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Part 1: Indirect investments – unit trusts, OEICs and investment trust companies

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Learning objectives

After studying this chapter, you should be able to:

- describe and analyse the characteristics, inherent risks, behaviours and tax considerations of unit trusts, OEICs, offshore funds and investment trusts;
- explain the advantages and disadvantages of direct investment in securities and assets compared to indirect investment through collectives and other products.

Introduction

In this chapter (which is in two parts) we will discuss, in detail, the characteristics of a range of indirect investments, looking at characteristics such as their tax treatment and risks.

At the end of the second part of the chapter, we will examine the advantages and disadvantages of direct investment in securities and assets compared to indirect investment through collectives and other products.

Key terms

This chapter features explanations of the following ideas:

Portfolio diversification	Collective investments	Unit trusts	OEICs
Investment trusts	Open-ended funds	Retail/non-retail	IMA performance categories
UCITSII and III	COLL	Approved securities	Unit trust manager
Unit trust trustees	Equalisation	Income allocation and distribution	Buying/offer price
Selling/bid price	Forward or historic pricing	Charges	ACD
Depositary	Single pricing	Multi-manager products	Offshore funds
Reporting and non-reporting funds	Closed ended funds	AIC classifications	Capital structure
Classes of shares	Gearing	Dividends and taxation	Offshore investment companies

A Indirect investment products

In a collective or packaged investment scheme investors participate in a large portfolio of securities or other assets with many other investors

In a collective or packaged investment scheme such a **unit trust** or **open-ended investment scheme (OEIC)**, investors participate in a large portfolio of securities or other assets with many other investors:

- each investor has a direct investment in the scheme that holds and manages the underlying investments and, in a unit trust, beneficial ownership of these investments;
- the value of the collective investment in the scheme will depend upon the value of the underlying assets;
- for unit trusts and open-ended investment companies (OEICs), the values are required by regulations to be based on the value of the underlying assets.

With collective investments such as investment trusts or with-profit bonds, the link is less direct. Investment trusts are covered in section G and with-profit bonds in section H (in Part 2 of this chapter). Collective investment schemes in general are popular with investors because:

- they offer a good way to invest small sums of money, because the investor's cash can be 'pooled' into a much larger fund;
- professional fund managers make the underlying investment decisions;
- an investor can achieve a balanced portfolio at a modest cost because the fund managers will invest in a spread of investments;
- they offer the ability to pursue particular objectives or specialise in particular markets that an investor might otherwise avoid, e.g. income or growth funds, Far Eastern funds; and
- the individual investor's risk is reduced by the wide spread of investments in the underlying portfolio.

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Pooling of resources

The pooling of resources enables the scheme to invest in a wide spread of investments at a lower cost than could have been achieved by individuals acting on their own. Investors buy and sell units or shares in the scheme and not the underlying investments of the fund.

B Units trusts and OEICs: general characteristics

Unit trusts and OEICs are very popular collective investments and are often referred to as **funds**. They have the following characteristics:

- they allow the individual investor to participate in a large portfolio of shares with many other investors;
- units or shares are sold to investors, each unit representing a small but equal fraction of a portfolio of perhaps 50 or 100 different share holdings;
- the assets of a unit trust are held for investors by trustees, hence the name ‘unit trust’, and they are invested by managers;
- the assets of an OEIC are held by an independent depositary; and
- there is generally an initial charge which covers setting up costs and also an annual management fee. Where a fund does not have an initial charge, an exit charge may be applied.

There are many different types of fund:

- very general funds, covering most markets and types of security;
- very specific funds that concentrate on a particular market sector or type of security;
- some unit trusts aim for a high income;
- some trusts look for above average capital growth; and
- the many so-called ‘balanced’ funds may look for a mix of both capital growth and income.

Unlike investment trusts, unit trusts and OEICs are **open-ended**. Units or shares can be created or issued when investors invest and cancelled when investors dispose of their holdings by selling them back to the fund manager. There is a direct relationship between the unit or share price and the value of the underlying investments.

Unlike investment trusts, unit trusts and OEICs are open-ended

Regulation

The Financial Services Authority (FSA) regulates the sale and marketing of unit trusts and OEICs.

B1 Unit trust and OEIC sectors and categories

The first unit trust was set up in 1931 and by the end of 2010 there were 2,406 investment funds with over £577 billion in assets, managed by over 100 different groups. To allow investors to select a fund and make effective comparisons, unit trusts and OEICs are categorised within a fund classification system of over 30 sectors. Each sector is made up of funds investing in either similar assets, the same stock market sector or in the same geographical region.

First unit trust was set up in 1931

- The sectors are determined by the **Investment Management Association** (IMA) in consultation with its members.
- Performance measurement companies such as Standard & Poor’s, Micropal and Lipper Ltd, rank the performance of funds in each sector. The data is published in a range of weekly and monthly trade publications.
- The general yardstick for inclusion in a particular sector is that the fund must have at least 80% of its assets invested in the associated sector.
- To qualify as an income fund, the fund must aim to produce a yield around 10% above the yield on the relevant market as a whole.
- The criteria for membership of a particular sector are constantly reviewed in the light of market developments and the launch of new types of funds.

IMA performance categories

The IMA categories are divided into five broad areas:

- funds principally targeting capital protection;
- funds principally targeting income (by asset category);
- funds principally targeting growth/total return (by asset category);
- specialist funds; and
- unclassified.

Activity

Visit the IMA’s website: www.investmentuk.org/statistics and familiarise yourself with the categories and sectors.

Note that the FSA authorises funds to be marketed publicly and— for regulatory purposes— originally defined nine types of scheme. Most funds were classified as 'securities funds' but among the other types are: funds of funds, money market funds, feeder funds (for pensions) and umbrella funds. (The FSA fund categories should not be confused with IMA's performance categories.) The FSA adopted new rules effective from 1 November 2002 – which, subject to transitional provisions, group the nine types into 'UCITS schemes' (mixed funds) and 'non-UCITS schemes'. Further changes to FSA rules, effective from 1 April 2004, classify funds as 'retail' or 'non-retail'. The latter are described as **Qualifying Investor Schemes or QIS (see appendix 1 for characteristics of Retail and QIS)**.

B2 Investment strategy

The IMA sector classifications give only a broad guide to the fund's investment activity and philosophy. Within each sector, there may be funds which invest in smaller companies, recovery situations, 'mid-cap', blue chip, ethical investments, index-tracking funds and so on.

- **Index-tracking funds**

'Index-tracking' funds aim to mirror the performance of a particular index as closely as possible

'Index-tracking' funds aim to mirror the performance of a particular index as closely as possible. Index trackers may follow the FTSE 100, the FTSE All-Share, the S&P 500, the Nikkei 225, or any other index. If the fund is large enough, the managers may be able to replicate the component shares of the index exactly; alternatives to this include sampling (stratification) and the use of a computerised model (optimisation). Some managers seem better able than others to emulate the movements of an index. Supporters of index-tracking would argue that:

– relatively few managers consistently outperform the index against which they measure their performance;

– outperformance by active managers is generally achieved by taking higher risks;

– index-tracking funds generally make lower charges than actively managed funds;

Other points worth noting are:

– as mergers increase the size of the largest companies, index-tracking naturally concentrates the portfolios. For example, as at May 2010 the UK's top ten largest companies accounted for 46.5% of the FTSE 100 and 39.6% of the FTSE All-Share;

– some mergers and takeovers caused problems for UK trackers as before 1 November 2002, they were restricted due to regulatory limits of no more than a 10% holding in any one stock. FSA rules now allow single holdings of up to 20%, and, in exceptional market conditions, 35%, for UCITS schemes established as replicating tracker funds.

- **Ethical funds**

There is no specific IMA categorisation for ethical funds, which mostly fall into the UK All Companies or Global sectors. The funds' investment strategy has tended to divide between those that use negative screening criteria, e.g. no arms companies, and those that adopt positive criteria, e.g. selecting companies in environmentally friendly industries. The levels and exact criteria for screening are far from homogeneous, e.g. the attitude to genetically modified foods varies between funds.

The screening process has tended to drive ethical funds away from many large capitalisation stocks. As a consequence some funds are now considering a neutral approach, i.e. allowing investment in companies that are neither positively harmful nor positively beneficial, or more positively, in what are known as 'socially responsible companies'.

Activity

EIRIS (Ethical Investment Research Services) is a leading global provider of independent research into the social, environmental and ethical performance of companies. Visit their website at www.eiris.org and use their 'Green and ethical Funds Directory' to review a sample of funds and the approach they use to selecting investments.

B3 Regulation

In response to UCITS II (the 'Product Directive') the FSA made two important changes:

UCITS II (the 'Product Directive')

- Since November 2002 funds have been allowed to use the word 'guaranteed' in their title only if they offer 100% capital protection for all investors. This must be by means of a legally enforceable guarantee with a regulated third party, i.e. a bank, which indemnifies the fund in the event of an investment shortfall at a given date. Where no guarantee exists, but the fund is adopting an investment policy to provide protection, i.e. using derivatives, the fund may use the word 'protected'.
- The FSA now allows 'limited issue funds' that may cap the number of units or shares issued to investors. The criteria for capping can involve a single issue of units or shares (which are only available for purchase during a fixed offer period) or a monetary limit on the amount that can be raised from investors. There would however, be no restrictions on redemptions.

The FSA now allows 'limited issue funds' that may cap the number of units or shares issued to investors

The intention is to allow funds to be managed more efficiently, particularly in less liquid markets (such as smaller companies and emerging markets) where their investment strategies might be compromised by an excessive inflow of new money.

Further changes were implemented by UCITS III (the 'Management Directive'), and a new FSA collective investment schemes rulebook (COLL) was issued in April 2004. This set out the framework for the authorisation and operation of authorised investment funds (AIFs) in the UK. AIFs are both authorised unit trusts (AUTs) and open-ended investment companies (OEICs). Under COLL, AIFs are permitted to undertake a wider range of investments and investment strategies, including the use of derivatives and short-selling.

UCITS III (the 'Management Directive')

B4 Investment risks

The risks involved vary according to the objectives of the fund:

- A gilt fund is relatively secure because of the government backing for gilts; additionally because gilts are not generally volatile, although they can sometimes move sharply in times of changing interest rates.
- A specialist fund such as a mining fund may be considerably less secure because of the inherent volatility of the underlying shares. However:
  - the wide spread of investments held in the fund should mean that investors will be protected against the consequences of one individual share becoming worthless if a company fails; and
  - the wide spread of holdings also reduces the effect on the portfolio of dramatic gains being produced by the success of one individual share.

B5 Investment powers and restrictions

A range of rules restrict the investment powers of authorised funds. These are designed to ensure that each fund has a proper spread of investments and that the investments are realisable on demand.

A range of rules restrict the investment powers of authorised funds

- The Financial Services Authority's Collective Investment Schemes Rulebook (COLL) sets out the rules for establishing and operating authorised schemes in the UK, including the spectrum of markets and types of securities in which funds can invest. All must be freely transferable securities, i.e. without restriction or requiring permission.

General limits for an individual fund

The general limits for an individual fund may also be laid out in the trust deed of a unit trust, to be monitored by the trustees and in the instrument of incorporation of an OEIC, to be monitored by the depositary.

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- The trust deed must contain a statement that the fund may invest in any securities or derivatives market which is eligible under the FSA regulations. No other investment limits need be contained in the deed unless it is intended that the fund should be subject to narrower investment powers than those set out in the regulations.
- The detailed investment limits must be set out in the scheme particulars or prospectus of the fund and must be no wider than the restrictions set out in the FSA regulations. The trustee or depositary therefore monitors the investment limits to ensure the fund is being managed in accordance with the trust deed instrument of incorporation, the scheme particulars prospectus and the FSA regulations.

B6 Approved securities and eligible markets

Securities that are admitted to an official list in EU Member States are 'approved securities' and managers may invest in those markets without further enquiry.

At least 90% of a securities fund must be in approved securities

At least 90% of a securities fund must be in approved securities. Markets in non-Member States and those on which securities are not admitted to official listing, must meet certain criteria to qualify as an eligible market for a particular fund. The FSA places a duty on unit trust managers and trustees, and on the authorised corporate directors (ACDs) of OEICs, to ensure that the market is liquid and meets four other standards. These are that the market must be:

- regulated;
- operating regularly;
- recognised (e.g. by a statutory body or government agency); and
- open to the public.

The FSA requires firms to carry out an annual review of the non-EU markets they consider eligible for each fund and, if necessary, update the fund's scheme particulars in which the eligible markets must be listed. The system replaced the FSA list of approved markets. Overseas markets may themselves impose restrictions, banning (as is the case in South Korea) foreign investors from holding more than 10% of the shares in any one company.

B7 Diversification rules

There are rules to ensure that unit trusts and OEICs are sufficiently diversified

There are rules to make sure that unit trusts and OEICs are sufficiently diversified. The FSA imposes an obligation on authorised fund managers in relation to UCITS schemes. They must ensure that, taking account of the investment objectives and policy of the scheme as stated in the most recently published prospectus, the scheme property aims to provide a prudent spread of risk. For example:

- A retail UCITS fund investing broadly in securities but which is not an index tracker is prohibited from holding more than 10% of the total value of the fund in the shares of any one company, meaning that:
  - the fund can invest in only four separate shareholdings to the maximum 10% holding, i.e. no more than 40% in aggregate, of holdings which exceed 5% of the fund;
  - any other individual shares holding must not exceed 5% of the fund;
  - in effect, the fund must have a minimum of 16 holdings. In reality, most unit trusts have a pool of between 50 and 100 shareholdings; and
  - UCITS schemes that are established as replicating tracker funds can hold up to 20% of the value of the fund in the shares of one company and, where justified by exceptional circumstance, up to 35%.
- UCITS funds are also prevented from over-exposure to the fortunes of any one company or group of companies by rules that prevent them from holding more than 20% of the securities or money-market instruments issued by the same group. Additionally, where a fund management group runs a range of funds they cannot aggregate their holdings of voting shares if this would give them the power to significantly influence the conduct of business of a company.
- Funds investing more than 35% in government fixed interest securities (e.g. UK gilts), issued by a single issuer are required to invest in at least six different issues of stock. No single stock holding can exceed 30% of the value of the fund.
- UCITS schemes can hold up to 10% of the value of the fund in 'unapproved' (unlisted) securities, and up to 20% can be in units of another collective investment scheme. Non-UCITS schemes can hold up to 20% of the value of the fund in unapproved securities and unregulated schemes, and up to 35% can be in units of another collective scheme. Such schemes must satisfy the same authorised criteria as the scheme making the investment and, if the former schemes are also operated by the same manager, they must be constrained to investment in a stated geographic or economic sector.
- UCITS schemes and non-UCITS schemes can hold warrants without limit.
- Other than money market funds, unit trusts hold cash for liquidity and cash flow purposes only, but may hold cash without limit during the initial offer period. Most fund managers maintain around 5% of a fund's assets in cash, although the new regulations impose no limit or restrictions. In practice, IMA sector rules prevent funds holding more than 20% in cash.

