position) the right to sell the underlying asset if they choose to do so. If the long decides to do so, the seller of the option must buy (take delivery) of the underlying asset at the agreed price.

Be careful not to confuse the buyer of an option with an option that gives the right to buy an asset.

To add a little clarity, you may find it helpful to think of options in terms of the following structure. There are four basic positions.

These are:



7.7.3 Underlying Asset

The underlying asset, often referred to as merely 'the underlying' is the subject matter of the option, the particular share, commodity or other asset.

7.7.4 Exercise (or Strike) Price

This is the price at which the underlying asset will be bought or sold, should the holder of the option choose to exercise it.

7.7.5 Premium

This is the cost of the option. It is the amount that the holder pays for the opportunity to be able to choose whether to buy or sell the asset at the agreed price in the future. The premium is paid, whether the holder of the option exercises it or not.

7.7.6 Expiry Date

All options have expiry dates, and expiry dates come in a number of styles, the two most common being:

- **American-style** – these options can be exercised at any time after the option is purchased, through to, and including, the expiry date.
- **European-style** – these options can be exercised only on their expiry date.
- **Asian-style** – for these options, the payoff depends on the average price of the underlying asset over a certain period of time, rather than the price at maturity. For this reason, they are also called average options.
- **Bermudan-style** – these options are a combination of the American and European styles, in that they may only be exercised on the date of expiration and predetermined dates before then (usually once a month), thus they are hybrid securities.

The vast majority of options are American or European style.

7.7.7 Option Strategies

Buying a Call Option

In this case, the holder of the option is 'long a call' of the underlying asset, and they are hoping that the price of the underlying asset in the market will rise above the strike price.

Example

Strike – $5.60
Premium – $0.55
Expiry – March 2026

Each option is for 1,000 shares (set by the exchange), so an investor buying this option has the right to buy 1,000 shares at $5.60. If the price rises to more than $5.60, the investor should exercise the option. If they do so, they can buy the shares at $5.60 and sell them at a profit. If the price falls below $5.60, the investor will not exercise the option (it is cheaper to buy them in the market at this point!) and will, therefore, forfeit the premium.

Buying call options is a bullish strategy. The investor hopes that the price will rise. The writer of the option is hoping precisely the opposite. If the price stays the same or falls, the writer of the option can do nothing and can keep the premium.

Selling a Call Option

Selling a call option is, therefore, a bearish strategy.

Risk and Returns

Call Options		
	Maximum Profit	**Maximum Loss**
Writer	Premium	Unlimited
Holder	Unlimited	Premium

The buyer of an option can make an unlimited profit as the price, in theory, could rise infinitely. On the other hand, the maximum they can lose is the premium, if they choose not to exercise the option and therefore forfeit it.

In this respect, options are sometimes compared with insurance policies. With an insurance policy, an individual pays a premium for the right to be able to claim if they need to. They do not get the premium back if they do not make a claim.

Buying a Put Option

In this case, the holder of the option is 'long a put' of the underlying asset, and they are hoping that the price of the underlying asset in the market will fall below the strike price.

Example

Strike – £7.00
Premium –£0.50
Expiry – June 2026

This time, the investor has the right to sell 1,000 shares at £7.00. If the price falls to less than £7.00, the investor should exercise the option. If they do so, they can sell the shares at £7.00 and buy them back at a lower price in the market and make a profit. If the price rises above £7.00, the investor will not exercise the option (it is more beneficial to sell the shares at the higher market price than it is to sell them at £7.00 under the option agreement) and will, therefore, forfeit the premium.

Buying put options is a bearish strategy. The investor hopes that the price will fall. The writer of the option is hoping for the opposite. If the price rises, the writer of the option will choose to do nothing and can keep the premium, because as we have seen above, the investor will choose to sell the shares in the market because they can get a higher price for them there.

Selling a Put Option

Selling a put option is, therefore, a bullish strategy.

Risks and Returns

Put Options		
	Maximum Profit	**Maximum Loss**
Writer	Premium	Strike price less premium
Holder	Strike price less premium	Premium

The buyer of a put option can only make a limited profit. The price can, at worst, only fall to zero.

The maximum that the writer can lose is the flip side of the holder's position; in other words, the maximum profit that the writer can make is the premium.

Example (continued)

Continuing with our example, if the price fell to zero, then the investor could sell the shares to the writer of the option for £7.00. They will have paid £0.50 per share premium.

The maximum profit they can make is £7.00 – £0.50 = £6.50. As before, the maximum that the holder can lose is the premium.

In this case, the writer will need to purchase the shares for a maximum price of £7.00, against which they can offset the premium that they have received.

7.8 Features of Exchange-Traded Options on Individual Securities and Indices

Note that the following sections refer only to exchange-traded options. They are similar to futures in that to ensure maximum liquidity in the market, the terms are standardised. For example, with the share traded options that we have already looked at, each option is for 1,000 shares.

The table below compares and contrasts the differences between equity and index-based traded options in the UK:

Equities	Indices
Each stock has a predetermined expiry date based on quarterly cycles (March, June, September and December). A number of expiry dates are available at any one time, allowing the investor some choice with regard to maturity.	Index options are available for monthly expiry dates for the first three months, and then continue in quarterly cycles to 24 months.
Equity options are physically settled.	There is no physical underlying asset that can be delivered.

Equities	Indices
Available on ICE Futures Europe on just under 100 leading stocks.	Available on ICE Futures Europe, FTSE 100 Index options and FTSE Index Flex Options.
The expiry date of many equity options is American-style.	Many broad-based equity indices are European-style.
Pricing (the premium) is quoted in pence per share. If the premium is quoted as 15p, it will need to be multiplied by 1,000 to work out the total premium cost of the option.	The amount paid under an index option is £10 per index point (tick size 0.5 points; tick value £5).
A range of exercise prices are available for each option, with different prices quoted for each.	A range of exercise prices are available for each option, with different prices quoted for each.
Holders of call options over an individual company's shares are not entitled to any dividend on that company's shares unless the option is exercised prior to the share going ex-dividend.	Index options do not pay dividends.

7.9 The Effect and Treatment of Bonus Issues, Rights Issues and Dividends in the Underlying Security

Learning Outcome

5.7.4 The effect of and treatment of bonus issues, rights and dividends in the underlying security

7.9.1 Bonus Issues

As we have already seen, an investor with a traded option has the right to be able to buy or sell 1,000 shares per single option contract. If a company announces a bonus issue, the terms of any pre-existing traded options will be adjusted to reflect the increased number of shares per issue.

Example

A company announces a one-for-one bonus issue. For existing shareholders, this will have the effect of doubling the number of shares that each shareholder owns and in theory, halving the price. Any pre-existing traded option is adjusted in the same way, *pro rata* the issue.

The terms of the original call option that we looked at will, therefore, change from:

Number of shares – 1,000
Strike – £7.00
Premium –£0.50
Expiry – June 2025

to:

Number of shares – 2,000
Strike – £3.50
Premium – £0.25
Expiry – June 2025

7.9.2 Rights Issues

If a company announces a rights issue, the terms of an existing option contract will be adjusted to reflect the rights issue. As above, this will result in changes to the number of shares, the exercise price and the premium.

7.9.3 Dividends

If the buyer under a call option exercises an option during the 'cum-div' trading period, they will be entitled to the dividend payment on those shares. If they exercise the option during the 'ex-div' period, they will not be entitled to the dividend payment on those shares.

7.10 Warrants

Learning Outcome

5.7.2 Terms and timescales of different kinds of traded options and warrants

5.7.5 Features of UK company warrants

5.7.6 Features of covered warrants on individual securities and indices

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A warrant is a security issued by a company that gives the holder the right (but not the obligation) to buy new shares in that company, at a fixed price, on a fixed future date.

Warrants can be issued on a standalone basis, but tend to be issued together with other instruments (such as bonds) as a sweetener to the deal, to tempt investors to buy the bonds.

In reading their description, you might think that they are very like call options. They are, but there are a number of important differences:

- Warrants are issued by the company itself and if exercised, the company issues new shares. The exercise of a call option results in the purchase of existing shares in the market.
- Warrants tend to be much longer dated than call options. When issued, the expiry date is likely to be many years in the future, whereas call options are available for expiry dates of the next three quarters (ie, a maximum of nine months).
- Warrants are traded on a stock exchange in much the same way as shares, whereas call options are traded on a futures exchange.

7.10.1 The Features of Covered Warrants on Individual Securities and Indices

Like an option, a **covered warrant** will give an investor the right (but not the obligation) to buy or sell an underlying asset at a specified price on or before a pre-specified date.

Covered warrants can be issued, not only over shares and a range of indices, but also over popular shares in other markets, commodities, exchange rates, baskets of investments and many other types of underlying asset. For the purposes of your exam, however, you will need to concentrate on covered warrants for shares and indices.

Much of the jargon around the use of covered warrants is the same as for options, and they too are issued in the form of call (investor can buy the asset) and put (investor can sell the asset) warrants.

They are, in effect, securitised derivatives issued by highly regarded financial institutions. In plain English, this means that financial institutions issue call or put options and cover themselves against exercise by purchasing or selling the underlying asset at the same time.

Example

A company issues a covered call warrant allowing the purchaser the right to buy 1,000 XYZ plc ordinary shares at $1.85. (Warrants are always issued with a strike price set (well) above the current market price at the time of issue.)

The issuer wants to make sure that it does not lose a fortune on the XYZ plc warrant, so at the same time, it goes out into the market and purchases an equivalent number of XYZ plc shares at $1.65 to hedge their position (they 'cover' their position).

In a year's time, the price of XYZ plc shares has risen to $2.00.

The investor will benefit from the price rise, as the shares are trading above the strike price of $1.85, so they are in profit. The issuer will also benefit from the price rising from $1.65 (cost of hedge) to $2.00. Although it will have to pass $0.15 per share profit on to the investor, it is still well up on the trade.

A covered warrant market had been around in many other countries across the world since 1985. In the UK, they were introduced in 2002, when the London Stock Exchange (LSE) launched a service allowing them to be bought and sold on the exchange in a similar way to equities.

Company Issued Warrants	Covered Warrants
Issued by companies.	Issued by financial institutions.
Exercise results in the issue of new shares.	Exercise results in cash settlement.
Stamp duty/SDRT is payable.	No stamp duty/SDRT is payable.
Market can be illiquid.	More liquid market.

7.10.2 Cover Ratio

Traditional company warrants tend (but do not have) to be issued with a ratio of one for one, ie, one warrant entitles the holder to one share in the company.

In the covered warrant market, this is not the case. It may require many warrants to give entitlement to one share. This is expressed in terms of the 'cover ratio'. If 25 covered warrants are exercisable into one share, then the cover ratio is 25:1.

If the share is particularly expensive, it can make the covered warrants look expensive. Using a cover ratio brings the price of each individual warrant down to an easily tradable and marketable level.

The cover ratio is of particular note when trading index-covered warrants. The value of a whole index will be very expensive, resulting in expensive covered warrants. No issuer has issued a covered warrant on a one for one basis. The ratio may be as low as ten or could be as high as 500.

7.10.3 Features/Contrast of Warrants with Options

- As with the company-issued version, covered warrants are securities traded on a stock exchange. The market is transparent and liquid.
- The covered warrant market can be accessed through a stockbroker.
- Covered warrants have a typical lifespan of between one and eighteen months, which is much longer than a typical traded option.
- Dealing commissions are payable in the same way as they are with shares.
- The spread (the difference between the buying and selling price) is usually tighter than it is for a similar option.
- A purchaser of covered warrants never actually owns the shares, so stamp duty and SDRT are not payable, dividends are never payable, and the purchaser will never acquire any voting rights.
- They are targeted at retail investors.
- They provide a way for retail investors to benefit when stock markets are falling.
- They are high-risk, leveraged products, but the maximum the investor can lose is the amount of money originally invested.
- There are different types of covered warrant available, eg, basket, barrier, capped, corridor.
- Covered warrants are issued on shares that are already in existence, not new shares.
- Prices can be volatile, with a small change in share price causing a substantial decline in the value of a covered warrant.
- Covered warrants can only be cash-settled.
- They are available in American, European, Asian and Bermudan styles.

7.10.4 Valuation and Quotation of Traded Options and Warrants

Learning Outcome

5.7.3 Valuation and quotation of traded options and warrants

If you know what goes into an option's and warrant's price, you will be better positioned to work out whether it represents good value. A 50p warrant, for example, can be expensive compared to a £1.00 warrant.

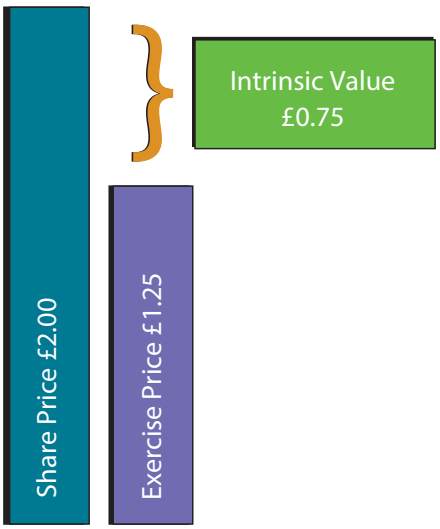
This is because there are a number of factors that influence the price of an option and covered warrant, including:

- the price differential between the strike (exercise) price and the current market price
- supply and demand, and
- the time until **expiry**.

To analyse the price, the first thing to do is to consider the differential between the strike price and the current market price. This is called the 'intrinsic value' (also known as the 'formula value' in the context of warrants) and measures the immediate profit that an investor would make, if they exercised the option or warrant (ignoring costs).

The cost (premium) of an option or warrant is split into two parts:

$$\text{Premium} = \text{Intrinsic value (IV)} + \text{Time value (TV)}$$



Any premium over and above the IV is TV and accounts for other factors.

8. Unit Trusts and Open-Ended Investment Companies (OEICs)

Learning Outcome

5.8.1 Similarities and differences

5.8.2 Types of fund, pricing, charging structures, separation of management and ownership, dealing and settlement, tax treatment

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In this section, we examine the two most commonly used collective investment schemes (CISs): unit trusts and **open-ended investment companies (OEICs)**. Please also bear in mind that OEICs are often referred to as ICVCs (investment companies with variable capital), as this is a direct translation of the European equivalent SICAV (Sociétés d'Investissement à Capital Variable), in order to make them recognisable to a European client; and mutual funds, in particular in the US.

While both units trusts and OEICs allow investors to pool investments in the same way, there are differences that reflect the development of the CIS industry over the past few decades. Being able to recognise and articulate these differences is important in the context of private client advice.

Broadly, most unit trusts and OEICs have two unit classes:

- **income** (or inc, where all income produced by the underlying investments is paid out to the unitholder/shareholder on a regular basis), and/or
- **accumulation** (or acc, where income is instead reinvested within the fund).

Note that distributions for both accumulation and **income units** are liable for income tax at the investor's marginal rate, even if they are accumulated.

If the unit trust/OEIC is more than 60% invested in fixed-income securities, then distributions are taxed as interest; otherwise, if less than 60%, they are taxed as dividends.

8.1 Classification of Collective Investment Schemes (CISs)

In the UK, the FCA rules on the operation of a CIS are covered in the specialist sourcebook Collective Investment Schemes (COLL). Here, the FCA does not make a distinction between unit trusts and OEICs. Instead, it classifies funds into one of three categories: UCITS schemes, non-UCITS retail schemes (NURS), and qualified investor schemes (QISs).

8.1.1 UCITS Schemes

These are funds that comply with the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive rules, and are designed for retail investors. From the product provider's perspective, the principal advantage of being a UCITS fund is that they are able to market the fund within the European Economic Area (EEA) without the need for further approval – a process known as 'passporting'.

When the UK was still a member of the EU, UK-domiciled UCITS funds were eligible for passporting and vice versa. However, with the end of the Brexit transition period with the EU on 31 December 2020 and subsequent expiry of temporary permissions (put in place to enable a smooth transition), so too did their passporting rights. EU-domiciled firms that wish to continue operating in the UK must obtain prior authorisation to do so.

For UK firms, the extent that they may continue providing services to EEA-based customers depends on local law and regulators' expectations, and the FCA expects UK firms to take steps to ensure they act consistently within those laws and expectations.

Other basic features of a UCITS fund include the following:

- Investors have access to a simplified prospectus.
- Can be sophisticated or non-sophisticated:
  - **Non-sophisticated** – can continue to operate using the same portfolio structure as traditional long-only funds, consisting primarily of physical assets such as equities and bonds.
  - **Sophisticated** – have access to a range of other collectives, eg, index funds and exchange-traded funds (ETFs), and fund managers can adopt new strategies to enhance their portfolios. This includes long/short strategies, hedging and derivative strategies. While physical **short selling** is not permitted within a UCITS fund, shorting is achieved through the use of derivatives, creating a synthetic short position.
    An example of this is a 130/30 fund where the fund can go short up to 30% of the value of the portfolio to go long with. This means that 130% is available to go long with. Another example of a UCITS fund is absolute return funds, which use a variety of hedging strategies in an attempt to produce a positive return in any market condition.

8.1.2 Non-UCITS Retail Schemes (NURSs)

NURSs are funds that do not comply with UCITS rules (eg, hedge funds, private equity firms and property funds), although they are still subject to the same level of investor protection and can be marketed to UK retail investors. NURSs can invest in a broad range of eligible investments (eg, real estate), and borrowing rules are less restrictive.

NURS managers are subject to the Alternative Investment Fund Managers Directive (AIFMD) – while the AIFMD is a piece of EU legislation, it has since been transposed into UK law so continues to apply in the UK post Brexit. The AIFMD provides a regulatory framework for NURS managers, with the aim of preventing market instability and improving investor protection (eg, by enhancing transparency through disclosure rules and mandatory reporting to competent authorities).

NURSs have wider investment powers such that they are excluded from UCITS qualification, but they are still aimed at retail investors. NURS managers must provide UK investors with clear and prominent information on liquidity risks to ensure that investors are adequately protected under circumstances in which access to their funds may be restricted. These measures aim to place additional obligations on NURS managers to manage liquidity risk, and to reduce the likelihood of a 'fire sale' of assets that disadvantages investors should there be a run on the fund.

AIFMs, UCITS and MiFID firms are also required to consider sustainability risks and factors in the management of investment funds and in the investment advice process.

8.1.3 Qualified Investor Schemes (QISs)

QISs are designed for more sophisticated investors, rather than retail investors; however, this does not mean that they will only have professional clients investing in them. These schemes are often created for substantial private clients, charities and family trusts.

Unit trust and OEIC structures could be used to create any of these categories.

8.2 Unit Trusts

Unit trusts are defined as trusts and have trustees who are ultimately responsible for safeguarding both the assets and cash of the investors (known as beneficial owners).

8.2.1 Unit Trust Structure

In the UK, Section 237 of FSMA recognises unit trusts as CISs created by a trust deed entered into by the fund manager and the trustee who must be independent of one another. Unit trust holders have a direct beneficial interest in the unit trust's portfolio of investments. The unit trust itself does not have a separate legal personality, so cannot be sued in its own name. The trustee undertakes all its actions on its behalf.

8.2.2 Dual Pricing

The most common form of unit trust pricing is dual pricing or bid/offer.

Price: Cancellation of Units

Bid value of all shares within the portfolio	−	Fees/charges for selling fund holdings	+	Any cash being held within the portfolio (including dividends received)	÷	Number of units in issue

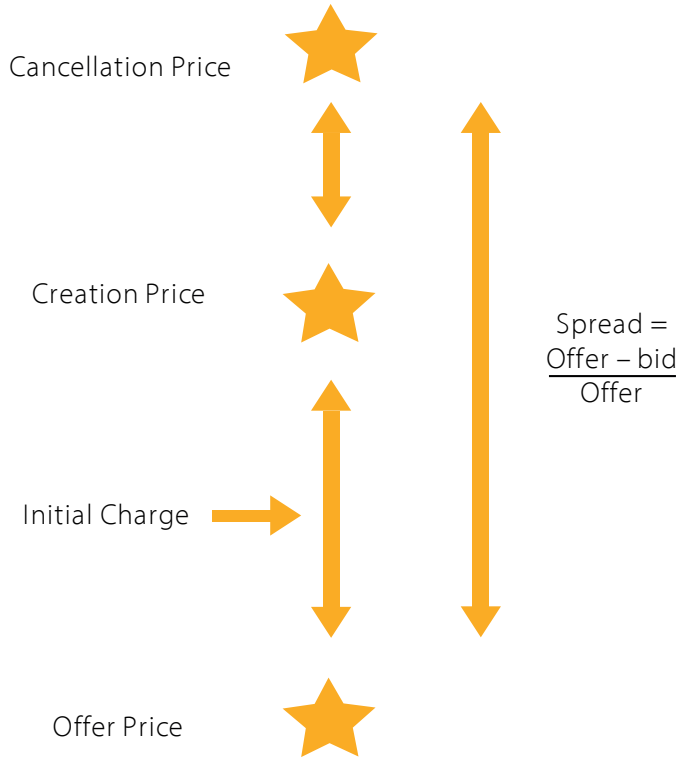
= True Bid Price or Cancellation (ie, the price paid to the trustees to cancel the units).

Price: Creation of Units

Offer value of all shares within the portfolio	+	Fees/charges for buying fund holdings stamp duty + stamp duty	+	Any cash being held within the portfolio (inc. dividends received)	÷	Number of units in issue

= Creation Price (ie, the price paid to the trustee to create units).

Creation Price + Initial Charge = Full offer price

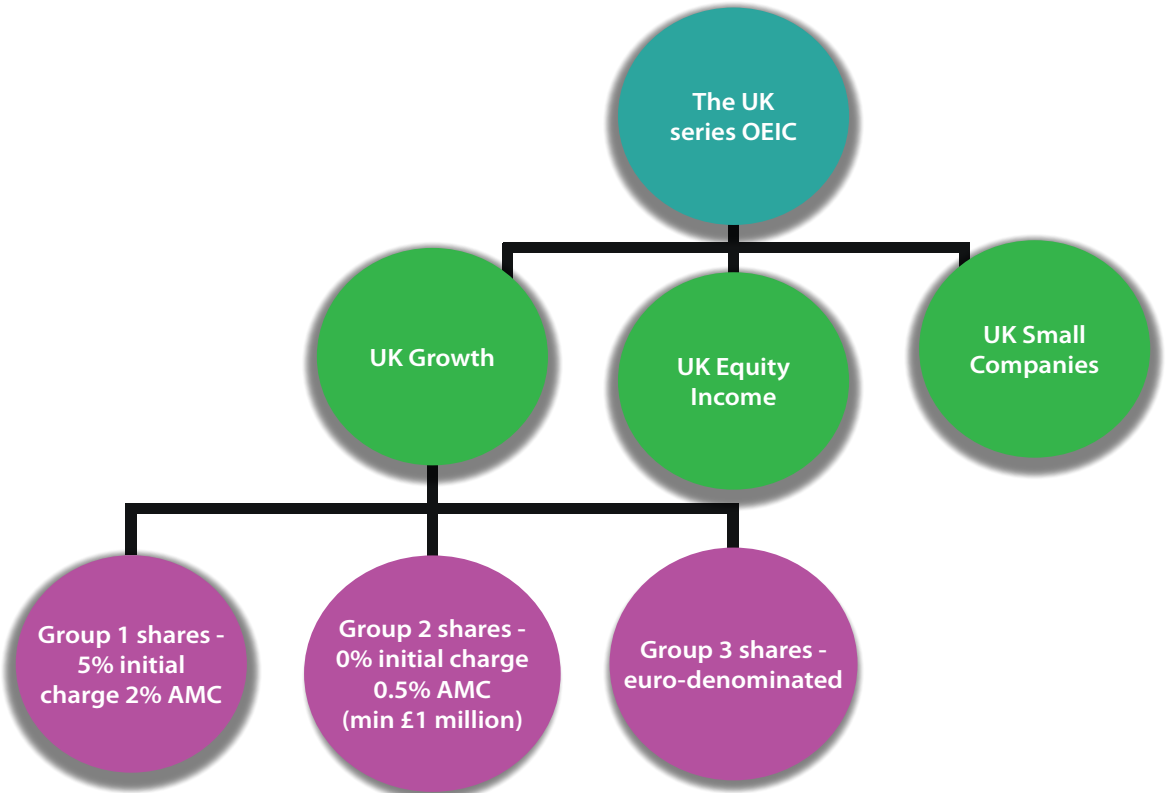


8.3 Open-Ended Investment Companies (OEICs)

8.3.1 The OEIC Structure

In the UK, the OEIC structure is empowered by Section 262 of FSMA 2000 and is a corporate body; hence, it issues shares and not units. This company must have at least one director referred to as the authorised corporate director (ACD). The OEIC then appoints a depository to hold the scheme's assets and provide oversight. Unlike unit trusts, it has no direct beneficiaries, but shareholders (ie, investors). As a legal entity, it can be sued.

The real flexibility with an OEIC structure comes from its ability to create a holding with a number of sub-funds beneath it. Each sub-fund can then create as many share classes as it wishes, and this is normally done to suit the investor profile and needs.



It is cheaper and quicker to set up a new sub-fund and/or share class under this structure compared to the establishment of a new unit trust with its own trust deed. However, as mentioned before, unit trusts can establish new unit classes in a similar way to OEIC share classes.

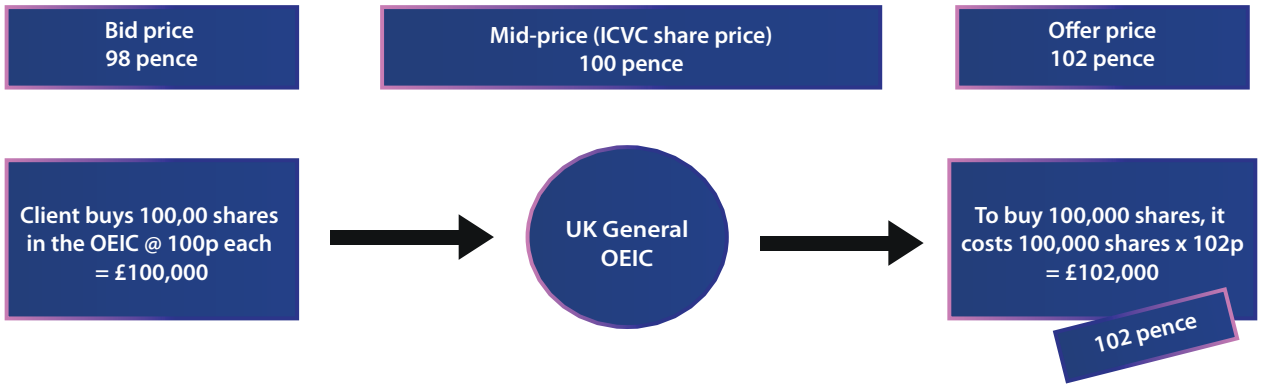
8.3.2 Single Pricing

In the UK, under FCA rules, OEICs can choose to be dual priced. By nature, single pricing is quite straightforward; that is, until there are more sellers than buyers (or vice versa), which will need to be reflected in the pricing basis (ie, bid or offer valuation).

Put simply:

- Single pricing: mid-market value of the underlying investments.
- Charges to clients are not quoted in this price.
- The price for buying or selling a share at any point in time will be the same:
  - 100 shares x £10.00 = £1,000
  - Initial charge of 2% = £20
  - Total = £1,020

However, by allowing all buyers and sellers to use this price, problems could arise. If there are net buyers or sellers of shares, this type of pricing may disadvantage the fund. The following example shows the problem and the resolution used by most OEIC managers:



1 million shares @ 100p = £1,000,000
based on value of underlying shares

This is an example of **dilution** adjustment or single swinging price. Obviously, the fund has been moved on to an offer valuation and everyone will be using this price. The manager does not have to make this public, but must inform investors if they ask. In reality, most managers will be swinging the price of smaller funds on a frequent basis. The alternative is a **dilution levy** applied only to larger investors, which can prove very unpopular with investors.

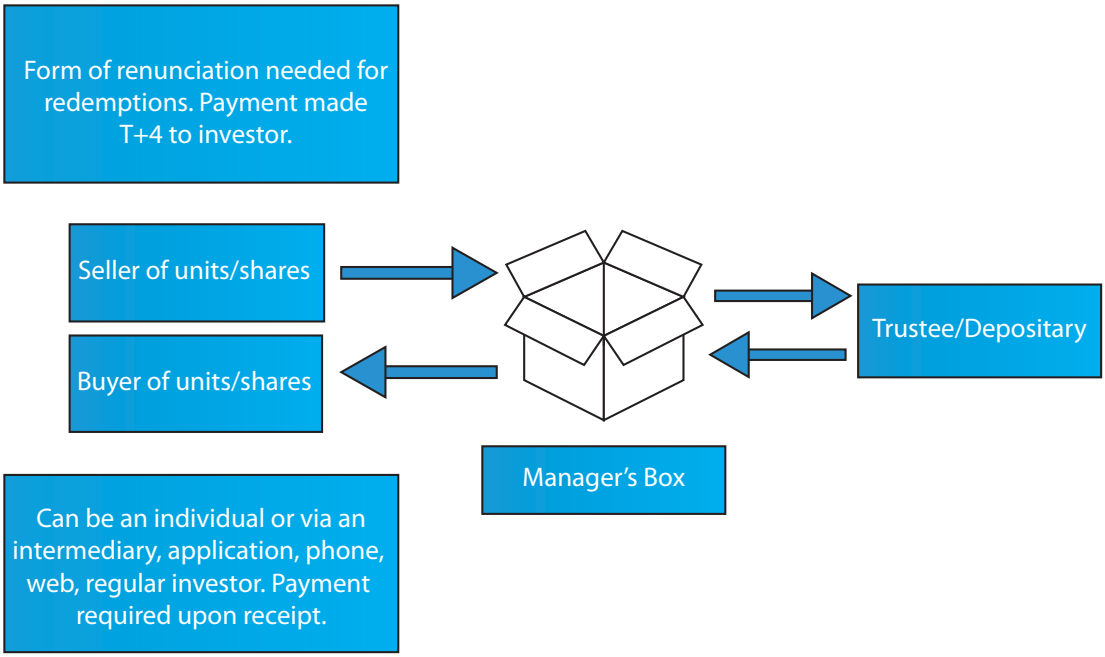
In the case of both dual and single pricing, there is the capacity to include the **initial charge** for buying new units or shares. The **annual management charge** or fee (AMC or AMF) is taken daily from the funds, as a figure calculated on the net asset value (NAV).

8.4 Separation of Management

For unit trusts and OEICs, the different entities involved in the management of the unit trust/OEIC have distinct roles and responsibilities. This separation of roles helps to maintain transparency, accountability, and investor protection within the relevant structure. This also reduces potential conflicts of interest and operational risks and provides a system of checks and balances to ensure that the management of the unit trust/OEIC is conducted in a professional and regulated manner.

Unit Trust	OEIC
• **Fund manager** – responsible for making investment decisions on behalf of the unit trust, conducting research and analysis, executing trades, and monitoring performance. • **Trustee** – acts in a fiduciary capacity to safeguard the interests of the unit trust investors. They are responsible for ensuring compliance with the unit trust's governing documents, for protecting the assets of the unit trust, and verifying that the fund manager operates within the regulatory framework. • **Custodian** – responsible for the safekeeping of the unit trust assets (eg, protecting from loss or theft), and segregated from the assets of the fund manager and the custodian itself.	• **Authorised corporate director (ACD)** – responsible for making investment decisions and managing the portfolio of securities held by the OEIC. They analyse market conditions, conduct research, and make investment choices based on the fund's investment objectives. • **Board of directors** – responsible for overseeing the overall management and operations of the company. They represent the interest of the shareholders and ensure compliance with relevant regulations. • **Depositary** – responsible for the safekeeping of the OEIC's assets. They also ensure that the assets are held separately from those of the ACD. • **Administrator** – responsible for the day-to-day operations of the OEIC (eg, maintaining shareholder records, and calculating the daily NAV).

8.5 Dealing and Settlement



8.6 Tax Treatment of Unit Trusts and OEICs

8.6.1 Income

Income received from a unit trust or OEIC is subject to corporation tax which, for 2025–26, is 20%.

Exceptions to this are certain types of bond funds and gross funds, such as common investment funds (CIFs) and charity authorised investment funds (CAIFs). CIFs and CAIFs are both pooled investment vehicles that have been specifically set up for charities, and they have benefits relating to tax (eg, management fees are VAT exempt, resulting in a reduced OCF to all investors), among other advantages.

UK dividend income is received by the funds as franked investment income. The dividends, therefore, flow through to dividends payable by the fund with no further tax liability, making them a transparent investment for tax purposes.

Where foreign dividends are received, they are subject to corporation tax at 19%. Funds can use the UK's comprehensive range of double tax treaties to eliminate or reduce the effect of overseas WHT on income at the fund level.

An optional tax structure for authorised investment funds (AIFs), known as the Tax Elected Funds (TEF) Regime, allows funds to elect to divide distributions into two parts:

- UK dividend, and
- non-dividend income

thus making them more tax efficient.

To be a TEF, they must meet certain conditions, and their application into the TEF regime approved by HMRC.

For investors, UK and foreign dividend income is distributed to the investor as a distribution:

- Funds that are at least 60% invested in fixed-interest securities are taxed as interest. Eligible individuals have the personal savings allowance (PSA), sums above which will be taxed at 20%, 40% and 45% for basic, higher and additional rate taxpayers respectively.
- Funds with less than 60% invested in fixed-interest securities are taxed as dividends. The dividend allowance is available for individual investors, sums above which will be taxed at 8.75% for basic rate taxpayers, 33.75% for higher rate taxpayers and 39.35% for additional rate taxpayers.

See chapter 2, section 3.2 for more information on income tax rates and bands. Unless held within a tax-efficient wrapper, the investor's tax treatment of distributions from UK-authorised funds is the same as when directly holding the underlying bonds and equities.

8.6.2 Capital Gains

Authorised unit trusts (AUTs; ie, a unit trust that has been authorised by the FCA and must conform to FCA regulations) and OEICs are exempt from tax on the gains made within their portfolios. For investors, gains on a fund are subject to a capital gains tax (CGT) rate of 18% and 24% for basic and higher/additional rate taxpayers, respectively. This is mitigated by the CGT allowance – see chapter 2, section 4.2.

Dealings by UK funds in shares are generally subject to stamp duty or stamp duty reserve tax (SDRT). Additionally, when an investor buys units/shares in a unit trust or OEIC, those trades are not subject to stamp duty or SDRT.

8.7 Types of Funds

The Investment Association (IA)[9] is a trade body representing 99% of fund providers in the UK. It has produced a classification system for unit trusts, OEICs and ETFs – all funds have been categorised into the following four main groupings, in order to help all advisers and clients measure how their fund is performing:

1. **Growth funds** – these are predominantly equity-like in character. The securities offer the potential for growth through capital price appreciation. Geographically, the regional focus of the securities selected in the funds cover the UK, Japan, Asia Pacific, China, North America, Europe and other equity markets. Under a mixed asset fund category, the sector classification allows for a series of **mixed investments**.
2. **Income funds** – these are separated into fixed-income, equity and mixed asset classes.
   - Fixed-income includes government, corporate and high-yield bonds, as well as emerging market debt and specialist bonds, and strategic bonds (ie, flexibility to invest across a range of bond types).
   - Under equity wrappers, both UK equity income and global equity income securities are listed.
   - Mixed assets have both bonds and equities from the above lists.
   - Income funds are intended to produce income from dividends and interest distributions from these securities. A common feature of this class of funds is that the bulk of the total return is offered via the income component, and the capital appreciation component of the return is minimised.
3. **Capital protection** – these include money markets, short-term money markets, and protected funds. They are designed to offer the lowest risk and to protect investor capital.
4. **Specialist funds** – these include targeted absolute return, property (UK direct and 'other'), commodities and natural resources, financials and financial innovation, healthcare, infrastructure, and technology and technology innovations. They are intended to strategically focus investment on a particular country, region or industry.

The IA defines these groupings as fund 'sectors' but should be distinguished from sectors/industries when investing in equities. For all of these fund sectors (categories), derivatives may be used, but they should be within the 'spirit' of the stated objectives or restrictions (ie, they should not lead to the fund being exposed to areas of the market outside their set limits).

9 The Investment Association. Fund sector definitions. Retrieved from https://www.theia.org/industry-data/fund-sectors/definitions (Accessed: October 2025)

Within the specified IA fund categories, there are the following types of funds for which there is not a separate classification:

- **Index-tracking funds** which track a share index such as the FTSE 100 Index rather than being actively managed by fund managers.
- **Ethical, responsible and sustainable funds** which aim to satisfy the criteria of some investors who wish to consider the moral implications of their investments, as well as returns. This may include choosing which firms to invest in as well as those they choose to avoid, or underweighting investment in firms involved in certain activities. See chapter 6, section 9.3 for further detail.

In response to the increasing priority of ethical, sustainable and responsible funds for investors, in 2019, the IA published its Responsible Investment Framework[10]. This framework revised and reorganised the IA's definitions of ESG funds to be more aligned with the **Global Sustainable Investment Alliance (GSIA)**, with the aim of helping investors to better understand the projects they are investing in which, in turn, should enable them to achieve their goals financially, environmentally and socially.

For example, the term 'sustainable' (which could be used to refer to environmentally, socially or economically sustainable goals) has been replaced with 'responsible' when referring to firm- and fund-level approaches including stewardship and ESG integration.

Candidates may want to visit websites such as Trustnet for a full list of sectors and constituents, and the IA website for sector updates.



How would you expect to use the sector categories when discussing performance with a private client? By looking at the sector, you will be able to see how many similar funds there are. Depending on where the fund manager and provider ranked, you will need to decide if this is satisfactory and meets the client's expectations as you know them. The following are some questions that you might often ask:

- How does this compare to others?
- How does this compare to the fund's own benchmarks?
- What is the fund manager's comment on this performance, and are there specific reasons for underperformance or overperformance?

8.7.1 The SFDR and the SDR

While the IA and the AIC do not classify funds from a sustainability perspective, initiatives are being (or have been) developed to ensure greater transparency and accountability in this area, in order to mitigate the risk of misleading claims.

In recent years, there has been a notable shift in investor priorities towards **responsible and sustainable investing**, which has driven demand for products that focus on ESG criteria. However, this surge in demand has heightened concerns about greenwashing (whereby firms might exaggerate or misrepresent their environmental credentials for marketing purposes), among other types of 'washing'.

10 The Investment Association, 2019. Responsible Investment Framework. Retrieved from https://www.theia.org/sites/default/files/2019-11/20191118-iaresponsibleinvestmentframeworkbrief.pdf (Accessed: October 2025)

The EU's **Sustainable Finance Disclosure Regulation (SFDR)** is the first product labelling regulation of its kind. Introduced in 2019, but not fully enacted until 2021, the SFDR is a piece of legislation that requires all fund managers, **financial advisers** and certain other regulated firms in the EU, as well as those offering products to EU investors, to provide prescript and standardised disclosures on how they integrate ESG factors at the organisation and product level.

Funds under the SFDR must classify themselves as Article 6, 8 or 9 based on their approach to integrating ESG factors:

- Article 6 funds disclose how sustainability risks are incorporated into their investment decisions, even if they do not specifically pursue sustainability objectives.
- Article 8 funds promote environmental or social characteristics, and must substantiate their claims with clear, transparent criteria.
- Article 9 funds aim for sustainable investments as their core objective, requiring detailed disclosures on how they achieve and measure these goals.

In doing so, the SFDR aims to create a level playing field and increase transparency, such that investors can easily compare the sustainability performance of different products and make more informed investment choices.

Many other territories are planning or have already implemented their own versions of this legislation; while the rules will differ in detail for each, they will likely be very much the same overall.

For example, while the UK is not signed up to the EU's SFDR (as it came into effect after the end of the UK's Brexit transition period with the EU), it has developed its own **Sustainability Disclosure Requirements (SDR)**, which came into effect from July 2024. The SDR requires investment products within its scope – ie, those that are marketed to retail investors in the UK, and that use certain sustainability-related terms in their product name and marketing materials (such as 'ESG', 'climate', 'sustainable' and 'impact') – to display a label reflecting their sustainability characteristics: 'sustainability impact', 'sustainability focus', 'sustainability improvers' and 'mixed goals'. If a product does not meet the qualifying criteria, then it will not be able to use these labels, nor use one these terms in its product name or marketing materials.

Investment products that do not use any of these terms in their product name or marketing materials, may voluntarily apply one of the four labels – again, this is provided that they reflect their sustainability characteristics. Where any product misuses a label, makes misleading disclosures and/or ignores the requirement to make the necessary disclosures, then the FCA has the authority to take enforcement action, including financial penalties and sanctions.

From this, we can see that the SFDR and the SDR have several key differences. For example, the SFDR establishes a hierarchical framework, and compliance is mandatory for all fund managers and financial advisers operating within the EU or offering products to EU investors. In contrast, the UK's SDR is more flexible and voluntary: it does not impose a hierarchical classification, and its voluntary nature gives UK fund managers more discretion in how they label and disclose their products' sustainability features.

The SDR also introduced an anti-greenwashing rule, effective from 31 May 2024, which requires all regulated firms to ensure that their sustainability-related claims in all marketing materials and communications are clear, fair and not misleading. Other components of the SDR regime came into force in stages from 31 July 2024.

As well as allowing consumers to make better informed decisions, by ensuring that environmental labels and claims are credible and trustworthy, the new law also aims to boost the competitiveness of businesses that are striving to increase the environmental sustainability of their products and services.

9. Exchange-Traded Funds (ETFs)

Learning Outcome

5.9.1 Features, including types of fund, pricing, charging structures, dealing and settlement, tax treatment

5.9.2 Comparison with other types of products

The first ETFs were established in the 1990s to rival index tracker funds that were launched in the 1960s and 1970s (initially in the US). Like index trackers, ETFs can similarly mirror market indices, but via a share rather than a fund; and notably, they have several advantages over index-tracker funds.

An ETF is an **open-ended fund**, many of which are designed to track the performance of a specific market index and deliver the performance of the underlying index with minimal **tracking error**. Some ETFs are actively managed, but the majority are passives.

They represent a natural evolution of investment funds by combining the benefits of traditional CISs with the ease and efficiency of holding and trading shares, making these vehicles more liquid and easier to trade in and out of than the traditional OEIC. This liquidity is provided by market makers to trade (buy and sell) the ETF during each trading day.

The legal structure of an ETF varies between jurisdictions. In the US, many ETFs are structured as unit trust investment funds; while in Europe, ETFs can be seen as OEICs in the UK and Ireland, and SICAVs and *Fonds Commun de Placement* (FCP; a type of open-ended collective investment fund, similar to a SICAV) in Luxembourg. The underlying structures they adopt, therefore, follow along traditional CIS lines. In the EU, many ETFs are structured as UCITS funds and are domiciled in either Dublin or Luxembourg so that they can be marketed cross-border.

ETFs can grow and shrink in accordance with investor demand; however, the creation and redemption processes are significantly different from traditional mutual CISs. This process takes place in the primary market while the investor buys and sells the shares in the secondary market. This is its major differentiating feature, namely that ETFs are listed and traded on a stock exchange, and are cleared and settled as with any other equity trade. Like other listed stocks, they are held in a central securities depository (CSD), with clearing and settlement taking place using exactly the same market mechanisms as for any other equity trade.

Market makers quote two-way prices on the ETF, giving investors the ability to trade the ETF at any time that the market is open rather than at a set daily price. An ETF trades at prices very close to its NAV and is not subject to the issue of trading at a discount that is seen with investment trusts and closed end funds.

That said, due to changes in supply and demand for an ETF at any single point in time, an ETF's price may deviate from its NAV. For example, if the ETF is in high demand with low supply, its price will typically exceed the NAV. Conversely, the NAV will generally be higher if the ETF has a high supply with little demand.

ETFs have no initial fees and typically have a lower total expense ratio than similar index funds, but it should be remembered that the investor will have to pay brokerage charges each time they trade. These features, along with low costs, have made ETFs one of the fastest growing types of CIS worldwide.

9.1 Structure and Objectives

ETFs are open-ended funds that are traded on a stock exchange. They replicate a very wide range of indices, investing in everything from shares and property to more exotic asset classes such as private equity, commodities and infrastructure; as well as those aiming to track the performance of indices comprising companies that have been screened for ethical, responsible and sustainable criteria. By trading a single share, users can effectively gain access to an entire index without the burden of investing in each of the constituent stocks, making ETFs a highly efficient and cost-effective investment tool.

A broad range of ETFs are available that track indices across various asset classes including equities, bonds, commodities and property, as well as a variety of industries/sectors (eg, technology, healthcare, infrastructure, energy and water) and niche and specialised areas (eg, lithium and battery technology). They can also focus on specific strategies – for example, a focus on higher dividend-paying companies in a particular stock market index, or sustainable investing. Thus, ETFs can cater to both broad and specialised investment interests.

9.2 Types of ETFs

For each of the below types of ETF, there are two main structures:

- **Physical ETFs** aim to track an index by investing in all, or a representative sample of, the constituents of that index. In doing so, they tend to have a low tracking error.
- **Synthetic ETFs** instead use derivatives, such as futures or swaps, to execute their investment strategy. In turn, this provides a solution for investors to invest in markets that may be harder to access or are less liquid, as well as other strategies that may otherwise have been very difficult or costly for physical ETFs to track. Many commodity ETFs are synthetic.

However, investors need to be aware that derivative vehicles (which are agreements between the ETF and one or more counterparties, usually an investment bank) carry counterparty risk – in other words, the risk that the counterparty will not live up to its contractual obligations, in which case investors risk incurring a loss. This risk may be reduced by entering into agreements with multiple counterparties, although it will never be fully eliminated (in fact, under UCITS rules, funds' exposure to any swap counterparty is limited to a maximum of 10% of NAV at any time).

9.2.1 Index ETFs

Index ETFs hold securities and attempt to replicate the performance of a stock market index. An index fund seeks to track the performance of an index by holding in its portfolio either the contents of the index or a representative sample of the securities in the index.

9.2.2 Commodity ETFs and Exchange-Traded Commodities (ETCs)

ETCs aim to track the performance of an underlying commodity or basket of commodities.

ETCs and commodity ETFs are both traded on the stock exchange. While the terms 'commodity ETF' and 'ETC' are used interchangeably, there are structural differences between the two:

- ETCs typically track one single commodity or commodity index. They allow smaller investors to gain exposure to specific commodities that may typically be difficult to access, particularly without buying futures and options (which are more complicated instruments) or the physical commodity. Thus, ETCs have a share price that moves with the spot or futures price of the underlying commodity.
- In contrast, commodity ETFs enable investors to gain exposure to different commodities or baskets of commodities. To do so, they either buy and sell the underlying commodities that the ETF is aiming to track, futures contracts on the underlying commodities, or the shares of commodity companies.

9.2.3 Bond ETFs

Bond ETFs invest in various fixed-income sectors across a range of credit qualities, maturities and durations.

9.2.4 Currency ETFs

The first ever currency ETF was launched in 2005, called the Euro Currency Trust New York. Since then, others have been issued, tracking all major currencies, both long and short different currency crosses.

9.2.5 Actively Managed ETFs

These ETFs use a custom or dynamic index and then construct a portfolio which tracks that index. Because these ETFs use a frequently changing or proprietary benchmark, rather than a major well-known index, this means they are active, as opposed to traditional ETFs which are passive. Publishing their current securities portfolios on their websites daily, these funds are at risk from arbitrage activities by market participants who might choose to front-run their trades.

9.2.6 Hedge Fund ETFs

A hedge fund ETF tracks an index based on a basket of hedge funds.

9.2.7 Leveraged ETFs

A leveraged ETF is a special type of ETF that attempts to achieve returns that are more sensitive to market movements than a non-leveraged ETF. These usually provide exposure at two or three times (ie, 2x or 3x funds) the underlying index, and often have both long and short versions.

9.2.8 Smart Beta ETFs

Also called strategic beta ETFs, smart beta ETFs consider a variety of alternative factors such as equal weighting, GDP weighting (in the case of countries), value, **momentum**, volatility and quality, and therefore employ both passive and active methods of investing.

9.3 Benefits and Limitations of ETFs (and Passive Investing in General)

Benefits	Limitations
• Passive investing brings about reduced marketing, distribution and accounting costs, thus lower fees overall. • Passive funds are liquid, so investors can build on their positions or access their funds when needed. • Investing passively is very transparent, as it is always clear which assets are held in the index. • Underlying index constituents are rebalanced frequently, so passive investing results in minimal market trading. • Investors who are able to remain invested for the long term can benefit from the long-term uptrend in the financial markets. • A wide variety of indices are available to suit a broad range of investing styles and risk tolerances.	• When adjusting portfolios to reflect constituent changes, investors may end up buying (or selling) securities at elevated (or depressed) prices. • Cash drag and internal costs can affect performance relative to the index ('tracking error'). • Passive funds are unlikely to employ any risk management strategies (eg, short-selling or increasing the cash weighting), so they can never outperform the index they follow. • If an index is overly concentrated in a handful of issuers, then so will the passive strategy aiming to track that index, which can leave many vulnerable to major political and regulatory events. • Indexed portfolios are still exposed to market risk and will likely follow the index down in bear markets. • Buy and sell decisions are based on index constituents, not research. • With full replication, all securities in the tracked index are owned, even those considered to be sub-optimal.

9.4 Comparisons with Other CISs

Both ETF and traditional index-tracker funds are similar, in that they aim to mirror an underlying index. The difference is that an ETF can be traded at any time of the trading day, whereas an index-tracker fund is normally either a unit trust or OEIC fund which can only be traded at one point in the trading day (a **valuation point** dictated by the fund manager).

9.4.1 Charging Structures

The charging structure of ETFs is also different. With an ETF, you only have to pay a stockbroker's commission and, significantly, no stamp duty. However, as we have learnt with unit trusts and OEICs, there are both initial and annual management charges. Additionally, with a traditional CIS, there is SDRT which is levied against the new shares or units that the fund may need to create. Although, this is not charged separately to investors, it is a charge against the fund.

The charges on an ETF can be slightly lower than those associated with index-tracker funds. The annual ongoing charges figure (OCF) for an equity-based ETF that invests in a highly liquid index, such as the FTSE 100 or S&P 500, is typically around 0.15% a year (if not less); for less liquid or more specialist sectors (eg, UK Small Caps, MSCI China, private equity), the OCF is typically higher (eg, 0.80% a year) to reflect the higher dealing costs involved. Either way, charges for ETFs can be slightly lower than those on some unit trust tracker funds, but careful comparison is required as it is not the case for all ETFs.

As ETFs are open-ended funds, the share price of the ETF is close to the value of the NAV.

9.4.2 Dealing and Settlement

As its name suggests, ETFs are traded on the stock exchange. Over 2,000 ETFs are listed and traded on the main market of the LSE[11], for example. Settlement, therefore, replicates normal equity trading.

9.4.3 Tax Treatment

There is no tax difference between holding an index tracker and an ETF tracking that index. Capital gains are subject to CGT and income to income tax, even if it is not physically received by the investor. UK-resident investors can hold within an ISA, pension or other tax wrapper, in which case, both will be free of CGT and income tax. However, many ETFs are based outside the UK, and they may be subject to WHT in the country concerned.

11 London Stock Exchange, 2025. Exchange Traded Funds. Retrieved from https://www.londonstockexchange.com/raise-finance/etps/etfs (Accessed: October 2025)

9.4.4 Criticism

By the end of 2024, assets in global ETFs reached almost $15 trillion[12] – this compares with only $200 billion in 2003. The number of ETFs worldwide has also grown rapidly during this period. From about 270 two decades ago, over 15,000 new ETFs have been launched, although each year some close due to a failure to attract sufficient assets. Within this universe, State Street's SPDR S&P 500 ETF Trust is the highest valued ETF globally, with a market capitalisation of over $670 billion[13].

These huge inflows that have flooded into ETFs (among other passive funds) over the years have radically shaped global stock markets. As ETFs are open-ended funds, new shares are created when investors buy, and the ETF will then purchase the underlying assets that comprise the ETF. Such large inflows can distort share prices, leading to structurally higher stock valuations that are disconnected from company fundamentals, and potentially causing asset bubbles. This has particularly been the case within the 'large' and 'growth' areas of the market (which have been popular with investors since the global financial crisis), at the expense of the 'small' and 'value' areas. The converse applies when investors exit their positions, and the underlying assets have to be sold to fund those redemptions.

Thus, while liquidity is not an issue when markets are rising, some ETFs will be tested in the event of a stock market collapse.

For some sectors or global markets, where a limited number of ETFs are available, ETFs may provide insufficient diversification and this narrow range could potentially limit investment opportunities. With a particular geographic region, investors may only be able to obtain exposure to larger company shares, leaving them very little (or even zero) exposure to medium- and smaller-sized companies, which have higher growth potential.

Additionally, as mentioned with regard to ETFs, some funds use custom (and thus unknown and untested) indices, which have been created specifically for that respective ETF to mirror and track. This calls into question the issue of the relationship between the ETF issuer and the index provider and possible conflicts of interest.

12 Statista. Development of assets of global exchange traded funds (ETFs) from 2003 to 2024. Retrieved from https://www.statista.com/statistics/224579/worldwide-etf-assets-under-management-since-1997/ (Accessed: July 2024)

13 Yahoo Finance. SPDR S&P 500 ETF (SPY). Retrieved from https://finance.yahoo.com/quote/SPY/ (Accessed: October 2025)

10. Investment Trusts

Learning Outcome

5.10.1 Features, including types of trust, pricing, charging structures, dealing and settlement, tax treatment

5.10.2 Similarities with and differences from other types of fund

5.10.6 Determinants and relevance of discounts and premiums to net asset value (NAV)

Investment trusts are public limited companies (plcs) and their 'product' is to invest in other companies, quoted or unquoted; and are found mostly in the UK and Japan.

As public companies, investment trusts are run by a board of directors. The directors can choose to self-manage, which means they undertake the investment management themselves. Alternatively, and more commonly, they can outsource the investment management, along with other tasks such as administration, registration and accountancy.

Unlike unit trusts and OEICs, investment trusts are closed-end funds, which means they have a fixed number of shares in issue at any time. The shares of investment trusts are traded as normal on the stock market, with the price fluctuating according to supply and demand.

Another major difference to unit trusts and OEICs is the option for investment trust managers to borrow money freely (within set limits) to buy shares and other assets when they see good investment opportunities. This **gearing** (or leveraging) adds to the possibilities of greater rewards, but at greater risk.

10.1 Categories of Investment Trusts

There are a vast number of different investment trusts offering a variety of investment objectives and risk levels, ranging from security of capital with no income, to very high income with low capital security.

The **Association of Investment Companies (AIC)**[14] classifies investment trusts by sector to make it easier for investors, asset managers and brokers (among others) to search and compare those with similar characteristics. These categorisations are based on the combination of regional and sectoral focus of a particular portfolio (eg, UK smaller companies, global emerging markets, loans and bonds, environmental, and VCT generalist). The combination of region and sector focus creates the very diverse levels of risk possible.

14 The Association of Investment Companies. AIC sector classification system. Retrieved from https://www.theaic.co.uk/aic/statistics/aic-sectors (Accessed: October 2025)

10.2 Closed-End Funds and Net Asset Values (NAVs)

As already mentioned, unlike unit trusts and OEICs, investment trusts are closed-end funds. This means that the amount of money that the investment trust raises to invest is fixed at the start by issuing a set number of shares to investing shareholders. Having a stable pool of money to invest enables the manager to plan ahead. Every investor looking to purchase or sell shares must be matched to a potential seller or buyer, via the stock market, before a transaction can take place. The company's own investments are not affected.

10.2.1 Net Asset Values (NAVs)

To some extent, the share price of an investment trust depends on the value of the underlying investments, but not as directly as is the case for a unit trust or OEIC. It can depend on a number of other factors that affect supply and demand. In many cases, the share price of an investment trust is less (at a discount) than the NAV per share, although it can also be more (at a premium). The NAV is the value of an investment trust's investments per ordinary share, after taking liabilities into account. The NAV is calculated by taking:

- the total value of a trust's **listed investments** at mid-market prices
- plus its unlisted investments as valued by the directors
- plus cash and other assets, and
- minus the nominal value of loans and preference shares.

The resulting figure is known as the 'shareholders' funds' and is divided by the number of ordinary shares in issue to arrive at the NAV.

? As a simple example, what would be the NAV per share of an investment trust if shareholders' funds are worth £80 million and there are 20 million ordinary shares in issue?

The NAV would be 400p (ie, £80 million / £20 million).

10.2.2 Discount and Premium

The share price of a closed-ended investment company, however, is not necessarily the same as the value of the underlying investments. The company will value the underlying portfolio daily and provide details of the NAV to the stock exchange on which it is quoted and traded. The price it subsequently trades at will be determined by the demand for, and supply of, the shares, and may be above or below the NAV per share.

- When the share price is above the NAV, it is said to be trading at a premium.
- When the share price is below the NAV per share, it is said to be trading at a discount.

The premium or discount can be calculated using the following formula:

$$\text{Premium or discount (\%)} = (\text{Share price} - \text{NAV per share}) / \text{NAV per share}$$

If the figure is positive (ie, the share price is above the NAV), then the investment trusts shares are trading at a premium to the NAV; if negative, then at a discount. Dividing the NAV by the number of ordinary shares in issue gives the NAV per share.

Example

ABC Investment Trust shares are trading at £2.30. The NAV per share is £2.00. Thus, ABC Investment Trust shares are trading at a premium. The premium is 15% of the underlying NAV.

XYZ Investment Trust shares are trading at 95p. The NAV per share is £1.00. XYZ Investment Trust shares are trading at a discount. The discount is 5% of the underlying NAV.

Most investment trusts operate at a discount to NAV, although some can trade at (sometimes significant) premiums. The level of premium or discount relates to the demand for shares and any factor that can influence demand will affect it. For example, if investment in emerging markets becomes unpopular, share prices for investment trusts which focus on that region may fall and, if the values of the underlying assets have not fallen as much, the level of discount to NAV may increase. A number of other factors contribute to the extent of the discount/premium, and it will vary across different investment companies.

