MONEY

WORTH THE NOTES
SOPRANO CHLOË AGNEW HAS NO REGRETS FORKING OUT FOR CONCERTS
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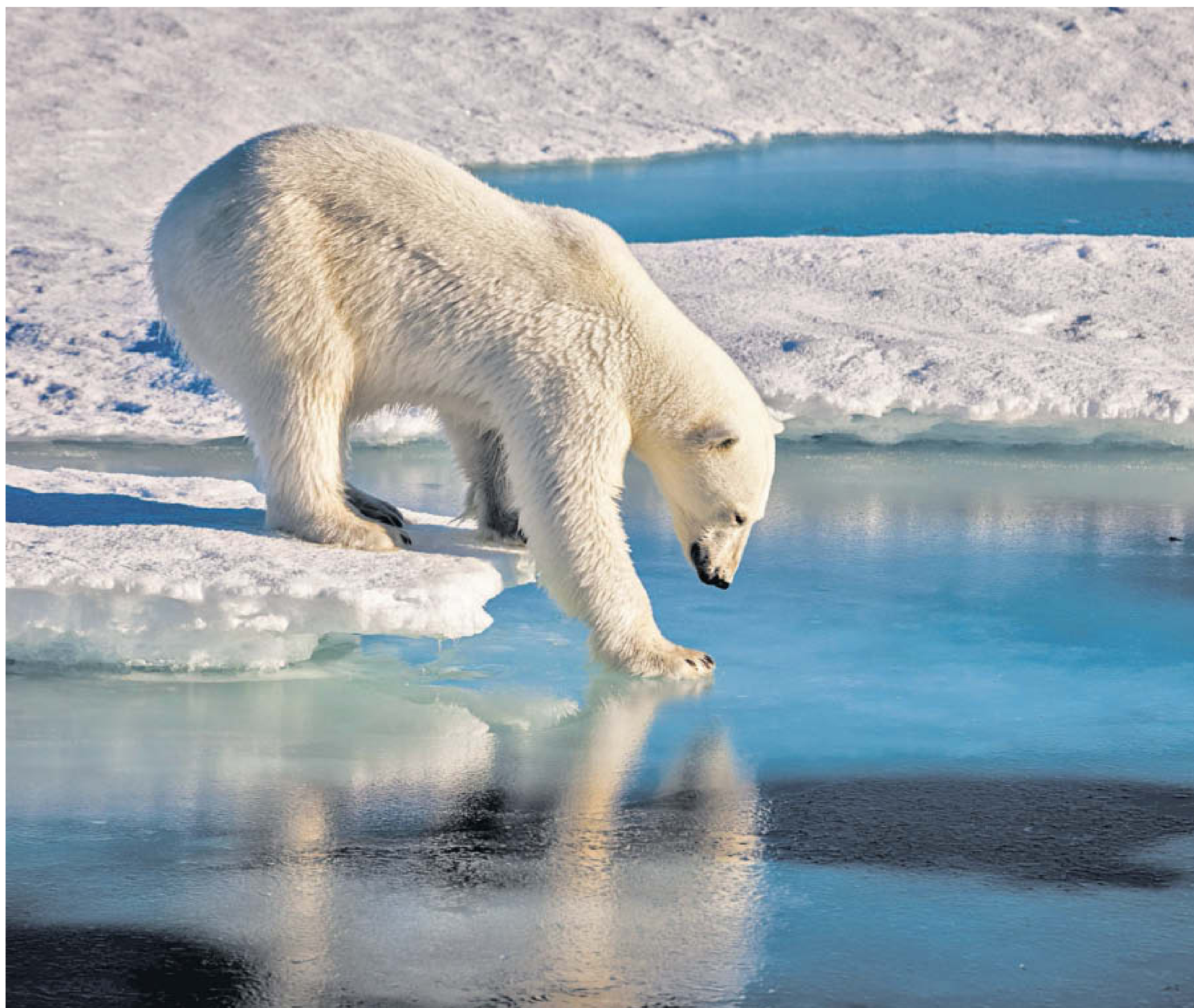
Kids testing the water before the big plunge

Since January, investors have had key information documents aimed at making it easier for them to compare products. How are they bearing up, asks *Eithne Dunne*



Key information documents were introduced by the EU to make the system less complex for people, like this polar bear, who are considering having a dip

If you have recently inquired about investing spare cash instead of leaving it on deposit, you might have some key information documents (Kids) floating about your house.