B8 Borrowing

A retail UCITS scheme is not permitted to borrow on a permanent or continuous basis to gear up its portfolio

A retail UCITS scheme is not permitted to borrow on a permanent or continuous basis in order to 'gear up' its portfolio in the same way as an investment trust. However, it is able to borrow up to 10% of the value of the fund's property on a temporary basis against known future cash flows such as dividends, subject to certain conditions.

Under the new regulations a non-retail UCITS scheme is allowed to borrow up to 10% of the value of the fund on a permanent basis, rather than the temporary basis that applies to retail UCITS schemes. A QIS may borrow up to 100% of net asset value of the scheme property.

C Unit trusts

C1 Managers and trustees

The **Financial Services and Markets Act 2000 (FSMA)** and subsequent rules issued by the FSA in its sourcebooks define the roles of the unit trust manager and the trustee, whose primary objective is to protect the investor. (Section D describes the equivalent rules and responsibilities for the authorised corporate director (ACD) and depositary of an OEIC.)

- This protection is ensured by a legally binding trust deed, made between the trustee and the manager. A unit trust can only be constituted by the signing of a trust deed:
  - the trustee legally holds the assets of the trust on behalf of unitholders, and
  - the manager is responsible for the day-to-day running of the unit trust, including the promotion, investment decisions and administration. The manager may delegate investment management and administration to a third party provider. However, in the interest of investor protection the manager retains responsibility for the actions of such providers, and their compliance with the regulations.
- Both the manager and the trustee must be incorporated under the law of the UK or another Member State of the EU and have a place of business in the UK.
- The manager must be authorised to conduct investment business in the UK and thus be subject to the rules set out by the regulators.
- The trustee must be regulated by the FSA and also have gross capital of at least £4 million.

To be marketed publicly in the UK the unit trust must be authorised by the FSA.

To be marketed publicly in the UK, the unit trust must be authorised by the FSA

C1A The trustee

The trustee is usually a large bank or one of the major insurance companies. Trustees are formally required to be independent from the management group.

The trustee's role
The key role of the trustee is to ensure that the investors' interests are protected by:

- checking that the manager's actions are in line with the regulations, the trust deed and the scheme particulars;
- ensuring that the fund manager invests in accordance with the investment objectives of the fund:
  - the trustee has the ultimate power to replace the manager if the manager goes into liquidation, insolvency or receivership, or if the trustee believes that the manager is not acting in the unitholders' best interests,
  - the trustee would have to remove the manager if a majority of unitholders voted for the removal; and
- holding or controlling the holding of the assets, ensuring that they are safely held by a competent custodian.

The trustee is the legal owner of the trust's assets and is often itself the custodian for the trust's underlying securities and cash. The securities are registered in the name of the trustee, and all income the trust earns is collected and held by the trustee. The trustee must report to its regulator if it is not satisfied that the trust is being managed in accordance with the regulations in any material respect. In addition, the trustee's responsibilities include:

Trustee is the legal owner of the trust's assets

- arranging the auditing of the trust, and issuing financial statements to unitholders;
- monitoring the calculation of unit prices, both for sale by the managers to the public, and for repurchase by the managers from the public;
- arranging meetings of unitholders;
- setting up a register of unitholders and issuing certificates, if appropriate;
- distributing the income of the trust to unitholders; and
- making any additional provisions necessary for the trust to be recognised as a pension scheme, or charitable scheme.

Question 6.1

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Trustees of unit trusts are usually what type of organisation?

C1B The manager

The manager agrees to manage the trust in return for an annual management fee

The manager agrees to manage the trust in return for an annual management fee, usually between 0.5% and 1.5%, depending on the type of fund.

The manager's duties
The manager is required under the regulations to:

- be an authorised person, i.e. have been granted permission by the FSA under Part IV of the FSMA to operate and promote funds;
- have adequate financial resources;
- manage the assets of the trust in accordance with the regulations, the trust deed and scheme particulars;
- supply information to the trustee when requested;
- maintain a record of units for inspection by the trustee; and
- notify the trustee and/or the FSA if it has breached any rules while running the trust.

The manager's functions
The manager is usually responsible for promotion, advertising, selecting investments and fund administration, but other groups may also be involved.

Sub-contracting

It has become increasingly popular for a manager to sub-contract administration to a specialist third-party company.

The manager may also select a third party to decide how the fund should be invested

The manager may also select a third party to decide how the fund should be invested. For example, a building society may promote a fund where the investment management is contracted out to a separate fund management company, which in turn selects a third party to handle day-to-day administration. However, in the interest of investor protection the manager retains responsibility for the actions of such providers, and for their compliance with the regulations.

Consider this…

A manager may switch trustees. The upheaval caused by such a move means that switches usually take place only when forced, say, by the acquisition of one fund management group by another.

C2 Registration

It is the duty of the trustee to establish and maintain a register of unitholders, although this is an activity it can delegate. (For OEICs, this responsibility falls to the authorised corporate director.) In practice, the register is usually run by the manager or the third party administrator, although the trustee continues to be responsible for the delegated activity and will, in the interest of investors, monitor its maintenance.

Contents of the register

The register is the conclusive evidence of the investor's title to the units and must contain the:

- name and address of the unitholder;
- number of units of each type held by the unitholder; and
- date on which the holder was registered.

Under FSA regulations, the manager and trustee must take all reasonable steps to ensure that the information on the register is up-to-date and complete at all times.

The trustee must make the register available for inspection by unitholders free of charge, at all times during normal office hours, although the register may be closed by the trustee for periods of not more than 30 days in any one year.

C3 Certificates

It has become increasingly common for the manager and trustee to no longer issue certificates. Instead, investors receive a periodic statement detailing the number of units they hold, and the value. If issued, certificates must show the:

- date;
- name of the scheme;
- names and addresses of the manager and the trustee;
- number and types of units held by the unitholder; and
- name of the unitholder.

C4 Reporting

Unit trusts are required to publish annual and half-yearly reports.

Unit trusts are required to publish annual and half-yearly reports

The content of the manager's report is set out in the Statement of Recommended Practice (SORP) for unit trusts. A statement of total return (capital and income), with details and charges etc., must be shown in the notes to the accounts. Managers are allowed to issue short form accounts, provided full accounts are available for unitholders on request.

C5 Unitholder rights

Unitholder rights are protected at three levels:

- by trustees who safeguard the fund's assets, are the legal owners of those assets and ensure that the manager is complying with the trust deed, the scheme particulars and the regulations;
- by the regulatory organisations set up under the Financial Services and Markets Act to ensure investor protection; and
- by the complaints and arbitration procedures, which enable unitholders to seek redress either through the regulators or via the independent ombudsman.

C6 General

The trust deed and the scheme particulars together establish the scope within which a unit trust can operate. Any material changes a manager may wish to make to the trust deed, e.g. a merger of trusts, must be approved at a meeting of unitholders held for that purpose.

Trust deed and scheme particulars together establish the scope within which a trust can operate

- The typical trust deed sets out the management charges of a trust. If a manager wishes to raise charges unitholders have to be given reasonable notice of the intention, which must not be less than 60 days.
- A trustee who considers that the unitholders are at risk has the power to remove the manager, although such an action is extremely rare.
- A manager cannot be removed without the approval of the FSA. The manager must notify the FSA of any proposal to replace the trustee.

If the management group running the trust goes into liquidation, the assets of the trust are protected by the trust structure.

C7 Authorised and unauthorised unit trusts

The FSA:

- authorises unit trusts;
- regulates trustees, managers, marketing and management; and
- regulates advisers and Designated Professional Bodies (DPB) (these regulate their members some of whom are also advisers, such as accountants and solicitors who give advice as an incidental part of their business).

FSA authorisation

As you saw in section C1, a unit trust must be authorised by the FSA if it is to be marketed to the general public:

- Without authorisation, the unit trust cannot be advertised and promoted to a private customer.
- Authorisation is a condition for CGT exemption, however, unauthorised trusts also exist for specialist purposes, e.g. some pension funds.

UCITS certificate
Funds authorised by the FSA as 'UCITS schemes' may apply at any time for a UCITS certificate: '**Undertakings for Collective Investment in Transferable Securities**'. This enables the manager to market the trust in any of the Member States of the EU, subject to that state's marketing rules.

Unauthorised unit trusts
The most common type of unauthorised unit trust is the **Exempt Unit Trust** which is:

- operated mainly for pension funds and registered charities;
- free of CGT on disposals within the funds; and
- subject to income tax not corporation tax.

The other main use of unauthorised unit trusts is for managers of enterprise zone property holdings.

C8 Taxation treatment of the unit trust fund

Authorised unit trusts are principally subject to the corporation tax regime, but only in respect of income

Authorised unit trusts are principally subject to the corporation tax regime, but only in respect of income. For investors this has the important effect of allowing annual management expenses to be offset against income other than UK equity income, i.e. annual charges are effectively tax relieved, provided that there is sufficient interest or foreign dividends.

There are a number of important modifications to the usual corporation tax regime that apply to authorised unit trusts, mostly for the benefit of individual investors. Unit trusts do not pay tax on any capital gains nor on income or gains derived from options or futures.

Different tax regimes apply, depending on the composition of the investments in the fund.

Rates
- Funds with less than 60% of their assets in interest-bearing securities, i.e. equity funds that pay dividend distributions, pay corporation tax at 20% on income received in the form of overseas income, rent or interest.
- UK dividends are received by a unit trust as franked investment income and therefore flow through to dividend distributions payable by the unit trust with no further tax liability for the fund. In other words, they are a transparent investment for tax purposes.
- Foreign dividends received by the unit trust are subject to 20% corporation tax, although this liability is often offset by foreign withholding taxes under double taxation relief rules. These are taxes deducted at source by foreign governments.
- Dividends paid by a unit trust are accompanied by a tax credit of 10%.
- Funds with more than 60% of their assets in interest bearing securities, i.e. corporate bond and gilt funds that pay interest distributions, are obliged to deduct income tax at 20% from the amount distributed instead of corporation tax.

C9 Equalisation

Unit trust income is usually distributed to unitholders half-yearly

A unit trust regularly receives income from the underlying investments of the fund, and this is usually distributed to unitholders half-yearly. When an investor buys units, the price of each unit includes the income that has accrued in the fund from the previous distribution date up to the date of purchase.

The first distribution a unitholder receives consists of the income that has accrued from the date of purchase up to that distribution date, together with an equalisation payment, which represents the income that was included in the price paid for the units.

> **!**
> ### Equalisation payment
> The equalisation payment represents a partial refund of the original capital invested and is not subject to income tax. However, it must be deducted from the purchase price of the units to identify their acquisition value for CGT purposes.

The aim of equalisation payments is to:

- achieve a broad fairness between unitholders in the apportionment of the income received by a trust during its accounting period; and
- allow the same pence per unit dividend payment to be made to all unitholders, although for the new unitholder, part will be taxable and part will be tax-free.

C10 Income allocations and distributions

The net income of a unit trust must be allocated, i.e. applied for the benefit of unitholders, and is usually distributed at least annually. Most funds make distributions twice a year, some quarterly and income funds often monthly. Income may also be retained in the fund and added to the capital for the benefit of holders of accumulation units.

Income distribution vouchers detail how an allocation is broken down between franked (UK equity) and unfranked (other) income and equalisation. The split is particularly important for corporate investors, where there may be an additional liability to tax on unfranked income.

Equity funds make a dividend distribution, which carries a 10% tax credit. Bond funds make an interest distribution, after the deduction of 20% income tax.

C11 Capital gains tax

Internal capital gains within an authorised unit trust are exempt from tax.

Consider this…
This means that disposals of investments by the unit trust can usually be made without any tax liability.

C12 Taxation treatment of the investor

Both the income tax and CGT positions need to be considered.

Income tax on distributions – dividend distributions from equity unit trusts
These are subject to income tax in the same way as dividends from equities. They are always treated as the top part of a person's income, i.e. above earnings and interest.

When income is received or accumulated it carries a tax credit. For every 90p of dividend paid to an investor (the 'net' dividend) there is a tax credit of 10p making a total dividend value of 100p (the 'gross' dividend). What investors do next depends on their overall income tax position:

When income is received or accumulated it carries a tax credit

- A basic rate taxpayer needs to take no further action. The tax credit fully covers the tax liability. In this context, being a basic rate taxpayer means that taxable income is below the higher rate tax threshold. The value of the gross dividend is added onto all other income for the year and tax allowances are deducted.
- A non-taxpayer cannot reclaim the tax credit from HM Revenue & Customs. ISA/PEP holders were able to reclaim the tax credit until 5 April 2004, but can no longer do so.
- A higher rate taxpayer needs to pay an extra 22.5% tax by assessment – bringing the total liability to 32.5% of the gross dividend distribution.
- An additional rate taxpayer needs to pay an extra 32.5% tax by assessment – bringing the total liability to 42.5% of the gross dividend distribution.

Dividend distributions paid to trustees
When equity funds are held within a discretionary trust, or an accumulation and maintenance trust where no interest in possession has arisen, the trustees are liable to pay income tax at 42.5% on the gross distribution received.

Dividend distributions paid to trustees: tax
The tax credit covers the first 10%, leaving the trustees to pay a further 32.5%.

Example 6.1

Unit trust position	£
Income	£100.00
Less corporation tax	(20.00)
Distributable income	80.00

£80 is distributed with a tax credit of £8.89 (which represents 10% of the gross dividend)

The dividend distributed (£80) plus the tax credit (£8.89) = the gross dividend (£88.89)

Non-taxpayer position	
Dividend	80.00
Unable to reclaim the tax credit of £8.89	
Basic rate taxpayer	
Dividend	80.00
No further tax liability	
Higher rate (40%) taxpayer	
Dividend	80.00
Tax credit	8.89
Gross dividend	88.89
Higher rate tax at 32.5% on gross amount	28.89
Less tax credit	–8.89
Additional tax due	£20.00
Additional rate (50%) taxpayer and trustees	
Dividend	80.00
Tax credit	8.89
Gross dividend	88.89
Additional rate tax at 42.5% on gross amount	37.78
Less tax credit	–8.89
Additional tax due	28.89

Interest distributions from non-equity unit trusts

Interest distributions

In order to pay interest distributions, a unit trust or OEIC must hold at least 60% of its investments in interest bearing investments, such as gilts and corporate bonds.

- These distributions are paid net of 20% tax.
- Non-taxpayers can claim back the tax deducted in full.
- Where a taxpayer's non-savings income is less than the starting rate limit for savings income (£2,560 in 2011/12), the savings income will be taxable at the 10% savings rate up to the limit, rather than 20%, and they will be entitled to a refund of part of the tax deducted.
- Basic rate taxpayers have no further liability.
- Higher rate taxpayers are subject to a further 20% charge on the gross interest distribution.
- Additional rate taxpayers are subject to a further 30% charge on the gross interest distribution.

