



A Model Portfolio Service
using
Exchange Traded Funds (ETF)

Executive Summary

The FSA's Retail Distribution Review (RDR) will fundamentally change the financial advice market over the next three years. The review looked at the provision of all forms of financial advice in the UK and came up with a range of desired outcomes by the end of 2012.

A central issue for the FSA within the RDR has been the problem of "commission bias". The FSA feel – with some justification – that the traditional practice of IFAs being paid by product providers for introduced business leads to bad practice with clients paying high initial fees (often hidden in complex policy terms) and those same policies being "churned" to the highest bidder on a regular basis.

In the latest RDR consultation paper the FSA have more clearly defined the definition of "independent" advice and specifically included Exchange Traded Funds (ETF) as products that must be included when researching investment options for clients. They have even stated that ETFs should be considered as an investment option under the current whole of market requirement.

IFAs are unlikely to have the necessary expertise in house to meet the research requirements proposed by the RDR and so "outsourcing" investment advice will become increasingly popular if not essential.

Traditional methods of "outsourcing" investment advice are expensive and can jeopardise the position of the IFA as the lead adviser and lead to downward pressure on advice fees.

The combination of these issues and our extensive use of low-cost Index Tracking and Exchange Traded Funds (ETF) combine to make the **assetfirst** fee-based, guided architecture, "outsourced" investment solution an extremely attractive proposition for a large proportion of the IFA community.

Introduction

The FSA's Retail Distribution Review (RDR) will fundamentally change the financial advice market over the next three years. The review looked at the provision of all forms of financial advice in the UK and came up with the following desired outcomes by the end of 2012

- an industry that engages with consumers in a way that delivers more clarity for them on products and services;
- a market which allows more consumers to have their needs and wants addressed;
- standards of professionalism that inspire consumer confidence and build trust;
- remuneration arrangements that allow competitive forces to work in favour of consumers;

A central issue for the FSA within the RDR has been the problem of "commission bias". The FSA feel – with some justification – that the traditional practice of IFAs being paid by product providers for introduced business leads to bad practice with clients paying high initial fees (often hidden in complex policy terms) and those same policies being "churned" to the highest bidder on a regular basis.

The RDR introduces the concept of "Customer Agreed Remuneration" (CAR) which in layman's terms is a fee. CAR will ensure that product charges and adviser charges are divorced and quoted explicitly making comparison much simpler for consumers and avoiding the problems outlined above.

In practical terms the RDR outlaws the practice of receiving high initial commissions (up to 7%) - which has been prevalent for many years – and instead will lead to advisers moving to a model where they charge lower initial fees but increased ongoing servicing fees, up from the traditional 0.5% per annum paid as trail commission to 1.0% per annum deducted from the clients portfolio or invoiced directly.

Broader Investment Scope

In the latest RDR [consultation paper](#) the FSA have more clearly defined the definition of "independent" advice as follows

- A new standard for independence requiring firms that provide independent advice to make recommendations based on a comprehensive and fair analysis of the relevant market, and to provide unbiased and unrestricted advice.

In order to define this further in CP09/18 the FSA actually sets out the scope of investments that they expect independent advisers to include within their analysis.

"This will mean that firms that provide independent investment advice to retail clients will be expected to consider more than just packaged products for their clients. One of the challenges for independent advisers will be to ensure they have sufficient knowledge of all of the types of products which could give a suitable outcome for their clients. The rules do not mean that we expect to see all advisers recommending products such as structured investment products, for example, as a matter of course. But, we would expect that if a structured investment product would best meet the client's needs and risk profile, then an independent adviser should have sufficient knowledge of these products to be able to recognise this and make a recommendation to buy this product."

Crucially the FSA highlight Exchange Traded Funds (ETF) as a particularly important investment product that has been traditionally overlooked by retail IFAs.