The discount/premium is also a function of the market's view of the quality of the management of the investment trust portfolio and its choice of underlying investments. For example, if the shares in an investment trust are trading at a premium to NAV, this may reflect investors believing strongly in the management of the company and in their ability to make the assets grow.

The existence of discounts and premiums for investors in investment trusts is crucial, as they can exaggerate returns either way. For example, a trust with a narrowing discount can enhance an investor's return.

Example

XYZ IT plc is trading at 80p and has a NAV of £1.00, thus the shares are trading on a discount of 20% to NAV.

Six months later, XYZ IT plc is trading at 135p and has a NAV of £1.50, which is a discount of 10%.

While the NAV has increased by 50% (£1.00 to £1.50), the share price has increased by 69% (80p to £1.35), providing a good return for the investor.

Alternatively, an investment trust may have a widening discount.

Example

XYZ IT plc is trading at 90p and has a NAV of £1.00, or a discount to NAV of 10%.

Six months later, XYZ IT plc is trading at 120p and has a NAV of £1.50, which is a discount of 20%.

Whereas the NAV has increased by 50% (£1.00 to £1.50), the share price has only increased by 33% (90p to £1.20).

In these two examples, the investment trust managers performed identically, increasing the NAV from £1.00 to £1.50. However, the movement of the share price, which they cannot control, meant very different returns for individual investors.

While the investment trust's prevailing discount/premium is useful, it must be contextualised relative to its history. For example, an investment trust whose shares are trading on a 10% discount today may look attractive in isolation, but if it has historically traded on a 20% discount, then this may not represent a buying opportunity. Similarly, an investment trust that is trading on a large premium may not necessarily be a 'sell' if its shares naturally trade at that level. It is important to consider the drivers for any widening or narrowing in the discount/premium over the long and short term (eg, a change in manager).

A smaller discount (or even a premium) will be displayed where investment trusts are nearing their winding-up, or about to undergo some corporate activity such as a merger or takeover. In this way, investment trust prices can have greater volatility than unit trusts and OEICs, whose unit/share prices are directly related to the market values of the underlying investments.

The existence of a discount may be favoured by investors seeking income. If an investment trust has £1 million of assets and 900,000 shares in issue at a market price of 100p, an investor could be seen as buying £1.11 worth of assets per share. If we assume a yield of 4%, then an investment trust investor will get 4.44p per share as a distribution (ignoring charges). An investor in an equivalent unit trust would only receive 4p.

The fact that a discount to NAV is common presents a problem in the initial launch of an investment trust, when the trust must raise enough money from new investors to make the trust viable. If investors foresee that a discount is likely, they will need some additional incentive to invest at the launch. Some investment trust companies arrange the capital structure of the company in order to ensure that the investment trust shares are marketable. One common way of doing this is to issue warrants, eg, one warrant being given away with every five shares issued – this is sometimes referred to as a 'sweetener'. Another way is to split the capital of the company into several different classes of share, each of which produces a different form of investment return.

Many investment trusts have programmes in place to try and manage the extent of any discount by buying shares and holding them in treasury in an effort to support the price:

- If the discount to NAV becomes very wide, investment trust managers may decide to buy back some of the shares, thus reducing the excess supply and possibly narrowing the discount, called a discount control mechanism (DCM). As for other companies, a buyback by an investment trust of its own shares requires the permission of shareholders.
- For those that operate at a premium, new issues of shares can be used to reduce the premium, called a premium control mechanism (PCM). Investment trusts can hold shares bought back (consisting of up to 10% of issued share capital) 'in treasury', rather than cancelling them. The shares could then be sold again at a later date.

These mechanisms can offer a way for the trust to balance supply and demand for the shares at different times.

The Financial Times (among other publications) publishes figures for the discounts or premiums to NAV, along with the share prices of investment trusts.

In capital terms, an investor is not affected by the discount or premium, if it does not widen or narrow.



What factors do you think affect the discount?

The factors include the following:

- Investor sentiment towards a particular market (for example, emerging market investment trusts tend to have a higher discount than general investment trusts).
- The reputation of the investment managers.
- The existence of a savings plan and an ISA, as these have tended to provide a steady demand for certain investment trust shares.
- Share buybacks which reduce the supply of stock and tap issues (ie, issuance of new stock) to meet investor demand.
- The provision of warrants.
- The structure and cost of any debt funding (gearing).

Discounts can also generate a significant income advantage for investors. In effect, a discount boosts the net yield of an investment trust. This is due to the fact that the yield on the underlying investments is based on the NAV, but the yield is expressed as a percentage of the market price.

Example

XYZ IT plc has a NAV of 100p on which it pays a dividend income of 3p to investors. The share price is 80p (a 20% discount), giving a yield of 3p / 80p x 100 = 3.75%. Even taking typical management charges into account of, say, 0.5%, this could still be considered to be an acceptable return.

10.2.3 Share Buybacks

If the discount to NAV becomes very wide, investment trust managers sometimes choose to buy back some of the shares, thereby reducing the excess supply and possibly narrowing the discount.

As for other plcs, a buyback by an investment trust of its own shares requires the permission of shareholders. In the UK, there are also FCA rules to which the investment trust will need to adhere.

Investment trusts are allowed to hold a limited level of shares bought back 'in treasury' (known as 'treasury shares'). This means the shares are not cancelled and can be sold again at a later date when demand improves (eg, when the shares are trading at a premium to NAV). This mechanism offers a trust an effective way of balancing the supply and demand for its shares at different times.

10.3 Gearing

As already mentioned, investment trusts can borrow to purchase additional investments. This is called 'financial gearing'. This facility allows investment trusts to take advantage of a long-term view on a sector, or to take advantage of a favourable situation or a particularly attractive stock, without having to sell existing investments.

The ability of investment trusts to gear can work to the advantage of shareholders, if the investment returns achieved with the borrowed money exceed the cost of the loan. However, if returns do not exceed costs, the investment trust's performance will suffer.

Gearing adds to the risk element of an investment trust, but it can also add to the potential returns, ie, it can magnify a trust's performance. If an investment trust 'gears up' and then markets rise and the returns on the investments outstrip the costs of borrowing, the overall returns to investors will be even greater. Conversely, if markets fall and the performance of the assets in the portfolio is poor, then any losses suffered by the investor will also be magnified.

This is probably best seen via an example.

Example

XYZ IT plc has 20 million shares issued and assets of £25 million. It borrows £5 million for a specific investment, at an interest rate of 6% (ie, £300,000). The investment trust has 20% gearing and annual interest payments of £300,000.

Prior to the borrowing, the investment trust's NAV is £25 million / 20 million shares = £1.25 per share. The assets bought with the loan increase the overall assets to £30 million, with debts of £5 million. This gives:

Shareholders' funds	=	£30 million – £300,000 = £29.7 million
NAV	=	£30 million – £5 million = £25 million
NAV per share	=	£25 million / 20 million shares = £1.25 per share

Scenario 1
If the investment trust assets grow by 10%:

Shareholders' funds	=	£33 million – £300,000 = £32.7 million
NAV	=	£32.7 million – £5 million = £27.7 million
NAV per share	=	£27.7 million / 20 million shares = £1.385 per share

This represents a growth in NAV of 10.8%.

If the investment trust had not borrowed, the 10% asset increase would have led to a NAV per share of £1.375 (ie, £27.5 million / 20 million shares), which is a straight 10% increase in the NAV.

Scenario 2
If the investment trust assets fall by 10%:

Shareholders' funds	=	£27 million – £300,000 = £26.7 million
NAV	=	£26.7 million – £5 million = £21.7 million
NAV per share	=	£21.7 million / 20 million shares = £1.085 per share

If the investment trust had not borrowed, the 10% asset decrease would have led to a NAV per share of £1.125 (ie, £22.5 million / 20 million shares). Instead, with gearing, the fund suffers a loss of 13.2%.

Summary
If the assets had grown or fallen by 20%, the NAV would have risen by 22.8% and fallen by 25.2% respectively.

Gearing, therefore, increases the volatility of an investment, as the effect of a fall in the value of assets bought via borrowing will be made worse by the effect of the interest payments on the overall picture.

10.4 Capital Structure of Investment Trusts

Learning Outcome

5.10.3 Differences between conventional and split-level investment trusts

Investment trusts are generally divided into the following two types:

- conventional, and
- split capital.

These reflect significant differences in their capital structures. We will now look at these types in more detail.

10.4.1 Conventional Trusts

Conventional trusts will issue just one main class of equity share: an ordinary share. These entitle investors to all of the income and capital gains produced by the trust investments (subject to any borrowing).

Conventional trusts are usually set up for an indefinite term.

10.4.2 Split Capital Trusts

A split capital investment trust is still a single portfolio of investments, but it issues different classes of shares to meet different investors' needs. A single trust may issue two, three or even four different classes of shares, and each will be entitled to different returns.

A split capital trust is also different from a conventional trust, in that at least one of the share classes will be likely to have a limited life with a fixed wind-up date. Therefore, each different class of share mentioned above is ranked in a particular order of priority for repayment when the trust is wound up. A typical trust may be set up for an initial life of five to ten years, often with the provision to extend it (eg, by three years at a time).



What different classes of shares can you think of that may be incorporated into a split capital trust?

The basic structure of the first split capital trusts that were introduced in 1965 comprised two classes of shares:

- **Income shares** – the shareholders of which were entitled to all the income generated from the investments held by the trust during its life.
- **Capital shares** – the shareholders of which received, at wind-up, the capital value of the trust including any capital growth achieved over its lifespan.

Since then, the market has expanded, along with the different classes of shares on offer. We will now look at some of the key aspects of the main share classes on offer, the investor needs they are designed to fulfil, and their priority order on wind-up.

Zero Dividend Preference (ZDP) Shares

Zero dividend preference (ZDP) shares are a class of shares with a limited life, offering a capital return from the assets of the trust in the form of a predetermined (but unguaranteed) redemption value at wind-up. They have no right to receive dividend income (hence their name).

Investor Need
These meet the requirement for a predetermined capital return at a specific date. The investor should have no requirement for income. This class of shares can be useful for tax planning, especially by using the CGT annual allowance to shelter profits.
Order of priority
As a preference share, these are usually ranked first in the winding-up order. This is still after prior charges, such as bank debts or loan stock.

Income Shares

There are different types of income shares, and investors should be clear about the terms of each. In essence, all income shares aim to provide dividend income generated from the trust's underlying assets. The different types vary in their income entitlements, and in their capital entitlements on wind-up.

Some income shares have a predetermined (but unguaranteed) maturity value. This is known as the redemption price and it might be as high as the original price of the shares. Other, more recent alternatives may offer a high-income level, but only a nominal redemption amount.

Investor Need
These meet the requirement to provide an income stream, with entitlement to capital at wind-up. The shares that offer high income with a nominal redemption value may be attractive to investors who have capital gains on other investments that can be set off against the capital loss generated by this sort of investment.
Order of priority
This depends on the structure of the trust. Even the distributable income will depend on the entitlements of any prior-ranking charges. Any predetermined capital entitlement also ranks after the payment of any prior-ranking charges.

Income and Residual Capital Shares

These are also known as ordinary income shares or highly-geared ordinary income shares. They offer a high and rising income plus all the surplus assets of the trust at wind-up (after other prior-ranking classes of shares have been repaid). They have no predetermined redemption value.

These may be issued by a trust with a stepped preference share, where the holder receives all excess revenue after the predetermined dividend payment to the other class of shares has been made.

Investor Need
They offer the investor high dividends and capital returns. The high gearing involved with this type of trust does make them a relatively high-risk investment.
Order of priority
Low priority, although if issued with a stepped preference share, this will be higher in the priority list.

Capital Shares

These shares do not pay dividends. Shareholders have no predetermined capital value, but are entitled, to all of the surplus assets on wind-up of the company, after prior-ranking charges.

The absence of guarantees means that capital shares are inherently risky, along with the low priority order held by the shares. They do have the potential for impressive growth (or significant losses) through the use of gearing, as explained earlier.

Investor need
Potential for capital growth, at a higher risk relative to other classes of shares.
Order of priority
Low priority.

Comparing Returns from Split Capital Trusts

There are a number of methods used to analyse the attractiveness of split capital investment trusts, including the following:

- **Gross redemption yield (GRY)** which measures the capital and income return on a particular share until wind-up. It is expressed as an annual percentage, allowing it to be compared easily with other investments such as bank deposits and fixed-interest investments. A GRY of 5% on a zero, for example, means that if an investor bought the share at the quoted price, a lump sum at wind-up would be paid, equal to the investment, plus 5% a year for the whole of the term.
- **Hurdle rates** which show how much the assets of a trust have to grow (compounded annually) to repay the redemption price. A negative hurdle rate is, therefore, good news in this respect as it indicates that there are already surplus assets and that the total assets can decline by a certain percentage each year and there would still be enough to pay the redemption price at wind-up.

- **Asset cover** which is a different way of measuring a trust's ability to meet or cover the liability to a zero from its assets. A cover of one indicates that the assets exactly cover the zero redemption price. A cover of 0.5, for example, indicates that half of the redemption price is covered.

Advice Issues

You will undoubtedly be aware that, at the start of the millennium, split capital investment trusts were involved in reviews by both a Treasury Select Committee and the Financial Services Authority (FSA) (the regulator at that time). The issues arose because many trusts, sold originally as 'low-risk' investments, had trading in their shares suspended as the value of their assets fell to below, or very close to, the level of their borrowing. This was due to several factors, including high initial gearing and the poor performance of global stock markets (particularly after the 11 September terrorist attacks of 2001). Also blamed was the surprising pattern of investments, where trusts purchased each other's shares for their portfolios (known as the 'magic circle').

Rules limit the cross-holdings between trusts to 10% of the gross assets of the investing trust company. Additional risk warnings also had to be included in an investment trust prospectus and promotional literature.

10.5 Other Types of Shares

Learning Outcome

5.10.1 Features, including types of trust, pricing, charging structures, dealing and settlement, tax treatment

5.10.4 Concepts of B, C and S shares and warrants, zero and stepped preference

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When an investor owns shares in an investment trust, they will most likely be ordinary shares. There are, however, a number of share types (albeit far less common) including B, C and S shares, as well as warrants.



Before we briefly look at each of these, what is your understanding?

10.5.1 B Shares

B shares have equal rights with ordinary shares of the investment trust, except that the shareholder receives no rights to dividends. Instead, the shareholder receives additional shares equivalent in value to the dividend distribution.

When these shares were first introduced in 1967, there was a tax advantage to this approach. That tax advantage no longer exists, as the shareholder is taxed on the scrip issue of the additional shares in the same way as they would have been had they received the cash dividend.

10.5.2 C Shares

C shares are initially allocated on a new issue of shares by an investment trust. When a new issue takes place, the cash received may not be invested immediately, and so could distort the overall situation for existing shareholders, with an increased holding in cash rather than equities.

C shares are, therefore, only converted into ordinary shares when the bulk of the new cash has been invested, being converted on an NAV basis.

10.5.3 S Shares

S shares are also known as 'perpetual C shares'. They are used to issue new shares on the market without incurring the costs generally associated with launching a new investment trust. The investment strategy will be close, but not identical to, the existing investment trust.

S shares form a distinct and different portfolio, which will remain separate throughout, with separate price quotes and NAVs.

10.5.4 Warrants

Warrants are a form of share derivative, designed to provide an incentive for investors to buy the shares of a new investment trust. When the new investment trust shares are issued, there will be no discount to NAV which, as we have seen, is a way of exaggerating returns for an investor. To encourage investors to invest, warrants may well be issued, giving the holder a right to buy shares in the investment trusts later at a specified strike price.

The warrant should have some kind of value, even if the investment trust is trading below the strike price, as the investment trust price should be expected to rise. This is of interest to speculative investors in particular, so warrants are relatively high-risk investments used for potential capital growth (as there are no dividends).

The issuing of warrants can distort the NAV, which we have already established is 'the value of an investment trust's investments per ordinary share'. This inclusion of just ordinary shares in the NAV calculation ignores warrants, and is known as the undiluted NAV. There is also an NAV calculation that assumes that all warrants are exercised, thereby increasing the overall shareholding. The NAV will, therefore, be lower, as the investment trust's assets are being divided by a greater number of shares. This is known as the diluted NAV.

10.5.5 Stepped Preference

Stepped preference investment trusts have an income entitlement, which grows at a predetermined rate and carry a predetermined maturity value.

In a stepped preference structure, the investment trust issues two classes of shares:

- **Preference shares** – these shares have a predetermined priority ranking (known as 'steps') when it comes to receiving income distributions from the investment trust's underlying assets. Each step corresponds to a specific period (usually a year), and has its own fixed dividend rate which is typically higher than the ordinary shares. For example, the preference shares may have a three-step structure, where the dividend rate increases at the start of each step: the first step might have a dividend rate of 4%, the second 5%, and the third 6%.
- **Ordinary shares** – in contrast, these shares receive any remaining income distributions after the preference shares have been paid their fixed dividend. If there is any surplus income, it will be distributed to the ordinary shareholders. However, if the income generated by the underlying assets is insufficient to cover the fixed dividend payments to the preference shareholders, then the ordinary shareholders may not receive any income distributions.

Stepped preference shares provide income certainty, hence they can appeal to investors who prioritise a consistent and predictable income flow.

10.6 Tax Treatment of Investment Trusts

Investment trusts that have been approved by HMRC are not subject to CGT on gains made from the sale of assets within the investment trust. They are also not subject to tax on the dividend income they receive from their shareholdings in UK companies. They do pay corporation tax of 19% on income from sources such as foreign share dividends and interest from gilts and bank deposits (unfranked income). Trusts can reduce their liability by offsetting their expenses against **unfranked income**.

For the investor, tax treatment is very similar to unit trusts and OEICs in terms of income tax and CGT. For income tax, more specifically, if 60% or more of the trust's income is derived from interest, then the entire distribution to investors is taxed as interest income; otherwise, the distribution is treated as a dividend.

10.7 Dealing and Settlement of Investment Trusts

The process of dealing with investment trusts is similar to trading individual company shares, in that investment trusts are bought and sold on the stock market. Investors specify the number of shares that they wish to buy or sell and at what price; and the transactions are executed on the exchange where the investment trust is listed. This accessibility and transparency ensure that investors can trade investment trust shares during market hours, benefitting from real-time pricing and liquidity.

One key difference between unit trusts and OEICs, therefore, is that an investor who purchases shares in an investment trust will be subject to pay stamp duty or SDRT.

Settlement of investment trust trades follows the standard equity settlement cycle, which usually operates on a T+2 basis. During this period, the transfer of shares and the corresponding payment are completed. The process involves updating the ownership records, ensuring the buyer receives the shares and the seller receives the payment.

10.8 Real Estate Investment Trusts (REITs)

Learning Outcome

5.10.5 Real estate investment trusts (REITs)

Real estate investment trusts (REITs) were first established in the US in 1960, and over 40 countries worldwide have REIT legislation. Other countries are considering REITs, but are yet to pass legislation that would set up a universal REIT framework in terms of taxation and rules.

REITs are designed to provide a widely accessible vehicle for investors, providing a liquid market in property investment with tax treatment similar to a direct investment in property.

REITs must be closed-ended, as explained earlier. To qualify for REIT status, they must also be listed on a recognised stock exchange (thereby excluding AIM companies). They must be a UK resident and can only have one class of ordinary share.

A REIT has two separate elements for tax purposes:

- A ring-fenced property letting business.
- A non-ring-fenced business.

A minimum of 75% of a REIT's total profits must originate from the ring-fenced element. The tax situation for each element is as follows:

Ring-fenced property letting business	Non-ring-fenced business
• Exempt from corporation tax.	• Subject to corporation tax at 19%.
• At least 90% of each accounting period's rental profits must be paid as a dividend to investors within 12 months from the end of the accounting period.	
• Payments are classed as property income distributions (PIDs) and paid net of WHT of 20%. • The dividend allowance does not apply to the PID element of the distributions.	• Any non-PID dividends are taxed as any other UK dividend, at the investor's marginal rate. • The dividend allowance applies to the non-PID element.

Gains on REITs are subject to CGT in the normal way for investors.

Existing listed property companies may convert to a REIT for a one-off corporation tax charge which is equivalent to 2% of the gross value of properties entering the ring-fenced element.

For investors, they are a relatively liquid investment, which are marginally less tax effective than property unit trusts and OEICs for basic rate taxpayers, but are more tax efficient for non-taxpayers.

In recent years, the UK government has revised the tax rules for REITs to boost their competitiveness. With effect from 1 April 2023, valuations for properties sold within three years of significant development will reflect value increases; and the rules for deducting tax from property income distributions (PIDs) to partnerships now allow for 'partly paid gross' and 'partly with tax deducted' payments. REITs can now also be established with a single property valued at £20 million, rather than requiring them to hold at least three properties to qualify for REIT status. Effective from February 2024, it has become easier for a REIT holding a single property to meet the £20 million value condition. The UK government continues to implement changes to the REIT regime.

11. Structured Products

'Structured products' is a term that is used to describe a series of investment products that are more commonly known as guaranteed growth bonds, capital protected bonds and a whole variety of other marketing names.

These types of structured products have been around for some time, and their features and terms differ markedly from product to product so there is no single, uniform definition to describe them. There are ones designed for the mass retail investment market, ones that target the high net worth market only, ones that are for the customers of a single private bank, and even ones designed around individuals for the ultra-wealthy.

Some structured products have hard guarantees (known as floors) to prevent capital loss, but others have variable levels of protection. Some structured products are traded on exchanges while others are arranged privately for customers. The type of structured product is key to its price, suitability, return on capital and customer expectation.

11.1 What are Structured Products?

Learning Outcome

5.15.2 The advantages and disadvantages of their use

Structured products are packaged products based on derivatives which generally feature protection of capital if held to maturity but with a degree of participation in the return from a higher-performing, but riskier, underlying asset. They are created to primarily meet the specific needs of high-net-worth individuals (HNWIs) and general retail investors that cannot be met from standardised financial instruments that are available in the markets. For example, some wealth managers may use derivatives and structured products as part of a client's life style strategy to enhance returns or reduce risk.

These products are created by combining underlying assets such as shares, bonds, indices, currencies and commodities with derivatives. Their main advantage is customising a particular type of risk/return profile or providing exposure to assets otherwise not available. Combining different instruments and asset classes also creates structures which could be difficult for clients to reproduce themselves. They

may have significant risk/return and cost-saving advantages compared to what might otherwise be obtainable in the market, but their complexity and frequent lack of transparency mean clients should take time to understand the costs and risks.

Benefits of Structured Products	Limitations of Structured Products
• Structured products are highly flexible in terms of underlying assets, pay-off structures and risk profiles, and can be tailored to suit a wide range of individual investment needs. • As a result, structured products allow investors to gain exposure to a diversified portfolio of underlying assets, which can help to reduce risk and enhance returns. • They allow investors to gain exposure to unique or hard-to-access market opportunities. For example, they can provide access to specific sectors, geographic regions, or investment themes that may not be readily available through traditional investment options. • Structured products can provide various risk management features, such as downside protection, capital guarantees, and risk mitigation strategies. These features can help investors to limit potential losses and manage their risk exposure effectively. • They can be designed in a way that provides potential tax advantages – for example, for the return to be treated as a capital gain rather than income; tax deferral; and tax-loss harvesting strategies. • Structured products can be designed to offer potential for enhanced returns (eg, higher yields) compared to traditional investments. • They typically provide clear and transparent documentation outlining the terms, conditions, and risks associated with the investment. This transparency helps investors understand the product's features and make informed investment decisions.	• Structured products are complex instruments due to their construction and use of derivatives, making them difficult to understand. As a result, they should only be recommended to 'informed' or 'experienced' clients. • Investors have no rights (eg, dividend payments, voting rights) as they do not hold the shares directly. • Where the return has been capped, investors will not generally reap the full benefit in a **bull** market. • Markets might fall to the point where protection barriers are breached. For example, some structured products will only protect capital if an index has fallen by less than 50% at maturity. • If no gain is achieved and only the capital is returned, the real value may have been eroded by inflation. • Inflexible – should an investor's views on markets change, they cannot amend the way in which the structured product has been set up. • Illiquid – structured products generally run for a fixed term. While there is a secondary market, only some can be traded (not all of them) so investors may get less than their original investment back. • Expensive – upfront costs are high, thereby impacting long-term returns to investors. • Lack of pricing transparency – as there is no uniform standard for pricing, it is harder for investors to compare one product against another. • Depending on the type, structured products can carry higher risk (eg, counterparty risk, market risk, liquidity risk, gearing risk and volatility risk, to name a few). • They are not covered by deposit protection schemes, so in the event that the issuer fails or defaults then investors will not be protected.

Interest in reduced risk investments has been growing in recent years, albeit in a lower leveraged format than was previously popular prior to the global financial crisis.

In recent years, some innovative managers have created funds of structured products to address increasing demand from retail investors. However, the onus on the adviser to carefully assess the value for money and the protection premium of a product (the value/cost for having certainty of capital returned, at the expense of potential growth) cannot be underestimated. An assessment of market levels and the potential for growth/income is also important.

11.2 Types of Listed Structured Products

Learning Outcome

5.15.1 The different types and key features of products available

There is a wide range of listed structured products, and the terms of each are open to the discretion of the issuing bank. They are known by a variety of names, including certificates and investment notes.

Despite being traded on the stock exchange, they are not standardised exchange products and the specification will change from issuer to issuer. However, they do fall into some broad categories that are considered below.

11.2.1 Index-Based Product Trackers

As the name suggests, a tracker structured product replicates the performance of an underlying asset or index. They are usually long-dated instruments or even undated so that they have an indefinite lifespan.

An index-linked note is an instrument whose return is determined by a specific index. This index could be an equity index, which can be based on the performance of a single share, a basket of shares, a market index, or an inflation index (eg, the CPI or RPI for a bond/debt instrument).

An equity-linked note is a debt instrument whose yield is determined by the performance of an equity product. A company might link the return of its debt to the performance of its share price as a method of lowering the base interest rate.

As a tracker replicates the performance of the underlying asset, its price will move in proportion to it. No dividends are paid on the tracker; instead, any income stream is built into the capital value of the tracker over its lifetime.

Where the underlying asset is, say, an index on an overseas market such as the S&P 500, an investor may be exposed to currency movements. Some trackers will, therefore, incorporate features that ensure the tracker is constantly fully hedged for currency risk.

Index-based product trackers directly compete with ETFs. The objectives can be similar, but the fund structures, tax and costs can vary.

11.2.2 Accelerated Trackers (and Boosters)

With an accelerated tracker, the investor will participate in the growth of the underlying index or asset provided that, when it matures, its value is greater than the initial value. If the asset or index is valued at less than its initial value, then the investor will lose the same amount. If the product pays out an income, which is accelerated (often quoted as a ratio) then this is often referred to as a booster.

Example

An accelerated tracker might provide for the investor to participate in 200% of the growth of an index. If an investor buys £1,000 of an instrument and the index it is based on grows by 10%, then they will receive back their initial investment of £1,000 plus 200% of the growth, which amounts to £200; that is, £100 growth x 200% = £200.

If the final value of the underlying asset is, say, 10% less than the issue price, then the investor will receive back the initial price of £1,000 less the change in the underlying asset (ie, 10% or £100), which amounts to £900.

The investor will usually surrender any right to the underlying income stream from the asset in exchange for the right to participate in any performance.

11.2.3 Reverse Trackers

A reverse tracker is similar to a standard tracker except that, should the underlying asset fall in value, then the value of the tracker will rise. These trackers are also referred to as bear certificates. Their ETF equivalent would be inverse ETFs.

11.2.4 Digitals

A digital is a structured product/note that has two reference indices instead of just one as the basis for the pay-out; for example, the S&P 500 and the secured overnight financing rate (SOFR; a broad measure of the cost of borrowing cash overnight, using US Treasury debt as collateral). For each day that both underlying indices are within their predetermined ranges, the product will accrue interest at a coupon rate; this rate is often fixed, but some structured products/notes may have provisions for floating rates, or that is itself tied to a variable reference index. However, if either of the underlying indices falls outside of this range, then interest accrues at a reduced rate, or even zero.

11.2.5 Capital-Protected Trackers

Capital-protected trackers, as the name suggests, allow investors to gain some exposure to the growth of an underlying asset or index while providing protection for the capital invested.

The amount of participation in any growth, and the protection over the capital invested, will vary from product to product and is obtained by surrendering any right to income from the underlying asset.

Example

An instrument might be issued to track the performance of the DAX index and provide participation of 140% of any growth but with 100% capital protection. If the DAX index is at a higher level at maturity, then the investor will receive back the initial price plus 140% of the growth over that period. If the index is lower than at the start, then the capital protection kicks in and the investor will receive back their initial investment. Since the client has no downside risk, such an instrument may require an upfront premium or commission.

A capital-protected product (which is also known as a capital-protected borrowing or capital-protected loan) is generally associated with the purchase and holding of shares or other financial securities, such as single warrants. This type of financial product allows an investor to borrow money or obtain credit to purchase shares or other types of financial securities. These shares and financial securities purchased then become security for the loan. Under the terms of the financial product, if the shares or financial securities fall in value below their purchase price then the purchaser can transfer the shares or securities back (a put option), or surrender them to the lender to meet all outstanding obligations under the loan (a limited recourse loan). Therefore, the purchaser/investor is guaranteed a minimum price/value for the shares/securities that are part of the capital-protected product. In effect, it is a loan with an embedded put option for the financed securities.

Capital-protected products generally have higher interest rates and/or additional fees than other types of product.

11.2.6 Structured Capital at Risk Products (SCaRPs)

SCaRPs are products like those above but have variable (or floating) floors rather than a fixed capital protection. Such products often pay out based on barriers, which determine the level of gain or loss. The rate of pay-out can change as it reaches different barriers, be it 1 for 1 (1:1) or a multiple such as 1.5:1, 2:1, 3:1 and so on.

One of the most popular features on structured products is a 'Kick Out' plan, or 'autocall plan', whereby the product can mature before its defined maturity date if certain pre-defined conditions are met. These conditions are defined on the start (strike) date of the product. Kick Outs mostly feature on growth products, but do also sometimes feature on income products. The returns to investors on maturity depend on the product's features and if any capital protection is included.

Example

A structured product that is linked to the S&P 500, and that matures in five years, has a Kick-Out feature that is observed each year on the anniversary of its start date. If, on the observation date, the S&P 500 is above 100% of its starting level at the market close, then the product automatically matures and the original capital plus accumulated growth is paid back to the investor. On the other hand, if the S&P 500 is below its starting level on the observation date, then the product continues for another year, when it is checked again, and this process continues until maturity.

11.3 OTC-Structured Products

OTC-structured products are bilateral contracts between two counterparties which allow participants to customise the structured products to their individual needs – for example, a custom contract expiration, or a specific pay-off profile. Thus, OTC-structured products are highly exotic securities and because they have multiple cash flow branches attached to them, this often makes it far harder to value them.

Further, as they are tailored to participants' specific requirements, the trade volume of OTC-structured products in the secondary market is relatively low.

11.4 Trading and Settlement

Listed structured products will usually be structured as an instrument such as a ZCB, and will be firstly offered in the primary market where they are made available to investors.

In the UK, they are treated as derivatives for the purpose of FCA Conduct of Business rules. A firm distributing these products must give a two-way risk warning, in the form of a generic warrants/derivatives warning notice, and either a tailored risk warning or a copy of the listing particulars.

Once the investment date has passed, they can be traded in the secondary market. The issuers of the products are obliged to maintain continuous prices throughout the lifetime of the product and to adhere to the standard market maker obligations of minimum size and maximum spread.

On any subsequent dealing in the secondary market, a contract note is issued as normal which will specify the name of the investment, the nominal amount purchased, the price at which it has been dealt and any commission charged.

One key feature of listed structured products is they are listed, held and settled in a securities settlement system (eg, CREST). They are issued in uncertificated form, and settlement is normally T+2, which is in line with other markets.

At the end of the term, the investor will usually sell the investment on the last valuation day, but, if it is not traded, then the instrument representing the structured product will be redeemed using settlement functionality at the central securities depository (CSD) where it is held (eg, CREST).

12. Individual Savings Accounts (ISAs)

Learning Outcome

5.11.1 The types of ISAs and their key features and benefits

12.1 Key Features and Types of ISAs

An ISA is not a product as such, but a 'wrapper' that makes an existing investment more tax efficient. The extent of effectiveness of this tax efficiency depends largely on the tax status of the individual investor.

There are seven types of ISAs, namely:

- cash ISA
- stocks and shares ISA
- flexible ISA
- innovative finance ISA (IFISA)
- help to buy ISA (H2B ISA)
- lifetime ISA (LISA), and
- junior ISA (JISA).

To subscribe to an ISA, an investor must be aged below 18 for a JISA, and 18 or over for an 'adult' ISA. Further, for lifetime ISAs, the individual must be below the age of 40 to open the account; they can then make subscriptions to the lifetime ISA up to the age of 50.

Additionally, the investor must be a UK resident, or a Crown servant or member of the armed forces (or their spouse or civil partner) working abroad. An individual who has opened an ISA in the UK before moving abroad can retain their ISA, and they will continue to enjoy tax relief, but they will not be allowed to make any more contributions into it after the tax year that they move, unless they are a Crown employee or a spouse/civil partner of one.

For under 18s, a JISA can only be opened if the child does not have a child trust fund (CTF).

12.1.1 Cash ISAs

Eligible investments include:

- savings in bank and building society accounts, and
- some NS&I products.

12.1.2 Stocks and Shares ISAs

Eligible investments include:

- investments that are eligible to be held in a cash ISA
- shares that are officially listed on a recognised stock exchange anywhere in the world (this means that **unquoted** or **unlisted shares** do not qualify, although AIM shares are eligible)
- officially listed corporate and government bonds
- UK authorised unit trusts (AUTs), UCITS, and qualifying non-UCITS retail schemes (NURSs)
- UK-listed investment trusts, including real estate investment trusts (REITs)
- shares acquired within the previous 90 days from an all-employee Save As You Earn (SAYE) scheme or share incentive plan. These qualify, even if the shares would not normally (eg, they are not listed on a recognised stock exchange)
- life assurance policies (provided they are single life), and
- stakeholder medium-term investment products.

12.1.3 Flexible ISAs

As their name suggests, flexible ISAs are a more flexible type of ISA, in that the money withdrawn from it can be replaced in the same tax year; whereas in a standard ISA, it cannot.

Example

An account holder subscribes £15,000 into a flexible ISA, then withdraws £10,000 later that tax year, they may subscribe a further £15,000 in that tax year to bring the total subscriptions to the annual limit (ie, £15,000 – £10,000 + £15,000 = £20,000).

For a standard ISA, the remaining subscription would be £5,000 (ie, £15,000 + £5,000 = £20,000).

Stocks and shares ISAs and cash ISAs can be flexible; some other types (such as JISAs) cannot. Therefore, the eligibility of investments within a flexible ISA depends on the underlying account type.

12.1.4 Innovative Finance ISAs (IFISAs)

Qualifying investments are peer-to-peer (P2P) loans and cash.

For a P2P loan to be eligible, it must be facilitated by an operator authorised under FSMA 2000. All loans must be made using cash held by the ISA manager and must be on genuine commercial terms.

12.1.5 Help to Buy (H2B) ISAs

H2B ISAs are designed to help first-time buyers, boosting savings by 25% towards the cost of their first home. The maximum amount allowed to be invested is £12,000 and, therefore, the maximum bonus is £3,000 per person; and for every £200 saved, they will receive the bonus of £50. Account holders may invest up to £200 per month, plus an initial deposit of £1,200 (which is inclusive of the first monthly payment). The minimum saving to qualify for the bonus is £1,600.

Note that the H2B ISA closed to new savers on 30 November 2019, but investors who opened a help to buy ISA before this date can continue to make contributions until November 2029.

12.1.6 Lifetime ISAs (LISAs)

Individuals can save up to £4,000 per tax year into a LISA. This ISA counts as part of the ISA allowance; so, if someone contributes the maximum of £4,000 to a LISA, they can only contribute a maximum of £16,000 into other ISAs.

Adults between the ages of 18 and 40 are eligible to open a lifetime ISA, and the individual must make their first payment into a LISA by the time they reach their 40th birthday. They receive an annual government bonus of 25%, which is paid monthly, up to the age of 50.

Savings invested in a lifetime ISA can be withdrawn at any time, but will be subject to a 25% charge unless:

- the withdrawals are to help buy a first home in the UK as the only residence a person will live in, worth up to £450,000 (in London) or up to £250,000 (outside London) with a mortgage
- the withdrawals are made when the investor is over the age of 60, or
- the investor becomes terminally ill.

If the house is a joint purchase, then both individuals can use their LISAs and government bonus towards the purchase, but the maximum value of £450,000 (or £250,000) still applies.

Further, an individual can save into both a LISA and a H2B ISA (subject to the overall maximum) if they meet the eligibility criteria. However, they will only be able to use the bonus from one to buy a house.

Example Charge

Jane pays £4,000 into her lifetime ISA on 7 April 2023. She receives her 25% bonus, but on 15 June 2024, she wants to withdraw £5,000 to invest in her business. How much will Jane receive?

The £5,000 is subject to an early withdrawal charge of £1,250 (25% of £5,000). She will, therefore, receive a payment of only £3,750, and has suffered a loss of capital of £250. If there has been no growth, then there will be nothing left.

12.1.7 Child Trust Funds (CTFs) and Junior ISAs (JISAs)

CTFs are long-term savings and investment accounts specifically for children, born on, or after, 1 September 2002 and before 3 January 2011.

After starting to claim child benefit, the parent/guardian automatically received an information pack and a voucher for £250 for their child. They could then use this voucher to open a CTF account. Children in families that were eligible for the full Child Tax Credit were sent an additional voucher of £250.

CTFs were phased out in 2010, although parents/guardians who already have them can continue paying in. JISAs are a relatively new scheme for saving and investing for children that started in 2011.

A child can have a JISA if they:

- are under 18
- live in the UK (or, if they live outside the UK, their parent or legal guardian is a Crown servant, and the child depends on them for care), and
- do not have a CTF.

There are two types of JISAs:

- **A cash JISA** – no tax on interest on the cash saved.
- **A stocks and shares JISAs** – no tax on any capital gains or dividends received.

A child can have one or both types of JISAs, as long as the total subscriptions between them does not exceed the annual limit. However, unlike adult ISAs (where the investor may open and subscribe to a new ISA each tax year), children may only ever have one of each type of JISA.

Only parents or guardians with parental responsibility can open a JISA for under-16s. Children aged 16 and 17 can open their own JISAs. Money in a JISA belongs to the child and cannot usually be taken out until they are 18. At 18, the child can encash the investment or it automatically becomes an 'adult' ISA.

Since 2015, it has been possible to transfer a CTF into a JISA, by an *in specie* transfer of the investments, in cash, or a combination of the two – the process takes up to 15 working days (for a cash account) or 30 working days (for non-cash accounts) to complete. However, not all providers have migrated their CTFs into JISAs, because not all are stakeholder-compliant.

Further, children who were not eligible to have a JISA at the time that the transfer is made, may transfer their CTF into a JISA. Subscriptions may then be made to the JISA in the normal way. The subscription limit for both CTFs and JISAs in 2025–26 is £9,000.

12.2 Investing in an ISA and Subscription Limits

For the 2025–26 tax year, the overall subscription limit is £20,000. This means that the total amount that can be invested is £20,000 across all types of ISAs. As we saw in section 12.1 above, there are some exceptions to this: LISAs have a total limit of £4,000 each year, and H2B ISAs of up to £200 per month, both counting towards the £20,000 cap.

In previous tax years, it was possible for individuals to subscribe to only one ISA of each type per year. This restriction was removed with effect from 6 April 2024 – this is provided that all subscriptions within the overall subscription limited. The only exceptions are the Lifetime ISAs (LISAs) and Junior ISAs (JISAs), with investors still restricted to subscribing to only one of each type in a year.

Any savings or investments into an ISA must be made by 5 April (ie, the end of the tax year). Unused allowances (or portions of them) do not roll over into the next tax year; they are lost for good, and the ISA allowance resets on 6 April for the next tax year.

12.2.1 Additional Permitted Subscriptions (APSs)

Learning Outcome

5.11.2 Additional permitted subscriptions (APSs)

Additional permitted subscriptions (APSs) can be made to a surviving spouse or civil partner of a deceased ISA holder, provided that the deceased and the survivor were living together at the date of death. The additional subscription can be used by the survivor to subscribe to a cash, stocks and shares, flexible or innovative finance ISA; and may be transferred to another ISA manager, other than the one who held the deceased's ISA. It can be made whether or not the survivor inherited the deceased's ISA assets. A non-resident can make an APS.

The APS is the higher of cash and/or investments passed on, or the value of the ISA on the date of death.

Example

The deceased held £30,000 in an ISA at the time of their death, but it had grown in value to £40,000 by the date of distribution. Thus, their surviving partner has an APS allowance of £60,000 (ie, £40,000 plus their own £20,000 ISA allowance) for 2025–26. This is regardless of whether the deceased had made provisions in their will to transfer the assets held in their ISA to someone else.

Non-cash ISA assets can be transferred *in specie* (Latin for 'in its actual form', meaning that the distribution of an asset in its present form, rather than selling it and distributing the cash proceeds) under the APS rules. However, only assets that were held in the deceased's ISA (and at the date that the manager was notified of their death) may be transferred in this way, or in cash. *In specie* transfers can only be done with the provider who already holds the assets; should the spouse or civil partner decide to make an *in specie* APS to a manager other than the one who held the deceased's ISA, then this option is not available.

The opening of a new ISA solely to receive the APS will not breach the 'one ISA of each type per tax year' rule. Once the additional subscription has been made, they are treated as an ISA subscription in the previous year and come under normal ISA rules.

Until the administration of the estate is complete, the ISA is closed, or three years have passed since death (whichever is sooner), the deceased's ISA becomes a 'continuing account of a deceased investor', or 'continuing ISA' for short. While no money can be paid into the account from this point, it continues to benefit from tax advantages in the same way as a normal ISA.

12.2.2 Transfers between ISA Managers

It is possible for investors to transfer their ISA investments. The regulations stipulate that ISA managers have to allow transfers out, but receiving managers do not have to accept transfers.

If an investor wants to transfer the current tax year's ISA subscription, the current tax year's subscription must be transferred in its entirety.

If an investor has made subscriptions in previous years, all or part of the previous tax year's subscription can be transferred to another ISA manager at any time. The transfer does not impact the current tax year's subscription.

Additionally, investors are allowed to transfer from a cash ISA to a stocks and shares ISA, or from a stocks and shares ISA to a cash ISA.

If investors transfer savings from a cash ISA to another cash ISA, the transfer must usually be completed within 15 business days of it being requested. Any other type of account transfer must usually be completed within 30 days of the request. It is important, when making a transfer, that the cash or investments do not pass directly to the investor, because the subscription rules would prevent them being reinvested in an ISA.

12.3 Tax Treatment

Whichever type of ISA is used, all investments held within them are free of UK income tax and CGT. As per other types of savings accounts, interest is credited gross. Indeed, part of the attraction of ISAs is that they do not even have to be declared on a Self-Assessment tax return.

For stocks and shares ISAs:

- interest, dividends and property income distributions are exempt from any additional income tax
- interest from directly held government, corporate bonds, interest-bearing funds (ie, funds that are at least 60% invested in interest-bearing securities) is paid without any deduction of income tax
- property income distributions from REITs are paid gross, and
- capital gains on ISA investments are exempt from CGT (although losses from ISAs are not allowable against other gains).

The market value of a plan at the date of death forms part of the deceased's estate for IHT purposes. As ISAs cannot be written under trust, there is no way to avoid this.

13. Private Equity Schemes

Learning Outcome

5.12.1 Characteristics of enterprise investment schemes (EISs), seed enterprise investment schemes (SEISs) and venture capital trusts (VCTs) including contribution limits, tax relief and suitability considerations

In this section, we will concentrate on the characteristics of AIM, enterprise investment schemes (EISs), seed enterprise investment schemes (SEISs) and venture capital trust (VCT) investments. All of them sit under the separate asset class of 'private equity', which involves taking a stake in, or acquiring, companies that are not publicly traded on a stock exchange.

The essence of private equity investment is to provide medium-term to long-term finance to unquoted companies, in return for an equity stake in that company. The hope is that the company will provide high growth, as companies backed by private equity have been shown to grow faster than other types of companies; this is often as a result of the capital and personal input provided by specialist private equity firms. However, the key word here is 'hope', as private equity investments sit at the higher end of the risk and reward scale.

Private equity schemes enjoy certain tax concessions to make them more attractive to potential investors.

13.1 AIM

Formerly known as the Alternative Investment Market, AIM was launched in 1995 to provide trading facilities for companies either too small or too new for a listing on the official list of the LSE. It bills itself as the '*most successful growth market in the world*' with nearly 700 companies traded on the exchange today, with a total market capitalisation of over £69 billion[15]. Although AIM share prices are quoted, the companies are not officially listed: therefore, for those companies that qualify, HMRC regards the shares as being unquoted for tax purposes, which can be particularly useful as investors are able to claim business relief (BR) – see section 6.6.2 of chapter 2.

There is generally much less trading in AIM stocks, so shares may be less easy to buy and sell (illiquid), occasionally leading to delays in being able to realise investments. The market in unlisted shares is particularly illiquid, but being quoted on AIM certainly helps the liquidity issue.

13.1.1 Tax Relief on Investments in AIM Shares

AIM shares offer certain tax concessions that may help attract investors to these investments.

15 London Stock Exchange, FTSE AIM All-Share. Retrieved from https://www.londonstockexchange.com/indices/ftse-aim-all-share (Accessed: September 2025)

Tax Relief	Description
Income tax relief on certain capital losses	• This is available when an investor acquires AIM shares by subscription, and realises a capital loss. The loss can be offset against any other income in the tax year of the loss, or the previous tax year, rather than against gains made from other assets. • This relief now only applies to shares in trading companies that meet the EIS regulations (see section 13.2) from 6 April 1998, and to all qualifying shares issued before 6 April 1998.
Interest relief	• This is another income tax relief, where tax relief is allowed on the interest paid on loans raised to buy shares in a trading company controlled by its directors, or by five or fewer people. These companies are known collectively as 'close companies'. • To be able to claim the relief, the borrower has to meet certain conditions at the time the interest is paid. They should either own more than 5% of the shares or, if they own less than 5%, work for the greater part of their time in the management of the company's business.
Relief against IHT	• Shareholdings of any size in unlisted trading companies qualify for 100% BR, and so benefit from 100% relief from IHT once they have been owned for two complete years (candidates should note that AIM shares that are also listed on a recognised stock exchange will not qualify for BR). • This is also exempt from stamp duty and SDRT.

13.2 Enterprise Investment Scheme (EIS)

The EIS intends to encourage private investors or 'business angels' (*Dragons' Den*-type investors) to invest in certain types of smaller unquoted UK companies. The way the government provides this encouragement is by providing tax incentives on investments, provided the receiving company meets set criteria.



We briefly looked at the tax concessions in chapter 2: Investment Taxation. What details can you remember?

See section 13.2.1 to see how well you did.

The set criteria for companies to provide shares that qualify as EIS shares include the following:

- It must be unlisted when the shares are issued, with no arrangements for it to become listed. Companies whose shares are quoted on AIM meet this requirement.
- It must be carrying out a 'qualifying trade' wholly or mainly in the UK. Most trades qualify, but those that are specifically excluded include property development, hotels, nursing homes, farming and companies providing financial, legal and accountancy services.
- The gross assets of the company must not exceed £15 million immediately before issuing eligible shares, and £16 million immediately afterwards.
- The company must have fewer than 250 full-time employees at the date on which EIS eligible shares are issued, and fewer than 500 employees for knowledge-intensive companies (KICs).

13.2.1 Tax Relief on Investments in EIS Shares

To be able to benefit from the tax concessions associated with investments into EIS shares, the investor must be a 'qualifying individual'. This is basically someone who is not connected with the company when subscribing, although they can subsequently become a paid director of the company. Mostly investors are UK residents, although non-UK residents are eligible, but they can only claim tax relief against any liability to UK income tax. Along with 'qualifying individuals', the shares purchased need to be 'eligible shares'. These are basically new ordinary shares that are not redeemable for at least three years.

The main tax reliefs are given below:

Tax Relief	Description
Income tax relief on certain capital losses	• The rate is 30% up to a maximum contribution of £2 million per tax year, if at least £1 million of this is invested in knowledge-intensive companies (KICs). This relief is given as a tax reducer. • A contribution to an EIS can be carried back to the previous tax year, provided there is scope to invest. • This income tax relief is withdrawn if the shares purchased are disposed of within three years (except to a spouse/civil partner, and the death of the investor also does not count).
CGT relief	• On EIS investments after 5 April 2000, where income tax relief has been given, gains made are free of CGT if the shares have been held for three or more years. • For EIS investments on or before 5 April 2000, the period is five years.
CGT deferral relief	• This is a special concession when investing capital gains into EIS eligible shares. • Any capital gain can be deferred by reinvesting that gain into an EIS company with no upper limit (although the gross asset rules for the company listed earlier effectively provide a limit). • The reinvestment must take place in the period beginning one year before, and ending three years after, the disposal that gave rise to the gain. • The deferred gain is then charged when the EIS shares are disposed of (unless a further qualifying reinvestment is made).
CGT loss relief	• Losses made on EIS investments (and there are likely to be some) are allowable where either income tax relief or CGT deferral relief has been obtained. In this case, a deduction is made for any initial income tax relief that has been given. • The loss can be set against either chargeable gains or against income (as seen earlier for unlisted shares purchased before 6 April 1998).
IHT business relief (BR)	• EIS shares qualify for 100% BR once they have been owned for two complete years.

If an individual disposes of their shares within three years of issue, or within three years of trade commencing (if later), there will be a claw back of relief that is given to the investor. This claw back works in one of several ways, depending on the nature of the disposal:

- If the individual gifts the shares within three years, all of the original relief obtained will be withdrawn and an assessment made in respect of the relief given.
- If the individual sells the shares within three years for a profit, the original relief obtained will be withdrawn, and an assessment will be made in respect to the relief given.
- If the individual sells the shares for a loss, the relief clawed back will be the proceeds of the sale multiplied by 30% (or 20% if the investment was made before 6 April 2011).

13.3 Seed Enterprise Investment Schemes (SEISs)

Unlike EISs, SEISs focus on small and very early-stage companies. The scheme finances start-ups with the aim of stimulating entrepreneurship and boosting economic growth. To qualify for SEIS status, a company must:

- be based in the UK, and have a permanent establishment in the UK
- have fewer than 25 employees (or, if the company is the parent company of a group, this number applies to the whole group)
- be no more than three years old
- trade in an approved sector (eg, not in finance or investment, or a property company)
- not raise more than £250,000 in total via SEIS investment
- not have more than £350,000 of gross assets, and
- not be controlled by any investor receiving their capital.

Additionally, investors cannot have more than a 30% stake in the company that they are investing in.

13.3.1 Tax Relief on Investments in SEIS Shares

To compensate for the additional risk that they would be exposed to, investors are compensated with greater tax reliefs, as follows:

Tax Relief	Description
Income tax relief on certain capital losses	• This is given at a rate of 50%, up to a maximum contribution of £200,000 per tax year. The relief is given as a tax reducer. • Similarly to an EIS, a contribution to an SEIS can be carried back to the previous tax year, provided there is scope to invest (ie, the investor has not used up the full £100,000 in that previous tax year). • This income tax relief is withdrawn if the shares purchased are disposed of within three years (except to a spouse or civil partner, and the death of the investor also does not count).
CGT relief	• This is the same as for EISs, above.
CGT deferral relief	• This is the same as for EISs, as above.
CGT loss relief	• Similarly to EISs, SEISs also qualify for 100% BR once they have been owned for two complete years.

A qualifying company can follow a share issue under SEIS, with further issues of shares under EIS, or investment from a VCT. However, it must have spent at least 70% of the monies raised by SEIS issue before it can do so. A company cannot issue shares under a SEIS scheme if it has already gained finance from prior investment in a VCT or issued shares in respect of which it has provided an EIS compliance statement.

13.4 Venture Capital Trusts (VCTs)

In section 10, we looked at investment trusts. VCTs are very similar, except that they must invest predominantly in the shares and securities of unlisted companies. As with EIS shares, the government encourages investment in VCTs by providing tax concessions to investors.



Now the EIS has jogged your memory, what details can you remember of the tax concessions that apply to VCTs?

See section 13.4.1 to see how well you did.

Again, for VCTs to be approved by HMRC (and, therefore, for an investor to benefit from the tax concessions), a number of conditions must be satisfied, including:

- the VCT itself must be listed on the stock exchange
- its income must be wholly or mainly derived from shares or securities
- at least 70% of its investments (by value) must be in 'qualifying holdings', which are newly issued shares in qualifying unlisted trading companies (the 'qualifying unlisted trading companies' are basically ones that meet similar criteria to that we have seen apply to EIS companies)
- not more than 15% of a VCT's total investment can be invested in a single company or group of companies
- at least 30% of the VCT's qualifying holdings (by value) must be in new ordinary shares
- at least 10% of the total investment in any one company must be in ordinary shares, and
- a VCT cannot invest more than £1 million in total each tax year in any single qualifying unlisted trading company.

13.4.1 Tax Relief on Investments in VCT Shares

The main tax reliefs are given below:

Tax Relief	Description
Income tax relief on certain capital losses	• The rate is 30%, up to a maximum contribution of £200,000 per tax year. The relief is given as a tax reducer. • Unlike EIS investments, VCT investments cannot be carried back to a previous tax year. • This income tax relief is withdrawn if the shares purchased are disposed of within five years (except to a spouse/civil partner, and the death of the investor also does not count).
CGT relief	• An investor may not have to pay CGT on any gain they make when they dispose of their VCT shares, called disposal relief. • If disposal relief is due, the investor will not have to pay CGT on any gain made on the disposal of VCT shares. The following conditions have to be met: ◦ Relief is limited to acquisitions not exceeding £200,000 worth of VCT shares in any one tax year. ◦ They are an individual (not a trustee) aged 18 or over at the date of disposal. ◦ The company was an approved VCT both when the investor acquired the shares and when they disposed of them. ◦ They acquired the shares for commercial reasons and not as part of a tax avoidance scheme.
CGT deferral relief	• VCT investments are exempt from CGT on disposal, with no minimum holding period. • Due to this concession, losses incurred on VCT investments are not allowable losses for CGT purposes. CGT deferral on disposal of any asset by reinvesting the gain in VCT shares (in the same way previously described for EIS and SEIS shares) is no longer possible.
CGT loss relief	• Where the above conditions for disposal relief are met, any loss made on the disposal of VCT shares is not allowable for capital gains purposes.
IHT business relief (BR)	• Not applicable.

This is one further point to note regarding the CGT tax profile of VCTs:

- The client will not have to pay CGT on any gain on disposal of the first £200,000 worth of the shares acquired in any tax year. A gain on their disposal of shares acquired above this limit is chargeable to CGT.
- Similarly, a loss is only allowable if it arises on the disposal of shares acquired above the £200,000 limit.
- With part-disposals, when more than £200,000 has been accrued, disposals are treated on a first-in, first-out basis. In relation to shares acquired on the same day, shares acquired in excess of the limit are treated as disposed of before others acquired on that day.

13.5 Suitability of Private Equity Investments

As highlighted above, these investments provide opportunities for high returns, but with high risk. It is a truism that companies generally grow at their fastest when they are young, but there is also a high risk of failure and investors losing their money. That could be because of cash flow difficulties, reliance on the success of a single product, or being more vulnerable to domestic downturns and recessions.

Liquidity (or, rather, the lack of it) is a key factor. Private equity securities are less liquid than other listed securities, are sold less readily in large amounts, and the transaction costs are often higher. With the majority of shares in private hands, the trading volumes can be very low.

In addition, lack of information and often transparency with some of these holdings (and funds) means they are not suitable for all retail investors. As a result, to protect investors (post the global financial crisis and credit crisis), the EU introduced the Alternative Investment Fund Managers Directive (AIFMD), which focuses on monitoring and supervising the risks posed by managers of hedge funds, private equity firms and investment trusts rather than the funds themselves. The AIFMD has since been transposed into UK law, so continues to apply in the UK after the end of the Brexit transitional period.

Of the areas we have covered, VCT investments are the least risky for two reasons:

1. They are a form of collective investment, so they benefit from a degree of diversification within the VCT.
2. As a minimum of 70% of the investment has to be in 'qualifying shares', in theory, that leaves 30% of the investment to be invested elsewhere. That includes listed shares, so a VCT could include investments in large capitalisation shares such as those in the FTSE 100, or even the S&P 500. It is still a high-risk approach, however: a minimum of 70% in small companies is a significant amount.

Private equity investments are therefore not deemed appropriate for inexperienced, small-scale investors, even though they can be accessed via a CIS. They are more suited to wealthy, 'sophisticated' investors who can weigh up the risk against the rewards and who, importantly, have the overall resources to put a relatively small amount of their investments into these riskier assets.

14. Life Assurance and Protection Policies

Learning Outcome

5.13.1 Purposes, key features and relative merits of life assurance products: term, whole-of-life, endowment; regular premium policies and single premium bonds; with/without profits, unit-linked; guaranteed income and growth; annuities

5.13.2 Income, capital gains and inheritance tax (IHT) implications of investing in life assurance products

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In this section, we will concentrate on the purpose and key features of life assurance and other protection products, along with the tax implications of investing in life assurance products.

14.1 Life Assurance Products – Terminology

To begin, we will concentrate on the three main types of life assurance policies:

- term assurance
- whole-of-life assurance, and
- endowment assurance.

Throughout these areas, there will be elements of recurring terminology that we might as well cover right at the start:

- **Proposer** – the person applying to the insurer for a policy.
- **Life assured** – the person on whose death the payment is triggered.
- **Assured** – the person who effects the policy and is the original owner.

