ADVICE MATTERS

The CPD Solution For Financial Professionals

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Welcome to the 11th edition of

ADVICE MATTERS

We know that most of you will be only too pleased to read something that is nothing to do with SM&CR so we have gone with a light touch in this month's edition only mentioning it briefly, but of course the fact that you are reading this will help to support your competence requirement especially if you are part of the Senior Managers or Certification Regime.

We start this month's edition with an interesting look at incentives and how the financial industry's view and implementation has changed since the financial crisis. This is followed by two articles which feature the higher risk end of investments – Contracts for differences, CFDs and Hedge Funds.

The next time you will be reading Advice Matters we will possibly have a change of government and SM&CR will have been implemented – all within a month – doesn't time fly when the county is in a quandary.

Happy reading!

The Advice Matters Team
at FSTP

ApEx Standards

The learning outcomes and the ApEx Standards can be found at the end of this edition of Advice Matters

Next month

We will focus on:

- Ethical v Compliant - are they equal opponents
- The market for SIPP and SSAS
- Other Regulatory bodies

Recognised CPD programme

The London Institute of Banking & Finance

Staying on Track

This section will keep you up to date with the changes in market, product, legislation & regulation.

Incentives – the regulator's view

We all know incentives can be non-financial as well as financial, depending on the circumstances, in order to achieve a desired outcome. For example, exasperated parents, at their wits-end, trying to get their truculent children to behave will either opt for the carrot or the stick (obviously we are not advocating the use of the stick here and I often found chocolate buttons worked far better than carrots). And in the context of work or investments we expect, if not demand, financial rewards for performances that exceed expectations or achieve above standard levels of productivity.

Definitions of "incentive"

According to online [Google] definitions, incentive is:

> *"Something, especially money, that motivates or encourages a person or organisation to do something… a payment or concession to stimulate greater output or investment… additional pay [above and beyond base salary] awarded to an employee – i.e. stock options or bonus plan that is forward looking".*

Bonuses may be in the form of a cash-award or other items of value such as stock and awarded for certain tasks achieved in a defined time-frame.

Examples of non-financial incentives would include praise and commendations from an immediate manager, recognition from leaders in the form of opportunities to lead projects or an additional responsibility for task forces – rewards intended to inspire and get the best out of ourselves.

For incentives to work, *"they need to be unambiguous and directly tied to a measurable action or achievement... offering incentives with long-term benefits can create even better outcomes for both the employee and the company. Educational and training incentives, for example, are a great* [non-financial] *way to reward team members."* and set out as part of a performance review or appraisal.

https://www.forbes.com/sites/forbescoachescouncil/2017/04/24/how-to-implement-incentives-that-actually-work/#509eab7d6221

I'm not sure how much I agree with the Forbes Coaches Council - I have never heard anyone say they would rather go on a training course than receive a cash bonus!

The use of incentives – pre-financial crisis

In the years leading up to the financial crisis, it was not uncommon for most employees in financial services to expect and factor in, as a right, an annual bonus into their total compensation package for that year. Hiring firms would also "front-load" hi-flyers' joining bonuses in expectation of stellar performances; anticipated-but-not-yet-paid bonuses would be bought out and paid at the onboarding stage and "golden handshakes" were frequently used to lure those with perceived, but not as yet proven sought-after skills in business-critical roles.

Back in 2000, a friend who worked in the front office had both his salary doubled and a 100% bonus guaranteed on the condition of not moving to a competitor bank. (More interestingly, the meeting in which he was told this first started as a conversation in which he at first thought he was being sacked!)

FCA CEO Andrew Bailey referred to this state of affairs in his speech in March 2018.

> **Commission selling based pay was awarded with little scrutiny** [and even a few years after the crisis noted] **it was quite typical as a supervisor to be told by boards that very high levels of remuneration had to be paid whatever the state of the firm, for fear of losing key staff.**

(See full speech – https://www.fca.org.uk/news/speeches/transforming-culture-financial-services)

The need for guidance – The Remuneration Code

These practices on their own did not bring about the crisis but were a contributory factor in the decision to introduce the Remuneration Code in August 2009 as part of the FSA's regulatory response (the FSA was the precursor of the FCA). In particular, the Capital Requirement Directive as regards to a bonus cap (CRD 4 – imposes restrictions on the amount of variable remuneration paid) and the timing of when bonus payments should be paid (CRD3 – imposes restrictions on timings of payment).

