WILL RING-FENCING MAKE THE UK'S BANKS SAFER?

LIVING OVERSEAS: HOW TO HELP CLIENTS RETIRE ABROAD

THE GREAT INTERGENERATIONAL WEALTH TRANSFER


# the review

PROVIDING INSIGHT AND ANALYSIS FOR FINANCIAL SERVICES PROFESSIONALS

CISI.ORG/REVIEW

Q1 2019

CISI
CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT


# The sensible optimist

NIKHIL RATHI, CEO OF LONDON STOCK EXCHANGE, ON HOW TO THRIVE IN A WORLD OF GEOPOLITICAL CHANGE

# welcome

“Thanks to everyone who completed the reader survey in the previous edition. We received many constructive comments and suggestions”

Pension funds in surplus – sounds like a dream for many, but not for FTSE 100 pension schemes, whose overall IAS19 accounting position jumped from a £31bn deficit in 2016 to a £30bn surplus at the end of September 2018, according to pension consultants Lane Clark & Peacock. Part one (pp.26–28) of our special report on pensions looks at the reasons behind this: investment performance or changes in accounting practices? Part two looks at ‘The changing world of pension fund asset allocation’ (pp.29–31).

Nikhil Rathi, chief executive of London Stock Exchange, says we should embrace change to remain resilient. He speaks from experience, having stepped into the role of leader of the UK Financial Stability Unit in 2008 when he was just 28 years old, helping to navigate the UK government’s global financial services interests through the turbulence of the financial crisis. Turn to page 32 for our profile interview on his impressive career to date.

Other highlights include our article on ‘Retiring abroad’ (pp.38–40), which looks at some of the points that financial planners could cover to help clients decide whether to relocate; our ethical dilemma about how to handle accusations of bullying made against a firm’s CEO (pp.44–45); and a piece by Russell Napier with the intriguing title ‘What the hell is water?’ on “profound and structural changes in liquidity often missed by investors” (pp.56–59).

As ever, we welcome your feedback. Thanks to everyone who completed the reader survey in the previous edition. We received many constructive comments and suggestions, some of which have been implemented immediately (no more QR codes) and some which you will see more of soon. Read the results on page 8.

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### Special report: Pensions



## professional development





## education

# CISI.ORG/REVIEW

CHECK OUT THE ONLINE EDITION OF *THE REVIEW* AND THE WIDER CISI WEBSITE FOR EXCLUSIVE WEB-ONLY CONTENT

100110
011001

## Watch

**Rebecca Tuck APP Chartered MCSI is the CISI Paraplanner of the Year 2018**. Rebecca shares a bit about her daily role and her plans for the future, plus some useful tips for aspiring paraplanners.
*cisi.org/poy18*

### MOST COMMENTED ON

**How to deal with poor mental health at work**
*cisi.org/mhwork*

**Beating the transfer market: when customers need to transfer their assets**
*cisi.org/transfer*

**Six questions to engage your clients**
*cisi.org/6questions*

## Learn


**INSURANCE DISTRIBUTION DIRECTIVE PROFESSIONAL REFRESHER**
**Distinct pass numbers: 66**

### Q1 MOST READ

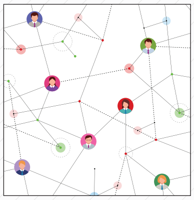
**Post-Modern Portfolio Theory and financial planning**
*cisi.org/pmpt*

**Ask the experts: Structured products**
*cisi.org/structured*

**Family investment companies: A useful tool for managing generational wealth?**
*cisi.org/fic*


**To read more, visit *cisi.org/review***

## Read



**SMCR – LEARNING LESSONS FROM BANKS**
What operational and cultural changes are required?
*cisi.org/smcr-banks*

### EVENTS

**Mansion House City Debate 2019**
**Thursday 11 April, 6pm**
A panel will debate the motion: This house believes that the City's best days lie ahead

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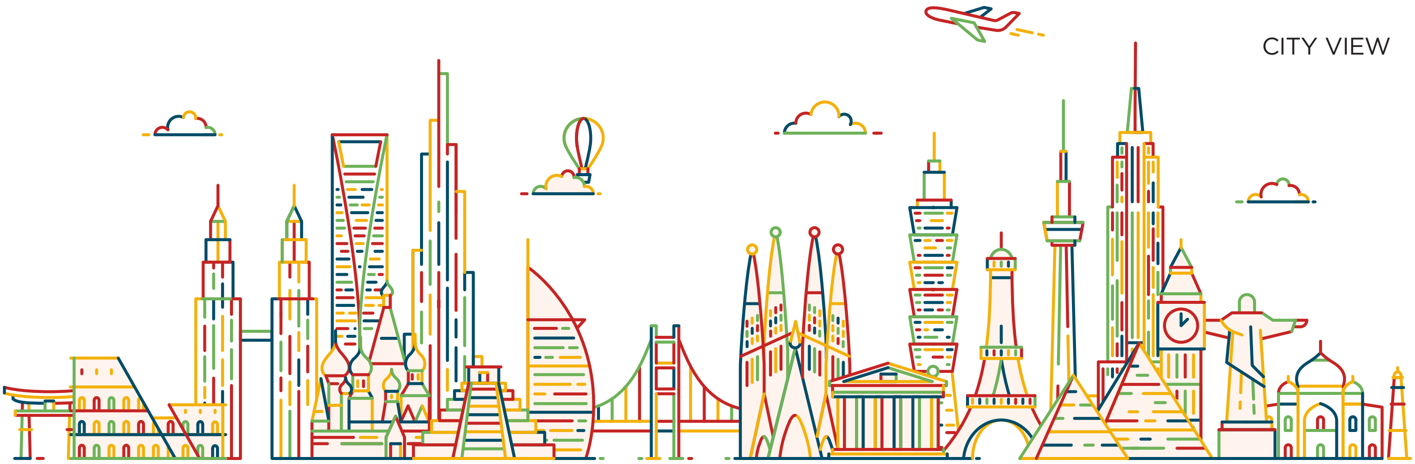


# MiFID II hits choppy waters

FIRMS SHOULD ENGAGE ACTIVELY WITH REGULATORS TO HIGHLIGHT PRACTICAL ISSUES THAT EMERGE FROM THE IMPLEMENTATION OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MiFID II)

No new regulation regime is born perfect. MiFID II was blemished from birth and fresh wrinkles are still emerging. New rules from January this year, for instance, led to a torrent of letters notifying clients that their portfolios had dropped by more than 10% in value since the beginning of the reporting period. Given the bath that most world markets took in 2018, the generally high level of communication between advisers and their clients, and the regular use of platforms by investors to monitor their holdings, this will not have surprised many. The lack of responses to these letters, of which many tens of thousands were issued – individual firms are coy about the details – was probably because tuned-in investors would have seen their portfolios dip far more within the reporting period.

// MiFID II WAS BLEMISHED FROM BIRTH AND FRESH WRINKLES ARE STILL EMERGING //

Had the new rules been in place over the previous decade, however, best estimates suggest that the bulk of firms would have sent them some 30 times, possibly more. Potentially alarming letters telling clients of 10% drops, then maybe 20%, or 30%, or even 40% or more (which would have happened for many in the seventies and the noughties) could lead to unfortunate and unnecessary sales by frightened clients, possibly even worse if a wave of selling triggered a major correction. Wise advice to take long-term patient positions could fly out the window. Regulators are not made of stone; should they bend a bit?

MiFID II is still bedding down, but fears of a MiFID III are misplaced. The FCA has made it plain that it sees MiFID II as a process, not an event, and values the work done by firms to cope with the 1,500 pages of legislation involved, plus the thousands more of guidance from the FCA and the European Securities and Markets Authority. It understands that some parts of the beast are purring more smoothly than others and is gaining a better grip on what is, and what isn't, working. Product governance and transaction reporting are notable headaches.

## Potential changes

The FCA is working on half a dozen potential changes to the legislation, the most profound of which involve firms based outside the EU, and new rules on suitability of environmental, social and governance (ESG) investments. This is the theme of the 2019 CISI Integrity Debate on 28 March. ESG brings noble aspirations to our sector and profession, but the reality of delivering real benefits to clients needs clear thought. Firms should engage actively with regulators to bring the practical issues to the surface to help avoid imprecise regulation.

The Packaged Retail and Insurance-based Investment Products Regulations – in force since January 2018 for retail investors as defined by MiFID II – is a classic example of this, and a mess. The current reform process is dictated by the timing of European Parliament elections, not by the needs of investors and firms. There is an urgent need to suspend the current regime and to take the time to produce a more informative and fit-for-purpose replacement in which clients and advisers can have confidence. ●

ILLUSTRATION: GETTY IMAGES

# AROUND THE GLOBE

The CISI's international network of offices looks after 45,000 members worldwide

**Over 40,500**

**exams sat in 86 countries in the past 12 months**

## UNITED KINGDOM

**Chief executive officer:** Simon Culhane, Chartered FCSI

We were pleased to host the inaugural London meeting of Women in Finance Nigeria (WIFNG) at our head office on Friday 22 February.

Toyin Sanni (centre), chair of WIFNG, CEO of Emerging Africa Capital Group and group CEO of leading African investment banking group United Capital, flew to London for the meeting. She said: "As we pursue our mandate, which includes advancing the economic empowerment and financial literacy of women, advocacy with policymakers and corporate leaders for equal opportunities for women in the workplace, especially in the world of finance, and capacity building, networking and mentorship for WIFNG members through our UK Chapter, we look forward to further support from the CISI."

## CYPRUS

**Chairman of CISI Cyprus National Advisory Council:** Petros Florides, Chartered FCSI

We launched the CISI Chartered Wealth Manager qualification in Cyprus in March 2019, in partnership with the European Institute of Management and Finance (EIMF). The first five-day training course began on 21 March at the EIMF headquarters in Nicosia.

Marios Siathas (pictured), general manager, EIMF, said: "This world-class, postgraduate level CISI qualification in the Cypriot market is suitable for wealth managers, IFAs, private client managers, discretionary portfolio managers and private bankers. We are extremely pleased to have Johanna Kirby of Financial Services Training Partners on board as our trainer for this qualification."

Johanna began her financial services career with J.P. Morgan, and quickly rose to become director of fixed income at Barclays in South Africa. She has been working as a consultant to provide technical training for financial institutions for the past eight years.

Kevin Moore, Chartered FCSI, CISI director of global business development, said: "We look forward to welcoming successful Cypriot candidates to our growing global community of practitioners in this important private wealth management market."

## JORDAN

**Regional director Middle East:** Matthew Cowan, Chartered MCSI

Following the recent announcement of our collaboration with the Jordan Securities Commission, we're proud to welcome the Integrated Development Academy (IDA), a specialised training provider in Amman, Jordan, as one of our newest accredited training partners in the Middle East.

Our internationally recognised qualifications will be available to IDA students and include: Fundamentals of Financial Services; Introduction to Securities & Investment; International Certificate in Wealth & Investment Management; and Islamic Finance Qualification.

Dr Abdullah Sartawi, general manager, IDA, pictured centre right, said: "With the CISI's qualifications now part of our training offering, the IDA can encourage its students to achieve professional excellence, producing world-class experts in the region."

## MOROCCO

**Senior international manager:** Praneet Shivaprasad

We signed an MoU with the Casablanca Stock Exchange (CSE) on Thursday 20 February. The partnership will initially offer globally recognised CISI qualifications to university students throughout Morocco, then expand to include financial services practitioners in the region.

The first CISI qualification to be made available is our Fundamentals of Financial Services. Free CISI student membership will be offered to those studying for the exam, with benefits including access to the CISI's suite of over 120 Professional Refreshers on the CISI elearning platform.

The qualification will be offered in English and French.

CISI CEO Simon Culhane, Chartered FCSI (pictured with Karim Hajji, CEO of CSE), speaking at the launch event, said: "We are honoured to have been chosen to partner with the CSE on this important project supporting the development and professionalism of human capital.

"Casablanca's growing influence as a global capital market was noted in the latest Zyen Global Financial Centres Index."

Karim Hajji said: "We wish, through these new certifications, to develop the knowledge and technicality of the financial centre of Casablanca. We are happy to partner with a recognised international organisation, the CISI, to offer a service that best meets this objective. We are also pleased that higher education institutions continue to trust us by supporting this initiative."


To find out more about the programme or to book for the qualification, contact *customersupport@cisi.org*

## INDIA

**Country head:** Ganesh Iyer

We've signed an MoU with Gitam University in Andhra Pradesh, which will help boost the university's finance students' career pathways. Students will be offered the chance to study for the CISI level 3 International Introduction to Securities & Investment exam, which can lead to either the CISI International Certificate in Wealth and Investment Management or the Investment and Operations Certificate.

Ganesh Iyer, CISI India country head, said: "Students will be entitled to a year's free membership, allowing them to use our elearning platform and attend our events in the region. We will also be working with Gitam University to facilitate internships and placements for students during their studies. We aim to provide students with a competitive edge in the international financial services jobs market."

Those interested in finding out more about the Gitam University/CISI programme or to book on to the course should contact *customersupport@cisi.org*

### ISLAMIC FINANCE EDUCATION IN EURASIA


Islamic banking assets stood at US$2.4tn in 2017 and major institutional estimates see them touching US$4tn by 2022. Rising demand for Shariah-compliant products in emerging markets – where most of the world's 1.8 billion Muslims live – is driving this growth, alongside massive global infrastructure investments, which are ideally suited to Shariah-compliant products.

The interface between Islamic finance and fintech, which has a unique role in improving access to finance globally, is proving particularly fruitful. The CISI hosted an international meeting on this theme at its London office in March 2019. Meanwhile, the group pictured at the Astana International Financial Centre are receiving an initial briefing on the Islamic Finance Qualification ahead of a national training course rollout in April 2019.

**46%**

**of those working in financial services would feel confident speaking to their manager about mental ill health, according to our latest survey**

# MAKING THEIR MARK: TWO NEW PRESIDENTS ANNOUNCED FOR THE CISI EAST ANGLIA AND BIRMINGHAM & WEST MIDLANDS COMMITTEES

## East Anglia Committee

Mark Hinds (pictured left), Chartered FCSI, investment manager and branch manager of the Norwich office of Charles Stanley, is the new president of the CISI East Anglia Committee.

Mark joined the CISI in 1998 and has been the branch manager of Charles Stanley Norwich since 2013. He holds a master's degree in engineering from the University of Leeds and Penn State University (US). He manages investment portfolios for private individuals, trusts and charities both directly and working with financial advisers, solicitors and accountants.

He said: "I hope to continue the great work of my predecessor Richard Larner, Chartered FCSI. I am delighted to have the support of Laura Ingram, our new vice president.

"Supported by an enthusiastic committee, we will strive to maintain the high quality and relevance of our continuing professional development (CPD) events in Norwich and Cambridge. We are also exploring involvement in other CISI projects, such as in education and the more recent launch of the Young Professionals Network. We are actively seeking collaboration with other professional bodies in our region. That sounds like plenty to get our teeth into!"

## Birmingham & West Midlands Committee

Mark Rogers ACSI (on the left in the picture, right), wealth planner at Succession Wealth, is the new president of the CISI Birmingham & West Midlands Committee.

Mark has worked for 37 years in the financial services sector and has previously been involved in the CISI Birmingham Committee, as chairman of the Birmingham Institute of Financial Planning branch. He is also chairman of Succession Giving, the national charitable arm of Succession Wealth, aiming to raise monies for Succession's various charities.

Mark said: "I am honoured to be taking up the role from Andrew Porter, Chartered FCSI, who will be a hard act to follow. Andrew has encouraged the committee to work with local schools, colleges and firms with a view to ensuring that local young people have the opportunities and the correctly designed education and career paths to enter and succeed in financial

services. Andrew's work on the Education Committee has been second to none.

"My aim is to continue this work and to extend the voice of financial planners throughout the region as I believe it is important for all financial services professionals, including investment managers, wealth planners and financial planners, to work together. The launch of the Birmingham Young Professionals Networking Community will form part of this overall strategy."

# *The Review* print edition reader survey 2018

Thanks to everyone who took the time to complete our reader survey, included in the front pages of the Q4 2018 print edition of *The Review*. We received 198 responses out of a mailing run of 17,433 copies, gaining valuable insights to inform future editions of the magazine.

Congratulations to Sviatlana Muddle MCSI (pictured), product manager at BNP Paribas Securities Services Fund Administration, for winning our reader survey 2018 draw. Sviatlana's name was selected at random to win a £100 Amazon voucher.

Sviatlana said: "I was so surprised and very pleased to have won. It was the highlight of my week. Thank you so much."

**You told us what you like**

Our profile interviews are the most popular section of the magazine (read by 70% of respondents), followed closely by 'City view' and CISI global and branch news (65% readership for both). Most of you (96%) say the quality of the writing is either excellent or good, and 93% say the same about the design. Almost all (95%) see the magazine as a membership benefit.

**What you don't like**

We have removed QR codes because a majority (60%) say they are not useful. We have brought back short links instead.

**And what you'd like to see more of**

We received many excellent suggestions of topics to pursue and people to interview, with the most popular topics being those to do with ethics, culture and conduct; and professional and career development. Look out for forthcoming editions to see more on those.

# Events preview

We offer many opportunities to help you meet your requirements for professional development. Below are just some of the highlights of the institute's CPD events programme, but for comprehensive details and to book, please visit *cisi.org* and click on the 'Networking & events' section. Please note that dates listed below are subject to change.

### 2019 CITY DEBATE: 11 APRIL

**'This house believes that the City's best days lie ahead'**

The 23rd annual City Debate will take place on the evening of 11 April at the Mansion House – the most stunning venue in the City.

Speaking for the motion is Sir Gerry Grimstone MCSI, past chairman of Barclays International, and Kay Swinburne, Conservative MEP. Speaking against the motion is Lord Myners, former City Minister (under Gordon Brown) and CEO and chairman of Gartmore, and John Kay CBE, Fellow of St John's College, Oxford and visiting professor at the London School of Economics.

For more information and to book, contact Oliver Warren at the CSFI on *oliver@csfi.org* or on *+44 20 7621 1056*.

### LONDON CPD

**9 MAY** Principles and practice of financial planning
**16 MAY** Compliance Forum: Regtech for compliance officers
**6 JUN** Young Professionals Network: Lessons from the great recession
**12 JUN** Risk Forum: Investment horizons 2019

### REGIONAL CPD

**30 APR** Mental health awareness in the workplace (Birmingham)
**30 APR** Increasing your personal impact (North East)
**14 MAY** Behavioural finance; Insurance Distribution Directive; cryptocurrencies and blockchain (joint Southern and South Coast event)
**17 JUN** CISI Paraplanner Conference 2019 (Stratford-upon-Avon)
**19 JUN** Effective prioritisation (Edinburgh)

### SOCIAL EVENTS

**11 APR** CISI Cyprus annual gala dinner 2019
**9 MAY** Liverpool, Chester & North Wales branch annual dinner 2019
**6 JUN** Birmingham & West Midlands branch annual dinner 2019
**20 JUN** Wales branch summer social 2019

- If you have an idea for an event or would like to contribute at one of our events, please email *cpdevents@cisi.org*
- For details of conferences and social events available to members, please visit *cisi.org/events*

# Disciplinary rules

CISI members agree to abide by the Membership Regulations. An important aspect of this is the obligation to promptly inform the institute of any matter which may impact your suitability to remain a member. Failing to do so may be considered as an aggravating factor in a disciplinary case.

We are currently recruiting for members to join the Disciplinary Panel and Appeals Panel. Should you wish to register your interest, please send a CV and covering letter to *standards@cisi.org*

# QUICK QUIZ

*The Review's* quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 150 modules covering topics including anti-money laundering, the UK Bribery Act, information security and data protection. The answers are on page 47.

***Which of the following organisations does the Insurance Distribution Directive apply to?***

**A** Insurers and re-insurers only
**B** Intermediaries, insurers and re-insurers
**C** Intermediaries only
**D** Insurers only

***When exploring the PESTLE analysis factors, which of the following is true?***

**A** They analyse the internal environment
**B** They will remain constant
**C** They vary from country to country
**D** The external environment always changes slowly

***Which of the following will not affect an individual's credit score?***

**A** A late repayment on your mortgage
**B** A county court judgment
**C** Living at the same address as a bankrupt person
**D** A student loan

***What statement best sums up the regulator's view on complete and accurate reporting?***

**A** Best efforts basis
**B** Firms should ensure systems and controls are in place
**C** The regulation specifically outlines the actions firms should take to ensure the integrity of their reporting
**D** Firms must use a third-party firm to validate the quality of their reporting

Access to Professional Refresher is available on an annual licence basis. The full suite of modules is free to CISI members or £250 for non-members. If you or your firm would like to find out more, visit *cisi.org/refresher* or contact the CISI on *+44 20 7645 0777*.

# Financial planning news

*A snapshot of financial planning news and events, by Jacqueline Lockie CFP™ Chartered FCSI, CISI head of financial planning*

## FINANCIAL PLANNING FORUM NUMBERS RISING

The CISI's Financial Planning Forum has passed 4,000 members as more people seek support in building financial planning services into their firms. The FP Forum membership comprises CERTIFIED FINANCIAL PLANNER™ professionals, wealth managers and other professionals, all looking to enhance their understanding for the good of the public and long-term health of their businesses.

We have recently launched the CISI's Financial Planning Mentoring Scheme that sees our CFP professionals supporting others in the FP Forum, to help them gain experience and grow the profession. Please see the FP Professional Forum pages on the website (*cisi.org/fpforum*) if you are interested in joining. We also have the support of three of our financial planning corporate supporters in Schroders, James Hay and Royal London, all offering their technical expertise to those on the mentoring scheme on a wide variety of subjects.

## GDPR AND YOUR PERSONAL DASHBOARD PREFERENCES

I've recently discovered that many financial planners are unaware of CISI financial planning news and events. If your MyCISI dashboard preferences are set to 'No', you will not receive any communications other than essential membership communications.

To that end, I have a few questions for you:

1. Are you receiving the fortnightly financial planning bulletins?
2. Do you know about the Financial Planning Mentoring Scheme?
3. Have you seen the launch of the Accredited Financial Planning Firms™ Conference, the Paraplanner Conference and the Financial Planning Conference?
4. Have you signed up to your secondary branch to be notified of local financial planning content?
5. If you are a CFP professional, did you see the pre-Christmas survey about the Ambassador Scheme, which included a request for volunteers for press comment?
6. If you are willing to volunteer to help develop financial planning exams and give feedback on CFP professionals' financial plan assessment, you can also set your preferences for exam panels to 'Yes'.
7. Were you involved in Financial Planning Week and World Financial Planning Day in October 2018? Will you be involved in 2019?

There is so much going on to support growth in the financial planning profession. Some of you are missing out because of your preferences settings. Please log in to your MyCISI account and click on 'Communication preferences' to select what you want to read about.

I will be speaking at a number of events and conferences in 2019 and look forward to meeting you at one of those. As always, your feedback is welcomed, so please do get in touch with me at *jacqueline.lockie@cisi.org*.

### INSURANCE DISTRIBUTION DIRECTIVE

Many of you are caught by the Insurance Distribution Directive (IDD) requirement of 15 hours of specific continuing professional development (CPD). We have a new Professional Refresher to view on the subject. Other relevant content will be available online and at branch meetings soon. When the Paraplanner and Financial Planning Conference programmes are released, they will highlight the IDD sessions to help you. The FCA has said that you do not need to log this as a completely separate item (in addition to structured/ unstructured CPD), you just need to be able to identify it in your CPD log.

### PARAPLANNER CONFERENCE 17–18 June 2019, Crowne Plaza, Stratford-upon-Avon

The Paraplanner Interest Group creates content for this popular conference. There are some technical topics and fresh new ideas on how to use graphics in financial plans. We have behavioural finance sessions, estate planning sessions and a new look to our welcome dinner, with marketplace stalls and fun and games for the evening. See *cisi.org/PPC19* for the full programme of sessions and speakers.

### FINANCIAL PLANNING CONFERENCE 30 September–1 October 2019, Birmingham Hilton Metropole

This year's conference is a step forward in thought leadership and is based on the feedback that you provided after the 2018 conference, along with input from our panel of financial planners on the conference content panel. We are keeping the three steams of 'Focus on your clients', 'Spotlight on your business' and 'Get ahead technically', but we have added in several more high-profile main platform sessions. There will be challenging financial planning content, thought leadership in related areas and plenty of time for debates, networking and fun. Our black-tie gala awards dinner will have a new structure and a surprise after-dinner speaker. Two full, action-packed days are in store so make sure you put the dates in your diary and book to come along. See *cisi.org/fpconf19* for details.

# FE AND THE CISI – WORKING TOGETHER

BE BETTER INFORMED

FE, like the CISI, believes that professionalism and competence in financial services are achieved through a blend of knowledge, integrity and skills. This is why, as a completely independent provider of comprehensive investment data, research and insight, FE has been able to support thousands of financial planners, wealth managers and advisers in achieving investment success for clients.

FE's intermediary proposition, FE Analytics+, combines our flagship investment research solution FE Analytics with a number of other solutions, including an award-winning discretionary investment management service, an end-to-end investment process, and digital reporting solutions, to name a few. We understand that, as a financial planner, there are many demands on your time and our aim is to make your job easier by providing you with the right tools. For instance, in response to recent regulatory requirements, we have launched an Ex Ante Costs and Charges calculator that provides users with a clear, transparent view of all the presale charges that need to be disclosed to clients under MiFID II regulation.

In addition to our core solutions, we provide training, knowledge and ongoing support. This takes the form of quarterly webinars, educational content, weekly reviews, training roadshows and investment briefings offering clients structured CPD certified content. The dedicated FE Training Academy offers customised modular training to advisers and financial planners to help them get the most of the services and tools they use from us. Following the CPD accredited training and examination, you can qualify as 'FE Analytics certified'. Since its launch, the certification has been quick to be adopted as it not only indicates a level of knowledge of FE's products, but also the key skills involved in researching investments and providing robust investment advice.

*enquiries@financialexpress.net*

**CISI FINANCIAL PLANNING CORPORATE SUPPORTERS Q1 2019**

**Gold**

**Just**
www.justadviser.com
**Schroders Investment Management**
www.schroders.co.uk/adviser

**Silver**

**Dimensional Fund Advisors**
www.dfauk.com
**Standard Life**
www.standardlife.co.uk

**Corporate**

**AIC**
www.theaic.co.uk
**BMO GAM**
ww.bmogam.com
**Financial Express**
www.financialexpress.net
**First Trust Global Portfolios**
www.ftglobalportfolios.com
**Hearthstone Investments**
www.homeinvestor.fund
**Independent Health Care Solutions**
www.ihcs.co.uk
**James Hay Partnership**
www.jameshay.co.uk
**Jupiter Asset Management**
www.jupiteram.com
**NS&I**
www.nsandi.com
**Orbis Investments**
www.orbis.com
**Puma Investments**
www.pumainvestments.co.uk
**Royal London**
www.adviser.royallondon.com
**Transact**
www.transact-online.co.uk
**Vanguard**
www.vanguard.co.uk

**Affiliate**

**Blackfinch Investments**
www.blackfinch.com
**Selectapension**
www.selectapension.com

# Socially responsible investments in residential property

Our investment philosophy at Hearthstone focuses on acquiring high-quality, energy-efficient and environmentally friendly homes accessible to all.

We seek to invest in rental housing with a positive social and environmental impact by acquiring new or nearly new homes with green space, close to transport links and schooling, saving on the use of motor vehicles and improving the lives of the tenant's family.

**Environmental**
Our properties exhibit significantly higher energy performance ratings, with 98% of them in Band B or C, compared to the national average of Band D. Similarly, our carbon footprint rating has 65% in Band B with the national average being at Band D.

TM home investor fund
RESIDENTIAL PROPERTY BY HEARTHSTONE

**Social**
All of the homes in our TM home investor fund meet Decent Home Standards, versus the market average of 80%.

By early purchasing of clusters of new-build homes, we are helping to facilitate the supply of much-needed new homes in the UK. We provide longer tenancies aligned with tenants' interests. While the legal requirement is six months, we offer a minimum tenancy of 12 months and our average stay is 24 months.

We provide everyone with the opportunity to invest in residential property, without the need for a mortgage or large initial deposit, with access from as little as £100.

**Governance**
One company, Touchstone, professionally manages all of our properties. We use digital maintenance software to improve tenant communications and service.

Our fund is FCA-authorised, with monthly independent valuations.

As with all investments, your capital is at risk.

# Making clients feel special and cared for

STAFFORD WEALTH MANAGEMENT WAS THE FIRST UK FIRM TO RECEIVE ACCREDITED STATUS IN 2011. DIRECTORS **MIKE STAFFORD** CFP™ CHARTERED MCSI AND **PHIL STAFFORD** CFP™ CHARTERED MCSI RELATE HOW IFP FOUNDER MEMBER PAUL ETHERIDGE CFP™ CHARTERED FCSI(HON) COACHED THEM TO SET THEIR FIRM ON THE PATH TO ACCREDITATION

***WHEN DID YOU BECOME AN ACCREDITED FIRM? WHAT HAS HAPPENED SINCE?***

On 6 October 2011, ours was the first firm in the UK to receive the new accreditation, under our previous trading name of Stafford & Co.