  Frequently, the life assured and the assured are the same person, in which case the policy is known as an 'own life' policy. However, this is not always the situation and the life assured and assured could be different. These policies are then known as **life of another policies.**

- Most life assurance policies are **single life**, so the death of the life assured will result in the policy pay-out and the end of the agreement.
- Policies can also be written for two lives assured (which is the most common, although it is possible to write policies for more), called **joint life policies**.
  - These are either joint life first death, paying out (unsurprisingly!) on the death of the first life assured to die. These are commonly used for family protection needs.
  - Joint life second death policies pay out on the death of the second life assured. They are commonly used on whole-of-life assurance policies to meet IHT liabilities.

14.2 Term Assurance

Term assurance is the most basic and cheapest form of life assurance that provides cover (the 'sum assured') at a fixed rate of premium payments for a specific period of time (the term of the policy). The sum assured will be paid out only if the life assured dies during the agreed term. If they do not, no payment is made, as generally there are no surrender or cash-in values. The policy then expires.

There are seven types of term assurance policies that we will briefly cover in this chapter, looking at how they are structured and their uses and merits.

 Before we look at what these are, see how many of the seven you can list.

14.2.1 Level Term Assurance

We start with the most basic form. The sum assured on a level term assurance policy does not vary during the policy term and, once the term expires, the policy expires with (normally) no value. It is a cheap form of basic cover.

Uses:
• This type of policy is often used to provide protection for the 'breadwinner' in a family scenario. This may not be ideal as most would expect their income to increase, and the sum assured remains static on a level term policy. • Level term policies have also been used to provide cover alongside an interest-only mortgage. As no capital is being paid out, the liability remains the same, which is ideally covered by a level term policy. • As mentioned in chapter 2, level term assurance can also be used for IHT planning when a previous gift may mean all or part of an estate falls above the nil rate band (NRB) for a set period (seven years). While the NRB generally increases each year (although it is currently frozen until 2027–28), possibly reducing the IHT liability, it can also be expected that the estate value will grow and, therefore, level term assurance remains appropriate.

14.2.2 Increasing Term Assurance

Similar to level term, except the sum assured increases. Generally, this increase will be at the annual renewal, but there are some policies where the increase takes place after a longer set period, say five years.

The rate of the increase differs. Many life offices offer set percentage increases, say by 3% or 5%. Probably the most appropriate are policies that increase the sum assured in line with the increase in the RPI. There is no guarantee that the RPI will increase, despite the fact that other costs may be increasing.

Some offices offer 'guaranteed insurability options', which allow the sum assured to be increased by much more substantial amounts (say, 50% of the original sum assured). These increases are offered alongside key events in an assured's life, such as marriage, the birth of a child or a remortgage.

The initial premium for this type of policy is slightly higher than that for level term policies, but this premium increases each time the sum assured increases throughout the term.

Uses:
• This type of policy is also used for family protection, with the added bonus of being able to keep up with inflation.

14.2.3 Renewable Term Assurance

The renewable option provides the opportunity for the life assured to take out a further term assurance at ordinary rates, without requiring further evidence of health (known as guaranteed insurability). The length of the renewed term is normally restricted by the original term, and also possibly by a maximum age. Each subsequent policy will have the same renewability option, incorporating the restrictions noted.

The initial premium will be higher than for a level term policy. When the policy comes up for renewal, the premium will increase further as it will be based on the increased age of the life assured.

Uses:
• This type of policy is used when there is a definite need for cover, but it is not known how long that need will last. • Often this may be the case with business insurance scenarios, such as key person protection, where an employee may be deemed a key person now, but may not be expected to remain so indefinitely.

14.2.4 Convertible Term Assurance

This is a term assurance which allows the assured to convert it to a whole-of-life or endowment assurance contract. This conversion can take place at any time during the policy term, and there will not need to be any further evidence of health.

The original premium will be higher than that for a level term assurance, as it carries this greater flexibility. Significantly, on conversion, the premium will be based on the nature of the new type of life policy, both of which are very much more expensive than term assurance.

Uses:
• This type of policy is used when there is a current need for term assurance (some kind of cover) but the likelihood of a more substantial policy requirement in the future. Ideally, the whole-of-life or endowment policy option would be chosen immediately, but there may be an impediment, primarily cost, that is stopping an assured from being able to pursue that route initially.

14.2.5 Decreasing Term Assurance (DTA)

DTA policies have a sum assured which reduces each year by a given amount, decreasing to zero at the end of the term.

Although the cover is decreasing, the premium remains level. The initial premium would be lower than for level term assurance, as the overall liability for the insurer is less. Occasionally, the premiums are actually payable for less than the full term, to try to remove the temptation for individuals to lapse the policies in the last few years when the cover is relatively low.

Uses:
• Primarily to cover reducing debts, such as on a repayment mortgage. • A special form of seven-year DTA, a 'gift inter vivos' policy, can be used by recipients of gifts that exceed the NRB, but have a decreasing liability due to taper relief.

14.2.6 Family Income Benefit (FIB)

This is a form of DTA, designed to provide the beneficiaries of the policy with regular income payments as opposed to a lump sum. A policy will pay a selected level of (tax-free) income each year, from the death of the life assured until the expiry of the term of the policy. The later the death during the term, the fewer income payments are made, so the total benefit decreases. At the end of the term, there is no remaining value in the policy.

The income payments themselves can usually be paid monthly, quarterly or annually. Alternatively, there is often an option for the income payments to be commuted to a lump sum payment.

The policies are, again, very cheap due to the decreasing nature of the cover. A slightly more expensive version would be an increasing FIB, where the income benefit increases automatically at a prearranged rate during the term of the policy.

Uses:
• As cheap family protection. Many individuals like the thought that the replacement cover will be in a form that they are comfortable with: income, as opposed to a lump sum that will require investing to produce the level of income required.

14.2.7 Unit-Linked Term Assurance

These are term assurance policies that only pay the sum assured on the death of the life assured during the term. However, in the background, the structure of the policy is such that the performance of the invested premiums may be more important.

Each month, the premiums paid are used to purchase units, and each month enough units are cancelled to pay for that month's life risk. The remaining units remain invested in a chosen fund. For term assurance, this may be a default fund set up by the life office, or possibly a very small selection of standard life office funds.

Assumptions are made by **actuaries** at the start of the policy for the performance they expect the units in the fund to achieve. If these assumptions are matched, the cover continues as normal. If the units outperform, it is possible the sum assured may be increased at no extra cost or that a cash value will build up and become available to the assured at the end of the policy term.

If the units underperform the market, a policy review may lead to an increase in premiums to sustain the existing sum assured, or the premiums remaining the same with the sum assured being decreased.

Uses:
• As we are just talking about a change in policy structure, the uses are the same as those covered (eg, an individual can have level, convertible, renewable, increasable unit-linked term assurance policies). • Potentially, unit-linked term assurance policies may be more attractive to individuals with a higher risk appetite, due to the link to fund performance, but fund performance is normally towards the bottom of the priority list when looking at life assurance protection.

14.3 Whole-of-Life Assurance

Whole-of-life policies will result in the sum assured being paid on the death of a life assured, whenever that is, and providing the premiums are up to date.

Due to the permanent nature of the cover, and the certainty of a claim as long as premiums are maintained, the premiums are more expensive than for term assurance policies. Whole-of-life policies can also build up cash-in values, although these can be very low (particularly in the early years). Certain whole-of-life policies have been established more as investments than protection vehicles, and we will look at them later in this section. For the time being, we will put the emphasis on protection.

There are four types of whole-of-life assurance policies that we will now briefly cover, looking at how they are structured and their uses and merits.

 Before we look at what these are, see how many of the four you can list.

14.3.1 Non-Profit Whole-of-Life Policies

Non-profit whole-of-life policies have level premiums, payable throughout life. They pay out a fixed sum assured, whenever death occurs.

It is possible to obtain products of this nature that cease collecting premiums at a specified age, such as 80 or 85. The initial premiums will be slightly higher as a result.

Uses:
• These types of contracts are rarely sold. • They are also the type of policy promoted by direct advertising to the over 50s. The proposal forms for these tend to be very short, with few medical questions. However, it is common for the sum assured to only be paid out if death occurs more than two years after the policy's commencement, and there is unlikely to be a surrender value.

14.3.2 With-Profit Whole-of-Life Policies

With-profit policies offer the opportunity for the sum assured to be increased by the addition of bonus payments. These bonuses are not guaranteed but, once allocated, cannot be removed. The level of the bonus depends on the performance of the life office and its funds, its assets and liabilities.

Bonuses that are added regularly are known as 'reversionary'. They are usually expressed as a percentage of the sum assured, and may be simple (based purely on the original sum assured) or compound (based on the original sum assured plus previously allocated bonuses).

It is possible that another bonus may be added when a policy comes to the claim stage (rather than surrender). This is known as the 'terminal bonus' and is usually expressed as a percentage of the total reversionary bonuses.

As mentioned, once a bonus has been allocated it cannot be removed. However, most offices reserve the right to apply a market value reduction (MVR) factor if an assured surrenders the policy or wants to switch out of the with-profit fund. The MVR enables the life office to reduce the surrender or switch value to apply fairness across all with-profit members (including those who are remaining in the fund). Bonuses are allocated from surpluses, but during times of market downturns, these surpluses are reduced. If an assured can keep their full allocated bonus, it could negatively impact on those who are remaining in the fund. Therefore, MVRs are generally only applied in periods of poor market performance if a policy is switched or surrendered early.

The amount payable on death on a with-profits whole-of-life policy is the sum assured plus whatever profits have been allocated up to the date of death.

The premiums are likely to be higher than for a non-profit policy due to the potentially higher pay-out.

Uses:
• As a standard form of whole-life cover, for example family protection or IHT planning. • The with-profit format should, in theory, be less risky than a unit-linked approach, as allocation of bonuses should provide a smoother increase in benefits. • Risk depends on the relative importance of reversionary and terminal bonuses; the greater the former, the lower the risk to the investor.

14.3.3 Low-Cost Whole-of-Life Policies

These are products sold as one policy, but, in effect, are a combination of two policies we have already considered:

- a with-profit whole-of-life policy element, and
- a DTA element.

The policy will pay out a full sum assured on early death, based on the combined value of these two elements. In the longer term, the bonuses added to the with-profit element will increase the payment from that element, while the DTA sum assured is progressively decreasing.

Example

A low-cost whole-of-life policy provides a sum assured of £100,000. This might be made up of £60,000 with-profit whole-of-life cover and £40,000 DTA. If the life assured dies immediately, therefore, there is a combined pay-out of the required £100,000. Over the years, bonuses should be added to the with-profit element, taking it up to, say, £70,000 over ten years. In the same time period, the DTA sum assured will have fallen by the equivalent amount to, say, £30,000. The sum assured pay-out on death would, therefore, be the same amount of £100,000.

The attraction of these policies is hinted at in the name: they are significantly cheaper than full with-profit policies. That is because, as we have already seen, DTAs are a very cheap form of life assurance.

The surrender values of these policies, as they are based on just the with-profit element, are even less than those available on a full with-profits policy.

Uses:
• They are used for much the same purposes as full with-profit contracts, but at a much lower cost.

14.3.4 Unit-Linked Whole-of-Life Policies

We touched on **unit-linked policies** when looking at term assurance and the same basics apply: premiums buy units, and each month, enough units are cancelled to pay for that month's life risk. The remaining units remain invested in a chosen fund.

The key benefit of unit-linked whole-of-life policies is their flexibility (indeed, they are often referred to as 'flexible whole-of-life policies'). At the outset, the assured has a choice for a given premium between:

- A standard sum assured (the sum assured that the life office has calculated they should be able to maintain for that premium based on an assumed fund rate growth).
- A maximum sum assured, where the initial sum assured is higher than the standard one. That will result in more units having to be cancelled each month to pay for the cover, and so fewer units remain invested. It is likely, therefore, that at a policy review (usually after ten years and every five years thereafter) the premium will have to be increased to be able to maintain that level of cover.

- A minimum sum assured, where the initial sum assured is lower than the standard one. That will result in fewer units having to be cancelled each month to pay for the cover, with more units remaining invested. The hope is to build up the surrender value at a time when a higher sum assured is not required.

Uses:
• The attraction is the flexible level of cover, enabling a high degree of protection in the early years (for example, when children are still dependent) and less protection with more investment in later life (when the children are expected to be independent and out of the house). • In essence, the maximum cover option is fairly similar to a ten-year convertible term assurance, with only a small amount of units actively being invested. • It is unlikely that anyone would opt for the minimum cover option at outset, as there are probably better ways to invest money if that is the intention.

14.4 Endowment Assurance

Endowments combine life cover over a specific term (like term assurance), with the guarantee that there will be some kind of payment (like whole-of-life assurance). They provide a steady mix of protection and investment, and are the most expensive form of assurance.

Endowments assurance plans developed a bad reputation in the marketplace due to many policies being sold, particularly in the 1980s and early 1990s, to repay interest-only mortgage debts. Despite the fact that ultimate cash-in values are very rarely guaranteed on any form of endowment, there were many clients who were not informed of this fact.

We will look at the three more common types of endowment assurance policies in this chapter, looking at how they are structured and their uses and merits.



To continue the familiar pattern, before we look at what these are, see how many of the three you can list.

14.4.1 Low-Cost Endowment Policies

These operate much in the same way as low-cost whole-of-life plans with two different policies operating under the structure of one, as seen below:

- A with-profit endowment element.
- A DTA element.

They guarantee to pay out the full sum assured on death. However, there is no such guarantee on the maturity of the plan, as that will depend on the bonuses added to the with-profit endowment element throughout the term. They often rely substantially on the terminal bonus pay-out to determine whether the amount required will be met.

Example

A low-cost endowment is set up with an overall sum assured of £100,000, made up initially of, say, a £60,000 with-profit endowment and a £40,000 DTA.

After 24 years and 364 days of a 25-year term, the bonuses added to the with-profit element takes the value up to £90,000, thus creating a shortfall. However, on maturity the next day a terminal bonus of £20,000 is added, providing sufficient funds to repay the debt and benefit from a reasonable surplus.

The attraction of these policies is that the initial cost is a lot less than that for a full with-profit endowment.

Uses:
• Particularly popular in the 1980s and 1990s to repay interest-only mortgages at a (seemingly) reasonable monthly cost. • Often surrendered early, eg, when people moved houses and changed their mortgage deal and terms. This provided extremely poor value for money, with very low surrender values in the early years (often a lot less than the premiums paid). • It has become popular to sell these policies on the traded endowment policy market, as the original life assured is likely to receive a higher benefit than by simply surrendering the policy to the life office.

14.4.2 Low-Start Endowment Policies

Low-start endowments are a development of low-cost endowments, but have a lower initial premium. That is because the premium rises, typically for the first five years of the policy, and then settles at a higher figure than would have been the case under a low-cost endowment for the remainder of the term.

Uses:
• These policies were originally aimed at professional people who could realistically expect their income to increase at a reasonable rate across a short period of time – for example solicitors, doctors and accountants. • Unfortunately, due to lower initial premiums, they were often sold to individuals whose income was not likely to rise, or certainly not by as much as was required to keep up with the payments. • As with the other low-cost plans just mentioned, many of these policies were surrendered early, providing a minimal return to the assured.

14.4.3 Unit-Linked Endowment Policies

These operate in the same way as the unit-linked policies we have already covered. The fund choice selection is often wider than for whole-of-life policies, as it is more of a pure investment product.

The maturity value of the policy will always be the bid price of the units, so they are very transparent (particularly in comparison with an alternative such as a low-cost endowment). As a result, if the maturity value reaches the amount required to, for example, repay a debt, the policy could be stopped immediately – saving premiums having to be paid in the future. However, this assumes that the fund performance is such that it reaches the required amount, which has certainly not always been the case.

Uses:
• Unit-linked policies in general offer greater transparency and so could appeal for that reason. • The possibility of early repayment of a debt is also attractive. • Along with other forms of endowment, the surrender values in the early years were very low, due to the high level of initial charges. Despite this, many unit-linked endowments were surrendered early.

14.5 Qualifying Policies

Given what we have just covered, you might be wondering what the appeal of endowment policies is. That appeal lies in its tax treatment and the fact that they are sold as '**qualifying policies**'.

The qualifying rules can be complicated, but broadly, a life assurance plan will be qualifying if:

- the policy term is ten years or more
- the premiums are payable annually or more frequently
- the sum assured is not less than 75% of the total premiums payable over the term
- the premiums paid in any one year are not more than twice that paid in any other year, and
- the premiums paid in any one year are not more than 1/8th paid over the term (for whole life policies where premiums are payable throughout life, the first ten years are used as the term for the purposes of this rule).

Life assurance policies all have tax to pay within the fund, which can restrict growth. The actual nature of this tax, taken as corporation tax, again can be very complex, but the net result is that funds are assumed to have paid tax at 20%. The advantage of a policy meeting the qualifying rules is that the proceeds from a qualifying policy are paid free of tax, regardless of the tax status of the assured on policy maturity or earlier death.

This was, and is, the appeal of endowments. They are always sold as qualifying policies and benefit from the 'no additional tax' treatment after ten years, or three-quarters of the term if that is sooner (ie, a 15-year policy would be qualifying after ten years, and a 12-year policy qualifying after nine years).

This 'no additional tax' status covers income tax and CGT (as for ISAs and other wrappers). Unlike ISAs, however, these policies can be written in trust. This is less of an attraction for endowments, where the life assured is generally intended to be the beneficiary and, therefore, we begin to overlap with the realms of a 'gift with reservation' (see chapter 2, section 6.3.5). However, whole-of-life plans, when used for protection purposes, are also qualifying policies and it often makes sense to write these in trust.

14.6 Non-Qualifying Policies

We have seen some of the rules for a life assurance plan to be qualifying. One of these is that premiums are paid regularly (annually or more frequently). As a result, any single premium life assurance bonds (SPLABs) will be non-qualifying, which impacts on its tax treatment. Despite this, SPLABs play an important part in the UK investment environment, as they offer something different to other collective investments already covered.

Unlike qualifying policies, non-qualifying policies are liable to additional tax. This additional tax liability is an income tax liability, not a CGT liability. The possible reason why people often get confused about this is that gains are measured to confirm the additional income tax liability.

As with qualifying policies, SPLABs pay tax within the fund, equivalent to 20%:

- **Non-taxpayers** cannot reclaim this tax as it is part of the product structure.
- **Basic rate taxpayers** have no further liability.
- **Higher rate taxpayers** will have an additional liability of 20% of the chargeable gain.
- **Additional rate taxpayers** will have an additional liability of 25% of the chargeable gain.

Significantly, this liability will only be measured when specific events occur and not on an ongoing annual basis. These events are known as 'chargeable events'. The main chargeable events are:

- **D**eath
- **A**ssignment for money or money's worth
- **M**aturity
- **P**artial surrender (over a specified limit)
- **S**urrender.

We have deliberately put them in this order, as a way to remember the chargeable events is to recall the acronym 'DAMPS'.

When a chargeable event occurs, a chargeable gain is calculated. When calculating the capital gain, any starting rate for savings and the personal savings allowance (PSA; see chapter 2, section 3.2) should be considered. The amount of the allowances that apply are determined by the individual's adjusted net income (see chapter 2, section 3.3).

You will recall from chapter 2, section 3.2.1, that the personal allowance is reduced by £1 for every £2 of income above the £100,000 limit. Previously, if a chargeable event took an individual's income above this limit, then the personal allowance was reduced accordingly. Following the implementation of the Financial Bill 2020, the personal allowance is no longer reduced, thus allowing individuals to retain the full benefit of their personal allowance.

As considered in chapter 2, an investor in a SPLAB is entitled to withdraw 5% of the original investment per annum, with no immediate tax liability. In the chargeable events list above, this is therefore the specified limit on partial surrender. The reason why it is termed a partial surrender is that these withdrawals are not officially classed as income, although they may be used by an investor as such.

The 5% available withdrawals are cumulative, and so if they are not used for a number of years, an investor may be able to take out a large withdrawal and not have an immediate tax liability.

Example

Harry invested £50,000 in a SPLAB just over nine years ago. He has never taken any withdrawals. As he is now in the tenth policy year, he is allowed to withdraw 50% (ie, 10 x 5%) of his original investment without an immediate tax liability. He is, therefore, able to withdraw £25,000 (ie, 50% of £50,000) without triggering an immediate tax charge.

As we can see from the list of chargeable events, a partial surrender over the permitted limit would result in an immediate tax liability. If Harry withdrew £35,000 rather than the £25,000 to which he is entitled, it would be a chargeable event, and a chargeable gain would have to be calculated. Whether Harry has any additional tax to pay would depend largely on his tax status at the time of the chargeable event. He is also able to utilise the top-slicing facility we saw in action in chapter 2, section 5.1.16.

Example

Harry has withdrawn £35,000, which is £10,000 above the amount allowed. He has made this gain over nine years, so he is into his tenth policy year. When top-slicing a partial surrender, we are able to use part years. Therefore:

$$£10{,}000 / 10 = £1{,}000 \text{ slice}$$

This is then added to Harry's taxable income (ie, after allowances) for that tax year.

If we first assume he has taxable income of £35,000:

$$£35{,}000 + £1{,}000 = £36{,}000$$

- This is below the basic rate band for 2025–26 of £37,700.
- Therefore, Harry has no additional tax to pay.

If we then assume he has taxable income of £37,000:

$$£37{,}000 + £1{,}000 = £38{,}000$$

- This is £300 over the basic rate band of £37,700.
- This £300 is taxed at 20%, ie, 20% x £300 = £60.
- We need to multiply by the number of part years the plan has been running:

$$£60 \times 10 = £600$$

- Harry would have an additional tax liability of £600.

The same basic concept applies to a full surrender, although the calculation is slightly different.

Example

Assume that Harry has never taken any withdrawals, but instead chooses to totally surrender the SPLAB in the tenth policy year. The surrender value is £62,000 (based on his investment of £50,000). When top-slicing a full surrender, we use full policy years in the top-slicing calculation. Therefore:

$$\left(£62{,}000 - £50{,}000\right) / 9 = £1{,}333.33$$

This is then, again, added to Harry's taxable income for that tax year. If we firstly assume he has taxable income of £35,000:

$$£35{,}000 + £1{,}333.33 = £36{,}333.33$$

- This is still below the basic rate band for 2024–25 of £37,700.
- Therefore, Harry has no additional tax to pay.

If we then assume he has taxable income of £37,000:

$$£37{,}000 + £1{,}333.33 = £38{,}333.33$$

- This is £633.33 over the basic rate band for 2025–26 of £37,700.
- This £633.33 is taxed at 20% (ie, 20% x £633.33 = £126.67).
- We need to multiply by the number of full years the plan has been running:

$$£126.67 \times 9 = £1{,}140.03$$

- Harry's tax liability on the surrender is therefore £1,140.03.

A similar calculation on full surrender can take place if the assured has previously taken partial surrenders within the 5% limit.

Example

Assume that Harry took a £25,000 withdrawal, as he was entitled to, in the tenth policy year. He then took no further withdrawals, but chose to surrender the plan fully after 15 years, with the policy value sitting at £55,000.

His chargeable gain is:

$$£55,000 + £25,000 - £50,000 = £30,000$$

Remember, when top-slicing a full surrender, we use full policy years in the top-slicing calculation, thus:

$$£30,000 / 15 = £2,000$$

This is then, again, added to Harry's taxable income for that tax year.

If, we firstly assume he has taxable income of £35,000:

$$£35,000 + £2,000 = £37,000$$

- This is below the basic rate band for 2025–26 of £37,700.
- Therefore, Harry has no additional tax to pay.

If we then assume he has taxable income of £38,000:

- The £38,000 already sits above the basic rate band for 2025–26 of £37,700.
- The full £2,000 top-slice is therefore taxed at 20% (ie, 20% x £2,000 = £400).
- We need to multiply by the number of full years the plan has been running:

$$£400 \times 15 = £6,000$$

- Harry's tax liability on the surrender is, therefore, £6,000.

In this last example, there was absolutely no point in top-slicing. When an investor is already a higher rate taxpayer, on a chargeable event, all you need to do is multiply the chargeable gain by 20% (ie, 20% x £30,000 = £6,000), which saves some time.

When a chargeable gain is assessed following a chargeable event, that particular gain will not be part of any future calculations.

For example, when Harry took a partial surrender of £35,000, then £10,000 was assessed because that was over his entitlement of £25,000. That £10,000 amount will not form part of any future chargeable gain calculation, although the £25,000 will.

For onshore bonds, if the chargeable event is a second or subsequent part or full surrender the gain is **top-sliced** by the number of complete years since the previous chargeable event (however, for offshore bonds the gain is always divided by the number of full years the bond has been in force, irrespective of previous chargeable events).

14.6.1 Using Non-Qualifying Policies as Investments

There is a continuous debate in the financial services sector about the use of SPLABs as investments as opposed to, say, unit trusts and OEICs. Despite the fact that they may be invested in roughly the same types of assets, their tax treatment is very different.

- SPLABs pay more tax in the fund, and in isolation, that would appear to be a good reason for using the more tax-efficient unit trusts and OEICs, as the latter should grow more quickly.
- Non-taxpayers can never reclaim the tax already paid in SPLABs, whereas they can do so if invested in interest-bearing unit trusts/OEICs.
- Withdrawals from SPLABs do not count as income, and therefore can be very tax-efficient for higher rate taxpayers and investors who are over 65, as the withdrawals do not count against their age allowance.
- Due to the ability to defer a tax liability, a canny investor can wait for an appropriate time to create a chargeable event. The most obvious example is to invest in a SPLAB when earning well and falling into the higher-rate tax bracket. Then, once income has decreased into the basic-rate tax bracket following retirement, create a chargeable event by surrendering the policy (or partly surrendering above the 5% cumulative amounts) and have no further tax liability due to top-slicing.
- Generally, SPLABs have very high and opaque charges compared with unit trusts, OEICs and investment trusts.
- The proponents of unit trusts and OEICs argue that the investor has greater control and the ability to limit tax from these types of products (eg, through the use of CGT allowances and ISA wrappers), so the above arguments carry little weight. Even if they pay CGT, it is a lower rate than income tax.

These types of policies are exempt from CGT in the hands of the original investor. Some policies, mainly qualifying, are sold on (assigned to a new owner) and it is possible these will be liable to CGT in the future.

As with qualifying policies, non-qualifying policies can be written in trust to help avoid an IHT liability. Indeed, many SPLABs written under trust have helped reduce IHT liabilities.

14.6.2 Guaranteed Income Bonds

Guaranteed income bonds are single premium non-qualifying life assurance policies. The concept is simple: in return for the single premium investment, the bond will provide a guaranteed income each year for a specified period. The income is usually payable annually in arrears, with terms normally up to five years. On maturity, the capital is returned. They follow the same tax rules as we have already covered for non-qualifying policies.

14.6.3 Guaranteed Growth Bonds

Guaranteed growth bonds are similar to guaranteed income bonds except that they pay no income. Instead, an investor invests a single premium and is guaranteed a capital sum in three, four or five years' time.

While the bond is invested, it generates no income for the investor.

Guaranteed growth bonds follow the same tax rules as we have already covered for non-qualifying policies, with the investor benefiting from guaranteed capital appreciation that is free of CGT and basic-rate income tax because it is levied on the fund, not on the individual investor.

14.6.4 Capital Redemption Bonds (CRBs) and Life Assurance Bonds

CRBs are issued by insurers, with the promise of the payment of a fixed sum on maturity that is the higher of either the value of the underlying assets or 2.5 times the premium. Broadly, CRBs and life assurance bonds are the same, with the application of the same tax treatments and the ability for investors to take tax deferred withdrawals within the 5% withdrawal allowance. However, the key difference is that CRBs have a maximum fixed term of 99 years, while the longevity of life assurance bonds is linked to the life (or lives) assured.

For this reason, CRBs are more popular with companies, as a way of investing cash reserves for the medium to long term while deferring tax charges until a later date. This is because, for life assurance bonds, companies would otherwise need to link the bond to the life of one or more of its employees (usually the directors), who could then leave the company at some stage in the future.

Similarly, CRBs are also typically favoured by trustees; as well as private investors who do not want to specify a life assured, or perhaps those who have an unfavourable outlook on life assurance (eg, on religious grounds).

Some of the advantages and disadvantages of CRBs are as follows:

Advantages	Disadvantages
• CRBs are much simpler than life assurance bonds as no lives are assured. • Plans do not end on death, so the timing as to when benefits may be taken out of the plan are more flexible. • From this, policyholders can control the timing of when (or where) tax charges may arise – eg, by deferring encashment of the plan until their tax position is more favourable, until they are resident in a more tax-friendly jurisdiction, or passing on the CRB to someone else. • CRBs have greater flexibility for passing on investments to someone appointed under the terms of a will or through a trust. • CRBs may, therefore, be beneficial for long-term IHT planning, as they may be passed on through a number of policyholders without interruption. • They are a useful aid in other ways for IHT planning. If the policyholder is UK resident, then there is no chargeable event as the policy does not come to an end. For non-UK resident policyholders, CRBs are classed as excluded property for IHT purposes.	• The value of CRBs may fall with any declines in the market (ie, they are exposed to market risk). • Those that are linked to fixed interest funds or bonds will fall in value when interest rates rise (ie, interest rate risk). • Similarly, foreign exchange-denominated investments are exposed to exchange rate risk. • No compensation scheme applies, as the insurer is the one invested in the assets. So, policyholders' savings will be lost if the insurer is placed into liquidation (ie, issuer risk). • If early withdrawals are made, policyholders must pay an 'early withdrawal charge', which reduces potential returns. These charges tend to be higher in the earlier years of the savings period. • That said, CRBs are not liquid investment vehicles, so are only suitable for individuals who can keep their savings locked up for the longer term. • Due to the long savings period, individuals should be prepared for changes in the markets in the meantime, which may impact returns.

14.7 Annuities

An **annuity** is a contract to pay a given amount on a regular basis (generally annually or more frequently) during the life of the annuitant (the person on whose life the contract depends). The size of the annuity depends on a number of factors, including the age (and, therefore, the life expectancy) of the annuitant, the prevailing interest rates, the number of options ('bells and whistles') built into the annuity, the health of the annuitant, even sometimes the annuitant's postcode.

The tax situation of annuities differs depending on the nature of the annuity. We will now consider the most common types of annuities.

14.7.1 Purchased Life Annuities

These are annuities that can be purchased from any source of money, at any age.

The annuity payment is treated partly as a return of capital and partly as interest. The return of capital amount each year is based on the life expectancy of the individual – the older they are, the shorter the life expectancy, the higher the proportion of the annuity is deemed to be simply the annuitant getting their capital back. This return of capital element is tax-free.

The interest element is taxed as savings income, often with tax deducted at the basic rate of 20%. Higher and basic rate taxpayers are therefore required to pay any additional tax due through Self-Assessment or an adjustment to their PAYE code.

It is possible for non-taxpayers to receive the whole annuity gross, even the interest element. In the UK, they can do this by completing an HMRC R89 form.

14.7.2 Pension Annuities

Pension annuities must come from accumulated pension funds.

Pension annuity payments are taxable in full and are generally operated under the pay as you earn (PAYE) system, with the provider deducting the appropriate amount of income tax by reference to the annuitant's tax code.

14.7.3 Immediate Needs Annuities

Immediate needs annuities are impaired life annuities used for long-term care. An impaired life annuity is one where the annuitant has specific health issues that adversely affect their life expectancy. They are underwritten on an individual basis. There is no income tax liability on this type of annuity when it is used for long-term care, and payments are paid directly to the care provider.

14.8 Protection Products

Learning Outcome

5.13.3 Purposes, key features and relative merits of protection products: income protection insurance (IPI), critical illness cover (CIC) and private medical insurance (PMI)

Having looked at life assurance products, we will now study the insurance solutions for when the situation is not quite so extreme: policies that provide benefits based on the health of the life assured.

14.8.1 Critical Illness Cover (CIC)

The concept of CIC (also known as 'critical illness insurance' or 'dread disease cover') is to pay out a lump sum on the diagnosis of one of several specified critical illnesses (still occasionally referred to as 'dread diseases').

The list of illnesses covered by life offices differs, but most claims are made from the assured contracting cancer, or suffering a heart attack or stroke.

Following poor publicity about claims being rejected due to the small print in the definition of illnesses, an industry working party has produced a set of standard definitions. Most insurers have adopted these definitions.

There has also been an issue over recent years about non-disclosure, where claims have been rejected due to information not being disclosed by applicants on proposal forms. Another situation may arise where the insured person delays or avoids seeking medical attention, which then affects the severity of the illness and the required pay-out. The ABI published guidance on this issue[16], which has been credited with helping produce a record level of CIC claim pay-outs.

CIC can be attached to life assurance cover, or issued on a standalone basis. The standalone nature introduced the concept of the survival period, with the life assured having to survive after diagnosis by, say, 14, 28 or 30 days before the claim is paid. This supports the notion that CIC is survival insurance.

Most CIC policies are reviewable policies. This means that premiums are only guaranteed for a fixed period of the overall term (eg, the first five years). Due to the ever-changing advancements in the medical profession, this is an important safety net for life offices. With diagnosis techniques becoming progressively more advanced, the likelihood that an illness covered under the policy will be diagnosed earlier than anticipated is growing, leading to earlier pay-outs for insurers.

A CIC payment is not a chargeable event and so there is no possibility of an income tax liability. No transfer of value is involved either and so there will be no IHT liability either.

Uses:
• CIC is commonly used to protect a debt, particularly a mortgage. This could either be on a level or decreasing basis. • It is particularly attractive to single people who have no real need for life assurance. A CIC pay-out can help them retain their independence. • The pay-out of an additional lump sum in addition to that required to cover a debt, is also advised. This additional amount can be used to help pay for alterations to a home, or to a car, that may be required following the illness. • At least one life office is also marketing CIC as retirement protection, based on the concept that suffering a critical illness could seriously impair an individual's chances of building up a sufficient retirement fund. • CIC is also commonly used in business protection insurance.

Over time, many insurers have been adding to the specific illnesses and conditions that they cover, in particular relating to child-specific conditions and pregnancy complications. The policies, terms and definitions may vary between insurers, so it is important for individuals to read through contracts and policy documents carefully.

16 Association of British Insurers, January 2008. Non-Disclosure and Treating Customers Fairly: Claims For Long-Term Protection Insurance Products. Retrieved from https://www.abi.org.uk/globalassets/sitecore/files/documents/publications/public/migrated/health/abi-guidance-on-non-disclosure-and-treating-customer-fairly.pdf (Accessed: October 2025)

14.8.2 Income Protection Insurance (IPI)

Whereas CIC provides a lump sum benefit, IPI provides a regular income following an illness or accident leading to an insured person being unable to work. This income continues until the insured recovers and is able to return to work, reaches a specified age, retires or dies. If the insured does recover, the insurer cannot cancel the cover based on the fact they know their risk has been increased, as long as the insured continues to pay premiums. This is why this form of cover was previously known as permanent health insurance (PHI) and is preferable to general insurance, such as accident and sickness cover, where the insurer can cancel cover at renewal.

There are many factors that impact on the premium for IPI in addition to the standard ones of age and amount of cover.



What other key pricing factors can you think of for IPI?
Examples include:

- **The choice of deferred period**. Standard deferred periods (the period before any income is paid out) are 4, 13, 26 and 52 weeks. The longer the deferred period, the cheaper the cover. The choice should be tied in with any possible sickness benefits paid by an employer, or the degree of cash funds built up for an emergency situation such as this.
- **The occupation of the insured**. Occupations are commonly split into classes, typically 1 to 4, with Class 1 being the least risky (eg, admin-based jobs) and Class 4 being skilled workers in hazardous jobs. Some occupations are simply too risky and are excluded altogether.
- **The type of incapacity cover**. Some insurers offer 'own occupation' cover where the insured will be paid if they are unable to undertake their own occupation. Others offer the less attractive 'suited occupation' or even 'any occupation' options where the insured will only be paid the benefit if they are unable to perform a suited occupation, or any occupation whatsoever.
- **The term of the cover**. Often, this will be up to an individual's retirement age, to provide income protection throughout a working life, but shorter terms (say, five or ten years) are available.

The underwriting for IPI is a lot stricter than for life assurance; and frequently, certain pre-existing conditions (such as knee or back problems) are excluded.

The tax situation of IPI policies is interesting, because the benefits are totally free of income tax. For this reason, and to provide an incentive for individuals to return to work as quickly as possible, the maximum level of cover is restricted to between 50% and 75% of the insured's pre-incapacity earnings. Again, different insurers have different rules, some incorporating state benefits and some not – this is not an FCA requirement, but a standard industry approach.

Uses:
• An IPI policy can benefit almost anyone who is working. • For an employed person, the benefit can be tied in with any sick pay they receive from their employer. • For a self-employed individual, they may want the deferred period to be shorter, but the need for cover might be greater, as it is possible that an illness could lead to all income ceasing. • Some firms also offer IPI cover for homemakers, conscious that an illness could lead to greatly increased costs for the family as a whole.

14.8.3 Private Medical Insurance (PMI)

Those living in the UK have the benefit of the National Health Service (NHS) and, therefore, if they are ordinarily resident, free medical cover. However, the market for PMI has grown by trying to meet the demand for treatment of various conditions.

There are many different types of PMI, from budget plans (with low costs, high excesses and limits on cover) to comprehensive plans (which are the costliest, but provide the fullest cover). There are also hospital cash plans, which pay a fixed cash sum for each day spent in an NHS hospital, plus fixed cash sums for specified treatments, including optical and dental treatment.

To try to keep costs down, the initial underwriting process is often fairly cursory. However, this is on the condition that pre-existing medicals will not be covered. Sometimes, this is based on a minimum time period, such as two years.

PMI is a general insurance contract, so premiums are subject to insurance premium tax (5%).

Uses:
• For anyone who would like more control over the timing of medical procedures for acute illnesses. • Also, for those who do not want to be treated in an NHS hospital, but would prefer a private room with treatment in keeping with the surroundings. • Dental plans are fairly common due to their affordability.

15. Pension Provision and Eligibility

In this section, we will concentrate on all forms of pension provision, from the state, to employers, to personal provision.

15.1 State Pensions

Learning Outcome

5.14.1 State pension provision

Despite many attempts to try to get individuals to take more personal responsibility for their pension income, the state remains a major provider.



List as many state pension benefits as you can. We are going to look at five state pensions, some in more depth than others, to establish an understanding of this important form of pension provision.

The sections below make reference to binary 'men' and women'. The UK government legally recognises individuals' acquired gender under the Gender Recognition Act (GRA) 2004 – this may differ from the gender that they were assigned at birth. In these cases, pension rules follow that of the assigned gender. This recognition is provided the individual has obtained a Gender Recognition Certificate (GRC), and they have met the criteria for recognition as set out in the Act. Legal recognition is not extended more widely (eg, individuals who are non-binary, non-gender, gender fluid and/or have not obtained a GRC). The current legislation, therefore, has the opportunity to be more inclusive of the diversity of genders that individuals identify with, and is a topic of active discussion.

15.1.1 State Pension

Two types of state pension need to be considered depending on the date the individual reached their state pension age:

1. Those who reached state pension age (SPA) before 6 April 2016 (a man born before 6 April 1951 or a woman born before 6 April 1953) are entitled to the old state pension, whether or not they took it before 6 April 2016.
2. For those reaching SPA after 6 April 2016, they will be entitled to the new state pension, although there are transitional arrangements to ensure that no one retiring after 6 April is worse off than they would have been under the old state scheme.

15.1.2 The Old State Scheme

The basic state pension (BSP) was the pension paid by the state if a person reached SPA before 6 April 2016.

- How much they received depended on how many years of National Insurance contributions (NIC) the individual made over their working lifetime.
- The maximum basic pension paid for 2024–25 is £169.50 per week. This increases every year by whichever is the highest of the average percentage growth in earnings, the percentage growth in prices as measured by the CPI, or 2.5%; this is a government commitment known as the triple lock.

In addition to the basic pension, an individual could qualify for additional state pension benefits.

15.1.3 State Second Pension (S2P)

S2P is an earnings-related pension. To ensure that the principal aim of government was met, that is that low and non-earners received a greater benefit from S2P, there were originally three bands of accrual. Since 6 April 2010, there have been two bands:

- A **lower earnings limit (LEL)** – this is the amount of earnings that allow an employee to qualify for certain state benefits (eg, the basic state pension).
- An **upper earnings limit (UEL)** – any individual who is paid over the UEL will pay NICs at a lower rate on the earnings above this limit; otherwise, the standard rate applies.

Since 2012, it has not been possible to contract out of S2P using a money purchase or appropriate personal pension/stakeholder plan. Following the introduction of the new state pension, since April 2016 it has not been possible to contract out of final salary schemes.

15.1.4 State Pension Credit

The state pension credit is made up of two elements: guarantee credit and savings credit. They work in combination to give each individual in the UK a guaranteed minimum level of weekly income with, possibly, a little extra based on previous savings.

15.1.5 The New State Pension (SP)

In 2016, the old state pension system was replaced in total by the new state pension. It applies to all eligible claimants who reach state pension age on or after 6 April 2016. To be able to claim the new state pension, a man must be born on or after 6 April 1951, and a woman born on or after 6 April 1953.

The full level of the new state pension is £221.20 a week for 2024–25 (again, rising each tax year under the triple lock), although how much an individual receives depends on how many years' NI contributions they have made over their working lifetime. To qualify, they need to have participated for at least ten qualifying years – either by working, being credited while caring for a family, or voluntarily paying to make up missed years. To get the new full state pension, individuals will need 35 qualifying years (for those without a pre-April 2016 NI record).

To pay NICs, individuals must earn over the primary earnings threshold (£242 per week for 2024–25). However, qualifying years can be established if a person earns more than £123 per week from one employer.

Some individuals are credited with NICs even if they do not earn this amount.

 When do you think NICs will be credited?

The most common examples of NIC credit are:

- Receiving certain state benefits, such as Statutory Sick Pay (SSP), Statutory Maternity Pay (SMP), Statutory Paternity Pay (SPP), or Jobseekers' Allowance (JSA).
- Carers (on carers' allowance) and some parents and foster carers.
- Being in full-time education between the age of 16 and 18 (university years are not credited).
- Unemployed men who have reached women's SPA (without the need to sign on to receive Jobseekers' Allowance).

For those who have qualifying years before April 2016, there will be a reduction in the state pension for any period that they contracted out of the additional state pension schemes. Qualifying years can be added after 5 April 2016, but not if the pension is already above the full new state pension.

15.1.6 State Pension Forecast

Anyone in the UK wanting an idea of their overall state pension entitlement can go online to check their state pension forecast on the GOV.UK website[17]. Alternatively, they can write to the Future Pension Centre and ask for a forecast application form (BR19). The individual can ask for the completed form to be sent to their nominated financial adviser if they choose.

The SPA has been undergoing radical changes since 2010. While currently 66 for both men and women, the SPA will be increasing to 67 between 2026 and 2028, to 68 between 2037 and 2039 (rather than between 2044 and 2046, as originally proposed), and to 69 by 2049.

An eligible claimant can defer their state pension. For those reaching SPA before 6 April 2016, the state pension will increase by 1% for every five weeks that the claim is delayed, this is equivalent to 10.4% for every full year. For those reaching SPA on or after 6 April 2016, the minimum deferral period is nine weeks, and the pension will increase by 1% for every nine weeks (just under 5.8% per year).

Under the old state pension scheme, if the pension was deferred, a spouse or civil partner could claim the amount deferred either as extra pension or as a lump sum, provided it had been deferred for at least 12 months and they had not remarried or entered a new civil partnership. The new SP cannot be inherited except for the protected payment. The protected payment is the amount a pensioner is entitled to which is above the full new SP and is calculated using the old state pension rules.

17 GOV.UK. Check your State Pension forecast. Retrieved from https://www.gov.uk/check-state-pension (Accessed: October 2025)

15.2 Occupational Pension Schemes (OPSs)

Learning Outcome

5.14.2 Occupational pension schemes, including the relative merits and disadvantages of defined benefit and defined contribution schemes

OPSs have long been seen by employers as key employee benefits, helping build loyalty in a firm and rewarding that loyalty with, in effect, deferred pay. The cost associated with certain types of OPS, however, is beginning to be seen by many as excessive, and with a more mobile workforce in general, the golden age of OPS may well be behind us.

There are two key structures of OPSs:

- defined benefit (DB)
- defined contribution (DC).



Before we go on to look at these in more detail, what do you think are the advantages and disadvantages of both structures?

15.2.1 Defined Benefit (DB) Schemes

DB schemes are retirement plans that promise employees a specific pension amount upon retirement. The pension amount is defined according to rules based on the employee's salary and the number of years that they have worked with a company. In a traditional DB scheme, this pension calculation is typically based on the employee's final salary (hence, DB schemes are often referred to as final salary schemes) or the average of their highest-earning years (a method known as career averaging).

The benefits of DB schemes are based on three factors:

- the rules based on the employee's salary (eg, final salary, career averaging)
- the years' service in the pension scheme of a member, and
- the scheme's accrual rate.

Example

Gareth joined XYZ ltd when he was 44 and, having served a one-year probationary period, was allowed to join the company's OPS. He is soon to retire at age 65, and has a salary of £40,000 a year, £7,000 of which is made up from bonuses for sales. The rest is his basic salary. The OPS is a '60th' scheme that determines pensions using only basic salary. His estimated pension benefit is:

$$£33,000 \times 20 / 60 = £11,000 \text{ a year}$$

Some schemes, generally in the public sector such as the NHS scheme, provide a tax-free cash payment in addition to the pension entitlement. Other schemes allow tax-free cash to be taken, but only via commutation (ie, forsaking some annual pension for a lump sum amount).

The funding of DB schemes is complicated because the scheme is promising the member a level of benefits that must be met in the future. This is a hard objective to achieve, as the vagaries of long-term investments play a big role in the success or failure of the scheme funding, but the promise remains. The risk is therefore predominantly carried by the employer, as they are committing themselves to a promise to pay for an unknown period of time, because they do not know how long the member will live, post-retirement. Some schemes are contributory where, for an employee to be a member, they are required to contribute a fixed percent of their salary, say 5% a year. Some, more generous schemes, are non-contributory.

There are strict rules that govern the safekeeping of pension funds, so that they are not used to prop up an ailing company (as was the case with the Mirror Group in the 1990s), and to try to ensure, as far as possible, that the scheme funding is sufficient to meet the liabilities. The ownership of the scheme assets lie with the trustees, who must safeguard the assets on behalf of the members. Most of these rules were laid out in the Pensions Acts of 1995 and 2004, which we will look at in section 15.3 of this chapter.

OPSs are also committed to statutory increases in pension entitlements. This impacts individuals who leave an OPS, but have built up 'preserved benefits'. They do not lose these benefits. Indeed, there is a statutory requirement on the OPS to revalue the final salary to retirement, at least trying to ensure the salary keeps pace with inflation. In addition, at retirement, there are statutory requirements for OPS to increase the actual benefit amounts being made, again in an attempt to try to ensure they at least match inflation. All of these statutory requirements add to an OPS's liabilities, and, therefore, its costs. The advantages and disadvantages of a DB scheme can briefly be summarised as follows:

Advantages	Disadvantages
• Members know roughly what they will receive. • Members benefit from statutory revaluing to keep pace with inflation. • Helps retention of staff for an employer, particularly as such schemes are becoming rarer.	• Scheme carries all the investment risk. • Scheme must appoint trustees, actuaries and auditors, and formulise costing structure. • Scheme must contribute to compensation schemes, adding to costs.

You can see from this very short comparison that the advantages of a DB OPS lie mainly with the member and not the employer. As a result, many trustees of OPSs have reacted in the recent past by trying to reduce costs. Examples are:

- Closing the scheme to new members, and therefore just maintaining their liability to members who joined before a certain date.
- Closing the scheme to all members, which is a more drastic approach than the one above.
- Reducing the accrual rate (eg, from a 60th scheme to an 80th scheme).
- Increasing the normal retirement age (NRA), so contributions are made for longer, while the pension will be paid for a shorter period.

- Altering the definition of 'final salary'. There has been a growing trend for 'career average' schemes, which use the average of the revalued earnings for an individual over the whole of their period in the scheme, rather than just the final (probably highest) salary.
- Insisting on an increase in employee contributions.
- Reducing pension increases to the statutory minimum, if the scheme was used to pay higher discretionary benefits in the past.

A DB pension scheme does not have access to the pension freedoms that are available to personal pensions.

15.2.2 Defined Contribution (DC) Schemes

With a DC OPS, the only known factor is the initial amount that is invested on behalf of the member. From then on, there are many uncertainties, including the performance of the fund in which the money is invested, the level of charges applied by the provider, the annuity rate that will be available at retirement if the fund is converted into income, and the value available for drawdown under new pensions legislation. Further, while investment decisions can lie with the employee, some firms offer only a default fund and, hence, no investment choice, only the choice to have a pension or not.

Since DC OPSs come under occupational scheme rules, trustees must still be appointed, but their role is less significant as far as the funding of the scheme goes. They have no liabilities to meet – in a DC scheme, that has been done simply by paying the contribution. The risk associated with the ultimate scheme benefits is therefore transferred almost entirely to the member.

The statutory revaluation requirements that apply to DB schemes do not apply to DC schemes. If a member leaves the scheme, the possibility of the benefits increasing will rely greatly on the performance of the fund that the member is invested in. If the member wants to ensure their pension benefits increase in retirement, they will have to incorporate an escalation option in their annuity. They can do this, but the initial annuity will be greatly reduced (by some calculations, by so much that it will take roughly 12 years for the income level to match the amount that could have been taken immediately as a level pension, and a further eight years to have actually received more money overall from the annuity provider).

The advantages and disadvantages of a DC scheme can briefly be summarised as follows:

Advantages	Disadvantages
• Employer knows exactly where their commitment ends. • Good fund performance could lead to higher benefits. • Helps retention of staff for an employer. • Lower costs for an employer to run. • Funds can be transferred to a new employer or personal pension.	• Members carry all the risks, investment and annuity. • Members are restricted to the fund choices offered by the employer. • Poor fund performance could lead to lower benefits. • Unknown benefits; therefore, hard to plan ahead.

Do not be misguided by the discrepancy in the number of advantages and disadvantages. The really important ones for the member are in the 'disadvantages' column, which is why the growing spate of DB schemes being closed is filling so many column inches in the press.

15.3 Pensions Acts

Learning Outcome

5.14.3 Relevance of pension legislation since 2006 in protecting members of occupational schemes including redress and compensation

As we have already mentioned, in the UK, the key Pensions Acts that are relevant to the protection of current members of OPSs are those that were passed in 1995 and 2004; other Acts have been enacted in the interim and since then, but these are more concerned with modernisation and governance than protecting OPS members. The most recent – the Pensions (Abolition of Lifetime Allowance Charge) Regulations 2024 – removed the lifetime allowance (LTA) from tax legislation; for example, see section 15.5.2.

The 1995 and 2004 Acts were very thorough and detailed when looking at them in their entirety, but we will concentrate on the key aspects of each. Also of importance are the Acts that brought in pension freedoms: the Taxation of Pensions Act 2014 and the Pensions Act 2015.

15.3.1 Pensions Act 1995

- Established a new regulator, called the Occupational Pensions Regulatory Authority (OPRA).
- Requires trustees to draw up a Statement of Investment Principles (SIP).
- Introduced the concept of a minimum funding requirement (MFR) which had the objective of maintaining a defined benefit scheme's assets at least to the point where they covered 100% of the scheme's liabilities.
- Established a Pensions Compensation Board (PCB) to cover losses of up to 90% in case of company fraud and misappropriation of scheme assets. This was a particular reaction to the Mirror Group situation.
- Trustees must appoint a fund manager authorised under the Financial Services Act (FSA) 2012.
- Members of large OPSs (100 members or more) have a right to appoint at least one-third of the trustees. These are designated member-nominated trustees (MNTs).
- Equal treatment of all persons in occupational schemes is required.
- Introduced the concept of limited price indexation (LPI), which initially was indexation up to the lower of the RPI or 5%. In this Act, LPI was designed to apply to both DB and DC benefits in payment.
- Introduced internal dispute resolution procedures which, under this Act, was a two-stage process starting with a nominated person examining the grievance, and trustees subsequently getting involved if required.

15.3.2 Pensions Act 2004

- By the turn of the century, the actuarial methodology involved in the MFR was proven to be questionable. It was, therefore, abolished in 2001 and replaced by the Pensions Act 2004.
- This Act established the Pension Protection Fund (PPF), which provides compensation if an employer becomes insolvent and they run a defined benefit pension scheme which is under-funded.
- Additionally, OPRA was replaced by The Pensions Regulator (TPR), and the previous powers under OPRA were extended. TPR is covered in more detail below.
- Employers have to consult members before making significant changes to schemes, giving 60 days for consultation.
- This Act also introduced the concept of scheme-specific funding which was designed to provide a long-term funding standard of a scheme that had to be agreed by the trustees and employer. The funding should reflect the specific circumstances of the scheme.
- The LPI was reduced to 2.5% for DB schemes and scrapped for DC schemes.
- The Act increased state pensions for individuals who defer state pensions beyond normal retirement age.

Pension Protection Fund (PPF)

The PPF is a compensation scheme in the UK for members of DB schemes (excluding public sector schemes) that should be viewed as a safety net of last resort in the event that an eligible pension scheme provider becomes insolvent.

To be eligible to fall under the PPF remit, the employer must have become insolvent after 5 April 2005, and there must be no possibility of rescuing the scheme. For employers that became insolvent before this date, they may be entitled to join the financial assistance schemes (FAS), which is covered below.

The PPF levels of compensation are as follows:

- 100% if the member was over the scheme's normal pension age or had started drawing their pension early due to ill-health when the employer had become insolvent.
- 90% if they were under the normal pension age.
- 100% of the pension income for anyone receiving a survivor's pension (eg, widows/widowers, civil partner's or children's pension).

There is no cap in monetary terms to the amount of compensation that can be paid out by the PPF.

Financial Assistance Scheme (FAS)

Formed by the government in 2004, the FAS covers 'qualifying DB schemes' (an insolvency event must have occurred in respect of the employer) which began to wind up from 1997 to 2005. It closed to new applications in 2016.

In contrast to the PPF, compensation under the FAS is capped. The FAS levels of compensation include the following:

- 90% of accrued pension entitlement at the date of commencement of the winding up is guaranteed. This amount will be revalued up to an individual's retirement date, but is subject to a maximum of £44,695 for entitlement in 2024–25.
- The benefit will be paid from the scheme's normal retirement date, subject to the earliest payment date of age 60.
- Payment of benefits based on service after 5 April 1997 will be increased in line with inflation, subject to a maximum increase of 2.5%.
- There is also provision for a 50% spouse's or civil partner's pension.

The Pensions Regulator (TPR)

The role of TPR is to regulate employers, trustees and advisers to ensure they can fulfil their duties to pension scheme members. A non-departmental public body, TPR has five areas of responsibility:

- Making sure employers put their staff into a work-place pension scheme and pay money into it (known as 'automatic enrolment').
- Protecting people's savings in work-place pensions.
- Improving the way that work-place pension schemes are run.
- Reducing the risk of pension schemes ending up in the PPF.
- Making sure employers balance the needs of their DB pension scheme with growing their business.

TPR has a range of enforcement powers available, including issuing notices, prosecution and/or fines.

15.3.3 Pensions Act 2008 and Auto-Enrolment

The Pensions Act 2008 introduced a requirement for all employers to enrol their eligible workers into a qualifying pension scheme automatically, unless those workers make an active decision to opt out if they do not want to benefit from a pension.

A new work-place pension scheme called the National Employment Savings Trust (NEST) was established to provide a low-cost form of pension savings. This time, the compulsion is to enrol and contribute, not just provide access, as was the case with stakeholder pension plans. Individuals are still allowed to opt out of the scheme, but must not be encouraged to do so.

From 6 April 2020:

- Total contributions (including tax relief) must be at least 8%.
- Employers are required to pay at least 3%.
- Jobholders (employees, but also other contracted staff) are required to pay the balance from their qualifying earnings. For example, if an employer pays 4% (ie, more than the minimum required) then the employee must contribute at least another 4%, to bring the total up to the 8% minimum.
- Tax relief at basic rate, equivalent to 1% of qualifying earnings, will also be credited to the member's account by the state.

If any eligible workers opt out, they must be re-enrolled into a work-place pension every three years.

15.3.4 Taxation of Pensions Act 2014 and the Pensions Act 2015

These Acts were designed to encourage arrangements that offer people different levels of certainty in retirement or different ways of sharing or pooling risk. Additionally, provisions have been designed to give people greater flexibility in accessing benefits and to help them make informed decisions about what to do with benefits. So far, only flexibility in accessing pension benefits has been achieved.

Since April 2015, some people over the age of 55 have greater freedom in how they can access the pension that they have built up during their working life.

Two key elements of the new pension regime are:

- **Flexible benefits** – while it was compulsory for members of a pension scheme to purchase an annuity on retirement, in previous years, the rules on pensions were changed in April 2015 to give people greater access to their pension savings. For example, members may now transfer a DB (or final salary) pension to a DC (or money purchase) pension scheme, or to encash the entire pot. With regard to the latter, advisers should be aware that 25% could be taken as a tax-free lump sum, with the remaining 75% taxed at the individual's marginal rate.
- **Safeguarded benefits** – these are primarily benefits of DB schemes (where members receive a guaranteed amount based on their salary and the number of years they have worked for their employer), as well as other promises in other types of schemes.

15.3.5 Pension Schemes Act 2021

The Pension Schemes Act 2021 amends the Pensions Act 2004. It introduced new duties for those involved in running pension schemes in terms of climate change governance and reporting. For example, the Act confers powers to require schemes to take the Paris Agreement goal into account, as well as other climate change goals set by the UK government.

The Act also introduced new duties for those involved in running pension schemes, such as climate change risk reporting and governance requirements. For example, they are now required to:

- implement climate change governance measures, and
- produce climate-related disclosures in line with the framework formerly developed by the Task Force on Climate-related Financial Disclosures (TCFD).

Additionally, the Act extended TPR's information gathering, investigatory and enforcement powers – for example, TPR will be allowed to intervene in how pension schemes report climate-related risk.

15.4 Personal Pensions

Learning Outcome

5.14.5 Types of pension scheme

Occupational pension schemes form an important part of the pension world in the UK, but there are many individuals who are not eligible to join them – for example, because they are not employed.