The Remuneration Code has undergone 3 subsequent revisions; in January 2011 (extension to the scope of firms); January 2014 (the aligning of remuneration principles in banks, building societies and investment firms across the EU) and in July 2015 (5 Remuneration Codes introduced as set out in the FCA Handbook, SYSC 19A -19E). See https://www.fca.org.uk/firms/remuneration.

In January 2018, the FCA introduced SYSC 19F *"which implements MiFID II requirements on staff incentives and the remuneration" and "seeks to ensure that sales staff and advisers are not remunerated in a way that creates incentives for staff to sell products inappropriately… Firms must not remunerate or assess the performance of staff in a way that conflicts with their duty to act in the best interest of their client."* and that *"the right to be treated fairly is not impaired by the remuneration practices adopted by the firm in the short, medium or long term."*

Misuse of incentives examples

Where incentives are misrepresented, difficulties will surely follow. The mis-selling of PPI to customers led to an unprecedented number of complaints and levels of compensation. In the case of Lloyds, staff members were coerced into selling to such an extent, some staff were purchasing products for family members to make their targets. https://www.fca.org.uk/publication/final- notices/lloyds-tsb-bank-and-bank-of-scotland.pdf. There have also been investigations into complaints' handling which revealed that members of staff at some firms were again incentivised to respond and manage a certain type of complaint ahead of others. These firms were fined. But outside banking and financial services, lessons are still to be learned. https://www.fca.org.uk/fca-fines-the-carphone-warehouse-over-29-million-for-insurance-misselling.

Virtue and moral incentives

William De Britaine said back in 1726 (Human Prudence) that "Virtue is its own reward". But this is clearly not enough in today's commercial world. Whilst a person acting against any moral incentive should feel guilt, face condemnation from peers and exclusion by certain colleagues or even ostracism from a community, a firm's culture has often been a key determinant in terms of the consequence management and severity of punishment received by that individual. If the tone from the top is to make compromises whenever expedient to do so, it will seep into other areas such as incentives and rewards, discipline and accountability.

Outside of banking and financial services again, the allegations against Weinstein and Green have *inter alia* further highlighted the necessity to consider what is appropriate in terms of boundaries, controls and use of incentives; as well as what is unacceptable in terms of a firm's culture and behaviour.

The importance of SM&CR as regards to incentives

SM&CR goes much further in the FCA's attempts to monitor, prevent, detect and investigate the kind of behaviour and culture conducive to a profits-before-good-customer-outcomes approach (especially SM Conduct Rule1 – Effective Control). Properly implemented, the regime will magnify the necessary scrutiny and focus required by firms as regards to culture, integrity and behaviours of customer-facing staff. SM&CR places an even greater focus on the importance on firms and staff integrity and inculcating a mantra of doing the right thing (even when no one is looking) - in an almost biblical evocation of doing unto others as we would have done unto ourselves.

Andrew Bailey in his 2018 speech states *"The role of regulation in culture is… to use rules and supervision to create the right incentives and to provide tools to diagnose the key characteristics."* Continuing on the key role played by the regulator he adds *"The Senior Managers Regime and measures to govern the payment of remuneration are important developments in creating incentives for good culture."* And finally, he endorses *"that culture is about encouraging and incentivising good things, not just stopping bad things from happening."*

Issues that firms have

Reports indicate that St James' Place (SJP) Financial Advisers are cancelling the "lavish incentive" of an annual cruise holiday. Partners/advisers are said to be so dis-incentivised that they have threatened to stop selling investments for the remainder of 2019 unless compensated for the loss of their trip. There are as yet no reported plans to compensate. CEO Andrew Croft maintains a firm stance and a SJP spokesman added that *"rewards and incentive programmes should be proportionate and balanced for supporting positive client outcomes… so that we are the company we want to be in the future"*. (City Am– 13 October 2019).

The issues with such 'stepped' incentive schemes is that it can create an elite circle within a firm whose members will behave differently from others because of the size, scale and nature of their reward relative to that of others. Firms must carefully monitor advisers at the foot of the bonus 'step' who are tempted to do what it takes to join the 'club' as well as adequately and appropriately incentivising and compensating those in non-revenue-generating, but nevertheless important support functions who can never be in the elite club.