We have since incorporated and split the financial planning function from the regulated investment services. Although they are complementary services, the split brings several operational benefits, such as lower costs and a wider client base.

***WHAT HAS ACCREDITED FIRM STATUS BROUGHT TO YOUR FIRM AND WHY SHOULD OTHERS SEEK TO BECOME ACCREDITED?***

It demonstrates you take your role seriously, which is reassuring for clients. It indicates that how we run our practice is in line with the expectations CISI has for a quality financial planning firm. It also influences staff and gives them standards to uphold and motivation with their studies.

***WHAT ACCOLADES AND AWARDS HAS THE FIRM PICKED UP IN RECENT TIMES?***

In the early years of building our practice we entered and won several categories in the [former IFP] Financial Planner of the Year award. We have not entered in recent years as we are concentrating on nurturing our staff to reach their potential. One of our treasured awards was received in 2013 following nomination from our peers for the Lloyds Bank/Scottish Widows Lifetime Achievement Award for services to the financial planning profession. The bronze 'widow' has held pride of place on our office mantelpiece ever since.

***WHAT SORT OF BUSINESS IS STAFFORD WEALTH MANAGEMENT AND WHAT SERVICES DOES IT OFFER? WHAT'S YOUR USP?***

We are first and foremost a financial planning practice. We seek to build a strong relationship with our clients and provide a bespoke service while working to a process. We have been working with clients for over 25 years and have helped them to accumulate while building their careers. We are now seeing them reach their goals and move to the next stage of their lives. We have seen them raise their children and now many enjoy being grandparents. It is extremely rewarding to know we have helped our clients to achieve financial independence and we can continue to help them assist their children and grandchildren and plan their estates effectively.

On the regulated side, we oversee our clients' investments and pensions, and assist in setting up and arranging the investments within many family trusts. We also work closely with local firms of solicitors, helping their clients for whom they hold powers of attorney to arrange immediate care planning.

Our strength is our attention to client service, where all the team strive to make clients feel special and cared for.

***HOW DID YOU GET INTO FINANCIAL PLANNING?***

We set up a traditional independent financial advice practice as a partnership in 1986, Mike having had a previous career in life assurance and Phil in banking. Two years later, while attending a conference, we visited an exhibition stand that was manned by a certain Paul Etheridge CFP™ Chartered FCSI [founder member of the former IFP] and became enthralled by his demonstration of how to provide financial planning for clients using dedicated software. We were hooked, but at the time the cost of the software Paul was promoting was beyond our budget. A further two years later we signed up, and in due course joined Paul's Advanced Planners Group. We were coached by Paul on a monthly basis for the following three years and then we became CERTIFIED FINANCIAL PLANNER™ professionals. The practice has been built on those foundations. In recent years, Phil has coached other financial planners under the Prestwood umbrella.

***WHAT'S THE BEST THING ABOUT BEING AT A FINANCIAL PLANNING FIRM?***

Seeing many clients achieve their lifestyle goals and ambitions provides huge satisfaction and reiterates every day the value of financial planning. Also, meeting people from so many different professions and careers and learning about them. It's very rewarding to have helped so many clients achieve their goals.

***WHAT IMPACT HAS MiFID II HAD ON YOUR BUSINESS?***

Little or none in terms of client services and relationships, although a small number of clients have been unable to keep pace with the ever-increasing cost of regulation. In practical terms, the regulated side avails of external compliance guidance and this means updating manuals, guides, notices and other documents. We tend to mirror appropriate general guidance on the financial planning side.

***WHAT DO YOU LIKE ABOUT THE CISI?***

The institute is big enough to make a difference in the financial services marketplace, in raising the profile of financial planning, for the benefit of clients and firms.

***WERE YOU INVOLVED IN FINANCIAL PLANNING WEEK 2018? IF SO, WHAT DID YOU DO?***

We get involved every year, usually in providing face-to-face surgeries.

***WHAT DOES A TYPICAL DAY LOOK LIKE?***

As the practice is built around client service, and client review/planning meetings are diarised well in advance, we invariably deal with a myriad of client issues that can arise on a daily basis. That is probably the typical element. We also have to factor in other activities like CPD, CISI meetings, professional connections and staff training, so no two days are necessarily the same. When we have the opportunity, we will often detour on the way home to visit our grandchildren, who live a five-minute walk from our office.

***WHAT ARE YOUR KEY TIPS FOR OTHER PLANNERS?***

Consider how a financial planning practice will look in the future and try to build around your vision. This includes technology, staff, services and locations. We can expect changes in every area of practice, so be mindful and alert to opportunities to advance as they arise. Trying to keep one step ahead is always worth the effort. ●

The Stafford Wealth Management team (clockwise from top left): Magda Furman, paraplanner; Pamela Moyo, trainee paraplanner; Victoria Peck, client services administrator; Sam Warner, trainee client services administrator

**MIKE STAFFORD CFP™ CHARTERED MCSI**

Mike serves on the CISI Financial Planning Forum Committee and the Accredited Financial Planning Firms Steering Group. Previously, he served as a board member of the Institute of Financial Planning (IFP), which merged with the CISI in November 2015.

Mike spent the early part of his financial services career primarily in broker development and management.

His spare time nowadays is generally spent with his daughter and grandchildren.

**PHIL STAFFORD CFP™ CHARTERED MCSI**

Phil's early career was in banking, including the trustee department of a major bank.

Phil has served on the board of the Financial Services National Training Organisation and the Financial Services Skills Council. She was a member of the Qualification and Curriculum Authority's Financial Services Training and Advisory Group, and the Small Business Practitioner Panel of the Personal Investment Authority (PIA), which became the FSA and is currently the FCA.

Phil enjoys spending time with her daughter and grandchildren.

LIAM PALMER, CHARTERED MCSI, CUTS THROUGH THE STRESS, INTENSITY AND CHALLENGES OF WORK BY PRACTISING THE JAPANESE MARTIAL ART OF KENDO TWICE A WEEK. **LORA BENSON**, CISI HEAD OF MEDIA, REPORTS

# The calm of kendo

Liam's firm, Darién Consulting, specialises in investment operations and transformation. Much of Liam's time recently has been consumed by working with Schroders business consulting and design teams, helping to mobilise a large programme to on-board Lloyds Banking Group's investment mandates – believed to be the biggest ever such transition in the UK.

But for a few hours a week he doesn't think about it. "I think of nothing but my kendo practice and the opponent in front of me. The aggression and speed of kendo makes it very easy to maintain focus … sometimes just on getting air into my lungs," says Liam.

Kendo is descended from traditional swordsmanship using bamboo swords (*shinai*) and protective armour (*bogu*). Liam first saw kendo when he spent a month in Japan in 1985 as part of his international business, economics and Japanese degree from Auckland University, New Zealand, where he was born and grew up.

He was attracted to kendo by the combination of strenuous physical effort and discipline required: "There is no defence or blocking in kendo – only attack. Advanced practitioners may use techniques that rely on the opponent initiating an attack, but only with the intent of being able to use that as an opportunity to strike themselves."

It cost Liam between £300 and £500 to be fully kitted out for kendo

He started practising kendo at the Ichi Byōshi Kendo Club in Aylesbury in July 2018. For the first six weeks, he was allowed to train in western clothing while he focused on footwork and cutting methods with equipment borrowed from the club. "At this point you need two swords: a *bokuto* wooden sword and a *shinai* bamboo sword. The *bokuto* is used to practise *kata*, which means 'form', and is a choreographed series of drills for learning and perfecting kendo techniques; the *shinai* bamboo sword is used for more energetic practices."

Once the basics are mastered, the student moves on to more serious kit in the form of a helmet, gloves, breastplate armour including waist/groin protector, *kendogi* jacket and *hakama* wide-leg trousers. To become totally kitted out, including armour and swords, a kendo student would spend between £300 and £500: "Some of the armour needs to be a close fit for your body, therefore buying second-hand is tricky."

Kendo duelling is called *jigeiko*, with the winner in a competition being first to two points, says Liam. "To score a point you must make an intentional, accurate strike to one of four designated areas – the head, wrist, torso and throat – using the top-third of the *shinai*'s 'blade-side'. All while keeping correct posture and *'zanshin'* mental state and displaying the required high spirits – kendo is a noisy sport!"

## Top instructors

Liam typically does three to six *jigeiko* a week for one to two minutes: "That may not sound like a lot but by the end I am covered in sweat and trying to suck air through my helmet grill." Part of the challenge at this point is "to maintain form and focus when you are tired".

His kendo club is fortunate to have both a top qualified instructor and a British squad member as instructors: "John Bates, our third-dan instructor and Chris Bowden, who fought for Great Britain at the 2018 Kendo World Championships in South Korea. In kendo everyone fights everyone in rotation, no matter what the grade – it is challenging to try to hit most of the class, but facing John and Chris gives you a weekly experience of just how patient, precise and explosive a great cut can be."

Kendo is for anyone big enough to control a sword, which, Liam says, is roughly from the age of eight onwards: "We have a talented female member in our club who attained *ikkyu* grade and is therefore one of our more senior members. There is some advantage to height as that allows you to stretch to the target from further away, but speed and accuracy are more important."

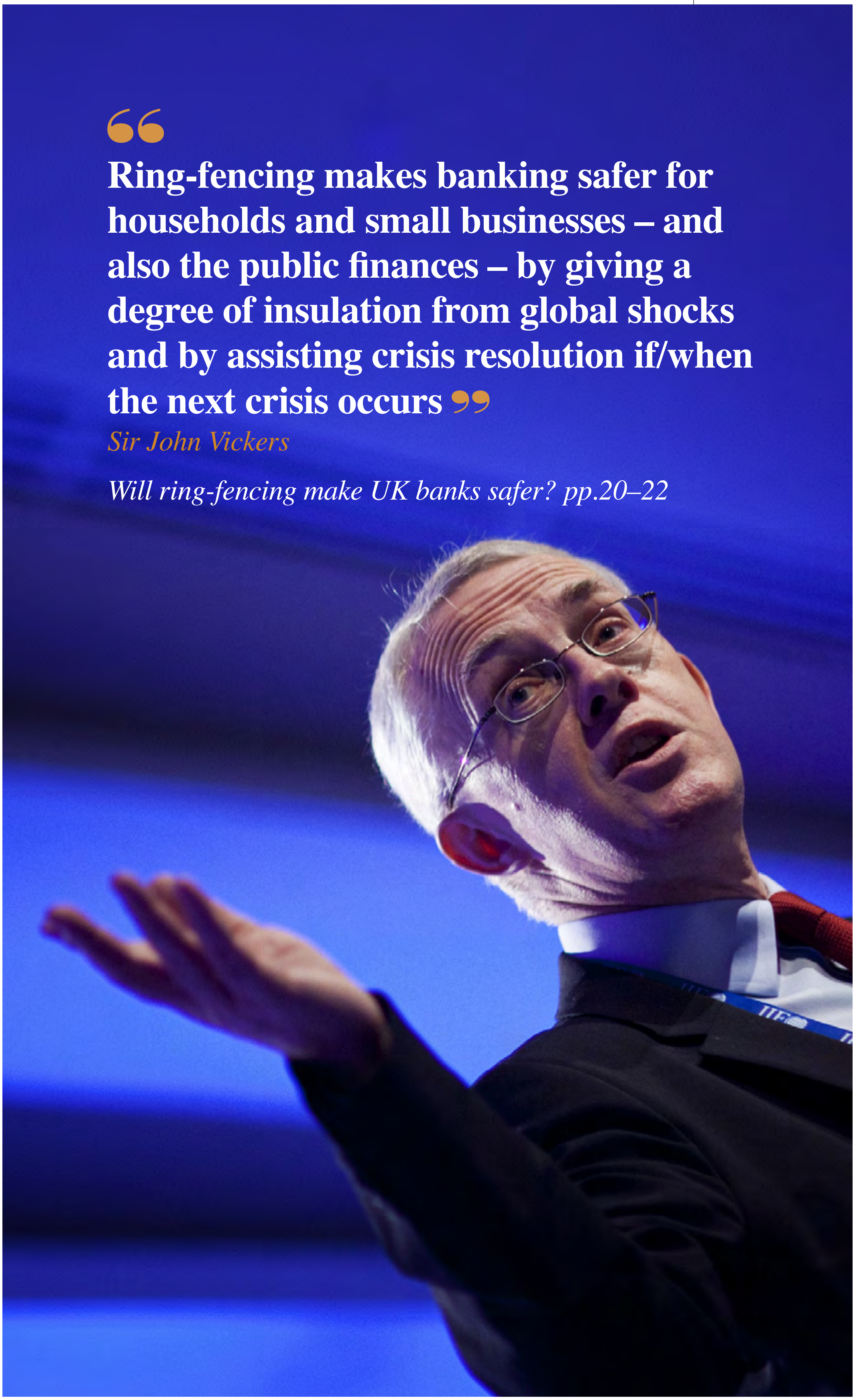
// THERE IS NO DEFENCE OR BLOCKING IN KENDO – ONLY ATTACK //

Injuries can occur: "We are particularly careful in practising the *tsuki* attack to the throat. If the attacker misses the armour, the sword can travel under the helmet wings. I've had minor injuries twice, once on the right thumbnail because I held the sword incorrectly, and once practising the eye-to-eye *tsubazeriai* technique without a helmet."

In terms of the kendo non-hierarchical approach to learning, one could argue that present-day corporate and business human resource management could learn a thing or two from it. "In every class the most junior person stands on the right and there is a huge focus on how teachers and students treat those more junior to themselves. It is good for the ego to be corrected by a ten-year-old who has been doing the sport only three months more than you," says Liam. ●

**Contact *jane.playdon@cisi.org* if you have a hobby you think will interest other CISI members. You will receive a £25 voucher if we publish your story.**

# global insights



> **Ring-fencing makes banking safer for households and small businesses – and also the public finances – by giving a degree of insulation from global shocks and by assisting crisis resolution if/when the next crisis occurs**

*Sir John Vickers*

*Will ring-fencing make UK banks safer? pp.20–22*

IMAGE: GETTY

FIRST PERSON

# Trackers on top

Anthony Hilton
FCSI(Hon)

ACTIVE MANAGERS ARE COMING UNDER GREATER PRESSURE AS INDEX FUNDS KNOCK THEM FOR SIX

**“Passive management means that investors simply buy a fund that replicates the index. Active management tries to find those shares which will outperform, and buys them. In theory, active managers should beat the trackers all ends up. But it does not work out like that. In practice, indexing is now all the rage.**

The first index tracker was launched in the 1960s, but it took a long time to get anywhere. Wells Fargo, the pioneer, started with the Samsonite pension fund, but only US$6m was pledged in 1971.

Others followed, including the late Jack Bogle, the founder of Vanguard. He wrote his thesis on passive management in the late 1950s, but it was almost 20 years before he put his ideas into practice. He launched in the mid-1970s and had a princely US$14m in 1976. Even in 1982, he only took US$100m and it was not until 1988 that he reached US$1bn. By 1996 he had raised US$10bn. Today, his main fund is worth US$400bn.

Exchange-traded funds (ETFs) have had an even shorter life, though they have made up for it since. The first was launched by the Toronto Stock Exchange in 1990. Nate Most, for many the father of ETFs, actually launched his S&P 500 product in 1993 at State Street, the US bank. It has grown to US$265bn and the overall ETF universe is now an astonishing US$5tn.

ETFs and index funds together are now worth US$10tn globally, or as much as private equity and hedge funds combined, and roughly 30% of the US fund management universe.

Particularly in recent years, active management has been knocked for six.

According to Rathbone, the UK wealth manager, in 2015 ETFs attracted US$200bn in the US while actively managed strategies saw outflows of US$124bn. It was the same story in bonds. ETFs took US$41bn in the first three months of 2016 whereas active funds lost US$16bn.

Since then, the trend has continued. Even if they are not quite as entrenched in the UK, index products are catching up fast.

This is no surprise. Index funds have most of the academic research with them. Eugene Fama’s Efficient Market Hypothesis, William Sharpe’s Capital Asset Pricing Model, and Harry Markowitz’s Modern Portfolio Theory all lend weight to passive investing.

So too does Warren Buffett, perhaps the world’s greatest investor. He not only recommends trackers to everybody who cares to listen, he also took a ten-year bet with hedge fund manager Protégé Partners to prove that the ‘hedgies’ (a hedge fund manager), with their active management, would underperform. His annual management letter in May 2018 said that the tracker delivered a performance of 126% whereas the active managers returned 36%.

> “Most active fund managers do not beat the index once their fees are taken into account”

Even more scathing was a *Wall Street Journal* article, which said: “Santa Claus and the Easter Bunny should take a few pointers from the mutual fund industry. All three are trying to pull off elaborate hoaxes. But while Santa and the Bunny suffer the derision of eight-year-olds, actively managed stock funds still have an ardent following among adults.”

The trouble is that most active fund managers do not beat the index once their fees are taken into account, so even if trackers go down, active managers do too.

Luck rather than skill accounts for many of those that do outperform. Managers need at least a 15-year period of outperformance to confirm that there is skill there, which means, in effect, that it can’t be verified because firms are not going to wait that long.

### Active managers protest

But active managers say they do better than it appears. From 1997 to 2014, Invesco surveyed a range of active funds and proved they were better than trackers. In particular, they do better in bear markets, it is said. The trouble is that someone else always has a different theory, or a different set of benchmarks, that tend to prove the opposite.

But perhaps active management will have its day if, as seems likely, there is a downturn in equity markets. In particular, Zeno Staub, chief executive of Vontobel, the Zurich fund manager, says indexing fails to distinguish between companies with the best environmental, social and governance credentials and those that are just scraping by. Clients want more than a ‘computer says no’ exercise from their investments. They want conviction to avoid doubtful sectors and to sleep well at night.

But it is getting harder. They say poker players need more skill once the dumb money has been taken by the good players. It is the same with active managers, who will find it harder to make money because the poor active managers will have given up.

Jeremy Grantham of GMO, a Boston money manager, says this logic will hold until index funds hold 90% of the universe. “Asset management is getting tougher and tougher,” he told the *Financial Times*. “The argument that it will become easier is nonsense.””

ILLUSTRATION: PADDY MILLS/SYNERGY

IMAGE: ISTOCK

THE CRIMINAL FINANCES ACT 2017 REPRESENTS A SIGNIFICANT SHIFT IN THE BURDEN OF PROOF FROM INVESTIGATING AUTHORITIES TO SUSPECTS. WHAT DOES THE LAW NOW SAY AND WHAT ARE THE CONSEQUENCES FOR WEALTH MANAGERS? **DOMINIC DUDLEY** REPORTS

# Whose wealth is it anyway?

It has not taken long for the UK's Criminal Finances Act 2017 to make an impression. Since its provisions on unexplained wealth orders (UWOs) came into force in January 2018, it has led to countless news reports, many of them focused on one particular high-profile court case.

But UWOs are not the only important element of the law. There are other measures in the Act, such as account freezing orders, which represent a profound shift in the UK's approach to tackling financial crimes. The FCA has made it plain that financial crime is one of its top targets in 2019–20 and that it will be pursuing offenders with vigour.

"The Criminal Finances Act is a pretty radical piece of legislation," says Alan Ward, a senior associate at law firm Stephenson Harwood. "The account freezing order and forfeiture provisions in chapter 3 of the Act have attracted far less media coverage than UWOs, but in many ways those provisions are very likely to have a far greater impact." They are easier to acquire – a UWO requires a High Court order while an account freezing order only requires the approval of a magistrates' court – which means they could be used more often.

## High-profile case

For now, though, it is UWOs that are the best-known element of the Act. The first two UWOs were served in February 2018, when the National Crime Agency (NCA) successfully applied to the High Court to >>

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issue orders relating to £22m worth of property in London and Berkshire owned by Jahangir Hajiyev, a former chairman of the International Bank of Azerbaijan, and his wife Zamira.

The Hajiyeva case will not be the last we hear of UWOs. Following the High Court ruling in October 2018, the NCA's director for economic crime, Donald Toon, said: "We will continue with this case and seek to quickly move others to the High Court. We are determined to use the powers available to us to their fullest extent."

Given this clear message, it makes sense for those working in the financial services sector to know the provisions of the 2017 Act, where and when they can be used and what should be done in preparation.

## Why the Act was passed

The government's motivation for passing the Criminal Finances Act 2017 was the need to clamp down on money laundering and clean up London's reputation as an international financial centre. It is impossible to know just how much money laundering goes on, but the amount is likely to be huge. In 2017, the anti-corruption group Transparency International UK said it had identified £4.4bn worth of property in the UK that had been bought with 'suspicious wealth' and it says much of this could now be the subject of UWOs.

NCA estimates are more eye-opening. In its *2018 National strategic assessment*, published in May of that year, the NCA says: "Given the volume of financial transactions transiting the UK, there is a realistic possibility the scale of money laundering impacting the UK annually is in the hundreds of billions of pounds."

## How UWOs work

Along with the NCA, a limited number of authorities can apply for a UWO, including Her Majesty's Revenue and Customs (HMRC), the FCA, the Serious Fraud Office and the Crown Prosecution Service. The orders themselves can only be issued by the High Court (or the Court of Session in the case of Scotland) and are designed to be used when there are suspicions about how someone acquired property.

They can be issued against two groups of people: someone who is suspected of being involved in a serious crime (or is connected to someone involved in such a crime); or a politically exposed person (PEP), such as a politician, entrusted with prominent public functions, or their family members or close associates.

The scope of the law is wide. In theory, a UWO can be issued against any person anywhere in the world and in relation to any asset worth at least £50,000. A key consideration is whether the target's known legitimate income appears sufficient to have acquired the asset in question. It does not matter whether the property was acquired before or after the law came into force.

"The extra-territorial effect of UWOs is remarkable," says Shaul Brazil, a partner at BCL Solicitors and a specialist in business crime and regulatory enforcement. "However, in practice, UK law enforcement authorities are unlikely to seek a UWO where neither the respondent nor the property is in the UK."

Another important aspect of UWOs is that they shift the burden of proof from the law enforcement agencies on to the individual being targeted. Thus, anyone who is served with a UWO will have to provide evidence to prove they have acquired the assets lawfully. In that sense, UWOs are "an extraordinary form of disclosure order, sought in aid of civil recovery proceedings," says Alan from Stephenson Harwood.

"They require someone who is, to all intents and purposes, suspected of benefiting from criminality to explain the source of the funds used to purchase particular property, anywhere in the world. There is a quite chilling reversal of the burden of proof."

Failure to cooperate with a UWO without a reasonable excuse creates a presumption that the property has been acquired nefariously and it can then be seized under the Proceeds of Crime Act

// THERE IS A REALISTIC POSSIBILITY THE SCALE OF MONEY LAUNDERING IMPACTING THE UK ANNUALLY IS IN THE HUNDREDS OF BILLIONS OF POUNDS //

During court proceedings, it emerged that Zamira Hajiyeva spent £16.3m in Harrods between September 2006 and June 2016

IMAGE: ISTOCK

2002. In addition, although the UWO is a civil power, anyone who knowingly makes misleading or false statements in response to a UWO is committing a criminal offence and could face up to two years in jail.

In contrast to UWOs, which are served on an individual suspect, account freezing orders are directed at institutions that hold a suspect's accounts. These orders expand the police's existing cash seizure powers into other areas such as bank and building society accounts. Previously, the authorities would have to apply to a Crown Court before making such a move, but the 2017 Act means they can instead go to a magistrates' court. Importantly, the legal threshold they have to reach is also now far lower. "The authorities have been afforded an enormous short cut to freeze and forfeit money held in bank accounts," says Alan.

### Reviewing policies and procedures

These are not entirely new issues for wealth managers to grapple with. Anti-money laundering regulations and know-your-customer provisions mean that the sector is already well used to vetting customers' wealth and checking if they are a PEP. In one sense, the provisions of the 2017 Act may simply be viewed as a useful opportunity for firms to review the policies and procedures they already have.

It may in some cases be necessary for a firm to strengthen such policies to ensure it has a fully rounded picture of how a client acquired their wealth. Given the extra-territorial nature of the legislation, firms may also want to ensure they are able to identify sufficient legitimate sources of income to account for all their client's assets wherever they are held.

However, the overlap with existing obligations means wealth management firms should already be in a strong position. "To a large extent, the systems, policies, controls and procedures put in place to address money laundering and terrorist financing risks should militate against a UWO being made against a client," says Shaul.

Even the most stringent tests will not necessarily prevent clients receiving unwanted attention, though. There is always the possibility that an innocent individual could become the target of an order and, in some cases, they may struggle to produce sufficient evidence to back up their claim to legitimate ownership – for example, for something acquired in the distant past. In all cases, however, the law makes it clear that it is up to the individual concerned to prove their right to the property and, if they are unable to do that to the court's satisfaction, the asset can be seized.

ILLUSTRATION: GARY WATERS/IKON

Perhaps the biggest unknown is how extensively the authorities will use their new powers. The evidence from other jurisdictions offers a mixed picture. According to a study by Florence Keen, a research analyst at the Royal United Services Institute's Centre for Financial Crime and Security Studies, similar powers in Ireland have led to impressive results in regard to civil confiscation by the Criminal Assets Bureau. In Australia, confiscation rates have been low. In a paper published in September 2017 – *Unexplained wealth orders: lessons for the UK* – Keen suggests the key factors behind a successful model for UWOs include a high level of skill among investigators, co-operation between government agencies, sufficient resources being allocated to the system and enough political will.

Whether UWOs are a tool which the NCA or other bodies use much in the future probably depends in part on the outcome of the Hajiyeva case. But there is anecdotal evidence that account freezing powers are being used more extensively. In the first such case to come to light, the NCA was granted an order in May 2018 to freeze three bank accounts belonging to the son of a former prime minister of Moldova after investigators suspected the funds in the accounts were the proceeds of illegal activity by the father.

"When an account freezing order lands, the institution will have a limited time to comply," says Alan. Preparation, it seems, will be the best policy. ●

// ANTI-MONEY LAUNDERING REGULATIONS AND KNOW-YOUR-CUSTOMER PROVISIONS MEAN THAT THE SECTOR IS ALREADY WELL USED TO VETTING CUSTOMERS' WEALTH //

# Will ring-fencing make UK banks safer?

SINCE 1 JANUARY 2019, LARGE UK BANKS HAVE BEEN REQUIRED TO PUT A PROTECTIVE BARRIER AROUND THEIR RETAIL SERVICES. WHILE THIS WILL MAKE THE SECTOR MORE ROBUST COME THE NEXT RECESSION, BANKS HAVE LOST THE OPTION OF USING THEIR CAPITAL CREATIVELY. **PHIL THORNTON** REPORTS

ILLUSTRATION: MATT KENYON/IKON

As Britain emerged from its worst financial crisis for generations, the incoming Coalition Government set up an independent commission in June 2010 to look at reforming the banking sector.

The sector was on the ropes after Royal Bank of Scotland (RBS) had to be rescued with a £45bn taxpayer bailout. Launching the Independent Commission on Banking (ICB), then Chancellor George Osborne said: “There are fundamental issues of protection for an economy still reeling from a crisis that in Britain saw the biggest bank bailout in the world.”

The commission, chaired by Sir John Vickers, former director general of the Office of Fair Trading, was set goals of ensuring banks were more resilient against future crises, safeguarding core high street banks, and ensuring vigorous competition.

### Ring-fence, not break up

Although there was pressure to break up the big banks, the ICB and the government favoured creating a ‘ring fence’, with each bank keeping retail operations separate from investment banking, with their own boards, balance sheet and regulatory obligations. The aim was to end the problem of banks being ‘too big to fail’ by isolating and protecting those services where continuous provision is critical.

After the passage of the Financial Services (Banking Reform) Act 2013, the new model went live on 1 January 2019. Ring-fencing applies to banks with more than £25bn of retail deposits and so embraces Barclays, HSBC, Lloyds Banking Group, RBS and Santander.

Brandon Davies, a lecturer in banking at the University of Buckingham and former treasurer at Barclays retail bank, says the drain on liquidity meant banks had to stop lending to anyone. “The lesson, I believe, that Vickers took from this was that the close relationship between wholesale and retail banking was dangerous,” he says, adding that the rapid contraction in liquidity caused by the need for banks to fund now illiquid securities held by the wholesale banks led to an equally rapid contraction of lending by banks’ retail arms. That, in turn, led to a fall in the supply of broad money to the economy and thus to a severe economic recession.

“How do you break that chain? One lesson is you don’t want the wholesale banks draining the retail banks of liquidity in a crisis,” Brandon says.

All the banks affected have created a ring-fenced entity to hold retail and small business accounts. In 2018, Barclays completed the transfer in March, HSBC in July, and RBS in August. Santander and Lloyds Banking Group say they have met the deadline.