Since January, all providers of packaged retail investment and insurance products (Priips) have been obliged under EU law to give potential investors these documents before they commit to a particular product. A Priip is any product offered by banks and other financial institutions as an alternative to deposit accounts. This means anything that is exposed to stocks or bonds, provides return and comes with risk – principally, investment products and insurance-based investment products. Pensions are not covered.

The legislation seeks to tackle the fact that the information provided by banks and life companies can be complex for ordinary investors, and therefore difficult to use for comparisons across products. The aim is to make it straightforward for an investor to look at several products and clearly see how they compare on cost, risk and potential reward.

Each Kid must be no longer than three A4 pages and include clear information under prescribed headings. It must show the risk/reward profile of the product – that is a risk rating and various potential performance scenarios – and a breakdown of costs.

This is the first time that companies selling these products have had to lay out all costs involved. In the past, the only charge they were obliged to specify was the annual management charge – a situation that left some investors unprepared for subsequent costs.

While Kids have been welcomed in principle, there is a strong sense they have missed the mark when it comes to making it easier for the ordinary investor to compare products.

"The whole idea was to simplify investing, and that's a noble objective," says Eamon Porter, principal of Aspire Wealth Management. "However, it reminds me of the saying 'a camel is a horse designed by a committee'. It has been designed by bureaucrats and is causing problems across Europe."

According to Steven Barrett, managing director of Bluewater Financial Planning, the intention was good but the execution has been poor.

"Kids cause a lot of confusion and require a lot of explaining from advisers. It took me a while to figure out what they meant, and there was a lot of going back to the providers and talking to actuaries," he says.

While all providers have made Kids available, they are not all on the same page when it comes to certain assumptions, and the inconsistencies in their approach make it difficult for investors to evaluate products.

Risk rating

The first section on a Kid shows the summary risk indicator or risk rating of the relevant product. This may not be the same as the rating on the product's fact sheet on the provider's website, because Kids must use the European Securities and Markets Authority scale.

According to Paddy Delaney, creator of the Informed Decisions financial planning podcast, this has given an element of consistency across products.

"Different product providers have different risk ratings, but the Kid has forced them to map these onto a standard scale," he says. "That way, even though a product may have one rating on the Kid and another on the company's fact sheet, it will be on the same scale as all other providers on the Kid, and should make it easier to compare products with similar risk profiles."

> **The legislation reminds me of the saying 'a camel is a horse designed by a committee'**

Performance scenarios

In the performance scenarios section, the provider gives estimated potential returns – after charges – over several periods, including the recommended holding period. This is done across four hypothetical scenarios.

Experts say this section is of limited usefulness, given that figures are usually based on performance and volatility over the previous five years. They may not be a reliable predictor, and run counter to the rider of past performance not being a future guarantee.

Delaney says there is merit in the scenarios, with the worst-case or stress ones providing a reality check for investors by reminding them they could lose a significant portion of their money.

"In my experience, not all investors understand that possibility when investing in various products," he says.

These scenarios are difficult to understand, according to Porter, and different providers use varying investment periods, making comparison difficult.

"Some will show possible scenarios if you cash in after one, four or seven years; others after one, three or five. How can you compare those?" he says.

Costs

This section shows the annual percentage reduction in yield (RIY) an investor can expect, based on the various costs they will incur. Costs are broken down into one-off (entry and exit costs), ongoing (portfolio transaction costs and annual management charges) and incidental (such as performance fees).