"We are aware that few independent firms constrain themselves to looking at packaged products only. The new standards aim to reflect this while also ensuring any new developments in the market will be captured by the rules. For example, although many exchange-traded funds (ETFs) would be regarded as packaged products, evidence suggests that they are not generally sold to retail clients in significant numbers. This may be because advisers do not feel they are suitable for their clients or because advisers feel ETFs are not a product with which they need to familiarise themselves. However, to the extent that ETFs can be a cheap and transparent way to invest in a particular market, even under our current whole of market requirement, these products should be considered when deciding which products are suitable for a retail client."

What the above extracts show is that in order for independent advisers to effectively double their ongoing client servicing charges they will need to be able to justify these fees through regular reviews and at the same time demonstrate to their clients that they are providing comprehensive investment advice at the lowest cost possible.

In the UK, ETFs account for less than 5% of total retail investment assets. The figure is higher in the Institutional market where commission is less prevalent as a method of remuneration

In the US where Customer Agreed Remuneration has been the established method of payment for independent advice for much longer, ETFs account for over 50% of investments in the retail sector.

Traditional “Outsourcing” Options

Many IFAs have traditionally picked fund portfolios for their clients in the past but have had little or no documented research behind their selections. Performance is generally poor and in larger firms each adviser may have selected different funds for their clients and therefore there is no continuity within the firm. The FSA will not view this favourably in the future and unless the IFA firm is willing to employ a specialist investment professional – at significant additional cost - to monitor and research their fund selections this may well prove to be a compliance problem in the post RDR world.

IFAs who do not have the internal expertise and capabilities to reliably select portfolios for their clients have traditionally had three “outsourcing” options available to them.

Fund of Funds/Multimanager Funds – These are packaged solutions where typically one overarching fund manager will select “best of breed” funds within a particular market or sector with the aim of delivering outperformance through regular monitoring and alterations to the underlying portfolio. This double layer of management oversight leads to double charging and Fund of Fund TERs are generally over 2% with many being considerably higher. Recently there has been a move amongst some larger IFA firms to produce their own “in house” funds specifically for their clients with the aim of delivering better returns than those available from the retail market. These “Distributor Influenced Funds” have attracted adverse interest from the FSA due to the fact that they are generally more costly than mainstream fund of funds due to lack of scale and they generate additional fees for the adviser firm leading to a potential conflict of interest!

Discretionary Fund Managers (DFM) – Perhaps seen as the most sophisticated option available, traditionally assets were transferred to the nominee account of the DFM (although nowadays the assets can be managed remotely e.g. on Wrap platforms) and then managed on behalf of the clients. The DFM will charge a management fee and many portfolios are built from collective funds which carry additional annual charges. Total charges can easily exceed 3% per annum once all fees and dealing costs are added in. Crucially the IFA has no role in the investment management process but will need to account to the client for any share of fees received from the DFM.

Model Portfolios – Some wrap platforms provide model portfolio options for IFAs using their service. These take the form of risk graded portfolios which are rebalanced regularly (usually quarterly) and the adviser elects to rebalance their clients back to the current weightings on an ad hoc basis. These portfolios have typically been based upon a selection of active funds (similar to Fund of Funds) and the providers tend to be limited to research houses like OBSR and fund providers such as SEI. Whilst there is no specific charge for this service, investors face the underlying fund charges in full.

Cost Analysis

Details of the costs and regulatory risks of each method are shown in the table below. In each case adviser fees have been excluded and we have assumed that the IFA firm comprises of 2 Regulated Individuals (RIs) and has £10m of client funds under management.

Portfolio Management Method	3 rd Party Costs	Average underlying Fund TER (net of trail)	Total Costs on £10m total client portfolio	Regulatory Risk
Pick Funds	nil	1.15% *	£115,000	High
Fund of Funds	nil	1.94% *	£194,000	Medium
Discretionary Fund Manager	0.75%	1.15% *	£190,000	Low
Model Portfolios	nil	1.15% *	£115,000	Low

*source: Lipper Fitzrovia 2008

As can be seen from the above table the lions share of costs borne by the client is generated by the Total Expenses of the underlying funds. In addition, since all these charges are based upon a percentage of assets under management, the adviser firm/client is effectively writing a blank cheque to the investment managers as the cost increases as more funds are introduced.