Paul Chisnall, director of finance and operations policy at UK Finance, the sector body, says ring-fencing represents a multi-billion-pound infrastructure project. "The Prudential Regulation Authority (PRA) has described this as arguably the largest ever structural change to the UK banking system."

### Changing the landscape

The main goal is to make sure the new entities are viable and have the capital and liquidity they need, says John Liver, head of financial services regulation at EY.

// THE AIM WAS TO END THE PROBLEM OF BANKS BEING 'TOO BIG TO FAIL' BY ISOLATING AND PROTECTING THOSE SERVICES WHERE CONTINUOUS PROVISION IS CRITICAL //

Banks have been given some discretion to adapt the rules to suit their models but the ICB estimates that between £1.5tn and £2.5tn of assets will be held behind the ring fence. "The basic need to set up the viable entity has been one of the drivers of the discretion they had about where they sited the fence within the group," John says. "For all the banks it has been a major project – there is no question about that."

Banks had to take specific steps to reorganise the structure of their organisations. One example is RBS. It created a holding company – NatWest Holdings – that contained five licensed banks: Royal Bank of Scotland; National Westminster Bank; Ulster Bank Ireland DAC; Ulster Bank Limited; and Coutts and Company. Outside the ring fence are its investment banking activities, in NatWest Markets, and its activities in the non-European Economic Area, at Royal Bank of Scotland International and Isle of Man Bank.

Banks had to adjust their existing operating model or implement a new one, alongside supporting organisation design for the ring-fenced and non-ring-fenced banks. This involved not just establishing clear roles and structures, but also determining how the different component parts of the bank continued to interact. A key consideration was how each bank's operational and corporate core functions, including HR, would provide services to both banks. Within the organisation design, the split of responsibilities needed to be determined in order to make sure that the entities were able to demonstrate independence. Rather than have complete operational separation, banks opted to find a way for the two banks to share back-office support functions. However, each entity should have full and effective corporate governance and a culture that meets the new requirements expected within the differing ring-fencing structures.

Other steps included transferring customers' sort codes and account numbers between entities and setting up new risk and decision-making processes. "They were large, complex and demanding pieces of work and certainly it was a major devourer of resource, capability and thinking, both strategically and operationally," John says.

Brandon says banks needed to update technology and processes anyway. "The implementation of new regulation has been costly, but much smaller than the cost of

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>> additional capital, which was I think inevitable under any new regulatory requirements," he says.

## Leading global reform

Britain has gone further than other major financial centres. In the US the main initiative is the Volcker rule that bars banks from carrying out investment activities on their own account – known as proprietary trading.

However, talk of recreating the Glass-Steagall law from the 1930s, which split retail and investment banks following the Great Depression, has not materialised. Opponents say it is not a panacea, pointing out that three of the institutions at the heart of the 2008 crisis – Bear Stearns, Merrill Lynch and Lehman Brothers – had no retail divisions.

Although the Liikanen Report, commissioned by the European Commission in November 2011, recommended separating proprietary trading and other high-risk trading activities, the Commission withdrew its proposals because of disagreement among member states.

Giving the annual Mansion House speech in the City of London in June 2018, Bank of England governor Mark Carney said the UK was "at the forefront of G20 reforms to create a global financial system that is safer, simpler and fairer".

He said ending 'too big to fail' would help make London a more robust financial centre. "With enhanced resolution powers and planning, the Bank of England now has the ability to resolve failing banks," he added.

## New entrants

A number of new banks have launched since the Vickers report. While ring-fencing will not directly affect small banks, John believes they will benefit from other aspects of the Vickers reforms.

The PRA has introduced a graduated way for small banks to increase the capital they must hold as they grow. "By not requiring it to be fully capitalised from day one, it recognises that it can match growth of capital to the growth of the business in a way that was not done before," says John. He says that a number of banks that entered the market recently are taking advantage of that lower-cost way of getting into the business.

However, Brandon says some banks launched in the expectation that Vickers would give them an opportunity as bigger

// RING-FENCING ENSURES A RETAIL BANK NO LONGER NEED WORRY DURING A CRISIS ABOUT CONTAMINATION FROM AN INVESTMENT BANK PORTFOLIO //

ILLUSTRATION: MATT KENYON/IKON

banks found themselves more constrained by regulation. "While we have seen a number of competitors come in, a number were mistaken and came in on the grounds that it would be easier to take the big banks on, but it has proved very much more difficult than they thought," he says.

"The reality is that the more regulations you bring in, the more oligopolistic any sector becomes." Although comparisons are tricky because of takeovers, figures from Statista show the big five had market share of 85% in 2014, the same as their predecessors did in 2007, according to Mintel.

## Any safer?

The UK Treasury has said ring-fencing will support financial stability by making banks easier to resolve without the need for a government bailout.

The balance sheet split across ring-fenced and non-ring-fenced banks should certainly give some degree of comfort. RBS now has approximately 80% of risk-weighted assets within its ring fence while Santander says its ring-fenced bank (Santander UK) is circa 98% of the capital base of the UK group (Santander UK Group Holdings). While figures for HSBC are not yet available, as a vast global, diversified bank, its share of assets within its ring fence is likely to be lower. As banks did not have to finalise the split until 1 January 2019 at the latest, it is not until the 2020 annual report season that we are likely to get a clearer picture of how bank balance sheets are split across the two banks.

Brandon believes banking is safer without the hidden cross-subsidy of investment banks by their retail banking arms. "If Vickers makes the bank more robust, we won't know until the tide goes out and we are in the next recession. But my bet would be it has made them more robust and that banks will be OK the next time round."

John at EY agrees that ring-fencing ensures a retail bank no longer need worry during a crisis about contamination from an investment bank portfolio. However, on the negative side, he says it prevents a bank's ability to move capital from one part of the organisation to protect another part. "Trapping capital in individual entities doesn't help because it means the group is constrained in what it can do to support an entity," he explains.

Marco Meyer, a Leverhulme early career Fellow at the University of York, who has co-authored a study into bank ethics called *Ethical banking: the key concepts*, doubts ring-fencing will make the banking system as a whole safer, but says it should make consumer banking safer. "It should open up more options to regulators when non-ring-fenced parts of banks get in trouble, so banks have less opportunity to twist the arm of regulators, which strikes me as a good thing," he says.

Eight years on from his report, Sir John is quietly confident. "Ring-fencing makes banking safer for households and small businesses – and also the public finances – by giving a degree of insulation from global shocks and by assisting crisis resolution if/when the next crisis occurs." ●

IMAGE: ISTOCK

# The art of listening

LISTENING CAN BE ONE OF THE MOST POWERFUL TOOLS IN AN ADVISER'S TOOLKIT, BUT THEY MUST LEARN HOW TO USE IT EFFECTIVELY. **SANDRA PAUL** REPORTS

Ask billionaire investor Warren Buffett about the biggest influences on his success and Dale Carnegie's iconic 1936 book, *How to win friends and influence people*, is likely to come up. Buffett took the Dale Carnegie training course when he was 20 years old and to this day has the diploma hanging on his office wall.

Since it was published, millions of people have read Carnegie's book or attended his courses and his advice has stood the test of time. Many of his golden rules revolve around listening: be a good listener; encourage others to talk about themselves; become genuinely interested in other people; try honestly to see things from the other person's point of view; and be sympathetic to the other person's ideas and desires. Carnegie discovered that, to be successful, knowledge alone is not enough. The way to be a more successful individual is to be mindful of others.

### Carnegie's approach

If Carnegie were alive today, he would probably endorse the activities, including research and lobbying, of the Mental Health Foundation (MHF) to promote the power of listening for good mental health. Chris O'Sullivan, head of business development and engagement at the MHF, writes in a blog post on the MHF site that listening is one of the best ways to maintain healthy relationships, alongside giving time and being present. One of the key messages underlying the MHF's work is that listening carefully has a powerful, positive effect on those you are listening to. Not being listened to can lead to frustration and, possibly, two different outcomes: a closing down, like depression, or an explosion of emotion. According to the MHF, negative mental health will affect two-thirds of us at some point in our lives. One factor that can play a part in combating this is the act of listening. The MHF suggests:

1. Listening actively to what others are saying in a non-judgemental way and concentrating on their needs in that moment.
2. Being present in the moment, rather than being tempted to check your phone, Facebook messages or even work emails when with family and friends.

In financial services, listening is crucial to the successful relationship between a client and adviser, be that a financial planner, wealth manager or an investment manager. Without the ability to listen effectively, messages are easily misunderstood, the client feels unheard and undervalued and will inevitably leave for a competitor.

According to Eleonora Mancini, business development manager at business coaching firm Strategic Coach, the most important person in this relationship is the client – it's all about them. The best thing the adviser can do to strengthen this relationship is to develop excellent listening skills. "Often, an

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>> adviser will ask a question, get an answer from the client, and then immediately jump in with a solution they're offering that will solve the problem. When you do this, it becomes about you and your offerings, not about the client at all," Eleonora says.

### Listening without judgement

Careful, non-judgemental listening establishes trust and empathy and is the key to building long-term, successful client–adviser relationships. Allowing clients the space and time to talk while you listen, particularly if it is nothing to do with financial matters, is one of the most important gifts you can give and should not be underestimated or undervalued.

Christopher Jones-Warner, Chartered FCSI, former chair of the CISI Wealth Management Forum, specialist in developing leadership and communication skills in wealth management firms, and now a senior adviser at the CISI, describes this as 'empathetic listening'. "Any potential client coming to wealth management is likely to be intimidated because they have a perception that they know nothing and the financial adviser knows everything. But they don't want to admit it. This is exacerbated in wealth management offices because they're built with the intention of making the firm appear successful. The potential exists for clients to be intimidated by the exterior, but what is important is how they are interacted with by the adviser and critical to that is how the adviser listens."

If your goal is to really listen, then taking your attention from your client to perhaps jot down notes is a distraction. A good way to ensure your focus remains on your client is to record your meetings or have another staff member take notes.

Nik Proctor, director of IFS Family Wealth Advisers, believes advisers should listen with their ears and their eyes. People will often respond to a question, but if you watch them, they're still processing the question you asked them in their mind. "The Kinder Institute of Life Planning course has taught me that listening is a skill," says Nik. "I always ask, 'Anything else?' then wait and that pause allows space for my client to think and speak."

### Conversations with colleagues

Listening is equally important to the colleague conversation. When you are talking to a colleague but they're facing their computer screen and not looking at you, are they listening? When your boss is staring fixedly at their mobile while you debrief them, are they listening? Hearing isn't necessarily listening. Staff can feel undervalued and not core to the success of the business if their voices are not heard. But just allotting time for staff to speak is not enough. A manager should take time to really listen and understand their employees' points of view. And remember the ones who do not speak – fear often prevents staff members from speaking in the first place.

Sally Boyle, EMEA head of human capital management at Goldman Sachs, says: "Don't underestimate the power of listening well and choosing words with care. Take time to reflect on the type of culture you are fostering in the workplace."

For example, saying your door is always open may lead to constant interruptions from staff. Instead, you may want to promote a working culture where innovation is encouraged, but rather than ad hoc discussions, new ideas are discussed in an allocated time slot. Managers should be aware of who they have regular one-to-one meetings or coffee breaks with. Is there a pattern and, as a result, are there individuals, or even a group, that they hear from less often? "After your next meeting, take a moment to reflect on who spoke and, more importantly, who was not heard. Take notes and repeat them back at your next meeting to demonstrate you have heard your team," Sally advises.

// ALLOWING CLIENTS THE SPACE AND TIME TO TALK WHILE YOU LISTEN IS ONE OF THE MOST IMPORTANT GIFTS YOU CAN GIVE //

#### DALE CARNEGIE'S TIPS ON HOW TO WIN FRIENDS AND INFLUENCE PEOPLE

1. Be a good listener. Encourage others to talk about themselves. The easiest way to become a good conversationalist is to become a good listener. To be a good listener, we must actually care about what people have to say. Many times, people don't want an entertaining conversation partner; they just want someone who will listen to them.
2. Talk in terms of the other person's interests. The road to a person's heart is to talk about the things he or she treasures most. If we talk to people about what they are interested in, they will feel valued and value us in return.
3. Make the other person feel important – and do it sincerely. The golden rule is to treat other people how we would like to be treated. We love to feel important and so does everyone else. People will talk to us for hours if we allow them to talk about themselves. If we can make people feel important in a sincere and appreciative way, then we will win all the friends we could ever dream of.

## Hearing through mentoring

One way of ensuring employees' voices are heard is through initiatives such as mentoring. Jacqueline Lockie CFP™ Chartered FCSI, head of financial planning at the CISI, has mentored many colleagues in the financial planning sector throughout her career. One previous mentee is Joanna Hague CFP™ Chartered MCSI, a paraplanner at Doncaster-based financial planning firm Investment for Life. Joanna says having access to a mentor within the profession has been a valuable tool.

"Mentoring is one of those things that can't be found by reading books or using the internet," she explains. "It has given me someone who listens and offers personalised advice based on their own experiences – whether it is regarding technical areas of the planning we do, preparing for a qualification or discussing areas of proposition to clients."

The CISI recently launched a Financial Planning Mentoring Scheme so that other financial planning professionals who are members of the institute can experience the same benefits as people like Joanna (for more details about the scheme, visit *cisi.org.fpmentoring*).

## Listening in the digital era

US academic Dr Charles Veenstra has studied what communication technologies do to the nature of communication, and particularly listening. In a March 2014 paper, *Social media's impact on listening and loneliness*, he defines listening as receiving, constructing meaning from and responding to spoken and non-verbal messages. A central value of technology, he observes, is efficiency, and social media – through its immediate access to friends and rapid response functionality – encourages efficiency of communication. (He equates efficiency with speed in the context of the report, noting that nonverbal communication in digital media is mostly absent.) It is at odds, says Veenstra, with the slow and "inefficient" process of listening.

The 'always on' and 'multitasking' characteristics of social media don't help either. They are major barriers to listening, Veenstra argues, quoting Nicholas Carr, author of *The shallows: what the internet is doing to our brains*, who likens the multitasking encouraged by social media to reading a book while doing a crossword puzzle.

Despite or even perhaps because of these barriers to active listening, digital native generations, millennials and younger, want a financial adviser who is more of teacher, who will educate them and can demonstrate that they place the client's interest above their own. This is according to research about millennials and investing, published by FINRA Investor Education Foundation and the CFA Institute. They want to be encouraged to listen, as well as be listened to, in other words.

Trying to get your message heard in the digital age is not easy when competing against a multitude of tools and messages. The increasing 'noise' has been said to contribute to rising stress levels and anxiety. Mark Rowland, CEO of the Mental Health Foundation, writes in an MHF blog post about the pressures of living in the 21st century. He says: "Never before in the course of history has so much information been spewed in our direction. When the demand for our attention outstrips the supply of time, stress is the result."

That's why the art of listening is so valuable. When your business is based on a foundation of effective listening for all clients and colleagues, you will find you have created a trust-based, long-lasting profitable operation. Clients will stay with you because they trust you. They will refer their family, friends and colleagues to you because you are trusted and have their loyalty. Listening could turn out to be your greatest strength, just as Carnegie advised. ●

### HOW TO LISTEN TO CLIENTS

Coaching firm Strategic Coach recommends a 'listening tool' for advisers to use when they meet their prospects or clients. The tool comprises three questions and guidance on when to pause and listen.

The first question focuses on the client's 'dangers': the issues that keep them awake at night.

After asking the question, pause and listen.

The second question is about the opportunities they see around them that they'd like to take advantage of.

Again, pause and listen.

The third question is about all the strengths they currently have working for them: it might be a strong, supportive, proactive team; it might be their good health and a happy marriage and family life; it might be that they carry very little debt.

Pause and listen after asking this final question too.

At no point in the conversation should the adviser offer up a solution that will solve all the client's problems, adds Strategic Coach's Eleonora Mancini.

"That's for later, when they write their report, which captures all the important information the client has provided them with and the adviser's solutions, addressing not only the dangers but the opportunities and strengths they see around them."

// ONE WAY OF ENSURING EMPLOYEES' VOICES ARE HEARD IS THROUGH INITIATIVES SUCH AS MENTORING //

SPECIAL REPORT: PENSIONS

FTSE 100 PENSION FUND SURPLUSES SHOULD BE VIEWED WITH CAUTION. SOUND GOVERNANCE AND INVESTMENT ARE THE REAL INDICATORS OF A FUND'S TRUE HEALTH. **GILL WADSWORTH** REPORTS




ILLUSTRATION: ISTOCK/GREAT APES

The UK's biggest 100 companies enjoyed rare good news about their defined benefit (DB) pension schemes in the summer of 2017.

Research from Lane Clark & Peacock (LCP), a pension consultant, showed FTSE 100 pension schemes were in surplus at the end of 2017 for the first time since 2007. According to LCP's *Accounting for pensions 2018* spring update, the overall funding level for the country's largest schemes had improved from 95% to 101% in the space of the year. Using the average of the 100 companies' IAS19 accounting assumptions, this equates to a £4bn surplus at year end 2017 – a jump of £35bn since 2016.

Then, in autumn 2018, LCP delivered further good news to the FTSE 100's finance directors when it revealed a £30bn aggregate surplus.

However, LCP's head of corporate consulting and the report's co-author, Phil Cuddeford, describes this positive landscape as a rarity and adds: "It remains to be seen if the current surplus is here to stay."

## Getting the measure

To determine how steady this surplus might be, it is worth understanding how scheme funding is measured.

LCP analysed FTSE 100 companies that use the IAS19 accounting measure to report funding status. IAS19 uses AA-rated corporate bonds to discount future liabilities and includes mortality assumptions and expectations for inflation.

Marian Elliott, from the Pensions Board at the Institute and Faculty of Actuaries, says: "The accounting basis is designed to be a best estimate and therefore should not contain a margin for prudence. On that basis, there is an equal chance that the actual cost of funding the benefits will be greater or lower than has been estimated on the accounting basis."

This differs from actuarial assumptions that the discount rate includes prudent assumptions about returns from the scheme's assets. If a scheme is invested in equities, the actuary might assume a discount rate of the return from gilts plus 3% to allow for assumed stock market performance. A more prudent actuary might assume gilts plus 2%, which would result in higher projected liabilities than in the gilts plus 3% discount rate.

Neither actuarial nor IAS19 measures are 'accurate' since they assume future returns. However, IAS19 is meant to give a consistent snapshot of DB health across the FTSE 100, while actuarial assumptions provide scheme-specific figures.

## Smoke and mirrors

IAS19 is prescriptive in demanding companies use a discount rate based on AA corporate bond yields, yet it allows some room for manoeuvre.

Examples of this include excluding certain bonds from the AA corporate bond universe and using multiple rating agencies to decide what constitutes an AA-rated bond. LCP says that these more sophisticated approaches to setting discount rates have improved balance sheets by around £15bn.

John Ralfe, an independent pension consultant, notes that such activity is legitimate, but may mean the improvements in funding levels reflect different discount rates rather than a tangible improvement in schemes' financial health.

John says: "There have been various nips and tucks which, when taken together, take scheme funding a long way in the right direction. None of this is illegitimate, but nothing has changed in underlying economics; it's just been cut and pasted in a different way."

Companies can also value future payable benefits differently under IAS19. LCP found a 40% difference, as at 31 December 2017, between the most prudent and most generous assumptions made by FTSE 100 companies in valuing the future worth of £1 pa of pension payable from age 65 for a 45-year-old man (see chart overleaf). Using those figures, LCP reports that if all FTSE 100 companies switched to the lowest possible valuation, the surplus would jump from £4bn to £75bn overnight.

Less optimistic forecasts for life expectancy have also played a part in driving up funding levels. In 2017, the Continuous Mortality Investigation Bureau (CMIB)

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### CHANGING BENEFITS

When UK finance directors became aware of the true cost of running a defined benefit (DB) pension scheme at the turn of this century, they started to act by switching to defined contribution plans.

Today, just 23% of the FTSE 100 companies provide DB schemes to a significant number of employees.

Closing DB schemes to future accrual can have a profound effect on liabilities. According to the Pensions Policy Institute (PPI), between December 2011 and December 2016, 900 DB schemes closed to future accrual, which saw their liabilities fall by an estimated £2.5bn.

However, this also reduces the time horizon over which schemes must meet pension payments, and with no new contributions from members coming in, plans will fall into negative cash flow more quickly.

Trustees would need to consider cash flow driven investments to meet future payment obligations.

An alternative option is to switch pension increases from the retail price index rate of inflation to the lower consumer prices index.

Assuming a compound gap of 1% between the two measures over 20 years could see benefits fall by 18%.

Employers can also limit DB costs by moving to a career average rather than final salary structure, capping benefits and changing accrual rates. However, all these options require a consultation with members.

>> reported a decrease in life expectancy for the third year running, which 75% of FTSE 100 companies reflected in their assumptions. While the current mortality trend is clear, there can be no real certainty it will continue, and a reversal would see funding levels deteriorate.

Charles Cowling, chief actuary at consultant JLT, says: "No one can know whether there will be a major advance in medicine, or any other factor, that could dramatically improve life expectancy."

// RESEARCH SHOWED FTSE 100 PENSION SCHEMES WERE IN SURPLUS AT THE END OF 2017 FOR THE FIRST TIME SINCE 2007 //

## Cash injections

Special sponsor contributions played a significant factor in bolstering DB funding levels in 2017, with FTSE 100 scheme sponsors injecting £13bn through the year. Employer contributions are critical to removing deficits, because they instantly improve the funding figures and allow trustees to derisk the scheme. For example, with a healthier funding status, trustees can buy out liabilities with a third-party insurer in the form of bulk annuities. They can also use contributions to hedge longevity risk or simply disinvest from risky assets. This creates a virtuous circle since derisking strategies can lock in surpluses and make the likelihood of continued funding improvements more realistic.

Ali Tayyebi, senior partner at Mercer, says: "The idea of locking in gains is on most trustees' agendas and a lot of them are reducing risk. Typically, they can't derisk without some improvement in funding or contributions from the sponsor."

Schemes were also able to make gains thanks to strong investment returns from stock markets in 2017 and 2016. LCP reports that the proportion of assets invested in equities fell by 4% over 2017 as trustees better matched assets to liabilities using bonds. Schemes will need to continue this trend if they are to prevent a reversal of fortune should markets slump.

Trying to understand the financial health of the UK's DB schemes based on a widely interpreted accounting measure taken as a snapshot is unreliable. A surplus can switch to a deficit simply by changing the discount rate by a few percentage points.

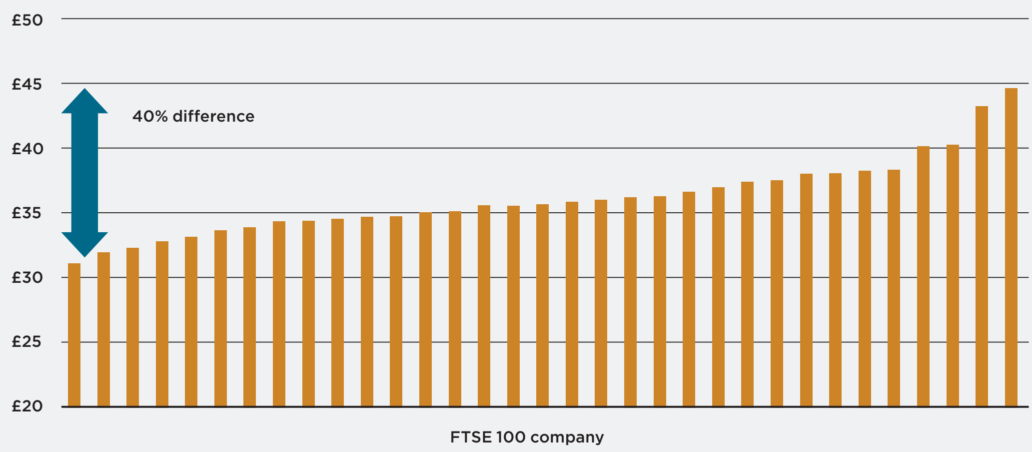
The motivation to make an occupational pension scheme look as healthy as possible is obvious; shareholders do not want to compete with plan members for a share of the company's cash. Company accounts need to reflect a positive funding position to attract investors.

However, creative accounting can only achieve so much. When rules change, markets shift or expectations adjust, the whole landscape can shift from black to red in an instant.

This is particularly relevant for financial planners whose clients may be considering a transfer out of their DB scheme. Typically, DB members will be advised to remain in their DB scheme and take the 'guaranteed' benefits at retirement. But planners must be sure that the sponsor covenant – the employer's ability to honour the DB scheme – is robust. If the surplus is a result of creative accounting rather than true funding improvements, and the sponsor is unable to support the plan for the foreseeable future, a transfer out may well be the right course of action.

What matters most – to investors, members, sponsors and planners alike – is that the pension fund is truly healthy, which requires strong governance, investment and, ultimately, time. ●

VALUE PLACED ON £1 OF PENSION TO A MAN AGED 45 BY DIFFERENT FTSE 100 COMPANIES




*Based on £1 pa pension payable from age 65 with inflation increases for an employee currently aged 45, as at 31 December 2017*

*Source: LCP*

# The changing world of pension fund asset allocation

PENSION FUNDS AROUND THE WORLD HAVE BEEN REDUCING THEIR EQUITY EXPOSURE GRADUALLY, BUT THE MOVE HAS BEEN MOST DRAMATIC IN THE UK. **PAUL BRYANT** REPORTS

In the early 1990s, defined benefit (DB) pension schemes were the norm in the UK and invested 80% of their assets into equities, with almost 60% invested into UK equities, according to a survey by the Investment Association – *Asset management in the UK 2017-2018*. Figures from the Office for National Statistics (ONS) show that these schemes owned more than 30% of the UK stock market.

In 2017, DB schemes invested only 29% of their £1.5tn of assets into equities, with 6% of that going into UK equities, according to the Pension Protection Fund (PPF). All workplace pensions owned less than 3% of the stock market, ONS figures suggest.

Bonds (government and corporate) have been the main destination for cash coming out of equities and now make up 56% of DB assets, the PPF says. 'Alternatives' such as private debt have also benefited.

A significant market impact might have been expected from this shift in asset allocation. For equities, counter forces have been at work to cushion the blow. But that has not been the case for bonds.

### The (very slow) decline of DB

With DB pensions, companies and individuals contribute to the pension scheme savings pot, which is used to fund a guaranteed income for retirees until death. Companies bear the risk of any funding shortfall and enjoy the upside of a surplus. In the private sector, DB pensions are no longer the norm. Nearly all new employees will instead join a defined contribution (DC) pension scheme. These still involve a contribution from companies and employees, but retirees shoulder the investment risk of their pension savings and do not enjoy a guaranteed income. Retirement must be funded from the DC savings pot, the size of which is heavily dependent on investment performance (see 'Pensions swap shop', *cisi.org/pensions-swap*).

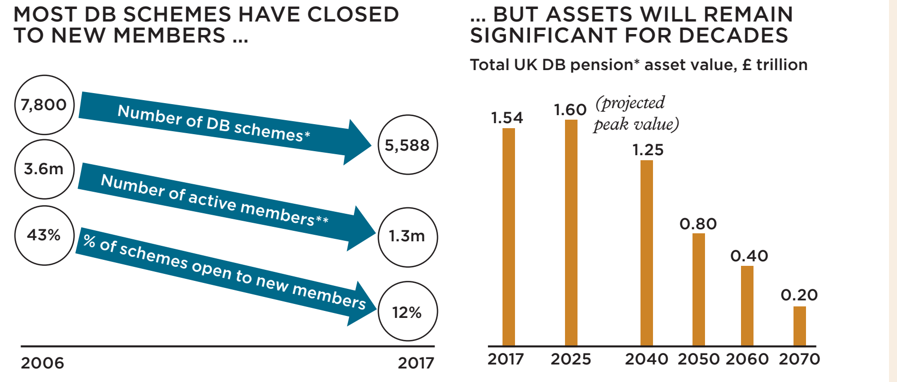
Prior to the 1995 Pensions Act in the UK, DB pension funds operated with far fewer regulatory restrictions on their investment strategies. Mark Johnson, head of institutional client management at Legal and General Investment Management (LGIM), says that, at the time, most DB funds were still open to new joiners and had a good balance of early, mid and late-career members, and those in retirement. Because of this multi-generation member base, the average duration of their liabilities (pension payouts) was very long and it made sense to look for capital growth from investments and deploy an 'equity-heavy' strategy. This had the potential to minimise companies' future pension contributions.

From the mid-1990s, the DB landscape became unattractive for companies (see box, p.31). The vast majority decided that their future pension schemes had to be on a DC basis and closed their DB schemes to new members. Active members – those working and paying contributions – fell off sharply.

Despite closing to new members, the drop in the number of DB schemes in operation has not been as sharp, and the value of their assets will remain the largest type of pension asset in the UK for many years, because schemes must 'run-off' and pay pensions to all members until they die.