The first of these is causing the most consternation among advisers and investors. For example, one-offs such as the 1% government levy are amortised or spread across the recommended holding period, which can vary across products.

Your Kid might say entry costs will mean RIY on your investment of 0.14%-1.08%. The first figure represents the government levy spread out over the recommended holding period of that product – seven years, in this example – but different products may show another figure. Remember, entry costs, including this levy, must be paid up front.

"Where total entry cost is, say, 1% and that figure has been amortised over six years, it will show up as 0.16%. In fact, if you put in €100,000 you'll have €1,000 taken out up front," says Barrett.

RIY caused by commission is not clearly defined, as different providers make varying assumptions about the level of commission taken by an adviser.

"Some Kids assume that no upfront commission is paid to the provider, whereas others assume the investor is paying 2%-4%," says Delaney. "On some Kids, only the government levy is broken down over, say, seven years, while on others entry costs will average 0.5% a year for seven years, which probably represents the government levy plus the commission. This makes it difficult to compare one-off costs."

Kids make it easier to compare ongoing costs, but there still is no clarity on the one-offs, according to Delaney.

"I've seen cases where the annual RIY is 3.5%. If someone invests in a conservative portfolio that's expected to deliver 4%-5% returns per annum after costs, they'll struggle to make any return on that," he says. "By the time you take tax off the profits, it's no better than a deposit account. I'd encourage investors to seek clarity on this before committing."

What to do?

Make sure you get Kids for all products you are considering, but do not base your decision solely on the figures and ranges on them. Ask for more specific detail on the commission and costs that will apply.

The best chance of comparing like with like is to ask your adviser for the factory-gate price, says Porter.

"That's the pure cost of the product including the government levy, but before distributors such as brokers or tied agents apply commission/fees. That is in essence what the Kids tried to do, but didn't," he says.

MARKET MOVER ANDREW PAISLEY

Andrew Paisley is investment director, equities, at Aberdeen Standard Investments. Among his responsibilities is the European Smaller Companies Fund. This aims to provide long-term growth by investing in shares of smaller companies listed on European stock markets, including the UK. The minimum regular pension saving amount for retail investors is €25 per month through a PRSA (personal retirement savings account), the minimum regular investment saving amount is €125 per month, and the minimum lump sum is €10,000.

Fund philosophy

The fund was launched in 2007 to provide investors with access to the growth potential of high quality smaller companies across Europe.

"Europe's economic woes have been well-documented and many investors have overlooked the region as an opportunity, particularly for smaller companies," says Paisley. "We target quality companies that have solid, non-speculative growth. We use a rigorous selection process to focus on 40 to 50 companies with good growth and momentum."

Performance

The fund has been performing well, recently and over the longer term. This year it delivered an absolute return of 7.7%, outperforming European Small Caps by 3.1% and European Large Caps by 5.6%. "Over the past 10 years the fund has delivered 276%, outperforming the smaller companies index by more than 100% and the large cap index by more than 200%," says Paisley.

Buying and selling

One stock recently added to the fund is French scent maker Interparfums. This is managed by the founder of the business, who is also the biggest shareholder in the group.

"We like this degree of tenure and 'skin in the game' as it shows strong alignment with the interests of shareholders," says Paisley. "The business has an excellent track record of investing in perfume brands. The group is benefiting from a strong reputation, giving it the opportunity to develop new perfumes under brand licence. We believe the market underestimates the growth potential from increased investment. This is a business that clearly meets our quality growth and momentum criteria."

The fund recently sold out of British polymer manufacturer Fenner — a holding it bought about 18 months ago — as it develops its polymer business for the seals and medical markets. "Michelin announced a takeover for the group at a circa 30% premium. We believe this is a good home for the company."