Conclusion

The Remuneration Code, the Senior Managers Regime and specific FCA Handbook provisions (found in SYSC 19A- 19F) enforce the need for firms to have adequate and robust controls in place to manage incentives, rewards and bonuses. Andrew Bailey has further emphasised that the "role of reward… is... to create the right incentives for good culture." Properly used, incentives can bring about and sustain positive behaviour and culture in firms leading to better customer outcomes, motivated staff, businesses that consistently perform well and enhanced public trust in financial markets, products and services.

That's the theory at least, but the SJP story is a timely reminder to firms to be circumspect in their incentive-making; the Neil Woodford saga equally reminds us of the need to be vigilant with our investments and take more individual responsibility and the regulator should perhaps do more as regards to publishing more examples of incentives best practice.

In Tech Check we address aspects of technical knowledge that you need to keep abreast of and that will enable you to have better conversations with your clients.

Contracts for difference - Why the restrictions?

What is a "contract for difference" or "CFD"?

In the realm of finance and investments, instead of being offered an actual underlying instrument such as an equity or fixed income instrument one can be placed into a contract for difference or "CFD".

These should be regarded as nothing less than a leveraged product.

With a small initial investment, there is potential for returns equivalent to and in excess of that of the underlying asset. Note we have underlined the word potential as with any investment nothing is assured. Markets can go down as well as up. However, when leverage is invoked, one can be sure that the risk factor is magnified and danger can ensue.

For the professional trader, even a well skilled private player, this would appear to be an obvious investment instrument. However, one should restate the age-old mantra of caveat emptor or buyers beware.

The superficial advantages of CFD trading all too often masks the associated risks, as shown in Figure 1. Below we highlight the key risk considerations that have led the Financial Conduct Authority (FCA) to confirm new rules restricting the sale, marketing and distribution of CFDs and CFD-like options to retail customers.

Figure 1: The Several Levels of Interdependent Risk Associated with CFDs
Source: Spotlight Ideas

Counterparty Risk (CPR)

The counterparty is that institution acting as the provider of the asset in a financial transaction. In trading a CFD, as buyer or seller, the actual asset traded is the contract issued by the CFD provider.

Therefore, this creates an exposure of the investor to the provider's other counterparties, including other clients the CFD provider conducts business with. So, the risk is far more opaque than the simply buying a vanilla equity from a market maker.

The associated risk associated with these counterparties is founded on the probability that they fail to satisfy their financial obligations. The consequence being, that if the provider proves unable to meet these obligations then the value of the underlying asset becomes irrelevant.

Market Risk (MR)

CFDs are clearly a member of the derivative family and if one believes the underlying asset will rise, the investor will choose a long position. Of course, it naturally follows that an investor will opt for a short position if they believe the value of the asset will decline in value.

Markets only exist because different agents hold differing opinions as to the direction and timing of the next price movement. That implies someone must be wrong and even the most experienced traders or active investors are never correct 100% of the time.

Even a sophisticated pricing model can be blindsided by unexpected information, changes in market conditions, government policy or exogenous shocks. These can result in aggressive price changes; therefore, the leveraged DNA of CFDs finds that small changes in other variables may have a significant impact on returns.

An unfavourable effect on the value of the underlying asset may lead to a new margin call which if not met in a timely manner may result in the position being closed by force and so incurring a loss. Therefore, investors really need to be aware of what is their unique level of risk tolerance.

Client Capital Risk (CCR)

Not every jurisdiction allows CFDs, i.e. they are classified as illegal in some quarters. In the United States, for example it is not permitted to trade CFDs as an individual. However, where they are permitted one should try to become familiar with what legislation is in place to afford the investor protection from potentially harmful practices.

Legally, money transferred to the CFD provider must be segregated from the provider's money. This is a means of preventing the providers from hedging their own investments.

Be warned as the law may not be so rigorous as to prohibit the client's money from being pooled into one or more accounts. When a contract is agreed, the provider will withdraw an initial margin and has the right to request further margins from the pooled account if price moves are adverse.

If several other clients in the pooled account fail to meet their margin calls, the CFD provider has the right to seize funds from the pooled account with potential to affect returns. In short, the investor may not be comfortable with the company they are keeping in the pooled account.

Liquidity Risks (LR)

Markets are not predictable. One can have a table of times for the high and low tides of the sea, although the tide can turn quickly. In the capital markets underlying conditions can rapidly affect many financial transactions and consequently magnify the risk of losses.

When there are not enough trades being made in the market, i.e. there is a lack of volume, for an underlying asset, the existing contract can become illiquid. At this point a CFD provider can require additional margin payments or close contracts at inferior prices, (see the section on market risk above).