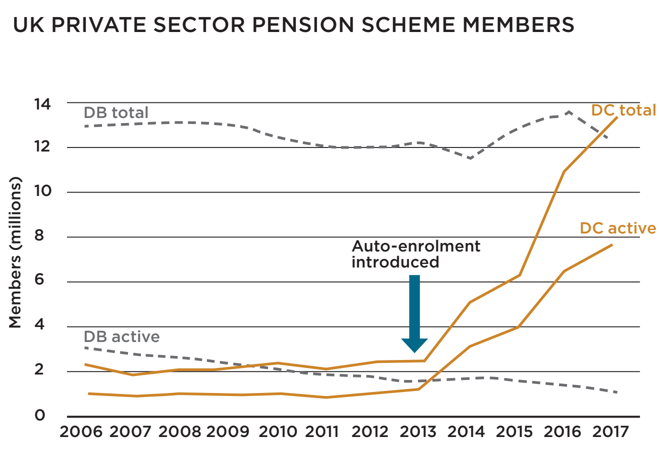
Closing to new members not only changes the demographic profile of scheme membership over time, it also changes the profile of liabilities. As more DB scheme members age and either approach retirement or start drawing pensions, the future liabilities of the scheme become more certain (for example, more final salaries are known and DB payouts are usually linked to final salary). The liabilities are also spread over a shorter time horizon because there are fewer younger members who will draw their pensions long into the future.

Mark says that DB schemes simply no longer need the proportion of riskier growth assets like equities that they once did: "They are maturing and now have a much better approximation of the cash outflows that they >>

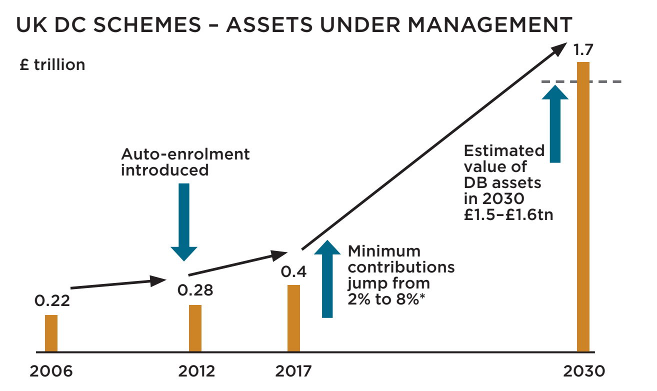



* Pension Protection Fund eligible schemes ** Members still working and paying into scheme

*Source: Pension Protection Fund, The Purple Book – DB pensions universe risk profile 2017; Hymans Robertson and Nomura, The age of peak LDI*




Source: ONS – Occupational pension schemes survey, 2017




*2% prior to 04/18, 5% between 04/18 and 04/19, 8% from 04/19

*Source: Spence Johnson, Deeper perspectives, January 2015; Hymans Robertson and Nomura, The age of peak LDI, 2018; Pensions Institute, VfM: assessing value for money in defined contribution default funds, 2014*

will require. So they can create a portfolio that can generate returns to closely match those outflows. Debt assets are most suited to this, both corporate and government bonds, and, increasingly, private debt, but because individual pensions are usually linked to inflation, index-linked gilts – government bonds that offer returns linked to the inflation rate – are most popular."

At the same time, Mark says his clients are more wary of the potential for large moves in equity markets as a result of factors like a maturing investment cycle, Brexit risks, slowing Chinese economic growth and the potential for trade wars.

## The rise of DC

Company DC schemes deploy very different investment strategies from their DB predecessors.

Initially, in the period 2006 to 2012, membership and assets of DC schemes grew gradually, but with the introduction of auto-enrolment in 2012 – which compelled employers to enrol employees earning more than £10,000 per year into a workplace pension scheme – growth accelerated.

According to figures from the ONS, total private sector DC membership has now overtaken that of DB – 13 million versus 12 million in 2017 – and active members in DC exceed those in DB by far – eight million versus one million. Note that in the chart above, left, the difference between total members and active members includes members in retirement and members with 'preserved' pensions – typically those who have left a job, kept their previous workplace pension, but are no longer contributing to it. For DC pensions, preserved pensions make up 98% of the difference. For DB, preserved pensions make up 54% of the difference, with pensions in payment making up 46%.

The Investment Association's survey says that DC assets have also been growing, reaching £400bn in 2017 – around a quarter of DB assets – and are set to receive a further boost as memberships continue to rise and statutory minimum contributions increase.

In April 2018, minimum contributions (employer and employee combined) were raised from 2% of earnings to 5%. From April 2019, they increase again to 8%. Consequently, the Pensions Institute has predicted that DC assets will grow to about £1.7tn by 2030. That would exceed the level of DB assets at that time, as forecast by Hymans Robertson and Nomura (see chart above, right).

> // TOTAL PRIVATE SECTOR DC MEMBERSHIP HAS NOW OVERTAKEN THAT OF DB, THE ONS SAYS //

But in stark contrast to DB schemes' 29% equity allocation in 2017, DC allocation was 66%, with 20% in fixed income and 14% in 'alternatives' and 'other' assets, according to the Investment Association's survey.

The primary reason for this difference is the younger demographic profile. ONS figures show that less than 1% of DC members are receiving pension payouts, compared with 41% in private sector DB schemes – so a much longer-term investment time horizon can be adopted, which favours equities. Also, because companies running DC schemes do not run the risk of pension fund deficits appearing on their balance sheets – employees absorb the investment risk – they tend to be less risk averse and are more comfortable offering strategies that favour equities to younger members.

Most DC members – over 90%, according to the Pensions Institute – choose to invest in schemes' 'default' funds, which allocate younger members a higher proportion of equities. Default funds typically deploy a 'glide-path' of decreasing equity allocation as members get older. For example, ten to 15 years prior to retirement, an individual's portfolio will gradually start to shift towards bonds and cash, to protect them from market shocks.

## Market impact

In 2017, DB schemes held around £125bn less in UK equity assets than they did in 2008 (£92bn versus £217bn, according to the PPF). With equity price rises over this period, market impact has been minimal.

The withdrawal has been partially or fully offset by the increase in UK equity purchases of DC and individual (non-workplace) pensions, and simply overrun by the post-financial crisis bull market.

Of much more significance than inflows or outflows from pension funds has been the increasing foreign investment into UK equities, which reached 54% of the stock market at the end of 2016, compared to the 3% share of all pension funds. This foreign investment is up from 42% in 2008 and around 15% in the early 1990s. In pound value terms, foreign investors increased their UK equity value by around £367bn between the end of 2010 and the end of 2016, according to ONS figures, exceeding the withdrawals of DB pension funds.

Piers Lowson, a director at Baillie Gifford, says it is a different story for bond markets: "There is real demand from DB schemes for high-quality liability-matching assets, which has contributed to both nominal and real government bonds being so expensive, and especially so for long-dated index-linked gilts where it is estimated that DB schemes own over 80% of all issued paper."

This 80% figure comes from a June 2016 report from Schroders – *Pensions funds and index-linked gilts: a supply/demand mismatch made in hell*. Schroders estimates the potential demand for long-dated index-linked gilts to be almost five times the current size of the market, and expands on the impact that pension funds are having: "There are not even close to enough bonds out there to meet this demand, suggesting that long-dated index-linked gilt yields are likely to remain suppressed for the foreseeable future. Pension funds are not active traders of bonds. They invest in them to match their liabilities. That means that once invested, they are unlikely to sell those bonds again in future … therefore prices bear little relationship with any concept of fundamental value as the key buyers are relatively price insensitive, driven by risk management rather than return maximisation priorities."

### Beyond bonds versus equities

While the dominant asset allocation switch in the UK has been from equities into government and corporate bonds, other asset classes and some sub-segments of equity and debt markets are attracting more investment, which looks set to continue into the near-term future.

LGIM's Mark says that as areas of the traditional credit market become more expensive, demand has increased for 'alternative credit', such as private credit and infrastructure debt where there is still a 'yield premium'. Jos Vermeulen, head of solution design at Insight Investment, also sees this trend: "High-quality (typically investment grade) publicly-traded bonds are likely to form the bedrock of most strategies. However, given the retreat of banks from traditional lending since the end of the global financial crisis, other opportunities have emerged for pension schemes outside of traditional credit asset classes that can diversify and add to a portfolio's return potential. One example is secured finance, an asset class that includes a range of public and private investments that deliver cash flows backed by collateral and that are relatively senior in the capital structure."

// ESG, FOR MANY, IS INCREASINGLY ABOUT ACTIVE INCLUSION RATHER THAN EXCLUSION //

Environmental, social and governance (ESG) investing is also growing rapidly. Mark says pension scheme members and government are putting pressure on pension funds to consider ESG as a core strategy. Piers, of Baillie Gifford, says: "ESG, for many, is increasingly about active inclusion rather than exclusion. It's no longer just about excluding the bad guys – the usual suspects such as fossil fuels, arms and tobacco – but actively including the good guys, such as healthcare and renewables. And this trend impacts both equity and debt investments. It could be the equity of a company heavily involved in renewables or asset-backed debt on an individual solar or wind farm project."

The move towards international equities is also growing for several reasons. With risk reduction being so high on the agenda of pension funds, increasing diversification by spreading investments across many international markets is attractive. And because information about foreign markets is simply easier to come by than in the past, investors are becoming more familiar with international opportunities, especially in developing markets where transparency and market access are improving. Also, in the UK, investors must look to foreign markets like the US for adequate exposure to certain sectors, such as big tech.

### Less dramatic shifts internationally

A 2018 report by Willis Towers Watson, *Global pension assets study*, presents an analysis of the seven largest pension markets in the world: US, UK, Japan, Australia, Canada, the Netherlands and Switzerland. Three types of markets with distinct asset allocation differences can be identified.

In Japan, Canada and the Netherlands, DB pensions dominate, making up 95% of pension assets in each market. Equity holdings are lower (30% in Japan, 45% in Canada and 33% in the Netherlands) and are on a slow but steady decline.

In Australia and the US, DC pensions have been dominant for over a decade and make up 87% and 60% of pension assets respectively. Equity holdings are higher but have also been gradually reducing over the past ten years – from 55% to 49% in Australia, and from 60% to 50% in the US.

The UK is in transition from the first group to the second. In terms of membership, a major shift out of DB and into DC has already happened. Over the next few decades, assets will follow suit. As the DB pot declines, and liabilities become more predictable, debt is likely to make up an even bigger proportion.

As for the DC pot, which will eventually make up the bulk of pension assets, Piers thinks that a likely 'steady state' asset allocation will start to emerge when a whole workforce generation has been through the DC system and there is more balance between pensions in payment and active members. He says this allocation is likely to end up closer to that of Australia. ●

### WHY EMPLOYERS FELL OUT OF LOVE WITH DB SCHEMES

- The 1995 and 2004 Pensions Acts introduced minimum funding requirements, obliging companies to top up pension funds if asset values fell below certain levels.
- Accounting rules changed, so that if pension assets fell below liabilities, the deficit needed to be reflected on the company's balance sheet.
- In the post dot-com era (when the proportion of equity assets was still around 70%), equities performed poorly, with the FTSE 100 losing around 50% between late 1999 and early 2003, leading to increased pension fund deficits.
- The drop in interest rates between 1998 and 2009 – when the Bank of England base rate fell from 7.5% to 0.5% – also led to increased deficits (if gilt yields fell, the value of liabilities increased, because a methodology for calculating the value of future liabilities was introduced based on a discount rate linked to the yield of gilts).
- Life expectancies continued to rise – according to the ONS, life expectancy at birth rose from 71 in 1981 to 79 in 2011 for UK males, and from 77 to 83 for UK females – increasing the total liabilities that companies had to provision for.

PHOTOGRAPHY: CHARLIE SURBEY

# The sensible optimist

NIKHIL RATHI, CEO OF LONDON STOCK EXCHANGE AND DIRECTOR OF INTERNATIONAL DEVELOPMENT AT LONDON STOCK EXCHANGE GROUP, SAYS WE NEED TO EMBRACE CHANGE TO FACE 21ST CENTURY CHALLENGES. **EILA MADDEN** REPORTS

Nikhil Rathi grew up in Barrow-in-Furness, an isolated town at the tip of the 33-mile Furness Peninsula in Cumbria, north-west England. Once home to the largest steelworks in the world and famous for its shipbuilding activity, today, Barrow hosts a BAE Systems shipyard and is a hub for offshore wind farms. In 2008, *The Guardian* national newspaper reported on a "not entirely serious" study by local directory website locallife.co.uk, which dubbed Barrow the blue-collar capital of Britain for its plethora of fish and chip shops, workingmen's clubs and bookmakers. Barrow suffered the highest population decline in England and Wales in the decade up to 2011, according to the 2011 census. It has continued to fall – from 69,100 then to just under 57,000 today.

Yet this isolated, industrial and working-class town produced someone who played a key behind-the-scenes role in UK government at the height of the financial crisis and has gone on to lead London Stock Exchange Group's UK business and serve as the group's director of international development. Nikhil's knowledge and experience of what 'real life' beyond the City and Westminster is like brings a refreshingly down-to-earth approach to running the most international capital market in the world.

## Times of crisis

After reading Philosophy, Politics and Economics at St Anne's College, Oxford, Nikhil graduated in 2000, completed a Master's degree in 2002, and joined the Civil Service. Although he was based at the

// NIKHIL DESCRIBES DEALING WITH THE FINANCIAL CRISIS AS THE MOST INTENSE PROFESSIONAL EXPERIENCE HE HAS EVER HAD //

Treasury, he spent three years in 10 Downing Street from 2005, serving as private secretary to Tony Blair and then Gordon Brown. In 2008, he moved back to the Treasury to lead the Financial Stability Unit, which was set up to oversee the government's interventions to steady the financial system during those first turbulent years of the crisis. Later, he became director of the Treasury's Financial Services Group, representing the UK government's financial services interests in the EU and across the world, and dealing with the swathe of regulatory reform that the crisis unleashed.

During his undergraduate years, Nikhil had spent time in the City as an intern and it was a career he had considered, but looking back, joining the Civil Service was absolutely the right choice. "The kind of things I was able to do and experience and witness were extraordinary," he says. "Some of the financial crisis stuff – no one could have predicted all of that."

He describes dealing with the crisis as the most intense professional experience he has ever had. He learnt a huge amount about the markets, public policy, the law and the way those areas intersected. More importantly, it opened his eyes to the interconnectivity between the City and the European and global financial systems. He discovered just how fundamental contingency planning, operational resilience and thinking through risk are to the smooth running of that system and its institutions.

He also learnt about leadership, endurance and managing in times of extraordinary uncertainty. "In a lot of these roles, you always have to have a degree of sensible optimism," he says. "However bad it might seem at the time, if you're measured about it, you can get through it."

## Lessons learnt

It's a lesson that Nikhil learnt early on in the crisis, during the winding up of Bradford & Bingley Building Society. Its troubles followed soon after the collapse of Northern Rock, which had to go cap in hand to the Bank of England after over-borrowing from the international money markets. Its poor governance triggered the first run on a British bank in 150 years and regulators and government alike were lambasted by the press and the public for being caught off guard.

"That had really taken its toll on the Treasury, as an institution, and on the government. It had been a very challenging experience and quite demoralising because there was a lot of criticism about how that all played out," Nikhil remembers.

Against that backdrop, Bradford & Bingley was wound down over a weekend. It was a real test, he says, of whether the Treasury and the government could execute a resolution successfully and in a way that protected customers, ensured financial stability and looked after taxpayers' money. Nikhil's team had done a huge amount of scenario planning. In the event, the resolution went smoothly and the news agenda moved on after a couple of days.

"That did a huge amount for the confidence of the institution, which really enabled people to feel more comfortable and more confident about what came next in the crisis and about the ability to handle the bigger challenges ahead," says Nikhil.

## A change of scene

When he was ready for a change after 11 years working at the heart of government, Nikhil wanted to see what he could achieve in a business environment and it was the capital markets world that fascinated him the most. He joined London Stock Exchange Group (LSEG) in 2014 as head of international development and chief of staff to then LSEG CEO Xavier Rolet. In 2015, he was appointed CEO of London Stock Exchange, the UK business that includes the listing business and UK exchange as well as others. It's a fitting role for someone who has witnessed the interconnectivity of the global financial system at first hand and truly understands those connections. London Stock Exchange's flagship exchange supports companies of all sizes – and from all over the globe – to access capital from the world's most international pool of investors on both the main market and alternative investment market.

> // NIKHIL WANTS TO POSITION LONDON STOCK EXCHANGE AS PARTNER OF CHOICE FOR CHINA //

Nikhil is excited about what lies on the horizon: a shift towards new markets; the potential of technological disruption; and opportunities uncovered by major changes in the regulatory landscape over the past decade or so. "All of those things provide fantastic opportunities for us because we have a global orientation with very strong products and a strong partnership approach with our customers," he says.

## Courting China

One new market Nikhil is particularly keen to pivot towards is China. It is on track to be the largest economy in the world, with the fastest growing capital market and asset management sector, and a long line of companies queuing up to go global. He wants to position London Stock Exchange as the international capital markets partner of choice for China.

The exchange has already been working on a number of 'firsts' with Beijing to make that a reality. The Shanghai–London Stock Connect, the launch of which is due to be announced soon, will allow investors on the London and Shanghai stock exchanges to more easily access each other's markets. London is now the largest offshore renminbi (RMB) centre outside Greater China and, in 2016, it hosted the first offshore sovereign bond from China in RMB and the first Chinese international green bond.

Nikhil also sees opportunities for LSEG in China's Belt and Road Initiative (BRI), which seeks to generate economic development by connecting trade routes between Asia, Africa and Central and Eastern Europe through infrastructure development. Chinese banks have already raised capital on London >>

## CV

**2015** Appointed CEO of London Stock Exchange

**2014** Joins London Stock Exchange Group (LSEG) as head of international development and chief of staff to then LSEG CEO Xavier Rolet

**2008** Returns to the Treasury to lead the Financial Stability Unit and, later, the department's Financial Services Group

**2005** Seconded to 10 Downing Street to serve as private secretary to Prime Minister Tony Blair and then his successor, Gordon Brown

**2002** Joins the Treasury after completing a Master's degree

**2000** Graduates from St Anne's College, Oxford, with a degree in Philosophy, Politics and Economics


markets to fund construction projects along the BRI, and BRI companies listed on the exchange account for more than US$1tn of market capitalisation combined.

What does he say to those who are more apprehensive about welcoming China with such open arms? The increasingly tense US–China trade war launched by the Trump administration is based on claims that China is hurting the US economy through counterfeit goods, pirated software and theft of trade secrets. China, in turn, has experienced economic slowdown because of trade tariffs imposed by the US. EU officials are said to be considering proposals that would see Chinese telecoms companies excluded from bidding for 5G mobile network contracts across Europe for fear that Beijing could ask these companies to build ‘back doors’ into the technology to allow for espionage. Claims and concerns seem fanciful, but they exist nonetheless.

For Nikhil, not engaging with China is not an option. Its banks now represent four of the top ten banks in the world by balance sheet and its companies have an increasingly international presence. At some point, it will be a major global capital market. “I think it is important for everyone to invest the time and effort in relationships to understand how different markets around the world operate and how they are evolving,” he says. “The focus should be on how we can build mutually beneficial partnerships with China, which serve the interests of our people, customers and investors.”

He believes London’s robust regulatory framework, high integrity and the equality with which it treats investors and participants of all nationalities – provided they meet its standards and rules – will steer it through any sensitive geopolitical issues that China may be associated with.

// THE GLOBAL SYSTEM OF REGULATION AND STANDARD SETTING IS CHANGING //

## Going green

One geopolitical issue where China is in the spotlight for all the right reasons is climate change. It prioritised green finance during its recent presidency of the G20 and, as mentioned earlier, issued its first green bond on the London market.

Nikhil believes China’s interest in green finance is a big factor driving a shift in attitudes towards this issue across the financial services sector. Others include Bank of England governor Mark Carney’s recent labelling of climate change as a global systemic financial risk, and a growing trend for sustainability to be considered in mandates from global institutional investors. Nikhil says that, by the end of 2018, US$30tn of assets under management across the world had a sustainability component to their mandates.

“There’s always more that can be done, and more that can be done more quickly, but those factors and the range of participants buying into this agenda would suggest the financial services sector is going to play a very significant role in driving decarbonisation of the economy globally over the next decade or so,” he predicts.

That it is China, and not just western countries, taking a lead in green finance is interesting, Nikhil acknowledges. It is a sign, he says, of how the global system of regulation and standard setting – and the players in that system – are changing.

## Looking ahead

Embracing change is what will help London Stock Exchange retain its leadership position in the capital markets. Beyond building new relationships with new markets, Nikhil has his eye on technology and the listings pipeline as areas of development.

He believes embracing technological disruption will help the exchange to remain resilient. London Stock Exchange is currently exploring how to use artificial intelligence and machine learning to improve market surveillance and monitoring. It is also looking at how blockchain can be used to improve efficiency, offer new services and scale those services globally.

LSEG will also continue to nurture its listings “stars of the future”, as Rathi describes them, through its ELITE initiative (see *cisi.org/float* for more on ELITE). Via ELITE, LSEG works with investors, advisers and corporate partners around the world to help high-growth private companies to scale up. The programme is currently helping more than 1,000 start-ups in 300 countries.

In 2018, LSEG launched ELITE in Ohio in the US, and several Middle East jurisdictions. It also established ELITE Club Deal – a private placement platform allowing investors, through a standardised process, to invest in high-growth private companies that have joined ELITE. Over the coming year, Nikhil wants to build and extend the programme into Africa.

From working at the heart of UK government to being part of a global response team during the financial crisis to leading the world’s most international capital market, Nikhil has had an impressive career already. At just 39 years old, there’s no doubt we will see him take on a few more high-profile roles. ●

AS THE UK PREPARES FOR £1.2TN TO PASS FROM OLDER TO YOUNGER GENERATIONS OVER THE NEXT 30 YEARS, FINANCIAL PLANNERS SHOULD START THINKING ABOUT HOW THEY CAN BEST SUPPORT THE HEIRS TO THIS WEALTH. **AMYR ROCHA-LIMA MCSI**, FINANCIAL PLANNER AT HOLLAND HAHN AND WILLS LLP, AND MEMBER OF THE CISI'S FINANCIAL PLANNING FORUM COMMITTEE, REPORTS

# The great wealth transfer


ILLUSTRATION: GILLIAN BLEASE/IKON

A July 2018 report by wealth manager Sanlam UK, entitled *The generation game*, indicates that more than 11 million 25- to 45-year-olds in the UK are expected to receive an inheritance from their parents or grandparents within the next 30 years; 5.1 million of these individuals expect to inherit £50,000 or more in fixed assets or cash. However, they might be banking on this windfall a little too heavily.

The report notes that four in ten of the under-45s surveyed are anticipating an inheritance, but have not yet discussed the specifics with the gifting party, and a third admit that they are delaying saving in anticipation of their inheritance. There's a strong case here for professional financial guidance but many likely won't seek it, or will hold off on doing so. Research released by insurer Prudential in August 2018 finds that just 26% of millennials see a financial adviser regularly.

But at least 56% of UK millennials (born between 1980 and 2000) have started saving for retirement, according to recent YouGov research. However, they appear reluctant to actually invest their savings, opting instead to hold cash or cash alternatives. This doesn't bode particularly well for their nest egg; it indicates they're shying away from the historically higher

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>> returns investments yield over the long term and effectively wasting the compounding advantage enjoyed by those who start retirement planning earlier in life.

According to a 2015 report from Unbiased.co.uk – *Value of advice* – the optimal age to receive financial advice regarding retirement is 25 – but most tend to delay this conversation for a further ten years. The study indicates that those who consult with a financial planner early in their careers tend to save more and have more realistic expectations of how long their retirement years will last. Furthermore, individuals who work with a financial professional can help to safeguard against some of the mistakes committed by DIY investors: from buying expensive products to overpaying on their taxes or obsessing over short-term performance.

The need for professional financial guidance was further underscored by a study on levels of financial literacy, released in March 2018 by UCL and the University of Cambridge, that finds adults in England and Northern Ireland perform worse on basic financial literacy tasks than their counterparts in most other developed countries – even when provided with the opportunity to use a calculator.

As the UK prepares for this unprecedented intergenerational wealth transfer – estimated to be worth up to £1.2tn over the next 30 years – there is a compelling opportunity to serve younger clients and help them prepare for financial security. The question is, what can financial planners do today to bring their clients' children and grandchildren into the fold?

## What millennials want

It's no secret that millennials are, for the most part, more tech-oriented than generations past. The advent of smartphones has facilitated a shift in how younger generations engage with financial services – 46% of UK millennials are keen to use their mobile phones to conduct all their financial planning, according to the *2018 Legg Mason global investment survey* – and this is something that financial planners should consider. Those without a mobile-optimised website, for example, can expect eye rolls at best. Millennials crave convenience and demand always-on access, and that's a reality financial planners need to plan for as they tailor their service proposition.

That said, this devotion to smartphones doesn't mean that younger adults don't value the human touch, or that they overlook the power of a financial planner's expertise. In fact, a significant majority of respondents in the Legg Mason survey select their preferred mode of advice as 'online with the option of face-to-face'. It also suggests that online-only options are appealing to just 12% of millennial respondents.

However, cost (or perceived cost) deters many young adults from seeking financial advice. When quizzed by Dabbl – an online share trading platform – about their attitudes towards investing, 62% of millennials claim that their reticence to establish an investment portfolio is driven by a belief that investing is solely the domain of the wealthy.

The Dabbl survey also shows that almost three-quarters (72%) of the 2,002 respondents aged 25 to 34 have eschewed investing because they think it is too complicated. This is where robo-advisers like Stash have excelled, producing educational content that is easily digestible and comprehensible to the average investing novice, breaking down key financial concepts in a non-judgemental tone. Financial planners could benefit from taking a leaf out of their book and drafting informative blogs and email content to market their expertise – whether it's a post explaining market volatility, or a quick blog decoding cryptocurrencies, it will elevate their profile and build trust in their ability to help clients navigate key areas of interest.

It's also worth keeping up to date on environmental, social and governance trends. Though millennials are seeking returns, they are concerned with ethical factors. But 29% of investors say a lack of information regarding sustainable investments prevents them from investing more in these assets, says Legg Mason.

// THE OPTIMAL AGE TO RECEIVE FINANCIAL ADVICE REGARDING RETIREMENT IS 25 – BUT MOST TEND TO DELAY THIS CONVERSATION FOR A FURTHER TEN YEARS //

**FIVE QUESTIONS TO KICK-START YOUR CONVERSATION WITH CLIENTS ABOUT WEALTH TRANSFER**

1. What was the key to your success in creating wealth and how might telling this story to the future generations be helpful?
2. What are your major concerns when deciding to give wealth during your lifetime versus through your will?
3. If you have multiple beneficiaries, what would be a fair distribution among your heirs?
4. Are you concerned that your heirs may lack the skills to manage wealth?
5. Outside of the executors of your will, who should know what about your wishes and intentions?

Social media is a useful platform for engaging with, and providing value to, existing and prospective clients – by posting informative content and showcasing results achieved for similar customers (with their permission, of course).

## Models and pricing

This confluence of factors – the appetite for expert input, affinity for mobile-centric communication and desire for affordability – highlights a need for financial planners to be creative with their pricing to capture the next generation of clients. Younger financial planners already have their fingers on the pulse of their peers' needs and are increasingly serving them via a fee-for-service model. In his article 'How to profitably price fee-for-service financial planning', Alan Moore CFP®, co-founder of the XY Planning Network, says 62% of millennial advisers are using this model.

Financial planners may wish to consider implementing a tiered/hybrid offering that empowers the client while giving them a 'safety net' of sorts. Such a model may allow clients to interact with their portfolio via an online portal yet also speak with a human (for example, via webchat, video conferencing, text or email), if they need a 'gut check' regarding certain decisions. As they accumulate wealth, or approach a major life event, clients can opt to move up to the next tier or purchase an additional service for a set price.

## Starting the conversation

Financial planners can start the conversation by speaking to the donors – their clients – asking if they've had a candid conversation with their heirs about the inheritance process and if they feel well equipped to manage their finances responsibly. Millennials are more likely to seek advice from their parents than prior generations. Suggest to the clients that they invite their designated beneficiary (or beneficiaries) to the next scheduled meeting for an informal, no obligation consultation where some of the key considerations for both parties can be broken down. The inheritance discussion needn't include actual figures, but it's important that all parties are clear about what's involved – whether it's distribution of property or assuming responsibility for the family business. These candid conversations can minimise the likelihood of conflict later on.

These meetings also represent a vital step in developing a relationship with the next generation, presenting an opportunity for you to learn more about them and their priorities. This includes some of the key life events, from family planning to home-buying, around which they could benefit from professional financial advice. Furthermore, the Sanlam report suggests clients will appreciate efforts to engage their progenies: two-thirds (61%) of over-55s surveyed don't think younger generations are receiving adequate financial advice and 40% are concerned about how they will use their inheritance. The majority (59%) want their children to see a financial planner – but just one in ten have suggested it.