Interest distributions paid to trustees

When gilt and corporate bond funds are held within a discretionary trust, or an accumulation and maintenance trust where no interest in possession has arisen, the trustees are liable to pay income tax at 50% on the gross distribution received.

Interest distributions paid to trustees: tax

The tax credit covers the first 20%, leaving the trustees to pay a further 30%.

Reinvestment of dividends and interest

If the dividend or interest is reinvested in the unit trust or OEIC in accumulation units, it still counts as being income for the investor. It will be subject to the same tax treatment as income that is distributed.

C13 Capital gains tax

Capital gains tax may also be payable on any profits made by a taxpayer who disposes of units. The profit is calculated in the usual way:

CGT may also be payable on any profits made by a taxpayer who disposes of units

- the original acquisition cost less equalisation is deducted from the sale proceeds;
- realised losses can be deducted from realised profits;
- unrelieved losses can be carried forward indefinitely;
- units that were held on 31 March 1982 are deemed to have an acquisition cost equivalent to their market value on that date;
- there is also an annual exemption for each person (husbands and wives have separate exemptions); and
- the taxable gain remaining after the annual exemption has been deducted is taxed at 18% or 28% (2011/12) depending on other income for the year.

Example 6.2

Anna invested £10,000 in the ABC unit trust in May 1988 and cashes in her holding in July 2011 for £31,522. Her first income allocation included an equalisation payment of £5.

Her net gain is as follows:

	£
Disposal proceeds	31,522
Less acquisition cost minus equalisation (£10,000 – £5)	(9,995)
Gain on ABC unit trust	21,527
Less annual exemption	(10,600)
Taxable gain	10,927

The gain will be taxed at 18% or 28% depending on Anna's other income for the year.

Gains or losses are realised by disposing of units. Usually disposals are made by selling units, but gifts are also disposals for the purposes of CGT.

CGT planning

Much CGT planning consists of planning disposals to make use of the annual exemption or in some cases capital losses.

A ploy used in the past to realise gains or losses without changing the units held was to sell and buy back the following day – known as 'bed and breakfasting'. The rules now are such that a sale and repurchase within 30 days is ignored.

Bed and breakfasting is no longer effective unless there is an interval of at least 30 days between sale and repurchase, which would usually involve an unacceptable level of risk.

- Alternatives for investors who want to retain existing investments after realising a gain or loss include:
  - selling units and buying back within an ISA;
  - selling units and arranging for a spouse or partner in a registered civil partnership to buy them back; or
  - selling and repurchasing another very similar unit trust.
- If an OEIC is an 'umbrella fund' with a number of sub-funds, a switch from one sub-fund to another is a disposal for CGT purposes. However, a 'fund of funds' unit trust or OEIC is exempt from CGT on switching its underlying holdings.

C14 Tax elected funds

Since 1 September 2009 Authorised Investment Funds (AIFs) have been able to elect to be treated as a tax elected fund (TEF). TEFs are required to make two types of distribution of the income they receive – a dividend and a non-dividend (interest) distribution.

TEFs are required to make two types of distribution of the income they receive: dividend and non-dividend (interest)

- UK dividend income received by the fund will flow through to dividend distributions payable with no further tax liability for the fund.
- All other income that is distributed as a non-dividend distribution will be subject to a tax deduction of 20%.
- UK investors will then be treated as receiving distributions of UK dividend income (including the non-repayable tax credit) and distributions of interest.

C15 Distributions

Unit trusts can pay an income and offer possible capital growth

One of the most popular reasons for investing in unit trusts is that they can pay an income and also offer the potential for capital growth. Generally, the income largely comes from dividends on shares and interest on stock.

- The unitholder can choose the dates when income may be received by investing in a range of unit trusts with a spread of distribution dates.
- Alternatively, the income can be used to increase the unitholder's investment by way of either accumulation units or income reinvestment plans, but the income still counts as income of the investor and is taxable in the same way as income that is distributed.
- Income is paid out net of expenses, usually including the manager's annual charge. The unitholder is sent a notification of income, including a tax voucher, showing how much tax has been deducted.

!

Changes made to FSA regulation

Following changes made to the FSA regulations some unit trusts now deduct charges from the capital, thereby enhancing the quoted yield but reducing capital performance. Unit trusts that follow this practice must include a prominent statement reflecting this policy in all scheme documentation. They must also state the risk to the growth of the capital that will result.

C16 Income and accumulation units

Many trusts allow the unitholder to choose between income receipt or reinvestment by offering income and accumulation units. Since 1 April 2004 unit trusts have also been allowed to issue additional classes of units in the same way as OEICs.

Accumulation units

These add all the income produced from the underlying investments, net of tax, into the investor's holding. Relative to income units the unit price increases to reflect the retained income.

Income units

Income units pay out the income of the unit trust to the investor

These pay out the income of the unit trust to the investor. The price of income units (sometimes called distribution units) will therefore be lower than that of accumulation units.

- Income funds may consist solely of income units.
- Equity growth funds may only have accumulation units.
- Mixed distribution/accumulation funds also exist, in which case there will be two unit prices quoted in the press, one labelled 'Acc' or 'Accum. Units' and the other 'Inc'.
- In the absence of accumulation units, the manager may offer a facility to automatically reinvest income to buy more units, which are then added to the unitholder's investment. This has the potential disadvantage that the unitholder may pay all or part of the initial charge on the new units, but it is increasingly favoured by managers and investors.

C17 Impact of allocations on unit prices

As income comes into the fund and the accounting date approaches, the unit price rises to reflect this.

- When the accounting date is passed, the price is marked 'xd' (i.e. ex-distribution) and then the price of income units usually falls by the amount of the income.
- The xd period may not be more than four months after the end of each annual or interim accounting period.
- If unitholders sell their units during an xd period they still get the allocation attributable to the prior period, while buyers will not.

C18 Link to ISAs

A unit trust can be held in an ISA

A unit trust can be held in an individual savings account (ISA). This allows it to benefit from the exemption from CGT on any realised gains.

- The full ISA allowance can be invested in qualifying unit trusts within a stocks and shares ISA, either by lump sum or regular savings.
- Virtually all unit trusts other than cash funds qualify as investments for a stocks and shares ISA. Cash funds qualify as investments for a cash ISA.

- All UCITS schemes are now qualifying investments for ISAs. However, as a wide range of investments can be held within a UCITS scheme, not all UCITS schemes are allowed into a stocks and shares ISA. Investment funds that guarantee a return of at least 95% of the investor's original capital in the first five years of investment are only eligible for a cash ISA.
- From 6 April 2006 the ISA rules were extended to permit investment in all retail collective schemes authorised by the FSA – both UCITS and non-UCITS retail schemes – provided they do not restrict investors' ability to access their savings. One of the main effects of this change was to allow ISAs to hold collective funds that invest directly in property.

C19 Charges

There are generally no extra charges for investing in a unit trust ISA offered by the manager, beyond the usual charges that apply to the unit trusts themselves. There may be reduced initial charges with exit charges introduced on surrender of units within the initial period of, say, five years.

C20 Process of buying and selling

There is usually a minimum holding requirement of £500 or £1,000 in each fund, which is set by each management group. Holdings can be purchased in single or joint names, for example by spouses.

There is usually a minimum holding requirement of £500 or £1000 in each fund

Many groups also offer monthly savings schemes, often linked to an ISA. Savings schemes usually begin at around £50 per month. There is no maximum investment limit because unit trusts are 'open-ended', creating or cancelling units according to demand.

Investors can buy or sell in several different ways; by telephone, via the internet, by sending in an application or renunciation form, or by dealing through an authorised financial adviser, provided the investor is in possession of the trust's **Key Features document**.

Consider this…

This works as follows:

- A deal handled over the telephone is as legally binding as a written deal.
- Once the deal has been made, the management group immediately sends a contract note. This shows the fund, the number of units/shares involved in the transaction, any other levies on the transaction, and the amount of commission payable to a financial adviser.
- Investments made on an application form must normally be accompanied by the payment.
- Telephone and internet orders normally require payment once the contract note has been received by the client or adviser.

Investors must be supplied with a Key Features document, detailing the main aspects of the product and the associated charges and expenses, before the transaction to purchase can be executed.

C21 Certificates

Traditionally, unit trusts have been evidenced by certificates. These set out the name of the fund and size of the holding. On the reverse is a letter of renunciation that unitholders complete when they wish to redeem units.

Certificates

However, certificates are not mandatory and the manager is not obliged to issue them.

Most unit trust groups have now switched to non-certificated units. This avoids the necessity of having to issue new certificates each time an investment is made through a savings scheme. Under non-certification, proof of purchase is simply the contract note; proof of ownership is entry on the register.

Most unit trusts have now switched to non-certificated funds

C22 Selling

To sell units, an order is placed with the management group, which will then issue a contract note.

- If the investor holds a certificate, they must sign the renunciation form on the back of the certificate and forward it to the manager.
- For non-certified holdings an investor may be required to sign a separate form of renunciation if a signed written instruction has not been sent.
- The manager is obliged to make payment no later than four business days after receipt of the signed documentation.

- Where investors only wish to sell a portion of their investment, the renunciation form should indicate how many units they wish to sell, or the amount of cash they wish to raise.
- If certificates are issued the management group will then issue a new certificate for the balance of the holding.

C23 Share exchange facilities

Share exchange schemes allow investors to exchange existing shareholdings in public companies for an equivalent value in the fund's units

Share exchange schemes are offered by a number of unit trust management groups. These allow investors to exchange existing shareholdings in public companies for an equivalent value in the fund's units.

A share exchange scheme can be a cheaper and simpler way of disposing of a small holding of shares than selling through a stockbroker, as the unit trust manager may offer advantageous terms to swap the shares for units.

- The unit trust manager may either accept shares in lieu of payment and absorb the shares into one of the group's funds, or dispose of the shares and apply the proceeds to buy units in a fund.
- Usually a share exchange scheme will have a minimum holding for a share and/or a minimum total value of a portfolio that it will accept. Most set a minimum at around £1,000, and prefer blue chip listed stocks to overseas and unlisted stocks.

Tax position

A share exchange does not exempt the investor from normal CGT considerations:

- selling shares via an exchange is a disposal for CGT purposes; and
- the investor can expect to pay tax if the gain on disposal exceeds their CGT exemption limit.

C24 Pricing and valuation

Each unit in a unit trust represents a proportional share of the property of the scheme

Each unit in a unit trust represents a proportional share of the property of the scheme. The valuation of units is achieved, in broad terms, by valuing the underlying securities and cash held by the fund, adjusting for income and charges and then dividing by the number of units in existence. Unit trust managers are required to calculate unit prices in accordance with FSA regulations. Under COLL this means 'fair value pricing' on a basis described in the scheme's prospectus. Managers may elect to operate under single-pricing or dual-pricing regulations.

Dual-priced unit trust

- For dual-priced unit trusts, the FSA formula determines:
  - the highest price at which units can be sold to investors; and
  - the lowest price at which the manager can repurchase units.
- The manager may create additional units to satisfy demand or may cancel existing units redeemed from investors. In this way, a unit trust, unlike an investment trust, is 'open-ended' and can expand or contract depending on market conditions.

The manager will value the capital and income property of the scheme on a buying and selling basis, which will produce the creation and cancellation value of the fund. The manager will calculate the selling or bid price and buying or offer price for investors from these values. Most unit trust managers quote both prices, and the selling or buying price will be applied to the deal depending on the type of transaction:

- the investor buys units at the higher buying or offer price;
- the investor sells units back to the manager at the lower selling or bid price; and
- the difference between the prices is known as the 'bid-offer spread'. This includes the initial charge.

Single pricing

It has been possible since the introduction of ISAs and 'CAT' standards, for managers to elect for 'single pricing' using mid-market prices for the underlying investments; incoming and outgoing investors deal at the same price, with any charges being disclosed separately. It is also possible for a unit trust manager to operate swinging single prices (see section D4).

C25 The buying and selling prices calculation

Unit trust managers have to calculate unit prices according to FSA regulations

Unit trust managers have to calculate unit prices according to FSA regulations. The following explains the traditional dual pricing basis.

The buying or offer price

To calculate the maximum buying price the managers:

- take the market buying value of the underlying securities at the published valuation point;
- add on the costs of buying securities in the market, such as stamp duty and brokerage;
- add on all the other property of the trust, such as un-invested cash and any accrued income less tax, fees, charges and expenses;
- divide the total by the number of units issued; and
- add on the initial charge and express the price to four significant figures.

Example 6.3

Buying price calculation	p
Lowest market dealing offer price	
Value of assets per unit, say	50.0000
Add stamp duty (0.5%)	0.2500
Add brokerage (0.25%)	0.1250
	50.3750
Add accrued income	0.7250
Creation price	51.1000
Add initial charge (6%)	3.0660
	54.1660
Express to four significant figures	**54.17p**
to give the maximum buying or offer price per unit	

Selling or bid price

To calculate the minimum price at which the managers will buy back the units, the managers:

- value the underlying securities at the best market selling prices;
- deduct the dealing costs that would be incurred if the securities were to be sold;
- add in any un-invested cash;
- add any accrued income after deduction of any annual management fees, trustees' fees, audit fees and outstanding tax;
- divide the total by the number of units in issue; and
- express to four significant figures.

Selling or bid price

This is also the 'cancellation price' receivable by the manager from the fund if they choose to cancel units they have repurchased.

Example 6.4

Selling price calculation	p
Highest market dealing bid price	
Value of assets per unit, say	49.0000
Subtract brokerage (0.25%)	(0.1225)
	48.8775
Add accrued income	0.7250
	49.6025
Express to four significant figures	**49.60p**
to give the minimum selling or bid price per unit	
(or cancellation price)	

Maximum bid-offer spread aggregates the underlying market spread, commission and stamp duty (as appropriate) and manager's initial charge

Bid-offer spread
The bid-offer spread is the difference between the buying and selling prices, expressed as a percentage of the buying price. The maximum bid-offer spread is the aggregation of the following three components:

- underlying market spread;
- commission and stamp duty as appropriate;
- manager's initial charge.

The bid-offer spread will vary depending on the type of assets held within the unit trust, and can be anything from a few basis points on very liquid assets such as UK Gilts, to 5% or more on assets that are more difficult to buy or sell such as property, or equity investments.

This is usually in the range of 5%–7% for equity funds, however:

- no-load index trackers (i.e. funds without an initial charge) have a narrow spread – often less than 1%;
- smaller companies and emerging markets funds have a relatively high spread because of the underlying market – the spread may be 10% or more, depending on the initial charge; and
- some cash funds have no spread at all.

There is a range of funds between these extremes. In order to enable the fund manager to control liquidity, the trust deed often gives the fund manager the right to vary the bid-offer spread to reflect market conditions.

Maximum spread
The maximum permitted spread (the difference between the maximum buying price and the minimum selling price calculated according to the FSA rules) is usually greater than the spread operated by the managers, although in practice it will depend on the demand for units:

- when one unitholder is selling and another investor wants to buy, there is no need for managers to sell any of the underlying assets and incur the dealing costs;
- if a unit trust manager is a net seller of units, the units can be priced towards the offer-end of the range; and
- if the manager is a net buyer, there will be costs and the units will be priced at the bid-end of the range.