Of course were you to add the adviser fee to the fund management fees outlined above the total annual charge would still be between 2.15% and 2.94%! We believe that, in the new era of complete disclosure, clients will be unwilling to pay this level of fees leading to downward pressure on the easiest target, the advisers own fee.....

assetfirst Guided Architecture - a viable Alternative

We have identified a market for a low cost Guided Architecture service, similar to the Model Portfolio service but utilising low cost Exchange Traded Funds (ETFs) rather than more expensive active funds. assetfirst has created a range of sophisticated, risk-graded model portfolios providing exposure to all major global asset classes at a fraction of the cost of all other outsourced services. In addition to monthly portfolio updates, clients of assetfirst will receive compliance support in the form of an investment manual detailing the methodology behind the portfolio construction process as well as monthly tactical reports and factsheets for use with their clients.

Rather than offering this service on a discretionary basis, **assetfirst** will provide IFA clients with monthly updated portfolio positions which they can then apply to their client portfolios as they see fit, either through the model portfolio functionality of most major Wrap platforms or through direct wrappers such as SSAS & SIPP.

Crucially, rather than charging a percentage of funds under management for this service **assetfirst** will charge our IFA clients a monthly retainer of £500 + VAT per month per RI. Comparison with the traditional methods outlined earlier shows what a compelling solution **assetfirst** can offer.

Portfolio Management Method	3 rd Party Costs	Average underlying Fund TER (net of trail)	Total Costs on £10m total client portfolio	Regulatory Risk
assetfirst Guided Architecture	£500 + VAT per RI	0.50%	£64,100	Low
Pick Funds	nil	1.15% *	£115,000	High
Fund of Funds	nil	1.94% *	£194,000	Medium
Discretionary Fund Manager	0.75%	1.15% *	£190,000	Low
Model Portfolios	nil	1.15% *	£115,000	Low

*source: Lipper Fitzrovia 2008

Since the fees for the **assetfirst** Guided Architecture service are met by the IFA firm, there is no need to disclose this cost to the client thereby reducing the overall reportable charge significantly over the traditional "outsourced" solutions and eliminating the likelihood of downward pressure on the adviser fee.

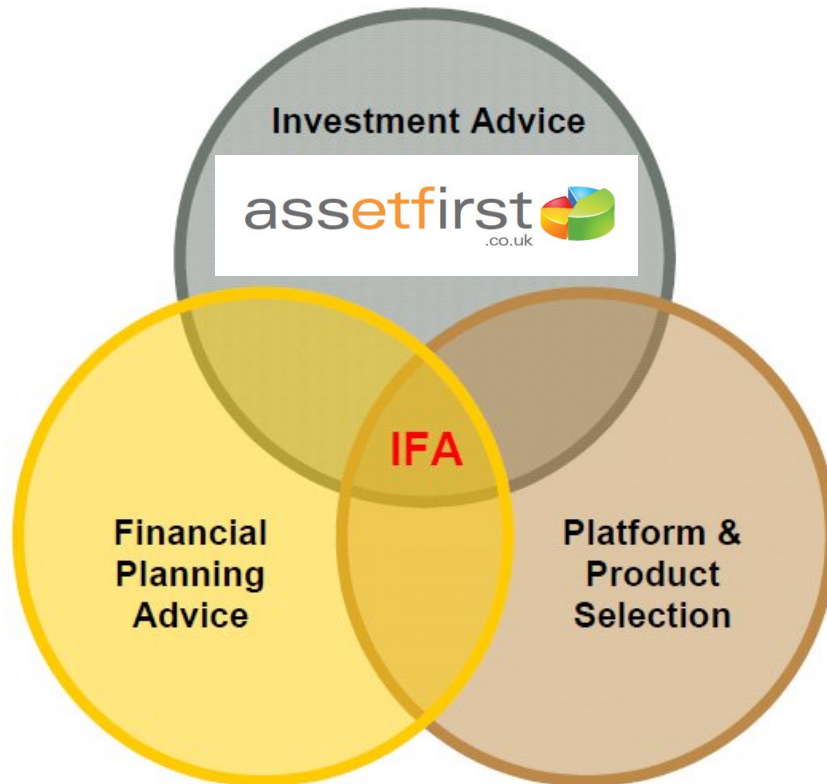
Most importantly the total costs faced by the client - including the advisers 1.00% per annum advice fee - would be just 1.5% per annum (plus Wrap costs where appropriate), an improvement of at least 0.65% (£65,000) per annum on any of the other alternatives.