Though some clients might be uncomfortable broaching end-of-life conversations, you can help them to take a rational and considered approach that offers them peace of mind while minimising the risk of family conflict. This might involve outlining your client's key legacy priorities, ensuring that their offspring are primed regarding financial literacy basics, helping them to create a comprehensive inventory of their noteworthy possessions, assigning beneficiaries for insurance policies and investment accounts, creating trusts that encourage responsible financial decision-making, and more.

Inheritance or no inheritance, stagnant wage growth, burgeoning student debt and rising inflation have created challenging economic circumstances for many young adults, who'll likely need to save more than their parents did to enjoy a comfortable life in retirement. As a profession, we need to adopt a nimbler approach that enables us to serve these next-generation clients in a way that resonates, meets their needs and augments the likelihood of a bilaterally beneficial engagement. ●

*Amyr Rocha-Lima MCSI is a partner and financial planner with CISI Accredited Financial Planning firm Holland Hahn & Wills LLP.*

// YOUNGER FINANCIAL PLANNERS ALREADY HAVE THEIR FINGERS ON THE PULSE OF THEIR PEERS' NEEDS //

IMAGE: ISTOCK

# Retiring abroad

FOR MANY CLIENTS, RETIRING ABROAD IS A DREAM COME TRUE, BUT THE REALITY CAN BE FULL OF PITFALLS. FINANCIAL PLANNERS CAN HELP THEIR CLIENTS TO MAKE THIS 'TRANSITION OF A LIFETIME' A SMOOTH ONE. **NEIL JENSEN** REPORTS

UK retirees have long been seduced by the idea of moving to Spain or France, with its promise of a more temperate climate, lower living costs and the prospect of living by the sea. This explains why almost half of the UK's state pension-drawing population who have elected to move abroad – 121,000, according to the Office for National Statistics – choose Spain as the place they wish to spend their autumn years.

With the UK's imminent exit from the EU, these people may no longer be able to take for granted some of the things they have become accustomed to enjoying. However, it is possibly going to take some time before they receive clarity about how their lives will change.

### Why retire overseas?

Economics aside, some see the chance to 'start again' or undertake some form of 'adventure' as the catalyst for change.

Essex-based recruitment director Bill Brace underlines the importance of having a well-charted plan for making the move, in his case, to Spain. "Reaching retirement age obviously provides the opportunity to make decisions that will shape the rest of your life," he says. "For my wife and I, this came in 2016, when the UK had just voted to leave the EU. We already had a property in Spain and had reached a point where our affairs were coming to an important stage – children grown up, mortgage cleared, career at a winding-down point. If we didn't do it when all the fundamentals were reaching this tipping point, perhaps we never would."

Bill stresses the importance of knowing what you are going into, but even some people with experience of their destination country encounter unexpected bureaucracy and legislation that can derail their plans. And when financial markets and geopolitics tend towards volatility, migrants can often be impacted by events beyond their control.

### Things to think about

Foreign exchange risks can be a pitfall for people retiring abroad. Writing in the Q4 2018 print edition of *The Review* ('World citizens – a practical example', pp.42–43), Phil Billingham CFP™ Chartered MCSI, director at Perceptive Planning, says that exchange rate fluctuation can slowly compromise retirement plans. People tend to be familiar with most assumptions around a financial plan – elements like inflation, asset growth and charges – but it is difficult to make assumptions around exchange rates, he explains. For example, the UK practice of deferring drawing a pension, which can deliver gains for the beneficiary, can prove hazardous if there are 10% exchange rate swings, which can erode the benefits gained over a period of time.

Marlene Outrim CFP™ Chartered FCSI, founder and managing director of UNIQ Family Wealth, says lesser-known local tax regimes can also come as something of a shock for the unprepared expatriate. "In France, for example, county taxes can be complicated, comprising occupier's tax (*taxe d'habitation)* and property tax (*taxe foncière)*, and there are also wealth taxes that affect a person's worldwide assets," she says.

Retiring expats have more than one eye on Brexit and how it may change the landscape in the coming years. Phil from Perceptive Planning told *The Review* in a subsequent interview that one could assume that the UK's existing double taxation treaties with other EU members, which prevent nationals of either country having to pay tax on the same income twice, will continue. "But," he adds, "retirees with pensions should be aware that HMRC can be hostile towards people moving their pension abroad – there can be charges that range from 25% to 55%. It's usually not worth looking at QROPS [Qualifying Recognised Overseas Pension Schemes], albeit they are heavily marketed at expats." QROPS meet certain requirements set by the UK tax authorities and can receive transfers of UK pension benefits.

Healthcare is also important, particularly for those in the latter years of their retirement. Marlene from UNIQ Family Wealth emphasises the need to ensure that retirees provide for sickness and that appropriate healthcare insurance is in place. In the EU, UK citizens have been entitled to a certain level of state cover, but with Brexit taking the country out of the trading bloc, healthcare becomes even more of an issue.

Then there is the property buying process to consider – this can differ from country to country. In France, for example, all the work is handled by a *notaire*, while in Italy, a country heavy on rules and regulations when it comes to property, lawyers are not necessary.

Simon Clark CFP™ Chartered MCSI, of Old Mill Group, an accountancy and financial planning firm, suggests that buying a property may not always be the best option. Some retirees he has worked with often opt for a series of long-term rentals to keep costs low and introduce an element of flexibility into their retirement.

// LESSER-KNOWN LOCAL TAX REGIMES CAN COME AS SOMETHING OF A SHOCK FOR THE UNPREPARED EXPATRIATE //

### Issues at home

Of course, retiring abroad doesn't mean leaving the UK behind completely. Phil stresses the difference between residency and domicile: a residence is a country where you expect to live for a temporary period and it is possible to be resident in more than one country at the same time; a domicile is where you intend to make your permanent home

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// ONE OF THE FIRST THINGS PEOPLE SHOULD DO WHEN RETIRING ABROAD IS ESTABLISH A WILL THAT IS RELEVANT AND BINDING IN THEIR NEW COUNTRY OF RESIDENCE //

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and remain indefinitely. Your domicile is where you are registered to vote, pay taxes, claim benefits and so on. It is not possible to have more than one domicile. Phil explains: "The UK doesn't require you to formally emigrate, it is extremely flexible. Maintaining one domicile means you can be resident abroad but still be domiciled in the UK."

Phil says expats should maintain their UK banking facilities. They also need to decide what to do with their existing property, if they choose to keep it. One option is to earn income from renting it out. In this case, they are liable to taxation on the money they receive and may find themselves liable to additional tax in the form of capital gains tax, which is charged on the increase in value. Renting out or not, retaining property comes with logistical issues – such as property management, security and cleaning – and the associated costs. Bear in mind that there will also be running costs of the place of residence to plan for.

Also remember that UK assets may not come with the same benefits abroad as they do at home. For example, the UK pension system allows you to take 25% of a pension pot tax free, but such a tax exemption does not necessarily apply in some countries. It may be worth looking at encashing investments such as ISAs before leaving the UK, as no UK tax would be payable, whereas in some countries, the proceeds from an ISA would be fully taxable.

IMAGE: ISTOCK

## Doing your homework

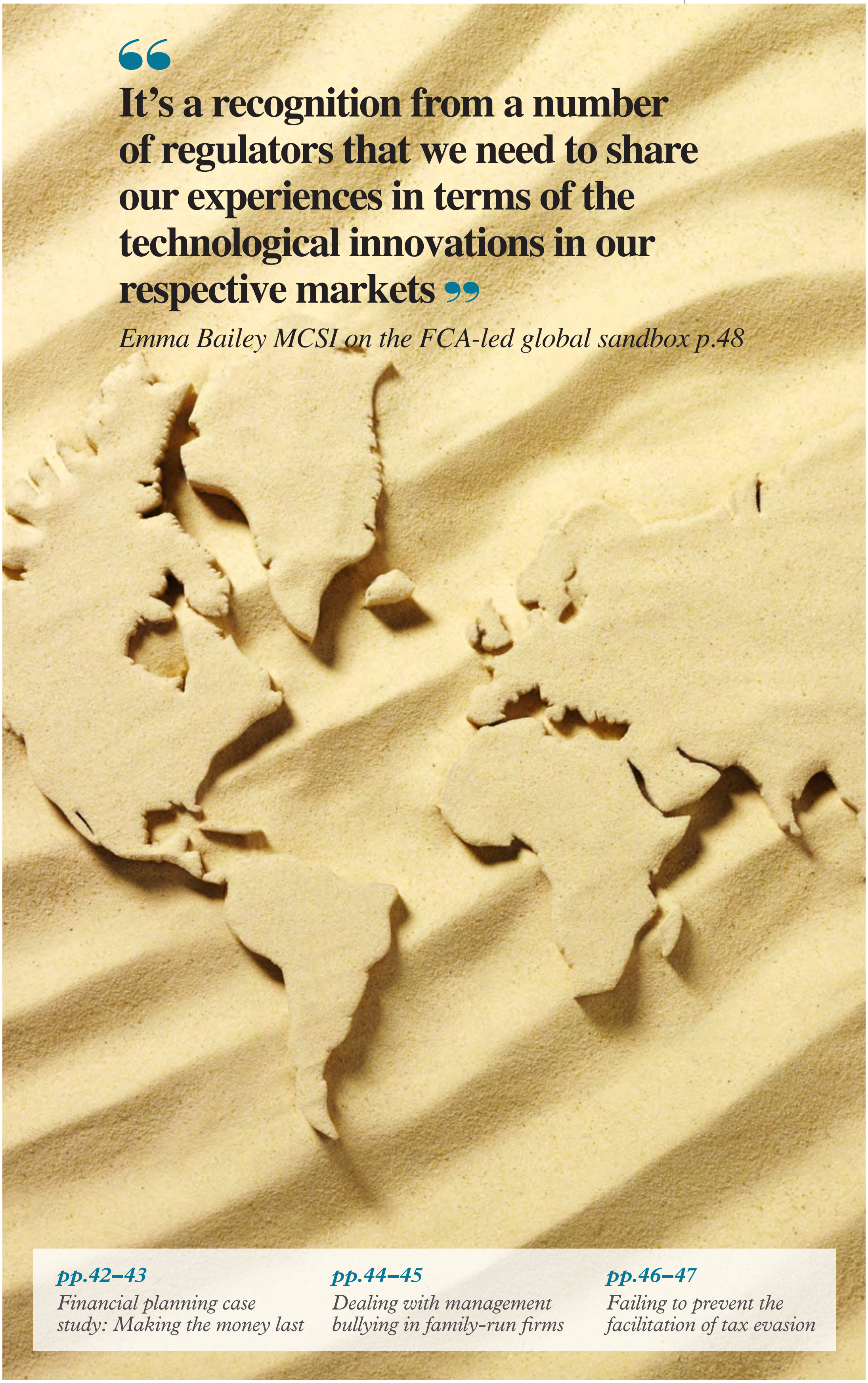
Clients should do their homework and develop a strategic plan that includes healthcare, cashflow, the cost of living, insurances and tax planning. This may be difficult to achieve alone and professional services should be engaged at an early stage.

The plan should be mindful of how family members still at home, such as children, are affected by a decision to retire abroad. For example, if someone dies while abroad, how will that affect the estate of the deceased? UK inheritance tax is chargeable on worldwide assets at 40% of the amount by which the total value of an expat's worldwide estate exceeds their nil rate band. If tax is also due to be paid by heirs in the country where the gain was made, tax relief may be obtainable through the double taxation treaty.

UK-based financial planners often cannot advise their clients once they are resident overseas, so seeking a CERTIFIED FINANCIAL PLANNER™ professional in one of the 26 countries that offer and promote this designation is advisable, although it is important that the individual(s) concerned are appropriately regulated. Simon from Old Mill Group says: "Once the retirees move, they need to form trusted relationships with lawyers, accountants and other professional services that can advise them on local requirements and practices. Every jurisdiction has its own peculiar characteristics – for example, in some locations, trusts are not recognised, which, given the age group we are dealing with, can create problems when someone dies." With that in mind, one of the first things people should do when retiring abroad is establish a will that is relevant and binding in their new country of residence.

With Brexit playing out, the landscape for retirees to the EU – the most popular destination for UK pensioners – is changing. Marlene says she would not dissuade people from pursuing their planned moves, but they should be more vigilant with their preparation. "We live in uncertain times, but foreign jurisdictions also benefit from the influx of overseas money, so there will surely be moves that will continue to make these locations attractive to expatriates. It is a significant market that will change, but it is unlikely to decline in the foreseeable future." ●

# professional development



> **It’s a recognition from a number of regulators that we need to share our experiences in terms of the technological innovations in our respective markets**

*Emma Bailey MCSI on the FCA-led global sandbox* *p.48*



IMAGE: ISTOCK

**JOSH BUTTEN** FPFS CFP™ CHARTERED MCSI, DIRECTOR AT BOOSST, HELPS PUT A RETIRED COUPLE'S MINDS AT REST AFTER THEY COME TO HIM WITH CONCERNS ABOUT THE LONGEVITY OF THEIR WEALTH AND THE THREAT OF INHERITANCE TAX

# Making the money last

### THE BRIEF

**Sue (68) and Adrian (64), a retired couple, were introduced to us by their accountant, who had supported them through the sale of their family business in 2008, generating £1.5m. They were keen to ensure that the proceeds of their hard work were invested prudently.**

Despite their combined assets of £3m, including their estate and pensions, they were worried about their spending and were trying to find ways to reduce their outflows. Their concern was founded upon their excellent health and the long lives enjoyed by their parents. Would their funds last long enough, and would they be swallowed up by inheritance tax?

// THEIR CONCERN WAS FOUNDED UPON THEIR EXCELLENT HEALTH AND THE LONG LIVES ENJOYED BY THEIR PARENTS //

At our initial meeting, it became clear that Adrian and Sue's key objectives were not typical of the average retiring couple. While there were some similarities, such as their desire to enjoy outstanding holidays and to spend time with family (especially their new grandchildren), and their eagerness to support a local charitable hospice – there were also some less common objectives. Adrian wanted to spend £20,000 per year on his fishing trips, which led to an amusing matrimonial conversation, and they had made the decision to not make any further financial gifts to their three children, who they both agreed had already been generously supported throughout their lives.

They have been receiving the net proceeds of their business sale in amounts of £100,000 per year for the past ten years, and will continue to receive this amount for the next five years. This currently funds the majority of Adrian and Sue's annual expenditure, but with the upcoming change, their attention had turned to their lofty personal pensions, worth just under £1m between them, to fund life thereafter.

We spent time learning about their lives and the financial decisions they had made along the way. It is always a powerful exercise to understand the roles that clients have taken in key decisions before moving on to discuss their future. We heard that Adrian is a creative engineer and designer by profession but, by his own admission, struggles with numbers. Sue had taken responsibility for the company finances and felt that she had a strong grip on numbers and data. This created an interesting dynamic for explaining ideas and presenting advice, needing to use methods that worked for both Adrian and Sue. Sue grasped the numbers in conversation and data in tables quickly, but Adrian was first to spot visual trends in our 'live' on-screen cashflow planning sessions. Adrian quickly absorbed the visual graphs and imagery and was soon explaining the impact of an annual inflow surplus or deficit to Sue.

A key moment in our first meeting was the revelation of inheritance tax (IHT) and the large liability that blocks the inheritance pathway to their children. Having always had a reasonably high net worth, Adrian and Sue had explored IHT many years previously and had been reassured that their assets were all within their allowances and reliefs. This was true at the time, but only until the day that their shares were sold and their estate lost its business relief. Thinking everything was okay, they hadn't sought new advice for many years and were now confronted by a £400,000 IHT liability.

Before our intervention, they had an estate of almost £2m plus their pensions, and were on the brink of accessing a pension commencement lump sum, drawing pension income and losing their main residence nil rate band (MRNRB).

With IHT planning back in their sightline, we built a new financial plan, which focuses on Adrian and Sue:

- Spending the capital and income they receive each year and deferring access to their personal pensions.
- Doing more of the things they love, creating an income deficit, to begin sustainably depleting their estate.
- Downsizing to a smaller home in 2024, when the £100,000 annual capital inflows cease, better suited to later life living. The downsize from a £1.5m home to a £750,000 home will release a further £750,000 of capital, which will be used to fund their lifestyle between ages 75 and 81.
- Acknowledging that it is likely they will spend less in later life as health hinders them from continuing their expensive hobbies and travel, so a key assumption is that expenditure from age 80 will reduce.
- Commencing pension withdrawals to fund their lifestyle once their taxable estate has reduced to just their main residence and £50,000 cash. This will leave them with a comfortable cash buffer for any spontaneous decisions. Their pensions will fund their lifestyle beyond age 110, without incurring higher rate income tax – which, Adrian says, "is probably long enough!"

By Adrian's 80th birthday, their estate will be valued at less than the projected nil rate band plus the MRNRB.

### JOSH BUTTEN FPFS CFP™ CHARTERED MCSI

Josh is a director at boosst, one of our newest Accredited Financial Planning Firms™. He has accrued ten years of financial planning experience and became a CFP professional at the age of 23.

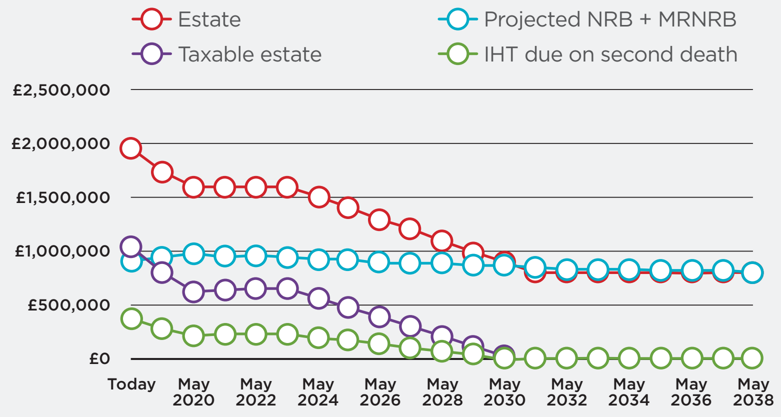
Josh aims to be a future leader of our profession and enjoys guiding other youngsters towards a long and happy career in financial planning. He splits his time between working directly with clients and mentoring boosst's trainees, and forms the boosst leadership team alongside his father Keith and colleagues Vicki and Jennie.

He represents boosst by hosting events, speaking at conferences, contributing to sector press and lecturing financial planning students.

// ADRIAN AND SUE HAVE A RENEWED FOCUS ON SUSTAINABLY REDUCING THEIR ESTATE //

### HOW DO WE MEASURE THE IMPACT OF OUR ADVICE?

The graph shows how Sue and Adrian's taxable estate would reduce over time




Notes:
- All figures are in today's terms
- Assumes inflation at 3% pa
- Assumes main residence growth at 3% pa
- Based on nil rate band remaining at £650,000 flat and MRNRB increasing by CPI, as per current legislation

*Source: boosst*

Although gifting funds to their children wasn't an immediate objective, they were keen to ensure their assets weren't diluted upon death by IHT. We explained their option of arranging joint life, second death, decreasing term assurance to insure the projected IHT liability as it reduces from around £400,000 to nil over the next 12-year period. They didn't know this was possible and they took up the option immediately. The cost of cover wasn't too severe.

We also discussed their objective to support the hospice that had supported their loved ones in times of need. Adrian and Sue decided to amend their wills to donate 10% of any taxable estate upon death, reducing the tax rate applied to the taxable estate by 10% from 40% to 36%. This also reduced the amount of decreasing term assurance required and therefore the cost of funding it.

We also advised a change to their personal pensions and moved their existing provisions to a platform solution, giving access to a far better range of funds, significantly reducing their ongoing costs and enabling flexible access in due course.

### What happened next

Adrian and Sue have continued to enjoy their retirement lifestyle, albeit now with a renewed focus on sustainably reducing their estate. With their financial plan in place, they have the confidence to do so with conviction. Most recently, Adrian surprised Sue with a memorable trip to see the northern lights from the Scandinavian wilderness for New Year's Eve. ●

# In his shoes

ALLEGATIONS OF BULLYING HAVE BEEN MADE AGAINST THE CEO OF A FAMILY-RUN ASSET MANAGEMENT FIRM. THE HEAD OF HR MUST CHOOSE BETWEEN THE EFFECTIVE MANAGEMENT OF THE COMPANY AND CAUSING TROUBLE WITHIN HIS OWN FAMILY

Footes & Co is a privately run boutique asset management firm, founded by John Footes in the 19th century. Ownership of the firm has been passed down through the Footes family ever since.

The firm has a set of core values, established by John Footes, which are: Respect; Integrity; Customer Care; and Honesty (RICH). All staff members, including the family members who sit on the Board and within the management team, are expected to abide by these values by 'walking the walk' and not just 'talking the talk'.

Mike Footes, the son of John Footes III (the current chairman of Footes & Co), pursued a career outside the firm after graduating from university. Determined to forge his own path, he joined a rival asset management firm, causing a rift in the family. During his 30s, the tension became so bad that he ended up not speaking to his father for a number of years, until the rift was healed when Mike married and had two children. Step by step, the relationship improved, and John was impressed when Mike told him about his professional successes, rising through the ranks at the firm in which he worked, finally being promoted to managing director. Mike's mother, Janine, often tried to press him for further details about his job, but Mike remained evasive. Janine was not concerned, believing Mike was being careful to avoid another fall out with his father.

In 2016, the Footes & Co chief executive Sheryl Brogues (not a member of the Footes family) decided to stand down from her post. To John's delight, Mike informed him that he would be interested in the role and John used his influence as chairman of the Board to fast-track Mike's application. While there were other applicants, it was seen as a foregone conclusion that Mike would step into the role. Richard Footes, head of HR, did his best to remain impartial during the recruitment process (which was difficult, as Mike is his cousin), but in the end he determined that Mike's impressive résumé and excellent interview marked him apart from the other candidates, and he was appointed as the new chief executive of Footes & Co.

The family were delighted to have Mike join the firm, and a couple of years passed without incident. Mike was known for his strong leadership style, and he would often dominate meetings, yet this was just seen as his way of achieving results. However, in 2018 a complaint was made against Mike by a fellow member of the management team, saying that Mike had been particularly aggressive in a meeting, and that he had shouted at a junior staff member who had disagreed with him. The complaint centred around the fact that this behaviour was not in keeping with the firm's RICH values (particularly the value of Respect). An

// MIKE HAD BEEN PARTICULARLY AGGRESSIVE IN A MEETING, AND SHOUTED AT A JUNIOR MEMBER OF STAFF WHO HAD DISAGREED WITH HIM //

ILLUSTRATION: ISTOCK

investigation was launched, and Mike extended an apology, which was accepted, and the matter was considered closed. However, over the next few months, staff morale at the firm sharply declined, and a couple of key staff members (not part of the Footes family) decided to leave.

In her exit interview, Lisa, formerly head of compliance, mentioned to Richard Footes, head of HR, that Mike was a bully. She said he was known for his coarse language and aggressive behaviour, and that these traits were not consistent with the firm's RICH values. However, she also mentioned that staff were scared to raise concerns, especially if they were not members of the Footes family. Lisa asked Richard to keep their conversation confidential, saying: "I only told you this because I trust you. I'm sorry for putting you in a difficult position, as I would not want to be in your shoes."

Richard recognises that he is in a difficult position. He is part of the Footes family and doesn't want to upset the relationship between Mike and his father that was only restored a few years ago. However, if Mike's behaviour is really that bad, it has the potential to affect the business and, with it, the family.

### What should Richard do?

**A.** Conduct further investigation, including reviewing the references received from Mike's previous employer and seeking witness statements from members of staff who might be willing to go on record about Mike's behaviour.

**B.** Report his concerns to the chairman (John Footes III, Mike's father), which is consistent with the guidance set out in the firm's whistleblowing policy.

**C.** Do as Lisa asked and keep the information confidential. He cannot take further action until more information comes to light about Mike, and exposing Lisa would be a breach of the trust she has placed in him.

**D.** Call Mike in to answer allegations of poor conduct that goes against the RICH values. ●

**WHAT WOULD YOU ADVISE?**
**Visit *cisi.org/shoes* to share your views. The survey results and CISI's opinion will appear in the Q2 2019 print edition of *The Review*.**

# Knowing your clients too well? The verdict

**This 'Grey matter', published in the Q4 2018 print edition of *The Review*, looks at what happens when a lack of understanding about new technology leads to unexpected problems.**

**Suggested solutions and results are as follows:**

**A.** All the data collected by the app should be deleted, and a message sent to clients noting that there was an unexpected technical glitch, no erroneous data will be retained, and that clients should delete the app. The survey questions should be sent out again by post. (19%)

**B.** Each client must be informed immediately about exactly what data has been accessed. These responses should be tailored to each client, especially for those who clicked 'yes' to the pop-up, therefore giving consent for the app to access their wider personal information. (29%)

**C.** All personal data should be deleted, even if the client consented to the pop-up request, but the responses from the survey questions can be kept in the client folders, especially since they can be used to improve customer service and fix small problems. (4%)

**D.** The responses to the survey should be anonymised. Where consent was given, some personal information obtained by the app can be used. However, the information should only be used for its intended purpose, and its use should be reasonable and proportionate. Any unnecessary information should be deleted. (48%)

We received 248 responses.

With the launch of the EU General Data Protection Regulation in May 2018, the use and collection of customer data is a key consideration for many businesses. The key issues in this case are a) it is unclear whether clients realised their responses were not anonymous and b) some irrelevant data has unintentionally been collected.

The most popular choice is option D, but if there's any confusion about what clients have agreed to, they must be told what information of theirs has been accessed. Option B is also not appropriate because, as one respondent said: "Option B … involves identifying the personal information accessed, [and] is much more likely to compromise confidentiality than option A."

**Our recommended option (option A) is in line with this.** It is too complicated to separate which clients consented to their response being attributed to them and which clients consented to the app accessing information from their phone. Additionally, this exercise would most likely narrow down the groups of respondents so much that it would be possible to identify responses provided by individual clients.

Should you wish to suggest a dilemma or topic to be featured in a future 'Grey matter', please contact us at *ethics@cisi.org*

# Countering corporate crime risk at investment firms

WHAT IS THE CORPORATE CRIMINAL OFFENCE OF THE FAILURE TO PREVENT TAX EVASION (FPTE) FACILITATION AND WHAT IS REQUIRED OF INVESTMENT FIRMS? **ALI KAZIMI**, MANAGING DIRECTOR AT HANSUKE CONSULTING, EXPLAINS

The Criminal Finances Act 2017 (CFA 2017), in force since 30 September 2017, introduces new corporate criminal offences (CCOs) for failing to prevent the facilitation of tax evasion against the UK Exchequer (the UK tax offence) and against any overseas jurisdiction (the foreign tax offence).

The offences are not applicable to individuals. They can be committed only by relevant bodies. A relevant body is a partnership, company or other body which has either:

- been formed or incorporated in the UK
- been formed or incorporated anywhere else in the world, but which
  - undertakes business in the UK
  - facilitates the offence from within the UK (in whole or in part).

## Overview of the FPTE offences

There are three stages, as set out below, that apply to both the UK and the foreign FPTE offences. There are additional requirements for the foreign tax offence, namely the 'UK nexus' and 'dual criminality'.

**Stage 1:** The criminal evasion of UK or foreign tax by a taxpayer (either an individual or a legal entity).
**Stage 2:** The criminal facilitation of the tax evasion offence by an 'associated person' acting on behalf of the relevant body.
**Stage 3:** The relevant body's failure to prevent its associated person from committing the criminal facilitation act at Stage 2.

The sole statutory defence against prosecution is to positively demonstrate the presence, at the time of the offence, of 'reasonable prevention procedures' designed to prevent associated persons from committing tax evasion facilitation offences, or that it is unreasonable to expect such procedures.

## FPTE guidance

SI 2017/876 brought into operation guidance entitled *Tackling tax evasion: government guidance for the corporate offences of failure to prevent the criminal facilitation of tax evasion* (the Guidance).

The Guidance sets out the minimal steps that should be undertaken to be compliant with CFA 2017, including the release of a statement from the board, proscribing the illegal activities, the training of staff, undertaking a risk assessment and the implementation of a clear reporting and whistleblowing procedure. A statement from the board can be provided in the corporation's tax strategy document and should set out how the board intends to combat financial crime.

## Sector guidance

Under s47(7) of CFA 2017, on 8 January 2018 the Chancellor of the Exchequer approved guidance for the financial services sector in the interpretation and application of CFA 2017. It should not be regarded as law, nor as a substitute for HMRC's Guidance.

## Territorial overreach of the FPTE legislation

CFA 2017 criminalises the failure to prevent the facilitation of both UK and foreign taxes.

### Facilitating the UK tax offence

The UK tax offence applies within the UK and extra-territorially to activities outside the UK. The simple act of the evasion of UK taxes by the taxpayer is sufficient to be within the scope of UK criminal law jurisdiction.

### Facilitating the foreign tax offence

The foreign tax offence is narrower in scope, as it requires a UK nexus and dual criminality to be established in addition to the three stages highlighted above. It applies if:

- the relevant body is incorporated under UK law
- the relevant body conducts a part of its business in the UK
- any aspect of the facilitation offence takes place in the UK, even though the UK operation may not be directly involved in assisting the evasion of foreign taxes.