Offer basis
If demand is high the manager will set the buying price at the offer-end of the spectrum, i.e. the full price at which it costs to create a unit plus the initial charge. This is what is meant when a trust is said to be on an 'offer basis'.

Investors coming into the fund will pay the maximum price, and investors choosing to redeem will get a relatively good price for their units, which the manager typically sets at their normal spread down from the offer price.

Bid basis
Conversely, if demand is low, and more units are being redeemed than being sold, the manager will choose a selling price at the bid-end of the range, i.e. the price of cancelling units.

In this case the trust is priced on a 'bid basis'. Investors choosing to purchase will pay a relatively low price for their units, which the manager sets at their normal spread up from the bid price. Sellers will get the minimum price for the units they redeem.

Manager can thus move the pricing basis of a trust in line with demand

The manager can thus move the pricing basis of a trust in line with the level of demand. It also means that spreads quoted in newspapers are not always followed. For example, a large purchase of units could cause a trust to shift to an offer basis when it may previously have been on a bid basis.

The box
Investors buy and sell units via transactions with the manager who may hold units in the 'box'. The box may be made up of created (new) units or units that have been repurchased from investors.

'Box management' is the term used to describe the stock control mechanism applied by managers in the buying and selling of units.

- Where a fund is expanding because investors are buying units, the manager will create units at the creation price.
- Where a fund is contracting, when there are more sellers than buyers, the manager will cancel units at the cancellation price.
- The decision to hold units in the box is made by weighing up the risk of the market turning and expected future demand.

The manager can match buyers and sellers in general two-way business. A manager can sell on units at a price lower than it would be possible to create them and buy back units at a price higher than it would receive to cancel them. This benefit can be passed on to the potential buyer or seller.

Box management was at one time a significant source of profit for unit trust groups, but the holding of large boxes is now out of favour.

Single pricing
Unit trusts may now be single price in the same manner as OEICs. This should not be confused with those trusts that have the same bid and offer price but create and cancel on a dual price basis.

Unit trusts may now be single price (as per OEICs)

The valuation point
The manager is required to carry out regular valuations of the property of the unit trust scheme under the FSA regulations.

Most unit trusts are valued daily and the 'valuation point' is the time of day that the manager carries out the valuation. The manager can decide the frequency and the time of day at which to value the fund. The frequency of the valuation must be detailed in the fund's scheme particulars.

Question 6.2

Before you leave this section, can you recall what we said was meant by the 'bid-offer spread'? What are the components which when aggregated make the maximum bid-offer spread?

C26 Forward and historic pricing

Unit trusts may be priced on either a forward or historic basis. The manager can decide the basis on which it will deal:

Unit trusts may be priced on either a forward or historic basis

- forward: at the price to be calculated at the next valuation point; or
- historic: at the price calculated at the last valuation point.

Consider this…

On which basis do you think most managers deal – forward or historic?

Forward pricing
When an investor buys on a forward pricing basis, they will pay the price that will be calculated at the next valuation point.

For cash investments, the exact number of units purchased will be unknown at the time of the deal. It will also not be possible to predict the number of units that will be sold where an investor has asked to raise an amount of cash by selling units back to the manager.

On a forward pricing basis the manager must create enough units at the valuation point to cover any deals taken since the last valuation point.

Managers operating on an historic pricing basis must move to a forward basis if the value of the trust is believed to have changed by 2% or more since the last valuation and if the investor requests it.

Usual practice

Most managers deal on a forward basis.

Historic pricing
When working on the traditional historic pricing basis, the manager creates a stock of units at the valuation point based on the expected level of sales until the next valuation point. They then sell them at the known historic price.

If they run out of units, the manager must either move to a forward basis or continue on an historic basis and risk losing money if the market moves unfavourably. They must create units to cover the oversold position at the next valuation point, when the creation price may rise.

The advantage of historic pricing is that small investors can be offered a known price when they place a deal.

There have been concerns, particularly for overseas equity funds, that a transaction does not fully reflect the value of the underlying shares, which may have moved substantially since the fund was last valued. This may be to the advantage or disadvantage of investors buying or selling. The FSA has addressed these concerns in COLL, with rules that require 'fair value pricing'.

C27 Charging structure

Charges cover most of the costs of managing and administering the fund, such as investment management costs, marketing costs and intermediary commissions, registration and other administration. There are usually two charges made by a unit trust manager:

- the **initial** or **preliminary charge**, which now varies between 0% and 6% and is included in the offer (buying) price of the units. The initial charge may be 0% on those funds operating exit charges; and
- the **annual management charge**, typically set at around 1%–1.5%, but on index funds it may be only 0.5%, or possibly less.

Level of charges is determined more by commercial than regulatory considerations

The level of charges is determined more by commercial than regulatory considerations. Many funds now have no initial charges.

The trust deed specifies the charges and all charges must be fully disclosed in the trust's scheme particulars and Key Features documents.

Rules under COLL

Under COLL, unitholders need only be given reasonable notice of the intention to increase any charges, which must not be less than 60 days. FSA regulations now permit exit charges on unit trusts, subject to the restriction that taken together with any initial charge, the total charge does not exceed the rate quoted for initial charges.

C27A Initial charge

The initial charge is included in the price at which managers will sell units to the public, i.e. the buying price.

- Many equity funds carry a charge of around 5%–6%.
- Gilt and fixed interest funds usually have a lower initial charge, often around 3%, which is a reflection of the unit pricing mechanism.
- Cash and money market funds have zero or negligible initial charges.
- Index tracker funds generally have no initial charge.

Some unit trusts have a low or nil initial charge and then make an exit charge for early encashment

- Some unit trusts have a low or nil initial charge, and then make an exit charge for early encashment, e.g. before five years have elapsed from the date of purchase.
- Initial commission, generally at the rate of 3%, may be paid by the manager out of the initial charge to the authorised financial advisers who introduce business. There are a number of financial advisers who rebate all or part of their commission, and pass it on to their investor client in the form of a discount to the offer price. It is also common for discounts to be negotiated with the manager for large investments. Most fund supermarkets also rebate all or a large part of the initial charge.

C27B Annual management charge

The annual management charge is usually deducted from the trust's income, but it can be charged against the capital where the income is insufficient. Income funds are also permitted to deduct charges from capital. This boosts the income that is paid, but increases the risk of eroding the capital. Unit trusts that follow the practice of deducting charges from capital must include a prominent statement reflecting this policy in all scheme documentation. They must also state the risk to the growth of the capital that will result.

- The charge is typically between 1%–1.5%, with overseas funds tending to charge more.
- Gilt and cash funds usually charge less. Index tracker funds typically charge 0.5%–1%.
- The annual charge on unit trusts cannot be rebated to investors or advisers, although it has become common for managers to offer a 0.5% renewal or 'trail' commission to advisers on ISAs. A small number of execution-only financial advisers do rebate part of this commission to investors.
- Under the regulations, trustees' fees, auditors' fees, registration charges, full regulatory fees and stockbrokers' commission may be charged directly to the fund, instead of being payable out of the manager's charge. Together these may amount to 0.15%–0.25%, but could be considerably higher for a fund with a high turnover.
- Discretionary portfolio managers and funds of funds may carry two levels of charges:
  - one charge to remunerate the manager of the underlying investments; and
  - a further charge to cover the overall strategic management function.
- To qualify as a stakeholder product (for ISA and Child Trust Fund investments) the maximum total annual charge must be 1.5% or less for the first ten years and 1% thereafter, with no initial charge.

C27C Exit charges

Where a unit trust does not have an initial charge, it may have an exit charge. These trusts are very few in number.

- The exit charge is generally on a sliding scale and only covers encashments within say the first five years of the initial investment.
- A typical exit charge is 5% of the value of the investment for encashments in year one, reducing to 4% in year two and so on. There is generally no exit charge if the investment is held for five years or more.

Typical exit charge is 5% of the value of the investment for encashments in year one

For a long-term investor a trust with no initial charge and exit charges during the first five years only is more beneficial than one with an initial charge but no exit charges, assuming annual charges are the same.

Exit charges

The manager may not introduce an exit charge retrospectively. The introduction of such a charge will apply only to investors after the effective date of its introduction.

C27D Performance-related charges

The FSA's COLL regulations make provision for performance-based fees, as long as they are disclosed both in the prospectus and Key Features document. Performance fees can be growth-based or referenced to outperformance of a fund's benchmark, and can be in place of, or in combination with, other permitted annual fees.

D Open-ended investment companies (OEICS)

As we have seen, an open-ended investment company (OEIC) is a diversified collective investment vehicle similar to a unit trust. Like a unit trust the underlying investment area will be specified, e.g. UK equities. It is an investment company with variable capital (ICVC).

The legal structure is that of a company incorporated under the FSMA and authorised under the provisions of a statutory instrument made by the Treasury, known as the **ICVC Regulations**.

- Individual investors' assets are pooled together in a centrally managed fund, which is then invested on a collective basis. The assets are valued on a net asset value (NAV) basis, like a unit trust.
- The first phase of OEICs were allowed to invest only in transferable securities, including warrants. Since 1 December 2001 OEICs could be established under the same categories as unit trusts (except feeder funds) and as UCITS schemes since 1 November 2002. From 1 April 2004 the latest FSA regulations have allowed funds to be established as retail and non-retail UCITS, and as QIS.
- The investors' interests in the fund are represented by shares in the fund company (very much like units in a unit trust, but without conferring beneficial ownership of the fund's assets).
- The capital is open-ended so the fund will expand and contract according to demand. Investors can sell their shares back to the OEIC on any dealing day specified in the prospectus.

The regulatory structure is broadly as follows:

- an OEIC must be authorised by the FSA if it is to be marketed in the UK;
- the OEIC is operated by its board of directors, which may comprise a single **authorised corporate director (ACD)**;
- the assets of the OEIC must be held by an independent depository;
- the ACD and the depository must be authorised persons, i.e. regulated by the FSA; and
- sales and marketing are mostly regulated by the FSA under Chapter 4 of the Conduct of Business Sourcebook, and the non-life disclosure and cancellation rules apply.

In addition to the ICVC regulations which govern the establishment and conduct of the OEIC, further operating regulations are set out in the Financial Services Authority's Sourcebooks and COLL.

D1 Product structure

An OEIC is not an investment trust or a trading company. It also differs from a unit trust in a number of ways including:

- it is a self-contained company which has its own constitutional documents and holds an annual general meeting;
- an OEIC may be a stand-alone fund, or it may take the form of an 'umbrella' company, with a number of sub-funds, each with its own investment objectives;
- all sub-funds of a scheme that is an umbrella must adopt the same pricing basis, i.e. forward or historic;
- it issues shares rather than units and different share classes may be issued with different charging structures and/or currencies;
- it appoints directors, including the ACD (see section D2);
- an independent depository is required to safeguard its assets and the depository must be an authorised person;
- annual audited accounts are issued;
- the costs of its creation may be met by the fund;
- single pricing is usually used, although from October 2006 single or dual pricing can be adopted by the ACD; and
- like a unit trust there is a limit on borrowing, which must be temporary (for a UCITS retail fund) and not exceed 10% of the fund, so it cannot gear up like an investment trust.

Single pricing is usually used in the case of OEICs

D2 Fund management and administration

OEIC equivalent of the unit trust manager is the ACD

The OEIC equivalent of the unit trust manager is known as the authorised corporate director or ACD. The ACD is responsible for:

- the OEIC's compliance with investor protection requirements, as set out in FSA regulations;
- day-to-day management issues such as valuation, pricing and dealing;
- the preparation of accounts; and
- the management of investments.

The depository
The depository is an independent authorised person who is responsible for overseeing the management of the OEIC in relation to investor protection, in particular:

- valuation, pricing and dealing in OEIC shares;
- the collection of income and authorising the payment of income distributions;
- ensuring the ACD correctly exercises the investment and borrowing powers; and
- the safekeeping of assets.

Reporting to holders
An OEIC's scheme operator:

- must report to holders twice a year – once at the interim stage (unaudited) and once at the annual stage (audited);
- must produce reports that comply with the OEIC Statement of Recommended Practice;
- may issue short form accounts; and
- must make available full accounts if requested.

D3 Individual Savings Accounts (ISAs)

ISAs are able to hold OEICs under the same constraints as unit trusts

ISAs are able to hold OEICs under the same constraints as unit trusts.

D4 Single pricing

An OEIC is like other open-ended funds such as unit trusts. Investors buy shares in their chosen fund and the value of each share of the same class represents an equal fraction of the value of the securities and other assets in that fund. The price of each share therefore reflects the total net value of the assets of the fund relating to that share class, divided by the number of those shares in issue – the NAV per share.

For example, if the OEIC holds a portfolio of securities worth £25 million and there are 10 million shares, the NAV per share is £2.50. When a fund uses single pricing there is no bid-offer spread.

The assets contained in the OEIC are valued at:

- their mid-market price where there is a market dealing spread in the assets themselves (e.g. shares); and
- the only price if that is all that is available from the relevant market.

When single pricing of shares is used, the single mid-market price makes no allowance for market dealing costs and any charges are shown separately (added or deducted) on investors' contract notes.

If an OEIC adopts a dual pricing policy, the shares will be priced in the same way as a dual priced unit trust (see section C24).

Where single pricing is used, shares are purchased from the ACD at the single price plus an initial charge to cover commission, sales and management expenses:

- A charge called the **dilution levy** can be added to the single price on share purchases or deducted from the price on redemptions, at the ACD's discretion. The dilution levy is paid to the OEIC to cover dealing costs and the spread between the buying and selling prices of the underlying investments. It can be applied if there are unusually large inflows or outflows of funds. The levy goes to the fund, not the managers. There are no FSA rules about the precise application of the dilution levy and practice varies greatly between funds, but the policy will be stated in the prospectus.
- Similarly, the ACD may impose a charge as a provision for Stamp Duty Reserve Tax (SDRT) that may be payable by the OEIC.
- Shares are bought from and sold back to the ACD by investors at the single price, although this may be subject to a dilution levy and/or a charge for SDRT.
- Shares are redeemed or issued by the OEIC at the request of the ACD at the single price.
- It is possible to compare the performance of OEICs with unit trusts and there will be no major difference in the way that figures will be produced. Buying to buying figures for unit trusts can be compared with NAV to NAV figures for OEICs.

Dealing costs

Since 1 August 2002 the FSA has also permitted OEICs and single priced unit trusts to collect dealing costs that have been incurred as a result of investor transactions, from investors when they invest or redeem funds through a swing (adjustment) to mid-market price. This avoids the need for dilution levies. Fund managers may choose to adopt the swinging price mechanism, or continue to use the existing dilution levy mechanism.

Dealing and management

Dealing in OEICs is much the same as unit trust dealing. The ACD issues a contract note for each trade and may also issue a share certificate.