There are alternatives, which we will look at now. They are all defined contribution (DB, or money purchase) arrangements, so the benefits are unknown with the risks including investment risk, inflation risk and annuity risk.

15.4.1 Retirement Annuity Contracts (RACs)

RACs were the first form of personal pension planning, and some individuals still fund them, despite the fact that no new RACs have been sold since 1988. They did have unique rules about the tax-free cash entitlement, but since A-Day (see later), they now closely resemble the other types of personal pension provision.

Probably the main differentiator is that it is unlikely that contributions can be paid net, with tax relief given at source. This is not a legislative restriction, more a technology restriction as many providers' old platforms that contain RAC details cannot be modified to collect contributions net rather than gross. Tax relief is still available, so the individual often has to claim it via their Self-Assessment tax retirement.

15.4.2 Personal Pension Plans (PPPs)

PPPs replaced RACs in a wave of publicity in 1988. They were the brainchild of the Conservative government and were designed to revolutionise the pension world, with individuals encouraged to 'take personal control' of their pension planning.

Unfortunately, this led to a large number of individuals being advised to transfer their benefits out of their DB occupational scheme into the DC world of PPPs. As we have seen, this involves a transfer of risk from the employer to the individual, so it was not long (the early to mid-1990s) before it became clear that in the vast number of situations, the individual would have been better off staying in the OPS. The subsequent pension misselling scandal did nothing for the reputation of the industry, and cost significant sums of money to put right (around £12 billion in compensation was paid out between 1994 and 2002).

Despite this, PPPs remain an integral part of the UK pension scene, creating the basis for what followed with stakeholder pension plans and, indeed, the basis for pension simplification. A couple of its main innovations were the concept of pension relief at source on contributions (given at the prevailing basic rate of income tax), and a tax-free lump sum entitlement of 25% of the pension fund.

Group PPPs also became popular, offered by employers who did not want to set up an OPS (with all the resulting paperwork and trustee requirements), but wanted to allow their employees to contribute to a pension plan via their work. Sometimes, the employer would contribute themselves to these plans, and sometimes they just allowed a source for employees to pay.

15.4.3 Stakeholder Pension Plans

The idea of stakeholder pension plans is to make pension planning accessible for the masses, by limiting charges and setting very low minimum premiums.

At heart, stakeholder pensions are very similar to PPPs, with basic rate tax relief given on the contribution and a tax-free lump sum of 25% of the fund. Stakeholder pensions introduced the idea that people who were not even working could contribute, up to a maximum of £3,600 gross a year, and still receive tax relief. The minimum age requirement that previously applied to PPPs was also removed, which introduced a new market of third-party stakeholder pensions, where individuals could fund on behalf of another. Often, this has turned out to be relatives, like parents or grandparents, funding pension plans on behalf of children/grandchildren.

The government was particularly keen to keep the charges for stakeholder pensions as low as possible. Initial charges were banned, with only ongoing AMC allowed. Even these were restricted, initially to 1% pa of the value of the fund. Mainly due to pressure from the pension industry, in 2005 the allowable charges were increased to 1.5% a year for the first ten years of a plan, and 1% a year thereafter; most PPPs now follow this structure as well.

The minimum contribution to a stakeholder pension remains an incredibly low £20 a year. This has stopped a number of pension providers from offering a stakeholder pension option, as it is not commercially viable, preferring instead to brand their PPPs as 'stakeholder friendly'. In other words, they are remarkably similar to stakeholder pensions, but have a minimum contribution of, say, £50 a month or £500 a year.

Stakeholder pensions must offer a lifestyling option. This is an investment strategy whereby the member's fund is automatically moved away from riskier investments, such as equities, into more secure investments, such as gilts and cash, as retirement approaches.

Stakeholder pensions also introduced a form of compulsory pension entitlement availability to employees. Any employer with five or more employees has to offer their employees access to a stakeholder plan, unless they are exempt. Note that the employer does not have to contribute to the plan, they just have to provide access. Many employers are exempt as they offer either an OPS or a Group PPP (GPPP) that meets set minimum requirements.

15.5 Pension Simplification – A-Day

Learning Outcome

5.14.4 Pension tax rules, including annual and lifetime limits

6 April 2006 was a momentous date in the history of pension regulation in the UK. Better known as A-Day, it marked the date when the many disparate rules that governed pensions were consolidated under one regime.

Effectively there were eight different pension regimes operating at the time of A-Day; the idea was to start afresh from 6 April 2006. The rules apply to 'registered pension schemes'. All old schemes which had previously been approved before A-Day were included automatically.

15.5.1 Annual Allowance

There is no legislative limit on the amount of contributions that can be paid into a registered pension scheme, either by the member or their employer. Rather, there is a limit on the amount of contributions paid by or on behalf of an individual that qualifies for tax relief. For the 2025–26 tax year, the annual allowance is £60,000 for all pension schemes.

If an individual has unused annual allowance from any of the previous three tax years and was a member of a registered pension scheme during those years, then they may be able to carry forward that unused allowance to increase the amount they can contribute with tax relief in the current year. This means that for 2025–26, the maximum that they could contribute with tax relief is £220,000 (ie, £60,000 for 2023–24 to 2025–26 inclusive, and £40,000 for 2022–23).

The annual allowance includes pension savings that individuals or someone else such as their employer makes on their behalf. It is not a restriction on the amount of tax relief given, but works by applying a tax charge when the allowance is exceeded.

There is a tapered annual allowance for individuals. This taper applies when both an individual's threshold income and adjusted income limits are both exceeded (see section 3.3 of chapter 2 for more details). For every £2 of adjusted income over £260,000, the annual allowance is reduced by £1, until the annual allowance reaches a minimum of £10,000 for 2025–26 – this contribution limit is known as the **money purchase annual allowance (MPAA)**. For individuals who have flexibly accessed a money purchase pension arrangement by taking an income (not just the pension commencement lump sum (PCLS)) where contributions exceed MPAA, they will be subject to the annual allowance charge.

The individual is responsible for paying the annual allowance charge, although they can ask the administrator of a scheme to pay it out of their benefits in the scheme. In some circumstances, the administrator is required to pay.

Valuing Different Pension Plans against the Annual Allowance

When dealing with a money purchase arrangement, it is very straightforward to see how much of the annual allowance is used up. With DB schemes, it is not so obvious as there is no defined 'contribution' as such.

To be able to include contributions to DB schemes in the whole picture, we need to look at the increase in an individual's pension entitlement over the course of the year, and then apply a multiplier to the increase.

15.5.2 Lifetime Allowance (LTA) and Tax-Free Lump Sum Allowances

In previous years, a lifetime allowance (LTA) was in place whereby the value of any pensions savings above a predetermined amount were subject to an LTA charge. The threshold for the LTA has been reduced over time, from a peak of £1.8 million in 2011–12. To allow individuals to lock in a higher LTA based on their specific circumstances, and therefore avoid a tax charge, various protections (such as fixed protection (FP) and individual protection (IP)) were in place.

The LTA was abolished as of 6 April 2024, as part of a government initiative to encourage pension savings without the constraint of an LTA. Further, it has simplified pension planning, since the abolition of the LTA removes the need for complex calculations following a 'benefit crystallisation event' (BCE), which previously triggered tax implications.

In its place, a new lump sum payment regime has been introduced. Effective from 6 April 2024, individuals now benefit from two distinct tax-free lump sum allowances:

- **The lump sum allowance (LSA)** – a fixed cumulative limit of £268,275 (ie, 25% of the former LTA). It applies to tax-free cash that can be received as pension commencement lump sums (PCLS), as well as the tax-free portion of uncrystallised funds pension lump sums (UFPLS) or stand-alone lump sums. Notably, certain benefits (eg, serious ill-health lump sums and trivial commutations) are not tested against this allowance.
- **The lump sum and death benefit allowance (LSDBA)** – a fixed cumulative limit of £1,073,100 (ie, the former LTA) on the tax-free components of lump sums payable during an individual's lifetime or upon their death. In addition to covering PCLS and the tax-free segments of UFPLS and stand-alone lump sums, it also includes tax-free segments of serious ill-health lump sums and most lump sum death benefits.

One of the key differences between the new regime and the previous LTA rules is how allowances are applied. Under the new regime, only the tax-free portions of lump sums count against these allowances, while pensions are not tested. This contrasts with the previous LTA rules, where all crystallised pension benefits contributed towards the allowance.

15.5.3 Eligibility to Tax Relief on Contributions

For an individual to be eligible for tax relief on their contributions they must be:

- an active member of a registered pension scheme
- a relevant UK individual, and
- made in the tax year in which the contribution is paid. Unused tax relief can no longer be carried backwards or forwards to other tax years.

An individual is a relevant UK individual if they:

- have the relevant UK earnings chargeable to income tax for that tax year
- are resident in the UK at some time during that tax year
- were resident in the UK at some time in the five years immediately before the contribution in question and were also resident in the UK when they joined the scheme, and
- are an individual (or spouse/civil partner of that individual) with earnings from overseas Crown employment that is subject to UK tax.

Although a member can pay contributions once they have reached the age of 75, they do not qualify for tax relief.

15.5.4 Tax Relief on Contributions

Contributions from both individuals and employers qualify for tax relief.

The maximum amount which a member of a scheme can have relieved is potentially the greater of:

- the 'basic amount', currently £3,600, or
- the amount of the individual's relevant UK earnings that are chargeable to income tax for the tax year.

There are three methods for tax relief to be received by individuals:

1. **Tax relief at source**
   This is the method used for most personal plans, such as PPPs and stakeholder pension plans. The relief at source mentioned in the name is **immediate** tax relief at the basic rate applied in that tax year. This is currently at a rate of 20%.

   Very simply, this means that an individual only needs to contribute £800 to have £1,000 invested on their behalf. The method of calculation is similar to the grossing-up calculation for interest payments that we looked at in chapter 2, where it is divided by 0.8.

   Tax relief at source is always given at basic rate, despite the fact the individual paying the contribution could be a non-taxpayer, basic rate taxpayer, higher rate taxpayer or additional rate taxpayer.

   - A non-taxpayer can pay up to £3,600 (gross), or £2,880 net, and still receive relief at source on the contribution.
   - Basic rate taxpayers receive their correct amount of tax relief immediately.

- Higher rate taxpayers are eligible to claim back an additional 20% of tax relief. They will have to do this via their Self-Assessment tax return (see chapter 2 for details).
- Additional rate taxpayers are eligible to claim back an additional 25% of tax relief, again via their Self-Assessment tax return (see chapter 2).

2. **The 'net pay' method of providing tax relief**
   This is the method used by OPS. Here, the pension contribution is paid gross and deducted from earnings **before** being liable for income tax. As a result, an individual will receive full tax relief at the relevant rate, immediately.
3. **To make gross contributions and claim the tax relief through a Self-Assessment tax return.**

Example

Rachel is self-employed, and earned £50,000 in 2025–26. She has not contributed to her pension for the past few years, and she qualifies for the full £220,000 of annual allowance when carry forward is applied. She now wishes to contribute £200,000 into her pension.

Although Rachel is within her available annual allowance, she will only receive tax relief on up to £50,000 (ie, the amount of her relevant UK earnings for the year). The remaining £150,000 of contributions could still be made, but would not qualify for tax relief.

In this case, it would be more efficient for Rachel to spread the contributions over multiple tax years. For example, she could contribute £50,000 annually over four tax years, receiving full tax relief on the entire £200,000. This assumes that sufficient annual allowance (including any unused allowance carried forward) remains available in each subsequent year.

15.6 Retirement Benefits

The main purpose of pension planning, particularly from the view of HMRC, is to provide an income in later life. Now, depending on the type of pension, an investor can withdraw as much as they wish, irrespective of other income, subject only to income tax at their marginal rate on the amount withdrawn in any tax year in excess of the initial tax-free sum. This flexibility does not apply to DB pension schemes.

The normal minimum age is currently 55, but this is due to rise in line with increases to the SPA (eg, to 57 by 2028, when the SPA increases to 67). Any withdrawals from a pension while the investor is below the minimum pension age will be treated as an unauthorised payment unless they retire due to ill health, they have a protected pension age, or if their occupation is excluded under the Registered Pension Schemes (Prescribed Schemes and Occupations) Regulations 2005 (eg, police officers, members of the armed forces and fire fighters).

There are a number of options for taking benefits, which we will now cover.

15.6.1 Lump Sums

When a member becomes entitled to authorised pension benefits, providing certain conditions are met, current tax rules allow the scheme to provide a tax-free lump sum (ie, the PCLS). The maximum amount payable is the lower of 25% of the member's LTA available at the time and 25% of the capital value of the pension. In certain circumstances, a person may have a higher percentage where the lump sum was protected.

Alternatively, where the fund is uncrystallised, the 25% tax-free lump sum can be taken as part of each withdrawal, which might be more tax efficient. The remaining 75% is taken as taxable income. This is known as uncrystallised funds pension lump sum (UFPLS), and technically it is not a drawdown. The individual must have sufficient LTA available to use UFPLS.

Other authorised lump sum payments include serious ill health, trivial commutation, winding-up and small pension payments. To avoid an authorised payment charge, the rest of the pension should be taken as income. However, there are various different methods of doing this.

15.6.2 Secured Pensions

A pension paid through the purchase of a lifetime annuity or paid as a scheme pension directly from the scheme is known as a secured pension.

Lifetime Annuity

This is the term applied to income taken from a money purchase arrangement (whether personal or occupational).

Basically, the individual is using their fund to buy an income (the annuity). The rate used for this conversion will depend on their age, health and the number of options they want included (ie, single/joint life, level/increasing, paid in advance/in arrears).

One of the choices available to an individual is that of capital protection. As suggested in its name, this is where the amount used to purchase the initial annuity is protected, less instalments paid up to the individual's death. Another possibility is to select a guarantee period – the period of time the annuity provider guarantees to pay the income for, regardless of whether the annuitant is alive or not. The maximum guarantee period is ten years, and has to be paid as an income (before A-Day it was possible to commute the remaining income into a lump sum).

Individuals are allowed to, and should, shop around to try and find the best annuity rate – you will have come across the term 'open market option' (OMO), which is related to this. Each pension fund provider of money purchase arrangements must offer the individual a choice of taking an annuity with it or with a different annuity provider. Often it is better for an individual to use the OMO – just because a company is good at providing fund growth does not mean they will necessarily have the best annuity rates.

It is useful to note that some old pension schemes (particularly RACs) offer guaranteed annuity rates which are often more competitive than the best available annuity now on the open market. The availability of these should be explored before transferring the money away via the OMO.

Scheme Pensions

This is the term applied to income that must be taken from a DB scheme, as the scheme itself may administer the pension or arrange for a specialist company to do so. A DC scheme can offer a scheme pension as well, but only if they offer an OMO to a lifetime annuity as well.

Remember that with a DB scheme, the employer has 'promised' an income level based on the three key factors of years of service, final/career average salary and the scheme accrual rate. It is, therefore, their responsibility to meet this promise.

15.6.3 Unsecured Pensions

The previous two examples are known as secured pensions – the amount of income is secure until death (or the end of a guarantee period if longer). The problem with secured pensions (particularly the lifetime annuity option) is that once committed to, all terms are fixed – the money is handed over and there is no flexibility. This can appear unattractive, particularly for someone relatively young with a long period until retirement. The alternative to purchasing an annuity is 'drawdown' where the fund remains invested, but an income is drawn from the income and capital.

15.6.4 Income Drawdown

Income drawdown (drawdown pension) is where the pension fund is left invested rather than being converted into an annuity. It is possible to take 25% of the pension fund as tax-free cash, leaving the remainder of the fund invested.

Since 6 April 2016, drawdown consists of two methods:

- flexi-access drawdown (FAD), and
- short-term annuity.

Prior to 6 April 2016, there were three types of drawdown: flexible drawdown, capped drawdown and short-term annuity. On 6 April 2016, these ceased when FAD was introduced. All those in a flexible drawdown were immediately automatically converted to the new FAD. However, those with capped drawdown can continue, which means that their level of benefits are restricted. An individual in capped drawdown is not subject to the MPAA, but retains their full annual allowance.

The maximum that can be withdrawn under capped drawdown each year is set by tables produced by the Government Actuary Department (GAD), which show the relevant annuity rate at each age. The maximum payable is 150% of the GAD annuity rate. The additional conditions are:

- no income has to be taken at all
- there is no upper age limit
- the upper income limit is reassessed every three years for those under 75, based on age and fund size
- the upper income limit is reassessed every year for those over 75, also based on age and fund size
- in the event of death, the remaining fund can be used by a dependent to continue to draw income, or buy an annuity
- the fund can also be paid to a charity in the event of death and is not then taxed, and
- the advantage of remaining in capped drawdown is that the MPAA rule will not apply.

However, there are disadvantages to drawdown plans:

- annuity rates could go down, if an individual later decides they want to buy an annuity with their remaining funds
- the drawdown fund could fall in value
- the ongoing income is not guaranteed and could go down
- for capped drawdown it also requires ongoing monitoring of the plan
- charges are higher for drawdown than annuity purchase, and
- for those still in capped drawdown, it also requires ongoing monitoring of the plan.

FAD does what it says. Any amount can be drawn by crystallising the pension fund and making it a drawdown pension. A PCLS can be taken up to a maximum of one third of the value of the fund put into FAD. When the member accesses the remaining fund, whether in the form of drawdown, or a short–term annuity, then the MPAA will apply to any future money purchase contributions.

Any money drawn will be taxed as income in the year it is taken. This means that by drawing a large amount, a person could become a higher or additional rate taxpayer. There are complicated rules for calculating the actual amount of tax deducted from the payment and although tax will be deducted under pay as you earn (PAYE), a further tax payment or a refund may be payable depending on when the recipient's total income for the tax year has been assessed.

If an individual draws an income from a FAD pension, then they will trigger the MPAA and can therefore only contribute a maximum of £10,000 per year before becoming subject to the annual allowance charge.

15.6.5 Uncrystallised Fund Pension Lump Sum (UFPLS)

Uncrystallised Fund Pension Lump Sums (UFPLSs) were introduced to ensure that individuals can take all their money out without suffering an unauthorised payment tax charge. The entire pension is released, of which 25% can be paid tax-free with the remaining 75% being taxed as income under PAYE. As its name implies, it can only be taken from uncrystallised pension money. There is no PCLS as there is no pension being paid. Taking a UFPLS will trigger the MPAA.

15.7 Self-Invested Options

The self-invested market has grown rapidly since pensions simplification, as some of the key eligibility rules, particularly for the employed, have been relaxed. There is now a massive market in SIPPs, in addition to the self-invested option favoured for years by small family companies – **small self-administered schemes (SSASs)**. We will take a brief look at these two options, which are primarily aimed at high earners.

15.7.1 Self-Invested Personal Pensions (SIPPs)

A **self-invested personal pension (SIPP)** is basically a PPP with wider investment opportunities. The contribution limits, tax rules and retirement options are the same as we have already covered. There are broadly three types of SIPP available in the market:

Full SIPP

These offer the widest range of investment opportunities, including direct investment in commercial property and individual listed securities, in the UK and overseas. For a long time, in the run-up to A-Day, the indication was that residential property was also going to be allowed to be part of a SIPP investment. This created great excitement in the pension industry. However, about six months before A-Day, the Chancellor announced that residential property was to remain a 'prohibited asset' along with other investments, such as investments in art or fine wine. The full SIPP is, therefore, not quite as full as many industry experts would have liked, although the general consensus is that the decision was correct.

Hybrid SIPP

These are insurance company products, typically offering a choice of the provider's insured funds and non-insured investments, with many providers stipulating a minimum investment to the insured element.

Deferred SIPP

This is a personal pension written under a SIPP trust. It, therefore, allows the opportunity to use SIPP investments on request.

A further difference between SIPPs and PPPs is the charging structure. As already mentioned, most PPPs are now stakeholder friendly, operating with a charging structure similar to that specified for stakeholder pensions. SIPP providers have usually charged fixed annual fees, whereas personal pensions have a percentage fee. This means that SIPPs are more expensive for funds up to about £50,000, but cheaper for much larger sums. A much wider range of SIPP products have been offered in recent years, and fees can be competitive with insured personal pensions at most levels.

As mentioned, SIPPs are able to invest in commercial property, and another feature that facilitates such investment is that they are able to borrow funds. In fact, a SIPP can borrow 50% of the net scheme assets.

Example

A SIPP with assets of £200,000 would be able to borrow a further £100,000 to potentially buy a commercial property and make it an asset of the SIPP.

This property is frequently the property the business operates out of, and so future rental payments are paid to the SIPP. The SIPP itself would have to pay a commercial rate of interest on the borrowing. SIPPs can also be used to help finance an individual's business by using SIPP assets to purchase private company shares.

15.7.2 Small Self-Administered Schemes (SSASs)

Just as SIPPs are a derivation of PPPs, SSASs originally started as a derivation of executive pension plans (EPPs). These were popular with company directors of small and medium-sized businesses. SSASs were marketed at the same type of companies, but with the added extras of the self-investment options and borrowing facility.

The 'small' nature of SSASs is defined by having a maximum of 11 members. All members have to be trustees with an equal say in the running of the SSAS and so, in reality, most SSASs have a maximum of three to four people. They are generally family run businesses that may offer a separate type of pension plan for the employees and keep the SSAS element for the directors.

Just as with SIPPs, SSASs are able to borrow up to 50% of the net scheme assets. Often this may be used for the same purpose of bringing a company's commercial property under the ownership of a pension scheme, with the tax benefits (ie, no CGT) that attracts.

Unlike SIPPs, SSASs are also able to lend money from the scheme to the sponsoring employer, and not face unattractive tax penalties. There are certain conditions for these loans to meet such as:

- not more than 50% of the scheme assets can be lent
- the SSAS must charge interest at a minimum rate of 1% over the average base rate, and
- the maximum term of the loan is five years, which may be rolled over once.

If any conditions are not met, the loan will be an unauthorised payment, which could, ultimately, result in the SSAS being deregistered.

SSASs can invest in the sponsoring employer, although the extent of this investment has been limited since A-Day. A SSAS can only invest up to 5% of scheme assets in any one sponsoring employer, and under 20% of scheme assets if the shareholdings relate to more than one sponsoring employer.

15.7.3 Uses of Self-Invested Options

Sophisticated investors who use the self-invested options to invest in diverse and risk-appropriate assets can benefit greatly from self-investment. The possibility of getting the business premises that the pension holder operates out of, under pension funding rules, is certainly attractive and makes sense for many. Also, if an individual has a portfolio of shares and bonds, a SIPP provides a good tax-efficient wrapper for them.

However, there are dangers of self-investment. It is a high-risk approach, for example, for an individual to invest heavily in the shares of their own company, as they are then relying on that company for income in retirement as well as in their working life. It should also be remembered that unlisted shares are particularly illiquid.

The FCA is keeping a keen eye on the burgeoning SIPP market (mainly funded by transfers from PPPs), and has issued guidance to advisers. This focuses on costs and cost comparisons, and on the need of advisory firms to be able to demonstrate that a particular consumer genuinely requires investment flexibility and control.

15.7.4 Pension Death Benefits

This section does not cover the death benefits relating to the state pension scheme.

Death benefits can be paid to any nominated person except in the form of a pension from a DB scheme which can only be paid to a dependant of the person who died. A dependant will normally be the spouse or civil partner, a child under the age of 23, or a financial dependant. Previously, if it was paid to another person, it was taxed at 55% as an unauthorised payment; but this was abolished in 2015, and individuals have since had the freedom to transfer their pension to any nominated beneficiary on their death. The rate of tax they pay depends on the age at which the individual dies and whether or not the pension was in drawdown.

The table below summarises the tax treatment on beneficiaries depending on the age of the pension holder, and whether the pension was in drawdown or uncrystallised:

Individual, on their death, was:	Aged under 75	Aged over 75
Not in drawdown (ie, uncrystallised)	Paid to any beneficiary, tax-free as a lump sum (up to the LTA). This can be as an annuity or as a drawdown pension.	Benefits are taxed at the beneficiary's marginal rate of tax, as a lump sum, annuity or as a drawdown pension. If paid to a trust, then this can be done as a lump sum and is taxed at 45%.
In drawdown	Benefits may be taken tax-free, whether through drawdown or as a single lump sum.	Benefits are taxed at the beneficiary's marginal rate of tax, as a lump sum, annuity or as a drawdown pension. If paid to a trust, then this can be done as a lump sum and is taxed at 45%.

In addition, the recipient of a pension death benefit can nominate a successor to receive that benefit providing the pension is in FAD. The tax deducted will depend on the type of scheme, age of the pension holder at death and the type of benefit paid.

Scheme Pension

When a pension is paid by the scheme (whether from a DB or DC scheme) income tax will generally be deducted by the administrator.

Other Pensions

Type of Pension Scheme	Benefit Type	Age the owner died	Income tax payable?
DC or DB	Most lump sums	Under 75	No
DC	Annuity or money from a new drawdown fund (set up or converted and first accessed from 6 April 2015)	Under 75	No
DC	Money from an old drawdown fund (a 'capped' fund or a fund first accessed before 6 April 2015)	Under 75	No
DC or DB	Trivial commutation lump sums	Any age	Yes
DC or DB	Most lump sums	75 or over	Yes
DC	Annuity or money from drawdown fund	75 or over	Yes

However, it is important to note that there is an important time frame in the case of most lump sums and untouched drawdown if the pension owner was under 75 when they died. Tax will be payable if the money is paid to the beneficiary more than two years after the provider has been told or ought reasonably to have known of the death of the holder.

Tax may also be payable if the pension holder who died had pension savings worth more than £1 million, the benefit was paid outside the two-year window and the pension holder's total pension savings exceeded their lump sum allowance (LSA).

If the death benefit is taxable, the money paid is added to the beneficiary's income in the year of payment and will be subject to income tax accordingly. Depending on the amount the beneficiary receives, this could increase their rate of tax.

Unless the provider has the recipient's tax coding, the provider will deduct tax on a 'month one' basis which means that more or less tax will be deducted than is actually due and the recipient may receive a tax refund or have to pay more tax later.

16. Custody of Investments

Learning Outcome

5.16.1 Understand the purpose and operation of nominee companies and investment platforms

16.1 Nominee Companies

Nominee companies are formed by banks or other fiduciary organisations (ie, ones that hold assets in trust for a beneficiary).

Financial institutions set up nominee companies with the sole purpose of holding clients' assets separately from their own (segregating the assets) to give clients maximum protection under English law. Shares and other securities owned by clients are legally registered in the name of the nominee company (which becomes the legal owner), but the beneficial ownership remains with the client. This aids in administering portfolios and speeds up trading.

Nominee companies maintain accounts, which may be 'designated' or 'pooled'. If a client's securities are held in a designated account, they are separately identifiable from those of the firm's other clients. If they are held in a pooled account, although there will clearly be detailed records showing which clients own what, there may be one large holding registered, covering the individual holdings of a large number of underlying clients.

Given that the function of a nominee company is to register and administer holdings of shares and other securities on behalf of clients, it is often involved in administrative tasks, such as:

- collection of dividends
- preparation of annual consolidated tax vouchers
- advising clients of corporate actions and seeking their instructions, and
- arranging transfers when a share is purchased or sold.

While holding shares through a nominee company certainly has its advantages, and money invested with the firm should theoretically be protected (or 'ring-fenced') from the company's activities, investors could still be left at risk if the firm goes into administration. Further, fees relating to the administration process may have to be borne by clients, so it is not guaranteed that clients will get 100% of their assets back, and any irreconcilable shortfall in the client asset pool would be shared pro rata among all clients.

16.2 Investment Platforms

Also known as wrap accounts, fund platforms, fund supermarkets and investment marketplaces, investment platforms are online services that provide individuals with a single platform account in which to invest in various financial products and assets. Thus, they provide a convenient and accessible way for people to manage their investments.

The types of investment in which investors can trade will vary from one platform to another, depending on the service provider. Many allow trading in shares and funds, although some will impose restrictions, so investors must check what is permitted before opening an account.

All of an investor's assets are held (and it follows that all of their dealings and related administration is carried out) in one centralised place, rather than across several fund managers. Hence, obtaining a valuation is simple, giving them a complete portfolio view; and they can quickly switch between funds as needed.

A further benefit of investment platforms is that they may offer reduced charges, which they have negotiated with the individual fund managers. Note that some investment platforms have a more significant presence and greater degree of influence than their peers, meaning that they have managed to negotiate better deals.

Other fees can also vary, depending on the platform and the services provided. Examples include:

- fees for opening or maintaining an investment account, which can be one-time or recurring
- trading fees for buying or selling securities (eg, equities, bonds and ETFs), typically charged per transaction and can vary depending on the size of the trade and the type of security being traded
- management fees for overseeing and managing the investments, usually calculated as a percentage of the assets under management (AUM), and
- custodial fees for holding and safeguarding the investments (to cover the cost of maintaining the account and providing custodial services).

Certain platforms also impose inactivity fees where an investor has an account but does not engage in any trading activity within a specific period. This fee is intended to encourage regular participation and discourage dormant accounts.

Investors should carefully review the fee structure of an investment platform before opening an account. Important considerations include how the investment platform aligns with their investment goals, trading frequency, and the services that they require.

16.2.1 Robo-Advisors

Also called automated investment platforms, robo-advisors are digital platforms that provide financial and investment services with little human interaction (if any at all).

Typically, robo-advisors use online surveys to collect information from clients about their financial situation and future goals. This data is then fed into an algorithm which automatically allocates the client's assets and builds a portfolio of diversified investments. Thereafter, the software automatically rebalances the portfolio on an ongoing basis, so it remains aligned with the target asset allocation. Some robo-advisors can also assess the CGT position of a portfolio, whereby they sell securities at a loss to offset gains in others, thus reducing the client's tax bill. This process is called 'tax-loss harvesting'.

While the very first robo-advisor (Financial Engines) was launched in 1996, they only started coming to the forefront in the wake of the global financial crisis when the first consumer-facing robo-advisors (Betterment and Wealthfront) began operations in 2008 (although neither company offered financial advice to retail advisers until 2010). Robo-advisors worldwide are projected to have assets under management of $2.8 trillion by 2030. The market has been growing rapidly, but as with any industry that matures, it has slowed in its expansion from high single digits to a compound annual growth rate (CAGR) of about 4%[18].

Robo-advisors can be suitable for a range of investors – from beginners, who do not yet have the financial knowledge to make informed investment decisions; to professionals, who may not have the time to actively manage their own portfolio. They can also be a solution for investors with simple strategies, or those who do not wish to hire a financial adviser but at the same time have little desire in selecting their own investments. On the other hand, automated portfolio management solutions may not be ideal for investors who prefer human assistance or need a more tailored approach, as well as those with multiple investment accounts.

The first robo-advisors usually used certain types of complex but deterministic algorithms to provide investment recommendations. With the advancements seen in **artificial intelligence (AI)** and machine learning (ML), however, robo-advisors are moving towards providing a much more interactive service, answering questions and providing tailored advice to clients.

18 Statista, Robo-Advisors – Worldwide. Retrieved from https://www.statista.com/outlook/dmo/fintech/digital-investment/robo-advisors/worldwide (Accessed: October 2025)

Merits of Using a Robo-Advisor	Limitations of Using a Robo-Advisor
• **Easy account setup** – users are then placed into a portfolio that matches their personal investment profile, based on their questionnaire responses. • **Automated process** – once a client opens their account, the robo-advisor automatically manages and rebalances it. • **Low minimum balances** – robo-advisors can be accessed by small net worth investors (eg, initial deposit of £250). • **Low fees and charges** – fees can be either a fixed amount in monetary terms (depending on the portfolio size), or a percentage of the value of the assets (typically 0.25% to 0.50% a year). • **Provide a variety of financial solutions** – clients may invest in a range of sectors or themes. Portfolios of low-cost ETFs and other CISs employing ethical criteria can also be constructed using algorithms. • **Tax efficient** – many robo-advisors offer services that help investors to increase their after-tax returns (eg, tax-loss harvesting). • **Remove behavioural biases from investing activities** – robo-advisors can remove common behavioural biases exhibited in humans, such as the tendency to panic-sell in a market downturn.	• **Not personalised** – investors may find it beneficial to talk with a financial adviser in person about any money-related issues and concerns. Financial advisers can also reassure clients after a significant drop in the markets. • **Not for clients with complex portfolios** – sophisticated investors may wish to have a broader investment portfolio with a wider range of asset classes (eg, options) which robo-advisors do not typically offer. • **Fees and charges** – some robo-advisors charge an initial set-up fee, plus ongoing portfolio monitoring fees. Others have sliding scales for their annual fees, based on the account balance. All in all, the amounts can be comparable to fees charged by financial advisers. Additionally, some robo-advisors are not as cheap as passive funds. • **Limitations in technology** – it is argued that robo-advisors should be used as a tool that help financial planners to implement and manage clients' investment portfolios. • **Performance is not guaranteed** – while this is true of any investment, investors should be aware that they are still exposed to market risk through a robo-advisor.

As with any important life choice, investors should carefully consider which type of investment guidance they need and select the type of service that best suits their individual style.

Chapter Six

Principles of Financial Advice

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be building on your existing understanding of how to establish a client's investment objectives alongside any constraints associated with their own circumstances, before designing an appropriate investment strategy.

This chapter is also closely linked with chapter 7, which considers portfolio performance and review.

2. Customer Profiles

Learning Outcome

6.1.5 Understand the essential features and purpose of a customer profile, particularly the customer's personal details, income, assets, liabilities, expectations, risk tolerance, capacity for loss and existing investment provision

Before providing clients with investment advice, it is important to record sufficient information concerning individuals' personal and financial situations and their prioritised objectives accurately. Doing so allows an adviser/manager to understand a client's current financial situation, which is crucial for creating a personalised financial plan and making suitable recommendations.

It may be that a standard fact-find form used by an adviser is not sufficient to cover the breadth of detail required to provide recommendations to a more sophisticated investor. Where possible, therefore, enough information should be documented on interview records and the adviser's own reports to verify the suitability of the advice given.

The following notes will provide you with a summary of the type of information that is likely to be needed, and the extent to which it can be used with portfolio management.

2.1 Personal Information

This will include the client's name and address, date and place of birth, residence and domicile status for tax purposes, marital status, health, hobbies and pastimes, and details of any children or other members of the family who are dependent on the client in some way, especially financially. These points are important in that they can open up questions for later on in the interview process.

For example, a client's marital status over their lifetime may vary from single to married to partner, to divorcee to being widowed. An adviser can find out a great deal about future plans and expected settlements (lump sum and income). This could then indicate potential needs/uses of any sums received or about to be received. It could also be that the adviser is restricted in the advice that they give (eg, only to customers who are UK residents and domiciled in the country in which the firm is located). As such, this information can be gleaned early on.

 What different sources of income could a client have?

2.2 Financial Information

2.2.1 Income and Expenditure

Employment Income

An adviser needs to ascertain details of all sources of income. The logical place to start is to find out the client's employment status. Are they an employee, company director, self-employed, business partner, homemaker, unemployed or retired?

When dealing with an employee, their entire income (eg, pay, bonus, overtime, commission and fringe benefits such as car allowance, private medical insurance, share option schemes and other benefits in kind) should be ascertained. The adviser will need to be able to understand which of these benefits are taxable and which are tax-free.

If the employee is a director with a controlling shareholding in a limited company, it is likely that the individual will be able to achieve corporate and personal tax efficiencies. It is worth obtaining a copy of the company's memorandum and articles of association, audited accounts for the past three years and projections for the current year.

In addition, asking the director questions about the business generally will give you useful information:

- Who owns the company?
- What has been planned to happen to the company in the event of death, retirement or ill health of directors/shareholders?
- Have any plans been made for continued succession?
- Who are the key people in the company?
- Is any more capital needed to fund the business?
- What are the client's plans for the future?
- What provision is being made for income in retirement?

If the client is self-employed or in a business partnership, then there is no distinction between the business entity and the individual. Income will, more or less, be the individual's net profit (or share of the profits if a partner). However, many of the questions above could also be equally relevant.

If a client is leaving or has left their employer, full details will be needed of any preserved pensions provided, redundancy benefits or any benefits in kind that have been provided with a continuation option (eg, life assurance).

Details of any previous employment are important, especially in terms of providing the adviser with information about any preserved pension benefits. The adviser/client should obtain full information from the former employer.

Pension Income

Clients may have built up pension income from several sources of work over the years. The adviser needs to identify all sources from both the state and privately. This will help to ascertain the tax position of the individual. In cases where income is very low, it could assist in establishing whether any extra state benefits are due to the individual.

State Benefits

The adviser should establish full details of any state benefits payable or due to the client. In the UK, these could include Child Benefit, Working and Child Tax Credit, state pension benefits, Jobseeker's Allowance, Income Support, Universal Credit, Employment and Support Allowance, Housing Benefit and disabled allowances.

State benefits are complex, but an adviser should have a reasonable knowledge of these benefits to assist the client in obtaining what is rightfully due to them in their local area.

Investment Income

The adviser should identify all sources of client income and draw up a schedule of income. This will assist with the assessment of net disposable income. It is important to question whether any of this income is being received from trusts, covenants or similar.

Outgoings

These can be divided between ongoing regular expenditure (eg, mortgage, property maintenance charges, utility bills, provision for school fees, travel to and from work, personal loans, car loans) and irregular commitments (eg, holidays, home improvements or unexpected healthcare costs).

Calculating the individual's net income will assist in establishing whether there is any scope for further savings and investment provision.

2.2.2 Assets and Liabilities

Assets

Individual client assets can be placed into different categories. Personal assets will include residential and holiday homes, personally owned cars and antiques.

Business assets will include those that are specifically earmarked for the client's business, for example, shares or ownership of business property. It should be noted that these assets are likely to be highly illiquid. In any event, considerable reliefs are provided to them, such as IHT business relief and CGT business asset disposal relief (BADR), so care should be taken as to when to dispose of these assets.

The client is likely to have some investments. Every attempt should be made to obtain full details, including current values, contribution levels, projected values, income taken, tax status and allowances.

The adviser should also ensure that the true ownership of assets has been established. If owned jointly, are the assets held on a joint tenants or tenants in common basis? In addition, the client may also beneficially own assets within a trust. The terms of the trust, and details of the individual's current and/or future entitlements, should always be ascertained.

Liabilities

These will be in the form of debts owed to individuals or to lending institutions. Again, full details need to be obtained; for example, the type of loan and the amount of debt outstanding, any early repayment penalties, loan term, repayment levels, redemption charges, whether held solely or jointly, secured or unsecured, and any associated insurances that the client holds (eg, endowment policy).

The adviser should also establish details of all other forms of debt, such as overdrafts and credit card balances. Generally, financial services regulators (eg, the UK's FCA) regard a recommendation to repay debt as the first course of action as good practice.

2.2.3 Existing Insurances

Life Assurance

Full details of all existing life assurance policies should be obtained, including start dates, lives assured, policy owners, length of term, any trusts in place, underwriting terms offered, qualifying status, fund type (eg, with-profits or unit-linked policy options), whether assigned and on what basis. Current surrender and fund values, and projected maturity values where relevant, should also be requested.

Health Insurance Policies

Again, all health insurance policies need to be ascertained to a similar level of detail as mentioned for life assurance. Likely products that will need to be investigated under this broad category include income protection, private medical insurance, critical illness cover (CIC), accident and sickness policies and long-term care.

Existing Savings, Investment Products and Pensions

It is important to obtain full details of all savings and investment products currently held. This includes product type, amount invested (by both the employer and the employee), current value, savings/investment purpose, when started, whether held solely or jointly, and how they are funded.

The adviser will also need to discuss the subject of pensions with the client. If the individual is a member of an occupational pension scheme, full details of benefits provided and accrued to date will need to be gathered, as well as projections at retirement. The individual may also have the opportunity to top up pension benefits. This can be achieved through a number of registered pension arrangements such as additional voluntary contributions (AVCs) or concurrent personal pension plans (PPPs), as well as non-pension associated products such as ISAs or similar.

If the client contributes to their own personal pension arrangements, full details of the type of plan and projections will be needed, as well as other information that might be useful in establishing the amount of retirement benefit available and the type of benefit taken. For example, is it segmented to allow phasing of benefits? Is it able to accommodate pension fund withdrawals? Are they in receipt of a state pension?

2.2.4 Knowledge and Experience

Before a personal recommendation can be made, an adviser must establish the knowledge and the experience of the customer in the investment field relevant to the service that is being offered. This could include knowing about the types of investments the client has held in the past and present, the nature, volume and frequency of the client's transactions, and their level of education, profession or former profession.

This is not to restrict a client to a type of investment that they already know or have experience with, but to ensure that the adviser explains the risks in a way that the client is likely to understand.

2.2.5 Planning for the Future: Wills and Powers of Attorney (PoAs)

Wills

If a client has made a will, full details need to be obtained to establish what effects the terms of the will have on survivors and beneficiaries of the estate. For example, what guardianship arrangements have been made for children? What trusts will be settled as a result of the will? Who are the executors? It is also important to find out when the will was written, in order to assess whether any major changes have occurred that make the will no longer valid, eg, marriage.

Powers of Attorney (PoAs)

A **power of attorney (PoA)** is a legal document that allows someone to make decisions on behalf of another, or to act on their behalf if they are no longer able, or want to make their own decisions. There are three different types of PoA:

Types of Power of Attorney	
Ordinary power of attorney	• These give the attorney power to look after the financial affairs of the donor or undertake a specific task on their behalf. • It is often created when the donor is going abroad or is unable to act for some other reason and the donor needs someone to have the authority to act on their behalf. The authority granted can be general or limited to specific affairs. • It will automatically be revoked if the donor loses mental capacity. • There is no requirement for an ordinary power of attorney to be registered with the Office of the Public Guardian.
Enduring power of attorney (EPA)	• Until 2007, it was possible to make an EPA to appoint someone to act when the donor could no longer manage their financial affairs. • These are still valid and can be used while someone still has mental capacity provided that the donor consents to its use. • Once the donor starts to lose their mental capacity, the attorney needs to register the EPA with the Office of the Public Guardian.
Lasting power of attorney (LPA)	• LPAs replaced the EPA in 2007 as part of the Mental Capacity Act 2005. • An LPA allows someone to choose a person to take decisions on their behalf if they subsequently lose mental capacity. • The biggest difference between the two is that an LPA can extend to personal welfare matters as well as to property and related affairs. There are, therefore, two types: a property and financial affairs LPA and a health and welfare LPA.

It needs to be established whether these arrangements have been made, with whom and for what reason. If any PoA has been written, it is essential that the attorney proves their authority by providing the original or authorised copy of the PoA. When dealing with the attorney, the adviser must be able to confirm that the power was duly executed, is still valid and gives authority for the intended transactions. In some instances, it may only be the attorney that the adviser will speak to, as the client may be incapable of acting on their own behalf.

As an attorney cannot delegate powers of investment, if an attorney intends to use a discretionary investment manager, it must be expressly allowed for in the PoA. This applies even if the manager was being used by the original investor before the PoA was implemented.

2.2.6 Attitude to Risk (ATR)

Also called risk tolerance, 'attitude to risk' is defined as the degree of uncertainty that an investor can handle, with regard to a negative change in the value of their portfolio. This must be viewed in the larger context of volatility – an investment which experiences wider swings will have larger moves, both up and down. It reflects the extent to which an investor is comfortable with the risk of losing money on an investment:

- If they are unwilling to take the chance that an investment might drop in price, they have little or no risk tolerance.
- On the other hand, if they are willing to take some risk by making investments that fluctuate in value, they have greater risk tolerance.

Finding out an individual's true ATR, and being able to quantify it into a level/band, is essential in assessing product suitability and making an appropriate investment recommendation. Risk should always be explained in a way that a customer understands. It is necessary to establish a client's investment experience to make sure that an investment recommendation is appropriate. For example, a high-risk client might be familiar with equity investing, but not derivatives trading – both are high risk and both would be suitable for a high-risk client, but if the client is an inexperienced investor, then highly speculative (small capitalisation) equites and derivatives would most likely not be appropriate.

There are a number of objective and subjective factors which can be established that will help define risk tolerance:

Objective Factors	Subjective Factors
• The timescale over which a client may be able to invest will determine both what products are suitable and what risk can be adopted. • Family commitments are likely to have a significant impact on a client's risk profile as they will want to meet their obligations which may make higher-risk investments less suitable. • Wealth will be an important influence on the risk that can be assumed. A client with few assets can little afford to lose them, while ones whose immediate financial priorities are covered may be able to accept greater risk. • Stage of life will impact the level of risk that can be adopted and the time horizon over which they consider investments. • The age of the client will often be used in conjunction with the above factors to determine acceptable levels of risk.	• Investors who are more knowledgeable about financial matters are typically more willing to accept investment risk. • Some individuals have a psychological make-up that enables them to take risks more freely than others, and see such risks as an opportunity. • A client's preferred investment choice (eg, a client's normal preferences for the relative safety of a bank account versus the potential risk of stocks and shares). • A client's approach to bad decisions. Some clients can take the view that they assessed the opportunity fully and, therefore, any loss is just a cost of investing. Others regret their wrong decisions and, therefore, avoid similar scenarios in the future.

Establishing objective factors is a preferable and more accurate way to help define a client's risk tolerance, but subjective factors also have a part to play.

Subjective factors enable an adviser to try and establish a client's attitude to taking risks. A client's attitudes and experiences must also play a large part in the decision-making process. A client may well be able financially to invest in higher-risk products and these may well suit their needs, but if they are cautious by nature, they may well find the uncertainties of holding volatile investments unsettling. In these cases, both the adviser and the client may have to accept that lower-risk investments and returns must be selected.

People's ATR can vary at different times in their life. A customer's portfolio must be reviewed regularly so that a change in their risk appetite, due to an unforeseen change in their personal and/or financial situation and recent market events, can be taken into account.

At this point, it is important to note that investment risk means different things to different investors – to some, it may mean volatility in security prices; while for others, it may mean permanent loss of capital, to give an example. Variations in attitude to risk arise because of individual differences in circumstances, experiences and psychological make-up.

Firms use a variety of questions and tools to ascertain a customer's risk profile before making a recommendation. These might come as a paper document or point of sale, as part of the standard fact-find or as a risk profiling/asset allocation tool supplied by a third party. In the UK, the FCA does not approve or endorse the use of these tools, but as the Conduct of Business (COBS) rules require firms to obtain the necessary information regarding clients' risk tolerance (among other things) and to ensure that customers understand risk, the use of these tools could be a useful aid and help in assessing the client's profile.

If firms do use risk profiling/asset allocation tools, this should be recorded on the customer's file. These tools are an aid to the adviser and do not take away the responsibility of the firm to ensure that the customer has the necessary level of understanding.

This is certainly not an exhaustive list. For example, an advisor should take account of the customer's existing portfolio; so, if their risk profile suggests that 10% of their investment portfolio should be in higher risk assets, and they already hold 10% in the higher risk category, no additional investments in that category should be made.

When explaining to a customer why a recommendation is suitable, reference should be made to how the recommendation reflects the customer's risk profile.

Risk Profiling Questionnaires

A common approach to evaluating an individual's attitude to risk is for them to fill in a risk-profiling questionnaire. These questionnaires work by asking clients to confirm how closely they agree with several statements about their current situation, feelings and attitude to risk – all questions need to be answered. The output from these questionnaires is then converted into a score (eg, between 1 and 5, 10 or 100), and the score is then mapped to risk attitude categories. These categories cover the range of risk profiles, from very cautious to very adventurous. We will come back to the categories in a moment.

Risk assessment questionnaires can be fairly detailed, so candidates are recommended to look at samples provided by some large international financial services organisations. Closed-ended questions may be used to assess an individual's risk profile. We have provided an example of what a questionnaire may look like on the following page. This one contains 12 questions, although the number of questions can vary between firms.

The subjective responses given to these questions are converted into a numerical scale (such as a Likert scale, which is a psychometric scale that is widely used to scale responses in survey research). The responses are evaluated and used to assign a risk aversion coefficient to that individual.

That said, there is always a risk that the client's hypothetical attitude to risk may not reflect their reaction when faced with real-life losses. Asking a client to complete a risk questionnaire should not merely be a form-filling exercise but should be a genuine attempt to best serve the client by understanding their requirements as fully as possible. Discussions with the client can help an adviser/manager to determine whether, in their qualitative judgement, the risk appetite expressed in the questionnaire appears consistent with what they would expect.

Note that all of the fields under 'Your Details' and 'Client Details' are required fields. With regard to the 'date of birth', different countries have different styles (eg, it is typically expressed as 'dd-mm-yyyy' in the UK and Europe, in the US, it is shown as 'mm-dd-yyyy', and in China and Japan, among others, it is 'yyyy-mm-dd'). The form, therefore, needs to make the format clear to avoid any ambiguity.

Your Details

Your name _____ Your company name _____

Client Details

Title _____ Forename _____ Surname _____

Date of birth _____ Retirement age _____

Risk Statements

An example of the type of statements used. A client would be expected to review and choose an answer to the following that most closely matches their current situation, attitudes and feelings:

1. People who know me would describe me as a cautious person.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
2. I feel comfortable about investing in the stock market.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
3. I generally look for the safest type of investment, even if that means lower returns.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
4. Usually, it takes me a long time to make up my mind on financial matters.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
5. I associate the word 'risk' with the idea of opportunity.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
6. I prefer the safety of keeping my money in the bank.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
7. I find investment and other financial matters easy to understand.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
8. I am willing to take substantial financial risk to earn substantial returns.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
9. I have little experience of investing in stocks and shares.
   - strongly agree • agree • no strong opinion • disagree • strongly disagree
10. When it comes to investing, I would rather be safe than sorry.
    - strongly agree • agree • no strong opinion • disagree • strongly disagree
11. I would rather take my chances with high-risk/high-return investments than have to increase the amount I am saving.
    - strongly agree • agree • no strong opinion • disagree • strongly disagree
12. I am not willing to take any financial risk.
    - strongly agree • agree • no strong opinion • disagree • strongly disagree

Questionnaire Design

Questionnaire design is a topic of some complexity in its own right. An adviser/manager would wish a questionnaire completed by their client to provide a reliable and objective indication of their client's true risk profile, yet client responses can easily be influenced by factors such as the phrasing used in questions or the order questions are asked in.

Questionnaires will often ask related questions in different ways to attempt to gauge a client's true feelings about the level of risk that they are prepared to accept. Beyond the difference between a client's intellectual response to a questionnaire and their emotional response when faced with reality, the wording of a question can influence the answers given. At the simplest level, these questions may be along the lines of '*You do agree, don't you?*', but the framing of questions can make a significant difference. Consider the following:

- Equity returns have historically exhibited much higher variability than bond returns, meaning they can generate larger losses. Would you prefer the majority of your portfolio to be invested in equities or bonds?
- Equity returns have historically exhibited much higher variability than bond returns, meaning they can generate larger gains. Would you prefer the majority of your portfolio to be invested in equities or bonds?

Although rather simplistic, this serves to illustrate the difficulties. Questionnaires should be designed to obtain attitudes of the client and not lead them to a certain conclusion.

Questionnaires may also be designed to attempt to elicit a response by not permitting 'middle-of-the-road' or 'neutral' answers. For example, answers on a scale of 1 (strongly disagree) to 5 (strongly agree) permit a neutral answer of 3 (neither agree nor disagree) since 3 sits in the middle. By changing the scale from 1 (strongly disagree) to 6 (strongly agree), a client is obliged to answer either 3 (slightly disagree) or 4 (slightly agree).

Considering potential discrepancies between the client's risk response (as assessed by a questionnaire) and their likely emotional response (when faced with real financial losses), then by having broader discussions with the client, an adviser/manager can help to determine whether, in their qualitative judgement, the risk appetite expressed in the questionnaire appears consistent with other views expressed by the client.

2.2.7 Capacity for Loss (CFL)

Having established the client's attitude to risk, it is vital to assess their capacity for loss (CFL) from their investments and how that might have a detrimental effect on their standard of living. This should be considered when assessing the risk that the client is able to take. Hence, while ATR is a subjective measure of risk, CFL is an objective measure.

In the UK, the FCA (when it was known as the Financial Services Authority (FSA)) defines CFL as:

> *'the customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take'*[1].

Often, this assessment can be undertaken using cash flow modelling tools or simple calculations. The adviser must gather the necessary information to calculate how much the customer can afford to lose rather than just accepting the customer's view on what they view as an acceptable loss.

Assessing a client's CFL can prove difficult when the client actually believes that they have unlimited CFL. However, the client will not necessarily consider everything that must be considered and, therefore, their opinion on potential loss is somewhat different to CFL.

2.3 Client Plans and Objectives

2.3.1 Shorter-Term Objectives

Emergency Funds

The adviser should establish with the client the extent of the emergency fund that will be required. There is no right or wrong answer to this, and discussions would have to be conducted with clients to ascertain an amount that they would consider suitable.

Trading Up

Any intention to move to a more expensive property or to purchase a holiday home would need to be considered before contemplating any longer-term investment.

Trading Down

People often decide that they are going to move to a smaller/less expensive property for economic reasons. Such a move could have been prompted by a change in marital status (eg, divorce). It might be that a client is about to retire and feels that they no longer need the space that is being enjoyed with the current property. Some people trade down simply to pay off debts.

Other Future Changes

There are a number of other future short-term changes that could affect the investment advice being given. These could include future changes in employment status (eg, retirement), marital status, anticipated future assets or liabilities (eg, gifts and loans). There is a need to question customers about any anticipated expenditure, and how it is to be funded. Further, disposal of assets may lead to funds available for investment.

1 Financial Services Authority, March 2011. Finalised Guidance. Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection. Retrieved from https://www.fca.org.uk/publication/finalised-guidance/fsa-fg11-05.pdf (Accessed: October 2025)

2.3.2 Longer-Term Objectives

It is advisable to explore likely future costs by taking a view of the current cost and adjusting for inflation to the point where the cost is likely to be incurred.



Identify some potential longer-term financial aims and objectives that a client may have.

Some examples are listed below:

- **Family** – clients may wish to help to finance relatives in respect of their marriage, education, business or even new homes.
- **Private/further education costs** – this is a common long-term (and expensive) objective. It is very much the case that estimates will need to be made of likely future costs.
- **Family home** – any potential home move will need to be factored into investment recommendations.
- **Career** – how long a client will want to remain in their existing role can give an idea of the plans that they have for the future in terms of career development. This can give an indication of likely rises in employment income. There may even be a desire expressed by the customer that they wish to start their own business at a later date.
- **Financial** – certain aims may be expressed purely in financial terms. For instance:
  - 'At age 65, I wish to receive pension and investment income of £40,000 a year, or
  - 'In ten years' time, I hope to have repaid my mortgage, five years ahead of schedule.'

2.4 Client Priorities

Clients will have varying priorities in respect of their financial needs and objectives. As a guideline, however, the following order is usually recommended:

1. Ensure sufficient funds to meet immediate living expenses.
2. Ensure that short-term savings and investment needs are addressed.
3. Ensure that sufficient protection needs are met, both in respect of early death and illness.
4. Ensure that pension needs are addressed.
5. Address longer-term savings and investment needs.
6. Address any estate planning issues.

2.4.1 Determining Investment Needs

Prior to considering the different investment asset types (available in chapter 5), we should address how needs are determined.

In the first instance, timescale is important, not just from the perspective of how long it gives the individual to generate sufficient funds, but also their ability to access the investment without penalty.

As already discussed, the client will need to generate sufficient liquidity to pay for everyday costs and also to fulfil short-term objectives.

The client may need income to be generated from the investment portfolio. It will be a matter for discussion as to what constitutes a reasonable amount. In some instances, the client's expectations as to the level of income they can draw will need to be managed. Any long-term investments may also require the adviser to consider inflation and the need for the investment to outpace rises in general price levels.

The client may need their investment or savings to generate capital growth. An adviser would need to discuss the level at which the investment should grow over the required timescale, taking into account the client's attitude to risk and market conditions.

The client will need to understand the various risks that can be incurred through savings and investment. Suffice to say that if the client is advised to enter into a savings or investment contract above or below the level of acceptable risk, the adviser may be accused of making inappropriate recommendations.

Clients have often overlooked the extent or importance of a particular need, and it is then the responsibility of the adviser to point this out, as the professional in this situation. We cannot prevent clients from choosing to ignore this, but advisers need to show that they have recognised priorities and have highlighted them to the client, and that the client has decided not to take up the recommendations.

This all forms part of offering holistic advice based on taking account of the client's entire financial situation and hence making sure that any recommendation is not only appropriate, but also suitable for the client's needs and their goals for investing. Furthermore, this is aligning with the FCA's view on conduct risk: creating products and services that match clients' needs.

3. Investment Objectives and Risk

Learning Outcome

6.1.1 Understand risk and return objectives and how to construct a risk-return profile

In this section, we will discuss the relationship between an individual's investment objectives and how they correlate with the level of risk they can afford and wish to take, as well as provide an introduction and brief explanation of the various types of risk that could be encountered by an investor.



Before we move on, consider how an individual's own circumstances and needs could have an impact on the level or type of returns they require from investment funds.

3.1 Investment Objectives

As we have seen, individuals have many different objectives.

As a result, there are many different savings and investment solutions and strategies.

In this regard, understanding a client's CFL is very important. The investor must fully understand the various risks that may attach to their investment choices, and know the impact that these may have on the required return from their savings or investment portfolio. They must also know if they can afford to take these risks.

The higher the sum that is available to invest, the greater the amount of flexibility and choice that will likely be available. Larger investment funds could also impact on other factors, such as the level of risk that the individual is willing to take.

As mentioned above, timescale is also an important factor. Before any recommendations can be made, the savings or investment term needs to be established. Again, this can have an impact on the level of risk that the investor may be prepared to take. In addition, if certain investments are encashed early, the individual could possibly incur early surrender charges, which can significantly lower the overall investment returns.

The economic, legal and political environment may impact on an individual's savings and investment needs and how they are tackled.

Relevant questions could be the following:

- Should individuals consider saving more for their retirement if the government of the day has a policy of continually reducing pension benefits provided via the state system?
- Should an individual invest over the short to medium term in property, if it appears that over that period, economic factors will force the property market into a slump?