In fact, to put the overall charge into context, it is less than the annual running costs (or Total Expense Ratio (TER)) (excluding dealing costs!) of Fidelity's Special Situations fund (1.66%) or Invesco Perpetual's Income Fund (1.69%), two of the most popular single-strategy active funds in the UK.

Central Role

Perhaps the main benefit of the assetfirst Guided Architecture service over traditional outsourced investment solutions is the fact that the adviser maintains the central role in the management of the clients financial affairs.

All rebalancing of client portfolios is carried out by the adviser during the regular review process and any changes to the tactical positions can be highlighted to clients using the unbranded monthly factsheets provided as part of the service.



What's included?

The assetfirst Guided Architecture service comprises a range of six risk-graded portfolios constructed almost exclusively using Exchange Traded Funds (ETF). The portfolios benefit from ongoing Tactical Asset Allocation informed by extensive quantitative analysis of global markets. The strategic portfolios consist of investments in the asset classes shown below.

Asset / Portfolio	Defensive	Defensive to Balanced	Balanced	Balanced to Aggressive	Aggressive	Balanced High Yield
UK Equities	√	√	√	√	√	√
Overseas Equities	-	√	√	√	√	√
Emerging Market Equities	-	√	√	√	√	√
Investment Grade Bonds	√	√	√	√	√	√
Sub-Investment Grade Bonds	√	√	√	√	-	√
Property	√	√	√	√	√	-
Commodities	-	√	√	√	√	-

Each of the strategic portfolios is further diversified across the high level asset classes as detailed below.

Portfolio	Defensive	Defensive to Balanced	Balanced	Balanced to Aggressive	Aggressive	Balanced High Yield
FTSE 100	√	√	√	√	√	√
FTSE 250	√	√	√	√	√	-
Smaller Companies	√	√	√	√	√	-
High Dividend	√	√	√	√	√	√
USA	-	√	√	√	√	√
EU	-	√	√	√	√	√
Japan	-	√	√	√	√	√
Asia Pacific	-	√	√	√	√	√
Emerging Markets	-	√	√	√	√	-
UK Gov Conventional	√	√	√	√	-	√
UK Gov Index-Linked	√	√	√	√	-	-
Corporate IG	√	√	√	√	√	√
Corporate SIG	√	√	√	√	-	√
Property	√	√	√	√	√	-
Commodities	-	√	√	√	√	-

Tactical asset allocation “slants” are made on a relatively long-term forward looking basis. By employing this discipline existing investor portfolios need only be rebalanced back to the tactical positions on a relatively infrequent basis.

To maintain the risk/reward integrity of the portfolios, we ensure that any tactical positions within each of the portfolios maintains a risk profile commensurate to the relevant risk banding in which they sit.

Due to the low cost nature of ETFs, the combined Total Expense Ratio (TER) of each of the 6 model portfolios is typically between 0.40% and 0.60%.

Back Tested Performance

Whilst we cannot guarantee the level of return that each portfolio can produce we have back-tested all of the portfolios to calculate the likely expected returns over the long-term and the spread of likely short-term returns or "standard deviation" which can be realistically expected to make up the long term average.