## Purpose of the FPTE legislation

In the UK, the absence of senior management knowledge or the inability to prove their direct involvement in the wrongdoing had made it difficult to secure a successful criminal prosecution against large corporations. The FPTE legislation is designed to overcome the difficulties in attributing criminal liability to corporations where its employees, contractors and other 'associated persons' have been aiding and abetting tax evasion by a taxpayer (which includes customers, employees or suppliers).

The CFA 2017 introduces 'strict liability' offences which do not require proof of involvement of a 'directing mind', such as senior management. Under the FPTE legislation, the corporation is subject to prosecution regardless of whether:

- any direct benefit is obtained by the corporation from facilitating of tax evasion, or
- any proceedings are brought against the associated person or the tax evader.

### Penalties, sanctions and Deferred Prosecution Agreements (DPAs)

The UK offence will be investigated by HMRC, with prosecutions brought by the Crown Prosecution Service (CPS). The foreign offence will be investigated by the Serious Fraud Office (SFO) and prosecutions will be brought by either the SFO or CPS.

A criminal conviction could lead to:

- unlimited financial penalties
- ancillary orders such as confiscation orders or serious crime prevention orders
- a public record of the conviction
- significant reputational damage and adverse publicity
- severe regulatory impact.

To encourage self-reporting, DPAs are also devices for prosecutors. DPAs enable the resolution of certain types of offences by corporations, which entail charges being laid but the prosecution is suspended for a specified period if certain agreed conditions are met. DPAs enable companies to avoid the consequences of criminal conviction and bypass the full investigation and prosecution process. Entry into DPA negotiations can only be initiated by the relevant prosecuting authority.

### Liability for third parties

Under FPTE, corporations will be criminally liable for their 'associated persons'. An associated person is one who acts on the corporation's behalf. The term is deliberately broad and aims to capture agents, sub-contractors, other third parties and employees.

As the concept extends to non-employees who operate outside the corporation's direct control, it is important to review the role of agents and third parties who fall within the definition of associated persons for these purposes and ensure that risk mitigation procedures are extended to cover such parties.

In the investment management sector, particular attention needs to be paid to intermediaries and outsourced arrangements.

### Establishing a 'reasonable prevention procedures' defence

A complete defence to FPTE offences is to prove that, when the tax evasion facilitation offence was committed, (a) the corporation had in place reasonable prevention procedures, or (b) it was not reasonable to expect the corporation to have any prevention procedures in place.

The Guidance requires corporations to institute 'bespoke prevention measures' based on the corporation's particular circumstances and risks.

The formulation of reasonable prevention procedures to prevent facilitation should be informed by six guiding principles, which mirror those identified in the guidance to the Bribery Act:

- Risk assessment
- Proportionality of reasonable procedures
- Board and senior management commitment
- Due diligence
- Communication and training
- Monitoring and review

According to the Guidance, reasonable prevention procedures must be proportionate to the risk posed by the business and its operations. The investment management sector is inherently high-risk under the offence, due to:

- the international dimension to the investments and vehicles in the investment management sector
- the fact that the manager, custodian, transfer agent and fund administrator are 'associated persons' of the investment fund vehicle
- the sector's dominance of customers who are high-net-worth individuals and/or politically exposed persons.

It is important for the investment management sector to seriously engage with the legislation. This has become particularly pressing as there is now considerable tax transparency through the operation of the Automatic Exchange of Information (AEoI) regimes, such as the Foreign Account Tax Compliance Act in the US and the Common Reporting Standard. Under AEoI, tax authorities have direct access to unprecedented levels of financial information concerning overseas wealth. It is likely that authorities will exploit this new information to intensify their investigation of all those whom they perceive to be at risk of having evaded tax. ●

### CCO IN THE INVESTMENT MANAGEMENT SECTOR

Factors a business should consider in performing and implementing a risk assessment and adopting reasonable prevention procedures depend upon the size, nature and complexity of its operations.

The following may be specifically relevant to investment management:

- Risks associated with cross-border non-resident investors
- Complexity of multiple fund distribution models involving third parties, including the different types of marketeers that may constitute associated persons of the fund
- Risks relating to investing structures used by investors intermediating through trusts or other vehicles that may obfuscate beneficial ownership
- Business culture and product risk in connection with fund entities, of relevance to funds established in common no/low tax fund domiciles
- Risks relating to the nature of investments, which can be from a broad spectrum, including traditional securities and alternatives such as derivatives
- Investment jurisdiction risk
- Remuneration structures for associated persons, such as marketing or distribution teams, and investment staff.

**Quick quiz answers:**
1.B, 2.C, 3.D, 4.C

**ALI KAZIMI** is managing director of Hansuke Consulting. A seminar on this theme at the CISI on 26 March 2019 will be available on CISI TV in April 2019

# Ask the experts: Global Financial Innovation Network

Financial services regulators from 29 key markets have come together to form a global sandbox, allowing firms to test their innovations across borders within a regulated environment. **Emma Bailey** MCSI, director of the Authorisations and Innovation Division at the Guernsey Financial Services Commission – one of the founding regulators – tells us more

### Why was the Global Financial Innovation Network (GFIN) set up?

It's a recognition from a number of regulators – led by the FCA and including ourselves and others – that we need to share our experiences in terms of the technological innovations in our respective markets. There also needs to be a way to help innovating firms ensure they have an environment in which they can operate with more certainty as to how each of the relevant jurisdictions will be treating them.

### What is it seeking to achieve?

First, as I mentioned, is to share our experiences as innovations come into each of our markets and collaborate on how we respond to those innovations. Second is to work together on areas such as regtech to provide certainty for firms around how they're likely to be treated when approaching each jurisdiction.

Finally, we want to provide an environment in which innovations can be trialled across different jurisdictions at the same time. This means firms won't have to apply to trial a solution in just one market and then roll it out. That should aid them with their innovation as they drive it forward.

### What types of innovation will GFIN focus on?

Financial services. It could be using technology to drive innovation in a company's business model or the product itself. Very often, innovation simply involves a different way of approaching something that we're already used to in financial services businesses.

### GFIN is launching a six-month pilot on cross-border testing of innovative solutions. Tell us more about this.

Applications for the pilot closed at the end of February. Once we have a good idea of who is interested in the pilot and which jurisdictions they're interested in doing the testing within, we'll establish how to proceed.

Currently, we're learning about how each jurisdiction would run such trials. We'll need to iron out any differences which might be barriers to firms running trials across different jurisdictions at the same time.

That will be the next piece of work, which will happen through March alongside selecting and speaking to the firms that will be involved in the pilot, which will run for six months from April.

### How will GFIN cooperate on regulation?

We're not looking to influence or establish any other jurisdiction's approach to innovation. It's about sharing experiences and understanding how others have approached it within the boundaries of their own legislation and learning lessons from that. The key to it all is making sure that everyone's welcome to join GFIN from the regulatory world and that there are opportunities for everybody to share and learn from each other.

> *“Firms won't have to apply to trial a solution in just one market and then roll it out”*

### How will the network help to increase speed to market for innovative firms?

Cross-border trials should give firms insight into how their product or service might operate in different markets much quicker. I can also imagine that some of the meetings that they might have with one regulator will actually now happen with several. So, if you're going in to meet your host regulator, there could be other regulators on the phone as well listening to your pitch. Simple things like that will help to speed things up.

There will be issues of confidentiality that we are still working through, but we're hoping that being more coordinated and allowing economies of scale and speed in what seem like quite minor areas will help a great deal overall.

### What is the main benefit that firms will gain from the existence of GFIN?

Having a group of regulators that are prepared to talk to each other and have a more joined-up approach. The feedback that network members have had from their markets is that firms are pleased to see that we're willing to collaborate so that they don't keep having to explain themselves every time they look to expand into a different jurisdiction.

### What does the GFIN initiative mean for CISI members and how can they participate in it?

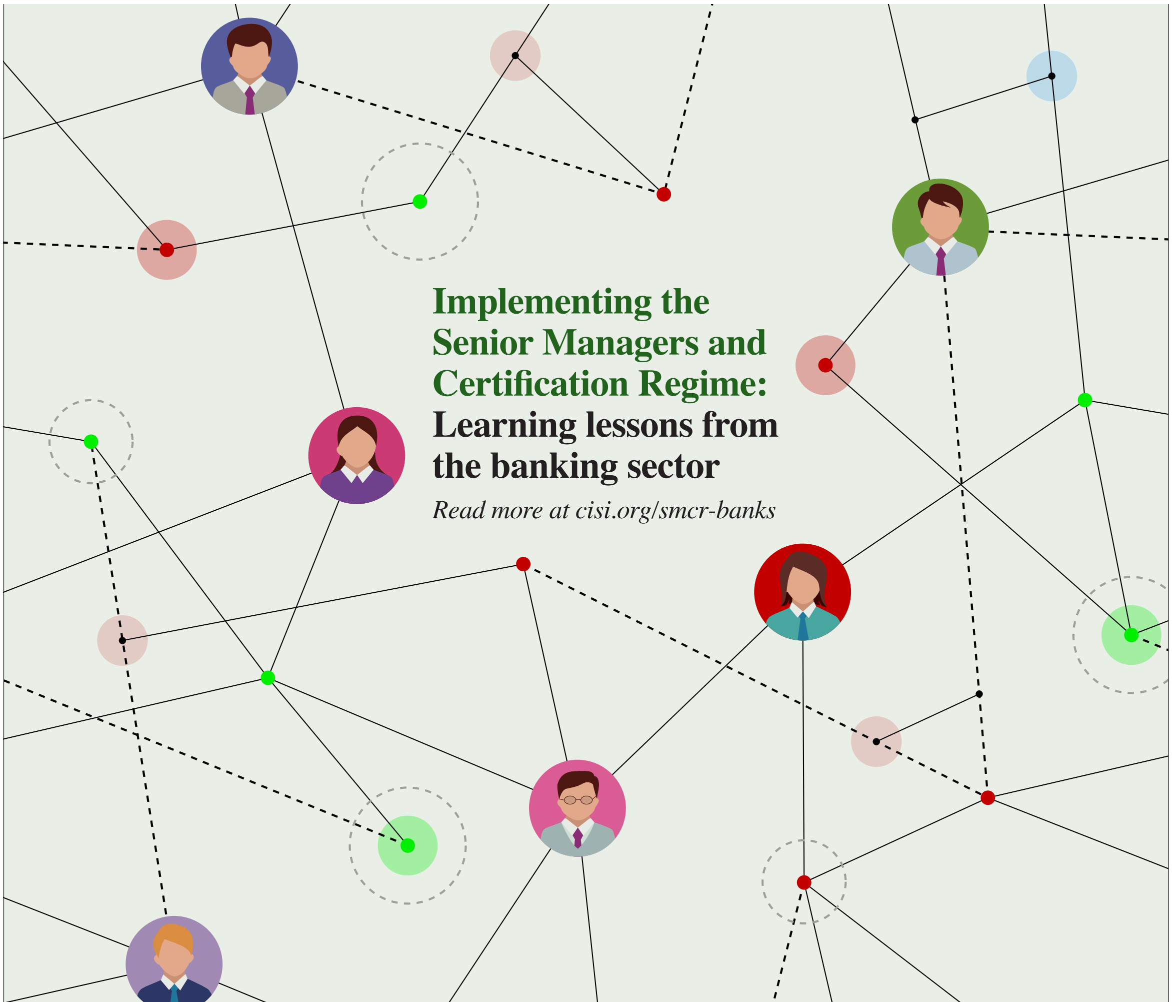
CISI members, through the firms they represent, are welcome to participate in the cross-border trials, particularly as their clients are likely to be demanding faster and more efficient interactions with those businesses that are providing financial services to them. In meeting those demands, businesses will want to be considering innovative ways of doing things better, and hopefully GFIN will help to encourage this behaviour.

### What's the plan after the six-month pilot?

Hopefully, a successful pilot will mean that we have some entities that are able to go ahead and operate in jurisdictions and I would imagine that the pilot then is rolled out into a more formal approach to undertaking cross-border trials in future. ●

EMMA BAILEY joined the Guernsey Financial Services Commission in 2002 and was appointed director of its Authorisations and Innovation Division in September 2018. She is a member of the CISI and an associate of the Institute of Chartered Secretaries and Administrators.

# education


Implementing the
Senior Managers and
Certification Regime:
Learning lessons from
the banking sector
Read more at cisi.org/smcr-banks

# FROM THE EDITOR

THIS SECTION PROVIDES REGULATORY AND STRATEGIC INFORMATION FOR SENIOR MANAGERS. IT DESCRIBES THE POSITION AS AT 18 FEBRUARY, EXCEPT FOR THE PRIVATE WEALTH MANAGEMENT SECTION, WHICH WAS UPDATED ON 15 MARCH. THE REPORT CAN ALSO BE ACCESSED AS A PROFESSIONAL REFRESHER AT *CISI.ORG/PR* OR LOG IN TO MYCISI.

**CHRISTOPHER BOND**, CHARTERED MCSI, EDITOR, REGULATORY UPDATE, *CHRISTOPHER.BOND@CISI.ORG*

## SOME REGULATORY HOT TOPICS

- Brexit preparations
- Starting the SMCR
- The pensions dashboard
- The use of machine learning by asset managers
- Product governance for providers and distributors
- Platforms retaining interest on client money
- Disclosure of transaction charges
- Research unbundling
- The RBC FCA culture enquiry

## GENERAL REGULATORY CHANGES

**1. Brexit**

As a hard Brexit becomes increasingly likely, UK and EU regulators have partially prepared for this in several ways:

- An agreement between the FCA and the European Securities and Markets Authority (ESMA) on continuing sharing of data on cross-border supervision of firms.
- The FCA has set up a system of temporary authorisation of EU firms in the UK. Even firms that do not apply for this will have five years to continue with longer term securities and insurance policies.
- ESMA will temporarily authorise UK clearers and central securities depositories, such as the London Clearing House, to continue to clear transactions from the EU after 29 March; however, there is no parallel permission for EU-regulated firms to trade on UK exchanges, such as the London Stock Exchange and London Metal Exchange, or do off-exchange trades, or for UK firms to do so in the EU.
- While EU funds can continue to be marketed in the UK, some countries, such as France, are insisting that UK funds cannot be marketed in the EU.
- EY estimates at least £800bn of customer assets will be transferred to the EU, creating 2,000 jobs (expected to rise to 7,000 shortly).
- UK companies have encouraged their EU staff to apply for settled status in the UK. The government proposes a one-year visa for EU nationals of all skill levels. Thereafter, EU nationals without settled status would have no priority to stay – it will depend on skill levels.
- The EU has proposed extending the capital and liquidity rules for banks to larger investments firms; ESMA would enforce harmonisation of these. This is relevant to the UK if it wishes or needs to remain 'equivalent' to the EU.
- The Bank of England has raised the question of whether the rules for small firms could be simplified post-Brexit. "We have often argued in Europe for simpler approaches for small firms, but differing legal traditions across the EU27 and the desire to harmonise regulation and supervision are powerful forces in the opposite direction." Coincidentally, the FCA is asking small advice firms about the impact of regulation. A 'small representative' number will be asked about specific impacts of FCA regulation; a questionnaire will then be sent to a larger number in April/May. This follows the Heath Report Three which finds that 5% of advisers plan to retire now, and a further 16% in the next five years.

Meanwhile, firms are preparing for a hard Brexit as best they can, given the serious lack of information:

- UK asset managers are setting up parallel funds in the EU for marketing there.
- Equity and commodity broker dealers are spending large sums on researching which countries they can legally sell products in under local reverse solicitation rules. Should they be asking existing customers to approve continuation of trading now? Others are simply expecting to continue to sell to eligible counterparties and professional


# REGULATORY UPDATE FEBRUARY 2019

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clients on the basis that reality will prevent any enforcement action (though this ignores the risk that the agreements may be unenforceable).

- Some firms plan to use promotions to EU clients that fall short of being regulated 'financial promotions', such as some trade ideas.
- Multilateral trading facilities (MTFs, which match customers' trades on an agency basis) which have set up EU parallel operations are planning on routing orders from EU customers away from London to EU MTFs.
- Uncertainty about UK/EU dual listed stock, such as Shell or Unilever: under EU rules, London Stock Exchange is an unrecognised exchange in a third country, so priority should be given to EU customers executing orders on the EU exchange; however, the liquidity may be in London. Opinions vary as to whether the customer can instruct which exchange the trade should be on.
- Some UK-based firms have set up or have existing subsidiaries in the EU. If the trading desk remains in London, they will often make transactions back to back – the EU company with the EU customer, then entering into a matching transaction with the UK firm. Practices on the involvement of the UK firm with the customer transaction vary a lot – from making the trade to no involvement.
- Some EU regulators, for example, Ireland, are demanding substantial staff in the parallel EU subsidiary with demands for risk, compliance, operations and front office staff.

**2. The FCA**

Understandably, the FCA is focused on Brexit and little else, although its next Business Plan is due out in March/April. Generally, the trend is towards encouraging firms to comply rather than penalising firms, as seen in the absence of enforcement action under the Markets in Financial Instruments Directive II (MiFID II) which started a year ago. Stephen Hanks, FCA head of markets policy, said: "We have been having discussions with firms across a range of issues which are in the nature of supervisory intervention, but there are no pending enforcement cases in relation to [disclosure of] costs and charges. It's just that there is nothing that we have found that meets the requirements for taking an enforcement case, which is complicated and time and resource consuming." On transaction reporting he said that generally its quality had improved over the past year but problems remained: "So it's important for firms to be monitoring the nature of their reports, checking them and sending us any errors and omissions – with particular focus on getting the fundamental economics of transactions correctly reported to us." Current errors are the same as historic ones, for example, 'buys' for 'sales'.

Other interesting trends include:

- The FCA is considering general changes to its conduct rules to ensure they remain fit for purpose, for example, in the transfer of risk to individuals under defined contribution pensions, and the struggle for millennials to buy homes.
- The criticism from the Financial Regulators Complaints Commissioner that the FCA sides with banks not customers under the Interest Rate Hedging Products compensation scheme.
- The FCA chairman commented that the Financial Ombudsman Service (FOS) would make a fundamental review of its funding this year following the reduction in PPI claims after the deadline of 29 August 2019.
- The continuing focus on 'operational resilience' of firms (this is defined widely beyond business continuity to include significant outsourcing, including to the 'cloud', all types of financial crime from market abuse to data protection, to IT systems of all kinds, to name a few). No customer detriment is necessary – for example interruptions in reporting to the regulator or markets – and it could be purely internal, for example, fraud. The FCA now sees the firm as the culprit if its systems are inadequate, even if the cause is external.

**3. Financial crime**

Money laundering continues to be a regulatory priority, nationally and internationally. The National Crime Agency (NCA) received a record 463,938 reports of suspicious activity in 2018 – up 20%; however, there were only 40 arrests arising from 28 cases. The Suspicious Activity Report system was criticised by the international Financial Action a Force (FATF), which has proposed "a significant overhaul to improve the quality of financial intelligence available". The FATF particularly criticised the under-reporting by lawyers and accountants, and the resources of the NCA – 46 roles will be added in the next three years. Market abuse is another hot topic. There are several recent Market Watches from the FCA which describe its concerns, for example, about the access to confidential information by senior managers within client companies. The FCA has launched its five conduct risk questions across banks and broker dealers, such as "ensuring that individuals within organisations understand their responsibilities to conduct business in an orderly fashion". Firms should "avoid overly relying on the permissions regime for insider lists and

> // MONEY LAUNDERING CONTINUES TO BE A REGULATORY PRIORITY, NATIONALLY AND INTERNATIONALLY //

deal teams. Essentially, move away from the assumption that if someone legitimately has access to information, they will always act legitimately with that information".

Firms should also proactively review permissions lists and remove those who no longer need access.

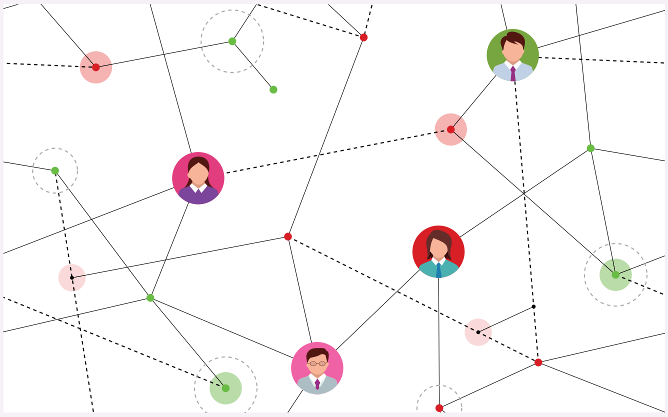
> // THE UK GOVERNMENT HAS FINALLY COMMITTED TO REQUIRING PENSION SCHEMES TO PROVIDE DATA FOR THE PENSIONS DASHBOARD //

Finally, whistleblower reports to the Information Commissioner's Office (ICO) have nearly tripled since the General Data Protection Regulation started in May 2018 – running at the rate of 82 reports a month. It is not clear yet what action the ICO will take. The ICO said: "It is not just disgruntled employees who act as whistleblowers but genuinely concerned individuals." News of the continuing stream of major data breaches supports these fears, so firms would be wise to put their policies and staff training into practice.

**4. The Senior Managers and Certification Regime**

Most firms are starting their preparations for the SMCR, due to be implemented in December this year. Key points are:

- Which individuals will take responsibility for the specific business areas that the FCA requires? Mostly this is obvious but in matrix and committee-led management structures, it is often less so.
- How many senior managers will there be, and will this include any overseas persons?
- What is the category of the firm for SMCR purposes – core, enhanced or limited. The intensity of the relevant rules – and preparation – will depend on the result.
- Which individuals will become certified persons? There is a list which includes consumer-facing roles, traders, material risk-takers and those managing certified persons but excludes some non-executive directors. This is sometimes a subjective call. The FCA plans to give firms discretion to exclude those who have contact with clients in purely administrative roles, for example, in opening accounts. This is because they could be considered to be 'arranging' or even 'managing'. The test will be for those who have "no scope to choose, decide or reach a judgement".
- To assess the chosen managers and certified persons as fit and proper. The sector generally thinks this is a higher standard of evidence required, given that it must be demonstrated to the regulator on demand, both initially and annually. Records of qualifications, training and CPD are desirable.
- To make a written statement of the managers' responsibilities, which is mutually agreed.
- To train both in the conduct principles and the SMCR generally from the start date, even though firms have up to a year to make the fit and proper assessment for certified staff.
- For enhanced firms, there are many additional requirements from more detailed responsibilities maps to taking detailed references and handover certificates.
- To set up a project team to oversee the whole. Frequently, members are from compliance, training and HR with senior management support.



What lessons can be learnt from the banking sector in the implementation of SMCR? Read *The Review* online article at *cisi.org/smcr-banks*

**5. Pensions**

This is a hot area. Some highlights:

- The UK government has finally committed to requiring pension schemes to provide data for the pensions dashboard, although it's not clear on the timing. More details will be in the feasibility study to be published in March, before the Pensions Dashboard Bill is introduced into Parliament. The Association of British Insurers is keen that advisers as well as pension schemes should pay the levy for its cost. Advisers want "transparency at the outset" on any levy on advisers. The first non-commercial dashboard service hosted by the Single Financial Guidance Body is expected to start this year.
- The FCA is consulting on drawdown investment pathways. This will require providers to offer customers easy to access ready-made drawdown investment products, to prevent the drawdowns remaining in cash for long periods. The FCA is also proposing that providers' charges should be clear and comprehensive, but has stopped short of imposing a cap on these – as it has done for contributions. Advisers are concerned by the proposal that customers who have not made an investment decision more than 12 months after the transaction should be treated as orphans and non-advised so that the provider may offer advice to them. IFAs dislike this.
- Transfers from defined benefit (DB) schemes to defined contribution (DC) ones are likely to hit £60bn annually over the next three years, according to Mercer, the pensions consultant, with annual amounts rising from £3bn to £20bn. DB schemes are likely to be better funded, but members could lose out. The Work and Pensions Select Committee is asking the FCA to ban the controversial practice of advisers using 'contingent charging' on transfers, as encouraging bad advice.
- The ban on advisers cold calling potential clients on pension transfer advice came into force on 9 January – later than some hoped. The ICO will also have powers to impose fines on managers of unregulated companies that cold call.
- More than a million people have been caught by loss of tax relief, limiting tax relief on their future contributions to

£4,000 a year, after they have drawn down from their pension.
- Some 3.6 million people aged 65+ have retired early due to external circumstances such as illness (25%), redundancy (21%) and care demands (10%). This may mean an inadequate pension; in contrast, the number of 65+ people in employment has increased.

**6. Culture**

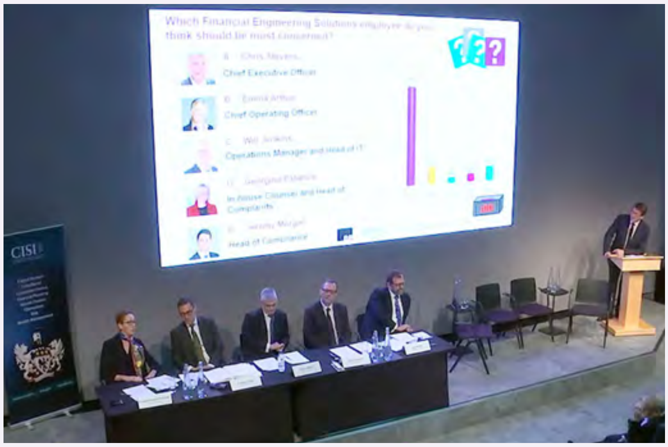
There is an interesting example of the FCA's approach to firms' culture in its investigation of the working culture of RBC, the Canadian bank. The scope of the inquiry includes the treatment of whistleblowers, the handling of complaints and the processes for dismissing staff. The FCA has taken the unusual step of contacting former staff. The case arose from a successful claim for unfair dismissal in which the employee said that he had been treated poorly after raising concerns about what he described as a 'box ticking' compliance culture There are lessons for all firms in this.

## SECTOR CHANGES

**7. Private wealth management**

Some developments:
- **Self-invested personal pensions' (SIPPs') responsibility for investments**. The FCA has monitored platforms' capital ever since the court's landmark decision in the Berkeley Burke case that the SIPP provider had a duty to prevent a client investing in non-standard investments in certain circumstances (investment ineligible for tax benefit, where the provider has information on the integrity of the investment promoters or possible issuer insolvency and where the SIPP investment rules change). This ruling is now under appeal. The FCA is planning to review advisers promoting risky investments generally: "We remain of the view that there is a place in the market for a wide range of investments, and that it is very important that non-standard investments are sold only to those consumers to whom they are suitable."
- **Annual client reviews**. Some advisers claim that some clients do not want annual portfolio reviews required under MiFID II, and refuse to pay the cost for a service they do not want, leaving the adviser to refuse the business, or bear the cost.
- The Investment Association has revived the controversy that **disclosure of expected transaction costs** to clients under MiFID II will lead them to compare managers on this cost alone; and that the fear that investors will do so will lead managers to reduce trading even when desirable.
- **Platforms holding interest**. FCA rules state that interest earned on client money by platforms should be paid to the client unless the firm discloses that it will keep some or all of it. Most platforms do just this. It is now on the FCA's radar – it was one of the questions the FCA asked in its recent platform market study. Some have called it poor practice and have asked the FCA to ban it.
- The controversy continues around the **FCA's decision to increase the FOS's limit on compensation** from £160,000 to £350,000 in respect of claims from 1 April 2019. (The rationale is that the FOS's scope will extend to small business then.) Some now fear a large increase in professional indemnity (PI) premiums, particularly those providing DB transfer advice. Examples given suggest insurers could be asking for increases of up to four times and impose restrictive conditions, such as no cover, if the customer is under 50.
- **Adviser capital requirements**. An interesting study of prudential and free capital of advice firms has found that the majority hold between £10,000 and £50,000 in prudential capital, and the larger ones £250,000 plus. This represents 10% of annual fees for smaller firms and 25% for larger ones. About half of single adviser firms have less than £25,000 to invest in improving their services, compared with about half of firms with five to nine advisers who have £100,000, and 84% of those with more having more than £250,000 to invest. One interpretation is that this will enable the larger firms to adjust to change better.
- **Product distribution**. MiFID II requires that advisers distribute fund products to the target market for which the products are designed by the provider. There are concerns that many advisers are ignoring the guidance from the provider. So far, the FCA has not warned about this, but given its focus on product governance in providers, it can only be a matter of time before it turns its attention to providers. They would do well to anticipate this.
- **Vulnerable customers**. The FCA has defined this as coming "in a range of guises, and can be temporary, sporadic or permanent in nature". It says that up to 50% of consumers could be potentially vulnerable and need extra support. Examples include those with mental or physical health issues, low financial capability, those who have experienced divorce or bereavement, those with an addiction or ex-offenders. Independent research suggests that firms think they only have 5% of vulnerable clients. The FCA does not have detailed rules on how the firm should support vulnerable clients; however, firms would be wise to develop policies and training to both identify them and what extra steps should be taken.