Other external factors certainly could impact on the choice of product recommended. For example, will the product be most suitable, bearing in mind its and the individual's tax status? What will be the type and level of charges imposed on the prospective product? The higher the tax levied for a particular investor and the greater the charges, the lower the ultimate returns.

3.1.1 Variance in Income Needs

Individuals may have a variety of income needs from their investment portfolios. Some will want a high level of income, to supplement income from other sources. Between the global financial crisis of 2007–08 and 2021–22, high levels of income have been difficult to achieve, with central banks worldwide cutting interest rates to historically low levels, or negative in some cases. As we have seen, though, interest rates have been rising in recent months to combat high and rising inflation. Often, this income comes at the price of zero or negative growth. The investor may accept a stagnant total value of their investments over time so that the required level of income can be provided.

To others, the requirement for income may be low because the investor's aim is to achieve capital growth.

Some investors will want the income from their investments to grow over time. If this is the case, the range of choices are narrowed, but there are still products available in the market that can and do achieve reasonable increases (often at the price of increased risk, less flexibility or perhaps a lower initial income).

3.1.2 Variance in Growth Needs

There are numerous reasons why capital growth is required. The type and level of growth will vary depending upon the specific requirements and risk profile of the investor.

Capital growth could be in the form of real value being added to an asset, or the reinvestment of income to purchase a further quantity of the particular investment.

3.1.3 Variance in Combined Income and Growth Needs

If an investor wants a combination of income and capital growth, they should understand that a variety of product types may need to be used.

Further, if an individual wants high levels of income, the effect of inflation on the underlying capital should be considered. Often, a combination of income and growth can be provided within the same product, and this may satisfy an investor's objectives; however, it may have drawbacks – not least the generally held belief that savers and investors should diversify their portfolios to a reasonable level to reduce risk.

Let us now consider risk in greater detail.

3.1.4 Risk Categories

An individual's ability to withstand risk (both psychologically and physically) will have an impact on the investments selected.

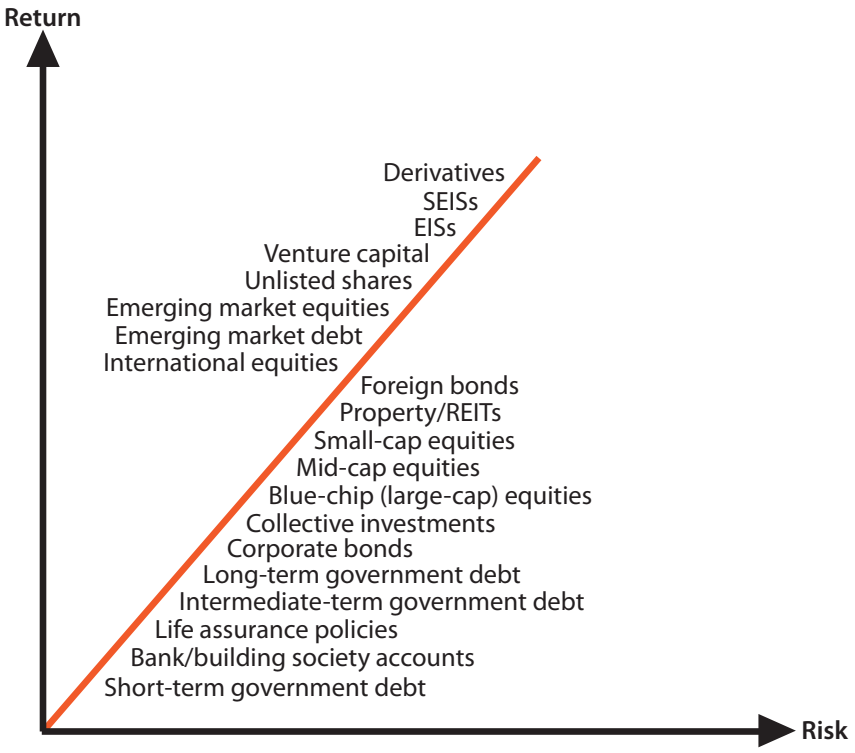
The risk categories are broadly divided as below. However, you may see low risk described as 'cautious', and high risk as 'adventurous' or 'speculative', but with similar descriptions. As these are broad descriptions, an adviser must be certain that they understand what the client understands by such illustrations and quantify what they mean to the client. This is because low, medium and high risk have different meanings to different people.

Risk Profile	Description
Very cautious (virtually no risk)	People who do not wish to take any risk with their capital, so favour cash on deposit. They understand that while their capital is safe, returns may be low and often barely keeping pace with inflation.
Cautious (low risk)	People who tend to target a return above bank deposit rates, while aiming to provide some capital preservation.
Cautious to balanced	People who accept the need to invest in areas other than cash, but wish to minimise the risk. These investors might consider investment grade government and very high-quality corporate bonds as part of their portfolio, as the risk is low and there is an element of capital guarantee. However, some capital could be lost.

Risk Profile	Description
Balanced (medium risk)	People who understand that to retain the capital value and achieve capital growth, they will need to balance risk against the potential reward.
Balanced to adventurous	People who recognise the potential for higher returns, and are willing to accept a higher level of risk in pursuit of those returns, while still maintaining a balanced approach to their portfolio. They may start to diversify into more volatile assets such as equities, away from lower-risk assets.
Adventurous (high risk)	People whose priority objective is achieving a higher return on their investment, and who understand and accept that in order to achieve it, there is a significant risk to their capital. These investors might choose individual shares, international funds, new listings, or other investments with even more risk.

3.2 The Relative Risk of Different Types of Financial Investment

The risk associated with different types of investments is often captured graphically with investments such as cash and government-backed securities at the safer end, with unlisted shares and derivatives at the opposite end. This is illustrated below.



For collective investments (eg, unit trusts, OEICs and investment trusts), their risk profile will depend on the specific type of investments held within them – for example, a blue-chip (large-cap) equity fund will typically be lower risk than a mid-chip equity fund. Compared with an individual share, though, a collective investment will generally demonstrate lower levels of risk due to diversification within the fund (eg, a blue-chip equity fund should be lower risk than an investment in a single blue-chip stock).

The following list demonstrates the potential returns and pitfalls that could be experienced when allocating funds toward some of these investment types:

Variable rate cash deposits	These provide protection against rising interest rates. Poor long-term performers in providing real returns, especially after accounting for tax.
Fixed-interest securities	Perform well in times of falling interest rates, providing secure income and known capital returns at redemption. Lose value in times of rising inflation and interest rates. More volatile, the longer the term to redemption.
Index-linked securities	Provide protection against inflation if held to redemption. Long-term performance likely to be less than that derived from equities.
Equities	Over the longer term, can provide rising income and capital returns. In the shorter term, equity values are volatile. In times of economic slowdown, equities tend to perform badly. Overseas equity markets do not necessarily move in line with each other, so diversification by selecting international investments could be viewed as a way of reducing risk.
Direct property	Normally, a good hedge against inflation over the longer term. Not directly correlated with other asset classes such as equities, so can be used to reduce volatility in a portfolio, although it is illiquid.
Commodities	Can also reduce risk in a portfolio in terms of volatility, through diversification. Again, little correlation with other asset classes.
Alternative assets	Looking to increase returns, but depending on the type (eg, hedge funds, venture capital/private equity, structured products), they may be illiquid and either raise or lower the risk/volatility levels in portfolios.

Note that derivatives are anomalous. While specific investment into them can be perceived in certain instances as very high risk, they are often used as a hedging mechanism within portfolios or investment products to reduce the overall effects of volatility; for example, by taking an opposite position to the rest of the assets held.

Additionally, the risk/reward profile of collective investments will depend on the underlying investments within the fund. One that invests mainly in short-term government debt, for example, will be taking on lower levels of risk (and, therefore, has the potential for lower returns over the long term) than one that invests in emerging markets equities.

3.2.1 Types of Investment Risk

Learning Outcome

6.1.2 Identify the major types of investment risk, and where and how they typically arise

The following are some of the types of risk that could affect investment returns:

Default Risk

This is the risk of a loan not being repaid. With investment-grade government bonds, there is negligible risk. However, an unsecured loan made to a company which is in financial difficulty will involve far greater risk. Default risk in relation to companies is often termed 'credit risk', covering both missed interest payments as well as capital defaults at the time of redemption.

Liquidity Risk

There is always a risk when you need to find a buyer for the asset you are holding before you can turn it into cash. Some assets are very liquid, such as no-notice deposit accounts; whereas some are illiquid, such as direct investment in property. Liquidity risk increases during unfavourable economic conditions.

Inflation Risk

This is the risk that the rate of inflation will erode the purchasing power of the investment by more than the increase in value of the investment. An investor locked into a low rate of interest may be susceptible to an increase in the rate of inflation.

Interest Rate Risk

We discussed how the prices of fixed-interest assets are affected by changes in interest rates. An increase in interest rates will normally have a negative effect on bond prices. This represents a risk to investors in bonds, especially if there is the possibility that they may need to sell them prior to redemption. Share prices also tend to move lower in a rising rate environment, particularly those that are leveraged as higher interest rates make borrowed capital more expensive to service.

Foreign Currency Risk

This is the risk of the effects of exchange rate variances on your returns. For example, a UK-based investor makes a 10% return in euro terms, on their investment in a Germany-based security after one year. However, if the value of the sterling against the euro were to go up by 7% over the same period, the real return (should the investor want to realise their investment and convert back into sterling) would, in effect, only be 2.3%.

Concentration Risk

This is when an investment is placed into one product type, asset class or institution. The risk can be reduced greatly by diversification across a number of asset classes, product types or institutions.

Overlap Risk

When investments are diversified, especially using collective investments, the underlying asset allocation may be similar, resulting in an inadvertent **concentration** in one or more assets or sectors. This risk can be reduced by analysing the underlying investments. Remember, if you do not understand an investment, do not use it.

Systematic (or Market/Undiversifiable) Risk

This is the risk that will affect all assets in that class, such as a recession or market crash – see chapter 5, section 6.7.1. Changes in interest rates and inflation, and fluctuations in currency exchange rates, are examples of systematic risk.

Unsystematic (or Specific/Diversifiable/Non-systematic) Risk

This is a risk that affects just one company irrespective of the overall market – see chapter 5, section 6.7.1. Examples of unsystematic risk include regulatory changes, a shift in management, and a product recall.

4. The Impact of Inflation, Deflation, Taxation and Charges

Learning Outcome

6.1.3 Explain the impact of inflation, deflation, taxation and charges on investment returns

There are several factors that have an impact to a greater or lesser extent on investment returns. In this section, we shall discuss some key areas, namely inflation, deflation, taxation and charges.

4.1 Inflation, Deflation and Disinflation

Inflation can be defined as a persistent tendency for the general level of prices to rise. Inflation is the rate at which the general level of prices for goods and services increase but, in essence, the purchasing power of currency (ie, one's available money) is falling.

Inflation will have an impact on all investments to a larger or smaller extent. At low levels, it does not cause great difficulties to an economy, but if unexpected rises are persistently high, they can have a damaging impact on investment returns as their real values erode, if the investments are not in securities whose returns are linked to an inflation index (eg, inflation-linked bonds, property and infrastructure). Unabated, inflation will cause an economy to 'overheat' as demand outstrips supply and prices spiral. In addition, a country with high inflation can have any advantage of a competitive nominal exchange rate erased if the rate of inflation is high and prices continue to increase.

Some equities have traditionally been seen as a good hedge against inflation because income and capital values can be anticipated to increase in line with the economy in the long term. For example, investing in those companies that produce goods or services that are needed in times of high inflation such as food staples. An alternative would be to invest in the object/commodity that is driving inflation, such as oil (eg, Shell, BP, Exxon Mobil or PetroChina).

Conventional fixed-interest securities, such as government and corporate bonds, are poor hedges against inflation because the fixed returns are eroded by the fall in value of money. Some bonds are inflation-linked, though, meaning the interest and capital payments are adjusted for inflation. Inflation-linked bonds are very useful by their nature, but this means they are priced at a level where the real return is very low or even negative. Also, due to the lag between the indexation and the cash flow dates, investors need to remember that inflation-linked bonds do not offer complete protection against inflation (see chapter 5, section 4.2.8 for more details).

The opposite of inflation is deflation, where prices actually decrease. This would usually be accompanied by declines in output and demand, as falling prices can give the incentive of delaying investments or business purchases. During deflationary periods, the opposite is likely to occur – share prices would fall as they are no longer offering attractive returns to investors, while bonds will become more attractive. Deflation should not be confused with disinflation, which is the term used for the drop in the rate of inflation.

4.2 Taxation

The taxation of savings and investments will frequently take two forms: income, and capital gains.

Often, any taxation will be payable on income and/or capital gains enjoyed by the investor.

Additionally, many investment vehicles will pay tax from within their own funds on the income and capital gains that they make. Some investments will have a competitive advantage where some or all returns from them are tax-free.

In many instances, the asset type and the investor can be protected from paying income tax or capital gains tax (CGT) by, for example, investing within a tax-free wrapper (eg, an individual savings account (ISA) or pension), or in a tax-free product (eg, NS&I National Savings Certificates).

Saving via tax-advantaged products should be an important (but not the only) consideration when assessing an individual's overall investment requirements. As a general rule, higher and additional rate taxpayers should look to minimise income and accumulate growth during the term of their investment. However, they should understand the tax consequences of an investment on encashment.

For example, in the UK, the disposal of shares would give rise to CGT on any net chargeable gains above their annual allowance – see chapter 2, section 4. Where possible, consideration could be given to reinvestment of proceeds into other investments whereby some form of CGT relief (eg, reinvestment relief) may be available.

Some portfolios are specifically geared up to take advantage of specific tax reliefs, such as investments into securities that are, subject to a sufficient holding period, eligible for inheritance tax (IHT) business relief.

Other factors must also be taken into account – eg, the investor's residence and domicile status for tax purposes (see chapter 2, section 2). If an individual is not resident/domiciled in the country where the tax is being levied, offshore investment may be a far more tax-efficient solution, subject to their other circumstances being taken into account.

4.3 Charges

The types of charges that apply to investment products vary considerably.

In certain instances, they may be 'hidden'. For example, the charges arising from a deposit account will be reflected by the rate of interest payable. The cost to an investor of saving into a with-profits fund can only be indicated by the levels of bonus applied.

Charges applying to other investment vehicles are more transparent. For instance, buying (higher) and selling (lower) prices applicable to securities, and administration fees for packaged products such as initial charges, annual management charges (AMCs) and lower allocation periods for the early years.

Costs can be higher if funds are actively managed. Active managers have flexibility of choice and are free to choose assets that they believe will provide a strong return, which gives them the potential to generate better performance relative to a benchmark index over time, even after fees. However, if that **active management** does not beat a comparative benchmark index or provide a consistently positive return (depending on the fund's objectives), then that product becomes very expensive for the returns that it is delivering.

Conversely, if the fund is passively managed, following the performance of a benchmark index, then charges are likely to be much lower. The disadvantage of these funds is that they can never outperform the index that they follow, after charges, and will often track the index down in falling markets.

Remember that not all passives are cheap, and not all actives are expensive. The rise of passive strategies has put active managers under increasing pressure to reduce their fees over the years to remain competitive.

Under MiFID II, asset managers must disclose a clear and simple breakdown of their costs and charges, and their cumulative effect on investment returns. This is to ensure that all clients get a specific and bespoke breakdown of all costs and charges relating to them. The UK's Consumer Duty puts additional emphasis on ensuring that firms act in the best interests of retail clients, promoting transparency and fairness in the treatment of customers, and providing clear communication about the costs, risks and expected outcomes of investment products.

5. Timescale

Learning Outcome

6.1.4 Understand the importance of timescale in relation to risk and the time value of money

There is a strong connection between required returns on investments and their accessibility.

If capital needs are to be preserved and accessed immediately to cover short-term emergency costs, for example, then choices are restricted to products such as current or short-notice deposit accounts.

Due to the need to access funds without penalty, the investor is going to have to compromise and accept potentially much lower real returns than, say, an equity-backed investment over the medium to longer term.

Likewise, an investor in equities would have to understand that while it will be possible to access their funds at virtually any time, they face a greater risk of sudden falls in capital values and dividend cuts which could significantly reduce returns.

Not only is it important to understand and plan for the client's time horizon and possible future changes, such as investing for retirement, but it is also important that the client's resulting strategy takes volatility into account.

Volatility is the uncertainty of returns. In the short term, volatility in markets and from asset classes has increased. This gives sharp movements in equity markets, either up or down, for example. In the short term these sharp, uncertain movements have increased, but over a longer time period they get smoothed out. Therefore, clients need to be made aware of the short-term volatility in any investment strategy and hence the investment strategy must take account of volatility when matching the client's time horizon for investing.



How much would you recommend that a client retains in cash within their investment portfolio?

5.1 Cash Liquidity

Everyone should retain an element of cash liquidity, whether that be within an investment portfolio and/or kept as an external cash reserve.

There is no set amount that should be on deposit. Recommended cash levels will be entirely down to the individual's circumstances. Each case needs to be judged on its own merits. Some factors are worth considering, which will help to determine the required amount.

- Most investors need funds that are instantly accessible for emergencies and to cover known expenditure in the short term. That being the case, a fair proportion of cash could be held on deposit with longer notice periods in return for higher rates of interest. The key point here is to ensure that the client is not penalised for accessing funds.

- Someone with high income needs from their portfolio may require much higher sums in cash-based or other fixed-income investments than someone who works in highly paid and secure employment.
- Funds held on deposit could enable an investor to take advantage of investment opportunities at short notice, such as a new share offering or rights issue.

It should be remembered that an excess of funds held in cash could eventually be an inefficient way to invest, particularly in the case of higher and additional rate taxpayers.

According to MoneyHelper (which we covered in chapter 1, section 2.5), a good rule of thumb is to have three to six months' essential outgoings available in an instant access savings account[2]. However, the size of the emergency fund will depend on the individual's life style, monthly costs and income, and whether they have any dependants.

5.2 Time Value of Money

The time value of money is a way of appraising the valuation of investments based on expected future returns. The theory looks at the anticipated value of money at a future point in time, and discounts it back to the present day to assess its current worth.

The formula for the time value of money is:

$$\text{Present value } (\text{PV}) = \text{Future value} / (1+r)^n$$

where r is the rate of interest and n is the number of periods.

Example

Jane wants to know what amount she needs to invest today to achieve a figure of £100 in one year's time, assuming an interest rate of 1.5%.

$$\text{PV} = £100 / (1+0.015) = £100 / 1.015 = £98.52$$

In terms of its importance to the timescale of an investment, a number of issues need to be taken into consideration when deciding upon an appropriate rate of interest:

- In reality, the rate of interest may change over the period in question.
- The rate of return chosen needs to take into account any taxation that may be applied, thereby reducing it.
- If the interest is to be reinvested, the rates earned will fluctuate over time.

Candidates who wish to understand more about the different time value of money calculations may refer to the CISI CFP publication, *'The Time Value of Money Guide'*, a copy of which is available directly from the CISI.

2 MoneyHelper. Emergency savings – how much is enough? Retrieved from https://www.moneyhelper.org.uk/en/savings/types-of-savings/emergency-savings-how-much-is-enough (Accessed: October 2025)

5.3 Rule of 72

The formula for the time value of money can be rearranged, to allow us to calculate the number of years for an investment target to be achieved (that is, if the present value and interest rate are known). However, this can be quite a complicated and complex process.

In specific cases, the Rule of 72 can be used. This is a shortcut method that estimates how long it would take (in years) for the present value (or, in other words, the initial investment) to double in value: by dividing 72 by a fixed rate of interest. This works on the basis that it will take longer for money to grow when interest rates are low, and shorter when interest rates are high (ie, an inverse relationship). It should be noted, though, that the Rule of 72 is less precise with higher interest rates and in any case is an approximation.

Example

Alessandra has £50,000 to invest and needs to generate £100,000. If her expected annual rate of return is 6%, approximately how long will it take for the money to reach the target value?

By the Rule of 72: 72 / 6 = 12 years

6. Client Agreements

Learning Outcome

6.1.6 Understand the regulatory requirements regarding the need for, and content of, client agreement documentation and related communications

The rules state that before entering into an agreement or providing any services relating to designated investment business for a retail client, a firm must provide the client with:

- the terms of any such agreement, and
- information about the firm and its services, including information on communications, conflicts of interest and authorised status.

In the UK, the agreement can be provided after the client is bound by the agreement, if the agreement was concluded using a means of distance communication. The agreement can be issued in any durable medium; in other words, any paper or email or any other medium that:

1. allows information to be addressed personally to the recipient
2. enables the recipient to store the information in a way accessible for future reference, and
3. allows the unchanged reproduction of the information stored.

Similarly, a durable method can be used to communicate material changes to the agreement. Any changes should be notified to clients in '*good time*', although this is not defined by the regulator.

Details of the rules around other communications, such as periodic and occasional statements, can be found in chapter 1, section 4.7.

6.1 Record-Keeping

To be able to demonstrate suitability, firms must keep copies of client records. There have been several fines over the years because of inadequate record-keeping. Consequently, more than ever, regulated firms must look beyond specific record-keeping requirements and ensure that they are able to produce the records necessary to demonstrate 'know your customer' (KYC) and suitability compliance at all times and in all respects. Remember the old adage: '*if it isn't written down, it hasn't happened*'.

A firm must keep a record of client agreements for a period of time as specified by the regulator. In the UK, this is the longer of:

- five years from the date on which the agreement was given
- the duration of the relationship with the client, or
- indefinitely, in the case of pension transfers, conversions, pension opt-outs or free-standing additional voluntary contributions (FSAVCs).

Also, remember that complaints can be forthcoming after a number of years and certainly later than five years after a relationship has finished.



Find a client agreement and examine the headings.

6.2 Requirements for Client Reporting

The way in which client reporting takes place, and its frequency, will usually be contained within the client agreement and/or the investment policy statement (IPS). Otherwise, it should be agreed in writing between the client and the investment manager.

The main items of reporting will often be:

- purchases and sales, either via contract notes or a list of transactions on the capital account of a portfolio
- summary portfolio valuation and statements showing income, interest received, dividends and cash outflows
- general market commentary and calculated investment returns compared with the agreed benchmarks, and
- recommended changes to the investment strategy.

A firm is required to send periodic statements when it acts as an investment manager.

In the UK, retail clients must be provided with the periodic statement every three months, unless the client requests it to be provided more frequently. If the client elects to receive information on a transaction-by-transaction basis, subject to certain conditions, the statement can be provided annually. If the portfolio agreement allows leveraging, the periodic statement must be issued monthly.

Periodic statements have specific content requirements laid down in the rules.

6.3 Customer Communications

In the UK, in accordance with the FCA's Principle 7 (PRIN 7) for businesses and approved persons, all communications with clients should be made in such a way that they are clear, fair and not misleading.

7. Confidentiality, Data Protection, Reporting and Communication

Learning Outcome

6.1.7 Understand and be able to address customer concerns about confidentiality and security, data protection, fees, periodic reporting and customer communications

Clients will naturally expect to be advised to the highest professional standards, in accordance with current regulatory requirements. This section briefly covers some of the concerns that are likely to be raised by clients during the advice process.

7.1 Customer Confidentiality

From a professional perspective, maintaining confidentiality with a client over their financial affairs is a standard that clients should expect as a prerequisite for doing business with an adviser and their firm.

Much regulation affecting client confidentiality stems from laws on data protection (see section 7.2 below) and the regulator's rules and principles concerning conflicts of interest (covered in chapter 1). In the UK, these rules and principles are contained in the FCA's Senior Management Arrangements, Systems and Controls (SYSC) sourcebook.

7.2 Data Protection and Regulations

Data is widely defined; it can even include telephone, CCTV recordings and photographs. Advisers may hold a good deal of sensitive information relating to clients' finances, which should not be disclosed to third parties without proper authority.

Many countries worldwide have enacted data protection laws. Currently, over 18 countries have legislation or regulations in place to secure data protection and privacy in some way[3], and this number continues to grow. In recent years, there have been several major developments in this regard, with 2023 standing out as being notable due to updates in data protection laws across several key jurisdictions. For example:

- The UK's Data Protection and Digital Information (No. 2) Bill amended data protection and online privacy laws.
- The revised legislation has changed the interpretation of 'legitimate interests' as a lawful basis for data processing. Previously, organisations had to balance these interests against the rights and freedoms of data subjects. Now, though, they are allowed to rely on 'legitimate interests' without conducting a balancing test in certain specified cases, such as national security and public security concerns.
- Another notable development was the European Commission's proposal for a new GDPR Procedural Regulation, intended to promote standardised and enhanced cooperation among EU member states' data protection authorities in enforcing GDPR compliance.
- Switzerland enacted a revised Federal Act on Data Protection (FADP), aligning closely with GDPR principles and introducing significant changes to Swiss data protection law. These include enhanced rights for individuals over their personal data and stricter compliance obligations for organisations.
- Historically, the US has not had federal-level data protection and instead operated under a complex mix of federal and state regulations, along with sector-specific laws (eg, the Health Insurance Portability and Accountability Act for health data, and the Gramm-Leach-Bliley Act for financial data). However, in 2023, the US started transitioning towards a more inclusive, rights-focused approach by introducing GDPR-inspired data privacy statutes in multiple states.

On the other hand, the UK notably lost its free data flow privileges in the EU following the end of the Brexit transition period. While EU legislation relating to data protection may no longer apply to the UK, many requirements have been written into UK law. We will now look at this in more detail.

There are circumstances in which disclosure of information about clients' affairs is required, however, and failure to do so could be a breach of the law. For example, it is a criminal offence under the Proceeds of Crime Act (POCA) 2002 for anyone working in a regulated financial firm not to report any activity that they suspect, or ought to suspect, involves the proceeds of crime. This includes an act of tax evasion by an individual. The report should be made to the firm's Money Laundering Reporting Officer (MLRO), who must then report appropriate cases to the National Crime Agency (NCA).

? Which independent public body oversees enforcement of the GDPR?

The Information Commissioner's Office (ICO).

3 UNCTAD, 2025. Data Protection and Privacy Legislation Worldwide. Retrieved from https://unctad.org/page/data-protection-and-privacy-legislation-worldwide (Accessed: October 2025)

7.2.1 UK Data Protection Regime

In the UK, the current data protection regime consists of the UK General Data Protection Regulation (GDPR), Privacy and Electronic Communications Regulation (PECR) and Data Protection Act (DPA) 2018.

The DPA 2018 replaced the DPA 1998, which applied to manual data as well as electronic data, and imposed a series of obligations on those affected by the legislation. DPA 1998 also imposed obligations on advisers with regard to the safekeeping of data on individuals and their affairs, among other things.

While the GDPR is a piece of EU legislation, its requirements have been transposed into UK law through the DPA 2018; and in doing so, the core data protection principles, rights and obligations are little changed. UK firms that only process domestic personal data must comply with DPA 2018 and UK GDPR. If they also offer goods and services to EU residents, then they must also comply with EU GDPR (which falls outside the scope of this workbook).

The PECR (known in full as the Privacy and Electronic Communications (EC Directive) Regulations 2003, or the 'e-privacy Directive' in short) also falls outside the scope of this workbook. However, candidates should be aware that it gives people specific privacy rights relating to electronic communications. It applies to firms that send electronic marketing or use cookies (or similar technology) on their website.

The Data (Use and Access) Act received Royal Assent in June 2025, superseding and supplementing previous legislation. It provides strengthened direction to and the powers of the Information Commissioners Office (ICO). The main objectives of the new Act are recognising: the desirability of promoting innovation and promoting competition; the importance of the prevention, investigation, detection and prosecution of criminal offences; the need to safeguard public security and national security; the extra protection that children require for their personal data. The earlier UK's Data Protection and Digital Information (No. 2) Bill of 2023 amended data protection and online privacy laws, thus updating the UK data protection framework. Some of the areas that bill addressed included changes to the definition of 'personal data', strengthening the UK's data regime, ensuring that privacy and data are securely protected, and reducing compliance burdens by limiting certain record-keeping requirements in order to reduce costs and burdens for UK businesses and charities, in turn removing barriers to international trade.

Terminology

There are several terms defined in the GDPR and DPA 2018 that you need to be aware of, including:

- **Personal data** – information in respect of a living individual who can be identified from the information held by the data controller (eg, the person's name and address).
- **Sensitive personal data** – this term is used in respect of a person's racial or ethnic origin, religious, political or other beliefs, mental or physical health, sexual orientation or criminal record.
- **Processing** – deals with the day-to-day activities that affect personal data, including disclosure to a third party.
- **A data subject** – the individual whose personal data is held.
- **A data controller** – decides the circumstances in which personal data should be processed.
- **A data processor** – a body (usually an organisation) that actually processes the data on behalf of the data controller.

 Before moving on, jot down what you believe are the main principles and effects of the GDPR.

GDPR Principles

All businesses that handle data must abide by the principles applicable to personal data. The UK GDPR sets out seven key principles, which should lie at the heart of firms' approach to processing personal data:

- **Lawfulness, fairness and transparency** – the individual data subject should have explicitly consented to the data processing, and there should be evidence in writing of this in the terms of a business letter or a separate form. They should also be told what data processing will be done, and this must match up with what has actually been done.
- **Purposes limitation** – data is obtained only for specified explicit and legitimate purposes. It can only be used for the specific processing purposes that the subject has been made aware of, and nothing more without further consent.
- **Data minimisation** – data collected should be '*adequate, relevant and limited to what is necessary in relation to the purposes for which they are processed*' (ie, only the minimum amount of data that is required should be kept for specific processing).
- **Accuracy** – data must be '*accurate and where necessary kept up to date*'.
- **Storage limitation** – personal data should be '*kept in a form which permits identification of data subjects for no longer than necessary*' (ie, firms should remove data that is no longer required).
- **Integrity and confidentiality (ie, security)** – processors should handle data in a way that ensures '*security of the personal data including protection against unlawful processing or accidental loss, destruction or damage*'.
- **Accountability** – this requires firms to take responsibility for how they process personal data, and that they comply with the other principles. This involves putting appropriate measures and records in place, so they may be able to demonstrate their compliance.

Penalties

There are a number of criminal offences under the GDPR, including:

- failure to make a proper notification of processing to the Information Commissioner
- failure to comply with an information notice or an enforcement notice, and
- processing data without the data controller's authorisation – an offence that could be committed by a firm's data processors or other individual employees.

The penalties for non-compliance with the GDPR could result in unlimited fines and penal/informative notices issued by the Commissioner.

7.2.2 Data Protection Regulations in Other Countries

As mentioned in section 7.2 above, many countries worldwide have enacted data protection laws. Below are some examples of the laws that are currently in place.

- As noted in section 7.2 above, the way in which the US historically handled data protection has started to shift towards a more inclusive, rights-focused approach, as demonstrated by the introduction of GDPR-inspired data privacy statutes in multiple states in 2023. More broadly, though, the US continues to grapple with hundreds of laws at both the federal and state levels, with significant variations from one state to another.
- In 2021, China introduced the Personal Information Protection Law (PIPL), which marks a significant departure from its previous approach. Previously, there was no single comprehensive data protection law; rather, rules relating to the personal information protection and data security are found across various laws and regulations within a complex framework. PIPL now places restrictions on user data collection, and requires organisations to comply with new obligations that were previously considered recommended practice.
  Alongside PIPL, the Data Security Law also came into effect in 2021. This law's primary purposes are to protect data security and regulate cross-border data transfers, which are two areas that policymakers have been focusing on since the Cybersecurity Law (CSL) was passed in 2016.
- Japan's data privacy protection issues are regulated by the Act on the Protection of Personal Information (APPI) and the Personal Information Protection Commission (PPC). The APPI was originally enacted in 2003, with amendments coming into force in 2017, with further changes coming into effect in 2022. The PPC is a central agency that acts as a supervisory governmental organisation on privacy protection issues.

7.3 Fees

Disclosure regulation ensures that clients are clearly and accurately advised of the level of fees they are likely to be charged for the services provided. The following sections provide some indication of the fees charged for a variety of typical products and services on offer in the marketplace today.

7.3.1 Direct Investment

Charges levied by investment managers and stockbrokers could include:

- stamp duty and stamp duty reserve tax (SDRT) at 0.5% on the purchase of shares, and
- private client stockbroker fees, which vary depending upon the value of securities. The percentage charged will usually decrease as the sums involved increase, subject to minimum fees.

Example

? Elodie wishes to invest £50,000 in ordinary shares of BDF plc. What would your firm typically charge for a private client stockbroking service on this level of transaction?

A typical answer may be:

First £12,500 charged at 1.95%
Next £12,500 charged at 0.7%
Balance charged at 0.5%.

Fees will also vary depending on the type of security (eg, government and corporate bond transactions would incur a lower fee). In the above example, Elodie would also pay stamp duty or SDRT on the purchase.

7.3.2 Collective Investment

Some investment funds (eg, open-ended investment companies (OEICs) and unit trusts) make charges for undertaking the management of the fund. The types of charges that can arise (but not necessarily always) include the following.

Loads

- **Initial charges** (also known as front-end loads or preliminary charges) are a type of front-end load. They are levied when the fund is purchased at NAV, expressed as a percentage of the amount invested.
- **Exit charges** (also known as the back-end loads, deferred sales charge or redemption fees) are a type of back-end load that may be incurred by investors when they sell their units back to the fund. Where an exit charge is applied, this is typically arranged on a sliding scale (ie, staggered), depending on how long the investment has been held. Hence, they incentivise investors to stay in the fund, although they are becoming less widely used.

There are also no-load funds that do not charge any one-off entry or exit fees; however, the funds recoup these fees as expenses from another part of the investment, which will lead to a higher expense ratio.

Expense Ratios

- **Annual management charges (AMC)** are levied on the accumulated value of the fund, usually expressed as a percentage of the funds under management and deducted periodically from the fund. The AMC covers the running expenses of the fund. A typical AMC is 0.5% to 1.5% a year, albeit lower for passively managed, fixed-income and money market funds, and higher for internationally invested and specialist funds. The most exclusive funds have charged higher, with AMCs of 2% or higher.

- **Ongoing charges figure (OCF)**, also called the ongoing charges (OGC), cover costs and expenses for the running of the fund such as dealing commissions, audit fees and custody fees. It is usually expressed as a percentage of the funds under management.

  Another way that these costs may be disclosed to investors is through the total expense ratio (TER) – the only material difference between the OCF and the TER is that the OCF excludes any performance charges (see below) that have been paid over the past year, while the TER includes them. Hence, the OCF gives the most accurate measure as to how much investors will pay to invest in a fund.
- **Performance-related fees** reward the fund manager for positive returns or returns above a certain level. The logic is that this better aligns the interests of fund managers and their clients (ie, investors). Usually, performance fees are stated to be payable only on net new highs (that is, the manager will not be rewarded if the fund falls in value and their 'outperformance' consists of simply regaining ground that was lost), often referred to as the 'high-water mark'. When performance is favourable, these fees can provide the majority of compensation for the manager.

Other Expenses

- Funds may also contain a number of charges and expenses not included in management fees, and which are not included in the marketing and distribution expenses. These may include custodial expenses, legal expenses, accounting expenses, transfer agent expenses, and any other administrative expenses. They may also include charges for trading costs, **bid-offer spreads**, slippage costs and research costs.

Charges vary from fund to fund, but the charging structure must be detailed in the fund's prospectus. Institutional investment in funds is clearly going to be significantly larger than any retail investment which can reduce overall charges in percentage terms.

7.3.3 Discretionary Fees

In addition to the stockbroker fees for direct investment or initial and annual management charges for collective investment, discretionary investment managers are likely to charge a further fee to cover the overall strategic planning of the portfolio.

 How would you describe a 'wrap account'?

7.3.4 Investment Platforms

As covered in chapter 5, section 16.2, an investment platform can provide access to any underlying fund or other type of investment, and can administer any of the product wrappers an investor may want to use.

Most investment platforms levy a single annual management fee that covers all fees for buying and holding underlying investments, and for administration – these fees can be between 0.5% to 2% of the portfolio's value each year, depending on size. Some investment platforms may charge a small percentage of the portfolio, but it is then up to the investor to incur dealing costs.

7.3.5 Adviser Charging

These are the charges made by advisers in relation to personal recommendations on retail investment products. They can consist of an initial adviser charge and an ongoing adviser charge.

The initial adviser charges a one-off fee at the commencement of investment, paid to the adviser for the advice given. It can be facilitated for new business, as well as any increments.

To charge an ongoing adviser charge, the adviser must provide a service, and both the charge and the service must be cancellable unconditionally. The client can either pay the adviser charge directly or can request that it is deducted from their investment. VAT may be payable on adviser charges depending on the service provided.

Regardless of how the adviser charge is calculated, the client must be told the charge in advance in monetary terms. If the amount cannot be ascertained prior to the transaction, then a reasonable estimate must be given and the actual amount confirmed once it is known.

8. Main Investment Management Approaches

Learning Outcome

6.2.1 Understand the key features and risk-reward profile of the main investment approaches including passive/active, buy/hold, core/satellite, direct/indirect, ethical/responsible/sustainable, life style, hedge and structured fund approaches

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Many different investment management strategies exist. We shall discuss these before moving on to investment styles and types of funds.

8.1 Investment Strategies

Ultimately, the choice between an active or passive investment strategy comes down to the client's individual preferences, risk appetite, investment goals, adversity towards cost, and belief in the effectiveness of active management.

8.1.1 Passive Management

It is always a topic of some debate, particularly with investors, that relatively few active investment managers consistently outperform their benchmark indices.

To many investors, **passive management** offers an attractive proposition, with the advantage of generally lower dealing costs. The disadvantage is that the investment manager is unlikely to employ any risk management strategies (for example, short-selling or increasing cash weighting) meaning that passive strategies will fall in value during **bear** markets.

The table below summarises the common types of passive management:

Passive Equity Strategies	Passive Bond Strategies
• **'Buy and hold'** involves buying and holding a portfolio of securities indefinitely. In the interim, only minor and infrequent adjustments are made to the portfolio. • **Indexation** replicates the performance of a market index, thus eliminating diversifiable risk. It may be employed in several ways: ◦ **Full replication** involves an investor holding all constituents of an index, weighted according to their relevant market proportions. ◦ **Stratified sampling** involves holding a sample of securities from each sector within an index, which is representative of the characteristics of that index. ◦ **Factor matching** selects securities based on specifically chosen factors or risk characteristics (eg, firm size). ◦ **Optimisation** uses sophisticated computer modelling to build a portfolio, by finding holdings that broadly mimic the characteristics of the index. ◦ **Synthetic** involves the investor entering into swap agreements to track the return of a benchmark index. • With **rebalancing**, the weightings are periodically realigned, since the optimal proportion that an investor has selected is not maintained over time. ◦ With **calendar rebalancing**, the weights are adjusted regularly (eg, quarterly). ◦ With **contingent rebalancing**, when the weights change by a predetermined percentage. This helps to protect investors from being overly exposed to undesirable risks. On the other hand, it incurs transaction costs and tax liabilities; and can negatively impact performance if the rebalance is carried out before a security, sector, geographic region or asset class has finished its bull run.	• **Cash flow matching** simply purchases bonds whose redemption proceeds will meet a liability as they fall due. • With **immunisation** (or duration matching), an investor buys a portfolio of bonds with a duration (not maturity) equal to any liabilities. • **Laddering** involves buying bonds with a range of different maturities, thus reducing sensitivity to interest rate risk. As each bond matures, funds become available for withdrawal, or can be reinvested in bonds with later maturities. • **Bullet portfolios** invest in bonds with durations close to that of the liabilities, eg, an investor with a liability due in ten years could construct a bullet portfolio of nine- and 11-year duration bonds in equal proportions. • **Barbell portfolios** involve investing in a portfolio of both short- and long-dated bonds, eg, one- and 30-year bonds. • **Combination (or horizon) matching** is a hybrid strategy that involves matching early liabilities with cash flows, and later liabilities with immunisation strategies.

? Which of the above five indexation strategies is likely to track its benchmark index the closest?

Full replication produces the lowest tracking error in terms of performance relative to the benchmark index.

Passive management is more commonly found in tracker funds, which aim to track the performance of a particular investment market or index. There is a need for a credible and liquid index to track – in the UK, this is usually the FTSE All-Share (although some index funds aim to track the performance of the FTSE 100), as well as global indices (eg, MSCI World Index) and regional indices (eg, S&P 500, SSE Composite Index) among others.

A passive fund incurs dealing costs when a security enters or leaves the index, or when weightings change (eg, due to takeovers, mergers or rights issues). These costs are not reflected in the calculation of the index itself. Although an index fund is by its nature diversified, in terms of portfolio construction, the index will not lie at the efficient frontier, since the constitution of the portfolio usually depends on market capitalisation (ie, size) for equity passive funds or maturity for bond passive funds, and does not take into account risk covariance. For example, in 2023–24, when the share prices of the 'Magnificent Seven' technology stocks (Nvidia, Microsoft, Amazon, Apple, Alphabet, Meta Platforms and Tesla) performed so strongly that they collectively represented about 30% of the S&P 500. Since then, even as the S&P 500 has hit new all-time highs in 2025, the performance of these 'mega caps', all of which have market capitalisation of greater than US$1 trillion, have diverged with some continuing to rise while others have fallen slightly.

Tracker funds incur lower charges and the returns should be close to the index with a low tracking error. These investments are, therefore, suitable for clients requiring a vanilla product with a broad exposure to a market/index. It is important to remember, though, that they are usually fully invested to track the index (ie, there is normally no cash position), so investors will still be exposed to market risk.

8.1.2 Active Management

Actively managed funds are managed by a fund manager with the objective of producing a return above the index for an appropriate level of risk. Returns can vary substantially depending on market conditions and the fund manager's skill. In choosing active funds, close attention should be paid to the fund manager offering them, its track record, the relevant experience of the fund managers, investment philosophy and process. Active funds can provide access to specific areas of the market (small cap) or specific styles (eg, income, special situations, alternative investments, or private equity), which may not be achieved by the passive route.

There are two methods of constructing portfolios using an active management technique:

Top-Down Active Management

The **top-down** method is usually employed for internationally diversified portfolios/funds but may also be used for larger developed markets.

An assessment is made of the overall economic environment, rather than individual stocks, when constructing the portfolio/fund.

This may take the form of considering the outlook for relative growth rates in different countries or regions. Will emerging markets represent a better option than Europe? Will China or India have better profit growth than the US? This could lead to a particular asset allocation. On a single country or bloc (eg, the EU) basis, allocation may be done on an industry level, to ensure sufficient diversification and implement views on how those economies will perform and which industries/sectors are most likely to perform well.

In larger organisations, asset allocation is often decided on by an investment committee or asset allocation committee that will meet regularly (eg, monthly, quarterly) and often use sophisticated and computerised quantitative models to assist them.

For pension funds, these decisions are often made with reference to a peer group **median** asset allocation like the **Combined Actuarial Performance Service (CAPS) ltd** median or **World Markets (WM)** median. The use of tracking error parameters to these peer groups can be set up in order to help minimise the possibility of the fund underperforming. Once the asset allocation has been decided, top-down active managers will consider how the funds should be allocated by sector within the chosen equity markets.

In practice, many managers will start by looking at their benchmark and try to mirror the sector weighting in that index or peer group average in order to avoid underperformance. The decision to go **underweight** or **overweight** in certain sectors will be taken with reference to their view on the economic outlook for the sector and other factors, eg, political, sociological, technological, environmental or legal. Finally, once the sector split has been decided, the manager will select the stocks within those sectors, usually with reference to fundamental and technical analysis. In many developing countries, the majority of listed companies or the largest capitalisation firms belong to only a few sectors, so broad diversification within a country may not be possible.

Bottom-Up Active Management

This form of investment management is more common in funds investing in a particular country or those following a particular theme.

With this technique, the manager concentrates their attention on individual stock selection (stock picking) in order to achieve positive returns. While other external events may be considered in the manager's decision-making process, their primary concern is the attractiveness or otherwise of the individual companies operating within the market or country in which they are investing.

They will hope to time their purchases and sales to take advantage of future events, for example, the development of new renewable energy technologies or a possible takeover bid being launched.

As a result of this approach, there are often large tracking errors against the benchmark – this could lead to outperformance (ie, it can generate **alpha**); or it could lead to underperformance. Alternatively, managers can become too defensive, trying to track the benchmark index to avoid underperformance and getting away from their chosen investment style; this, in itself, can become self-defeating, since it can result in higher costs and a resulting underperformance against peers.

Some managers are wholly **bottom-up**, but may also take into account top-down factors (eg, macroeconomic and market background) in choosing stocks. For example, the global financial crisis influenced investors' attitudes to banks, the coronavirus (COVID-19) pandemic towards technology (with more people working remotely during lockdown), healthcare and biotechnology, and the cost-of-living crisis towards oil and gas companies.

There are many factors to look for when selecting funds adopting a bottom-up active management approach such as:

- track record of effective stock selection (generation of good ideas and research)
- investment process stock evaluation (which methods they use, resources available), or
- fund limitations (numbers of stocks to be held, limits on overweight or underweight positions in individual stocks and sectors, permitted level of cash holding).

Active Equity Strategies	Active Bond Strategies
• **Growth investing** focuses on investing in companies with above-average growth prospects. Two types of growth investing include: ◦ **Momentum (or trend) investing**, which seeks to achieve gains through the analysis of an asset's price momentum either up or down. ◦ **Fashion-led investing**, which assumes that a trend or fashion will continue to outperform the market. • **Value investing** seeks established companies that appear to have been ignored in the market and are set for recovery, by looking at their intrinsic value. • **Blend investing** combines growth and value investing, thus offering the potential benefits and risks of both styles. • **Contrarian investing** is similar to value investing, but it takes a view that the market has overreacted to a particular situation, and believes a company offers better prospects in the future as a result. • **Income investing** often focuses on mature, slower-growing companies paying regular dividends. • **Quality investing** focuses on creating a portfolio of companies with strong fundamental characteristics (eg, high return on equity (ROE), low debt-to-equity, strong free cash flow). • **Thematic investing** aims to identify long-term global themes and trends that are transforming the world. Then, investing in a collection of companies (no matter there they are located) offering solutions to these issues. • **Absolute return investing** seeks to generate positive returns in all market conditions.	• **Duration switching** alters the portfolio duration with expected changes in interest rates. For example, an investor expecting a fall in interest rates may increase the duration by replacing low- with high-duration bonds. • **Riding the yield curve** involves buying a long-term bond, but selling it before maturity, to profit from a declining yield over the bond's life. This is a valid strategy when the yield curve is upward sloping. • **Bond switching** (or swapping) exchanges one bond for another. There are two main types: ◦ **Anomaly switching** moves between two bonds similar in all respects apart from their yields and/or prices. This pricing anomaly is exploited by switching away from the expensive to the cheap bond. ◦ **Policy switching** switches between two dissimilar bonds, to take advantage of anticipated changes in interest rates, the structure of the yield curve, or bond credit ratings. • **Intermarket spread switching** moves between government and corporate bonds with different terms (eg, coupon rate, maturity date, or credit rating) to obtain a more positive yield spread.

8.1.3 Active and Passive Management: A Blended Approach

Having considered both active and passive management, it should be noted they are not mutually exclusive. Rather, a combination of different styles can be incorporated by investors, some examples of which we will now consider.

Core and Satellite Strategy

This is an investment strategy incorporating traditional fixed-income and equity-based securities held in passively-managed funds known as the core portion of the portfolio, with a percentage of individually selected securities known as the 'satellite portion'.

- **Core portfolio** – this is made up of passively-managed securities (index funds, ETFs, passive mutual funds) and uses a traditional benchmark (eg, the FTSE 100 or the S&P 500 index) to compare performance.

  The core funds may have a particular investment style bias – for example, more smaller over medium-sized/larger companies, more value stocks over growth, and higher or lower concentration in developed markets than emerging markets.

  Because of the holding's passive nature and the belief that this structure allows for longer-term planning and growth, core holdings are generally not replaced by another type in this class or style, and are rarely sold. They are often only sold if the client needs cash for personal use, the allocation is out of bounds within the constraints of the portfolio's plan, or the client's mix of fixed income/equities ratio is modified, based on premeditated or unforeseen client events.
- **Satellite portfolio** – this will comprise holdings that the adviser expects will outperform the market. These are typically equities and alternative assets (eg, REITs, commodities, derivatives, hedge funds or foreign currencies), although it can be used for fixed-interest securities such as high-yield bonds, emerging market debt and individual bonds.

  Holdings may include actively-managed stocks, mutual funds, and separate account managers with a particular sector, region of positions, or passively-managed assets with a certain style that is counter to, or even enhances, the style bias of the core.

Smart Beta

The line between active and passive investing has been blurred by the expansion of products such as smart beta. The objective of smart beta funds is to overcome the main drawback of passive funds, which automatically follow the ups and downs of the market, and cannot avoid exposure to any troublesome holdings. This is achieved through the creation of a custom benchmark consisting of stocks that exhibit certain behaviours (eg, low volatility, value, or momentum). This is the active part of the strategy and then becomes the passive strategy as the fund tracks that benchmark.

Smart Alpha

Smart alpha funds aim to benefit from an investor's best investment ideas, independently of market movements. The way in which smart alpha works is very similar to smart beta, in that an investor creates a custom benchmark (active) that tracks their best investment ideas (passive). A key difference, though, is that the index's exposure to the wider market (ie, beta) is hedged out, thus enabling the strategy to capture pure alpha.

A smart alpha strategy is, therefore, 'market-neutral', in other words, it does not move with the broader market, but instead follows the performance of the investor's individual ideas.

8.1.4 Ethical, Responsible and Sustainable Investing

An increasing number of people are taking an interest in responsible and sustainable issues, covering subjects as diverse as environmental improvement, climate change, genetically modified (GM) foods, the destruction of rainforests, and diversity (including gender, racial/ethnic and age). **Socially responsible investing (SRI)** has become a very popular investment theme as awareness of these issues increases.

Historically, responsible and sustainable investing gave an emphasis to 'progressive', smaller growth companies, and, therefore, funds tended to focus on generating capital growth over anything else. However, as investors have become increasingly aware of responsible and sustainable business practices over the years, company management has come under increasing pressure from shareholders and prospective investors to better manage risks relating to ESG factors. This, combined with the development of screening techniques, means that more companies (and across the market cap spectrum) satisfy responsible and sustainable criteria. The resultant widening of the investment universe not only enables managers to construct more diversified portfolios relative to history, but also allows for a broader range of objectives such as preserving capital, generating an income, or a combination of income and capital growth. Consequently, broad ESG indices have generally kept pace with the broader market over the longer term.

That said, the difficulties of defining responsible and sustainable investing are both theoretical and practical. What ethical/responsible/sustainable stance should be adopted? Should it be based on religious or other moral principles? If religious, there will be differences between, say, Christian and Muslim principles. Both would be against alcohol, tobacco and gambling, but Muslims are generally also opposed to insurance, banking, pork production and borrowing. Should the criteria encompass both positive and negative criteria?

8.1.5 Liability Driven Investment (LDI)

A liability driven investment (LDI) strategy is where the target of the fund is the liability of the fund, as calculated by actuaries, rather than working to a benchmark set by reference to an external index.

In pension funds, clearly the promises made to pensioners in terms of benefits will represent the liabilities of the fund. Two of the biggest risks faced by pension funds are the effects of interest rate changes and inflation. In the past, these risks have been partially hedged by the extensive use of bonds. In LDI, the focus has been on hedging these risks by the use of swaps and other derivatives. This provides greater flexibility and capital efficiency than the use of bonds.

8.2 Other Ways of Investing

Some investment managers will use a combination of the above styles (known as multi-style) or not adopt a particular style at all, believing that being limited to a rigid style will inhibit future performance of the fund. Hence fund managers may describe their investment style in various other ways (such as 'pragmatic' or 'research/stock pickers') or clearly state their intention not to adopt any particular style.

8.2.1 Lifestyle Investing

One of the uses of life style investing (also called 'lifestyling') is within pension funds.

As the investor approaches retirement, the proportion in bonds and cash increases relative to equity. This is done for two reasons:

1. To prevent people who are about to retire from losing large amounts of their pension savings in a stock market crash.
2. To try to match the value of the assets to annuity rates. Annuity rates are usually calculated using the yields on a government bond, so if the price of these bonds fall in the pension, this will be compensated for by higher rates on an annuity – in theory, offering more protection against value losses.

As the investor grows older, the proportion in bonds and cash increases relative to equity. A common rule of thumb is to set the weighting in bonds and cash equal to age (eg, a 60-year-old might have 10% in cash, 50% in bonds, and 40% in equities). This is intended to reduce risk and increase yield. However, this strategy might be questionable when bond and cash yields are low.

8.3 Investment Funds

There are thousands of different funds competing for business, and these adopt a number of different approaches/styles to attract new investors. A small selection of funds follows as examples of the variety available.

8.3.1 Enhanced Index Funds

Enhanced index strategies offer a good alternative to traditional passive index management, adding the potential to outperform the index while only marginally varying the characteristics of the index. Enhanced index funds offer many of the benefits of traditional passive index management, such as low fees and diversification. However, the difference is that these funds usually combine an index fund with a quant methodology to provide a bit of a kick.

Quants are funds or managers which utilise quantitative models. These models are formulas or frameworks constructed by data analysts and processed on computers, which select stocks based on several different criteria – **quantitative analysis (quant)** looks at actual data and statistics, as opposed to **qualitative analysis** which looks at intangible factors such as the quality of management. Proponents of quantitative funds argue that their management style takes human emotions out of the investment decision-making process, and leads to more objective stock selection.

8.3.2 130/30 Investing

This strategy (often called a long/short equity strategy) takes advantage of UCITS III and, with the ability to short a percentage of the portfolio in order to improve performance.

The reason for the name is that the fund manager will rank shares in order of their expected future return, and invest 100% of the funds in securities which the fund manager thinks will perform better in the future. They will then short sell those securities at the bottom of their ranking, to raise up to 30% of the value of the fund. The money raised by the short selling will then be invested in the top-ranking securities, allowing for further diversification.

There are clearly more risks involved in this type of fund. For example, it requires experience to manage short positions; and price rises in short positions not only lose money, but the relative size of the position also magnifies. Leverage also means that returns can also be more volatile. So, if the fund manager gets both the short and the long selections wrong, this will have far greater impact than a traditional long-only fund that picks the 'wrong' stocks. Managers vary this concept to take more or less risk – for example, 120/20 or 140/40.

8.3.3 Focus Funds

Focus funds are concentrated funds. Some have a fixed number of stocks which must be held in equal proportions, while others have holdings which can be weighted.

While mainstream funds tend to pick a larger number of securities which broadly mirror the asset allocation and securities which make up an index, the focus fund manager is given the freedom to select a small number of stocks from the sector, which they feel offers the best growth prospects in, say, the next 12 months.

The idea is that with a mainstream fund that follows the broad asset allocation of the index, it is often difficult to outperform that index. The focus fund aims to outperform the index by really testing the stock-picking ability of the fund manager.

If a stock is not performing, since there are so few other stocks in the portfolio, the fund manager will have to make a hard decision about whether to keep faith in that stock or not. As mentioned above, some funds set a rebalancing limit which forces them to sell if the stock becomes too large or small a percentage of the overall fund. This instils a strict selling policy and ensures the fund is kept fresh. The downside of these funds is that with fewer stocks comes increased risk (less diversification). However, investors will be getting very active management and a real focus on outperforming the market.

8.3.4 Equity Income

Equity income funds focus on stocks that pay dividends to investors. Some of these focus on investing in companies with the highest yields, while others instead consider how sustainable dividends are and the potential for payouts to grow in the future. All of these companies tend to be cheap by dividend yield and often other measures, so often fall into the 'value' style of investing.

Larger, more mature companies are often expected to pay higher dividends, and smaller companies to reinvest their profits back into the business to drive further expansion. Equity income funds, therefore, typically have higher allocations to large caps, although potential investment opportunities can be found in the mid cap and smaller company areas of the market. Regarding the latter, active managers have also benefited from reduced analytical coverage by major brokers in this area of the market.

In terms of sector, equity income funds are typically biased to companies operating in defensive sectors (eg, utilities and healthcare companies) on the basis that they often make higher distributions. These companies are generally referred to as 'bond proxies' due to their bond-like characteristics in terms of providing low-risk, higher levels of income.

Under the IA's classification, as covered in section 8.7 of chapter 5, qualifying funds must yield at least in line with the index. Fund managers usually seek to offer both an above-index yield together with a growing income stream, although the weight given to the two can vary. Some investors will rely on these funds for income and hold income units, while others will use them for growth, rolling up the income via accumulation units.

8.3.5 Multi-Manager Funds

This is an extension of the traditional active manager approach. In the UK, it has a small, but growing, market share, although it has been more established in a number of other markets (eg, North America and South Africa) for some time.

Multi-manager funds are designed to make an investor's life easier by packaging together teams of specialist fund managers into a single fund. For **independent financial advisers (IFAs)**, the main advantage of multi-manager funds is that some IFAs may feel that they do not have the resources to select funds or decide asset allocation. Equally, they may segment their client base and may feel that different levels of investment require a different approach in order to improve their own profitability.

The main multi-manager fund categories are 'fund of funds' (FoF) and manager of managers (MoM). There are quite obvious differences between the two categories, most notably that the first invests in funds, whereas the second invests in stocks and shares through appointed fund managers.

The primary advantage of FoF over MoM is that underlying assets and fund records offer greater visibility and speed of management. They have also generally outperformed MoM funds in the past. However, this approach can add an extra layer of charges. In contrast, MoM funds may fit smaller investors who cannot afford the full service and, therefore, effectively outsource the fund management.

9. Choosing a Suitable Investment Approach

Learning Outcome

6.1.8 Apply their knowledge to client objectives and constraints

6.2.3 Determine a suitable investment strategy with regard to preferred investment approach, time horizon, income/growth/balance, tax position, costs, market and sector diversification, and expected risk and return

6.2.5 Specify or recommend appropriate portfolio components, taking into account overall suitability, cost, and ease of implementation and maintenance

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In chapter 7, we shall discuss the mechanisms that an investment manager has available in order to measure (and hopefully improve upon) the performance of a portfolio. These include how to assess the likely returns of the portfolio relative to the rest of the market, while also accounting for the level of risk being taken.