Markets can move quickly from extremely low levels of volatility to sudden surges. This can create the right conditions for prices of assets to gap higher or lower in an instant. They can become the victim of a "Flash Crash".

This fast flow means the market moves from being orderly to becoming "plastic" and the price of a CFD can fall before one's trade can be executed at a previously agreed upon price. This means the holder of an existing contract would be required to take sub-optimal profits or cover any losses incurred by the CFD provider.

Bottom Line (BL)

The bottom line is the investors profit and loss account (P&L). Leverage implies that for a small initial fee the potential for high returns/losses is large and we have illustrated how CFD trading can result in illiquid assets and hence severe losses.

In trading CFDs, stop loss orders are highly recommended although they can be irrelevant in plastic markets.

They are designed to mitigate the apparent risks. To overcome fast markets, one may find a CFD provider will offer a protected or guaranteed stop loss order; however, one must consider what fee is involved for such a service and determine if it is something one wishes to pay for?

When thinking about participating in these types of investments, it is important to assess the risks associated with leveraged products. **The resulting losses can often be greater than initially expected**.

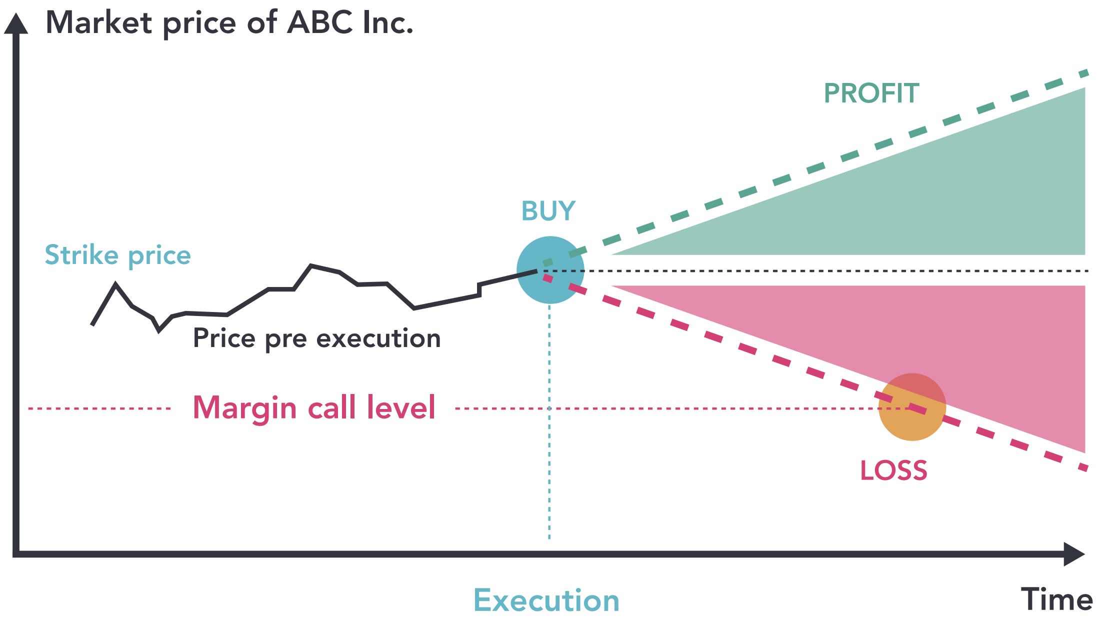

Figure 2: The Mechanism of CFD's; Losses or Profits Can Be Generated
Source: Spotlight Ideas

The price at which a CFD is trading will always match the current market price of its underlying asset. If one wanted to acquire an equity CFD of ABC Inc., then the CFD will increase in value as ABC Inc.'s equity price increases. The illustration in Figure 2 is the bullish scenario that follows the green line. In contrast if ABC Inc.'s equity price decreases (red line), then the CFD loses value accordingly and at a certain, pre-agreed level of decline a margin call will be issued.

With leverage, one can agree to exchange the difference in price of a larger amount of an asset without committing to the full cost of the position at the outset. If one wanted to open a position equivalent to 500 ABC Inc. shares in a standard long equity trade, that would mean paying the full cost of the shares. In contrast with a CFD, one could put up just 10% of the cost.

Of course, one will still exchange the difference in price of 500 ABC Inc. shares from when the position is opened to when it is closed out, so the profit and loss will still be calculated on the full size of the position.