// UP TO 50% OF CONSUMERS COULD BE VULNERABLE //



Conduct, culture and common sense are intrinsic to regulatory compliance in financial and non-financial conduct in financial services. Two experts outline scenarios from both sides in 'FCA investigations - the new world' at *cisi.org/fca-newworld*

*Views expressed in this update are those of the author alone and do not necessarily represent the views of the CISI.*

Q1 2019 - ISSUE 20
REVIEW of FINANCIAL MARKETS
RESEARCH INTO WEALTH MANAGEMENT, CAPITAL MARKETS AND BANKING

# A WORLD OF WONDER – AND SURPRISES

Jaw-dropping surprises have become the norm in business, economic and political life. Even leaving aside the increasingly parochial British twists and turns and somersaults over Brexit, the world's markets and governments have rarely floundered themselves into a more febrile state. In this issue of *Review of Financial Markets* (*RoFM*), we bring together some of the best of academic and institutional thinking to consider markets, long and short term, and future trends in learning and cooperation between universities and our sector.

A meeting with Russell Napier is never without surprises. His starter for 2019 was to pull out Adam Smith's *The theory of moral sentiments*, published 260 years ago, in 1759, 17 years before his more famous and much more influential magnum opus, *The wealth of nations*, the first modern work of economics. *The Theory* is much less read, but Mr Napier wonders whether its time has come, as a counterbalance to its more robust and (apparently) nakedly capitalist successor.

*The Theory* begins with this assertion:

> How selfish soever [sic] man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it. Of this kind is pity or compassion, the emotion we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrows of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous or the humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it.

When the Soviet Union collapsed in 1991, robust, market-driven capitalism had won the great battle; socialism's days of political oppression and economic failure were over. But was that the end of the story? In America, the flock of candidates for next year's presidential election has veered sharply left. Millennials (and others) the world over are intent on shaking up economics and saving the climate. In our own sector, interest in environmental, impact, social, sustainable, call-it-what-you-will investing has never been higher; it forms the theme of this year's annual integrity event, on 28 March.

The CISI's own mighty campaign for greater understanding of mental health in the workplace has unearthed some unlikely supporters – some of Smith's "greatest ruffians" in finance turn out to be the best and most empathetic listeners to others' problems.

So, are we in for a period when Smith's hard-line capitalism will be tempered by his earlier work? Mr Napier's take on markets positions him well to have a view here. His work for Orlock Advisers – and in particular, his quarterly Solid Ground analysis – from which we are privileged to glean some wisdom in this *RoFM* (from page 56) takes a much-needed long-term view of economies and markets. His History of Financial Markets programme is two-and-a-half days of rigorous analysis by top-flight practitioners on where we are and where we are going. This long-running course, which is supported by the University of Edinburgh Business School and the CISI, among others, is praised by senior professionals and clients alike for tackling many of the more important, and more daunting, questions in finance and investments, and for putting today's frenetic financial markets into context.

## // MILLENNIALS THE WORLD OVER ARE INTENT ON SHAKING UP ECONOMICS AND SAVING THE CLIMATE //

The course is run by Didasko Education, a not-for-profit owned by five of the leading investment management houses in Edinburgh. The surpluses go to support students who would otherwise not be able to afford an education, as does a slice of the revenue from the Solid Ground reports.

## TERMS FOR ALL SEASONS

In the list of what they don't teach at business schools, 'term sheets' come near the top of the list, even though – with 'Series A' and 'drag-alongs' – they are part of the lingua franca of sassy entrepreneurs and their kin in the investment world. A term sheet is one of the most critical documents an entrepreneur – and on the flipside, an investor or adviser – can sign. After gallons of sweat equity, the hipster, hustler and hacker teams that make up most tech start-ups rely on the terms they sign for the future of their start-up baby and their dreams for it. (The hipster, for clarity, is the one with the ideas; the hustler gets the money; and the hacker, the techie, makes it work.)

These term sheets for early stage financing are rarely longer than the well-crafted example below – from an online think-in between entrepreneurs and investors in the UK and 'the Valley' (Silicon) – but combine a wealth of necessary understanding of the basics of equity investment, and of ethics and integrity, protecting the rights of both sides in unknown start-up and scale-up territory.

Here at *The Review*, and in cooperation with universities and business schools – brimming with wannabe entrepreneurs and private equity investors – in the UK and overseas, we've been asking investors and their advisers on the one side, and start-ups and more grown businesses on the other, how best to help the entrepreneurs on whom we all depend for our future (see the chart on page 64 for graphic evidence of that) and how best to satisfy the reasonable requirements of the creators at this stage in their development, which are:

1. to raise as much capital as possible, while giving up as little of the company as possible, and
2. to ensure that they have not given up too much of the upside potential or assumed too much risk on the downside.

We'd like to hear the views of members on how this key to future growth can best be used to help finance the businesses of the future. Thoughts welcome to the email below.

## SPREADING THE WORD

Technology-enhanced learning – in which the CISI is one of the global leaders – is addressing the need for continuing professional development that derives from the emergence of new, specialised and constantly changing work practices. While CPD is fundamental to enabling individuals to function in and productively shape contemporary financial institutions, digital technology is increasingly central to productive workplace practice.

Just as new technologies continue to transform the way in which we work, so they have influenced learning interactions in professional contexts. In the past decade, CPD delivery through events and this print *Review* has been greatly overtaken by electronic delivery methods to a global membership and student base – with digital versions of this magazine, CISI TV and Professional Refreshers. The closing article in this issue takes a critical look at MOOCs – massive open online courses – once welcomed as a panacea but now seen to be in want of some tender loving care to bring them to their full potential in the workplace.

// SWEAT EQUITY, HIPSTERS, HUSTLERS, AND HACKERS //

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*Senior Adviser, CISI*
*george.littlejohn@cisi.org*

### COMING TO TERMS ...

| | |
|---|---|
| **Securities:** | Series A Preferred Stock of the Company ("Series A"). |
| **Investment Amounts:** | £[_] million from [___________] ("Lead Investor")<br>£[_] million from other investors<br>Convertible notes and safes ("Convertibles") convert on their terms into shadow series of preferred stock (together with the Series A, the "Preferred Stock"). |
| **Valuation:** | £[_] million post-money valuation, including an available option pool equal to [__]% of the post-Closing fully-diluted capitalisation. |
| **Liquidation Preference:** | 1x non-participating preference. A sale of all or substantially all of the Company's assets, or a merger (collectively, a "Company Sale"), will be treated as a liquidation. |
| **Dividends:** | 6% noncumulative, payable if and when declared by the Board of Directors. |
| **Conversion to Common Stock:** | At holder's option and automatically on (i) IPO or (ii) approval of a majority of Preferred Stock (on an as-converted basis) (the "Preferred Majority"). Conversion ratio initially 1-to-1, subject to standard adjustments. |
| **Voting Rights:** | Approval of the Preferred Majority required to (i) change rights, preferences or privileges of the Preferred Stock; (ii) change the authorized number of shares; (iii) create securities senior or pari passu to the existing Preferred Stock; (iv) redeem or repurchase any shares (except for purchases at cost upon termination of services or exercises of contractual rights of first refusal); (v) declare or pay any dividend; (vi) change the authorized number of directors; or (vii) liquidate or dissolve, including a Company Sale. Otherwise votes with Common Stock on an as converted basis. |
| **Drag-Along:** | Founders, investors and 1% stockholders required to vote for a Company Sale approved by (i) the Board, (ii) the Preferred Majority and (iii) a majority of Common Stock [(excluding shares of Common Stock issuable or issued upon conversion of the Preferred Stock)] (the "Common Majority"), subject to standard exceptions. |
| **Other Rights & Matters:** | The Preferred Stock will have standard broad-based weighted average anti-dilution rights, first refusal and co-sale rights over founder stock transfers, registration rights, pro rata rights and information rights. Company counsel drafts documents. Company pays Lead Investor's legal fees, capped at £20,000. |
| **Board:** | [Lead Investor designates 1 director. Common Majority designates 2 directors.] |
| **Founder and Employee Vesting:** | Founders: [_______________].<br>Employees: 4-year monthly vesting with 1-year cliff. |
| **No Shop:** | For 30 days, the Company will not solicit, encourage or accept any offers for the acquisition of Company capital stock (other than equity compensation for service providers), or of all or any substantial portion of Company assets. |

The "No Shop" is legally binding between the parties. Everything else in this term sheet is non-binding and only intended to be a summary of the proposed terms of this financing.

# "WHAT THE HELL IS WATER?"

**RUSSELL NAPIER** ON WHY JANUARY 2018 MARKED A 'GENERATIONAL PEAK' FOR US EQUITY VALUATIONS

Russell Napier's followers – of whom there are many round the financial world – know that he currently expects a deflation shock before we have an inflation shock. "Inflation has steadily undershot expectations since the global financial crisis and will continue to do so," he says. "A key part of any undershoot is highly likely to involve further declines in commodity prices, particularly as we witness ever-lower nominal GDP growth in China."

Meanwhile in the US, from 1994 to 2014, US Treasury ownership shifted from savers to central bankers, depressing the risk-free rate and creating money and growth. Now a move in ownership from central bankers to savers is under way and the result will be higher risk-free rates, less money, less growth and lower equity valuations. What pointers for investors from global trends?

Savers financed the US government to the tune of US$163bn in 2014, but in 2019 they will have to stump up US$1,341bn. This supply of Treasury securities in 2019, from the US Treasury and the Federal Reserve, will exceed the likely entire increase in US personal savings by US$322bn. These dynamics are behind a shift in savings, away from equities to Treasuries, acting to depress US share prices, despite, since January, a significant rise in the S&P500 earnings per share and record stock buybacks. This shift in savings is accelerating as the fiscal deficit grows, as the Federal Reserve has reached the maximum level of its balance sheet contraction, and as foreign central bankers are now also sellers of Treasury securities.

Since 2014, this shift in Treasury ownership from central bankers to savers has been under way, pushing interest rates higher and growth rates lower – particularly outside the US and in emerging markets. Asset markets have been reacting and the MSCI World Index ex US is back to its 2011 level; commodity prices are well below 2011 levels. The shift in savings is now impacting the US, where commercial credit spreads are widening and US equity valuations have been declining since January 2018. This is the beginning of a structural shift that means US equity valuations will not return to January 2018 levels for a generation.

There is growing evidence that the water of liquidity that has sustained high equity valuations is draining away. OECD broad money (M3) growth has reached the lowest level recorded, apart from the levels associated with the global financial crisis. China's broad money growth has reached a new all-time low and its commercial bank reserves are contracting for the first time since records began. Unless China abandons its exchange rate target, it will be unable to create the level of money growth necessary to inflate away its ever-rising debt-to-GDP level. Despite numerous post-crisis interventions by global central bankers, there is already evidence – outside the US – of lower growth, lower inflation and lower asset prices.

The period from 1994 to 2014, when central bank buying of Treasuries reduced the global risk-free rate and boosted the global growth rate, thus inflating equity valuations, is over. Where once the gap between the growth rate and the risk-free rate seemed structurally embedded in the system, a new reality is dawning: a new structure is in place, the gap is reducing and thus the net present value of future income streams is declining. Such a profound and structural change in liquidity conditions is often missed by investors rewarded for focusing on the short term and thus where we are in the business cycle. The situation is akin to the David Foster Wallace tale of the old fish who, passing two young fish one day, remarked: "Morning boys. How's the water?" After a pause one of the young fish remarked to the other: "What the hell is water?"

> // PROFOUND AND STRUCTURAL CHANGES IN LIQUIDITY ARE OFTEN MISSED BY INVESTORS REWARDED FOR FOCUSING ON THE SHORT TERM //

The latest edition of global macro report the Solid Ground looks at the high level of water we have been swimming in, representing the gap between the risk-free rate and the growth rate, producing higher equity prices. It concludes that this high level of water was the product of a unique monetary setting that pertained from 1994 to 2014, and has now ended. The analysis shows how the water has been draining away since 2014 and why the young fish, even those swimming in the US, will soon have an obvious answer to their question: "What the hell is water?"

### MONETARY CAUSES OF THE GREAT EQUITY VALUATION INFLATION 1994–2014

This analysis focuses on dramatic shifts in the ownership of US Treasury securities and the very negative impacts these shifts augur for global growth and the price of risk assets. Investors, particularly bottom-up equity investors, will wonder how something as mundane as the composition of Treasury security ownership could have such a profound impact on the value of their equity portfolio. In particular, investors will query how changes in US Treasury ownership could really have a global impact. This section of the report seeks to answer these questions. It looks at the links, direct and indirect, between Treasury security ownership, global economic growth, the determination of the global risk-free rate and share prices. In the second section of the report we look at the already observable shift in Treasury ownership and its already major impact on money growth, inflation and asset prices. So far, the impact of the post 2014 Treasury ownership shift has been outside the US, but there is now evidence, since January 2018, that it is impacting US equity prices.

The key assertion in this analysis is that the devaluation of the renminbi in 1994 has been the driver of the uplift in equity valuations to a seemingly "permanently high plateau" – to use a famous quote from economist Irving Fisher from 1929.

If correct, this assertion has important implications for investors as the surge in equity valuations since 1994 does not reflect some new permanent shift in valuations based on fundamentals but instead is the product of a particular monetary setting that, as the full analysis shows, is now clearly ending. The worrying conclusion for investors would be that the last low for the cyclically adjusted price-to-earnings ratio (CAPE) of 13.3X in March 2009 does thus not represent the low in the seeming higher 'new normal' range for equity valuations. Instead, in looking for the lowest valuations that can be expected, investors should look at the full history of the CAPE since 1881 and the average of the four great bottoms for CAPE, from 1881 to 1982, is just below 7X. More urgently, if this monetary driver for valuations is deteriorating quickly – as the later parts of the full study suggest – the decline in the CAPE from 33X to 30X, during the course of 2018, is just the beginning of a major mean reversion in US equity valuations.

The rise in equity valuations to a seeming new range since 1994 is the result of an artificial depression of the US risk-free rate through a monetary mechanism that simultaneously boosted emerging market growth and hence global growth. The monetary change that produced this apparent upward shift in valuations was the devaluation of the renminbi in 1994. Since that devaluation, the accumulation of US Treasury securities by foreign central banks has been the key monetary driver of higher equity prices. That is not to say that monetary factors are the only driver of higher equity prices, as technological change and stock buybacks, amongst others, also play important roles. However, it is to say that this key monetary setting has been the key driver of the global risk-free rate, the yield on US Treasury securities, and the rate of global economic growth. If this one factor has been the key driver in determining the risk-free rate and also the economic growth rate, then it has played a profound role in determining the net present value of the future income streams of corporations as reflected in their share prices. If it has indeed played such a profound role in driving share prices, then there are major implications as this relationship ends. Clearly something did change for US equity valuations after 1994.

// THE DEVALUATION OF THE RENMINBI IN 1994 HAS BEEN THE KEY MONETARY DRIVER OF HIGHER EQUITY PRICES //

**US CAPE 1881-2018**


*Source: www.econ.yale.edu/~shiller/data.htm*

The chart above shows how the CAPE for the US equity market has seemingly shifted into a higher range. That shift in valuations astounded many investors, and by November 1995 the CAPE had risen above its 1966 and 1901 peaks. It did not stop there and by 1997 it had risen above even its 1929 high. While the US stock market has crashed twice since its record high valuation of March 2000, the lowest valuation since recorded, of 13.3X CAPE in March 2009, was just below the average CAPE that pertained for the period prior to the devaluation of the renminbi. By January 2018, the CAPE, at 33X, had once again exceeded all pre-1994 valuations. From 1881 to 1993, the average CAPE of the US market was 14.8X and from 1994 to current, it has averaged 26.9X!

For many other developed markets, we have CAPE data from 1978 and it shows a very similar pattern, with the exception that non-US equity valuations have declined steadily since 2015, while US equity valuations rose until January 2018. The PE of the MSCI World ex US index has declined from 21X in 2015 to a current PE of 14X. The shift in the monetary regime since 2014 has coincided with lower equity valuations outside the US, and this analysis considers why the same forces now bring lower valuations to the US.

The most common reason provided for the shift higher in equity valuations is the changing nature of the corporation, in particular towards the asset-light business model that permits permanently higher returns for corporate capital. This explanation, of course, has the advantage that it is based on what seems a permanent new business model and thus the higher valuation range for US equities is 'the new normal'. It is an argument that asserts that neither competition nor regulation can assail the high returns associated with such business models. It is an argument that ignores the fact that the role of intangible assets on the US corporate balance sheet has been growing steadily for many decades and a structural shift in valuations would thus probably have happened gradually over decades rather than from 1994 to 2000.

Perhaps it was only in the 1994 to 2000 period that the implications for such a shift were finally recognised by the market. If so, that was a global recognition, even in equity markets far from US shores, where the role of intangibles was much more limited, where CAPEs also soared from 1994 to 2000. This argument, that asset-light companies attract permanently higher returns and permanently higher valuations, ignores the fact that the 1994 to 2000 rise in equity valuations to all-time highs coincided with the devaluation of the renminbi and the creation of a new monetary order.

Perhaps there is a combination of both factors at play, but while investors have their eyes focused on what they believe is the transformational impact on corporate returns of the capital-light model, they are missing the crucial role that the reset of the global monetary system from 1994 played in also boosting equity valuations. The Solid Ground doubts that we have created corporates with profits now insulated from the power of competition and regulation, but even if it were so, current lofty valuations are not insulated from global monetary factors. These factors, as we shall see, are taking a marked turn for the worse. Of course, correlation is not causation; by what mechanism did the devaluation of the renminbi in 1994 lead to a move higher in the range of the US CAPE that continues to this day?

The chart below right shows the growth in world reserves and the acceleration in that growth after the devaluation of the renminbi in 1994.

## GROWTH IN WORLD FOREIGN RESERVES

Why should equity investors care about the massive growth in world foreign reserves that followed the devaluation of the renminbi in 1994? This growth matters for investors because it represents forced, non-price sensitive buying of US Treasury securities combined with the creation of excessive amounts of money by those doing the purchasing. It is a monetary setting that depresses the global risk-free rate, frees up savings to fund private sector opportunities and also boosts global growth. In this way it increases the gap between the growth rate and the discount rate and leads to higher equity valuations.

The surge in world reserves, shown in the chart to the right, was led by China but then came to a halt in 1997 as China's 1994 devaluation had undermined the competitiveness of other emerging markets and eradicated their external surpluses. There then followed the Asian economic crisis in which, initially, the foreign reserves of Asian countries were depleted in an attempt to defend their exchange rates. In only a few cases, most notably Hong Kong, did these attempts succeed. Following massive devaluations across Asia and eventually in Latin America these countries also linked their currencies to the US dollar at gross undervaluations.

This caused massive external surpluses in the countries operating such policies and thus massive growth in their foreign reserves. World foreign reserves then entered a period of supercharged growth as China entered the WTO in December 2001, and as a result moved to even larger current account surpluses. This growth in world foreign reserves continued until it peaked at an incredible 30% year-on-year in Q1 2008. The collapse in growth that followed coincided with the global financial crisis and would have been even greater had the Federal Reserve not granted swap lines to many foreign central banks to allow them to provide US dollar funding to their local financial systems without forcing them to liquidate their US dollar reserves. After the financial crisis, a flood of debt capital into the emerging markets, from developed world investors seeking to boost the yield on their savings, created another surge in the growth in world reserves as emerging markets' central banks fought to prevent appreciation in their exchange rates. The chart below also shows how the growth in world reserves has now all but gone, and it is on the consequences of this slowing that the full report focuses.

// GROWTH IN WORLD FOREIGN RESERVES PEAKED AT 30% YEAR-ON-YEAR IN Q1 2008 //

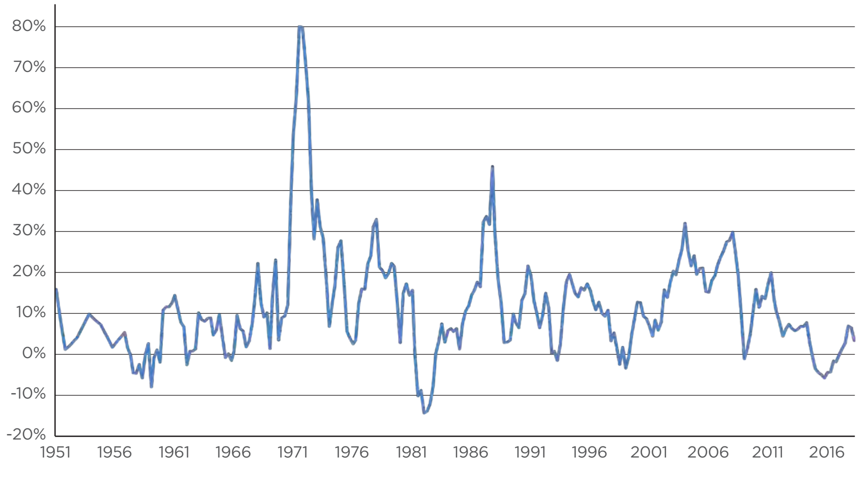
The impact of this unparalleled growth in world foreign reserves was very positive for equity valuations. The key link between the rise in US equity valuations and the devaluation of the renminbi in 1994 is the ensuing wave in foreign central bank purchases of US Treasury securities necessitated by the growth in world foreign reserves. The table on page 59 shows the ownership of US Treasury securities split into the four key categories of owner: US savers, foreign savers, foreign central banks and the US Federal Reserve. The data is taken from the US Flow of Funds Statistics up until 2011, when this data stopped including Treasury ownership by foreign central banks. After 2011 the data is taken from the Treasury International Capital (TIC) System database, which attempts to track foreign central bank treasury ownership (data that is subject to significant revision).

## US TREASURY SECURITY OWNERSHIP

The table on page 59 shows how foreign central bank ownership of the Treasury market surges from just 11.7% to 38.5% from 1991 to 2010, an incredible change in the ownership of the world's largest government bond market. Throughout this period, the proportion of the Treasury market owned by US savers was thus able to steadily decline and this decline accelerated as the US Federal Reserve bought Treasuries aggressively from 2009 to 2014.

In 1991, the US saver owned US$1,857bn or 71% of the US Treasury market but by 2014, US savers owned just 32% of the Treasury market with a total value of

GROWTH IN WORLD FOREIGN RESERVES




*Source: IMF*

## US TREASURY SECURITY OWNERSHIP

| | 1991 | 1995 | 2000 | 2005 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 2Q |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Total Treasury Securities** | 2619.7 | 3503.7 | 3173 | 4472.9 | 9173.6 | 10243 | 11386.4 | 12149.1 | 12578.8 | 14969.5 | 15817.9 | 16069 | 16932.8 |
| **Owned by US Federal Reserve** | 266.5 | 378.2 | 511.7 | 744.2 | 1021.5 | 1663.4 | 1666.1 | 2208.8 | 2451.7 | 2461.6 | 2463.6 | 2454.2 | 2378.3 |
| **% of Total Outstanding** | **10.17%** | **10.79%** | **16.13%** | **16.64%** | **11.14%** | **16.24%** | **14.63%** | **18.18%** | **19.49%** | **16.44%** | **15.57%** | **15.27%** | **14.05%** |
| **Owned by Foreign Central Banks** | 307.1 | 471.5 | 639.8 | 1344.5 | 3527.6 | 3620.6 | 4032.8 | 4054.6 | 4122.6 | 4091.6 | 3814.1 | 4025.6 | 3988.4 |
| **% of Total Outstanding** | **11.72%** | **13.46%** | **20.16%** | **30.06%** | **38.45%** | **35.35%** | **35.42%** | **33.37%** | **32.77%** | **27.33%** | **24.11%** | **25.05%** | **23.55%** |
| **Rest of World (Foreign Central Banks & Savers)** | 496.6 | 860.5 | 1021.4 | 2196.8 | 4394.1 | 5004.4 | 5571.5 | 5794.9 | 6078.9 | 6146.2 | 6002.8 | 6284.9 | 6290.7 |
| **% of Total Outstanding** | **18.96%** | **24.56%** | **32.19%** | **49.11%** | **47.90%** | **48.86%** | **48.93%** | **47.70%** | **48.33%** | **41.06%** | **37.95%** | **39.11%** | **37.15%** |
| **Owned by Foreign Savers** | 189.5 | 389 | 381.6 | 852.3 | 866.5 | 1383.8 | 1538.7 | 1740.3 | 1956.3 | 2054.6 | 2188.7 | 2259.3 | 2302.3 |
| **% of Total Outstanding** | **7.23%** | **11.10%** | **12.03%** | **19.05%** | **9.45%** | **13.51%** | **13.51%** | **14.32%** | **15.55%** | **13.73%** | **13.84%** | **14.06%** | **13.60%** |
| **Owned by US Savers** | 1856.6 | 2265 | 1639.9 | 1531.9 | 3758 | 3575.2 | 4148.8 | 4145.4 | 4048.2 | 6361.7 | 7351.5 | 7329.9 | 8263.8 |
| % of Total Outstanding | **70.87%** | **64.65%** | **51.68%** | **34.25%** | **40.97%** | **34.90%** | **36.44%** | **34.12%** | **32.18%** | **42.50%** | **46.48%** | **45.62%** | **48.80%** |

The table above shows how foreign central bank ownership of the Treasury market surges from just 11.7% to 38.5% from 1991 to 2010 – an incredible change in the ownership of the world's largest government bond market. Throughout this period, the proportion of the Treasury market owned by US savers was thus able to steadily decline and this decline accelerated as the US Federal Reserve bought Treasuries aggressively from 2009 to 2014.

*Source: CBO, Treasury TIC Data, Federal Reserve Z1*

US$4,048bn. Had their proportion of ownership stayed steady at 71%, they would have had US$8,931bn invested in Treasuries in 2014. The difference between these two numbers – US$4,847bn – is the amount of savings that US investors were freed up to invest in private sector assets. By freeing up US savers to buy equities and other private sector assets, Treasury security purchases by foreign central banks and then the US Federal Reserve produced an upward shift in US equity valuations. This was just the first way in which the 'new normal' of higher US equity valuations was related to the devaluation of the renminbi in 1994 and the ensuing devaluations of emerging market currencies from 1997.

The surge in foreign central bank purchases of US Treasury securities decoupled the US yield curve from economic fundamentals. While savers judge the attractiveness of US Treasury securities based upon their price/yield, central bankers have no interest in such niceties. Their purchase of Treasuries is driven by their policy targets and they do not consider Treasury security price in relation to any fundamentals. The rapid growth in world reserves and hence Treasury purchases was solely necessitated by the policy targets of exchange rate management. Similarly, the Fed's purchases of US Treasury securities were necessitated by their policy of QE, regardless of what price Treasury securities happened to be trading at when that policy was implemented. In pursuing other targets, central bank buyers of Treasuries were insensitive to the key variables that drive savers' purchases of Treasuries – most notably inflation expectations.

In 1991, 78% of the Treasury market was owned by savers, both US and local, but by 2014 this had declined to just 47% of the market. In this process the price-sensitive buyers of the market had been increasingly replaced by buyers who were entirely insensitive to price and inflation expectations. The so-called 'bond vigilantes', who cared particularly passionately about inflation expectations, were increasingly driven from the Treasury market by the civil servants implementing their monetary targets. Had savers maintained their ownership share of the Treasury market at 1991 levels, the value of their total ownership of Treasuries would have been US$9,488bn in 2014 compared to their actual ownership of US$5,962bn.

What yield on Treasury securities would need to have pertained to attract that additional US$3,526bn of private savings to the Treasury market? The retreat of the price-sensitive buyer and the arrival of the central banks depressed the yield on Treasuries to levels well below those that would have pertained had the US government continued to be primarily funded by savers. The devaluation of the renminbi thus led to a depression of the global risk-free rate to levels below that associated with US growth and inflation. Anyone who has ever played around with discounting calculations will know that the change in the gap between the discount rate and the growth rate can have major impacts on the net present value calculation. The new monetary system that developed post the devaluations of 1994 and 1997 created a bigger gap between those two variables and thus higher equity valuations.

**Russell Napier is a market strategist and founder of research platform ERIC. Watch him on 'What the hell is water?' and other themes on CISI TV now, and join him at a CISI Chartered members and Fellows masterclass in London on 24 April 2019. Details at *cisi.org/events***

**For a full analysis of market trends, including why the end of world reserve growth reasserts the "gravity of value", and why central bankers will be "pumping harder, producing less", plus details of the Solid Ground report and the History of Financial Markets courses, please contact Russell Napier.**

RNAPIER@ERI-C.COM

# BRINGING BRIGHT, YOUNG, GLOBAL BRAINS TO BEAR ON FINANCE ANALYTICS

## A PROJECT BETWEEN ONE OF BRITAIN'S LEADING BUSINESS SCHOOLS AND TOP INVESTMENT FIRMS SHINES FRESH NEW LIGHT INTO INDUSTRY ISSUES

The CISI is working with the University of Edinburgh Business School to engage its finance Master's students with the sector through company-sponsored dissertations (CSDs). These – which involve no fees either way – involve a student carrying out an authoritative piece of work on a business analytics issue identified by a project client. The work typically takes an in-depth look at a defined research area and results in a substantial report containing extensive research, rigorous analysis and practical conclusions. The school currently has more than 120 students studying on its postgraduate one-year MSc Finance programme, which has three specialisms: corporate finance; finance and investment; and energy finance and markets. The students are drawn from almost 40 countries, from Afghanistan to Vietnam. Over 90% are from outside the UK.