In this section, having considered the various methodologies used within investment management, we now start to look at the actual construction process of a suitable portfolio for an individual investor. So where do we begin?

> *'What do you want to achieve or avoid? The answers to this question are objectives. How will you go about achieving your desired results? The answer to this you can call strategy.'*
>
> William E. Rothschild

9.1 Setting the Strategy

One place to start is to determine exactly what the investor wants to achieve and by when. There may be a number of objectives requiring different sorts of returns at different times, all of which need to be considered, and a suitable approach should be adopted for each. Given the client's desired returns, are they realistically achievable against their attitude to risk, the market or sector they wish to invest in and the strategy they wish to adopt?

How will the client's current tax status affect the returns received from the portfolio? Are the likely costs and charges associated with the considered investments an acceptable price to pay relative to likely returns? By the time the client is ready to invest funds, they should generally have agreed on the outline investment strategy. The agenda would often follow something along the lines of the following:

- Agreed asset allocation.
- Approach to thematic investment (eg, ethical, responsible and sustainable investing).
- Fund selection strategy and criteria.
- Choice of tax wrapper, if investment is not being made directly into assets.



How would you agree on a suitable asset allocation strategy with a client?

9.2 Asset Allocation

Any asset allocation structure should set out the asset classes in which the client should invest, given their investment objectives, attitude to risk and any other requirements. The following table provides a simple range of asset allocation models using three key asset classes. Classes could be split even further (eg, between domestic and international assets; and within this, different geographic regions/individual countries, and between different industrial and commercial sectors). In addition, other asset allocation models will include other classes, such as cash and commodities.

A client with a lower attitude to risk will often skew the asset allocation decision towards the more cautious end of the scale.

By way of an example:

Asset allocation							
More cautious				More adventurous			
	1	2	3	4	5	6	7
% Equities	20	30	40	45	55	70	90
% Alternative investments including property	10	10	15	15	15	10	5
% Fixed interest	70	60	45	40	30	20	5

9.3 Ethical, Responsible and Sustainable Investing

Ethical, responsible and sustainable investors are looking to maximise the return on the money invested, but it should cause benefit (or at least do no significant harm) while generating that return. This sentiment is often known as 'doing well while doing good'.

We say here 'no significant harm' (rather than 'no harm') on the basis that every company – even if they are the best operator in their field – is likely to be causing some level of negative impact. For example, wind turbine blades are not yet 100% recyclable; and for solar farms, construction of solar facilities on vast areas of land imposes clearing and grading, which results in soil compaction, alteration of drainage channels and increased erosion. Further, the materials required to make wind turbines and solar panels have to be mined, which can have environmental and social impacts (eg, water and air pollution, and mining under conditions that violate human rights).

What is also important, therefore, is a company's direction and the trend of their operations: are they actively improving themselves to minimise these impacts, and move towards more sustainable practices?

Notably, increasingly, many different companies across a range of sectors (even those whose business is, say, oil extraction or mining) are expressing their commitment to environmental, social and governance (ESG) factors. Many companies worldwide are looking at their carbon footprint (ie, the total amount of greenhouse gases, including carbon dioxide (CO_2), that they generate as a result of their activities) as a way to play their part.

Positive and Negative Screening

Depending on a client's values, various filters or screens may be applied. Screening involves testing a potential or actual investment against a set of responsible investment measures; for example, the environment, in society, in the work-place, ethics and business values. Only investments that pass the various tests are considered candidates for portfolio inclusion. At a high level, when considering sustainable and ethical investing, one can either follow a 'negative screening' process, 'positive screening' process, or both.

Negative Screening	Positive Screening
• Deliberately excludes companies producing 'undesirable' products. Examples include alcohol, tobacco, gambling, adult entertainment and weapons manufacture (known collectively as the 'sin stocks'). The term 'sextet of sin' comprises the 'sin stocks' and nuclear power-related activities. • The list has extended over the years to include deforestation, the fur trade, and the charging of excessive interest rates (typically associated with payday loans), among others. Additionally, more environmentally harmful forms of natural resource and energy production (eg, coal power plants) have been increasingly added. • One challenge that can arise is determining whether a company should be excluded if part (but not all) of its operations are involved in a particular activity. To address this, *de minimis* levels (ie, the level of exposure to the excluded activity deemed acceptable) may be applied to the firm's turnover or revenue: the lower the level, the stronger the exclusion.	• Grew out of negative screening. • Seeks to support firms providing positive solutions to challenges such as climate change and social justice. • While this would exclude companies involved in activities deemed to be unacceptable, there is room for investment in what some investors may consider to be 'less-than-perfect' businesses (eg, a clothing company that sells fur), as long as they are making efforts to improve their practices (eg, preserving the environment).

Responsible and Sustainable Investing

'Responsible and sustainable investing' is an umbrella term representing three key investment strategies:

- **ESG** involves three key dimensions of responsible and sustainable investing:
  - **Environmental** – this includes concerns about CO_2 emissions, pollution, the degradation of forests and woodland, overfishing and intensive agricultural methods, among others.
  - **Social (impact)** – this relates to human rights (eg, the use of modern slavery) and working conditions (eg, paying below the living wage), as well as corporate governance structures. It may also include efforts by businesses to reinvest in the local communities where they operate to improve social infrastructure, such as education and healthcare.
  - **(Corporate) governance** – companies with weak internal controls may have management that is not following company policies, which increases the risk of irresponsible behaviours and corruption.

- **Socially responsible investing (SRI)** is broadly similar to ESG, except that SRI is driven first by investors' individual values rather than investment potential. Today, one of the most important issues for SRI (among other forms of responsible, sustainable and **ethical investment**) is shareholder engagement, whereby shareholders (as partial owners of a business) may enter into dialogue with management to encourage behavioural change and address serious ESG issues, as an alternative to the formal vote on a shareholder resolution.
- **Impact investing** refers to investment into companies to generate a positive environmental or social impact, alongside a financial return. That is not to say that impact investors will not expect a decent financial return, but they are prepared to consider the positive or beneficial impact of their investment as part of their overall 'return' (ie, they consider both financial and non-financial benefits).

By incorporating these factors into their investment decisions, responsible investors hope to better manage risk and generate sustainable, long-term returns. In comparison, sustainable investors focus on progressive practices, and recognise that companies solving the world's biggest challenges, while incurring a cost to ensure their businesses operate according to ESG principles, can be best positioned to grow and generate superior returns over the long term.

Ethical Investing

Ethical investing is the practice of selecting investments based on ethical or moral principles. This involves filtering out unethical companies involved in the 'sin stocks' (or, expanding on this, the 'sextet of sin'). At the same time, it may involve supporting ethical companies, that are making a positive contribution through their products and services.

The evidence supporting a nexus between performance on sustainable and ethical issues and financial performance is becoming greater, and the combination of fiduciary duty and a wide recognition of the necessity of the sustainability of investments in the long term has meant that ESG concerns are now becoming increasingly important in the investment market. While the debate has not been settled as to whether portfolios tilted toward sustainable stocks perform as well or better than those which are agnostic to 'sin' stocks, the demands of the client must be respected; and an increasing number of plan sponsors and other institutions are requiring managers to incorporate some form of ESG or SRI criteria.

9.4 Fund Selection

Even if a portfolio manager agrees with the client on a suitable asset allocation strategy, taking into account any ethical/responsible/sustainable issues, will the actual investment funds from the wide range available be chosen competently? Much will depend on the resources and expertise of the managers, and those working for their organisations.

? What criteria, as a portfolio manager specialising in fund selection, would you use in order to choose suitable funds for your client?

Such an organisation would commonly pick funds on the basis of a number of criteria:

- Investment philosophy and process.
- Strength of the investment process, and the length of time that it has been in place.
- Continuity of the fund managers (eg, tenure).

- Relevant experience of the fund managers.
- An investment style that has been proven over a period of time.
- Clear investment objectives.
- Charges and expenses.
- Consistently strong past performance record.

In addition, for ethical/responsible/sustainable funds, portfolio managers must satisfy themselves that the fund is as 'good' as it says it is; for example, by analysing the fund's alignment with global or national targets on climate change mitigation, among other methods. This is because funds labelled as 'green' may not be following through with their environmental pledges, in a process known as 'greenwashing'.

The 'washing' term has evolved over the years such that, today, there are many other types, whereby companies make misleading claims about their environmental and social practices, performances or products.

Fundamentally, the aim of asset allocation and fund selection is to design a portfolio that matches the client's investment objectives, risk profile and any restrictions. This is always likely to be an imprecise art.

9.5 Wrapper Selection

It is important that the investment vehicles or tax wrappers being used are appropriate for the client's own tax situation.

In the UK, the main tax wrappers include:

- ISAs
- collectives
- life assurance policies
- offshore life assurance policies, and
- registered pension schemes.

A summary of the tax position each, from an investor's viewpoint, is shown below for easy reference:

Tax wrappers			
Wrapper	**Initial contribution**	**Capital Growth and Income**	**Encashment**
ISA	No relief	Tax-free	Tax-free
Collectives	No relief	Income fully taxable, CGT free	Gains chargeable to CGT
Life assurance policies	No relief	Income chargeable at the basic rate equivalent, CGT taxable	Higher rate income tax on gains, or tax-free on qualifying policies

Offshore life assurance policies	No relief	Tax-free	Full income tax on gains
Registered pension schemes	Full relief (restricted by annual allowance charge and for high income individuals)	Tax-free	25% of fund tax-free; balance taxable as income

9.6 Conclusion

With clear investment objectives and adequate understanding of the client's own circumstances, risk profile and any investment restrictions, it is perfectly possible to select suitable assets and/or packaged funds within an appropriate investment portfolio. It is important, though, to always remember the fundamentals of building a solid investment portfolio for a client based on a clear mandate that the client fully understands.

10. Implementing the Investment Strategy

Learning Outcome

6.2.4 Analyse the means to implementing that policy, including short-term liquidity, available investments, choice between UK and overseas markets, and direct and indirect routes

In this final section, we discuss further the implementation of an investment strategy, considering the advantages and disadvantages of the different approaches that can be taken (eg, direct investment vs packaged products), as well as some final decisions that need to be made in building a client's portfolio. We revisit the need for liquidity, consider what to do with any existing investments that a client holds, before finally discussing the merits and pitfalls of domestic and overseas investment.

10.1 Advisory or Discretionary Service

When it comes to the selection of other asset classes, the client needs to decide the type of service required:

- Under an **advisory** service, the portfolio manager suggests a strategy or particular course of action such as buy, sell or hold an investment, but it is up to the client to accept or reject the advice. Advisory services are usually provided by stockbrokers or investment advisors/wealth managers. The portfolio manager still needs to fully understand the client's circumstances, objectives and attitude to risk before making recommendations.
- With a **discretionary** service, the portfolio manager has the right under the terms of business to purchase, sell and hold investments in accordance with the client's objectives, without giving prior warning to, or seeking approval of, the client, as what the client signs up to is an investment mandate. This gives the portfolio manager the ability to act quickly.

- It is possible to limit the discretionary service so that, for example, certain stocks are not sold without prior consultation with the client. For best practice, that investment mandate should be supported by the IPS so the client has a good understanding of how the investments will be managed.

Firms are expected (and, in many cases, required by regulation) to consider the appropriateness of the level of service to be provided to their clients based on their circumstances; and to ensure that the type of service being provided is clearly understood by both parties.

10.2 Liquidity

In section 5.1 of this chapter, we mentioned the need for liquidity and the reasons why funds should be held on deposit for short-term access. It is worth reiterating that clients must feel comfortable with the amounts they hold on deposit to avoid the need for early encashment of other investments which could, due to market volatility, cause severe losses in value or even incur penalties for early withdrawal.



You have been asked to meet a client to provide investment advice following a recent inheritance they have received. They have a number of existing investments in place. Would you advise the client to retain or liquidate these investments?

10.3 Existing Investments

If your answer to the above question was to liquidate the existing investments, beware!

A switch of investments takes place when a new investment is affected as a result of a full or partial encashment of an existing investment.

Churning is an illegal practice in most jurisdictions. It takes place when investments are switched with the primary intention of generating commission/fees rather than acting in the client's best interests. The FCA rules on churning are located in the COBS sourcebook. If churning does take place, then it can attract severe fines, sanctions, and/or suspensions from regulatory bodies.

Switches can be justified if:

- there has been a clear alteration in the client's investment objectives or circumstances, requiring investments to be moved in accordance with a different risk strategy or to produce different returns
- market conditions adversely affect the current investment or are balanced in favour of an alternative
- the client gives clear instructions to go ahead with a switch
- there has been consistent underperformance of an investment over a medium to longer-term period, or
- the value of an investment is returned as part of a takeover or restructuring of capital.

There could also be tax penalties imposed as a result of an investment being disposed of, such as CGT. Advisers and managers should try to mitigate these penalties with careful planning – eg, passing assets over to a spouse prior to disposal to use up their allowances, or offsetting gains against other losses.

As always, the resulting portfolio should clearly reflect the new mandate that has been agreed. A discussion could be had with the client beforehand to let them know which securities will be sold and which will be retained. A manager should not agree to manage securities that they or their firm do not cover. If the client wishes to still retain the non-researched securities, then most firms offer a custody execution-only account or alternatively there are many online execution-only platforms available.

Another risk to switching is 'cash drag.' This is the underperformance which could take place after the previous investment has been liquidated and sits in cash for a period of time as the manager has not been able to fully deploy funds into the new preferred investment. Funds or strategies which closely track a benchmark are particularly sensitive to this.

10.4 Direct vs Indirect Investment

Once the investment adviser has established the client's objectives, and agreed an appropriate asset allocation in accordance with their risk profile and any investment restrictions (and so on), the format of the portfolio should be discussed. A key consideration will be whether to invest directly into different asset classes or indirectly via collective investment products. We will now have a look at the advantages and disadvantages of each route.

10.4.1 Direct Investment

Investment is usually only suitable if portfolios are large enough in order to be able to accommodate charges and provide sufficient diversification among investments.

Advantages	Disadvantages
• Many clients are interested in having direct holdings in particular companies because they enjoy following the fortunes of those companies. • Direct investment is likely to interest investors prepared to accept risk up to a certain degree. • Low costs of switching investment managers due to the transferability of stocks without the need to encash them. • The portfolio can be tailored to accommodate the investor's requirements. • It is easier to exclude holdings in specific stocks. • Greater transparency of costs. • Exemptions and reliefs can be used to offset capital gains made that are subject to CGT. • Larger portfolios can enjoy an economy of scale and lower expense ratios than can be achieved via collective investments.	• Potentially higher volatility of performance because fewer investments are likely to be held compared to a collective investment scheme (CIS). • Costs are higher for smaller portfolios. • Usually need greater involvement by an investment manager. • Results may be more volatile as they depend on individual managers, and the performance of one or two stocks can provide a disproportionate effect on returns. • It may be necessary to switch investments more within a large portfolio, thus potentially incurring gains subject to CGT (after exemptions and allowances). • Potentially more administrative costs than with collective investments. Value-added tax (VAT) will be charged on management fees, which are not tax relieved in any way.

10.4.2 Collective Investments

Collective investment schemes (CISs) hold several attractions, not least the ability to pool relatively small resources with others in order to manage a large portfolio of diversified investments. Outlined below are some further advantages and disadvantages of CISs.

Advantages	Disadvantages
• A wide variety of funds available, allowing most needs to be catered for. • A spread of risk can be achieved, even for small investors. • Specialised CISs can give exposure to specific markets or sectors, which might otherwise be inaccessible. • No CGT on gains realised within a CIS. • VAT not payable on the annual charges levied within the funds.	• Further management fees are payable on top of the initial and annual management charges levied by fund management groups. However, some low-charging CISs exist. • Changes to the portfolio could be expensive due to bid-offer spreads that many funds operate. • Little direct involvement from investors. • Higher costs could be incurred upon changing fund managers.

Exchange-traded funds (ETFs) generally have the lowest charges with many specialist funds available (particularly sectoral and single country), and provide a hybrid approach with some advantages of both direct investments (eg, priced throughout the trading day) and collective investments (eg, a diversified underlying portfolio through a single investment).

AMCs for older investment trusts are often lower than unit trusts/OEICs. That said, the Association of Investment Companies (AIC) reported that, in 2023, a total of 26 investment trusts either cut their fees, introduced or reduced tiered fees, or abolished their performance fees to the benefit of shareholders[4], thus strengthening their competitive edge (this follows 27 fee cuts in 2021[5]). Heavy competition and continued pressure for lower fees led to numerous mergers and liquidations, as well as fee reductions at 32 more investment trusts in 2024.[6]

? Assuming that investment is made into the same type of fund, how do the risk and potential reward of an investment trust compare with unit trusts and OEICs?

The risk and reward of investment trusts is often considered greater, mainly because price movements follow supply and demand and may operate at a discount or premium to net asset value (NAV). In addition, investment trusts have unlimited borrowing capability and may 'gear up' to extend returns. However, losses will be equally exaggerated.

The discount to NAV that could apply to investment trusts, as well as their ability to retain income in good years (in the form of revenue reserves) so they may top up dividends to investors in bad years, could also provide higher levels of income (or, at the very least, a more stable and reliable income stream) to investors than would otherwise be received by unit trusts/OEIC investment.

4 The AIC, December 2023. Investment company 2023 review. Retrieved from https://www.theaic.co.uk/aic/news/press-releases/investment-company-2023-review (Accessed: August 2024)
5 The AIC, January 2023. Investment company 2022 review. Retrieved from https://www.theaic.co.uk/aic/news/press-releases/investment-company-2022-review-0 (Accessed: August 2024)
6 The AIC, January 2025. Investment trust 2024 review (updated) https://www.theaic.co.uk/aic/news/press-releases/investment-trust-2024-review-updated (Accessed: October 2025)

10.4.3 Cost Averaging (Regular Investing)

The basic idea behind cost averaging is to invest the same amount on a regular basis as opposed to investing a lump sum. This way, more units/shares are purchased when the price is lower, and fewer units/shares are bought when they are more expensive. As a result, the average price paid for each unit/share held is less than the average of the price of the units/shares over the period of investment. This strategy is called 'pound cost averaging (PCA)' in the UK, where investors are investing in the market and not timing the market.

Suppose an investor has €1,200 to invest over the course of the year (ie, €100 per month) in an OEIC. The following table may help to explain how this principle works in practice:

Month	Price of shares	Shares purchased
January	1.00	100.0
February	1.10	90.9
March	1.20	83.3
April	1.25	80.0
May	1.50	66.7
June	1.55	64.5
July	1.60	62.5
August	1.40	71.4
September	1.25	80.0
October	1.30	76.9
November	1.35	74.1
December	1.65	60.6

Number of shares bought	910.9
Investment amount	€1,200
Average price paid for shares = €1,200 / 910.9	€1.317
Average price of shares = (1.00 + 1.10 + 1.20 +…+ 1.65) / 12	€1.346

An alternative to PCA is value averaging (VA), where investors buy shares such that the portfolio value increases by a fixed amount at fixed intervals of time.

As a starting point, a VA strategy begins with the same premise (ie, the desire to invest €1,200 over several instalments). However, it fundamentally differs from PCA: the PCA investor's objective is simply to invest €100 per month, while the VA investor aims to adjust their purchases to ensure the portfolio value increases by at least €100 per month. Therefore, when prices fall, the PCA investor continues to invest €100, but because the VA investor focuses on increasing the portfolio value, they are then

compelled to purchase more shares to meet their target of increasing the portfolio's value by €100 each month. Consequently, the VA strategy leads to the investor purchasing more shares when they are inexpensive and fewer shares when they are costly. The result is that the VA strategy is more likely to outperform PCA (although this outcome is not guaranteed).

A PCA or VA approach is usually taken by the client themselves as it is very hard to time investments and, following the rules on suitability and discretionary agreements, a client's money should be invested as per the mandate agreed. By trying to time investments, a portfolio manager risks being out of the market and charging the client to hold cash.

10.5 Domestic versus Overseas Investment

When building the client's investment portfolio, serious consideration should be made as to whether funds are allocated towards domestic or overseas securities, or a combination of both. Many asset allocation models will accommodate investment into foreign stocks and shares as part of the recommended allocation splits, depending upon the client's risk profile and circumstances. The main reason is to take advantage of different gross domestic product (GDP) growth expectations and different economies at different points in the domestic economic cycle.

Investing overseas holds the obvious advantage of further diversification into international markets and specialist sectors that would not otherwise be available from domestic securities. However, the downside of such investment is the additional foreign currency risk presented. Any gains made could be wiped out by a worsening exchange rate between the base/home currency and the country in question. There are ways to mitigate this, by derivatives, although there is a cost of investing in a fund that hedges the currency exposure. On the other hand, it could also be prudent to diversify the base/home currency, in case it depreciates. An example is UK investors at the time of Brexit (the UK's vote in June 2016 to leave the EU) when the value of sterling depreciated against the world's major currencies.

One reason to consider overseas investments is a desire to have exposure to a different currency. In addition, financial and trading information on foreign companies may be difficult to understand or even obtain! In addition, some countries (eg, Japan) only allow foreign investors to hold shares in a certain amount/lot size. Further, certain investments need to be held with overseas custodians, which increases the risk profile for the client.

Investing solely in domestic securities removes the immediate exchange rate risk, but most of the world's largest companies have substantial operations overseas, so there would be a foreign currency exposure through imports/exports and profits generated from overseas activities.

10.6 Asset-Liability Management (ALM)

Learning Outcome

6.2.2 Apply the principles of asset and liability matching when managing investments in different currencies

Also called an asset-liability model, ALM is a risk management technique to earn an adequate return, while maintaining a comfortable surplus of assets beyond liabilities. It takes into consideration several variable factors such as interest rates, currency exchange rates, earning power and a degree of willingness to take on debt. It is also called 'surplus management'.

The early origins of asset and liability management date back to the high interest rate periods in the mid-to-late 1970s and early 1980s in the US. Previously, for example, a bank could borrow money for a year at 5% and lend the same money at 5.5% to a borrower for five years. This appeared to be a good transaction for the bank, but with it came risk. When the time came for the bank to refinance its loan, interest rates may have risen and it may have had to pay a higher rate on the new financing than the fixed 5.5% it was earning on the loan. This led to a potential mismatch between assets and liabilities, a mismatch that could be shown in the market value (immediate) method of accounting, but not so immediately in the accruals method of accounting.

Managers of financial firms focused on asset-liability risk. The focus was not so much on whether the value of assets might fall, or the value of liabilities might rise, it was more on the fact that capital could be depleted by a narrowing of the difference between assets and liabilities. In essence, a cash flow risk became apparent, as the capital of most financial institutions is small relative to their assets or liabilities, so a small change in assets or liabilities can be translated into large percentage changes in capital. We only need to look at the situation over recent years, and the 'credit crunch', to see this in practice.

A number of different techniques were used to analyse the risks, and became known as asset-liability management (ALM). These included techniques such as gap analysis and duration analysis, which worked well if both assets and liabilities comprised fixed cash flows.

A more expansive technique is that of 'scenario analysis' where several interest rates are specified for the following five or ten years. This involved examining many different scenarios, and anticipating very different behaviours throughout the entire yield curve. Assumptions were then made as to how assets and liabilities would perform under each scenario. Based on the assumptions, the performance of a firm's balance sheet could be projected for each scenario. If the projected performance was poor under certain scenarios, the firm could adjust assets or liabilities (or both) to address the situation.

ALM has evolved immensely since the 1980s. The growth of the derivatives market has helped facilitate a variety of hedging techniques (eg, a utility company's hedging of gas prices can be presented as a form of ALM). There has also been a major development in the securitisation market, allowing firms to directly address asset and liability risk by removing assets or liabilities from their balance sheet. Again, we have witnessed the fallout from this securitisation development during the global financial crisis.

The scope of ALM has also increased, which is why it is included in this section. Along with interest rate exposures and liquidity risk, ALM techniques are being adopted to address foreign exchange risk.

Chapter Seven

Portfolio Performance and Review

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An exam specification breakdown is provided at the back of this workbook



1. Introduction

In this chapter, we will be looking in greater detail at risk and return, the role of the investment manager, portfolio construction and performance measures.

Portfolio construction is an important step in the financial planning process as it lays the foundation for achieving a client's financial goals, and optimises their investment outcomes.

Ongoing appraisal of the investment portfolio is a key element in maintaining a well-informed and adaptive investment strategy. If the performance of the client's portfolio is not monitored and kept under review over time, then they run the risk of missing potential opportunities, failing to identify underperforming investments, and making ill-informed decisions that could adversely affect their financial goals.

2. Risk and Return

Learning Outcome

7.1.2 Understand the principles and theories of risk management including volatility, standard deviation, alpha and portfolio risk

As we will now observe in the following sections, much research has been done on this subject over the years, and important theories have been developed in an attempt to improve the construction of portfolios and manage risk more effectively. We will now consider the main theories used by fund/portfolio managers today.

2.1 Modern Portfolio Theory (MPT)

Modern portfolio theory (MPT) was developed by Harry Markowitz in 1952[1]. The theory states that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits of diversification, primarily by reducing risk (not putting all your eggs in one basket) without lowering overall returns.

For most investors, the risk they take when they buy a security is that the return will be lower than expected, in other words, it is the deviation from the average return. Each stock has its own **standard deviation** from the average (or mean), which MPT calls '**risk**'. The risk in a portfolio of diverse individual stocks will be less than the risk inherent in holding any single one of the individual stocks (provided the risks of the various stocks are not directly related).

Let us consider a portfolio that holds two risky stocks: one that pays off when it rains and another that pays off when it does not rain. A portfolio that contains both assets will always pay off, regardless of whether it rains or not. Adding one risky asset to another can, therefore, reduce the overall risk of an all-weather portfolio.

In other words, Markowitz showed that investment is not just about picking stocks, but about choosing the right combination of stocks among which to distribute one's nest eggs – hence the term 'intelligent diversification'.

2.1.1 Diversification

The risk of having two holdings, A and B, in isolation is given by their respective standard deviation of returns.

However, by combining the two stocks, it is possible to lower the weighted average sum of standard deviations in these two securities.

We use two concepts to quantify the diversification potential of combining securities when constructing a portfolio: correlation and covariance. We will discuss these concepts in turn below, but it may first be helpful for us to touch upon standard deviation, which is a measure of volatility.

2.1.2 Standard Deviation

The standard deviation of a set of data is simply the square root of the variance and is the most commonly used measure of dispersion. The formula for calculating it is therefore:

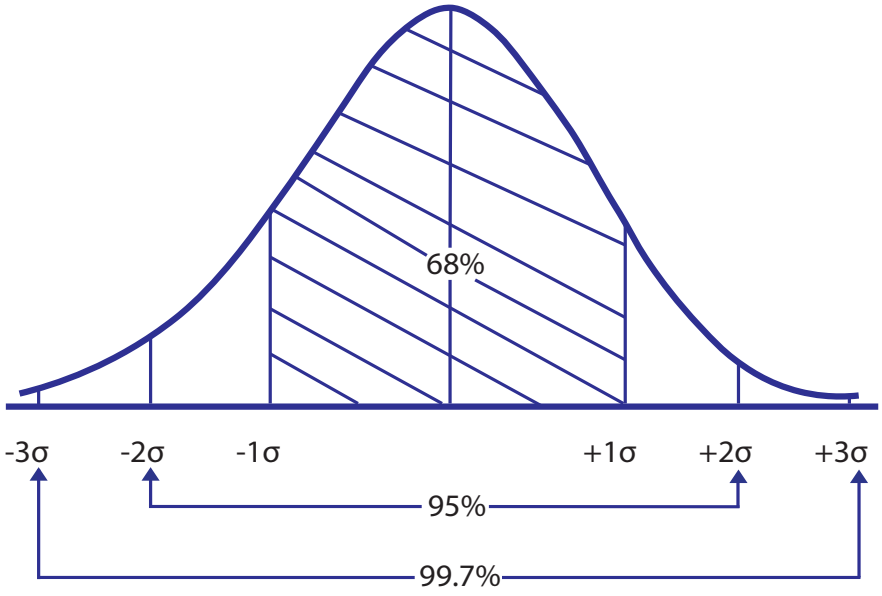
$$\text{Standard deviation of population, } \sigma = \sqrt{\frac{\sum\left(r_i - \mu\right)^2}{n}}$$

where:

r_i = each value of the population
μ = the population mean (or average)
n = the sample size

1 Markowitz, H., 1952. Modern portfolio theory. *Journal of Finance*, 7(11), pp.77–91.

In effect, by taking the square root of the variance, the standard deviation represents the average amount by which the values in the distribution deviate from the mean. With sufficiently large data, the pattern of deviations from the mean will be spread symmetrically on either side and, if the class intervals are small enough, the resultant frequency distribution curve may look like the cross-section of a bell (ie, a bell-shaped curve) as shown in the chart below:



Following on from this, in statistics, the normal distribution is commonly associated with the 68–95–99.7 rule. In other words, there is:

- a 68% probability that the result will fall within one standard deviation of the mean (represented by the shaded area)
- a 95% chance within two standard deviations of the mean, and
- a 99.7% chance within three standard deviations of the mean.

There are fundamental mathematical reasons for expecting an accumulation of small random events to result in a normal distribution. However, in real-world financial market situations, notably, it is by no means always the case that asset returns will always be normally distributed. More extreme moves can often be associated with returns distributions that are not normal, with either of the following:

- **Kurtosis** – this measures the shape of the distribution, but not whether it is asymmetrical.
  - A non-normal distribution may be leptokurtic, in which case it is more pointed in the middle than the normal distribution, has longer tails, but is 'skinnier' in between. In this case, more returns than expected (compared with the normal distribution) would be close to the mean, or else at extremes (both positive and negative).
  - Alternatively, a non-normal distribution might be platykurtic, in which case it would have fewer results closer to the mean, and fewer results at the tails, but have a 'fatter' curve in between (ie, the opposite of the leptokurtic case), compared with the normal distribution.
  - The normal distribution is known as mesokurtic, which is to say it has the same kurtosis as the normal distribution.

- **Negative/positive skew** – skew measures the asymmetry of the distribution (the normal distribution is symmetrical about its mean). A normal distribution has zero skew. Negative skew means the distribution has a longer negative tail; positive skew means the distribution has a longer positive tail. A negatively skewed distribution will have more low returns (or losses) than expected compared with a normal distribution.

2.1.3 Correlation

In statistics and probability theory, correlation indicates the strength and direction of a linear relationship between two variables. If two variables tend to vary together (that is, when one of them is above its expected value, then the other variable tends to be above its expected value too), then the covariance between the two variables will be positive. On the other hand, if one of them is above its expected value and the other variable tends to be below its expected value, then the covariance between the two variables will be negative.

In portfolio construction, diversification is achieved by combining securities that have returns which ideally move in the opposite direction to one another, or if in the same direction, at least not to the same extent. The aim is to measure how the returns from two different assets move together over time and is scaled between +1 (ie, perfectly positive correlation, when the returns of two securities move in exactly the same direction, to the same extent) and –1 (ie, perfectly negative correlation, when they move in the opposite directions, to the same extent).

The definition of how strong a relationship between two variables is can vary greatly among investors, but broadly they are as follows:

- Correlations from 0.66 to 1 demonstrate strong relationships.
- Correlations between 0.33 to 0.66 demonstrate moderate relationships.
- Correlations between 0 and 0.33 demonstrate zero to low-level relationships.

Diversification and risk reduction are achieved by combining assets whose returns have not moved in perfect step, or are not perfectly positively correlated, with one another. Assets with a low or negative correlation are attractive to investors in that, when one asset is performing badly, the other asset is hopefully rising in value.

Diversification benefit is maximised by holding investments exhibiting low (ie, close to zero) correlation. It is worth noting, though, that correlations do not remain constant – they are dynamic.

While securities A and B may individually have very high risk as measured by their standard deviations, the most important factor when deciding whether to include them in a diversified portfolio would be the correlation of the returns. If one moved in the opposite way to the other, then the risk would be reduced by including them both. It can be seen from this that the weaker the correlation of the returns of A and B, the more that risk is reduced.

When there is no predictable common movement between the returns of two securities, there is said to be zero or imperfect correlation. In practice, correlations between assets will vary over time and depending on the measurement period. There may still be benefits of diversification since their returns will not react in the same way; in fact, the only scenario when diversification will not reduce risk is when there is a perfectly positive correlation (+1).

As you may be aware, you are able to obtain correlation charts from several business information services, such as Morningstar and Trustnet. Using a series of charts, or lining up the returns in a spreadsheet, it is possible to create a correlation matrix to establish the relationship between stocks or funds that comprise a portfolio.

2.1.4 Covariance

Covariance is a measure of the combined variability of two investments (a statistical measure of the relationship between two variables such as share prices). Covariance is calculated by multiplying the correlation of two securities (A and B) by the standard deviation of A and then by the standard deviation of B:

$$\text{Cov}_{AB} = \rho_{AB}\sigma_A\sigma_B$$

where:

ρ_{AB} = the correlation between A and B
σ_A = the standard deviation of A
σ_B = the standard deviation of B

Rearranging this formula gives:

$$\rho_{AB} = \text{Cov}_{AB} / \sigma_A\sigma_B$$

Thus, covariance depends on their individual risks (standard deviations) and the degree of correlation between them (correlation coefficient).

We can see from the formula that the lower the correlation and standard deviations of the two securities, the lower the covariance. Low covariance is preferred since it means the risk is lower.

If one of the securities had a higher standard deviation than the rest, when combined with another security, because of the correlation between them, risk will be reduced.

An example of this would be if share A produces high returns whenever share B produces high returns and vice versa. These outcomes would mean that they have high positive correlation. In a diversified portfolio, the inclusion of Company A shares and Company B shares would not reduce risk as much as choosing two stocks with prices that react differently to each other (ie, have low positive or negative correlation).

A positive covariance between the returns of A and B would mean that they have moved in the same direction, whereas a negative covariance would mean that they have moved in the opposite direction.

The key message here is that to reduce risk, portfolios should ideally contain shares as negatively correlated to each other as possible and with low standard deviations so as to reduce the covariance (and overall risk).

Example

Consider a portfolio of two securities, A and B, the returns of which are shown in the table below (R_A and R_B respectively).

From this data, we calculate the mean (average or μ) returns and, in turn, the deviations of A's and B's returns each year from that mean. We then square the deviations to remove the negative signs. This is needed to calculate the variances and standard deviations of A and B.

The final column multiplies the deviation of A, with the deviation of B. This is needed to calculate the covariance and, in turn, the correlation between the two securities.

	Security A			Security B			$(R_A - \mu_A) \times (R_B - \mu_B)$
Year	Return R_A	Deviation $R_A - \mu_A$	$(R_A - \mu_A)^2$	Return R_B	Deviation $R_B - \mu_B$	$(R_B - \mu_B)^2$	
1	5	–0.0833	0.0069	–2	–5.3333	28.4444	0.4444
2	–7	–12.0833	146.0069	1	–2.3333	5.4444	28.1944
3	10	4.9167	24.1736	5	1.6667	2.7778	8.1944
4	3	–2.0833	4.3403	12	8.6667	75.1111	–18.0556
5	6	0.9167	0.8403	18	14.6667	215.1111	13.4444
6	–2	–7.0833	50.1736	–1	–4.3333	18.7778	30.6944
7	–20	–25.0833	629.1736	10	6.6667	44.4444	–167.2222
8	2	–3.0833	9.5069	–5	–8.3333	69.4444	25.6944
9	25	19.9167	396.6736	12	8.6667	75.1111	172.6111
10	10	4.9167	24.1736	5	1.6667	2.7778	8.1944
11	–1	–6.0833	37.0069	10	6.6667	44.4444	–40.5556
12	30	24.9167	620.8403	–25	–28.3333	802.7778	–705.9722
Sum =			**1,942.9167**			**1,384.6667**	**–644.3333**

For security A:

- Mean return μ_A = Sum of returns / 12 = 61 / 12 = 5.0833
- Variance, σ_A^2 = 1,942.9167 / 12 = 161.9097
- Standard deviation, σ_A = √161.9097 = 12.7244

For security B:

- Mean return μ_B = Sum of returns / 12 = 40 / 12 = 3.3333
- Variance, σ_B^2 = 1,384.6667 / 12 = 115.3889
- Standard deviation, σ_B = √115.3889 = 10.7419

For the combined portfolio:

$Cov_{AB}^2 = -644.3333 / 12 = -53.6944$

$\rho_{AB} = Cov_{AB}^2 / \sigma_A \sigma_B = -53.6944 / (12.7244 \times 10.7419) = -0.3928$

The two securities have a negative covariance, meaning that they have moved in the opposite direction. Further, they are negatively correlated (ie, as the price of one moves up, the other moves down) – the magnitude shows that they have a low to moderate relationship.

2.1.5 Volatility

Many investors realise that the stock market is a volatile place to invest their money, but it is this **volatility** that also generates the market returns that investors experience.

Volatility is a measure of dispersion around the mean or average return of a security. One way to measure volatility is by using the standard deviation, which tells you how tightly the price of a stock is grouped around the mean or moving average (MA).

When the prices are tightly bunched together, the standard deviation is small. When the price is spread apart, you have a relatively large standard deviation. For securities, the higher the standard deviation, the greater the dispersion of returns and the higher the risk associated with the investment.

As described by MPT, volatility creates risk that is associated with the degree of dispersion of returns around the average. In other words, the greater the chance of a lower-than-expected return, the riskier the investment.

Another way to measure volatility is to take the average range for each period, from the low price value to the high price value. This range is then expressed as a percentage of the beginning of the period. Larger movements in price create a higher price range, and thereby result in higher volatility, while lower price ranges result in lower volatility.

Example (Continued)

We calculated above that security A has a standard deviation of 12.7244 and security B of 10.7419. As the standard deviation of security B is lower (ie, lower dispersion of returns around the mean), this shows that it has historically demonstrated lower levels of volatility, so there is a lower risk associated with security B than security A.

2.1.6 The Efficient Frontier

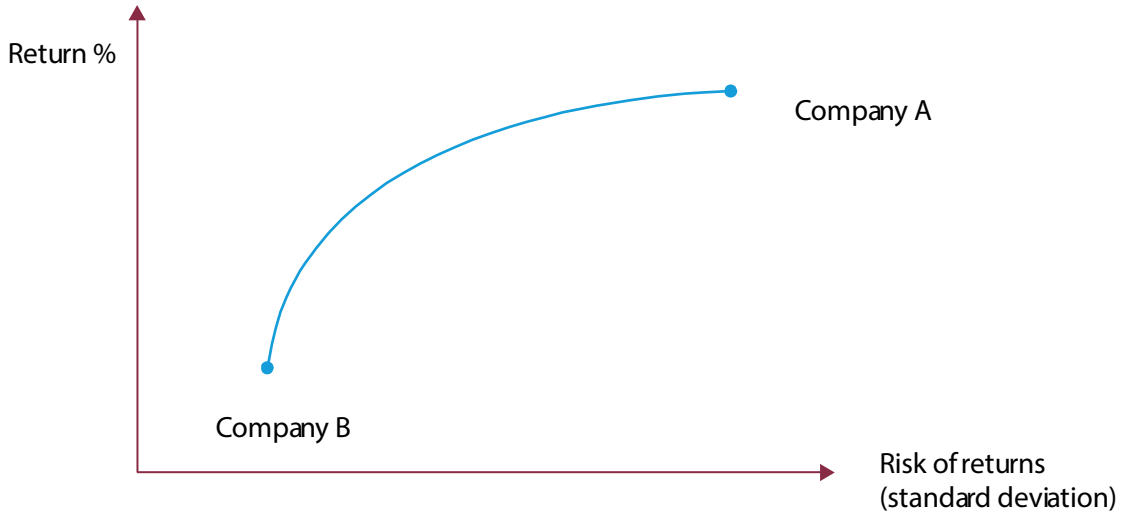
Now that we have looked at how diversification reduces risk, we need to find out how we can identify the best level of diversification.

For every level of return, there is one portfolio that offers the lowest possible risk, and for every level of risk, there is a portfolio that offers the highest return. These combinations can be plotted on a graph, and the resulting line is the efficient frontier.

Firstly, let us look at the efficient frontier for just two securities:

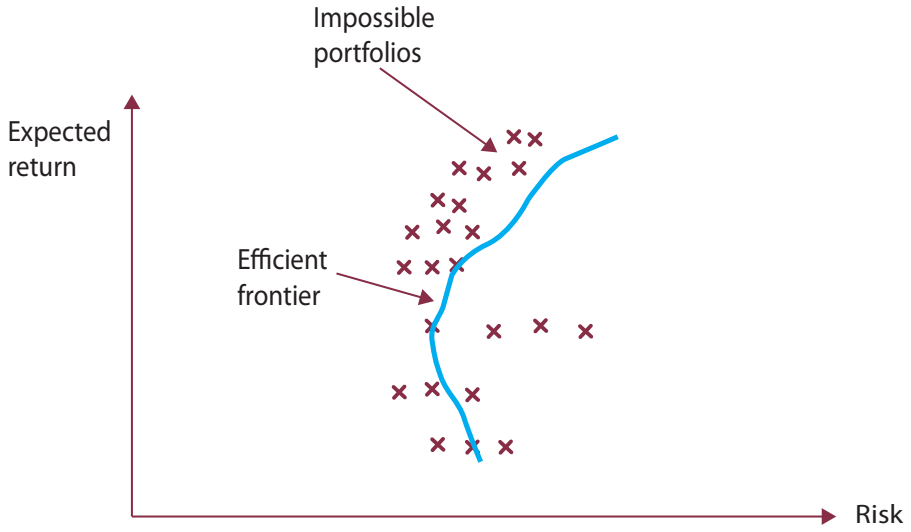
- Company A, a high risk/high return technology security, and
- Company B, a low risk/low return consumer products security.

The line plots the best possible combinations of the two stocks to produce the highest returns for the lowest risk.



Any portfolio combining these two stocks that lies on the curve is efficient; in other words, it gives the maximum expected return for a given level of risk. A rational investor will only ever hold a portfolio that lies somewhere on the efficient frontier. The maximum level of risk that the investor will take on determines the position of the portfolio on the line.

If we now look at a portfolio of securities, we can plot all combinations of them held in different proportions on a chart that plots risk and expected returns to arrive at the efficient frontier for the portfolio.

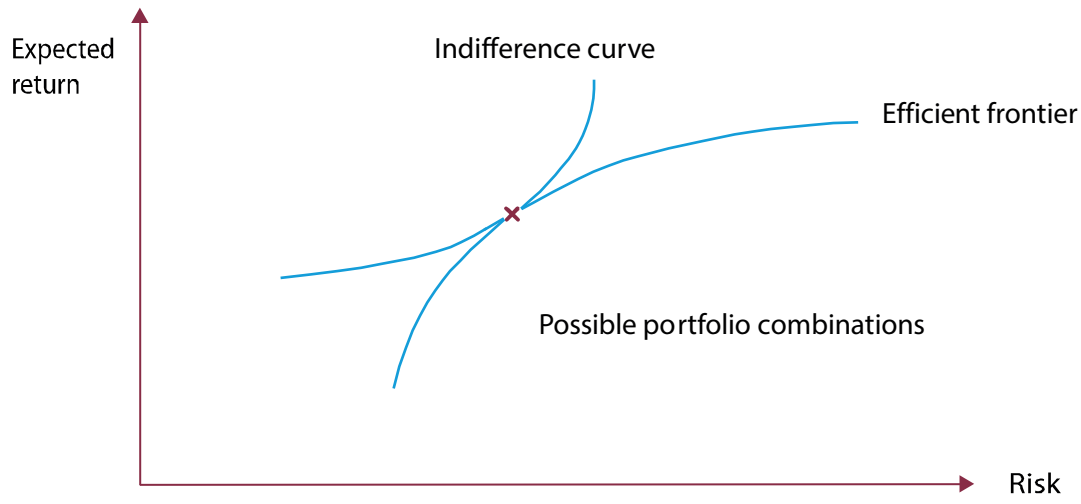


The efficient frontier will plot the combination of securities that will offer the maximum expected return for any given level of risk.

The portfolios sitting on the efficient frontier will provide the best return for a given level of risk. It therefore follows that no portfolio will be above the efficient frontier, hence the term 'impossible portfolios'. The portfolios below the line are inefficient and should be avoided, since essentially, an investor would be taking the same risk as a portfolio that could provide a higher return.

This efficient frontier is based upon the risk and return of a given universe of stocks (eg, the constituents of the FTSE 100, the S&P 500 or the SSE Composite Index); and by investing in other markets (global diversification) or by using other asset classes (and using hedge fund techniques), it is possible to push out the efficient frontier. This is perhaps proof that, in investment terms at least, a creative approach can bring surprising results.

Remember that investors will have individual risk and return criteria, and the point on the efficient frontier that they will choose will depend upon their appetite for risk, which is represented by an indifference curve, as shown on the chart below.



The portfolio to be selected for this client would be at X, where the two arcs are tangential.

2.2 Efficient Market Hypothesis (EMH)

The **efficient market hypothesis (EMH)** states that in price-efficient markets, securities respond immediately and rationally to publicly available price-sensitive information and move independently of past trends.

There are certain assumptions made; for example, that investors are rational and risk averse, and that they have the ability to source and process accurately all publicly available information.

There are three common forms of market efficiency stated in EMH: weak form, semi-strong form and strong form.

2.2.1 Weak-Form Efficiency

In a weak-form price-efficient market, stock prices are not affected by past price movements and volume data, so no excess returns can be earned by using investment strategies based on historical share prices.

Weak-form efficiency implies that technical analysis techniques will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide excess returns.

In a weak-form efficient market, current share prices are the best, unbiased estimate of the value of the security. Because weak-form efficiency is theoretical in nature, its advocates assert that fundamental analysis can be used to identify stocks that are undervalued and overvalued. Therefore, keen investors looking for profitable companies can earn profits by researching financial statements. One of the implications of weak-form efficiency is that information may not be broadly distributed instantaneously, which can provide opportunities for outperformance.

2.2.2 Semi-Strong-Form Efficiency

Within a semi-strong-form price-efficient market, share prices adjust within an arbitrarily small but finite amount of time and in an unbiased fashion, to publicly available new information, so that no excess returns can be earned by trading on that information.

Semi-strong-form efficiency implies that fundamental analysis techniques will not be able to reliably produce excess returns.

To test for semi-strong-form efficiency, the adjustments to previously unknown news must be of a reasonable size and must be instantaneous. To test for this, consistent upward or downward adjustments after the initial change must be looked for. If there are any such adjustments, it would suggest that investors had interpreted the information in a biased fashion and hence in an inefficient manner.

2.2.3 Strong-Form Efficiency

In a strong-form price-efficient market, share prices reflect all information, public and private, so no-one can earn excess returns.

If there are legal barriers to private information becoming public, as with insider dealing rules, strong-form efficiency is impossible, except in the case where the rules are universally broken.

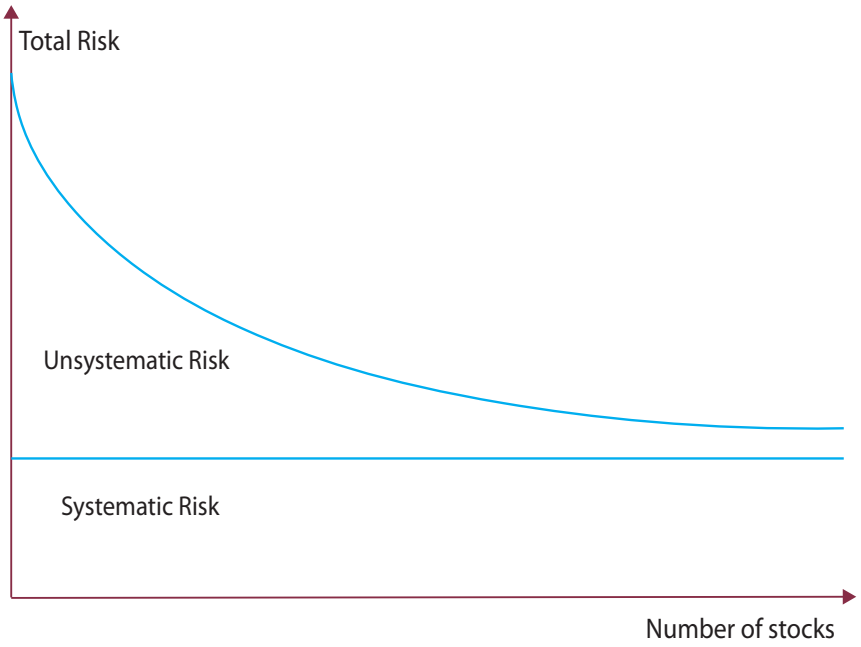
To test for strong-form efficiency, a market needs to exist where investors cannot consistently earn excess returns over a long period of time. Even if some fund managers are consistently observed to beat the market, no refutation (even of strong-form efficiency) follows. With tens of thousands of fund managers worldwide, even a normal distribution of returns (as efficiency predicts) should be expected to produce a few dozen 'star' performers.

The key point here is that most well-developed stock markets in the developed world are relatively price-efficient and, on the basis that few fund managers consistently outperform the market, this would indicate at least some degree of strong-form market efficiency. However, less developed markets do not show strong-form price efficiency and, therefore, can provide opportunities for active fund managers to outperform.

2.3 Capital Asset Pricing Model (CAPM)

The capital asset pricing model (CAPM) says that the expected return of a security or a portfolio equals the rate on a risk-free security plus a risk premium. If this expected return does not meet or beat the required return, then investors should not proceed with the investment.

The CAPM was introduced in the 1960s, and developed MPT by stating that the risk for individual stock returns (and, therefore the risk of a portfolio overall) is primarily determined by two components: systematic and unsystematic risk, as covered in section 6.7.1 of chapter 5.



The general idea behind the CAPM is that investors need to be compensated in two ways:

1. For the time value of money.
2. For the risk that cannot be diversified away.

Beta (or β, which is covered in section 6.7 of chapter 5) is used to measure the systematic risk of a security relative to the overall market risk. In fact, experience has proved that about 70% of the unsystematic risk can be eliminated with 50 or fewer securities, provided they are diversified across different asset classes and sectors (among other considerations). The risk that would remain is the systematic risk.

2.3.1 CAPM Equation

The amount of compensation that the investor needs for taking on the additional risk is calculated by taking a risk measure (beta) and multiplying it by the market premium. The market premium is the expected market return minus the risk-free rate.

The risk-free rate is the theoretical rate of return that an investor can expect to achieve over a period of time from an investment with zero risk. Short-dated, investment-grade government bonds have historically been described as risk-free, since the assumption is made that they do not default on their debt. Hence, the risk-free rate is often taken as the interest rate on a three-month government bond, such as a gilt for UK-based investors or a T-bill for US-based investors.

There are, however, a couple of points to note:

1. In practice, the risk-free rate does not truly exist, as every investment carries some level of risk. Some of the previously largest, most stable economies have historically defaulted on their sovereign debt in one way or another. Unlike emerging market countries, this usually does not occur due to outright non-payment, but rather through more subtle ways such as periods of high inflation, currency devaluation, or policy shifts (eg, when the US stopped convertibility of the US dollar into gold in 1971 (the US dollar has lost 99% of its value since then relative to gold)).
2. There is no single risk-free rate. A short-dated, investment-grade government bond may be free of risk to a short-term investor, but not necessarily to an investor with a longer time horizon due to the potential for inflation expectations to influence the price of securities trading on secondary markets. Therefore, the instrument that is actually used will depend on the investor's time horizon.

Consequently, market participants have only found appropriate proxies for the risk-free rate.

For the purposes of CAPM, the interest rate on a three-month government bond will serve as a good substitute for the risk-free rate. The CAPM calculation looks like:

$$R_{CAPM} = R_F + \beta\left(R_M - R_F\right)$$

where:

R_{CAPM} = the expected return under CAPM
R_F = the risk-free rate
β = the beta of the portfolio
R_M = the market rate of return
$R_M - R_F$ = the market risk premium

Example

A fund has a beta of 1.4 in a market with an average return of 8%. There is a risk-free rate of 4%. What is the expected return on the fund under CAPM?

$$R_{CAPM} = 4\% + 1.4\left(8\% - 4\%\right) = 4\% + 5.6\% = 9.6\%$$

In other words, as the fund is more volatile than the market, the expectation would be for a higher return which, when taking into account average market returns and risk-free rate, would be 9.6%.

The equation can also be altered to calculate the beta required to, in theory, achieve an expected return:

$$\beta = \frac{R_{CAPM} - R_F}{R_M - R_F}$$

The security market line (SML) plots the results of the CAPM for all different risks (betas):

- Any security that provides a return above the SML is providing an excess return (positive 'alpha' or α), and is, therefore, undervalued.
- Conversely, any securities lying below the line have a shortfall in returns (negative alpha) and are therefore overvalued.

We will look at alpha in more detail in section 4.1.5 of this chapter.

In CAPM, the SML expresses the relationship with a beta risk. In this case, unsystematic risk is ignored and assumes that investors can eliminate it via diversification.

Thus, when a portfolio is fully exposed to the market (indicated by β = 1), it will give an investor the full market equivalent return of R_M (in theory). The portfolio, therefore, moves in sync with the market – if the market went up by 10%, then the portfolio should go also up by 10%, so long as it lies on the SML.

That is, the investor can expect to achieve the risk-free return (R_F) plus a proportion of the market risk premium ($R_M - R_F$), based on the levels of relative risk (β) they are willing to take.

2.3.2 Problems Associated with CAPM

As an investment theory, CAPM has come in for its fair amount of criticism, no more so than in the aftermath of the credit crunch. Some common criticisms levelled at CAPM are as follows:

- Betas are based on historical data and are therefore not a reliable guide to future returns.
- Market risk can be difficult to establish.
- CAPM assumes the market is the only risk factor; other later models such as the Fama-French three-factor model and the Carhart four-factor model incorporate numerous other risk factors to more accurately capture the drivers of volatility and return.
- Some studies suggest unsystematic risk is being valued in the market, which distorts predictability.
- Some hindsight studies have shown actual returns bore no relation to that expected under CAPM.

3. The Role of Financial Advisers and Portfolio Managers

Learning Outcome

7.1.6 Evaluate and periodically review portfolio composition in order to continually maintain adherence to client objectives

3.1 The Role and Responsibilities of Financial Advisers

The role and responsibilities of the financial adviser are to:

- assist clients to determine and prioritise their financial needs
- determine an appropriate financial strategy to meet those needs
- identify and record in writing the client's overall objectives, risk tolerance and other requirements
- act in the client's best interests in terms of the advice they give, and the products and services they recommend
- exercise professional judgement and care in constructing the financial strategy, and
- keep the agreed strategy under review and make changes in line with developments in the investment, economic and tax environments, and changes in the clients' personal circumstances.

3.2 The Role and Responsibilities of Portfolio Managers

The role and responsibilities of the portfolio manager (also called a wealth manager or investment manager) are to:

- act in the client's best interests in line with the agreed objectives, risk tolerance and other requirements as identified by the financial adviser
- exercise professional judgement and care in carrying out the management of the investment portfolio
- agree the performance benchmark
- monitoring the performance against the benchmark and keeping the client up to date with performance
- keep the agreed strategy under review and make sure that it remains appropriate to the mandate, and hence client requirements
- make changes to the portfolio in line with developments in the investment, economic and tax environments, and changes in the clients' personal circumstances, and
- carry out the required administration and accounting in order to maintain the portfolio.

The adviser and client develop a customised investment policy statement (IPS). This is an important document that both the adviser and the client sign to demonstrate their mutual agreement to the strategy to be adopted (including the establishment of an investment portfolio).

3.2.1 Advisory and Discretionary Management

In section 10.1 of chapter 6, we introduced advisory and discretionary management services. To summarise: under an advisory service, the portfolio manager suggests a strategy or particular course of action, but it is up to the client to accept the advice or reject it; while with a discretionary service, the portfolio manager has the right to take action in accordance with the client's objectives, without giving prior warning to, or seeking approval of, the client.

3.2.2 Implementing the Investment Strategy by the use of Suitable Asset Classes and/or Funds

As we have discussed, portfolios can be put together using a variety of different asset classes including cash, fixed-interest securities, equities and derivatives; either held directly, or indirectly via collectives. It is typical for the client to sign an investment management agreement (IMA) which sets out the general objectives and stated characteristics of the portfolio. As long as the manager conforms to this document and does not deviate significantly (for example, by investing in a different asset class or restricted geography), the manager can make changes to the holdings in the portfolio without seeking further approval. The features and benefits of various asset classes and financial products are covered in chapter 5; and meeting the client's needs and objectives, as well as ensuring suitability, is covered in chapter 6.

3.2.3 Measuring/Evaluating Performance

Performance of an investment portfolio is usually measured in relative terms compared to a particular index and peer group. Most portfolio managers have their own internal measure to ensure consistency and alert managers to significant deviations from benchmarks. When managers decide to use the collective investments or investment vehicles of other providers, it will be necessary for those managers to monitor their performance and evaluate them accurately for their clients.

3.2.4 Portfolio Review

The portfolio manager must agree on the frequency of review with the client (at least annually) and bear in mind their regulatory responsibilities to ensure continued suitability.

This will not only include the necessity to review the portfolio to take into account changes in investment conditions. The client's objectives may change over time, and it is important that the portfolio manager is still managing their investments to an agreed investment objective or mandate. This will incorporate any changes to the client's personal circumstances and any external changes affecting them (eg, taxation).

Clients should also be proactively encouraged to contact their financial adviser or portfolio manager with updates of any changes in their circumstances.

4. Performance Benchmarks

Learning Outcome

7.1.5 Apply appropriate indices and benchmarks to the comparative analysis of investment performance

Once a portfolio has been constructed, it is important that the portfolio manager and client agree a benchmark against which their performance will be judged. The benchmark selected should reflect as closely as possible the asset split, and the risk and return profile of the portfolio.

If one asset class is used as opposed to a multi-asset class approach, then an index can be used; sometimes, though, the base rate or some other reference rate may be deemed to be more appropriate, especially for absolute return style strategies. The key is that the benchmark used should represent a realistic alternative to the portfolio, such as a **strategic asset allocation (SAA)**. The role of the portfolio manager would be to manage the portfolio along a **tactical asset allocation (TAA)** strategy, but not managing the portfolio outside of the agreed risk and return bands. A balanced portfolio, therefore, always remains in balance, but can differ from the stated benchmark or SAA.