Therefore, profits can be multiplied many times; but so can the losses even to the extent of exceeding one's original deposit. Hence the seller may demand a margin call or close one's trade at a heavily loss.

Complex trading... larger risk

Not all trades or investment strategies are based around a bull or bear view of an individual asset.

As an example, foreign exchange is based around a "pair", e.g. Euro's and Dollars, EURUSD or Dollar's and Yen, USDJPY. If one part of the pair rises the other must fall in value, i.e. this is a binary decision. The same could be arranged for equities, e.g. a long position in J. Sainsbury Plc and a short in Tesco Plc.

Pairs trading strategy works by taking the arbitrage opportunity of temporary anomalies between prices of related assets which will tend to return to a long-run equilibrium level. When such an event occurs, one asset will be overvalued relative to the other asset.

One can then invest in a two-asset portfolio (a pair) where the overvalued asset is sold (short position) and the undervalued asset is bought (long position). The trade is closed out by taking the opposite positions of these assets after the asset prices have settled back into their long-run relationship.

Figure 3 illustrates this point through the spread of French 2-Year debt over the German 2-Year in the past 4-Years. Market fears around the 2017 Presidential election created a great pair trading opportunity by working the 2-Year spread of France over Germany. At the start of this year, when French data was disappointing one could, if quick, exploit the spread movement again.

Pairs trading allows profit capture from short-term discrepancies in the two asset prices. Since the profit does not depend on the movement of the market, pairs trading can be said as a market-neutral investment strategy. However, the pattern can be broken as a relationship breaks out from an old channel by breaking over 2 Standard Deviations (2) from the running mean of the trade. Unless there is a return to the former long-term equilibrium, a new trend may have evolved and being on the wrong side of the pairs trade can become extremely costly indeed.

Two-year spread France over Germany (BPS)

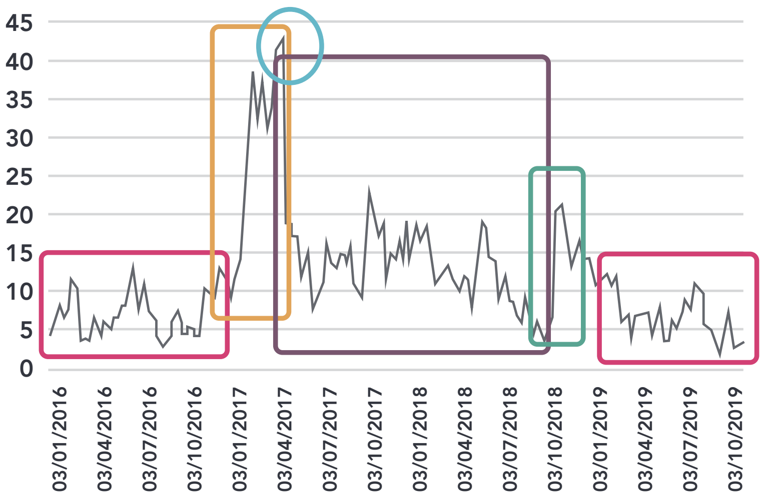

Figure 3: The Pair's Mechanism of French and German 2-Year Debt

Source: Spotlight Ideas

Key:

Long-Run Relationship Spread

Election Risk, Could Le Pen Win? Sell France Buy Germany

Macron Wins...Therefore Buy France and Sell Germany

Be Prepared to Return to Neutral

Early in 2019, French Unemployment rises and Business Confidence declines

For the investor that looks at pairs trading there are four approaches to be considered.

1. Distance approach
2. Combine forecasts approach
3. Stochastic approach
4. Cointegration approach.

If one uses CFD's positions to replicate the trade the cointegration approach may be preferable.

This incorporates mean reversion into a pairs trading framework and if the value of the portfolio is known to fluctuate around its equilibrium value, then deviations from this value can be traded against by using a cointegration coefficients weighted (CCW) rule.

The CCW rule works by trading the number of units in two assets based on their cointegration coefficients to achieve a guaranteed minimum profit per trade. The minimum profit per trade corresponds to the pre-set risk tolerance boundaries upper-bound (U) and lower-bound (L) chosen to open trades. The optimal pre-set boundary value is determined by maximising the minimum total profit (MTP) over a specified trading horizon with respect to one's risk profile.