Dealing in OEICs is much the same as unit trust dealing

OEICs are allowed to issue bearer certificates, which are convenient for some investors (e.g. non-UK domiciled shareholders).

D5 Advantages to OEICs

There are several advantages to OEICs:

- For the investment industry, the most important advantage is that this type of open-ended fund structure is the most widely recognised type of collective investment in Europe: OEICs are capable of being marketed internationally in a way that is virtually impossible with unit trusts.
- The OEIC regulations permit multiple share classes, which allows more flexible charging and currency structures than are possible with unit trusts, although COLL allows different classes of units or shares for all types of funds.
- The OEIC structure allows management groups to offer umbrella funds. These give the investor a choice of funds covering a range of investment objectives, each sub-fund offering or issuing a different class of share within the company. Switches between funds therefore become a simple matter of share exchange, often at nil cost.

The OEIC structure allows management groups to offer umbrella funds

- From the manager's viewpoint, the umbrella structure also makes it easier to create new funds, the interest in which is represented by another class of share.

D6 Taxation of OEICs

Tax position of OEICs is basically the same as for unit trusts

The tax position of OEICs is basically the same as for unit trusts:

- Corporation tax is payable by the OEIC on income received according to its source (interest, dividends or income from overseas), less chargeable expenses of management. As mentioned in the section on the tax treatment of unit trusts, annual management expenses can be offset against interest or foreign dividends meaning that annual charges are effectively tax relieved provided there is sufficient income.
- Dividends paid by OEICs are treated in the same way as distributions from unit trusts. Dividends are paid with a 10% tax credit. Interest payments from fixed interest funds have 20% income tax deducted.
- ISA exemptions are available on the same basis as for unit trusts.
- Internal gains within an OEIC are exempt from CGT.
- Personal CGT liability arises on the sale of an OEIC or a switch in the class of shares held, where this involves a change of sub-fund, although a switch within an umbrella fund does not incur stamp duty.

E Unit trust and OEIC management services

E1 Multi-manager products

Most fund management groups now offer at least one multi-manager product

Most fund management groups now offer at least one multi-manager product. These allow investors to spread their money between different managers or different funds so that they can achieve greater diversification and balance than if they had invested in just one fund.

The two main types of multi-manager categories are:

- **fund of funds**, which invest directly into funds managed by other managers; and
- **manager of managers funds**, which appoint specialist investment managers to look after different parts of the portfolio to a particular brief.

E1A Fund of funds

Fund of funds can be either 'fettered' or 'unfettered'

A fund of funds service invests in a selection of funds and the fund of funds can be either 'fettered' or 'unfettered':

- a fettered fund of funds only invests in funds run by the same management group; and
- an unfettered fund of funds is not obligated to invest solely in internal funds, and can select from the entire universe of funds and management groups.

In-house fund of funds may levy no additional annual charge on top of the fees of the underlying fund. External fund of funds normally have the additional expense of the charges of the underlying fund. This additional cost is not added to the initial or annual fees of the fund itself, but is instead taken from the fund's assets. Most management groups are able to negotiate a rebate on these charges, or they may purchase an institutional class of unit or share that has significantly lower dealing and management costs, and no commission.

The fund of funds provider selects the individual funds and monitors their performance, with the aim of maintaining a balance between them and maximising returns. If it becomes necessary to change the exposure within the fund, a manager can do this by selling and then purchasing a new underlying fund.

> **!**
> **Fund of funds structure**
> The fund of funds structure provides a capital gains tax shelter, as switching between funds by the manager does not create any capital gains tax liability.

E1B Manager of managers funds

Manager of managers funds owe their heritage to the world of institutional investment, where a fund manager appoints several investment managers, each with a specific management style, to manage a part of the portfolio:

- the overall fund manager will decide on an appropriate asset allocation for the fund;
- for each asset class an external investment manager will be chosen to run that part of the portfolio; and
- the overall fund manager is responsible for identifying competitive managers and monitoring exactly what each of them is buying and selling.

The overall fund manager, via its custodians, has direct control over the assets of the fund. If it becomes necessary to replace an existing investment manager, rather than having to sell a fund and reinvest the cash, responsibility for the management of the assets can simply be assigned to a new investment manager. This avoids any difficulties in liquidating large holdings and is a quicker and more efficient way of making the transition.

Costs of manager of managers fund

The costs of a manager of managers fund are more transparent than those of fund of funds. The additional fees for the individual investment managers are not charged separately to the fund, but are paid for from the annual management charge of the manager of managers fund.

E2 Fund supermarkets

Fund supermarkets first appeared in the USA and have been available in the UK since late 1999. They offer a variety of funds from a number of different management groups, but the decision of which funds to buy is generally left to the investor or their adviser. While each investor will have their money managed by a range of fund managers, there is no multi-manager involved. The investor will have all of their holdings within a single product, i.e. an ISA, but not a single multi-managed fund.

Fund supermarkets first appeared in the USA and have been available in the UIC since late 1999

No fund supermarket offers every single fund that is available in the market. The majority offer unit trusts and OEICs, but only a few also include investment trusts. This can be a drawback as it may prevent a client consolidating all of the funds with a supermarket by transferring across their existing holdings.

Fund supermarkets usually offer their own ISA wrappers, allowing investors to hold funds from a range of providers which would otherwise only be possible at additional cost, e.g. via a self-select plan. The supermarket becomes the investor's single ISA manager, with the increased range of funds being available at no extra charge, together with the ability to view the investments in one portfolio.

Consider this…

From an adviser's viewpoint wraps and other platforms can greatly simplify the administration of client's portfolios, as each client's holdings can be consolidated into one supermarket account. Similarly, block switches of funds can be made much more easily and quickly than if the individual holdings of one management group had to be sold and reinvested in the funds of another management group.

E3 Wrap accounts

Wrap accounts were launched in the USA in the 1970s and are now used extensively in both the USA and Australia. They are currently being offered in the UK by a number of providers, although several different types of wrap account have evolved.

A wrap account is a platform that can provide access to any underlying fund or other type of investment and can administer any of the product wrappers an investor may wish to use. It can also allow an investor to follow an investment strategy across their whole portfolio, regardless of providers or products.

The range of assets can include unit trusts, OEICs, investment trusts, equities, fixed interest securities, exchange traded funds and cash. The wrappers can include ISAs, SIPPS, the Child Trust Fund, pension contracts and investment bonds.

The investor's holdings are all shown in a single account. This can usually be accessed on-line, enabling investors to view their total assets and asset allocations, and the up-to-date value of their investments, in one place.

With a wrap account the investor's holdings are all shown in a single account

Wrap accounts typically make an explicit charge for their services. In contrast, wrap supermarkets generally charge the investment product providers rather than make direct charges to the investment client. For further information on wraps and platforms see chapter 8.

Minimum investment size

Some wrap accounts have a high minimum investment size, although there are providers who impose no minimum.

F Offshore funds

Offshore funds are broadly those funds established outside the UK– usually in low tax areas

Offshore funds are broadly those funds established outside the UK – usually in low tax areas. They are open-ended investment funds, structured as either investment companies or unit trusts. Offshore funds have become of greater importance in recent years.

Consider this…

As the EU's encouragement of cross-border financial services sales becomes more successful, advisers will have to become increasingly familiar with non-UK funds.

F1 Background

A brief history of offshore funds in the UK could be described as follows:

- Offshore funds, particularly those based in the Channel Islands and the Isle of Man, have a long history in the UK. They have been sold both to UK resident and domiciled investors, to UK expatriates and to non-UK domiciled individuals working in this country.
- In recent years, a European element has emerged as 'offshore' funds have been established in the EU tax havens of Luxembourg and Dublin.
- These can have marketing advantages over many of their Channel Islands and Isle of Man counterparts, particularly in terms of sales within the EU.

Much mythology has built up about the tax benefits of offshore investment, however:

- for an individual who is UK resident and UK domiciled there are very few tax benefits, beyond the initial payment of income gross and hence possible tax deferral;
- for UK expatriates who are classed as non-residents and for non-UK domiciled UK resident investors there may be both income and capital gains tax advantages and, for the non-domiciled investor, inheritance tax benefits.

Chapter 6:1

F2 Classes of recognised schemes

The FSA recognises offshore funds for purposes of marketing in the UK. They are generally categorised under three different sections of the FSMA:

- **Funds categorised as UCITS under EU legislation**: receive 'automatic' recognition from the FSA (s.264).
- **Certain funds in 'designated territories' (s.270)**: a designated territory is one that the FSA is satisfied gives a UK fund investor at least the same protection as applies to authorised unit trust investment. In practice, this means the offshore legislation, under which such funds are authorised by their home states, is very similar to the rules applying in the UK and there is a compensation scheme that is at least equal to its UK counterpart. Guernsey, Jersey, the Isle of Man and Bermuda all have designated territory status.

  Not all funds from these countries are covered by the respective regulations and FSA recognition

  However, not all funds from these countries are covered by the respective regulations and FSA recognition, and there are generally three layers of fund:
  - those approved by the regulator for the territory and FSA recognised (s.270 schemes);
  - those approved by the regulator for the territory, but not FSA recognised; and
  - those funds neither regulated by the territory, nor FSA recognised.

Classes of funds not recognised by the FSA

The two classes of funds not recognised by FSA are therefore subject to severe marketing restrictions (see section F5).

- **Funds from outside the designated territories but recognised by the FSA in their own right**: this is on an individual basis and they are covered by s.272, the least used section.

The *Financial Times 'FT Managed Funds Service'* pages clearly indicate those funds that have FSA recognition. They also show funds that, while not FSA recognised, are regulated by the authorities of Jersey, Bermuda, Guernsey, Ireland or Luxembourg. Owing to the advertising restrictions on unregulated funds, only the addresses and telephone numbers of managers of FSA recognised funds are shown in the Financial Times.

F3 Types of scheme

With so many different offshore centres all with different legislation, there is no uniform structure to offshore funds. Indeed, the structure of the fund may only become apparent on close reading of the product literature.

F3A OEICs

The basis of most offshore funds is very different from UK unit trusts, which have a similar structure in Europe known as the Fonds Commun de Placement (FCP). Many of the offshore funds marketed into the UK are constructed in a format that is similar to an OEIC and their structure is an open-ended ICVC. Investors are therefore buying shares in offshore companies, although the actual type of share held may be a participating redeemable preference share, rather than an ordinary voting share.

Many of the offshore funds marketed into the UK are constructed as OEICs

The most common type of investment fund in Europe is the Société d'Investissement à Capital Variable or SICAV. This is a type of investment company with variable capital and is the model for the UK open-ended investment company.

To allow marketing in the UK under the investor protection measures which pre-date the FSMA, some of the longer established offshore funds obtained (and still have) UK stock exchange quotations for their shares.

Umbrella funds

The OEIC structure allows many management groups to offer umbrella funds. These give the investor a choice of funds covering a range of investment areas, each sector fund offering or issuing a different class of share within the one company. Switches between funds therefore become a simple matter of share exchange, often at nil cost. This once offered a tax advantage to UK investors, which no longer exists. A switch between funds is now treated as a disposal with an immediate potential tax liability for the investor.

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Umbrella structure

From the managers' viewpoint, the umbrella structure makes it easier to create new funds, the interest in which is represented by another class of share. OEICs also allow managers to operate single pricing (i.e. there is no buying and selling structure), although this should not be taken to mean that initial charges disappear. In practice, 5%–6% is usually added as a sales charge.

F3B Unit trusts

A small number of funds are constructed along the lines of unit trusts, some of which are based on the foreign equivalent of UK trust law. A number of older, non-EU trust funds exist, invested in UK equities, which were tailored primarily for UK investors who wished to retain the benefit of UK tax credits or, as non-domiciled investors, hold UK shares in an IHT-efficient manner.

F3C Specialist funds

With fewer restrictions on investment, offshore funds can provide investment opportunities that are outlawed for their UK unit trust counterparts. For example, some offshore funds invest directly in commodities, while others are heavily invested in the options and futures market. However, the more specialist (and speculative) funds are usually not FSA recognised and would not satisfy UCITS rules.

The more specialist (and speculative) funds are usually not FSA regulated and would not satisfy UCITS rules

F4 Undertakings for Collective Investments in Transferable Securities (UCITS)

Once an UCITS fund is authorised in its host country, it can be marketed elsewhere within the EU, subject to the marketing rules of the other country being satisfied. In the UK that means that an UCITS fund from, say, France, has to register with the FSA under s.264 of the FSMA, and then wait for two months before it can start marketing under FSA rules.

F4A UCITS Directives

The original 1985 UCITS Directive laid down various requirements that a fund must satisfy. These include:

- an approved UCITS fund could not hold commodities or real property investments and a fund of funds was excluded from being a UCITS until the UCITS II Directive of 2001;
- fund assets must be held by a trustee or depositary, who manages the accounting and pricing aspects of the fund; and
- an UCITS fund must be open-ended, so close-ended funds, such as UK investment trusts, cannot be UCITS recognised.

In practice, the investment areas covered by the original UCITS funds are very similar to those on offer from UK unit trusts authorised as securities funds, the vast bulk of which themselves satisfied the old UCITS rules. However, the most recent Directive now allows a broader range of funds. To date, the theoretical marketing opportunities offered by UCITS have not resulted in a massive flow of money around Europe.

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Marketing into the UK

Marketing into the UK has been mainly undertaken by Luxembourg and Dublin UCITS funds, often established by well-known US and UK investment houses. Some management groups believe it is easier to establish UCITS funds, particularly in Dublin, rather than set up new UK-based unit trusts or OEICs. Others point to the fact that costs are much lower than in the UK.

F5 UK marketing status

Funds with FSA recognition can be marketed in the UK in much the same way as authorised unit trusts

Funds with FSA recognition can be marketed in the UK in much the same way as authorised unit trusts. However, they may not be sold following cold-calling because cancellation rules do not generally apply. If the fund manager is not a member of a UK regulatory body, all advertisements, including brochures, need to be approved by a member of a suitable regulator. For funds with UK parents, this will mean that the group's UK marketing company will provide approval.

Those funds without recognition are severely restricted by the FSMA regulations. In practice, they are primarily used within the UK by intermediaries for established clients with appropriate discretionary management agreements. The funds themselves cannot be publicly advertised except to investment professionals.

F6 Taxation treatment of investors

Reporting funds and non-reporting funds

For UK taxation purposes, offshore funds currently fall into two categories:

- reporting funds; and
- non-reporting funds.

F6A Reporting funds

Tax treatment

Most UK resident and domiciled investors prefer reporting funds.