With collectives, often a sector type of benchmark is used (eg, the IA Mixed Investment 0–35% Shares for a more cautious UK investor).

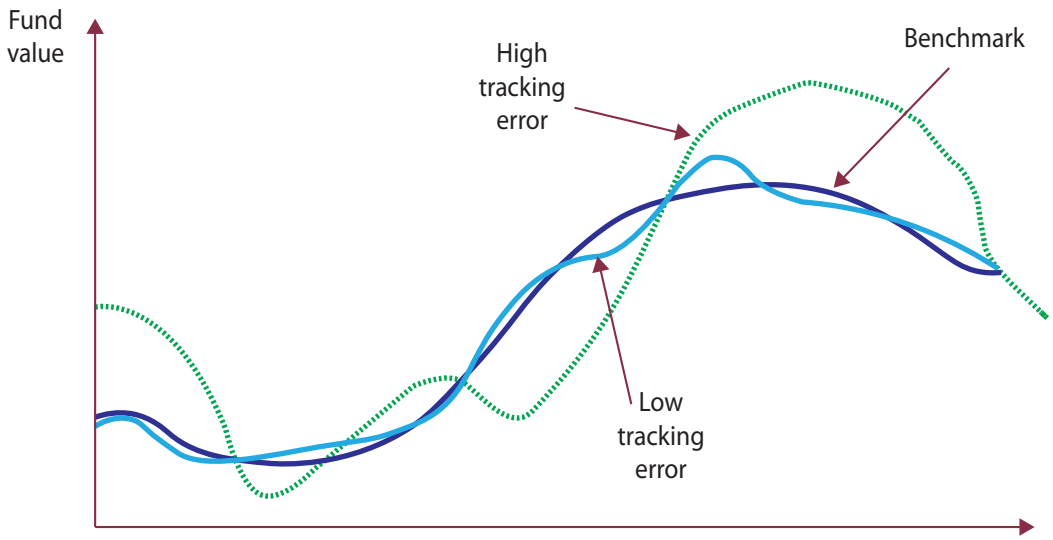
Thus, whatever the objectives of the fund, an appropriate benchmark must be chosen; and tracking error, active share and other measures of deviation can be measured.

4.1 Performance and Risk Measurements

4.1.1 Tracking Error

Tracking error is a risk measure as it measures the difference between the performance of a portfolio and the performance of a benchmark. This is a form of **active risk**, as the risk arises due to active management, although it is also used to assess performance for passive strategies; in other words, it is a measure of how closely a portfolio follows the index to which the fund manager is benchmarked.

Tracking error can be demonstrated graphically as follows:



Many portfolios are managed to a benchmark. As we have seen, some portfolios are expected to replicate the returns of an index exactly, before trading and other costs (called an index-tracking fund). Others are actively managed, in that their construction deviates markedly from the index, with the aim of generating active returns or lowering transactions costs.

Index funds would have a tracking error close to zero, indicating that the manager is taking very little risk against the index; while an actively managed portfolio would normally have a higher tracking error. As with any risk measurement where a benchmark is used, it is important to use an appropriate benchmark. For example, a very high tracking error might be no more than an indication that a portfolio is being measured against the wrong benchmark.

4.1.2 Information Ratio

This **information ratio** is a risk-adjusted return measure used to evaluate a fund manager's relative performance. It is a measure of active management rather than closet indexing. It looks at the return relative to the benchmark, divided by the risk taken by the manager against the benchmark.

The higher the positive information ratio, the better. Generally, though, anything above 0.5 is deemed good and would likely be in the top quartile (or decile even); and anything above 1.0 is exceptionally good.

Information ratios could be negative and any result less than –0.5 would be deemed poor. A negative information ratio is saying that a manager's active return is negative; therefore, for the period in question, an investor would effectively have achieved a better result by matching the index using an index fund or exchange-traded fund (ETF).

The formula for the information ratio is:

$$\text{Information ratio} = \frac{R_P - R_B}{\text{Tracking error}}$$

where:

R_P = average annual portfolio return
R_B = average annual benchmark return

The tracking error used for this equation is the standard deviation of relative returns. It measures the degree of uncertainty of the excess return (alpha – see section 4.1.5, below). Thus, the information ratio measures alpha divided by the amount of risk taken on in order to generate it.

Generally, an information ratio between 0.4 and 0.6 is considered to be good; and less than 0.4 means that the portfolio/fund was unable to produce risk-adjusted excess returns for a sufficiently long time, so it may be a poor investment. That said, the typical value for information ratio varies by asset class. It is rare for a portfolio/fund to have an information ratio of 1 for long periods of time.

? A portfolio has an annual return of 12.2% against a benchmark return of 9.8%. The standard deviation is 6. What is the information ratio?

$$\text{Information ratio} = \frac{12.2\% - 9.8\%}{6} = 0.4\%$$

This would be regarded as a moderately good information ratio.

Note that if a fund's returns are not normally distributed, then using the information ratio can be misleading since the tracking error may not be an appropriate measure of risk.

4.1.3 Active Share

As an alternative to the information ratio, a number of portfolio/fund management groups provide their active share for each fund. This is a measure of how much their holdings differ from the benchmark index. The figure can range from 0% to 100%, where 0% indicates they have the same holdings as the index with identical weightings (ie, perfect replication, as a tracker) and 100% means that there are no holdings in common with the index.

4.1.4 R-Squared (R^2)

Before we look at the risk ratios themselves, it is important for us to consider R^2, as this shows the fund or portfolio in question is being compared with an appropriate benchmark.

R^2 is a statistical value that shows what percentage of a fund's or portfolio's performance is as a result of the benchmark. It is measured between 0 (or 0%) and 1 (or 100%). The higher the R^2, the closer the fund's or portfolio's performance aligns with the benchmark, so the risk ratios are more useful. Where the R^2 is 0.7 or less, the fund or portfolio generally does not follow the movements of the benchmark, so these ratios are not necessarily reliable.

4.1.5 Alpha

Alpha is a risk-adjusted measure of the active return on an investment. It is basically a measure of a manager's stock-picking skill. Alpha can be used to measure individual securities, but is usually applied to portfolios or funds.

A positive alpha is good news; and the higher the alpha, the better. While this alpha may have been achieved through skill on the part of the fund manager, remember that not all managers are skilled, in which case, the positive performance may have simply been due to luck. If a fund is being measured against an inappropriate index, then the general movement in the market may also provide 'skill-less' return. Alphas measured over a number of different time periods would help determine the luck element.

The formula is:

$$\alpha = \text{Actual return} - \left[R_F + \beta \left(R_M - R_F \right) \right]$$

where:

R_F = the risk-free rate
β = the beta of the portfolio
R_M = the market rate of return
$R_M - R_F$ = the market risk premium

You may recognise the second part of this formula (ie, $R_F + \beta (R_M - R_F)$) as the expected return on an investment from the CAPM in section 2.3.1, above. Alpha, therefore, represents the return in excess of CAPM. Strictly, this is known as Jensen's alpha (named after Michael Jensen, who first used the measure in the 1970s), and it is also known as the residual return.

? A fund has an average fund return of 9.5% against a market return of 7%. The risk-free rate is 4% and the fund's beta is 1.6. What is the fund's alpha?

$$\alpha = 9.5\% - \left[4\% + 1.6\left(7\% - 4\%\right) \right] = 0.7\%$$

Alpha can be used to compare funds and portfolios, and looks beyond the 'headline' returns.

For example, the above fund is compared with another that has a fund return of 8.2% and a beta of 1.1. The other factors stay the same. What is the alpha, and what does that tell us about the two funds?

The alpha of the second fund is:

$$\alpha = 8.2\% - \left[4\% + 1.1\left(7\% - 4\%\right) \right] = 0.9\%$$

The alpha of the second fund is slightly higher than that of the first. This shows that the manager of the second fund, despite underperforming the first, added more value through 'better' stock picking. (We have put 'better' in inverted commas because of the above comments regarding skill and luck.)

4.1.6 Sharpe Ratio

The **Sharpe ratio** was originally called the 'reward-to-variability' ratio when it was devised by William Sharpe, and this unambiguous original name effectively describes its use. The Sharpe ratio adjusts rates of return to incorporate the riskiness of an investment or fund. It measures the excess returns for every unit of risk (measured by standard deviation) which is taken in order to achieve the return.

The formula for the Sharpe ratio (S_A) is:

$$S_A = \frac{R_P - R_F}{\sigma_P}$$

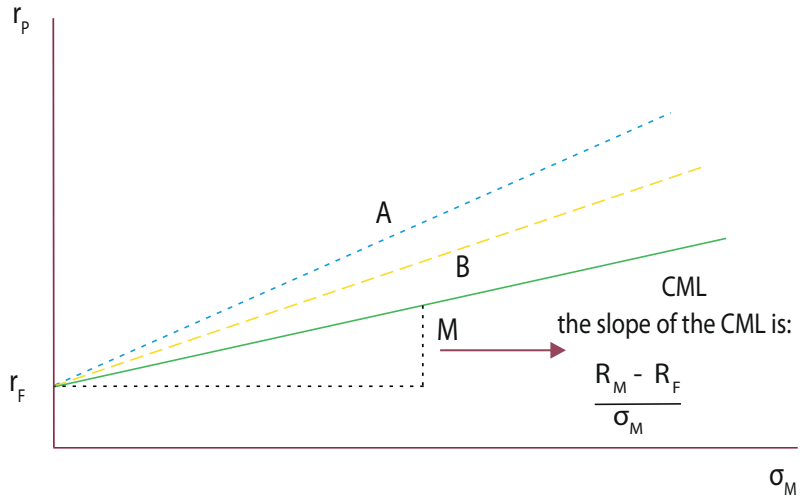
where:

R_P = the average portfolio return
R_F = the risk-free rate
σ_P = the portfolio standard deviation

The excess return is measured on the top line and is the difference between the average performance of an investment and the rate of return from the risk-free investment. This is also known as the numerator, and if the numerator increases for the same level of risk, the Sharpe ratio becomes greater. This is good news for an investor. Conversely, when the risk measure (the denominator) increases, the Sharpe ratio will decrease.

The higher the Sharpe ratio, the better its risk-adjusted performance, so the more attractive the investment.

Sharpe ratios are most useful for comparing funds with the same benchmark, and which provide performance data over the same time period.



The Sharpe ratio is the slope of the excess return on a fund ($R_P - R_F$) relative to riskiness of that fund, measured by its standard deviation, σ. In the diagram, fund A outperforms fund B, and both A and B outperform the index (represented by the market portfolio on the capital market line (CML)).

Example

An investor expects their stock portfolio to return 12% next year. If returns on a risk-free investment are 5%, and the portfolio carries a 6% standard deviation, we can use the formula above to calculate the Sharpe ratio for the portfolio as:

$$S_A = \frac{0.12 - 0.05}{0.06} = 1.17$$

This means that for every unit of risk, the investment is expected to generate 1.17 units of return.

4.1.7 The Treynor Ratio

Sometimes called the 'reward-to-variability' ratio, the **Treynor ratio** was developed by Jack Treynor and is a further risk-adjusted measure of return based on systematic risk. Again, it is similar to the Sharpe ratio, except that the Treynor ratio uses beta as the measurement of volatility. This means that a well-managed and well-diversified portfolio has a high Treynor ratio.

The formula for the Treynor ratio is:

$$\text{Treynor ratio} = \frac{R_P - R_F}{\beta}$$

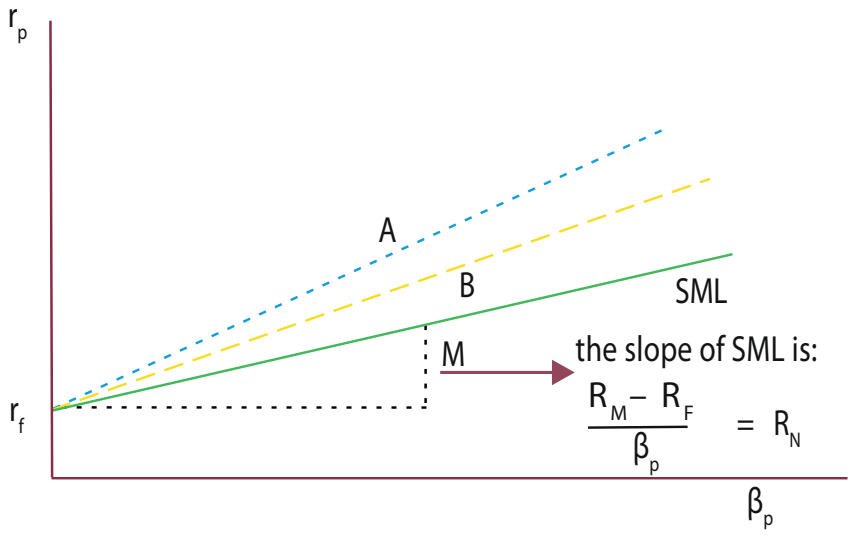
where:

R_P = the average portfolio return
R_F = the risk-free rate
β = the beta of the portfolio return

Again, the higher the ratio, the greater the portfolio's return relative to its beta.

Like the Sharpe ratio, the Treynor ratio is a ranking criterion only as it does not quantify the value added by a fund manager. The Treynor index shows relative performance of funds to each other, and to the index. In the diagram, fund A outperforms fund B, but both A and B outperform the index (represented by the market portfolio on the SML).

Graphically, the Treynor ratio of the securities market line and portfolios A + B will look like this:



4.2 Benchmark Reviews

A review of the portfolio (see section 3.2.4, above) may also highlight the need to change the benchmark against which the portfolio manager is being judged. For example, if the client has retired and asked for the manager to adopt a more cautious, income-producing stance, it may be appropriate to review the index previously used when the portfolio was geared aggressively for growth. A review of the benchmark may also be required if it contains assets to which the portfolio no longer has exposure, or if the benchmark in question is no longer (or is due to stop) being calculated.

If a portfolio manager wishes to change the benchmark against which performance is assessed, they should inform the client of the change along with the rationale for this change and the date from which it will take effect. This will demonstrate to the client that the manager has not simply chosen the new benchmark to provide a more favourable comparison. The change should also be reflected in investment policy documents and updated client agreements.

4.3 Stock Market Indices

Learning Outcome

7.1.3 Know the main stock market indices and how they operate

On the topic of benchmarks, below we discuss some of the most well-known equity and bond indices used in the UK and on a wider, global basis.

For ethical, responsible and sustainable indices, investors and advisers must understand that each index has its own eligibility criteria for inclusion, so they may hold companies that investors consider to be undesirable or controversial. The methodologies must, therefore, be rigorously checked to ensure alignment with the investor's specific investing criteria.

4.3.1 Equity Indices

UK Equity Indices

The UK stock market is one of the most international. About 80% of revenues of companies in the FTSE 100 Index are derived from overseas[2], implying that global economic conditions are more important than what happens in the UK. Several companies (eg, Shell, HSBC, GlaxoSmithKline, Vodafone and Diageo) are multinationals with substantial interests all around the globe.

A UK investor can gain significant exposure to many sectors and to a range of countries without buying shares quoted on overseas exchanges. That said, as we saw in section 2.1 of chapter 3, the industries and sectors that make up the UK stock market are different from other indices worldwide, so performance will vary in different market conditions.

Index	Description
FTSE 100	Comprises the 100 most highly capitalised blue-chip companies. It is used extensively as a basis for investment products, such as derivatives and exchange-traded funds.
FTSE 250	Comprises those 250 companies which, by market capitalisation, are positioned directly beneath the FTSE 100 and represent about 15% of the FTSE All-Share Index.
FTSE 350	Comprises the combined constituents of the FTSE 100 and FTSE 250 indices.
FTSE Small Cap	Comprises companies outside of the FTSE 350 Index and represents approximately 2% of the UK market capitalisation.
FTSE All-Share	Represents about 99% of the UK market capitalisation. It is the aggregation of the FTSE 100, FTSE 250 and FTSE Small Cap Indices.
FTSE4Good Index Series	This series has been designed to measure the performance of companies that meet globally recognised corporate responsibility standards, and to facilitate investment in those companies. There are various indices available in this series, covering the UK, Europe, Australia and the US as well as global indices. Index constituents are screened for the quality and extent of certain ESG criteria such as addressing climate change, human rights and community and tax transparency. From this, companies are assigned an ESG rating, which must be at least 3.3 out of 5 for the company to be suitable for inclusion in the index. Additionally, companies with exposure to 'significant controversies' (eg, tobacco, controversial weapons and coal) are excluded. The FTSE4Good Index Series is reviewed every June and December. At these times, any companies with an ESG rating below the threshold are allowed a 12-month grace period to improve its rating before being removed from the index, as a way of incentivising improvements in corporate practices.

2 LSEG, March 2024. The UK's very global country index. Retrieved from https://www.lseg.com/en/insights/ftse-russell/the-uks-very-global-country-index (Accessed: October 2025)

Overseas Equity Indices

Globalisation is a reality in the world of investors. In addition to domestic investments, a well-diversified portfolio will include substantial exposure to overseas companies and markets. In the UK, many of these overseas companies are quoted on the London Stock Exchange (LSE).

A key issue is that investment in overseas markets will expose investors to currency risk. Currency changes can make a significant difference to returns from overseas investments, when converted back into the investor's home currency.

The table below describes some of the world's key indices.

Country/Region	Index	Description
Global	FTSE Global Equity Index Series	The aggregate of over 16,000 stocks in about 50 different countries. The series is divided into developed and emerging segments. The modular nature of the series provides the ability to structure portfolios with indices calculated at regional, national and sector level.
	FTSE All-World	A subset of the FTSE Global Equity Index Series, of over 4,200 large and mid-cap stocks. The index represents 90–95% of the world's investable market capitalisation.
	MSCI ACWI	The All Country World Index (ACWI) is a market capitalisation-based index, including over 2,500 large- and mid-cap companies from over 20 developed market countries and nearly 25 emerging market countries.
	STOXX Global 1800	An index consisting of 600 European, 600 North American and 600 Asia/Pacific large-cap stocks (as represented by the STOXX Europe 600, STOXX North American 600 and STOXX Asia/Pacific 600 indices respectively).
	S&P Dow Jones Sustainability Indices	A series of indices that track the financial performance of the world's leading companies in terms of ESG criteria. Launched in 1999, DJSI are the longest-running sustainability benchmarks worldwide, and today are used for a wide range of ESG benchmarking and investment applications.

Country/Region	Index	Description
Continental Europe*	FTSE Eurotop 100	A tradeable index, designed to represent the performance of the 100 most highly capitalised blue-chip companies in Europe.
	CAC 40	A capitalisation-weighted measure of the 40 most significant French-domiciled companies.
	DAX 40	Includes the 40 major German companies trading on the Frankfurt Stock Exchange.
US	Dow Jones Industrial Average (DJIA)	A price-weighted measure of 30 blue-chip companies in the US.
	S&P 500	500 largest-cap, US-traded, multinational companies operating in global markets.
	Nasdaq (National Association of Securities Dealers Automated Quotation)	Comprises stocks of technology and growth companies. Since US and non-US companies are listed on Nasdaq, this is not exclusively a US index.
	MSCI KLD 400 Social	A screened version of the S&P 500. Its constituents meet certain environmental and social standards. It also excludes specific sectors, including alcohol, tobacco and gambling, among others.
	Calvert US Large-Cap Core Responsible (CALCOR)	Comprises large US companies that are considered socially responsible or ethical, based on Calvert's social criteria.
China	SSE (Shanghai Stock Exchange) Composite	Tracks the performance of all stocks (A shares and B shares) traded on the SSE. It contains over 2,000 listed companies.
Hong Kong	Hang Seng	Over 60 companies listed on the Hong Kong Stock Exchange selected on the basis of market value, turnover and financial performance.
Japan	Nikkei 225	225 large and regularly traded Japanese companies.
	Topix	Tracks all domestic companies in the Tokyo Stock Exchange's (TSE's) Prime market division, which is one of Japan's top-ranking markets.
	FTSE Japan	Forms part of the FTSE All-World Index Series. It contains over 500 large and mid-cap stocks, capturing 90% of the Japanese market.

Country/Region	Index	Description
Emerging Markets	FTSE Emerging	Derived from the FTSE Global Equity Index Series (GEIS). It comprises over 1,800 companies in over 20 emerging markets including China, Taiwan, India, Brazil, Saudi Arabia and Greece.
Frontier Markets	FTSE Frontier Index Series	Covers securities in countries classified as frontier markets (see chapter 3, section 4.1).

*Since the launch of the euro in 1999, most investors focus on continental Europe as a whole, rather than on specific countries.

4.3.2 Bond Indices

There are many providers of indices relating to bonds.

UK Indices

Index	Description
FTSE Actuaries UK Gilt Indices	A number of indices that can be used for both conventional and index-linked gilts. These are sub categorised according to redemption date (eg, 0–5 years or 5–10 years), and by conventional/index-linked types. They are weighted according to the market value of each constituent stock and are calculated daily.
FTSE UK Broad Investment-Grade Bond	Consists of sterling-denominated, investment grade bonds including government, government-sponsored, collateralised and corporate bonds, irrespective of the market in which they have been issued.
FTSE UK Domestic Investment-Grade Bond	Uses the same design criteria and calculation assumptions as the FTSE UK Broad Investment-Grade Bond Index (above), but with a lower 'minimum amount outstanding' threshold for all bonds (except sovereign bonds). Thus, the index provides a broader capture of the domestic UK bond market.
FTSE Sterling High-Yield Bond Index	Measures the performance of high-yield debt denominated in sterling. This forms part of the FTSE High-Yield Bond Index Series, which also comprises indices denominated in euros, US dollars and Swiss francs.

Overseas Indices

Country/ Region	Index	Description
Global	FTSE World Government Bond Indices	A broad index of global sovereign bonds, issued by governments of over 20 countries, denominated in a variety of local currencies. Sub-indices are available by country, currency, maturing and credit rating.
	Bloomberg Global Aggregate (Agg)	A flagship measure of global investment-grade bonds from over 20 local currency markets. It includes government, government-related, corporate and securitised fixed-rate bonds, issued in both developed and emerging markets.
	JP Morgan Emerging Market Bond Global Diversified (EMBI GD)	The most widely used index for emerging market debt. It tracks the total returns for debt instruments issued by sovereign and quasi-sovereign entities in over 70 emerging market countries, denominated in US dollars. The EMBI GD replaced the JP Morgan Emerging Market Bond Index (EMBI), which was the first ever index in this asset class. At its launch in 1992, EMBI covered just 10 countries, predominantly in Latin America.
	Bloomberg MSCI ESG Fixed Income Indices	A series of fixed income indices that incorporate measures of ESG risk and exposures. Broadly, the series can be split into three methodologies (SRI, Sustainable, and ESG-weighted) to meet the needs of a diverse community of investors. Recent additions to the range include Green Bond indices and Climate Benchmarks for climate-focused and impact investors.

4.4 Peer Group Averages

Learning Outcome

7.1.4 Understand the key features of indices published by FTSE and MSCI PIMFA

Sometimes, instead of using an established index as a benchmark, a peer group average is used to evaluate the portfolio's performance. The peer group used will, to a large extent, depend upon the type of portfolio in question (for example, whether it is a pension portfolio or a retail portfolio).

For retail clients, in addition to the above, benchmarks are produced by FTSE Russell and the MSCI, whose component index weights are provided by the UK-based Personal Investment Management and Financial Advice Association (PIMFA).

These indices are designed to be used as:

1. a measure for comparing the performance of conservative, income, balanced, growth, and global funds
2. a basis for reviewing the asset allocation and structure of a portfolio with fund managers or stockbrokers, and
3. a benchmark for assessing and comparing the performance of discretionary fund managers.

While there are common aspects between the FTSE and MSCI index (as we will see in sections 4.4.1 and 4.4.2 below), there are also differences, particularly in terms of the breakdown in exposure to different types of bonds. Comparing and contrasting the allocations is a useful exercise to help get a feel for the range of possibilities, and emphasises the point that any one source should only be regarded as a guide.

Note that most fund/portfolio managers measure themselves against both an appropriate index and their peer group. For UK-based retail collective investment schemes (CISs), those groups are the ones defined by the Investment Association (IA) – for example, IA Global and the Mixed Investment sectors.

4.4.1 FTSE Russell

The FTSE Private Investor Index Series is designed to represent the performance of multi-asset benchmarks with low, average and high levels of historical volatility, by blending allocations covering equities, bonds, cash, property and other investments. The indices provide a sample set of asset allocation benchmarks, which market participants may then use to evaluate the performance and risk of their investment portfolios across different asset classes. The index weightings are reviewed semi-annually (in March and September).

Risk profile	Conservative	Income	Balanced	Growth	Global Growth
UK Equities	5.8	9.9	12.4	15.3	–
Global ex UK Equities	25.8	38.5	51.0	61.1	–
Developed Market Equities	–	–	–	–	84.3
Emerging Market Equities	–	–	–	–	15.7
UK Government Bonds	9.6	7.8	5.6	3.3	–
£ Corporate Bonds	5.3	4.3	3.2	1.5	–
Global ex UK Bonds	38.3	26.1	15.9	8.8	–
Cash	8.6	6.7	4.5	3.9	–
Commercial Property	0.1	0.1	0.1	0.0	–
Other Investments	6.5	6.6	7.3	6.1	–
Total	**100**	**100**	**100**	**100**	**100**

Source: FTSE Russell[3]

In addition to the above indices, there is also an Ultra Conservative Index and an Ultra Growth Index, which are designed to represent the performance of predominantly fixed-interest benchmarks and equity benchmarks respectively.

3 LSEG FTSE Russell, FTSE Private Investor Series: September 2025. Asset Allocation Review Results https://www.lseg.com/content/dam/ftse-russell/en_us/documents/other/ftse-private-investor-index-series-asset-allocation-levels.pdf (Retrieved: September 2025)

4.4.2 MSCI PIMFA

The MSCI PIMFA Private Investor Index Series provides investors with an objective measure of performance against which to assess their investment portfolios, based upon the assumption that they are domestic investors with sterling denominated accounts. The indices include weightings of equities, bonds, real estate, cash and **alternative investments** in proportions that reflect the longer-term objectives for each strategy. The weightings are updated when the PIMFA Private Investor Indices Committee determines that strategy changes across the industry warrant a review; this can (but may not) occur up to four times a year.

Risk profile	Conservative	Income	Balanced	Growth	Global Growth
UK Equities	7.5	12.5	15.0	20.0	–
International Equities	22.5	35.0	45.0	57.0	–
Developed World Equities	–	–	–	–	90.0
Emerging World Equities	–	–	–	–	5.0
Government Bonds	12.5	10.5	5.0	2.5	–
Corporate Bonds	32.5	20.0	15.0	7.5	–
Inflation-Linked Bonds	2.5	2.5	2.5	0.0	–
Cash	2.5	2.5	2.5	2.5	2.5
Real Estate	2.5	2.5	2.5	2.5	–
Alternatives	17.5	15.0	12.5	7.5	2.5
Total	**100**	**100**	**100**	**100**	**100**

Source: MSCI[4]

4 MSCI, 2025. MSCI PIMFA Private Investor Index Series. Retrieved from https://www.msci.com/pimfa-private-investor-indexes (Retrieved: September 2025)

5. Statistical Data

5.1 Portfolio Return Calculations

Learning Outcome

7.1.1 Understand the valuation principles of time-weighted and money-weighted rates of return

The performance measurement process involves calculations of the investment return over stated periods. The portfolio return calculations can be measured in a number of ways, but we will look at the three most common in this section:

- Holding period return (HPR)
- Money-weighted rate of return (MWRR)
- Time-weighted rate of return (TWRR).

5.1.1 Holding Period Return (HPR)

HPR is a simple calculation that looks at just the return made over the period of an investment, expressed as a percentage of the cost:

$$\text{HPR}(\%) = \frac{D + V_1 - V_0}{V_0}$$

where:

D = the income received in the period
V_0 = the price or value at the start of the period
V_1 = the price or value at the end of the period

Example

An investment costs £2,000, pays a dividend of £100 and is sold for £2,050 after one year. The holding period return (HPR) is:

$$\text{HPR} = \frac{100 + 2{,}050 - 2{,}000}{2{,}000} = 0.075 \text{ or } 7.5\%$$

Example

Investment A costs £1,000 and at the end of six months provides income of £50, and is immediately sold for £1,200. How can it be compared with investment B, bought at £500, held for one year and then sold for £800 with no income paid out?

HPR for Investment A:

Using this equation, the HPRs for Investment A can be calculated as follows:

$$\text{HPR} = \frac{50 + 1{,}200 - 1{,}000}{1{,}000} = 0.25 \text{ or } 25\% \text{ in six months}$$

HPR for Investment B:

Using this equation, the HPRs for Investment B can be calculated as follows:

$$\text{HPR} = \frac{0 + 800 - 500}{500} = 0.6 \text{ or } 60\% \text{ in one year}$$

The HPRs of A and B are not yet directly comparable, since B was invested for twice as long as A.

When A was sold, the proceeds could have been reinvested for another six months, but we do not know what return would have been available to the investor at that time.

To compare the returns, they must be for a standard period. This is achieved by using the equivalent period interest rate formula to annualise the returns as follows:

Investment A: HPR = 25% in six months. To annualise this return, we use the formula:

$$1 + \text{HPR}_{\text{annualised}} = \left(1 + \text{HPR}\right)^{n}$$

$$1 + \text{HPR}_{\text{annualised}} = \left(1 + 0.25\right)^{2} = 1.5625$$

$$\text{HPR}_{\text{annualised}} = 0.5625 \text{ or } 56.25\% \text{ in one year}$$

Investment B: HPR = 60% in one year

As a result of converting both returns to a common base of an annual return, there is now a standardised measure of return: this is the annualised HPR.

5.1.2 Money-Weighted Rate of Return (MWRR)

The MWRR, also called the money-weighted return (MWR), measures the overall return on capital invested over a specific period. It looks at not just the difference between the value of the portfolio at the start and end of a certain period, but incorporates any income or capital distributions made from the portfolio during that period.

The MWRR is calculated by finding the rate of return that will set the net present values (NPVs) of all cash flows to zero (ie, the rate of return where the PV of all cash flows equals the value of the initial investment); hence, it is also called the internal rate of return (IRR). The formula is complex, so when there are many inflows and outflows, MWRR/IRR must be determined through trial and error or by optimisation techniques.

One approach to calculate the MWRR (which is commonly used in the industry) is based on a modification of the HPR calculation. When new funds are invested or withdrawn during the year, the calculation can be modified. This will allow for the differences in the timing of capital additions or withdrawals, with a weighting incorporating the number of months remaining at the time of the additions or withdrawals.

$$\text{MWRR}(\%) = \frac{D + V_1 - V_0 - C}{V_0 + \sum\left(C \times \frac{n}{12}\right)}$$

where:

C = the net new money introduced during the year (if added, it is a positive figure; and if withdrawn, it is a negative figure)

n = the number of months remaining in the year at the time that the addition/withdrawal took place.

Example

A portfolio was worth £30,000 at the start of the calendar year and £34,000 at the end of the calendar year. During that year, an additional £4,000 had been invested at the end of April and £1,000 withdrawn at the end of October. There was an income payment of £150 during the year. Calculate the MWRR.

From the above, there has been a net cash inflow of £3,000 (ie, £4,000 – £1,000), so C = £3,000.

$$\text{MWRR} = \frac{150 + 34{,}000 - 30{,}000 - 3{,}000}{30{,}000 + (4{,}000 \times 8/12) + (-1{,}000 \times 2/12)} = \frac{1{,}150}{30{,}000 + 2{,}666.67 - 166.67} = 0.0354 \text{ or } 3.54\%$$

? A question for you to try! A portfolio was worth £25,000 at the start of the calendar year and £28,000 at the end of the calendar year. During the year, no additional money had been invested, but £1,000 was withdrawn at the end of June. There were no income distributions. What is the MWRR?

From the above question:

D = 0 (no dividends)
V_0 = 25,000 (value at the start of the year)
V_1 = 28,000 (value at the end of the year)
C = 1,000 (money withdrawn in the year)
n = 6 (money was withdrawn in June, so six months to the end of the calendar year)

$$\text{MWRR} = \frac{0 + 28{,}000 - 25{,}000 - \left(-1{,}000\right)}{25{,}000 + \left(-1{,}000 \times 6/12\right)} = 0.1633 \text{ or } 16.33\%$$

5.1.3 Time-Weighted Rate of Return (TWRR)

Whereas the MWRR measures the compound rate in the value of all funds invested over a specific period, the TWRR measures the compound rate of return over a given period for one unit of money. The MWRR is sensitive to the timing of external cash flows, whereas the TWRR is not affected.

The TWRR is, therefore, a more appropriate measure for evaluating managers who have no control over the size or timing of cash flows. Indeed, in order to comply with **global investment performance standards (GIPS)**, returns must be presented on a time-weighted basis.

The formula for TWRR can, therefore, appear extensive as a holding period return needs to be calculated for each sub-period, with a sub-period being the period of investment until the next cash inflow or outflow. The overall return is then established by compounding the returns of each sub-period.

For example, in the case of two investment periods:

$$\text{TWRR}(\%) = \frac{V_1}{V_0} \times \frac{V_2}{V_1 + C} - 1$$

where:

V_0 = the initial value
V_1 = the value at the end of the first investment sub-period
V_2 = the value at the end of the second investment sub-period
C = the additional capital added at the start of the second investment sub-period

From here:

$$R_{TWRR} = \left(1 + R_1\right)\left(1 + R_2\right) \ldots \left(1 + R_t\right) - 1$$

It may be best seen from an example.

Example

Assume that all investments are directed into a growth stock that is rising during the year. At the start of the year, its value was $100; after six months, $105; by the end of 12 months, it was worth $125.

Manager A receives $100,000 at the start of the period, while manager B receives $50,000 at the start of the period and a further $50,000 after six months.

Manager A:
Value of initial fund: $100,000 (ie, 1,000 shares at $100)

Value of final fund: $125,000 (ie, 1,000 shares at $125)

$$\text{HPR} = \frac{0 + 125{,}000 - 100{,}000}{100{,}000} = 0.25 \text{ or } 25\%$$

Manager B:

First Investment:

The $50,000 grows to be worth $52,500 after six months.

$$\text{HPR} = \frac{0 + 52{,}500 - 50{,}000}{50{,}000} = 0.05 \text{ or } 5\%$$

Second investment:

With the $50,000, manager B could only purchase 476 shares (50,000 / 105), so they start with 976 shares worth $102,480 (ie, 976 x $105). At the end of the period, the shares are worth $122,000 (ie, 976 x $125).

$$\text{HPR} = \frac{0 + 122{,}000 - 102{,}480}{102{,}480} = 0.1905 \text{ or } 19.05\%$$

This is not the end of the equation though. We now need to link these returns, which we can do as they apply to exactly the same period:

$$\text{TWRR} = \left(1 + 0.05\right)\left(1 + 0.1905\right) - 1 = 1.25 - 1 = 0.25 \text{ or } 25\%$$

We can see that both managers have achieved the same TWRR, which makes sense as both were invested in the same stock, and the TWRR has not been distorted by the additional cash flow that Manager B received after six months.

If we had just used the MWRR, the indication as to the manager's skill may have appeared different:

- Manager A's result would have been the same, at 25%.
- For manager B, MWRR = (0 + 122,000 – 50,000 – 50,000) / (50,000 + (50,000 x 6 / 12) = 0.2933 or 29.33%.

Despite the fact that both managers may have been instructed to invest in the same stock, by just using the MWRR it may have appeared that Manager B achieved a better outcome. However, that may have been due only to the fact that their client was not able to provide the second half of the overall payment for six months.

For comparison purposes, therefore, the TWRR is the preferred measure, as the result is not affected by cash flows and different new money flows. Based on what we have covered, an exact calculation of the TWRR would require a full valuation of the portfolio whenever a cash flow occurs. In practice, approximations are made so that the TWRR can be calculated using either monthly or quarterly valuations. For GIPS, portfolios must be valued for return calculations at least monthly, and also whenever large external cash flows occur. The definition of a large external cash flow can be formulated by the firm, but they must then use the definition consistently.

However, there are occasions when the MWRR may be a more appropriate measure. Considering the example that we looked at, it may have been luck that the client was not able to provide additional funds for six months. Alternatively, it may have been the manager's recommendation to hold back half the payment for six months, in which case their decision was validated by the MWRR. Therefore, for situations where managers control the size and timing of cash flows, it may be more appropriate to judge them on the MWRR.

5.2 Annual Equivalent Rate (AER)

The AER shows the rate of interest a saver will receive over a year, assuming the cash is left in the account for the full year.

The means of calculating AER is the same as that used for calculating the annual percentage rate (APR), although there is a key difference between them: AER is the term used for investments and savings, and APR is used for loans. They are both effective annual rates (EAR) and represent the higher rate of interest as a result of compounding.

For example, it is apparent that an investment paying 4% pa with interest paid quarterly in arrears will return more than an account paying 4% pa with interest paid annually in arrears, but by how much more? That is where AER may prove helpful:

$$AER = \left(1 + r / n\right)^{n} - 1$$

where:

r = the annual rate of return
n = the number of interest payments

An account paying 4% pa paid quarterly will return:

$$\text{AER} = \left(1 + 0.04 / 4\right)^4 - 1 = 0.0406 \text{ or } 4.06\%$$

This is more than a return on an investment paying 4% annually.

You can also work out the AER from the return over a longer period by using the following formula:

$$\text{AER} = \sqrt[n]{\left(1 + r\right)} - 1$$

where:

n = the number of years
r = the return over the period

If a return is 40% over three years, the annual equivalent rate is:

$$\text{AER} = \sqrt[3]{\left(1 + 0.4\right)} - 1 = 0.1187 \text{ or } 11.87\%$$

This is less than the simple annual rate of 13.33%, (ie, 40% / 3) due to compound interest; in other words, the interest paid on the initial deposit plus accumulated interest over time.

6. Performance Evaluation

In this section, we will look at evaluating how an investment manager achieves their returns. Was it due to their skill in stock selection, their overall asset allocation, or a combination of the two?

6.1 Stages of Evaluation

There are five stages to the process, which we will now look at, in turn.

6.1.1 Step 1: The Benchmark

Select the benchmark. We have already seen examples of different benchmarks in section 4 of this chapter. As mentioned then, it is important that the choice of benchmark is appropriate to the portfolio being reviewed, or the review process will not be helpful or could be misleading.

6.1.2 Step 2: The Benchmark Asset Allocation

You then need to ascertain the asset allocation of the benchmark chosen. For example, the asset allocation split based on the FTSE Private Investor Index Series or the MSCI PIMFA Private Investor Index Series, which we covered in section 4.4 of this chapter. For the purposes of this example, we will use the MSCI PIMFA Private Investor Balanced Index, which you will recall is as follows:

Asset class	Asset distribution (%)
UK Equities	15.0
International Equities	45.0
Government Bonds	5.0
Corporate Bonds	15.0
Inflation-Linked Bonds	2.5
Cash	2.5
Real Estate	2.5
Alternatives	12.5
Total	**100**

6.1.3 Step 3: The Benchmark Returns

You then need to calculate the return that each asset class in the benchmark portfolio would have achieved if it had performed in line with the appropriate index for its sector (the percentage return figures shown are for illustrative purposes only).

Asset Class	Asset Distribution (%)	Index Performance for Each Class (%)	Contribution to the Overall Return (%)
UK Equities	15.0	7.14	1.07
International Equities	45.0	12.92	5.81
Government Bonds	5.0	–6.35	–0.32
Corporate Bonds	15.0	–3.26	–0.49
Inflation-Linked Bonds	2.5	–9.42	–0.24
Cash	2.5	0.40	0.01
Real Estate	2.5	–7.86	–0.20
Alternatives	12.5	1.37	0.17
Overall contribution to return			**5.83**

If a portfolio manager had copied the asset distribution of the chosen benchmark and performed at exactly the index level for each asset class, they should have achieved a 5.83% return.

6.1.4 Step 4: Comparison of Asset Allocation

The next step is to compare the benchmark performance with the actual portfolio's performance, but in terms of asset allocation only. With comparisons of this sort, you need to maintain a control figure; therefore, at this point, we ignore the actual performance achieved by the portfolio manager. We are keen to only concentrate on the returns they would have got had they achieved the index performance of each asset class.

The results should show how effective (or otherwise) the portfolio manager's choice of asset allocation was:

Asset Class	Asset Distribution (%)	Index Performance for Each Class (%)	Contribution to the Overall Return (%)
UK Equities	15.0	7.14	1.07
International Equities	50.0	12.92	6.46
Government Bonds	2.5	–6.35	–0.16
Corporate Bonds	10.0	–3.26	–0.33
Inflation-Linked Bonds	10.0	–9.42	–0.94
Cash	2.5	0.40	0.01
Real Estate	5.0	–7.86	–0.39
Alternatives	5.0	1.37	0.07
Overall contribution to return			**5.79**

The portfolio's overweighting to international equities would appear to be effective, as the returns from this asset class exceeded that from the benchmark portfolio. The underweighting to government corporate bonds, cash and alternatives (which did not perform as well as the benchmark) also contributed. All in all, these helped the overall return of the portfolio.

On the other hand, the underweight allocation to UK equities (which performed well) and the relative overweights to inflation-linked bonds and real estate detracted.

6.1.5 Comparison of Stock Selection

The final step is to calculate the effect of the portfolio manager's stock selection to see if the portfolio overperformed or underperformed within each asset class relative to the benchmark. However, as it currently stands, the numbers are skewed because of the differing asset allocations, so we will need to strip this out for a fair comparison – this is done by working out the difference in performance for each segment, then multiplying by the benchmark's allocation so that they are equally weighted:

$$\text{Contribution to return} = \left(\text{Actual performance} - \text{Benchmark performance}\right) \times \text{Benchmark asset distribution}$$

In this example, the actual performance achieved by the portfolio manager is included in the table below, as well as the contribution for each asset class to their overall portfolio return:

Asset Class	Asset Distribution (%)	Index Performance (%)	Actual Performance (%)	Difference (%)	Contribution to Return (%)
UK Equities	15.0	7.14	5.81	–1.33	–0.20
International Equities	45.0	12.92	10.12	–2.80	–1.26
Government Bonds	5.0	–6.35	–4.97	1.38	0.07
Corporate Bonds	15.0	–3.26	–5.41	–2.15	–0.32
Inflation-Linked Bonds	2.5	–9.42	–4.65	4.77	0.12
Cash	2.5	0.40	0.50	0.10	0.00
Real Estate	2.5	–7.86	–10.32	–2.46	–0.06
Alternatives	12.5	1.37	–4.99	–6.36	–0.80
Overall contribution to return					**–2.45**

The table illustrates that overall asset allocation was good, but specific investment selection was poor. The equity investment returns were particularly disappointing – maybe the portfolio manager stayed invested in a particular sector or stock for too long, and that had the detrimental effect? This was worsened by being overweight in international equities. On the other hand, this was compensated for partially by effective security selection within government and inflation-linked bonds.

Performance is what is quoted as opposed to good financial planning. The reality is that good financial planning remains the most critical part of the wealth management process. Getting this wrong means that the rest of your service can be compromised. Another way to say this is 'focus on process rather than short-term results', because over time, a well-structured investment process should generate superior returns.

Glossary

Investment Terms

Account

An arrangement whereby a body (such as a bank, building society or asset manager) holds funds on behalf of a single client, or a group of clients.

Accumulation Shares/Units

Shares or units in a fund that automatically have income reinvested into that fund.

Active Management

Active fund managers believe securities are mispriced and they can spot opportunities to outperform the market through asset allocation and/or stock selection.

Active Risk

The risk arising from active management in excess of the risk that would be incurred if the portfolio was passively managed (ie, the weighting differential versus the benchmark/ index).

Actuary

A professional skilled in evaluating and assessing the potential impact of risks. Actuaries monitor and advise on the solvency of life assurance companies and pension funds.

Additional Voluntary Contributions (AVCs)

Employee contributions over and above any compulsory contributions to a tax-approved occupational pension scheme. Free-standing AVCs (FSAVCs) are not connected to an employer's pension scheme.

Advisory

A service where a client seeks professional investment guidance from a portfolio manager. The manager must consult with, and obtain authorisation from, the client before making changes to their portfolio.

Aggregation

Multiple client orders are bulked together and processed as a single order. Customers must be notified of this procedure as well as its advantages and disadvantages.

AIM

The UK market designed to help companies that are either too small or too new for a listing on the official list of the stock exchange. Formerly called the Alternative Investment Market.

Allocation

The division of a single aggregated order between two or more investors' accounts.

Alpha

The outperformance of a portfolio against the benchmark attributable to the fund/portfolio manager's strategy.

Alternative Investments

Investments outside the mainstream areas of bonds, equities, cash and property. They normally form a small proportion of portfolios. Examples include hedge funds and venture capital.

Annual Allowance

A limit up to which tax relief applies, each year. This applies to capital gains tax (CGT), income tax, inheritance tax (IHT) and pensions; and can be a valuable tool in an individual's tax planning.

Annual Management Charge

A charge imposed each year by a management firm on a portfolio or fund.

Annuity

A fixed sum of money, paid to someone each year (normally in in the form of a pension).

Approved Person (APs)

In the UK, an individual who has been approved by the Financial Conduct Authority (FCA) to perform one or more controlled functions for an authorised firm.

Arbitrage

A strategy used by market traders to exploit the price difference between similar assets.

Artificial Intelligence (AI)

The science of teaching computers to mimic human learning. Using special algorithms and through iteration, it has been possible to generate very complex behaviour and solve problems and detect patterns which would be difficult for a person. AI is often conflated with General Artificial Intelligence (GAI) – ie, a computer which is able to think completely on its own – although GAI has not been achieved yet. Instead, machine learning (ML) is an applied form of AI and is often highly tailored to the specific problem (for example, image recognition) being solved.

Asset Allocation

The distribution of investments across different assets classes.

Asset Class

High-level categorisation of various groups of securities (eg, equities, bonds, property and cash).

Association of Investment Companies (AIC)

The UK trade association for closed-ended investment companies (eg, investment trusts).

At Best

An instruction to deal at the best price ruling in the market at the time – ie, the highest price (selling) or lowest (buying).

At-the-Money (ATM)

When the market price of the underlying instrument is the same as the exercise price of the option/warrant.

Auction

The normal process of selling government securities. The central bank accepts bids down to the lowest acceptable price (ie, highest yield).

Authorisation

The process whereby firms seek approval from the FCA to carry on a regulated activity in the UK. Regulated collective investment schemes (CISs) are also authorised.

Authorised Person

In the UK, a person (or entity) who has Part 4A permission to carry on one or more regulated activities.

Backwardation

An unusual occurrence in futures markets where the futures price is lower than the spot price. Opposite of contango.

Bank of England (BoE)

The central bank for the UK. Also referred to as the BoE or the Bank.

Bargain

Another name for a trade or transaction of the stock exchange.

Base Rate

The minimum rate at which banks will lend money to individuals.

Bear

Someone who believes prices will fall in the future. A bear market is a market in which share prices are falling, thereby encouraging selling.

Benchmark

A target against which investment performance is measured. It may be an index, a group of indices, or the average performance of similar portfolios (eg, CAPS or WMA).

Beneficial Owner

The true owner of a security, regardless of the name in which it is registered.

Best Execution

The duty of investment services firms that are executing orders on behalf of clients, to ensure that they seek the most favourable option to execute those orders within the prevailing market environment (eg, cost, speed, likelihood of execution and settlement in light of the size and nature of the deal).

Beta

The relative move of a security, portfolio or fund against the market.

Bid Price

The price at which securities (or units in a unit trust) are repurchased from the investor.

Bid-Offer Spread

Difference between the bid (selling) and offer (buying) price.

Bond

Security issued by a corporate or government, to back borrowing. The issuer guarantees to repay the principal sum on redemption date plus interest (coupons) during the life of the bond. Bonds may be secured over assets of the firm, or unsecured.

Bonus Issue

A process whereby free shares are issued to existing shareholders, out of company reserves. Often used instead of a cash dividend. Also called a scrip issue or capitalisation issue.

Book

The stock (or line) of securities held by market makers.

Book Value

Value at which a security is recorded on a statement of financial position (also called a balance sheet). Usually, the purchase cost less any depreciation.

Bottom-Up

Approach to investment management that gives priority to stock selection rather than asset classes. Bottom-up managers rely on identifying and selecting securities to build an optimum portfolio.

Budget Deficit

When a government spends more money than it collects through taxes. The opposite is called a budget surplus. It is used as an indicator for a country's financial health.

Bull

Someone who believes prices will rise in the future. A bull market is a market in which share prices are rising, thereby encouraging buying.

Call Option

The right to buy an underlying asset at a pre-determined strike/exercise price.

Cancellation

The destruction of units in open-ended funds as cash is taken out of the fund (redemption).

Capital

The money injected into a business by shareholders and bondholders.

Capital Account

An account relating to the capital property of a portfolio (ie, excluding income).

Capital Asset Pricing Model (CAPM)

An economic model for valuing securities. It is a mathematical model that enables investors to determine the expected return from a security. The model uses beta as the main measure of risk.

Capital Gains Tax (CGT)

Tax paid by chargeable persons on profits realised from selling qualifying assets above the annual allowance; and after adjusting for losses, tax reducers and business relief (if applicable).

Capital Requirements Directive (CRD)

Designed to ensure that UK and European Union (EU) firms (eg, banks, building societies and most investment firms) hold adequate resources and have adequate systems and controls to manage both their businesses and the associated risks.

Capitalisation

Total market value of share capital issued by a company, calculated by multiplying the number of ordinary shares in free float by the price.

Capital Markets

The financial market for equity instruments and debt instruments with a maturity greater than one year.

Cash Flow

A measure of the cash moving through a company. It provides a useful indicator as to how much money is being generated by a company, thereby indicating its financial health.

Cash Memorandum Account (CMA)

A record of a CREST member's running total of a day's payment obligations to or from its payment bank. CMAs are set to zero at the start of each day, because at the end of each day, net payments are settled between payment banks.

Central Bank

Typically, responsible for setting a country's or a region's short-term interest rate, controlling the money supply, acting as banker and lender of last resort to the banking system and managing the national debt.

Chargeable Lifetime Transfer (CLT)

Transfers that are not exempt, or potentially exempt, from inheritance tax (IHT).

Child Trust Fund (CTF)

Long-term savings and investment accounts specifically for children, born on, or after, 1 September 2002 and before 3 January 2011. Replaced by junior individual savings accounts (JISAs) in 2011.

Chinese Wall (Information Barrier)

Separation of different activities in an investment bank (eg, investment management, corporate finance and broking). Aims to prevent confidential information passing from one area to another.

Churning

Excessive trading by a broker in order to generate commission, regardless of the interests of the customer.

Class

A designation applied to shares in a company/ Open-Ended Investment Company (OEIC) or units in a unit trust. Some companies have more than one share class (eg, ordinary, preference) which indicates shareholders' voting and

dividend rights, and the order of priority in the event of liquidation. For funds, different share classes have different annual charges; and they determine if income is paid out ('income') or used to purchase more shares/units ('accumulation').

Clean Price

The price of a fixed-income security that excludes accrued interest.

Client Assets/Client Money

Securities or other assets (such as cash) held by a firm on behalf of its clients. The assets have to be kept separate (segregated) from the firm's own assets.

Clearing

Confirmation of trade details with the counterparty or the exchange.

Collar (or Cylinder, Tunnel, Fence or Corridor)

The sale of a put (or call) option and purchase of a call (or put) at different strikes; typically both out-of-the-money and the purchase of a cap combined with a sale of a floor.

Collateral

A form of security, guarantee or indemnity provided by way of security for the discharge of any liability arising from a transaction.

Combined Actuarial Performance Services (CAPS) ltd

Independent performance measurement service widely used by pooled funds to compare the performance of the portfolio manager.

Commercial Paper (CP)

Unsecured short-term debt issued by banks, corporates and other borrowers as part of a funding programme.

Commission

Fee paid to a broker for buying or selling a security. Usually, a percentage of the cost.

Commodity

Any item that can be bought and sold. Usually a physical item (eg, gold, oil, meat, coffee, and sugar).

Competition and Markets Authority (CMA)

A non-ministerial government department that aims to strengthen business competition, and to prevent and reduce anti-competitive activities, for the benefit of consumers in the UK. It has also concurrent powers with the FCA under the Competition Act 1998 and the Enterprise Act 2002.

Concentration

The number of different shareholdings in a portfolio. The fewer the securities held, the more concentrated the portfolio is said to be.

Consideration

The monetary value of a deal excluding commissions, stamp duty and other taxes (eg, VAT). Total consideration will include the above.

Consultants

Actuarial and insurance firms that advise trustees (eg, choosing portfolio managers, meeting managers, asset allocation strategies).

Contango

A futures market occurrence where the spot price is lower than the futures price. Opposite of backwardation.

Constraints

Limits or restrictions imposed on a fund/portfolio manager in relation to stocks, sectors or markets.

Consumer Duty

A piece of UK regulation that sets higher and clearer standards of consumer protection across financial services, and requires firms to put their customers' needs first.

Consumer Price Index (CPI)

A measure of inflation, and how the cost of living is changing over time.

Contract for Difference (CFD)

A contract designed to make a profit or avoid a loss by reference to movements in the price of an item. The underlying item cannot change hands.

Contract Note

A document sent to investors on a purchase or sale being made, detailing the price at which the securities were traded, among other factors.

Convertible Loan Stock

Unsecured loan stock (ULS) that usually converts into equity of the issuing company.

Core/Satellite Portfolio

The partitioning of assets between a core portfolio (lower risk/tracking funds) and more actively managed satellite funds (higher risk).

Corporate Actions

Actions involving issued securities other than trading. The decision may come from the issuer (eg, distribution, redemption) or the holder (eg, conversion or exercise of warrants).

Corporate Bond

Securities issued by a company (as opposed to government). Investors accept credit risk in exchange for potentially greater returns.

Corporate Governance

How shareholders govern the management of a company using voting powers.

Correlation

The strength of a linear relationship between two investments, measured between ±1. A perfect correlation is when the investments behave in exactly the same manner, either in the same (+1) or in opposite directions (–1). In portfolio construction, diversification is achieved by combining stocks with little or no correlation to one another.

Coupon

The regular payment made on fixed-income securities.

Covered Warrants

A type of option issued by a third party, usually a major securities house, whereby the writer of the warrant (an investment bank) will often 'cover' or hedge their exposure by buying the underlying stock or taking out futures or options on the derivatives exchange. They may be issued on baskets of shares, debt securities, currencies, metals, and oil.

Creation

Making new units in open-ended funds, to accommodate cash inflows.

Credit Rating

Rating given to a company or institution by a credit rating agency as an indication of the likelihood of default on its bonds or other debt. The highest (lowest risk) rating is called 'triple A' (Aaa as given by Moody's, or AAA by Standard & Poor's and Fitch).

CREST

The UK settlement system for shares, gilts, money market securities, ADRs and mutual funds. Institutions may be sponsored members of CREST or settle using broker nominee accounts.

Criminal Justice Act (CJA) 1993

A substantial act which includes provisions relating to insider dealing, including a definition of that offence.

Cum-dividend (cum-div)

Shares generally trade with any entitlement to the next dividend going to the buyer whose name will be on the register at the record date. Shares sold with the entitlement are sold with (cum) the dividend.

Custody

Safekeeping of client assets. Firms are required to be able to identify client assets separately from firm's assets. The firm may use nominee accounts to pool securities of different clients.

A global custodian is responsible for this operation on a worldwide basis. They may appoint local custodians (depots or sub-custodians) in certain countries.

Customer Due Diligence (CDD)

The process of obtaining proof of a customer's identity and their source of wealth and funds. For clients not covered by an exemption and for those that present a standard level of risk, prescribed CDD applies.

Cyclical Stock

Security that is sensitive to fluctuations in the economic or business cycle (eg, capital goods, banks).

Debenture

Loan stock secured against the assets of the borrower (corporation). They are usually paid out first if the firm goes into liquidation.

Debt-to-Equity Ratio

The ratio of long-term debt to equity in a company.

Defensive Stock

Security that is less sensitive to movements in the economic or business cycle (eg, utilities, tobacco).

Denomination

A unit of value, most commonly assigned to financial instruments as well as physical currency.

Depositary

Bank acting as custodian of the securities held by the sub-funds of an OEIC.

Derivatives

Collective term given to forwards, futures, swaps and options that derive their value from an underlying asset. These are contracts that give the contract holder either the obligation or the choice to buy or sell a financial asset or commodity at some future time.

Delivery versus Payment (DVP)

This is the ideal method of settlement whereby cash and securities are switched simultaneously between client accounts, reducing settlement risk.

Depositary Receipt (DR)

A negotiable certificate representing shares in a foreign company traded on a local stock exchange providing investors with a straightforward way of trading on the international markets. One of the most common types are American depositary receipts (ADRs). Global depositary receipts (GDRs) are issued in more than one country.

Dilution

A fall in existing shareholders' ownership of a company when convertible securities are converted, and warrants and stock options are exercised. From the company's perspective, it affects earnings per share and book value per share (EPS). It also impacts the transaction costs on pooled funds due to investors buying/selling.

Dilution Levy

Charge imposed on a large purchase or sale of units in an open-ended collective investment (eg, OEIC, SICAV), to discourage investors from entering or leaving a fund that may otherwise adversely affect existing shareholders.

Dirty Price

The price paid for a fixed-income security, including accrued interest.

Discretionary

A service whereby a client delegates decision-making to a third party (eg, a discretionary portfolio manager, or discretionary stock lending undertaken by a global custodian).

Diversification

Risk reduction by spreading investments across a wide variety of asset classes, geographies and individual investments within a portfolio, and whose prices do not move in tandem with each other (ie, correlation).

Dividend

The distribution of profits by a company to its shareholders. The dividend may be passed or cut if profits fall. The technical term for the coupon on a government bond is also 'dividend'.