MTP is a function of the minimum profit per trade and the number of trades during the trading horizon. The number of trades is also influenced by the distance of the pre-set boundaries from the long-run cointegration equilibrium. The higher the pre-set boundaries for opening trades, the higher the minimum profit per trade but the trade numbers will be lower. Of course, the opposite applies for lowering the boundary values.

Worrying trends

A recent innovation in the field of CFDs is the use of "copyfunds". These group together the top performing traders within an online broker's platform and allow the client to invest in them as a group.

It removes some of the risk associated with social trading and the idea is that copyfunds will diversify one's portfolio and spread the risk across many traders instead of just one or two.

Firstly, one needs to have enough capital to invest in many positions at once and the real concern is that for all the early levels of success the real leverage is generated by not just using a singular CFD.

Pairs are used and in addition they use the concept of bundling groups of CFDs together. This is said to mitigate some of the risk that investors are exposed to with a single CFD. As a word of warning, please recall the same claim being made for collaterised mortgage obligations (CMOs).

Despite prevailing legislation there is a risk that inexperienced investors may be seduced by touted returns from repackaged CFDs as Collateralised CFDs (CCFD) and even more magnificently leveraged tools:

CFD ➡ CFD Pairs ➡ CCFD ➡ $CCFD^2$ ➡ $CCFD^3$

If these instruments are based around pooled accounts one could face a squeeze at both ends of the asset structure.

Of course, all the while the wheel is spinning the markets allow CFDs, pairs and even the bundled or collaterised hybrids to generate substantial gains. However, no-one really saw the crash that began 12-years ago today causing such havoc.

So far there has been no normalisation of central bank balance sheets or rates. So, we have not escaped the skinny yields on bonds. At the moment, the vanilla asset classes appear wedded to the zero-bound. All the while this makes CFDs look attractive. However, it would be wise to adopt a modicum of caution amid the hubris.

Skills & Expertise

Personal development is often forgotten or neglected, as it is not seen as important as the other areas of CPD. In reality it can be the aspect that makes the real difference to your clients and your earning capacity. In each edition of Advice Matters we will discuss potential development areas and ensure any regulator focus that aligns to this area is covered in a very timely manner.

Hedging your bets

Imagine the scene. You have supported Leicester City all your life and being an eternal optimist always have a bet at the start of the season on them winning the league. Except this year is different, they are in the Premier League for the second season running, having secured promotion the season before last. It was a painful season for much of last year, the club being marooned at the bottom of the table for four-and-a-half months between late November and mid-April, however in the end the Foxes managed to put together a run of seven wins from their last nine fixtures to survive comfortably.

So you have a punt and take the odds offered at 5,000-1.

Your £50 would win you £250,000 if the unthinkable happens and then as the season progresses your dream starts to become a reality. Wind the clock forward to March. You fear that your team cannot keep this run going; after all you have seen it all before. City, Arsenal, Chelsea and Spurs are all chasing the Foxes and you fear that your dream is about to become a nightmare. What do you do?

This is where you may want to hedge your bet. You could give up some of your potential profits to bet on the other clubs. That way you are guaranteed at least something whatever happens. But how much do you bet on the other teams and what are you prepared to give up of your winnings to ensure you are guaranteed to come away with something as opposed to nothing?

A hard decision, but one that hedge fund managers have to make on a frequent basis. For example, absolute return funds aim to make money in any market conditions, not an easy task and unlike the scenario above one that is not guaranteed to succeed.

What is a hedge fund?

In fact, the term hedge fund has no precise legal definition and is construed widely.

Generally, the term hedge fund describes a fund that can use a wide range of investment strategies, many of which may not be permitted for authorised schemes.

It is important therefore to understand the various strategies available to hedge fund managers and to appreciate how the strategies may be used to deliver returns to prospective investors.

The popular misconception is that all hedge funds are volatile, that they all place large directional bets on currencies, commodities, bonds and shares, whilst using lots of leverage (borrowing to enhance potential returns). In reality, many hedge funds do not use leverage at all and use derivatives sparingly to hedge out a potential risk or do not use them at all.

According to the Hedge Fund Association, hedge fund returns over a sustained period of time have outperformed standard equity and bond indices with less volatility and less risk of loss than equities.

So what is so good about investing in hedge funds?

Many hedge funds aim to produce positive absolute returns in any market conditions. This is attractive from an asset allocation standpoint since the correlation of returns with traditional long only funds should be low resulting in diversification benefits.

