Outline

Assignment on Investment Management

Introduction to Investment Management

Investment management is defined differently by various scholars. Different meanings depend on the scholar's personal and professional perceptions; however, most of them agree that investment management entails the acquisition of assets in terms of equities, fixed income securities, and properties. The aim of acquiring such assets is to increase the capital gain (Markowitz 2009). In such cases, the chosen investment portfolio should be characterised by low risks. At the same time, the investment portfolio should have desirable returns. In addition, the investment portfolio should have a reduced tax liability, but at the same time it should be efficient. This means that if an investment decision does not comply with the requirements stated above, then there is a need to get an alternative investment portfolio to maximise the investor’s capital gains.

The current piece of writing is based on client's assumptions and suggestions, however, the author is the one who analyses various investment decisions made by Mr Philip Lewis, the client. In addition, the author provides an alternative investment decision for him, which is aimed at maximising his capital gains while, at the same time, reducing his exposure to risk. Tax efficiency, balanced portfolio and risk assessment are some of the issues highlighted by the author in this report. These issues are accented in terms of their correlation to his decisions which eventually help the author provide the client with relevant recommendations for future investments.

Gilts

According to The Financial Times (2012a), gilts are government debts that are held by the public. The holder of such debts receives semi-annual interest payments until his/her maturity. According to Debt Management Office (herein referred to as DMO), the single gilt held by the treasury makes 6% of 2028 and is valued at 150.3063 Sterling Pounds. The value is inclusive of accrued interest gilt. It translates to 25 × 150.3603, which makes up 3,759.008 Sterling Pounds.

Gilts are associated with various advantages and benefits accruing to the investor. One of the major advantages associated with gilts as a form of investment is the fact that they are non-taxable. This means that the investor enjoys tax-free returns (Haugen & Baker 2008). In addition, gilts are linked with low risks; meaning that they are rarely affected by the risk of default. The major challenge, however, is connected with inflation the gilts are exposed to. The current high inflation rates brought about by the recession diminished the earnings made from gilts. The reduction of profit is attributed to higher interest rates and instability of market, which leads to low earnings from gilts (Markowitz 2009).

OEIC Holdings

According to Trustnet (2012), OEIC holdings are usually managed by JP Morgan Asset Management because the company specialises in long-term investments. In spite of the managers' wide experience and skills in the field of asset management, this trust company was affected significantly by the global economic recession. Globally, this firm considers class A Asset Management Fund a risky venture. Trustnet (2012) ranks the fund at the position#1184 in the world. Such a low rank is linked to the risks associated with the funds invested (Trustnet 2012). JP Morgan Asset Management's competitor, Fidelity China Special Situations Investment Trust is currently regarded as the best alternative. The reason behind is that China is an aggressive and fast growing market, where industrialisation is at its peak.

Drax Group PLC and Severn Trent PLC

According to The Financial Times (2012a), the revenues realised by Drax in 2012 have grown by 11.37% compared to the revenues realised in 2011. The growth has made the firm’s net income rose by 146.06% from 188.4 million sterling pounds in 2011 to 464.60 million sterling pounds in 2012. The increase in profits made the earnings per share increase by 145.53%, even though the dividend per share decreased by 13.13%. In addition to the above said, the company is characterised by low debt equity, considering that its debt to capital ratio is 0.56%. The company closed its stock at 566.50 million sterling pounds.

On the other hand, Severn Trent recorded a decrease of 36.98% in its net income. However, the company’s revenues were increased from 1.71 billion to 1.77 billion sterling pounds. The Financial Times (2012b) associates the increase in revenue with the increase in sales. The losses are attributed to a high cost of goods sold by the company. The losses notwithstanding the firm’s dividend per share were increased by 7.70% within the same period, whereas earning per share were decreased by 38.08%. The company’s debt financing is significantly high compared to that of Drax. In addition, the company has some problems with the water and sewer regulatory agency and is currently suffers losses from its various transactions.

The value of the shares indicated below is computed using the Weighted Average Cost method:

$(250 \times 565) + (150 \times 1557) / (250 + 150) = 951.125$ sterling pounds.

Inheritance of £50,000

The client is of the view that the funds he inherited recently should be invested in another investment avenue. This is one of the reasons why he consulted this firm for financial advice. According to Markowitz (2009), portfolios that yield small or no profits should be invested, so they can produce some good returns. Taking this information into consideration, Mr. Philip Lewis is advised to invest the aforementioned inheritance in a vibrant Real Estate Investment Trust (herein referred to as REIT). Such investment trusts include, among others, UK-REIT. Investing in such funds will ensure that the client owns a property that is supported by his portfolio. In addition, he will get professional services, which will help in managing the property. Through this trust, the client can even own a commercial property.

Balanced Portfolio

A balanced portfolio seeks to strike a balance between the returns and the risks associated with it. There are various strategies used in achieving a balanced portfolio. One way of achieving it is by combining equities and fixed income securities. Based on the information provided by Mr. Philip Lewis, it appears that most of the investments he has made so far can yield him capital gains. He has bought shares from three counters belonging to different sectors of the economy. In addition, he has bought gilts, from which he earns semi-annual interest payments and the deposit made in a building society savings account can be turned into a real estate investment.

Risk Assessment

According to Pring (2010), all investments are associated with various risks. The risks lead to changes in the expected capital gains, resulting in either a profit or a loss.