- The main advantages of a reporting fund are that:
  - the dividends are paid gross; and
  - any capital gain on a sale is subject to the normal CGT rules.
- For investors to benefit from this CGT treatment, the fund must have retained reporting status throughout the period of their ownership.
- Since 22 April 2009, UK resident individuals have been entitled to a 10% non-reclaimable tax credit on distributions from all offshore funds.
- Dividends from funds constituted as companies are taxed as foreign dividends. They are paid with a 10% tax credit which is non-reclaimable and satisfies the liability of a basic rate taxpayer. Higher rate taxpayers are liable at 32.5%, and additional rate taxpayers at 42.5% as with other dividends.
- Where an offshore fund holds more than 60% of its assets in interest bearing securities, any distribution will be treated as a payment of interest in the hands of a UK investor. This means that no tax credit will be available and the tax rates applying will be those applying to interest (10%, 20%, 40% and 50%).
- A reporting fund does not have to distribute all of its income, but must report its income to HM Revenue and Customs (HMRC).
- The income need not be physically distributed, as the regime allows for deemed distributions or a combination of physical and deemed distributions.
- A UK investor in a reporting fund will be taxed on their share of the income of the fund, even if an actual distribution is not received.

F6B Non-reporting funds

Tax treatment

Non-reporting funds are usually roll-up funds

Non-reporting funds are usually roll-up funds, i.e. all income is accumulated and no dividends are paid.

The gain on any disposal, including the death of the investor, is calculated on CGT principles and is taxable in the year of encashment. However, the annual CGT exemption cannot be used to mitigate the tax liability.

- For the UK resident and domiciled investor the gain is liable to income tax at the basic rate, higher rate or additional rate, even though the gain may consist wholly or largely of dividends or reinvested savings income.
- Roll-up funds can be used to shelter accumulated income, perhaps allowing the investor to realise profits when their tax rate has dropped or they have become non-UK resident.

- For investors who are not resident in the UK, offshore income and gains will be free of UK tax, but possibly taxed in their country of residence.
- Investors who are UK resident, but not UK ordinarily resident and/or not UK domiciled are taxed on an arising basis on all UK or non UK income and capital gains as they arise. These investors with more than £2,000 unremitted foreign income can elect to be taxed on the remittance basis where they are only taxed on foreign income that they actually remit (bring into) the UK. If they elect to be taxed on a remittance basis they will lose their entitlement to personal allowance and the annual CGT exemption, and may also be subject to a tax charge of £30,000. Where unremitted foreign income is less than £2,000, the individual can elect to be taxed on a remittance basis, but retain the personal allowances and exemptions and not be subject to the remittance basis charge.
- Non-domiciled investors gain inheritance tax benefits by investing offshore. Their IHT liability is based only on their UK assets, so offshore funds will escape the UK IHT net.

Question 6.3

Do most UK investors prefer reporting, or non-reporting funds? Why is this?

F7 Taxation treatment of funds

Although offshore funds are based in tax havens, the funds are not completely free of tax as the following demonstrates:

Although based in tax havens, the funds are not completely free of tax

- If an offshore fund invests in equities, the dividends it receives will usually be subject to a non-reclaimable withholding tax. This is a minor inconvenience where investment is in low-yielding markets, such as Japan, but is a more significant loss in higher-yielding markets, like the UK.
- Investments in fixed interest securities will generally yield tax-free income because the funds will choose securities, such as Eurobonds or gilts, which pay income gross. Thus, for the UK resident investor, offshore fixed interest funds are generally more tax-efficient than offshore equity funds.

Taxation of offshore funds themselves

The offshore funds themselves may also be subject to a small amount of tax. For example, Jersey funds are subject to a small flat annual corporation tax charge, while new Luxembourg funds have to pay 0.10% of asset value each year.

F7A European Union Savings Directive (ESD)

The European Union Savings Directive (ESD) is a mandatory Directive, implemented by the EU in co-operation with some non-EU member countries. It provides for an automatic exchange of information between Member States on savings income payments made to EU resident individuals, and is designed to counter cross-border tax evasion on savings income. In the UK HMRC will receive information about the savings income that individuals receive from abroad from the tax authority of the country where the income is paid. They will then compare that information with what the investor declares to them.

ESD is designed to counter cross-border tax evasion on savings income

The Directive, which came into effect on 1 July 2005, applies to investors who are resident in an EU Member State and hold savings in another EU Member State or dependent territory. It also applies to EU residents who have savings in certain other countries, such as Switzerland, Liechtenstein, San Marino, Monaco and Andorra.

Under the directive, 22 EU Member States and their dependent territories will exchange information on savings held by non-residents. The three other EU members, Austria, Belgium and Luxembourg, and a number of territories, including Guernsey, Jersey and the Isle of Man and other financial centres such as Switzerland, Liechtenstein and Monaco have decided to operate a withholding tax on savings income instead of exchanging information. Since the directive was introduced, Belgium has now decided to exchange information and has ceased imposing withholding tax.

Twenty-two EU Member States and their dependent territories will exchange information on savings held by non-residents

For EU residents the withholding tax will be deducted at source at a rate of 15% initially, rising to 20% from 1 July 2008 and 35% from 1 July 2011 onwards.

In Guernsey, Jersey and the Isle of Man, the withholding tax will be known as retention tax.

As an alternative to the withholding tax, an investor may be able to receive gross interest if they authorise the bank to pass details about them and the interest they have received to HMRC. It should be noted that while banks can offer this service to customers, in practice individual organisations may decide not to do so, in which case the withholding tax option will be applied by default.

Any withholding tax that is deducted under the directive may be offset against other tax the individual has to pay, or can be reclaimed from HMRC if it exceeds their total UK income and capital gains tax liability.

Consider this…

The new regime is not limited to interest on bank deposits and bonds. The Directive extends the definition of interest to include payments from many collective funds, where more than 15% of the assets are fixed interest securities. For roll-up funds (which pay no interest) the threshold is 40%, but in time this will also fall to 15%.

F8 Underlying investments

In many ways the underlying investment spread of overseas funds mirrors that of UK unit trusts

In many ways the underlying investment spread of overseas funds mirrors that of UK unit trusts. A quick look through the categories covered in the financial press reveals that many offshore fund sectors are also to be found among authorised unit trusts.

F8A Equities

There is a spread of UK and international equity funds, although UK funds do not generally play the predominant role they do onshore. Other characteristics are:

- withholding taxes generally means that the investment emphasis of equity funds tends towards growth rather than income;
- as the funds are targeted at a wide range of overseas investors, the international equity choice is extensive; and
- as well as the general global international funds, there are single country funds, geographical sector funds and specialist sector funds, such as technology and commodity.

F8B Fixed interest

Biggest single bond is international fixed interest

Many foreign investors favour bond investments and there is no shortage of offshore fixed interest funds. The major currencies (euro, dollar, yen etc.) warrant a fund sector each, with sterling being the largest. However, the biggest single bond fund sector is international fixed interest, which covers funds investing across the world's bond markets.

Fixed interest

Withholding tax is not generally a problem for most offshore bond funds because they can usually invest tax-free both directly, or through the Eurobond and other international markets. As a result, income is normally a more important factor in selecting bond funds.

F8C Currencies

An offshore sector that does not have a UK unit trust counterpart is the currency fund sector

An offshore sector that does not have a UK unit trust counterpart is the currency fund sector. This sector has grown rapidly, offering international investors a tax-efficient and cost-effective alternative to currency deposits with banks.

- Many groups use umbrella funds for this market, with a range of sub-funds covering each of the major and some minor currencies. Some groups aiming at UK investors offer two series of funds: one distributor, the other non-distributor.
- Switching between funds is simple, quick and usually carried out at much finer exchange rates than banks usually offer for small sums of currency. While the funds often end up depositing money back with the banks, the larger amounts they deposit mean that the interest rates they receive are typically higher than those most individuals could earn.
- In addition to single currency funds, some offshore groups also run managed currency funds, which attempt to capitalise on changes in exchange rates.

F8D Fund denomination

Most offshore funds are denominated in a currency other than sterling

Most offshore funds are denominated in a currency other than sterling. However, the denomination of the fund may be driven by the target audience, rather than by specific currency considerations.

Thus, while one Japanese fund denominated in dollars may always invest directly into Japan and never hedge currency risk, the other may hedge against the yen falling against the dollar. For the fund that does not hedge, the currency of denomination is actually irrelevant, as the investor is directly exposed to the yen. Often, the only way to discover the fund's approach to currency risk is to ask the fund managers.

F8E Specialist funds

Beyond these mainstream categories a number of specialist funds can be found investing in areas such as physical commodities, derivatives and warrants. These funds tend to fall outside what the FSA will allow to be marketed in the UK.

G Closed ended funds/investment trust companies

Investment trust companies are among the oldest and most widely used types of collective investment. Investment trusts were first set up over 100 years ago to provide small investors who wanted to invest overseas with an opportunity to do so at a low cost, and to diminish their risk by spreading their investment over a number of stocks. They still fulfil this function today, although investment trusts are also widely held by institutions.

Investment trust companies are among the oldest and most widely used types of collective investment

They are a collective investment that pools the money of many investors, spreading it across a diversified portfolio of stocks and shares that are selected and managed by professional investment managers. Subject to any restrictions in their Articles of Association, investment trusts can:

- invest in any kind of company, whether its shares are quoted on a stock exchange or it is an unquoted, private company;
- provide venture capital to new firms or firms that want to expand; and
- invest in any country in the world.

There is a wide range of investment trusts offering exposure to different industries and regions of the world. They have a variety of investment objectives, ranging from security of capital with no income, to very high income with low capital security.

Question 6.4

Who do you think runs an investment trust?

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G1 Main categories

The Association of Investment Companies (AIC) classifies investment trusts into 22 main sectors, five property sectors, 12 specialist sectors and 7 VCT sectors, based on a combination of the regional and industry focus of the portfolio. Different regions of the world and economic sectors will have varying levels of risk:

- some areas of the world are more stable than others;
- some economic sectors can be more affected by unpredictable world events, such as weather patterns; and
- overseas funds can be affected by currency fluctuations.

Activity

Visit the AIC's website: www.aitc.co.uk/statistics-publications and familiarise yourself with the various sectors. Find an example of each.

G2 How investment trust companies work

Investment trusts operated initially as common law trusts. However, doubts about the legality of this status led them to become public limited companies when the first Companies Act was passed in the 1860s. As such, they:

Investment trusts operated initially as common law trusts before becoming public limited companies

- issue a fixed number of shares, hence they are described as **closed-ended** funds; and
- are regulated by company law and their shares are traded on the London Stock Exchange.

One of the advantages of their fixed capital structure is that managers can take a long-term view with their investments. They do not have to sell their best holdings if investors want their cash back in the way that unit trust managers are sometimes forced to do.

As public limited companies, investment trusts can borrow to 'gear' up (see section G11).

An investment trust is run by an independent board of directors that is responsible for looking after the interests of shareholders:

- the directors may employ a salaried fund manager (or managers) directly, in which case it is called a **self-managed trust**; however,
- nowadays, it is more common for the directors to employ, under contract, an external management group to undertake the day-to-day investment management and also to provide other services such as administration, registration and accountancy.

Management groups

Management groups typically provide services to a range of different trusts and are instrumental in setting up new trusts. However, they must appoint a majority of independent directors to the trusts' boards and this majority must be maintained under the FSA regulations.

Day-to-day running of the trusts is in the hands of the managers

The day-to-day running of the trust is in the hands of the managers, although they will usually meet with the board on a regular basis to discuss investment policy. If the board is unhappy with the progress of a trust, it can move it to another management group. Sometimes shareholders may also press for such a move to be made.

G2A Share price

Investment trust company shares are traded on the London Stock Exchange after they have been issued. The share price will then depend on supply and demand in the market. The share price published in the newspapers is the mid-market price, although dealers actually quote two prices:

- the higher, buying or **offer price** is the price at which investors can purchase shares; and
- the lower, selling or **bid price** is the price at which investors can sell shares.

The difference between the prices is known as the **market makers' spread** or **turn**. The spread varies according to the supply and demand for the shares. Large, generalist trusts have narrower spreads than smaller, specialist trusts because there is generally more demand and more stock availability in these trusts.

Consider this…

Buying and selling shares in investment trusts is exactly the same as buying and selling any other shares quoted on the Stock Exchange, although investors can often deal more easily and cheaply through investment trust managers themselves rather than having to use stockbrokers.

G2B Net asset value (NAV) per share

In principle, the net asset value (NAV) of an investment trust is equal to the total value of all of the investments within the trust, less any liabilities that the trust may have.

Calculating the NAV per share

It is calculated by taking:

- the total value of a trust's listed investments at mid-market prices;
- **plus** its unlisted investments as valued by the directors;
- **plus** cash and any other assets;
- **less** the nominal value of loans, debenture stock and preference shares; then
- the resulting figure is known as the **shareholders' funds**.

The NAV of an investment trust is usually expressed as an amount per ordinary share. The NAV per share is the available shareholders' funds divided by the number of ordinary shares in issue.

Example 6.5

If shareholders' funds are worth £50 million and there are 25 million ordinary shares, the NAV per share would be 200p. If an investment trust is wound up, shareholders receive the NAV of their shares, after repayment of prior charges and the payment of wind-up expenses.

Diluted and undiluted NAV

The simple approach used to calculate NAV can, however, give a misleading figure, as many investment trusts have issued warrants or loan stocks with options to convert into ordinary shares. Typically, these give warrant holders the right to subscribe for one ordinary share for each warrant that is held, at a fixed price, within a specified period of time, and allow the holders of convertible loan stock to convert into ordinary shares under specific terms and conditions.

The diluted NAV per ordinary share is calculated assuming that all of the outstanding warrants and convertible loan stocks are exercised, something that the undiluted NAV figure ignores. The result of the holders exercising their rights would be an increase in the number of ordinary shares amongst which the assets are divided, but without a proportional increase in the value of the trust's assets.

Example 6.6

If a trust has ten million ordinary shares and two million outstanding warrants that give the holders the right to subscribe at £1 per share, and the trust's assets are worth £16 million, the diluted NAV per share is calculated as:

$$\frac{\text{Net assets plus money subscribed by warrant holders}}{\text{Number of ordinary shares in issue plus new shares issued to warrant holders}}$$

$$= \frac{£16\text{m} + £2\text{m}}{£10\text{m} + £2\text{m}} = £1.50 \text{ per share}$$

The undiluted NAV per share would be:

$$\frac{\text{Net assets}}{\text{Number of ordinary shares in issue}}$$

$$= \frac{£16\text{m}}{£10\text{m}} = £1.60 \text{ per share}$$

G2C Discounts and premiums

Over the long term the movement in a trust's share price will reflect the progress of its investments. However, it is rare for the price to match the NAV per share exactly, since the price is set by market demand for the shares.

Over the long term movement in a trust's share price will reflect the progress of its investments

Discounts

When the share price is lower than the NAV per share, it is described as trading at a **discount** because shareholders are 'buying' the underlying assets at a lower price than they would pay if they purchased the same investments direct. The discount is the difference between the share price and the NAV per share, expressed as a percentage of NAV per share.

For example, if the share price is 180p and the NAV per share is 200p, the discount is 10%. Discounts arise when there are more sellers than buyers of the shares. In general, most investment trust shares trade at a discount.