Portfolio	Defensive	Defensive to Balanced	Balanced	Balanced to Aggressive	Aggressive	Balanced High Yield
Expected Total Annual Returns	6.4%	7.4%	8.1%	8.7%	10.2%	7.6%
Expected Standard Deviation	+/- 7.8%	+/- 9.3%	+/- 10.9%	+/- 12.7%	+/- 17.7%	+/- 11.5%
Average annual yield (included in above annual returns)	4.24%	4.08%	3.78%	3.18%	2.53%	5.56%

As an example, the range of short-term annual returns applicable to the Balanced portfolio are likely to fall between -2.8% and + 19% (i.e. 8.1% +/- 10.9%)

Selection of underlying Investments

Whilst the assetfirst Guided Architecture portfolios will comprise predominantly ETFs we will recommend index tracking unit trusts and/or actively managed funds when appropriate.

Our aim is to maintain a TER within the portfolios below 0.60% per annum at all times.

We also provide our IFA clients with a second range of portfolios which are constructed using only index tracking funds and/or active managed funds in order to avoid the dealing costs associated with ETFs.

These additional portfolios are particularly appropriate for regular premiums and smaller investment sums or for use on platforms where ETFs are not available.

Selection of Wrap Platform

Our sister company WKH Financial Services Limited has been using these portfolios as part of their Provisio Wealth Management service since March 2008 and has a great deal of experience in their cost effective implementation via several Wrap platforms. For an additional fee we are able to assist clients with Wrap Platform selection/due diligence to ensure that they are able to access and manage the assetfirst portfolios at competitive rates.

In addition we are experienced in running model portfolios on several of the main UK platforms and can assist in the training of your staff in model portfolio maintenance and rebalancing.

About assetfirst

assetfirst is the result of a collaboration between WKH Financial Services Limited and Cormorant Capital Strategies.

WKH Financial Services Limited is a Regional IFA specialising in Wealth Management and Financial Planning. An early adopter of Wrap technology and fee based advice, WKH quickly identified the need for cost control in their wealth management service – Provisio – particularly within the investment management component of client fees. Unwilling to compromise on quality, WKH enlisted the help of Cormorant Capital Strategies to build a unique investment management proposition for the Provisio service based on a combination of strategic and tactical asset management. The resulting range of risk-graded investment portfolios - utilising low-cost Exchange Traded Funds (ETF) and Index tracking unit trusts - form the basis of the assetfirst Guided Architecture service.

Cormorant Capital Strategies is a unique British-based provider of innovative asset allocation strategies and investment analysis with a focus on the following services,

Strategic Asset Allocation – Mean variance optimisation models, scenario selection models and probability testing.

Tactical Asset allocation – Consistent and concise present day analysis of global capital markets.

Security Selection – Mutual and hedge fund research and third party performance assessment.

By combining the experience of both firms assetfirst can provide IFAs with access to a proven range of model portfolios at exceptionally low cost. Unlike most outsourced investment management options, the Assetfirst Model Portfolios can be used with any Platform or Wrap which allows access to the underlying securities or run within existing SSAS/SIPP and Offshore Bond vehicles.