Outlook

Paisley is positive on the outlook for smaller companies generally, given the good recovery in Europe. "With valuations in some market segments stretched, investors are right to question whether sentiment could soon sour," says Paisley. "Evidence points to the contrary. At corporate level, above-forecast results and upbeat trading statements from our holdings tell a positive story, particularly for France and Germany."

"While previously, executives expressed caution over Europe's recovery, their tone is now one of optimism. This is reflected in a greater willingness to invest, with planned capital expenditure rising and M&A activity picking up."

Gary Connolly

Compound interest means it's best to invest early

In November 1626, Peter Minuit of the Dutch West India Company purchased Manhattan from Native Americans for some beads, cloth, and trinkets worth about 60 Dutch guilders, the equivalent of $24 at the time.

When people hear this story they say the Dutch swindled the natives, paying them a pittance for what is now the epicentre of world finance, the richest and most famous of the boroughs that comprise New York City. But was it really such a bad deal?

When we consider money we tend to think of it in nominal terms – the euros and cents in our accounts. But what if the Native Americans had invested the money and earned a reasonable return – what would it be worth today?

There's a simple rule in maths called the rule of 72, which computes how long it takes for a sum of money to double. So you divide 72 by the rate of return, and the answer is how long it takes for it to double. So at a 7.2% pa rate of return, the sum doubles every 10 years (72 divided by 7.2).

So in 1636, the Native Americans would have had $48 at this rate of return; $96 in 1646 and so on. Every century then, you get roughly 10 doubles, or 1,000 times the sum – add three zeros (it's actually 1,024, but the maths is easier if we simplify).

So in 1726 they would have had $24,000. In 1826, $24m. In 1926, $24bn. And in 2026, it would be $24 trillion. We haven't reached 2026 yet, so if we take one double away and its 2016 equivalent would be $12 trillion.

The total net worth of the entire United States is estimated at $123 trillion, according to Wikipedia. I don't know what Manhattan is worth, but it's unlikely that 20 sq km of America accounts for a 10th of the country's wealth. So maybe the native Americans didn't get such a bad deal after all.

The long-term return on the US stock market has been about 10% per annum going back to 1900, according to several sources. Maybe future returns will be lower, who knows. The rate of return we can quibble about, but the central point here is that compounding is one of the most important ideas to be fanatical about.

> **97.6% of Buffett's worth is tied to his teens**

One person who discovered the importance of this at a very early age and was completely obsessed by it was Warren Buffett. At age 11 he said he wanted to be a millionaire by the age of 30. And that he did achieve.

Buffett today is worth an estimated $81bn. In a thought experiment, Morgan Housel wonders what if Buffett had got serious about investing when he was age 22 instead of age 11? If, at age 30, Buffett had been worth $24,000 instead of the $1m he had actually accumulated, and went on to earn the same returns, he would be worth $1.9bn today; 98% lower than his actual net worth.

The punchline is that 97.6% of Buffett's worth can be directly tied to the base he built in his teens. As Housel says, "Without the capital base he built before he could grow a beard, you'd probably never have heard of him."

As the father of 11-year-old twins, I've struggled to create a sense of fanaticism about compounding in my own children. Though I have to admit that I believe a lot of this to be innate anyway – we can help at the margins in terms of nurturing but most of it comes from within.

A nice idea proposed by one of my work colleagues is to promote the idea of saving by having three jars for money; one is a savings jar, one a spending jar and a third for charity. They agree a split between each and then apportion money earned (or given) between them. I've let early enthusiasm for the idea wane a little, but initially found it to work quite well.

Whatever route one takes, I think the important part is the initial decision and action, the earlier the better. Some historians claim that the Native Americans with whom Minuit made the deal were actually from Long Island and never owned the island of Manhattan. Selling something you don't own is another, less honourable approach to making a fortune.

In the interests of staying on the starboard side of the law, however, the stock market has proven to be a very powerful (and legal) way to compound wealth.

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