In other words, whilst long only funds will thrive only in bullish markets, some hedge funds may adopt a bearish stance to benefit from falls in the market or non-directional strategies that aim to produce positive returns whether the market goes up or down.

Hedge funds can therefore, despite their reputation, reduce risk within a portfolio in much the same way as other non/low-correlated asset classes, for example gold or property.

How much is needed to invest in hedge funds?

Hedge funds used to be the province of the super rich; typically the minimum investment amount was £1 million. However, some newer funds have a considerably lower entry level making them more assessable to the average investor.

Indeed, investors can gain access to hedge fund strategies via retail funds with minimum investment amounts of as little as £500.

It is not uncommon for the hedge fund manager to be personally invested in the fund he or she is managing. For some investors this could be a source of comfort, i.e. the interests of the fund manager and investors are aligned. However, the more cynical could observe that the hedge fund manager could afford to lose more than the average investor.

It is certainly true that successful hedge fund managers can make a great deal of money. A typical charging structure would involve a 2% annual management fee and a performance/incentive fee of 20% relating to realised profits. In reality, these percentages can vary but are often between 1% and 3% annual management fee and between 15% to 30% incentive fees. It is worthy of note that there is no performance penalty for incurring losses.

To slightly ameliorate that fact most hedge funds have a high watermark provision stipulating that performance fees are only payable once the fund reaches that point. Once performance fees have been triggered, the high watermark is reset to the highest month-end asset value of the fund.

The size of these performance fees is the subject of much debate. On the positive side, they represent a real incentive to deliver positive performance and therefore align the interests of both the investor and the fund manager. However, the counterpoint is that it could encourage the fund manager to take excessive risks particularly in view of the fact that no penalties are imposed for negative growth of the fund.

What other facts should investors be made aware of?

Since some of the strategies adopted by hedge fund managers may take months or years to come to fruition, there is often a necessity to lock in investors and typically these periods are from 1 to 3 years. Even after the lock in period, there may also be provisions where exits can only be permitted within pre-specified windows.

Another consideration with regard to hedge funds investment is the location of the fund. Many hedge funds are based offshore in tax havens. Whilst this may be beneficial to certain non-domiciled UK investors, the lower standard of regulation and disclosure requirements could put off many potential investors.

So what are the main types of hedge fund strategies?

You can broadly sub-categorise hedge fund strategies into two – directional and non-directional.

Non-directional strategies

There are many types of non-directional hedge funds strategies.

Relative value - with this strategy the fund manager aims to exploit the relative values of two securities as opposed to taking a view as to the direction of either security. For example, there could be two mining companies, company A and company B, about which the fund manager has contrasting views. If he believes that company A will outperform company B, then he could buy shares in company B and short shares in company B either by borrowing stock or using derivatives such as put options or contracts for differences.

If the market goes up, then he will make a profit so long as company A goes up by more than company B. Alternatively, if the market falls, he will still make profit as long as company B falls by more than company A. As you can see from this example, market shifts should have a minimal impact since it is the relationship between the two companies that is the important factor.

Arbitrage - the concept of arbitrage is that you can profit from buying something in one market (or form) and selling in another. There are various ways fund managers try to exploit arbitrage opportunities, for example fixed income arbitrage or convertible arbitrage. With the former, fund managers will look to exploit inefficiencies in yield curves or in corporate bond spreads (the difference in yield between the bonds of one company compared with another). This could result in the fund manager exploiting price anomalies or predicting changes in the yield curve by shorting long dated gilts and buying short dated gilts. Convertible arbitrage will seek to profit from any mispricing of convertible securities. This could involve buying the convertible stock of a company whilst simultaneously shorting the equities of that company.

Event driven - this could involve a variety of strategies including special situations, distressed securities and merger arbitrage. Briefly, special situations will look to profit from mergers, hostile takeovers reorganisations or leveraged buy-outs. Distressed securities could be corporate bonds or shares in companies that are in financial difficulty. If the company was unable to meet its obligations, the debt securities would substantially fall in value. In such circumstances many investors would wish to dispose of their holdings at a greatly reduced price on the basis that some money is better than no money. Investors in distressed securities would take the view that the company is not in as much difficulty as the market believes.

Directional strategies

We have so far only considered non-directional strategies but there are several hedge fund strategies where the fund manager expresses the view as to the future direction of the market or a particular asset class.

These strategies could be broadly categorised into two, equity hedge and tactical trading.