Cost Neutral

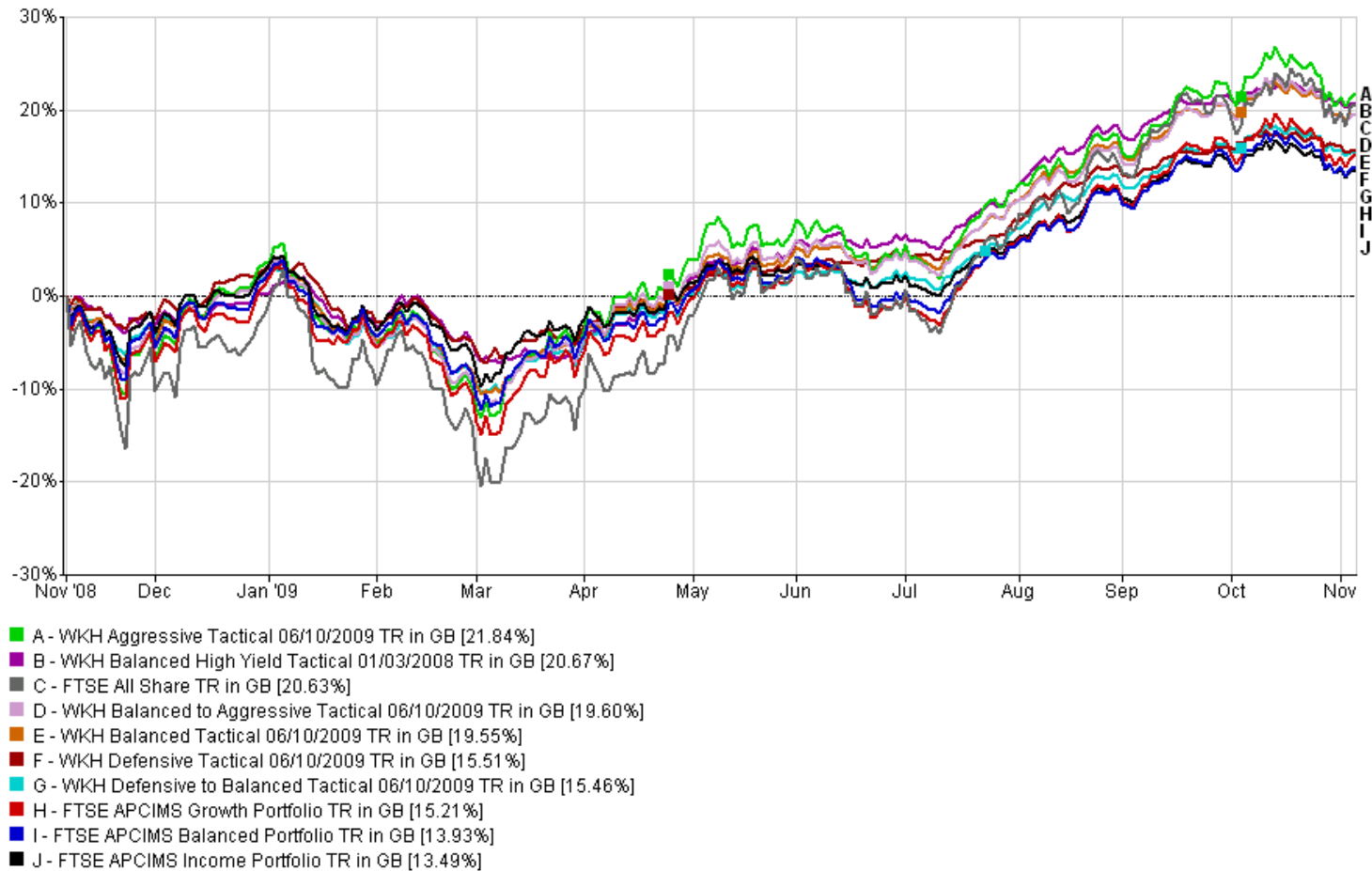
Uniquely, assetfirst charges the IFA for this service, not the client. This, combined with the low cost nature of the underlying assets makes the migration from 0.5% trail based remuneration to a 1.0% fee based service cost neutral to the majority of clients.

Protection for You

Unlike most other outsourced investment solutions, assetfirst Ltd. is not authorised to give investment advice nor do we manage client money. Our clients are professional advisers, working with us secure in the knowledge that there are no conflicts of interest.

