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A direct investment alternative for advisers

David Manchee

Clients are increasingly asking their financial planners about owning Australian shares directly. There are various reasons for this, including the ability to receive franked dividends, timing sales to offset losses for capital gains tax purposes, the desire to own something tangible, and the wish to avoid excessive management costs associated with managed funds and platforms.

Just as frequently, clients are seeking ongoing advice about their existing portfolio or the shares within their self-managed super fund (SMSF).

Traditionally, financial planners have only really been able to offer access to the model portfolios of their group or an outside research house as an alternative to managed funds, or to refer the client over to a stockbroker entirely. Many planners are reluctant to do the latter as it hands over control of the client without an ability to check on the stockbroker, which could lead to complaints or conflicting advice and interests later on.

Model portfolios

Many groups use externally recommended portfolios and then arrange for the client to acquire the shares in such a portfolio.

Although these model portfolios do offer stock diversity and are based upon some level of research, they have a major shortcoming in that they are ignoring the price of a stock on a particular day and, in turn, the financial risk of buying the shares that day.

Typically, a model portfolio will include a portfolio of blue chip stocks and is rarely changed.

Let's say a model balanced portfolio proposed 12 months ago included a company such as [Wesfarmers](#).

To be included, the logic would be that its earnings and dividends offered value. It is a reasonable assumption that during the past 12 months such a stock would have remained on the Recommended Model Portfolio for the entire time, despite fluctuations in its share price (see chart 1).

The point is that although Wesfarmers is a great Australian company, the price you pay determines the value, the dividend yield on the investment and, in turn, the risk.

A client who purchased in March and paid \$41.50 would now consider that investment to be a failure and risky.

Conversely, buying near its lows, the dividends would yield over 8 per cent gross.

A mature investment

Take the example that is included in most model income portfolios over the past year – Transurban. Transurban owns and operates the Citilink from Tullamarine to Melbourne and the M2 in Sydney.

As both are mature tollways, the distributions are highly predictable and have in fact been stated by the company to be 50



cents in 2005 and 54 cents in 2006.

As the percentage yield is a function of the distribution and the price paid, what at first glance appears to be a reasonable distribution can become relatively low in yield terms if the price paid for the investment is too high (see chart 2).

In this example, if the investor purchased shares at \$8 at the beginning of 2005, the yield for the forthcoming year is going to be 6.25 per cent, while recently at \$6.50 the yield is an attractive 8.3 per cent tax deferred. Same company, just the return to the investor is very different.

Just as importantly, capital risk depends not only on the underlying investment but, more importantly, on the price paid for it.

These examples highlight the shortcomings of model portfolios being too static and not market responsive.

Sell recommendations

The other problem facing financial planners who use a model portfolio is how to know when to recommend to their clients to sell an investment.

Even if a mechanism is in place it will require daily monitoring of clients' portfolios, which detracts from the planners ongoing responsibilities to the clients' long-term structures and planning.

Stockbrokers would argue that these price movements are why they are best placed to advise private share investors.

However, lack of responsibility to the planner and the problem of brokerage for each transaction present conflicts of interest.

Indeed, many planners have fielded complaints from clients who felt their portfolio was churned simply to raise brokerage.

Individually managed accounts

Clients of financial planners should remain the clients of the planner and should not be faced with the conflict of trading for brokerage or churning.

An alternative is for advisers to use individually managed accounts (IMAs), which are fee-based rather than commission-based and attract no transaction fees that could compromise the relationship.

An IMA is exactly what the name suggests – each portfolio is managed under an agreed investment mandate (risk, income requirements, and so on) and the portfolio changes as the portfolio manager deems appropriate.

That is, if a share price represents value then the portfolio manager will buy for the client, and if the price moves above valuation the portfolio manager sells the share and reinvests the proceeds in another stock offering greater value, or may invest in fixed interest if they think there is nothing suitable or the market is too high.

The key is that each client portfolio is managed with a greater emphasis on buying and selling the appropriate investments at an appropriate price, rather than following a model portfolio.

The shares in an IMA are registered in the investor's name and the client always remains the client of the financial planner. The service is designed to complement a subsection of the financial planner's overall plan for the client, their direct equities.

Further, the client and the financial planner are kept constantly updated on the state of the portfolio.

The portfolio manager liaises with the planner regarding the client's capital gains position and if there have been any changes to the client's financial position or objectives and adjusts the portfolio accordingly.

Depending on the planner's practice, part of the management fee charged may be rebated to the planner for their ongoing

responsibilities or to the client.

IMAs that are managed by experienced portfolio managers do not compromise the relationship between the planner and the client.

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