Dividend Cover

Company's total earnings (profits) divided by the total paid in dividends. Used as an indication of the company's ability to maintain its dividend payments.

Dividend Yield

The annual income (usually interim plus final dividend) from a share divided by the market price of the share, as a percentage.

Domicile

The country that an individual regards as their natural home. They may only have one domicile at a time. This is not necessarily the same as residence or nationality.

Durable Medium

A suitable permanent electronic or paper file (if the client is known not to have access to the internet) that remains accessible by the client for future reference.

Earnings

Net profits of a company after interest, tax, and any preference dividends have been deducted.

Earnings Yield

Company's earnings per share divided by its current share price. The inverse of the P/E ratio.

Efficient Market Hypothesis (EMH)

The theory that the public availability of relevant information about the issuers of securities will lead to a correct pricing of those securities if they are freely traded in properly functioning markets.

Eligible Contract Participant (ECP)

An entity (eg, a corporation, partnership, organisation, trust, or brokerage firm) or individual (ie, an investor with total assets in the millions) allowed to engage in certain transactions that are not available to the average investor.

Emerging Market

A developing or newly industrialised nation with low gross domestic product (GDP) per head. Can deliver high returns due to rapid pace of industrialisation, but can be risky due to factors such as poor legal protection, currency, custody and settlement risk, and government corruption.

Endowment Policy

A life assurance policy that pays out a sum assured on the death of the life assured, or at the end of an agreed term, whichever is the earlier. The money is traditionally invested in a range of securities, including equities. A traditional with-profits policy may provide a higher payout by the addition of bonuses.

Enhanced Due Diligence (EDD)

The process of obtaining proof of a customer's identity and their source of wealth and funds. EDD should be undertaken when there is scope for the firm to be at risk of being used for money laundering or terrorist financing.

Enterprise Investment Scheme (EIS)

A UK government-sponsored programme designed to encourage investment in certain types of smaller unquoted UK companies by providing tax incentives.

Equalisation Payment

A return of capital when an investor first buys units/shares in a unit trust/OEIC. As such, it is not liable to income tax, but is deducted from the cost of the holding when calculating any chargeable gain on an eventual disposal.

Equities

Ordinary shares (ie, the risk-taking part of a company's capital) which confer full voting and dividend rights to the owner. Equity holders rank last in the event of the winding-up of a company and for income distribution. Also called common stock or common shares.

Equity Risk Premium

The extra return expected from investing in equities rather than a risk-free asset.

Environmental, Social and Governance (ESG)

A form of investing that focuses on companies that are addressing (or developing ways to address) at least one of the key dimensions of sustainable investing: environmental, social and corporate governance issues.

Ethical Investment

The practice of selecting investments based on ethical or moral principles. This involves filtering out unethical companies involved in the 'sin stocks' (ie, alcohol, tobacco, gambling, adult entertainment and weapons manufacture). At the same time, it may involve supporting ethical companies, that are making a positive contribution through their products and services.

Eurobond

International negotiable, bearer loan stock (bonds) issued outside the country of the issuer, traded over-the-counter (OTC). Coupons are paid gross. Accrued income is calculated on a 30/360-day basis.

Euroclear

The alternative European settlement house with Clearstream. Euroclear settles international bonds, gilts and shares. It is an international securities depository (ISD).

Ex-Dividend (ex-div)

Where the dividend related to a share belongs to the seller who is named on the share register, rather than the buyer. The price of the share is therefore usually discounted to allow for the fact that the buyer will not receive the dividend that will be paid after the buyer has bought the share.

Execution-Only

A transaction executed on the specific instructions of a client where the firm does not give advice on investments relating to the merits of the transaction. The rules on assessment of appropriateness do not apply.

Exchange-Traded Funds (ETFs)

Open-ended funds traded on an exchange. Most EFTs aim to track the performance of a specified index, although some are actively managed.

Exercise Price

The price at which the holder of an option or warrant can buy/sell the underlying asset.

Exit Charges

Managers can levy a charge on the sale of units/shares in a fund, rather than an initial charge.

Expiry

The date on which an option or warrant expires.

Fair Treatment of Customers (FTOC)

Principle 6 of the FCA's Principles for Businesses (PRIN), to ensure the fair treatment of (and desirable outcomes for) customers.

Fallen Angel

A bond that has migrated from investment to non-investment grade. It has increased credit (default) risk.

FCA Handbook

Sets out the FCA's rules with which all regulated firms in the UK must comply. It is divided into blocks, each of which contain sourcebooks.

Financial Adviser

An authorised person who provides personal recommendations in relation to retail investment products to their retail clients.

Financial Conduct Authority (FCA)

The UK regulator responsible for conduct issues across the entire spectrum of financial services. It is also responsible for market supervision as well as prudential supervision of firms not supervised by the Prudential Regulation Authority (PRA).

Financial Ombudsman Service (FOS)

Part of a statutory complaint procedure. The Ombudsman deals with complaints against investment firms, that the firm has not been able to resolve.

Financial Policy Committee (FPC)

An official committee of the BoE with responsibility for macro-prudential regulation: regulation for stability and resilience of the financial system as a whole.

Financial Services and Markets Act (FSMA) 2000

UK legislation that created a new regulatory framework for the supervision and management of the UK's banking and financial services industries. It was amended by the Financial Services Act (FSA) 2012.

Financial Services and Markets Act 2023

UK legislation that introduced several important updates to the UK's regulatory framework for financial services – for example, creating new, or expanding existing, enforcement powers of the BoE.

Financial Services Act (FSA) 2012

Amended the Financial Services & Markets Act (FSMA) 2000. It replaced the then regulator with the FCA and Prudential Regulatory Authority (PRA); and established the Financial Policy Committee (FPC) on a statutory basis.

Financial Services Compensation Scheme (FSCS)

The UK's statutory compensation fund of last resort, established to compensate eligible claimants when authorised firms fail.

Floor

A package of interest rate options whereby at each of a series of future fixing dates, if an agreed reference rate of interest is lower than that of the strike rate, the option buyer receives the difference between them, calculated on an agreed notional principal amount for the period until the next fixing date.

Flotation

The first issue of shares by a company of a stock exchange. An example of an initial public offering (IPO).

Free Float

The proportion of a company's shares that are traded in the stock market.

Fund

Usually, a single asset class over which several investors have pooled ownership.

Fundamental Analysis

Assessment of a company's share value and potential for future profit and dividends, based on accounting information and economic analysis.

Gearing

The amount of borrowing vs debt on a company's statement of financial position (or balance sheet, calculated as net debt/ordinary shareholders' funds. Warrants and options also exhibit gearing (ie, a small move in the price of the underlying asset can be magnified in the move in the price of the option).

Gift with Reservation

A gift which is not fully given away by the donor, so the donee either receives the gift with conditions attached, or the donor retains some benefit.

Gilts

UK government securities.

Global Investment Performance Standards (GIPS)

Set of minimum performance presentation standards for investment managers. Sponsored by the Association of Investment Management & Research and intended for global comparison of investment performance.

Global Sustainable Investment Alliance (GSIA)

A consortium of membership-based sustainable investment organisations around the world that aims to 'deepen and expand the practice of sustainable investment through intentional, international collaboration'.

Gross National Income (GNI)

The sum of value added by all resident producers plus any product taxes (minus subsidies) not included in the valuation of output plus net receipts of primary income (compensation of employees and property income) from abroad.

Gross Redemption Yield (GRY)

The total return earned by holding a fixed-interest security to maturity (redemption). Includes coupon and the capital gain/loss on redemption. Also known as yield to maturity (YTM) or discount rate.

Growth Stock

A company that is expected to achieve higher-than-average earnings growth. Growth stocks usually have a high price/earnings (P/E) ratio relative to the market as a whole.

Hedge

Taking an opposite position to the main strategy of a portfolio. For example, the sale of futures contracts or purchase of put options, could limit or prevent a loss in the event of a market decline.

Hedge Fund

A limited partnership with few investment restrictions. Usually based offshore (eg, the Cayman Islands), but shares in the fund are often quoted in Luxembourg or Dublin.

Hedge funds can use a number of strategies including sell short (ie, sell stock they do not own to profit from price falls). Some hedge funds gear up to increase leverage, which may result in large losses.

Hold-Over Relief

A form of capital gains tax (CGT) deferral where the donor of gifts of certain assets can effectively hold over the gain so that no CGT becomes payable at the time of the gift, but the acquisition cost of the receiver is reduced by the amount of the held-over gain.

Iceberg Orders

Generally, an order type that specifies an additional display quantity, which is smaller than the overall order quantity. The order is queued along with other orders, but only the display quantity is printed to the market depth.

Impact Investing

Investment into companies to generate a positive environmental or social impact, alongside a financial return. Impact investors are prepared to consider the positive or beneficial impact of their investment as part of their overall 'return'.

Income

Receipts from earnings or investments owned.

Income Units/Shares

Units or shares in a fund that pay out distributions and dividends to investors in that fund.

Income Tax

Tax paid on earned and unearned income by individuals.

Independent Financial Adviser (IFA)

An authorised person who provides personal recommendations in relation to retail investment products to their retail clients based on a comprehensive and fair analysis of the relevant market, and is unbiased and unrestricted.

Index

A basket of securities to provide a benchmark for performance measurement. May be single sector/country, regional or global.

Index-Tracking Fund

Funds that seek to produce returns in line with an underlying benchmark (usually a stock index). The manager does not take active bets. The fund may buy stocks or track using quantitative techniques or derivatives.

Individual Savings Account (ISA)

A tax-efficient wrapper around investment products including cash in the UK.

Inflation

A measure of the rate of change in prices or earnings. In the UK, inflation is measured by indices such as the retail prices index (RPI) and the consumer prices index (CPI).

Information Ratio

The extra return from a portfolio vs the benchmark relative to the deviation from an index.

Inheritance Tax (IHT)

Tax on an estate (ie, property, money and other assets) of someone who has died.

Initial Charge

Charge imposed on buyers of new shares/units in a collective investment scheme (CIS).

Initial Public Offering (IPO)

The first issue of any class of security.

Insider Dealing

Knowingly trading in shares when in possession of price-sensitive information that is not widely known. This is illegal in several countries.

In-the-Money (ITM)

When the exercise price of a call option or warrant is less than the underlying asset price, or when the exercise price of a put option is more than the underlying asset price.

Intrinsic Value

The amount by which the exercise price of an option or warrant is in-the-money.

Inverted Yield Curve

When the redemption yields of short-dated debt instruments are higher than those of long-dated debt instruments of the same credit quality.

Invest

To employ money in the purchase of anything from which interest or profit is expected.

Investment Trust

A closed-ended company whose shares are quoted on the stock exchange, with a fixed number of shares. The company invests in shares of other companies. The share price can move independently of the value of the underlying assets, so investment trusts can trade at a premium or discount to the net asset value (NAV).

Issuing House

An investment bank that masterminds a new issue. It is responsible for launching and marketing the new securities in return for a fee from the issuer.

Junior ISA (JISA)

A special type of ISA for children in the UK for children born after 3 January 2011 and who do not have a child trust fund (CTF).

Junk Bond

A bond that has been given a low rating by credit rating agencies ('BB' or lower by Standard & Poor's and Fitch, and 'Ba' or lower by Moody's). Traditionally, these bonds pay a higher yield to be able to attract investors.

Key Features

Factual information that must be sent out on request to inform new investors in an authorised fund, of the scheme objectives, charges and dealing procedures.

Key Investor Document (KID)

A stand-alone, pre-contractual, two-page document that, under the Packaged Retail Investment and Insurance Products (PRIIPs) Regulation, must contain the essential features of the fund and is to be systematically provided to investors before they decide to invest.

Key Investor Information Document (KIID)

A stand-alone, pre-contractual, two-page document that, under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, must contain the essential features of the fund and is to be systematically provided to investors before they decide to invest.

Leverage

The same as gearing.

Liabilities

Something that a person or company owes, usually a sum of money.

Life Tenant

An individual entitled to income on trust property, but not the capital. Those with an immediate right are called 'interest in possession', and those without an immediate right are called 'interest in remainder'.

Liquidity

The part of a portfolio that is held in cash or cash-like securities or the ability to buy or sell an asset quickly or to convert to cash quickly.

Listed Investments

Investments that have an official listing on one of the world's recognised stock exchanges. Also known as quoted investments.

Loan Notes/Loan Stock

Unsecured corporate bonds. May be convertible or have a warrant attached.

Long

Used to indicate a holding of a security or purchase of futures contracts.

Lump Sum Allowance (LSA)

A new lump sum regime, effective from 6 April 2024, that replaced the lifetime allowance (LTA) for pensions. It applies to tax-free cash that can be received as pension commencement lump sums, among other sums.

Lump Sum and Death Benefit Allowance (LSDBA)

A lump sum regime that applies to the tax-free components of lump sums payable during an individual's lifetime or upon their death, among other sums.

Macaulay's Duration

The weighted average term to maturity of the cash flows from a bond, including final repayment. Also called simply 'duration'.

Mandate

A contractual description of the service that a client will receive from a financial institution (eg, investment management or custody).

Market Capitalisation

The total market value of securities issued by a company, industry, sector or market. Calculated by multiplying the number of securities in issue, by the current market price.

Market Maker

A market professional who buys and sells stock on behalf of the broker-dealer firm.

Markets in Financial Instruments Directive (MiFID)

European law that provides harmonised regulation for investment products and services. MiFID II came into force in 2018, to address issues of MiFID in relation to transparency, investor protection and market infrastructure. MiFID was transposed into UK law in 2017.

Markets in Financial Instruments Regulation (MiFIR)

A regulation which came into effect alongside MiFID II in 2018, following a review of MiFID and as a response to the financial crisis of 2007–08. Following the end of the Brexit transition period, this has been onshored into UK law by virtue of the European Union (Withdrawal) Act 2018.

Median

One form of the average. The middle item in a ranked order.

Mid-Price

Halfway between the bid and offer prices. OEICs operate on a mid-price basis, for example.

Mixed Investment

Funds invested in a range of asset classes (eg, bonds, equities, cash and property) under the discretion of the fund/portfolio manager.

Modern Portfolio Theory (MPT)

A theory about how portfolios may be constructed, to optimise or maximise the expected return based on a given level of risk.

Modified Duration

The percentage change in the price of a bond resulting from a one percentage point change in the gross redemption yield (GRY).

Momentum

Extent to which prices are influenced by strong investor buying/selling.

Money Laundering

Aiding drug traffickers, arms dealers and other criminals to invest their proceeds and take 'clean' money out of the system. An international criminal offence. It is an offence to fail to report the knowledge or suspicion of money laundering by a client.

Money Purchase Annual Allowance (MPAA)

In the UK, the annual limit for tax relief on contributions to a pension scheme, once a person has flexibly accessed their pension.

Multilateral Trading Facility (MTF)

A regulated activity which allows investors to trade shares or other securities by means other than on a recognised investment exchange (RIE).

National Association of Securities Dealers Automated Quotation (Nasdaq)

The OTC market run in the US on a market-making basis specialising in high technology and biotechnology shares.

Net Asset Value (NAV)

The aggregate value of the securities in a fund, net of liabilities (eg, money owed to lending banks, investment manager's fee). This value is used as the basis for valuing the units (or shares) in a collective investment fund.

Also, a company's break-up value. Used by value investors as a measure of the price to pay for a company's shares.

Nil-Paid

A new issue of shares on which no payment to the company has yet been made.

Nil Rate Band (NRB)

In the UK, the value of an estate that is not chargeable to inheritance tax (IHT).

Normal Market Size (NMS)

The average size of bargains transacted in a particular share. A market maker's prices are firm for the NMS. Prices are negotiable for deals outside the NMS.

Nominal Value

Par value of a security (eg, redemption value on a bond).

Nominated Adviser (NOMAD)

A requirement for companies seeking a listing on AIM. Their role is to advise directors of their responsibilities under AIM rules, and the content required in the prospectus that they must issue, in order to be admitted to the AIM.

Nominated Broker

A requirement for companies seeking a listing on AIM. Their role is primarily to make a market and facilitate trading in the shares of the company.

Nominee

The legal owner of securities that are held by a third party on behalf of the underlying beneficial owner. Nominee accounts may be pooled (ie, the details of the beneficial owners are only known to the nominee company) or designated (ie, individual owners are identified on the register, along with the nominee).

Offer Price

The price at which securities (or units in a unit trust) are sold to the investor.

Offshore Funds

Collective investment funds run in an offshore jurisdiction with favourable tax regimes. Usually, minimal regulatory oversight and investor protection.

Open-Ended Funds

A type of collective investment scheme (CIS). Cash inflows from new investors increase the NAV of the fund and new units/shares are created, while redemptions (outflows) from the fund cause the NAV to shrink. Investors' units/shares are repurchased and may be cancelled. Unit trusts, open-ended investment companies (OEICs) and exchange-traded funds (ETFs) are types of open-ended funds.

Open-Ended Investment Company (OEIC)

Open-ended collective investment schemes that may have several sub-funds and different share classes.

Open Outcry

A trading approach where trades are conducted on the floor of the exchange. Largely replaced by electronic trading, although the New York Stock Exchange (NYSE) and some derivative exchanges still operate an open outcry floor.

Option

A security that confers the right to buy or sell an underlying asset at a predetermined strike (or exercise) price on or by a certain date. Options can be bought and sold to profit from the move in price of the option itself.

Ordinary Shares

See **Equities**.

Out-of-the-Money (OTM)

An option or warrant that is not worth exercising at the current price of the underlying asset; the option has time value only.

Over-the-Counter (OTC)

A security that is traded through a dealer network rather than a centralised, formal exchange. Examples include debt securities and derivatives.

Overweight

A larger allocation to a stock/sector/region (and so on) than the relevant benchmark weighting.

Packaged Product

A life policy, unit trust or open-ended investment company (OEIC), investment trust saving scheme, stakeholder pension or personal pension.

Packaged Retail and Insurance-based Investment Products (PRIIPs)

A market-based EU regulation that aims to support the European single market, enhance comparability with UCITS funds, and improve the overall comprehensibility of financial products for retail investors. It covers packaged financial products (including insurance products) that are publicly marketed in the EU and includes insurance policies. In 2020, PRIIPS was transposed into UK law (called UK PRIIPS).

Par

The nominal (or face) value of a security. Fixed-interest securities are usually redeemed at par. It is generally illegal for a company to issue its shares at a discount to par.

Part 4A Permission

Permission given by the FCA to carry on regulated activities in the UK.

Passive Management

An investment approach that aims to match the returns from an index/benchmark.

Passporting

Allows firms in one European Economic Area (EEA) state to establish branches or offer services in another EEA state, without the need for authorisation in each separate jurisdiction, under MiFID. Passporting rights between the UK and EEA ended on 31 December 2020.

Pension

A benefit for an individual upon their retirement.

Permanent Interest-Bearing Shares (PIBS)

A special type of share issued by building societies that pay a fixed rate of interest. They are undated, so can be very volatile when interest rates change; are not covered by a deposit protection scheme.

Perpetual Subordinated Bonds (PSBs)

A type of debt that has no maturity date for the return of principal, thus they pay coupons continually until redeemed by the issuer (although the issuer is under no obligation to do so). Permanent interest-bearing shares (PIBS) in demutualised former building societies have been converted to PSBs.

Placing

A new issue may be placed with a small number of institutions, thus reducing the costs.

Portfolio

Group of assets to meet the needs of a specific investor.

Potentially Exempt Transfer (PET)

A lifetime transfer by a donor to another individual, a bare trust, or a disabled trust. If the donor survives seven years, the transfer becomes fully exempt from inheritance tax (IHT); otherwise, tax due can be tapered down based on how long the donor lived after making the transfer.

Power of Attorney (PoA)

An individual who acts on behalf of and for the benefit of another.

Preference Shares

Shares which pay a fixed dividend (which is quoted as a net percentage of par). Preference dividends must be paid before ordinary dividends, but the dividend may be passed. Preference shareholders rank above ordinary shareholders if the company is wound up.

Price/Earnings (P/E) Ratio

The ratio of the market price of a share to the annual earnings per share.

Primary Market

The market for newly issued securities.

Private Equity

Unquoted shares in a company. The shares may never have been listed on the stock exchange or may have been issued to raise capital in a buyout.

Prospectus

A legal document accompanying the issue of shares in a share class by a company or investment fund. Contains information such as details of investment objectives and charges.

Protector

A person under a trust deed whose most common role is to veto the proposals of trustees. Unlike trustees, they do not have trust property vested in their name. Protectors are much more common in offshore trusts.

Proxy Votes

When a shareholder appoints someone else to vote on their behalf at shareholder meetings if they are unable to attend themselves.

Prudential Regulation Authority (PRA)

Established as part of the BoE for the prudential regulation of deposit takers (ie, banks, building societies, credit unions), insurers and systemically important investment firms.

Public Sector Net Cash Requirement (PSNCR)

The official name for the budget deficit in the UK. It is managed by the Debt Management Office (DMO) via the issuance of gilts.

Pump and Dump

A form of fraud that involves artificially inflating the price of an owned stock through false and misleading positive statements, in order to sell the cheaply purchased stock at a higher price. Once the operators of the scheme 'dump' their overvalued shares, the price falls and investors lose their money. Stocks that are the subject of pump-and-dump schemes are sometimes called 'chop stocks'.

Put Option

The right to sell an underlying asset at the strike price.

Qualifying Policy

A UK life policy that allows the proceeds to be paid tax-free, provided certain HM Revenue & Customs (HMRC) rules are followed.

Qualitative Analysis

Determining the value of an investment by examining non-numeric characteristics (eg, people).

Quantitative Analysis ('Quant')

The use of mathematical techniques to make investment decisions.

Real Estate Investment Trust (REIT)

A closed-ended vehicle that provides a liquid market in property investment with tax treatment similar to direct investment in property.

Redemption

Cash taken out of an investment.

Redemption Date (Maturity)

The end of a fixed period, when the nominal value of a redeemable security will be repaid to the investor.

Remainderman

Individuals who inherit, or are entitled to inherit, assets upon the death of someone else. Also called an 'interest in reversion' or 'reversionary interest'.

Repo

A repurchase agreement – ie, an agreement to sell securities and buy back (repurchase) at a later date. A **reverse repo** is the same transaction but from the buyer's perspective, not the seller's.

Residence

There is no statutory definition of residence. It is where a person lives. A person may have more than one residence or no residence at all.

Residence Nil Rate Band (RNRB)

An additional nil rate band in the UK, conditional on the deceased's home being passed to their children, grandchildren or other direct descendant.

Responsible and Sustainable Investing

An umbrella term representing three key investment strategies: environmental, social and governance (ESG); socially responsible investing (SRI); and impact investing.

Restricted Adviser

An authorised person who can only recommend certain products, product providers or both.

Retail Investment Product

A life policy, unit trust or OEIC, investment trust saving scheme, stakeholder pension or personal pension or any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset, a structured capital-at-risk product.

Retail Price Index (RPI)

A measure of the cost of living (inflation).

Retained Earnings

The part of a company's profit that is not paid away as a dividend. Used to produce future earnings by reinvesting into the business.

Return on Equity (ROE)

Company earnings divided by net asset value.

Reverse Yield Gap

The difference between the dividend yield on ordinary shares and the redemption yield.

Rights Issue

A new issue of shares offered to existing shareholders in proportion to their existing holdings. Usually offered at a discount to entice take-up that causes the existing shares to fall in value to the theoretical ex-rights price.

Risk

See **Standard Deviation**.

Safeguarded Benefits

Pension benefits other than money purchase or cash balance benefits.

Secondary Market

A market in which existing securities are traded.

Securities

Rights to payment of regular income or a share in the profits of a corporation. Negotiable – ie, may be market-traded or OTC.

Seed Enterprise Investment Scheme (SEIS)

An enhanced form of the UK government's enterprise investment scheme (EIS).

Self-Invested Personal Pension (SIPP)

A personal pension that generally allows more investment flexibility than an insured personal pension. Aimed at individuals wishing to benefit from a greater range of direct and fund investments.

Senior Managers and Certification Regime (SMCR or SM&CR)

A financial services regulation that aims to raise standards of governance and increase individual accountability initially among UK-regulated banks and insurers, to reinforce consumer confidence. Note, the current framework will undergo reforms by the FCA and PRA.

Separate Trading of Registered Interest and Principal of Securities (STRIPS)

Created when a government security is stripped into its component parts (coupons plus principal). Each part is sold as a separate zero coupon bond (ZCB).

Settlement

The delivery or receipt of securities in exchange for payment.

Sharpe Ratio

A measure of the excess return earned on a portfolio, per unit of absolute risk (standard deviation).

Shares

Form of security that represents a shareholder's stake in a company.

Short Selling

Selling more of an asset than the investor owns in order to make a profit once the price falls. This is usually not permitted for authorised funds and pension funds, but may be a strategy of hedge funds. The fund will need to borrow stock to cover a short position.

Simplified Due Diligence (SDD)

The process of obtaining proof of a customer's identity and their source of wealth and funds. SDD can be applied if there is a low risk of money laundering or terrorist financing by the business relationship or transaction.

Sinking Fund

Provision for repayment of the capital, either by gradually establishing a counterpart fund, or by using the annual provision to buy in through the market or by ballot. This will reduce the market risk (ie, reduce the duration) and the default risk of the bond.

Small Self-Administered Schemes (SSASs)

Company pensions in the UK for up to 11 members. A derivation of personal pension plans (PPPs), with the added extras of self-investment options and borrowing facility. They are also able to lend money from the scheme to the sponsoring employer and not face unattractive tax penalties.

Socially Responsible Investing (SRI)

Broadly similar to environmental, social and governance (ESG), except that SRI is driven first by an investor's individual values rather than investment potential.

Speculate

To engage in the buying or selling of an asset, in order to profit from a change in the market price.

Split

Company splits one share into several, with a corresponding reduction in the share price and the par value.

Spot

The current prevailing price/rate. This would apply to deals for standard settlement (ie, not a forward). Also called spot price or spot rate.

Spread

The difference between the bid and offer prices.

Stamp Duty

A purchase tax on UK shares. Gilts and AIM stocks are exempt. Currently 0.5%, rounded up to the nearest £5. Stamp duty only applies to transfers of stock and marketable securities in paper (certificated) form.

Stamp Duty Reserve Tax (SDRT)

A purchase tax on UK shares. Gilts and AIM stocks are exempt. Currently 0.5%, rounded up to the nearest 1p. SDRT only applies to transfers of non-physical securities.

Standard Deviation

A measure of absolute volatility. It is the measure of the square root of the variance of returns from the mean. The higher the figure, the greater the volatility (ie, risk).

Statement of Investment Principles (SIP)

A written statement of the principles governing investment decisions. Legally required for stakeholder and occupational pensions.

Sterling Overnight Index Average (SONIA)

An interest rate benchmark that reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions, and is based on actual transactions.

Stock

Shares ('common stock' in the US), although may also be used to describe corporate bonds and government securities.

Stock Exchange

An organisation (either owned by the members or operated as a corporate body) that supervises and runs the market in securities. Ensures compliance with rules, such as listing rules and corporate governance.

Stock Exchange Automated Quotation (SEAQ)

The London Stock Exchange (LSE)'s quote-driven scheme where market makers make two-way prices. It is a quotation system, not an automatic dealing system, unlike Stock Exchange Electronic Trading Service (SETS). It is largely restricted to fixed interest and less liquid AIM shares.

Stock Exchange Electronic Trading Service (SETS)

Anonymous electronic order matching system of the London Stock Exchange (LSE).

Strategic Asset Allocation (SAA)

An active management portfolio strategy whereby target allocations for various asset classes are set (for the longer term), and rebalanced periodically.

Structured Product

A series of investment products using derivatives (whether they are call and put options, futures, zero coupon bonds or swaps) to enhance, leverage, protect or guarantee an investment return.

Sustainability Disclosure Requirements (SDR)

The UK's sustainability disclosure framework, designed to provide investors with the information they need so they can make informed decisions about their investments. For example, by requiring certain investment products to display a label reflecting their sustainability characteristics.

Sustainable Finance Disclosure Regulations (SFDR)

European Union (EU) Regulation 2019/2088 on sustainability-related disclosures in the financial services sector. It requires fund managers, financial advisers and certain other regulated firms in the EU to provide prescript and standardised disclosures on how they integrate environmental, social and governance (ESG) factors at both the organisation and product level.

Tactical Asset Allocation (TAA)

An active management portfolio strategy that involves shifting allocations to various asset classes, to take advantage of market pricing anomalies or strong market sectors in the shorter term. Used to produce superior returns over the chosen time period.

Tender

A method of setting prices for new issues. Potential investors are asked to tender an amount and price.

Tick

Financial markets move in different size price increments, and the minimum price movement is known as a 'tick'.

Top-Down

Investment strategy that relies on decisions about asset classes, markets and industry sectors before stock selection.

Top-Slice

Selling part of a holding to reduce its weight in a portfolio. Also used in establishing taxable gain for non-qualifying life assurance policies.

Tracking Error

The volatility of returns of a fund relative to its benchmark.

Trash and Cash

Deliberately spreading false bear stories in order to depress the share price, and using the opportunity to buy cheaply.

Treasury Stock (or Treasuries)

Fixed-income securities issued by governments.

Treasury Bills

Short-dated debt issued by a central bank, to finance government expenditure.

Treynor Ratio

A measure of the extra return earned by a portfolio, relative to the systematic risk taken, vs other portfolios.

Trust

A means of holding assets (legally owned by trustees) on behalf of underlying beneficial owners. Investment portfolios within a trust may be professionally managed (eg, a charitable trust or unit trust).

Trustee

An individual or a group of people or independent institution responsible for the management of the trust, as defined by the trust deed. The trustees have the power to veto any investment they feel does not adhere to the trust deed.

Undertakings for Collective Investments in Transferable Securities (UCITS) Directive

A European directive enabling investment vehicles to be marketed throughout the EEA, without the need for additional authorisation in each separate jurisdiction. Since the end of the UK/EU transition period, UCITS has been written into UK law, so it continues to apply in the UK.

Underweight

A lower allocation to a stock/sector/region (and so on) than the relevant benchmark weighting.

Underwriter

A firm that agrees to underwrite a new issue, for a fee, guaranteeing the securities will be sold.

Unfranked Income

Income on which no withholding tax has been deducted. The investor may have a tax liability.

Unit-Linked Policy

A policy where returns are directly linked to the underlying assets. Units are purchased with premiums and are valued on a daily basis. They can be purchased in a variety of life assurance funds.

Unit Trust

A type of open-ended fund. Authorised unit trusts (AUTs) are subject to FCA investment regulations, while unauthorised unit trusts (UUTs) are not so restricted but cannot be marketed to the public.

Unlisted/Unquoted Securities

A security that is not listed on a stock exchange and is traded OTC (eg, eurobonds, ADRs, AIM shares and private equity).

Valuation Point

The time when open-ended funds are valued and the unit price is calculated.

Venture Capital Trust (VCT)

A company, approved by HM Revenue & Customs (HMRC), that invests predominantly in the shares and securities of unlisted companies. They provide tax concessions to investors, to encourage investment.

Volatility

See **Standard Deviation**.

Warrants

A security that gives the holder the right to buy/sell a specified quantity of a particular stock, or any other asset, at a fixed price on or before a specified date.

Weighting

A percentage holding of a security in a portfolio, relative to the underlying benchmark. Underweight means the portfolio holds a smaller percentage than that in the benchmark, while overweight portfolios hold a higher percentage.

Withholding Tax (WHT)

Tax deducted from investment income that is paid to foreign investors. May be offset against the investor's domestic tax liability.

World Markets (WM)

Independent performance measurement service. Offers pension funds and private client services.

Yield

On fixed-interest securities, the income yield is the annual gross interest payment (coupon) divided by the price.

On equities, the dividend yield is a company's dividend per share divided by its share price, expressed as a percentage. It provides investors with an indication of how much income they are earning on their shares.

Yield Curve

A graphical representation of the gross redemption yields for government bonds, plotted over a range of securities. The shape changes over time, so can be a useful indicator of changes in real economic activity.

Yield Gap

The spread (ie, difference) between government bond and equity yields.

Zero Coupon Bond (ZCB)

A security that is issued at a discount to par (face value), and usually redeemed for full face value. May offer tax advantages by utilising CGT rates and allowance rather than income tax.

Zero Dividend Preference (ZDP)

A class of share with a limited life, offering a capital return from the assets of the trust in the form of a predetermined (but unguaranteed) redemption value at wind-up. Shares carry no right to receive dividend income.

Useful Websites

Association of Investment Companies (AIC)	www.theaic.co.uk
Barclays Capital	www.ib.barclays
Bloomberg	bloomberg.com
Debt Management Office (DMO)	dmo.gov.uk
European Securities & Markets Authority (ESMA)	www.esma.europa.eu
Financial Conduct Authority (FCA)	www.fca.org.uk
FCA Handbook	www.handbook.fca.org.uk
Financial Ombudsman Service (FOS)	www.financial-ombudsman.org.uk
Financial Services Compensation Scheme (FSCS)	www.fscs.org.uk
Financial Times	ft.com
HM Revenue & Customs (HMRC)	www.gov.uk/government/organisations/hm-revenue-customs
Investment Association	www.theia.org
Joint Money Laundering Steering Group (JMLSG)	www.jmlsg.org.uk
Nikkei Asia	asia.nikkei.com
NS&I	www.nsandi.com
Pensions & Investments (P&I)	pionline.com
Prudential Regulation Authority (PRA)	www.bankofengland.co.uk/prudential-regulation
Securities and Exchange Commission (SEC)	www.sec.gov
Wall Street Journal (WSJ)	wsj.com

Syllabus Learning Map

Aims

The aims of this paper are to:

1. Develop a broad understanding of the principles of private client investment within the context of the current regulatory environment.
2. Identify the investment requirements of clients from the relevant information available.
3. Select suitable solutions available to meet the clients' needs.
4. Demonstrate the ability to communicate conclusions to a client in an appropriate manner.
5. Ensure that students have sufficient skills from which to develop and maintain their competence and knowledge.
6. Be able to apply their knowledge and understanding to private client situations.

Assessment Structure

A three-hour paper divided into three sections:

Section A: Ten compulsory short answer questions. This section will carry 40% of the marks.

Section B: Three questions predominantly on regulatory changes and regulation relating to: business and professional conduct and suitability of products and investment advice of which students will be expected to answer one. In this section, students are expected to show depth of knowledge of a particular regulatory topic and be able to discuss all aspects of the subject in question. This section will carry 20% of the marks.

Section C: One compulsory structured question comprising a number of parts, based on a case study in which the students' ability to give investment advice will be tested. This section will carry 40% of the marks.

Tax tables will be provided in the exam paper.

Reading List

At the end of this syllabus, we have supplied a reading list. Candidates attempting this examination are strongly advised to relate their reading to practitioner experience. Candidates who read more widely and can draw on this broader context fare better in higher, post-graduate level examinations of this nature, where both breadth and depth are required.

Section One

Financial Advice Within a Regulated Environment

Learning Outcome:

Candidates will be able to assess the implications of the UK legal and regulatory framework as they apply to the provision of private client investment advice and management and how these provisions apply their knowledge to real working examples.

Assessment Criteria:

Candidates can:

- Interpret the regulatory environment, supervision and rules governing private client advice and management in the UK.
- Summarise the fiduciary responsibility towards customers and their legal right to recourse.
- Assess the regulatory requirements of the main investment trading and settlement mechanisms within the UK and overseas.
- Determine how the factors above govern and influence the business processes and practice of private client advice and management.
- Apply their knowledge and understanding to both workplace and private client situations.

Learning Objectives:

1.1 The Legal and Regulatory Framework

1.1.1 Understand the main provisions of the Financial Services and Markets Act (FSMA) 2000 and associated secondary legislation and assess their implications for the business operations of the private client adviser.

1.1.2 Know and understand UK regulatory requirements, and evaluate the effects on the business systems and controls of the private client adviser.

1.1.3 Understand the role, regulatory objectives and functions of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) and how they affect the control structures of firms.

1.1.4 Relate the FCA's Principles and Conduct of Business rules to the processes of advising clients, managing investments and reporting to customers.

1.1.5 Apply the Consumer Duty principles

1.1.6 Know the extent of an investment adviser's duty to disclose material information about a recommended investment.

1.1.7 Identify conflicts of interest and their potential impact on clients and business operations, and understand the compliance requirements that exist to prevent such occurrences.

1.1.8 Understand the Senior Managers and Certification Regime (SM&CR) for firms and individuals.

1.1.9 Understand the fiduciary responsibilities of intermediaries, the rights of aggrieved customers, and the rules for handling complaints.

1.1.10 Understand the principal measures to combat financial crime (insider dealing, market abuse, money laundering (ML) and terrorist financing) and evaluate their impact on the firm, the private client adviser, and the process of advising and managing private client investments.

Section Two

Investment Taxation

Learning Outcome:

Candidates will be able to assess the impact of taxation on the evaluation of investments and the provision of investment advice as well as applying the rules to working examples.

Assessment Criteria:

Candidates can:

- Summarise the basic structure of the UK tax system.
- Determine the impact of the main taxes (on income and capital) that may be charged to individuals.
- Determine the impact of domicile and residence on an individual's liability to UK tax.
- Assess the impact of taxation on the investment decision-making process, and the need to tailor an appropriate strategy according to the needs of the client and the range of strategies available.

Note that all references to taxation refer to taxes applicable in the UK; tax tables will be provided in the examination where necessary.

Learning Objectives:

2.1 Income Tax

2.1.1 Understand the role of His Majesty's Revenue & Customs (HMRC) and the structure of the UK Self Assessment tax system.

2.1.2 Understand when and how income tax is applied to earnings, interest and dividends and, in some cases, capital gains.

2.1.3 Be able to calculate simple tax computations.

2.1.4 Apply the main rules relating to allowable deductions, personal allowances and reliefs, marriage and civil partnerships and their breakdown, and the tax liabilities of minors.

2.1.5 Understand the tax treatment of different kinds of investments and the taxation of income arising on overseas investments.

2.1.6 Evaluate the tax efficiency of an investment asset within the wider context of suitability for an individual customer.

2.2 Capital Gains Tax (CGT)

2.2.1 Understand the principles of CGT, and when and how it arises.
2.2.2 Understand the main CGT exemptions and reliefs available including main residence, exempt assets and exemption limits applicable for individuals, trusts and estates.
2.2.3 Understand the main disposal rules for CGT, including special rules that apply to disposals on death and between spouses/civil partners.
2.2.4 Be able to calculate taxable gains on an individual's net gains for a tax year.
2.2.5 Understand due dates for paying CGT and the use of CGT deferral.
2.2.6 Understand the taxation treatment of cryptoassets.
2.2.7 Apply the rules to working examples.

2.3 Inheritance Tax (IHT)

2.3.1 Understand the liability to IHT, and the effects on IHT liability of chargeable lifetime transfers (CLTs) and transfers on death.
2.3.2 Understand IHT exemptions and reliefs, excluded assets, potentially exempt transfers (PETs) and gifts with reservation.
2.3.3 Understand the rules governing the administration of estates, grant of probate and registration of probate.
2.3.4 Be able to value assets for probate and lifetime transfers.
2.3.5 Be able to calculate IHT liability based on a straightforward example.
2.3.6 Understand the relationship between the valuation of assets for CGT purposes and valuation of assets for IHT-related chargeable lifetime and estate transfers.
2.3.7 Understand the principles behind commonly used estate planning products, such as discounted gift trusts and IHT portfolios.
2.3.8 Apply the rules to working examples.

2.4 Offshore Tax

2.4.1 Understand the tax treatment of onshore and offshore funds and directly held assets.
2.4.2 Evaluate the suitability of offshore investments for UK-domiciled individuals.
2.4.3 Apply the rules to working examples.

Section Three

Financial Markets

Learning Outcome:

Candidates will be able to evaluate the relevance of market-related factors that can influence investment decisions, processes and advice and how they apply to private client portfolios.

Assessment Criteria:

Candidates can:

- Differentiate between the key features of the main UK and overseas markets (including fixed-income and equity) and specify the purpose and methods of trading, settlement, registration and holding of assets.
- Assess and justify the political, economic and practical risks, costs and benefits of trading or investing in a particular market.
- Assess the suitability and appropriateness of trading or investing in certain markets to help meet the investment objectives of a private customer.
- Explain the purposes of and requirements issuing contract notes and the operation of nominee companies in the UK.
- Apply these factors to private client portfolios.

Learning Objectives:

3.1 World Financial Markets

3.1.1 Understand the relative size of world equity markets and predominant asset classes within each market.
3.1.2 Know the key features of global government and corporate bond markets.
3.1.3 Understand the relative benefits, risks and costs of investing in developed and emerging markets.
3.1.4 Understand and differentiate between exchange-traded, over-the-counter and alternative markets.
3.1.5 Understand how indices are constructed, and the purposes and limitations in using them.

3.2 UK Markets

3.2.1 Understand the main organisations and processes used for transacting, clearing, settling and safekeeping UK financial securities.
3.2.2 Know the methods by which UK securities are issued and brought to market.
3.2.3 Be aware of the purposes and requirements for issuing contract notes.
3.2.4 Understand the applicability of value added tax (VAT), stamp duty and stamp duty reserve tax (SDRT) to transactions in UK financial securities for UK firms.

Section Four

Trusts and Trustees

Learning Outcome:

Candidates will be able to understand the principles and key features of UK trusts and the UK law governing their creation and management.

Assessment Criteria:

- Compare the main types of trusts available under UK law, their key features and taxation considerations.
- Explain the benefits, limitations and requirements to achieve charitable status.
- Evaluate the taxation implications of different scenarios involving trusts.
- Evaluate the merits of using a trust as a means to achieve a specific client objective.

Learning Objectives:

4.1 Trusts and Trust Legislation

4.1.1 Know the key features of UK trusts, including the arrangement, participants, types, and documentation.

4.1.2 Know the different types of UK trusts and their individual purposes what each is designed to achieve.

4.1.3 Understand the key provisions of the Trustee Act 2000 and how these relate to the investment powers of trustees and the trust deed.

4.2 Taxation of Trusts

4.2.1 Understand the concept of chargeable lifetime transfers (CLTs) and be able to assess the IHT consequences of different scenarios relating to each type of trust.

4.2.2 Know the requirements for charitable status, how charities are taxed, and the purpose and rules of Gift Aid.

Section Five

Financial Instruments and Products

Learning Outcome:

Candidates will understand the different types of investment asset classes, financial instruments, retail investment products and schemes available in the UK and how they apply to private client circumstances and their portfolios.

Assessment Criteria:

Candidates can:

- Differentiate between the investment asset classes, financial instruments, products and schemes that are available in the UK in terms of key features, potential risk and reward, advantages and disadvantages to investors, product pricing and availability, any special taxation considerations, and any redemption and penalty features that may apply. In addition, candidates can apply their knowledge in this area to private client situations and their portfolios and be able to ascertain the suitability of each product depending on client circumstances.

Learning Objectives:

To be able to understand, analyse and evaluate:

5.1 Bank and Building Society Savings Accounts

5.1.1 The different types of bank and building society accounts.
5.1.2 The advantages and disadvantages of cash investments.
5.1.3 The deposit protection scheme.

5.2 National Savings & Investments (NS&I)

5.2.1 The characteristics of different NS&I investments.
5.2.2 Their suitability for different tax status investors.
5.2.3 The terms and penalties for early surrender.

5.3 Fixed Interest

5.3.1 Features and redemption terms of fixed, floating rate and index-linked bonds.
5.3.2 Strips and strippable bonds.
5.3.3 Redemption dates and the use of sinking funds.
5.3.4 Calculation of accrued interest.
5.3.5 The tax efficiency of comparative stocks.

5.3.6 Break-even inflation rates.
5.3.7 The calculation and interpretation of flat yield and redemption yield.
5.3.8 The features and determinants of the yield curve.
5.3.9 Duration and its determinants
5.3.10 Modified duration, its determinants and usefulness as a measure to price volatility.
5.3.11 Structure and relevance of credit ratings in the evaluation process.
5.3.12 Capital and interest cover
5.3.13 Security and borrowing powers.

5.4 Government Debt

5.4.1 Types of securities issued by central government and local authorities.
5.4.2 Methods of trading government debt including relative merits and disadvantages.
5.4.3 Reasons for investing in government debt.

5.5 Corporate Debt

5.5.1 Features and redemption terms of different types of corporate debt.
5.5.2 Convertible bonds, and the effect of conversions on a company and its securities.
5.5.3 Building Society PIBS and Perpetual Subordinated Bonds.
5.5.4 Relationship with government debt and yield spread.

5.6 Corporate Equity

5.6.1 Features of ordinary shares and types of dividend.
5.6.2 Features of cumulative, non-cumulative, participating, convertible and redeemable preference shares.
5.6.3 Shareholders' voting rights and their responsibilities.
5.6.4 Capitalisation and rights issues, buybacks and their effects.
5.6.5 Risks and rewards of equity.
5.6.6 Beta values.
5.6.7 Analytical measures of equity valuation, and their relative merits and uses.
5.6.8 Measures of dividend yield, dividend cover, earnings yield, price-earnings ratio, and price book ratio.
5.6.9 Relevance of the yield gap and reverse yield gap.

5.7 Financial Derivatives

5.7.1 Features of UK-traded options and covered warrants on individual securities and indices.
5.7.2 Terms and timescales of different kinds of traded options and warrants.
5.7.3 Valuation and quotation of traded options and warrants.
5.7.4 The effect of and treatment of scrip issues, rights and dividends in the underlying security.
5.7.5 Features of UK company warrants.
5.7.6 Features of financial futures on equity indices.
5.7.7 Relevance of cost of carry and fair value.
5.7.8 Operation and relevance of margin in the clearing and settlement process.
5.7.9 Features of contracts for difference (CFDs).

5.8 Unit Trusts and OEICs

5.8.1 Similarities and differences.
5.8.2 Types of fund, pricing, charging structures, separation of management and ownership, dealing and settlement, and tax treatment.

5.9 Exchange-Traded Funds (ETFs)

5.9.1 Features, including types of fund, pricing, charging structures, dealing and settlement, tax treatment.
5.9.2 Comparison with other types of product.

5.10 Investment Trusts

5.10.1 Similarities with and differences from other types of fund.
5.10.2 Differences between conventional and split-level investment trusts.
5.10.3 Concepts of 'B/C' shares and warrants, zero and stepped preference.
5.10.4 Real estate investment trusts (REITs).
5.10.5 Determinants and relevance of net asset value (NAV) discounts and premiums.

5.11 Individual Savings Accounts (ISAs)

5.11.1 Key features of ISAs.
5.11.2 Additional Permitted Subscriptions (APSs).

5.12 Junior ISAs (JISA)

5.12.1 Key features and types of JISA.

5.13 Private Equity Schemes

5.13.1 Characteristics of Enterprise Investment Schemes (EISs), Seed Enterprise Investment Schemes (SEISs), Venture Capital Trusts (VCTs), including contribution limits, tax relief and suitability considerations.

5.14 Life Assurance and Protection Products

5.14.1 Purposes, key features and relative merits of life assurance products – term, whole-life, endowment; regular premium policies and single premium bonds; with/without profits, unit-linked; guaranteed income and growth; annuities.
5.14.2 Income, capital gains and inheritance tax implications of investing in life assurance products.
5.14.3 Purposes, key features and relative merits of protection products: income protection insurance (IPI); critical illness cover (CIC) and private medical insurance (PMI).

5.15 Retirement Provision and Eligibility

5.15.1 State pension provision.
5.15.2 Occupational pension schemes, including the relative merits and disadvantages of defined benefit and defined contribution schemes.
5.15.3 Relevance of the Pension Legislation since 2006 in protecting members of occupational schemes including redress and compensation.
5.15.4 Pension tax rules, including annual and lifetime limits.
5.15.5 Types of pension scheme.

5.16 Structured Products

5.16.1 The different types of products available.
5.16.2 The advantages and disadvantages of their use.

5.17 Custody of Investments

5.17.1 Understand the purposes and operation of nominee companies and investment platforms.

Section Six

Principles of Financial Advice

Learning Outcome:

Candidates will be able to recommend suitable investment products for private clients.

Assessment Criteria:

Candidates can:

- Combine their knowledge in fiduciary, ethical and regulatory responsibilities with technical proficiency when conducting customer fact-finds.
- Prepare a client profile in line with 'Know Your Customer' (KYC) principles, showing a clear relationship between the information elicited and the formulation of appropriate customer-led objectives and constraints.
- Identify, analyse and select suitable investments in order to construct a portfolio tailored to meet the agreed objectives of an individual customer.
- Recommend investment suggestions in a non-misleading and balanced way, setting out both the potential merits and disadvantages of an investment and its net effect on a customer's investment portfolio.

Learning Objectives:

6.1 Establish Client Objectives and Constraints

6.1.1 Understand risk and return objectives and how to construct a risk-return profile.
6.1.2 Identify the major types of investment risk, and where and how they typically arise.
6.1.3 Explain the impact of inflation, deflation, taxation and charges on investment returns.
6.1.4 Understand the importance of timescale in relation to risk and the time value of money.
6.1.5 Understand the essential features and purpose of a customer profile, particularly the customer's personal details, income, assets, liabilities, expectations, risk tolerance, capacity for loss and existing investment provision.
6.1.6 Understand the regulatory requirements regarding the need for, and content of, client agreement documentation and related communications.
6.1.7 Understand and be able to address customer concerns about confidentiality and security, data protection, fees, periodic reporting and customer communications.
6.1.8 Apply their knowledge to client objectives and constraints.

6.2 Design an Investment Strategy

6.2.1 Understand the key features and risk-reward profile of the main investment approaches, including passive/active, buy/hold, momentum, core/satellite, value, growth, direct, indirect, ethical/responsible/sustainable, lifestyle, hedge and structured fund approaches.
6.2.2 Apply the principles of asset and liability matching when managing investments in different currencies.
6.2.3 Determine a suitable investment strategy with regard to preferred investment approach, time horizon, income, growth, balance, tax position, costs, market and sector diversification, and expected risk and return.
6.2.4 Analyse the means to implementing that policy, including short–term liquidity, available investments, choice between UK and overseas markets and direct and indirect routes.
6.2.5 Specify or recommend appropriate portfolio components, taking into account overall suitability, cost and ease of implementation and maintenance.

Section Seven

Portfolio Performance and Review

Learning Outcome:

Candidates will be able to evaluate investment performance and review portfolio requirements in response to market movements and customer requirements.

Assessment Criteria:

Candidates can:

- Apply appropriate indices and benchmarks to the comparative analysis of investment performance.
- Evaluate and periodically review portfolio composition in order to continually maintain adherence to client objectives.

Learning Objectives:

7.1 Portfolio Performance Measurement

7.1.1 Understand the principles of time-weighted and money-weighted rates of return.
7.1.2 Understand the principles of risk including volatility, standard deviation, alpha and portfolio risk.
7.1.3 Know the main stock market indices and how they operate.
7.1.4 Understand the key features of indices published by FTSE and MSCI PIMFA.
7.1.5 Apply appropriate indices and benchmarks to the comparative analysis of investment performance.
7.1.6 Evaluate and periodically review portfolio composition in order to continually maintain adherence to client objectives.

READING LIST

- Periodicals and Newspapers etc.
- Financial Times and financial sections of other newspapers.

NOTE: Candidates should pay particular attention to weekend editions in which savings and investment are frequently given specialist coverage.

Also:

- The Review
- Bloomberg Money
- Financial Analysts Journal
- Investors' Chronicle
- Money Management
- Planned Savings
- What Investment?

Introductory Reading

- Pagdin, Ian. & Hardy, Michelle. (2018). ***Investment and Portfolio Management: A Practical Introduction***. Kogan Page.
- Stewart, Scott D. & Piros, Christopher D. & Heisler Jeffrey C. (2019). ***Portfolio Management: Theory and Practice***. John Wiley & Sons, Incorporated.
- Berns, David. (2020) ***Modern Asset Allocation for Wealth Management***. John Wiley & Sons, Incorporated.
- Warner, Stuart. & Hussain Si. (2022) ***The Finance Book***. FT Publishing International.
- Estrada, Javier. (2011) ***Ft Guide to Understanding Finance: A no-nonsense companion financial tools and techniques***. FT Publishing International

Taxation Reading

- Hayes, Claire. & Newman, Ruth. & Hubbard, Andrew. (2021). ***Tolley's tax guide 2021–22***. Tolley.

General Reading

- Harrington, Brooke. (2020) ***Capital without Borders: Wealth Managers and the One Percent***. Harvard University Press.
- Jenkins, Hywel & Dankos, Cat. (2019) ***A practitioners Guide to the UK Financial Services Rulebook (7th Edition)***. Sweet and Maxwell Ltd.
- Buffet, Warren. (2021) ***The Essays of Warren Buffet lessons for investors and managers (6th Edition)***. John Wiley & Sons, Incorporated.
- Malkiel, Burton. (2019) ***A Random Walk Down Wall Street***. W.W. Norton and Company.
- Strumeyer, Gary. (2017) ***Capital Markets Evolution of an ecosystem***. John Wiley & Sons, Incorporated.
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Websites

Students should regularly check investment websites, such as:

www.bankofengland.co.uk

www.bloomberg.com

www.dmo.gov.uk

www.euronext.com

www.fca.org.uk

www.ft.com

www.ftserussell.com

www.investopedia.com

www.londonstockexchange.com

www.nsandi.com

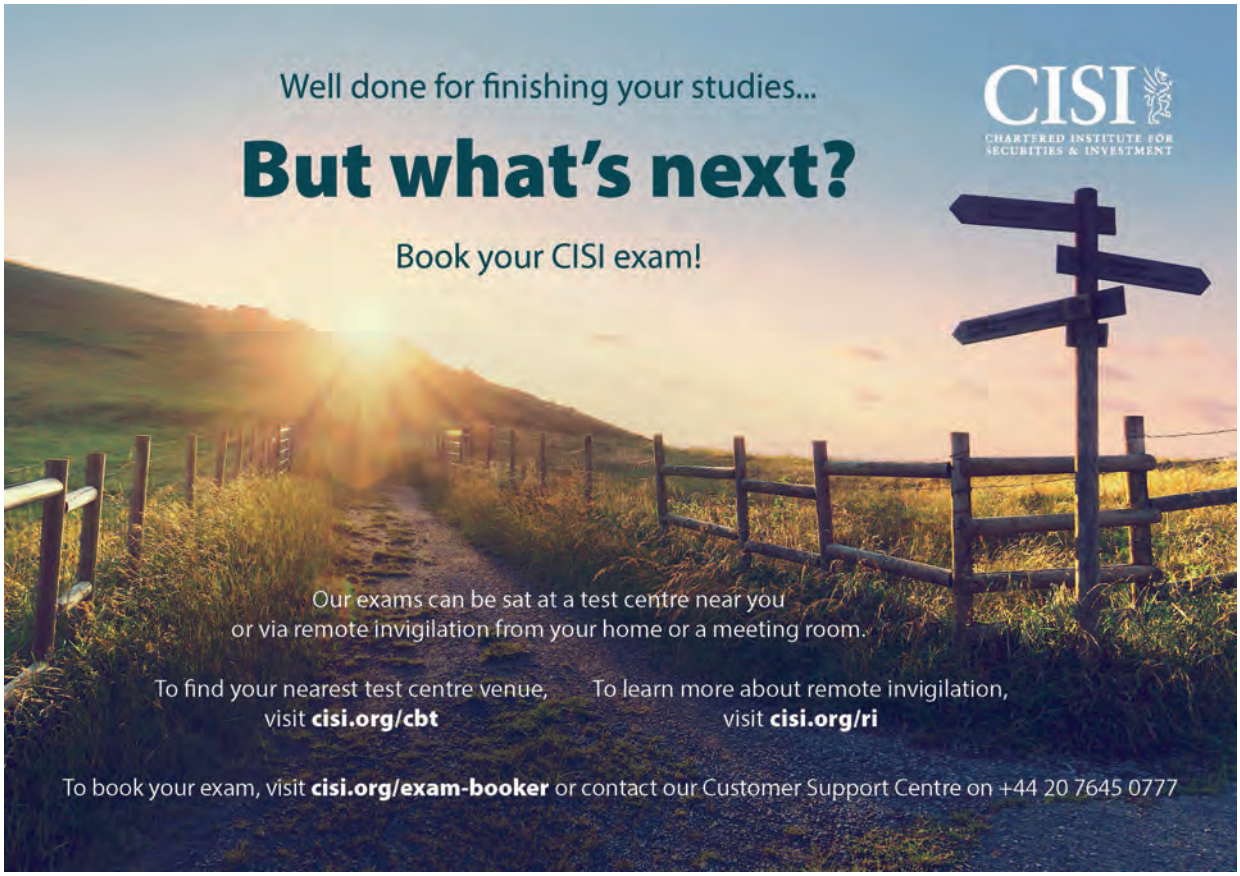
www.gov.uk/browse/tax/capital-gains

www.gov.uk/browse/tax/income-tax

www.gov.uk/browse/tax/inheritance-tax

www.gov.uk/government/organisations/department-for-work-pensions

www.trustnet.com



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Gain an overview of the principles and high-level rules associated with holding and protecting client assets.



Conflicts of Interest
Consider examples of conflicts of interest, tools, policies and procedures, enforcement action, and good practice.



Data Science
Digitisation of business operations has accelerated the speed of data capture. Harness the value of your data.



Diversity and Inclusion
Targeted at those responsible for diversity, equality and anti-discrimination, and those recruiting and managing.



Financial Crime
Gain an overview of insider dealing, market abuse, money laundering, terrorist finance and financial sanctions.



Financial Planning
Gain an overview of the financial planning process, key terms and the regulatory framework that governs it.



Greenwashing
This module explores the key concepts surrounding greenwashing, the wider implications, and the measures being taken to fight it.



Impact Investing
Aim to take ethical and sustainable investment principles a step further through intentional investment.



Integrity and Ethics
Understand ethics in finance, the importance of trust and trustworthiness, and compliance versus ethics.



Market Abuse
Examine offences, penalties, safe harbours, reporting obligations and the relationship with other offences.



Neuroscience at Work
Learn how to work optimally without harming your health when faced with increased workloads and deadlines.



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