Portfolio performance

assetfirst Model Portfolios (main) – 1 yr TR

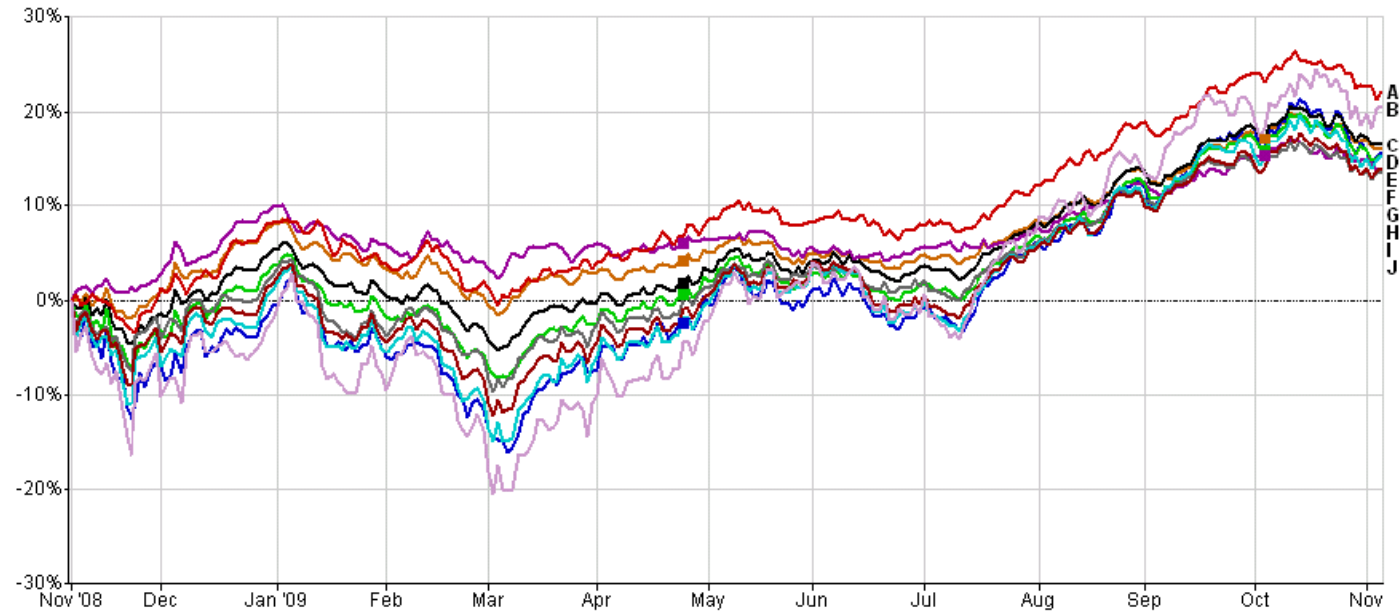


05/11/2008 - 05/11/2009 © Data provided by Financial Express 2009

Performance data based upon model portfolios used by WKH Financial Services Limited in their Provisio Wealth Management Service

Portfolio performance

assetfirst Model Portfolios (UT) – 1 yr TR



- A - WKH Balanced High Yield Tactical (S) 01/03/2008 TR in GB [22.05%]
- B - FTSE AI Share TR in GB [20.63%]
- C - WKH Balanced Tactical (S) 07/12/2009 TR in GB [16.61%]
- D - WKH Defensive to Balanced Tactical (S) 07/12/2009 TR in GB [16.07%]
- E - WKH Aggressive Tactical (S) 27/04/2009 TR in GB [15.55%]
- F - WKH Balanced to Aggressive Tactical (S) 07/12/2009 TR in GB [15.23%]
- G - FTSE APCIMS Growth Portfolio TR in GB [15.21%]
- H - FTSE APCIMS Balanced Portfolio TR in GB [13.93%]
- I - WKH Defensive Tactical (S) 07/12/2009 TR in GB [13.86%]
- J - FTSE APCIMS Income Portfolio TR in GB [13.49%]

05/11/2008 - 05/11/2009 © Data provided by Financial Express 2009

Performance data based upon model portfolios used by WKH Financial Services Limited in their Provisio Wealth Management Service