Such capital gains include, among others, interest payments on such debts as gilts and dividend payment on shares. To this end, there is a need to urgently assess the risks that Mr. Lewis is facing with regard to his investment decisions. Risk assessment should provide information to help one determine if the portfolio is a risky one, which may result in losses (Haugen & Baker 2008). Below are some of the potential risks that are going to be assessed:

- **Inflation Risk**

There are various causes of inflation; for example, the inflation can be brought about by an increase in the price of commodities in the market, when the increased prices lead to high interest. The increase in interest rates is meant to reduce the inflation levels since the inflation has a direct impact on gilts. For example, an increase in inflation will lead to a decrease in interest payments made on gilts. Markowitz (2009) notes that interest rates are inversely related to debts.

In addition, dividends may be affected by inflation, depending on the capital structure adopted by the company. A company that uses a lot of debt financing will be forced to pay more interest rates compared to a company that uses less debt financing (Rothchild 2010). As a result, this counter will record losses in case of inflation. For instance, Severn Trent uses a lot of debt. The debt is justified given the company’s debt capital ratio of 81.76% (The Financial Times 2012a). Analysts argue that this is one of the reasons why the company records losses, given that it pays high interest rates.

- **Market dynamics**

The shares and gilt are affected by the market dynamics as stated by Pring (2010). The scholar is of the view that market dynamics bring about price fluctuations as far as the shares and gilt are concerned. The main cause of this dynamics, according to Trustnet (2012), is the change in demand and supply of stock and gilt. The changes bring about profits and losses.

- **Risk of Default**

The risk of default is evidenced in various situations. For example, the risk can occur when the issuer of equity or debt fails to honour the payments that are already due in terms of dividends and interests. In such a case, the expected amount is carried forward. The defaulting can take place if the issuer of equity is going through difficult economic times and profits are not recorded as expected. In most cases, risk of default affects shares and occurs when the company in question ceases to trade. In addition, the risk can occur if the company in question is placed under receivership or winds down its operations.

- **Operational Hazards**

According to Pring (2010), operational hazards are punitive measures that affect the normal trading of the stock. It can either result from punitive taxation or from a decrease in dividends payable. In most cases, punitive taxations or a decrease in dividends are evidenced in trading of stocks, for example the stock held by Drax and Severn Trent.

- **Issue Specific Risk**

The issue Specific Risk involves a situation where the stock or gilt is called by the issuer prematurely (Haugen & Baker 2008). In most cases, gilts are subject to early calls. In such cases, the issuer repays the gilt before the scheduled date of payment. However, it is important to note that shares traded through a stock exchange can only be called if the company is declared bankrupt. Even in such cases, the calling can only take place after the company refunds the sum owned to its shareholders

Tax Efficiency

According to Pring (2010), tax efficiency is a situation whereby the investors realise low tax liability. The realised tax liability is lower than the expected tax liability. Several strategies are used in achieving tax efficiency. One such strategy involves realigning and modifying the investment portfolio. The major aim of such realignments and modifications is the reduction in the tax effect.

Markowitz (2009) is of the view that returns from shares can help one achieve tax efficiency. Dividends are liable to 10% tax credits, which reduces the overall tax liability. To this end, Mr. Lewis can increase his tax efficiency by making monthly contributions to a pension scheme. The amount contributed to his pension scheme will decrease his income tax. Consequently, the decrease will ensure that the investor benefits by joining a lower tax bracket (Markowitz 2009). Another way of becoming tax efficient is through the purchase of tax-free gilts and securities. Mr. Lewis can increase his tax efficiency through purchasing such securities and gilts.

Recommendations

Given the information provided by this client, various recommendations are made with the view of enhancing his investment portfolio. As a starting point, Mr. Lewis should seek information regarding the status of his pension plans. The information will help in evaluating his overall investment portfolio. Moreover, he should start his individual pension scheme. The individual pension scheme will not only help him become tax efficient, but it will also help him in securing his future.

The inheritance, which he terms as ‘idling’ in the building society account, should be channelled into a real investment trust fund because of low returns. The financial advisor recommends the UK Real Estate Investment Trust (herein referred to as UK-REIT). The trust is recommended given its emergency as a key player in this sector. Currently, UK-REIT has managed to acquire property for 80% of its clients. The high rate is an indication of the company’s competence in handling the client’s investments (Haugen & Baker 2008). Furthermore, the counter is quite busy and its shares are very strong, something that is attributed to the goodwill the company enjoys in the market.

If the client wants to sell his shares, it is recommended that he does so for Severn Trent. The reason behind this piece of advice is that the company is facing many financial challenges, especially in terms of various fines imposed on it. Severn has various legal issues raised by the industry regulator. The issues include providing incorrect information, as well as leakage of confidential data. The actions of the company can lead to the cancellation of its license to operate. As a result, many investors have abandoned its shares (Pring 2010).

Furthermore, the client is advised to invest in new and emerging markets. For example, the client can sell his shares in the OEIC Holdings and buy those held by Fidelity China Special Situations Investment Trust. As aforementioned, Fidelity China has recorded a huge success in the market. In addition to this, the trust is backed by a growing and industrious economy. Mr. Lewis should realise that investing in the trust will significantly increase the value of his multiple holdings.

References

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