Equity hedge - this strategy could involve long/ short equities and emerging markets. Whilst long/ short equities may sound familiar this is a different strategy to the market neutral strategy described above. The fund manager will seek to identify securities that are mispriced both on the long and the short side of the market. Typically, the fund will take market direction risk since their exposure may be net long, net short, or neutral at any given time and will fluctuate as market conditions change in the opinion of the fund manager.

Tactical trading - the most familiar strategy under this category would have to be global macro. Pioneered by George Soros, this strategy involves finding large-scale themes in the global capital markets, identifying trading opportunities and taking large position on broad indices and currencies. His Quantum fund was reputed to have made $1 billion from speculating on the £ when the UK had to leave the European exchange rate mechanism in 1992.

Another form of tactical trading is systematic strategies. These use sophisticated computer models to trigger buying and selling signals and generate investment decisions. These models typically follow trends after analysing factors such as the strength of momentum.

Some of these systematic strategies are known as ' black box' strategies because they use tools which the creators do not wish to disclose. This makes proper evaluation difficult for potential investors but track record and the management of risk would be primary factors to be considered.

Fund of funds

With such a variety of choice available to potential investors it is no wonder that many take the easy option of buying in a single fund which invests in a variety of hedge funds.

There are several benefits of this approach: it will achieve greater diversification, could provide access to funds which are otherwise closed to new investors and gain access to the expertise the manager of the fund of funds.

However, they could be disadvantages not least of which would be the duplication of management and performance fees, potential for the hedge fund strategies to work against each other and lack of visibility of the underlying investments (typically a fund of funds merely reports its top 10 holdings).

Conclusion – what is the key consideration for investors?

When considering hedge funds, it is very important to recognise that there are many different strategies many of which aim to achieve very different objectives. When reviewing performance therefore it is important to consider the other benefits being provided by the hedge fund, for example low correlation with other assets within the portfolio (a low absolute return would be preferable to a large negative return in times of poor market conditions).

Hedge funds can therefore be risky and may be expensive compared with long only funds. However, they can also play a part in reducing risk within a portfolio when used intelligently and appropriately.

Back to the football

Going back to the story at the beginning. It was a real-life example. In March the punter was offered £72,335 to cash out by Ladbrokes, the firm he had the bet with. He took it and then went on to watch his team win the league with games to spare. Still a very tidy profit but not as good as the cool £250,000 he could have won. Please remember the value of your investment can go down as well as up! Anyone got a bet on Leicester this year ?

Links to FCA documents

November 2019

Relevant consultation papers (CP), policy statements (PS), guidance consultations, finalised guidance, press releases, speeches, statements, news stories, and discussion papers

Reference	Title	Link
Speech	The future of financial services regulation	https://www.fca.org.uk/news/speeches/future-financial-services-regulation-uk
Statement	UK's exit from the EU delayed	https://www.fca.org.uk/news/statements/uks-exit-eu-delayed
News	Policy development update	https://www.fca.org.uk/news/policy-development-update
Speech	Meeting the pace of technological change	https://www.fca.org.uk/news/speeches/meeting-pace-technological-change

Learning outcomes

By reading this edition of Advice Matters and applying the learning you will be able to:

Understand how the use of incentives in financial services has changed
Clarify the regulator's view of financial incentives
Confirm the MiFID II incentive requirements
Discuss the correlation between SM&CR and incentives
State what a CFD is
Understand the restrictions around CFDs
Be aware of the risks associated with CFDs
Explain the CFD investment considerations for clients
Consider the principles around hedge funds
Clarify the main type of hedge fund strategies
Explain the concept of arbitrage and relative value

The ApEx standards

The ApEx standards addressed in this edition of Advice Matters are:

Core or specialist subject	Learning outcome	Indicative content
FSRE	The UK financial services industry, in its European and global context.	• Impact of the EU on UK regulation
FSRE	Regulation of financial services.	• The role of EU regulations and directives
FSRE	FCA's responsibilities and approach to regulation.	• Main principles and rules of the FCA handbook
IP&R	Merits and limitations of the main investment theories.	• The key features of the main investment theories • Portfolio theory, diversification and hedging
IP&R	The nature and impact of the main types of risk on investment performance.	• Risks relating to liquidity and access • Risks relating to income and capital growth • Short-term investment volatility • Long-term investment performance
IP&R	Characteristics and behaviours of investment products	• Types, uses and structure of derivatives • Types, uses and structure of investment strategy based products

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