Premiums

If the share price is higher than the NAV per share, then the investment trust is said to be trading at a premium. If the share price is 210p and the NAV per share is 200p, the premium is 5%. This is rare, but can occur when there is a particularly high demand for an investment trust. An example of an investment trust trading at a premium is Fidelity China Special Situations Trust where investors are prepared to pay a premium to access the investing skills of legendary fund manager Anthony Bolton.

If the share price is higher than the NAV per share, the investment trust is said to be trading at a premium

Premiums and discounts

It is not necessarily a good thing to buy shares when they are trading at a discount, or a bad thing to buy them when they are trading at a premium. It is the growth of the underlying assets that will, over time, drive the share price.

G3 Investment performance

The performance of investment trusts is usually measured over various periods on the basis of share price movements, taking into account reinvested income. This is the return to shareholders.

An alternative basis for measurement is net asset value return, including reinvested income. This shows the performance of the trust's investments and is a more accurate reflection of how skilfully the investment managers have run their portfolio.

An alternative basis for measurement is net asset value return, including reinvested income

Narrowing discounts

When the popularity of an investment trust increases and demand for its shares rises, the share price performance figures can show it in a particularly favourable light. Not only can they reflect the increasing value of the trust's investments, but the narrowing of the discount helps to enhance the results. If the discount narrows during the period the investor holds the shares, it provides a better return on the share price than on the underlying assets.

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Example 6.7

If at the beginning of a period an investment trust has a share price of 86p and a NAV per share of 100p, this means that it is trading at a discount of 14%, i.e.:

$$\frac{100p - 86p}{100p} \times 100 = 14\%$$

Assuming its share price rises to 141p and its NAV to 150p, this means the discount has closed to 6%, i.e.:

$$\frac{150p - 141p}{150p} \times 100 = 6\%$$

While the NAV per share has appreciated by 50% from 100p to 150p, the share price has increased from 86p to 141p; and hence an investor's return has been enhanced to 64% by the closing of the discount.

Widening discounts

Widening discounts will have the reverse effect as they can reduce the gain an investor could potentially receive. Worse still, if the stock market falls and discounts widen as well, an investor's losses will be greater than the reduction in the value of a trust's investments. It should, however, be noted that if an investor is not a 'forced' seller, any loss is only a paper loss and not a 'real' loss until the shares are actually sold for cash.

Wider discounts can be regarded as buying opportunities by professional investors, who may put pressure on managers to restructure a trust or convert it to a unit trust in order to overcome the discount problem. Any such action, which results in the narrowing or disappearance of the discount gives investors an automatic gain.

If the discount is wide managers may also seek to 'buy back' some of a trust's shares to reduce the oversupply and bring about a narrowing of the discount.

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Question 6.5

If a share price is 210p and the NAV per share is 200p, are the shares said to be trading at a discount or premium? What is the discount or premium here?

G4 Regulation and approval

An investment trust company must conform to regulations laid down by the Companies Acts, the FSA and HMRC.

Trusts themselves do not deal directly with the public. However, if a management company or subsidiary company wants to sell the trust's shares to the public through a savings and investment scheme, then it must be authorised to carry on investment business under the **FSMA**.

As a public limited company, an investment trust is formed under (and controlled by) the Companies Acts, FSA and HMRC

As a public limited company, an investment trust is formed under, and controlled by, the Companies Acts. When it is formed, the rules and objectives of the trust have to be laid down in its Memorandum and Articles of Association.

The FSA lays down a number of principles for a company seeking a listing as an investment trust, as follows:

- the investment managers must have adequate experience;
- there must be an adequate spread of investment risk;
- the company must not control, or seek to control, or be actively involved in the management of the companies in which it invests;
- the trust must not, to a significant extent, be a dealer in investments; and
- the trust must have a board that can act independently of its management.

The FSA also requires that the company must seek HMRC approval under s.842 of the **Income and Corporation Taxes Act 1988**. A company will usually want to do this anyway, as HMRC approval means that a trust will not be liable for tax on the capital gains it makes from sales of shares. To gain approval, the company must satisfy HMRC that:

- it is resident in the UK and is not a 'close' company (basically a company controlled by five or fewer persons);
- its income is derived wholly or mainly (at least 70%) from eligible investments including shares and securities;
- it does not invest more than 15% of its assets in any one company;
- the ordinary share capital is listed on the London Stock Exchange;

- the Memorandum or Articles of Association prohibit the distribution as dividend of surpluses arising from the realisation of its investments (this rule does not apply to venture capital trusts); and
- it does not retain more than an amount equal to 15% of the gross income received from its investments in shares and securities.

The March 2011 budget contained proposals to simplify the tax system for investment trusts. The proposed new rules will remove the obligation for investment trust companies to hold no more than 15% of the portfolio in any one company, replacing this with a characteristics-based approach. This is to be based on the current Listing Rule requirement for an investment company to produce an investment policy which demonstrates how it will spread risk within the portfolio.

Regulation and approval

Some investment companies registered offshore are managed in the UK and therefore can qualify as investment trusts. These companies are listed on the London Stock Exchange and have s.842 approval from HMRC. However, some companies marketed in the UK do not have s.842 approval and investors need to check the tax situation with the managers.

G5 Capital structure

Investment trusts are generally divided into two types:

- conventional; and
- split capital;

reflecting differences in their capital structures.

Investment trusts are generally divided into 'conventional' and 'split capital'

G5A Conventional trusts

Conventional investment trusts issue one main class of equity share, known as ordinary shares. These entitle investors to all of the income and capital gains produced by the trust investments, subject to any borrowing or preference shares that have a prior charge.

Conventional trusts

Conventional trusts are usually set up for an indefinite term and some are now over 100 years old.

G5B Limited life investment trusts

A number of the newer conventional trusts have started off with limited lives after which time shareholders are asked to vote on whether to wind up or continue the life of the trust, typically by extending its life for three years at a time.

The benefit to investors of a limited life trust is that it helps to reduce the discount (the difference between the share price and the net asset value).

In theory, as the winding-up date draws near, the discount will narrow because investors could obtain the full value of a trust's assets (after repayment of any prior charges, wind-up expenses etc.) if they voted to wind up the trust. However, there is no guarantee of this happening. Nevertheless, the possibility of such a vote can help to keep the investment managers on their toes.

Consider this…

It should be noted that, as with any plc, shareholders can vote to wind up an investment trust at any time.

G6 Split capital investment trusts

Like a conventional trust, a split capital investment trust has one portfolio of investments that can produce both growth and income. However, it may have two, three or even four different classes of shares, which are entitled to different returns and are ranked in a particular order of priority for repayment on a winding up. The different categories are useful for investors looking for a particular type of return – growth or income, high risk or lower risk.

Some split capital investment trusts also offer 'units' which are packages of its different classes of shares that produce equivalent returns to an ordinary share in a conventional trust.

Split capital investment trusts have a limited initial life span, which is typically five to ten years. They can then be wound up and the different classes of shares repaid in order of priority, assuming sufficient assets are available.

Shareholders are not locked into the split capital investment trust until the end of its life

Shareholders are not locked into the trust until the end of its life. They can buy and sell the shares of splits at any time, just like conventional trusts. However, it is important to bear in mind a trust's winding-up date, as this will influence the behaviour of its share prices.

G6A Redemption yields

The redemption yield measures the capital and income return on a particular share until wind-up. It is expressed as an annual percentage, so that it can be compared with returns on other forms of investment, such as building society deposits or gilt-edged securities.

A redemption yield of 7% on a share means that if the investor bought it at the quoted price, and held it until the company is wound up, the value would have grown by 7% each year between purchase and redemption.

Redemption yields for income, capital and other variable shares are based on assumed growth rates of –2.5%, 0%, 2.5%, 5%, 7.5% and 10%.

The redemption yield shows the total return as an annual percentage. It assumes that the shares are bought at the current price, held until redemption, and that the assets and dividends payable (for share classes entitled to dividends) grow at the rate assumed.

The **equity redemption yield** shows a similar annual percentage rate, but bases the return on growing only the equity portion of the portfolio, holding any cash and fixed interest holdings constant.

G6B Hurdle rates

The hurdle rate indicates the annual growth rate at which the company's investments must grow each year in the future, if they are going to be sufficient to repay each class of share at the wind-up date at either the current purchase price, the pre-determined redemption value (if applicable), or just repay the prior charges ranking before each share class. The calculation takes into account any classes of share that rank for prior payment.

The hurdle rate can be expressed in one of three ways; in relation to:

- the current share price;
- the pre-determined redemption value; or
- a zero terminal asset value, known as wipe-out.

These hurdle rates can be found for each class of share in the Association of Investment Trust Companies Monthly Information Service. They have the following implications:

- a hurdle rate of 2%, for example, means that the company's investments must grow by 2% each year to pay either the current purchase price, the pre-determined redemption value or just wipe out the value at wind-up; and
- a negative hurdle rate means there are already surplus assets and that total investments can decline in value by that amount each year and still leave enough to pay either the current purchase price, the pre-determined redemption value or nothing at wind-up.

Consider this…

It should be possible by looking at a trust's investment portfolio to make a judgment about whether the hurdle rates will be met over the remainder of the trust's life. A high hurdle rate may be difficult to achieve if the trust has a heavy weighting in fixed-interest securities or has expensive borrowings.

G6C Asset cover

Asset cover is another way of measuring the company's ability to meet or cover, from current assets, the liability to share classes with a pre-determined redemption price.

It is the ratio by which the pre-determined redemption value for a class of shares is currently covered by those assets of the company that are available for them. Any shares ranking for prior payment are taken into account first.

Asset cover

A cover of 1 means that the assets exactly cover the redemption price. A cover of 50% or 0.5 means that half of the redemption price is covered.

G6D Redemption

In practice, when a split capital trust reaches its redemption date, rather than winding it up, managers will generally offer investors a 'roll-over' investment vehicle. This will usually be a new investment trust of a similar nature into which they can transfer their investment without incurring an immediate capital gains tax liability.

However, a cash alternative will almost always be offered to those investors who do not wish to continue.

G7 Classes of shares

Some investment trusts have complex structures, with various classes of shares offering different types of return to investors.

The main classes of share in the investment trust sector are detailed in the following sections.

G7A Ordinary shares

These are the main type of conventional investment trust share. Generally these shares are entitled to all of the income and capital growth from the trust's investments, subject to any borrowings with a prior charge that the trust may have.

Ordinary shares are the main type of conventional investment trust share

G7B Preference shares

Conventional investment trust preference shares pay a fixed dividend, which must be paid before any income is distributed to ordinary shareholders. They also have a prior claim to the assets of a company in the event of a winding up. Nowadays zero dividend preference shares are a common feature of split capital trusts.

G7C Split capital shares

Split capital trusts were originally designed in the 1960s with two classes of shares:

- **income shares**, which are broadly entitled to all of the income received by the investment trust, with a pre-determined capital return when the trust is wound up; and
- **capital shares**, which have no entitlement to any income, but receive the remainder of the assets on wind-up.

This structure has evolved over the years to include other classes of share, offering different combinations of income and capital.

Zero dividend preference shares

Zero dividend preference shares (zeros) are found in virtually all newly-launched split capital investment trusts. They have the following characteristics:

Zero dividend preference shares (zeros) are found in virtually all newly-launched split capital investment trusts

- **Limited life**, with a capital return from the assets of the split capital fund.
- **Fixed redemption dates**, which coincide with the end of the trusts' lives, this is typically no more than ten years. As their name implies, zeros have no entitlement to income, instead they participate in the capital performance of a trust. They have preferential rights over the distribution of capital at the end of a trust's life, subject to any borrowings with a prior charge.
- **Issued at an initial value**, which in effect rises at a pre-determined compound annual growth rate until it reaches the final redemption value. The market price may not reflect this progress exactly. Prices and redemption yields will be influenced by general interest rates and the security of the underlying portfolio. The shares have no entitlement to any of the residual capital value of the fund.
- **Taxed under capital gains and not income tax rules**. They are especially attractive for investors not using their annual capital gains tax exemption because they can obtain tax-free returns. In the past, they have been regarded as low-risk investments as trust assets at outset are often sufficient to cover their repayment. However, this is not guaranteed because a trust's assets may fall in value. Investors will need to check how well a trust's zeros are covered to ascertain the risk and the nature of the trust's investments.

Traditionally zeros were regarded as being useful for investors who wanted relatively low risk, predictable returns to meet a known liability, such as school fees. However, the problems in the split capital market in September 2001 underlined the risk in zeros of highly geared trusts with cross shareholdings in other splits, with some of them not achieving their full maturity values, although it should be noted that this problem did not affect all trusts.

Income shares

There are several types of income shares that are entitled to income paid in the form of dividends

There are several types of income shares that are entitled to income paid in the form of dividends. However, there can be significant differences in their capital entitlement at wind-up. It is important to distinguish between these when advice is given, because certain shares can give rise to substantial capital losses at redemption. The characteristics of income shares are as follows:

- The traditional income share gives a right to income with a fixed redemption price (often equal to its issue price), subject to sufficient assets remaining after repayment of debts and other preferred classes of share. However, the redemption price may be well below the current market price.
- Some split capital issues have included income shares closer to an annuity in form, with a high income level, but only a nominal redemption amount that is far less than the issue price, e.g. 1p for a 100p share.
- A third, and increasingly common, type of income share is the ordinary income share. These are often found in trusts in combination with zero dividend preference shares. They have no pre-determined capital value, but receive all the income and all the surplus capital available, if any, after the holders of the zeros and any borrowings have been paid. They may also be described as **income and residual capital shares**. There is no guarantee how much capital, if any, will be available after the zeros and any borrowings have been paid off. These shares may be attractive to investors who want an above average income and are prepared to take risks with their capital.

Capital shares

Generally, these entitle the shareholder to the capital remaining on winding up of the trust after all other classes of share and borrowings have been repaid. They have no pre-determined capital entitlement or any rights to receive income, but because of the gearing effect of the other classes of shares, they provide the possibility of superior capital returns. However, gains are not guaranteed. Indeed, investors could suffer a total loss. These shares are only suitable for investors prepared to take a high risk for a potentially high return.

Packaged units

Some of the recent split capital investment trust issues have bundled together 'packages' of capital, income and zero dividend preference shares. This creates what is the equivalent of an ordinary share of a conventional trust.

G8 Warrants

Warrants are not shares but are a right to buy shares at a fixed price at a pre-determined date or within a specified period in the future. They produce no income and are an investment with a potentially high level of risk and reward. The price of a warrant is only a fraction of the share price but movements in the price of the warrant tend to magnify changes in the share price.

Warrants can be bought and sold on the Stock Exchange at any time until their final exercise date

Warrants can be bought and sold on the Stock Exchange at any time until their final exercise date. They are usually worth exercising if the holder is able to buy the shares at a discounted price. If they are held beyond expiry and not exercised then they have no further value.

Warrant holders have no income tax liability, as they receive no dividends. They are therefore taxed under capital gains rules, with any gain in excess of the investor's annual capital gains tax exemption being subject to tax.