The MSc Finance programme covers all aspects of investment, corporate and energy finance. We can consider almost any topic that has a finance, accounting, investment and/or energy market focus. Successful projects tend to have an empirical element, which has practical relevance. Most students are keen to work with practitioners on projects which will be of real value to them, helping them find solutions to strategic financial issues such as validity forecasting, forecast asset market returns, risk modelling, dynamic life cycle strategies etc. *Further details of the programme can be found at https://www.business-school.ed.ac.uk/msc/finance*

### WHAT KIND OF TOPIC IS SUITABLE?

Previous client projects have included:

- investigating the dynamic life cycle strategies for defined contribution pension plans
- researching global financial features of the steel industry
- researching whether cross-sectional dispersion of stock market returns is an alternative to the time series approach to estimating global correlation level of equity markets
- investigating valuation multiples that drive share price re-rating and de-rating in growth companies across developing and developed countries
- analysing historic returns to gold
- testing the relationship between corporate ownership and financial performance
- analysing the increasing demand in the shorting market
- applying a behavioural economic perspective towards the understanding of potential mispricing of deep-out-of-the-money options
- investigating whether investors capture similar return from property investment using more liquid and less costly alternatives
- researching how options strategies can be used to increase the yield of a portfolio.

### NEXT MOVES

**If you are interested in submitting a project topic for next year's scheme, please send a brief outline of the project topic to Aidan Hetherington at the address below, which the programme director will then discuss with you.**

AIDAN.HETHERINGTON@ED.AC.UK OR 0131 650 9841

## FEEDBACK FROM PAST CLIENTS: THREE RECENT CASE STUDIES

**Alliance Trust** is a self-managed investment company with investment trust status. It is one of the largest generalist investment trusts in the UK, based in Dundee, and has been investing since 1888. Alliance Trust tasked the student to research which types of investment vehicles have delivered the best net returns over the short, medium and long term. In particular it was keen to investigate the key differences between the open-ended structures and the closed-ended investment trust sector.

The project involved detailed analysis into the relative performance of investment trusts and OEICs. One of the major challenges of the project was to ensure that the correct datasets were compared like for like.

> Many previous studies in the area have failed to capture the differences between regional and fund types as well as the impact of fees. This was not an easy task and the student encountered many difficulties in isolating the correct data. However, after considerable effort and persistence, the student delivered an accurate and comprehensive project.
>
> This is the fourth year we have undertaken such a project with the University of Edinburgh Business School and every year we have been encouraged by the enthusiasm and competence of the students involved, as well as finding the output challenging and worthwhile.

**George Renouf, director, public affairs, Alliance Trust**

The research division of **State Street Investment Analytics** spends a lot of time working on topics that provide its clients with a better sense of the quality of returns delivered by their investment managers. One such topic is the dispersion of returns and how the general investment environment over a particular period enhances or limits the opportunities for active management. State Street issued a research paper on this in April 2018 concentrating on the UK equity market.

> We wanted a student on the MSc Finance course to help us expand our research to global equity markets, in particular to look at the time varying nature of global equity market dispersion and its relationship to the returns achieved by our clients' global equity portfolios.
>
> The student matched with our research proposal, Hang Zhou, was ideal – very bright and engaged and he contributed substantially to developing our thoughts on the research during a series of highly productive meetings. We have worked with students from the course for a number of years and it has proved both enjoyable and worthwhile in terms of tangible results for our research programme.
>
> **Alastair MacDougall, vice president, State Street Global Services**

**Scottish Widows Investment Partnership** is one of Europe's largest asset management companies and part of Lloyds Banking Group.

> This is the third year I have been involved in setting a dissertation. Previously we have asked students to look at using currency market turbulence as a signal to exit risky currency trades, or appraise and back-test various early warning signals to cut out of emerging market foreign exchange 'carry' strategies. This time we asked the student to consider how the exploration and extraction of natural gas might affect the exchange rates of gas producers, including sterling. Karin Mashler took up the challenge and after a couple of brief meetings, produced a good dissertation on the subject. According to her model, increases in the UK's recoverable gas resources may lead to a rise in exchange rate volatility while increased net exports may decrease volatility.
>
> I have always found the school easy to work with and the students require surprisingly little input. At a time when resource is tight for most companies, it is no doubt mutually beneficial for industry and the school to work together in this way. I would encourage more companies to do so.
>
> **Roddy Macpherson, investment director, currencies, Scottish Widows Investment Partnership**

# FIGHTING ECONOMIC CRIME – A SHARED RESPONSIBILITY

REGULATORS ROUND THE WORLD – NOTABLY BRITAIN'S FINANCIAL CONDUCT AUTHORITY – HAVE ECONOMIC CRIME AT OR NEAR THE TOP OF THEIR AGENDAS. HOW CAN THE SECTOR WORK WITH REGULATORS AND OTHER LAW ENFORCERS TO HELP STAMP OUT THIS SCOURGE?

UNIVERSITY OF CAMBRIDGE

Economic crime touches on all aspects of the financial sector. Economically motivated criminals poison our prosperity and undermine our stability through victimisation, exploitation and subversion. In the investment world, securities-based money laundering has become one of the biggest issues of this decade and, alas, the next.

The Cambridge International Symposium on Economic Crime was first convened nearly 40 years ago as a result of widespread concern that both the development and the integrity of the global financial system were at risk from those who engage in economically motivated crime, and those who would assist them.

From the very beginning its mission has been to bring together anyone who has a responsibility to prevent and inhibit such abuse – no matter their background – to better understand the threats and to facilitate co-operation and collaboration in protecting all our economies and societies. The Cambridge symposium has, over the years, grown into a unique international platform that makes a real difference to the control of economically relevant crime and misconduct across the world.

The symposium runs over eight days, with an emphasis on expertise, topicality and practicality. Its emphasis has always been practical; therefore, it brings together experts across a range of fields to share knowledge and expertise. There are over 120 plenary sessions and workshops, as well as smaller interactive workshops and think tanks. With delegates from over 100 countries, the symposium is truly international and a unique opportunity to forge cross-border connections. Over 2,000 participants join the symposium each year. This makes the symposium a unique well of expertise and experience.

For more information on the symposium, which this year runs 1–8 September, and its special 'City Day' on 'Financial institutions and crime: the new frontiers' on Thursday 5 September 2019, please visit *www.crimesymposium.org.*

# SCYLLA AND CHARYBDIS: THE INVESTMENT ODYSSEY CONTINUES

ODYSSEUS WAS RENOWNED FOR HIS INTELLECTUAL BRILLIANCE, GUILE AND VERSATILITY (POLYTROPOS). 2019'S INVESTORS NEED SOME OF THAT POLYTROPOS, AND THE REST, TO NAVIGATE STORMY SEAS

DWS, the asset management wing of Deutsche Bank, has entertained and informed CISI members in recent years with tales of Odysseus and his struggles with the two great nautical monsters, Scylla and Charybdis – in the DWS model, taking market and economic form. Francesco Curto, DWS head of research, active and passive, was our latest guide to the markets' *Odyssey* – his analysis is available on CISI TV. Here, with his colleagues Colin McKenzie and Sarvesh Agrawal, he gives an introduction to the theme and the analytical basis that underpins it.

In the ten years since the financial crisis, central banks have played a fundamental role in stabilising economies and financial markets. During this period, equity investors have benefited from two principal trends: the inflation of asset prices via quantitative easing and strong earnings growth from the technology sector. Both these trends are now showing signs of fatigue. In addition, growing populism has also created uncertainty about future growth. The rise in share price volatility points to investors' unease about these shifting trends.

Alternative economic models that remove some of the imbalances of globalisation are certainly possible, but switching to those models is likely to be a lengthy process, just like the *Odyssey*. Regular cash return on capital invested (CROCI – see box, p.63) followers are probably familiar with the references to Homer's Odysseus which have served as themes for CROCI Outlooks for the past couple of years. Well, our mythical hero eventually returned to Ithaca, but his journey was perilous, fraught with risk and came at great human cost.

As we entered 2019, investors faced the same dilemma as Odysseus, a choice between Scylla and Charybdis. Steering the ship unscathed between the two monsters is not possible. Choosing Scylla involves losing the lives of sailors but the whirlpool of Charybdis risks the entire ship.

For investors, Charybdis is the central banks' tightening programmes. In theory, a country's neutral rates should be similar to its nominal GDP. In the US, this would mean interest rates close to 4%. Accommodative monetary policy, alongside twin trade and budgetary deficits, is not desirable in the long term. Still, excessive tightening risks creating a whirlpool which rapidly deflates asset prices and constrains the very animal spirits that central banks have tirelessly tried to revive over the past decade.

The alternative is Scylla: the six-headed monster. This route would involve fewer rate hikes (as companies and consumers deal with the additional cost of protectionism), a synchronised global economic slowdown and the hope that the journey does not veer off course. Our mythical hero chose Scylla – a rational choice that kept the ship safe in return for the sacrifice of a few sailors. Conservatism might dictate a similar choice to policymakers now. The main difference is that Odysseus had a clear objective in mind, which may not be the case today.

Our bottom-up analysis suggests that a slowdown is well under way, with capital expenditure (capex) falling and risk premia rising. Equity valuations may still be rich at the market level, but there are few alternatives available to investors and good pockets of value are starting to emerge for astute investors.

## THE CALM AFTER THE STORM?

Some of the most interesting debates we have with economists are on equity prices. While economists generally respect CROCI's bottom-up approach built upon economic analysis, it is not clear whether they fully appreciate the impact that equity prices have on economic activity.

The relationship between the two is straightforward, in our view. Equity markets connect owners of financial capital with those in need of that capital. The two forms of capital, namely financial and operational, have returns and over the long term these returns have to match. When equity prices rise, the embedded return on that capital falls, incentivising projects that would otherwise not qualify for investment. At the broad economy level, this means that higher equity prices themselves contribute towards increased activity.

The opposite happens when prices fall. Investors' return on capital increases beyond the levels that earlier operational capital investments are able to generate. Companies respond by delaying investments in new projects, thereby reducing levels of economic activity, and this may ultimately end in recession. From this perspective, equity prices are not only the result of economic activity but also a principal driver. In other words, the mother of all leading indicators.

// GROWING POPULISM HAS ALSO CREATED UNCERTAINTY ABOUT FUTURE GROWTH //

After the financial crisis, central banks tried to harness this connection between equity prices with economic activity. By increasing market liquidity, they tried to revive animal spirits and inflate asset prices. The objective was to lower the expected return on capital (that is, the cost of capital) thereby incentivising more investment and kick-starting economic activity. Between 2011 and 2017, the economic earnings of our developed market coverage fell 9% in real terms. By comparison, equity prices increased by 60%, taking the economic P/E from 18.1x to 28.4x by 2017. By this reckoning, central banks clearly succeeded in lowering the cost of capital.

Things have now changed, however. This past year, equity valuations fell for the first time in eight years. We calculate a market-implied expected return from equities by equating discounted future earnings from companies with their observed prices, taking earnings cyclicality into account. This measure of cost of capital rose last year, suggesting lower future economic activity. Companies are already factoring in this higher cost. Capital expenditure is expected to fall from 2018 levels this year, which is only likely to aggravate the impact on economic activity.

Economists prefer to look at other economic indicators, though, and assume that the impact of prior monetary stimulation, such as bubbles, can somehow be contained. One of the problems with monetarism is that asset prices do not increase smoothly. Monetarism is like an inflatable with an uneven surface: as you pump it up, some areas inflate more than others and some even inflate excessively. The role of central banks is to ensure that if a pocket is faulty and inflates excessively to the point of bursting, the burst can be controlled and does not make the inflatable useless. The impact of rising risk aversion has been marginal so far for equity investors. Despite the correction, the number of companies in bubble territory remain high by historical standards although the bubble amplitude is now smaller. However, the impact has not been this benign everywhere. The most brutal effects are being felt by cryptocurrencies, which are down by more than 80% this year. Other areas deemed major beneficiaries of QE also had a tough year (for example, high yield, emerging markets, commodities).

Should investors be concerned? Only if the Fed goes on with its excessive tightening programme. Low capital productivity may push companies to become more cautious. A slowdown is already under way, but the full impact of the unwinding of QE is still uncertain. The market may also lose one of its strongest drivers, IT. If cryptos were in a bubble, some of the demand growth in IT was speculative as IT was a major beneficiary of investment growth for mining cryptocurrencies. A slowdown in IT demand is also under way. The problem is that IT has been the primary driver of the market for the past ten years and it is difficult to identify another sector that can take over its leadership. There is limited scope for sector rotation as well. Staples had a phenomenal performance recently, but has the highest proportion of companies in bubble territory. Traditionally defined value is also not that cheap, when analysed through CROCI's framework.

// ONE OF THE PROBLEMS WITH MONETARISM IS THAT ASSET PRICES DO NOT INCREASE SMOOTHLY //

As investors entered 2019, the risk of being sucked into Charybdis's vortex (of excessive quantitative tightening) was high. The Fed could manage to steer the economy towards the more benign Scylla (by not tightening policies as much as planned), but that would leave structural imbalances.

Within this context, the market has done the right thing: volatility has risen as investors try and estimate the new economic normal. Further concerns will start to emerge:

- Valuation is still unattractive on long-term assumptions, so can we really afford a full adjustment? Lowering the price of equities further is economically not appealing and, in any case, dividend yields are not far from ten-year US Treasuries. The level of free cash flow (FCF) yield is twice the dividend yield, so long-term investors can buy and wait for the eventual economic recovery.
- Isn't the level of profitability high by historical standards and so unsustainable in the long term? True, but this argument has been present for the past 20 years. Could it finally be a realistic concern?

Uncertainty will remain abundant, but eventually the storm will be calmed and volatility will come down, as the Fed realises that it has already tightened enough. This may come earlier than expected, given that the slowdown is well under way.

At a practical level, markets may remain expensive, but the correction is starting to create attractive opportunities for long-term investors. We find good quality companies with high levels of profitability, positive revenue growth, low financial leverage, attractive dividend yields (and cover) and trading on a FCF yield of over 6%. Investors will require nerves and stamina, but in the end, who said that the journey to the new world was going to be easy?

*For further information, please contact Colin.McKenzie@dws.com*

**TECHNOLOGY: COMING OF AGE?**

Technology has returned an annualised 18.5% since March 2009, outperforming the MSCI World by 540 bps (as of October 2018), which makes it the best performing developed market sector since the financial crisis. Even in 2018, despite the sharp correction in September and October, the sector managed to outperform the market. The strong performance of technology and related stocks was underpinned by earnings growth. Over the past decade, global Economic Earnings grew by a real 3% annually, whereas technology managed to grow by 10%. Next best was Consumer Discretionary, where earnings grew by 9%.

**WHAT IS CROCI?**

Cash return on capital invested (CROCI) is a cashflow-based analysis which, by making a series of economic adjustments to traditional accounting data, aims to make non-financial companies comparable – regardless of industry or domicile. The main areas where CROCI 'economic data' differ from accounting data are as follows:

- Accounting for 'hidden' liabilities – CROCI enterprise value (EV) includes not only financial liabilities (such as debt) but also operational liabilities (such as operating lease commitments, warranties, pension funding, specific provisions).
- Depreciating similar assets in a similar manner – adjusting depreciation to reflect 'economic depreciation' and effective useful economic life.
- Replacement value of assets – inflating the value of net assets using the relevant inflator (based on the real age of assets).
- Unreported assets – systematically capitalising real cash-generative assets that are left off the balance sheet. Research and development costs and advertising are examples of such assets.

# A TIME FOR THEMATIC INVESTING?

## MEGATRENDS ARE GIVING RISE TO A NEW SET OF POWERFUL INVESTMENT THEMES. WHERE DO THE OPPORTUNITIES LIE?

In a well-received event for CISI members at BlackRock in February 2019, managing director Alastair Bishop delved deep into the theme of thematic investing, with a particular emphasis on transport. He pointed to a confluence of global trends that is promoting structural shifts in many industries and changing the drivers of corporate earnings.

Most major economies, he said, are undergoing powerful shifts in their demographic profiles, while resourcing scarcity and climate change are coming under greater scrutiny.

Rapid urbanisation is resulting in significant investments and changing consumer behaviour, especially in high-growth emerging economies. At the same time, the increasing ubiquity of technology is redefining business models in a host of industries, while also enabling a new breed of asset-light innovators.

### THE TALK FOCUSES ON FIVE OF THESE MEGATRENDS

"These forces," Alistair said, "which we call megatrends, are giving rise to a new set of powerful investment themes – the advent of disruptive technologies, radical shifts in consumer choices, greater regulatory intervention, and new opportunities for growth."

Against this backdrop, he said, investing thematically can add value to the more traditional methods of assessing and valuing stocks. How? "By analysing companies across regions and sectors, thematic investing can identify stocks that are favourably positioned to the most rewarding themes and build portfolios that offer pure exposure to them."

Alastair and his colleagues focus on five of these megatrends – demographics and social change, changing economic power (emerging markets), climate change and resource scarcity, rapid urbanisation and technological breakthrough. Their most powerful investment themes tend to be drawn from two or more of these megatrends.

Consider, for instance, the impact of demographic and social change as well as the proliferation of technology on eating habits. On the one hand, rising healthcare costs have led to greater regulatory intervention in food products (such as the introduction of a sugar levy in the UK in 2018). On the other hand, greater consumer awareness and the use of social media have led to a gradual decline in calorie and sugar consumption in the West, primarily among younger age groups. In the US, the share of high school students who drink soda daily has fallen to 20.5% from 33.8% a decade ago. More recently, companies have pointed to the growing popularity of organic foods, low-calorie alternatives and plant-based proteins.

// RAPID URBANISATION IS RESULTING IN SIGNIFICANT INVESTMENTS AND CHANGING CONSUMER BEHAVIOUR //

"We believe these shifts," said Alastair, "have an enduring impact not just on food producers, but also on food retail, beverages, restaurants, staples, consumer tech, brands and healthcare companies."

Turning to the theme of the February talk, rapid urbanisation and the rising scrutiny on pollution and climate change have together accelerated investments in electric vehicle technologies in both advanced and emerging economies. By the end of next year, global original equipment manufacturers are expected to have launched 132 electric vehicles, up from just 33 in 2012.  The ripple effects of this are being felt not just by auto manufacturers, but also component suppliers, tech hardware firms and commodity suppliers, as well as infrastructure providers. BlackRock's own Future of Transport fund invests in this theme and looks ahead towards more connectivity in cars and autonomous technologies.

Alastair and his colleagues are alert to the life cycle of themes. "Themes have longevity because the key megatrends that underpin them tend to persist for a long time. However, across this extended timespan, themes evolve and change shape. Themes overcome hurdles and gain momentum. Themes can be accelerated by innovation, but constrained by consumer inertia. Themes can be reinforced by corporate investments, but hindered by regulatory uncertainty. Thematic investing is non-linear."

This is particularly true for themes that are triggered by new hardware technologies. Take for example electric vehicles and batteries, clean energy and wind turbines, or even the Internet of Things and sensors. For each of these themes, the initial stage is marked by high expectations for the new hardware, and in turn hardware producers tend to outperform as demand overtakes nascent supply. In the BlackRock view, artificial intelligence and certain types of automation are currently in this early adoption phase.

As the chart shows, in this new world it's the quick or the dead.

*Alastair Bishop's talk on thematic investing is available now on CISI TV.*
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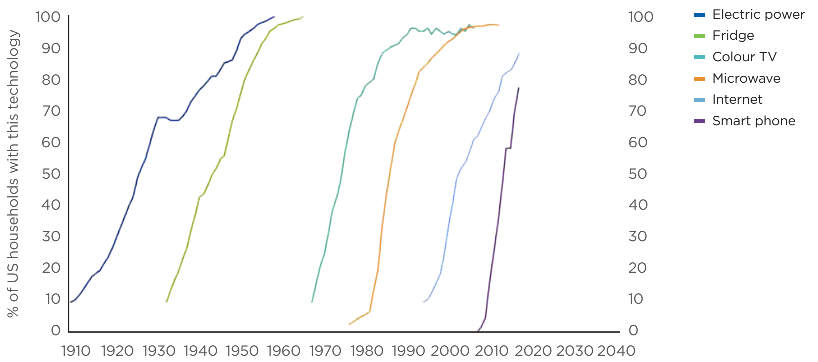
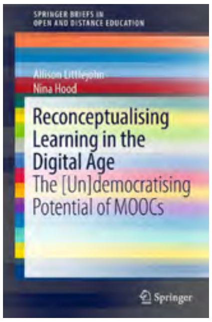
**THERE'S NO STOPPING THE TAKE-OFF OF NEW TECHNOLOGIES**




*Source: BlackRock, July 2018.*

# RECONCEPTUALISING LEARNING IN THE DIGITAL AGE

NEW LEARNING TECHNOLOGIES ARE TAKING OFF IN FINANCE LIKE THE ROCKETS CHARTED OPPOSITE. WILL MOOCS – MASSIVE OPEN ONLINE COURSES – DELIVER ON THEIR EARLY PROMISE?




Massive open online courses (MOOCs) have been hailed as a disruptive and democratising force in education, providing free education from the world's top institutions to students of all ages and abilities wherever they are. But are they the panacea that they seem? A new book* by Professor Allison Littlejohn, chair of learning technology and academic director at Britain's Open University, and Nina Hood of the University of Auckland in New Zealand, examines these claims, identifying characteristics that influence their development. MOOCs, they say, appear to advantage elites, rather than act as equalisers; they tend to reproduce formal education, rather than disrupt it; they are designed for those who can learn, rather than opening access for all; and they are measured by metrics that may not be appropriate for open, distance education. These tensions are analysed and potential ways forward are sketched out.

The Open University

Massive open online courses have become popular in recent years. The term MOOC has become synonymous with almost any open, online learning. This book identifies specific tensions that beset MOOCs and characterise open online learning in general, and looks at how both could be harnessed better for both professional and general education and development.

- MOOCs have the potential to democratise education. However, by highlighting prominent universities and organisations, they reinforce the values and extend the influence of the privileged. Open online learning could be introduced in ways that emphasise the value, knowledge and cultures of all societies and institutes.
- MOOCs have the potential to disrupt education. Yet, rather than being based on a future-focused view of learning, MOOCs often are modelled on the designs and traditions of conventional education. These norms include an expectation that learners intend to complete a course or that they will complete assignments, yet research illustrates that MOOC learners often have very different intentions. MOOC designs could be future-focused to ensure they disrupt education, rather than replicate conventional forms of learning online.
- An important feature of MOOCs is to open access to learning for everyone. Conversely, they are designed in ways that require learners to regulate their own learning even though there is ample research that indicates not everyone has the capability to learn independently. More emphasis should be placed on governments to make sure all citizens have the ability to regulate their learning. Until this happens, all forms of open online learning will benefit those who can learn, rather than serving everyone.
- A vision that underscores open online learning is that learners can follow their own goals. Yet MOOC designs and analytics are often based on predetermined objectives, rather than learner-defined goals. Learners usually are expected to conform to expected 'norms', such as submitting an assignment or completing a course. MOOCs could be designed in ways that allow learners autonomy and freedom to learn what they want in ways that suit them.
- An important aspect of the vision of people learning autonomously in MOOCs is the idea of drawing on the support of the massive numbers of other learners in the MOOC. Yet these social features of MOOCs often are missing. MOOCs have to be designed to allow learner interaction with other learners and with tutors.
- Data that is used to measure progress in open online platforms may provide a reductionist view of learner development. Future analytics platforms and tools for open online learning should capture data in ways that provide a holistic understanding of the learners' intentions and scaffolds to support them in achieving their goals.
- Open online courses and credentials sometimes are viewed as products for 'consumer' students. This view might oversimplify the notion of learning as a means to transform human thinking and practice. This transformative role of education and learning has to underpin our future planning and policy around open online learning.

**Reconceptualising Learning in the Digital Age: The [Un]democratising Potential of MOOCs by Allison Littlejohn and Nina Hood (Springer; 2018)*

**THE COMMERCIALISATION OF MOOCS**

The original MOOCs were developed by educationalists using rudimentary tools and platforms. These were funded through small-scale projects and often staffed by educators volunteering their time and labour. The leap from informal business arrangements to larger-scale commercial enterprises took place around 2011–12 when three US-based platform providers opened up: Udacity (*www.udacity.com*), formed as a for-profit educational organisation; Coursera (*www.coursera.com*), a spin-out from Stanford University; and edX, funded by Harvard University and Massachusetts Institute of Technology (MIT). The UK government, keen to be seen at the forefront of online learning innovation, founded FutureLearn (*www.futureLearn.com*) in December 2012, as a for-profit company wholly owned by The Open University.

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LAST WORD

# Testing times for P2P players

SUITABILITY QUESTIONS COULD BE THE BEST WAY OF PROTECTING RETAIL INVESTORS FROM THIS HIGHER RISK SECTOR

**The timing was so bad it could have been scripted. Right in the middle of the FCA's recent consultation on new rules for peer-to-peer (P2P) lending, news broke of problems at an operator called Lendy. This company arranges high-yield, short-term property bridging and development loans, offering annualised returns of up to 12% to retail investors willing to provide the funding.**

Trouble was brewing, the *Financial Times* (*FT*) reported, because a large borrower had threatened legal action after Lendy gave notice of recovery proceedings against it. More than £8m of investors' money, tied up in a development in London's Marylebone district, is at stake. And that's not all. The *FT* reported that £112m of Lendy's £180m of outstanding loans were over their term, with some borrowers already bust. Lendy's investors could end up nursing big losses.

Although most in the P2P sector would disagree, this episode lends weight to the assertion in the FCA's consultation paper that P2P loans "are generally high risk". The air must have turned blue in the offices of the leading players on the morning the news broke.

Aside from the blast of negative publicity, the main reason for their consternation is that problems like this might increase support for the FCA's big idea to protect retail P2P investors: requiring them either to take regulated advice or to give an undertaking that they won't put more than 10% of their investible assets into P2P loans. The FCA's proposal attempts to answer one of the biggest questions the regulator faces right across the financial services market: how should it protect retail investors against the dangers of chasing high returns from financial products they don't understand? Or to put it less delicately, how should it save greedy people from themselves?

Virtually everyone at the big P2P platforms is bitterly opposed to the idea of a 10% limit on retail investors. They fear it will signal to the public that P2P is too risky for them and so scare them away, stifling the sector's growth.

I have some sympathy with their concerns. The P2P players could simply turn their back on retail investors and fund their lending with institutional money, of which there is plenty. This would get the FCA off their backs, but it would run counter to the founding ideas of the sector – to give private individuals access to opportunities previously reserved for professionals and the very rich. It would also leave the P2P providers with a less diverse funding base.

> **"Virtually everyone at the big P2P platforms is bitterly opposed to the idea of a 10% limit on retail investors"**

But there are other reasons to question the regulator's approach. First, the risks in P2P lending vary enormously. At one end there are loans to prime consumer borrowers of the sort that banks court, where default risks are very well understood and there is wide diversification across a big pool of loans. At the other end are outfits like Lendy, which operate in highly specialised, private lending markets where you need to know the rules of the game to survive.

Most people would be shocked to learn that the 1% interest per month that they receive on these high-yield property loans frequently comes out of their original advance – they're being paid with their own money. But not those in the know. Where else can it come from when the underlying asset is a building site that's not generating any cash flows? For lenders, getting their money back depends entirely on the borrower's ability to finish the project on time and refinance their loan with a new one. There are often hiccups and delays in that process, hence loans frequently go over term. It's all part of the game, if you know how to play.

Bracketing this kind of lending with much more plain-vanilla activities and imposing a blanket 10% limit for retail investors seems wrong-headed. But just as importantly, I cannot see how the FCA's 10% limit would be enforceable in practice. Who's going to check how much of my wealth I've put into P2P loans and how?

This points to a much wider problem for regulators in the age of online finance – self-certification. As a private investor, I can get access to lots of racy opportunities simply by clicking a box to confirm that I'm a sophisticated investor. Again, no one checks whether that's true. But under the Financial Services and Markets Act, by doing that I sign away my statutory protections as a retail investor. Bingo – the investment providers are covered and all the risks fall on me.

There's another way. Instead of allowing investors to give hollow promises about their knowledge or intentions that absolve providers of major liabilities, the FCA should insist on suitability tests to verify that people understand the risks. It will always be possible to find out from the internet how to answer the suitability questions and gain access, but at least that means investors will have to read a little about the risks they are taking, rather than just ticking the box. ●

ILLUSTRATION: PADDY MILLS/SYNERGY