Most investment trust warrants are issued as 'sweeteners' with new investment trust share issues. Typically, one warrant is given away to investors for every five shares purchased. The difficulty with new investment trusts is that investors have to pay the net asset value plus the launch costs for the new shares issued to them. However, the investment trust will usually trade at a discount very soon after launch, creating an instant loss. The aim of the warrant is to enhance the return to the investor by offsetting the reduction in the share price.

Once issued, investors have the choice of selling the warrants separately from the shares or of retaining them to buy extra shares by exercising the warrants at a future date. However, this will not be worthwhile until the market price of the shares exceeds the 'exercise price'.

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Prospective investors

Prospective investors in a trust which has warrants in issue need to be aware that if the warrants are exercised and more shares created, there will be a dilution in the NAV per share of existing shares. The exercise of warrants will result in a greater number of shares, without a proportionate increase in the value of the trust assets. Recently some trusts have repurchased their warrants to reduce the dilution effect.

G9 Suitability for investors

Split capital investment trusts provide investors with the opportunity to invest in different share classes to fulfil different financial needs, i.e. investors who:

- require a very high income, and who are prepared to erode their capital, can purchase annuity income shares;
- require income with some capital protection, can purchase traditional income shares;
- require a combination of income and the potential for capital growth and who are prepared to accept a relatively higher level of risk, can purchase income and residual capital shares;
- do not require income, but are looking for capital growth at lower risk, can purchase zero dividend preference shares; and
- are seeking the possibility of higher than average capital growth and are prepared to take a higher risk, can purchase capital shares.

G10 Share buybacks

Boards of investment trusts with large discounts can initiate programmes of share buybacks in order to reduce the oversupply of a trust's shares. Trusts have first to seek the permission of their shareholders to carry out a buyback.

Since 1 December 2003 investment trusts that have carried out a share buyback have been permitted to hold up to 10% of its share capital 'in treasury', as opposed to having to cancel them. This works as follows:

- an investment trust can hold treasury shares indefinitely and then choose, at a later date, either to cancel them, or sell them for cash; and
- until they are sold, treasury shares carry no voting rights or rights to dividends.

This gives boards of investment trust companies a greater ability to balance supply and demand for a trust's shares. This is because they are able to buy back shares when they are out of favour and sell them to investors when there is an increase in demand.

Chapter 6:1

G11 Gearing

Investment trust managers can borrow money to buy shares and other assets if they see a good investment opportunity but do not have sufficient free capital available to take advantage of it. This is known as financial gearing (this concept was introduced briefly in chapter 5, section C).

Gearing

Gearing is expressed as an investment trust's total gross assets divided by the net assets (shareholder's funds), multiplied by 100:

i.e. $\frac{\text{total gross assets}}{\text{net assets}} \times 100$

- A figure of 100 means that there is no gearing.
- A figure of 120 means that the fund is 20% geared (20% of the total assets are borrowed funds).

Financial gearing can be implemented in a number of ways. Investment trusts can arrange long- or short-term bank loans in sterling or foreign currencies, or issue debentures, unsecured loan stock or preference shares.

Investment trusts can arrange bank loans in sterling or foreign currencies, for example

The ability of trusts to gear can work to the advantage of shareholders if the investment returns achieved with the borrowed money exceed the cost of servicing the loan.

However, if they do not exceed the cost the trust's performance will suffer. A bank may call in its loan if the assets of the trust fall too far in relation to the loan. A trust may then be forced to sell shares in order to repay its borrowings.

This can badly damage its performance, and trusts with high levels of gearing are thus generally regarded as a more risky investment than those without borrowings.

Use of gearing

Not all investment trusts use financial gearing, and many of those that do use it to very modest levels. The decision on whether or not to use gearing is taken by the fund manager and the board of directors. Other investment vehicles are unable to borrow to the same extent as investment trusts.

Trusts with different share classes

Split capital investment trusts may be financially geared, but they will also be geared as a result of their capital structure. The different share class priorities and their pre-determined entitlements can provide a type of gearing called structural gearing, with the different classes of shares having varying levels of risk. This has the following effects:

- the returns on each class of share are affected by the entitlements of other share classes that rank for prior payment;
- the number of share classes and their particular entitlements determine the level of structural gearing involved; and
- classes of shares that are lower down the order of entitlement are higher risk as a result of the capital structure.

Structural gearing is inherent in the nature of split capital investment trusts, but some also have borrowings (financial gearing).

Structural and financial gearing?

Those split capital investment trusts with high levels of financial gearing in addition to their structural gearing will be even higher risk.

G11A Risk warnings in respect of geared investment trusts

The FSA Conduct of Business rules state that advisers need to provide an enhanced risk warning to clients if they recommend or buy significantly geared investment trusts. The rules state that the enhanced warnings must be given if:

- an investment trust uses or proposes to use gearing as an investment strategy;
- it invests or proposes to invest in other investment trust companies that use or propose to use gearing as an investment strategy; and/or
- the overall result of the exposure to gearing is likely to subject the value of the investment trust company share to significant fluctuations compared to the underlying investment.

The definition of gearing is broad and relates to financial gearing (i.e. bank loans, debentures), structural gearing (in the case of splits) or investing in other types of geared instruments (e.g. warrants or other derivatives). It also covers additional exposure to gearing that arises if the company invests in other investment trusts, which themselves use gearing. It is therefore necessary to look at gearing in its totality, both in the investment trust itself and in its investments, and determine whether the total effect of gearing is 'significant'.

Consider this…

There is no precise definition of 'significant', but typically a conventional investment trust with no underlying or structural gearing, and with effective financial gearing in place below 30%, should not be subject to the risk warning rules. Where the enhanced risk warning is required, an adviser must bring the risks to the customer's attention before recommending a particular transaction.

G12 Investment trust charges

The main charges that are made within an investment trust are detailed in the following sections:

G12A Annual management charge

The annual management charge pays for the external management of an investment fund, or the staff costs of a self-managed fund:

- management charges tend to be lowest on the older, general trusts, where they are still typically under 0.5%;
- on newer, more specialist trusts, annual management charges of 1%–1.5% have become usual; and
- some trusts also have performance fees, with managers receiving an extra fee if they out-perform certain stock market indices. A number of managers have moved over to performance fee structures in the past few years.

Management charges can be taken from a trust's income or capital, or both

Management charges are generally scrutinised periodically. They may be renegotiated and are usually subject to one year's notice of termination. They can be taken from a trust's income or capital or both.

While average charges have risen with the launch of new trusts, they still tend to be lower than annual fees on unit trusts and OEICs, which these days are between 1% and 1.5%.

G12B Other expenses incurred within the fund

Some expenses are incurred separately by the trust. These include such items as auditors' and custody fees, directors' remuneration, marketing and promotion costs and secretarial costs. These expenses may add another 0.2%–0.5% a year to the costs of the fund.

The resulting figure is known as the **total expense ratio (TER)**. The TER is a single percentage figure that shows the proportion of a fund's assets that are consumed by the operating charges incurred in the fund, during the period under review, which is usually a year.

The TER takes into account the annual management charge and all of the other expenses of running the fund. It is a fairer and more accurate indicator of the charges and their effect on a fund's performance, than the quoted annual management charge.

TER takes into account the annual management charge and all of the other expenses of running the fund

TERs for most investment trusts are available from internet sites specialising in the sector.

G12C Extra charges made outside the fund

These are charges that usually occur at the time of the transaction, and include:

- **the spread**: the difference between the price at which an investor can purchase and sell shares;
- **dealing charges**: commission for carrying out the deal, and stamp duty on purchases;
- **ISA charges**: an additional charge to cover administration costs, or a withdrawal, switch or transfer fee when a trust is held in an ISA; and
- **charges for advice**: a fee paid to a professional adviser by the client, or commission paid by the product provider.

G13 Disclosure requirements

Providers of investment trust savings schemes and ISAs have to supply investors with a Key Features document. This contains essential information about their trusts and includes a table showing the effect of charges and expenses at the end of one, three, five and ten years. This will include any extra charge made for the savings plan or ISA wrapper.

Providers of investment trust savings schemes have to supply investors with a Key Features document

As future investment performance is unknown, managers are required to base their projections on reasonable assumptions of future growth, supported by objective data.

The Key Features document will allow investors to compare costs with those levied on similar investments, such as unit trusts and insurance products, which must show their charges in the same way.

G14 Dealing in investment trust shares

Investment trust shares can be bought and sold either through a stockbroker, or through the managers via an investment trust savings and investment scheme (ITSS).

G14A Stockbrokers

Until the mid-1980s the only way to buy investment trust shares was through a stockbroker.

Until the mid-1980s the only way to buy investment trust shares was through a stockbroker

Now, most smaller investors prefer the convenience and low cost of buying shares through the investment trust manager. However, not all investment trust shares can be purchased through an ITSS so their shares still have to be bought through a stockbroker. Moreover, if share prices are moving rapidly, or an investor wants to buy or sell at a certain price, then it may also be more suitable to use a broker. This is because ITSS operators may not deal on a daily basis.

Execution-only
Investors who know which investment trust they want to buy can deal through a stockbroker on an 'execution-only' basis. Commission is lowest for this type of deal, although it will vary from broker to broker. Many have a minimum fee of, say, £10 and there is also government stamp duty of 0.5% to pay.

Trust recommendation

If a stockbroker is asked to recommend a trust, a higher rate of commission will be payable for this advisory service.

Discretionary investment
Some stockbrokers offer discretionary investment trust management services for larger investors with, say, £25,000 or more to invest. They will select and manage a portfolio of investment trusts to meet different needs, e.g. capital growth or income. Investors are charged an annual management fee plus the costs of dealing.

G15 Savings and investment schemes

Direct investment through a management company first became possible when Foreign & Colonial introduced its ITSS in 1984. All the major management groups now accept direct investment. As well as catering for private investors who want to deal direct, most of the schemes also provide for the optional payment of commission to advisers.

Minimum investments

For investors with modest sums, the schemes are convenient and low cost

For investors with modest sums, the schemes are convenient and low cost. They cater for regular savers contributing as little as £25 per month and for investors with lump sums starting at £250. For investors who do not want income, dividend reinvestment facilities are available.

Charges

Charges vary between managers. Initial purchasing costs typically range between 0.2% and 1%, but some managers charge nothing at all for buying or selling shares through their schemes. All the investor has then to pay is government stamp duty of 0.5% on a purchase. For lump sums, investors can agree that up to 3% be deducted to pay an adviser.

Managers usually keep their costs down by dealing in bulk, pooling investors' money and buying shares just once a month or once a week, although daily purchases may be made for larger lump sums.

Share exchange

As well as accepting cash into their savings and investment scheme, some managers offer attractive low cost share exchange services. They will take holdings of UK shares, realise them for cash and provide investors with investment trust shares in return.

Documentation

When purchasing shares through an investment trust manager, an advice note will be sent to the investor after an application and a cheque have both been received. This will confirm the purchase and show the number of shares purchased and their price. To keep costs down, shares purchased in this way are usually held in a nominee account so the investor will not receive a share certificate. Investors investing monthly receive six-monthly statements.

Investors who buy shares in new issues or deal through a stockbroker will receive a contract note

Investors who buy shares in new issues or deal through a stockbroker will receive a contract note. Stockbrokers also tend to operate nominee accounts unless a share certificate is specially requested.

G16 Individual Savings Accounts (ISAs)

Many investment trust managers offer a stocks and shares ISA linked to one or more of their trusts. While some managers do not make any charge for the ISA wrapper, most levy a small initial and annual charge. This can be at a flat rate or at a percentage of the investment value, to cover the additional administration costs. A growing number of investment trust managers will also increase the initial charge in order to pay commission to IFAs. All s.842 approved investment trusts can be held via ISAs.

For many investors, the 1999 reduction to 10% in the rate of dividend tax credit repayment and its eventual removal in April 2004, mean that the ISA's income tax advantage is more than nullified by the annual charges levied.

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Appeal of investment trust ISAs

Investment trust ISAs are therefore likely to be of most appeal to higher rate taxpayers and those who need the capital gains tax shelter which ISAs provide. For others, a straightforward savings scheme is likely to be a better option, unless the ISA is free of additional charges.

G17 Dividends and taxation

Investment trust dividends are paid either by means of a cheque sent directly to investors, or transferred into an investor's bank account. If investment takes place through a savings and investment scheme, investors can opt to have the money reinvested in more investment trust shares. However, the charge for this facility and how it is organised should be investigated beforehand to make sure it is worthwhile.

G17A Taxation of investment trust companies

The taxation situation is as follows:

Investment trust companies are not subject to any additional tax on franked income

- Investment trusts that have been approved by HMRC are not subject to any tax on gains made from the sale of shares or other holdings in their portfolios.
- They are not subject to any additional tax on franked income (franked income is the dividend income that investment trusts receive from their shareholdings in UK companies).

- They do have to pay corporation tax on unfranked income, which is income from sources such as foreign share dividends, interest from gilts and bank deposits, and underwriting commission. However, trusts can reduce their tax liability by offsetting their own expenses – interest paid on borrowings and management fees – against the unfranked income. This means they often end up paying little or no tax.

G17B Taxation of the investor

Income and gains from investment trusts are taxed in the same way as income and gains from other shares. When investors receive dividends from an investment trust, they also receive a 10% tax credit. Their tax position is as follows:

When investors receive dividends from an investment trust, they also receive a 10% tax credit

- Investors who are non-taxpayers cannot reclaim the tax credit.
- Investors who pay tax at the basic rate have no more tax to pay on their dividends as the tax credit fully covers their tax liability.
- Higher rate taxpayers are liable to pay an additional 22.5% in tax on the gross dividend, i.e. the net dividend plus the tax credit, bringing their total liability to 32.5% of the gross dividend.
- Additional rate taxpayers are liable to pay an additional 32.5% in tax on the gross dividend, i.e. the net dividend plus the tax credit, bringing their total liability to 42.5% of the gross dividend.
- Investors are also liable to CGT on their profits if they sell their investment trust shares for more than they paid for them.
- Tax is only chargeable if their total gains on all disposals, after deduction of losses, exceed the annual CGT allowance.
- If an investment trust is held within an ISA, all dividends and capital gains are tax free.

If an investment trust is held within an ISA, all dividends and capital gains are tax free

G17C Investment trusts investing in interest bearing assets

The Budget of 2009 introduced a new optional tax framework for investment trust companies, which allows them to invest in interest bearing assets in a more tax efficient way. The rules move the point of taxation from the investment trust to the investor, with the result that investors face broadly the same tax treatment as they would have, if they had owned the interest bearing assets directly.

- An investment trust company will not be liable to corporation tax on any interest income it receives.
- When an interest distribution is made, the income will be treated as if it were a payment of interest in the hands of the investor.

Effective date for the new measures

The new measures took effect for any interest distributions made on or after 1 September 2009, if an election is made.

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G18 Offshore investment companies

Investment companies established in countries outside the UK are not subject to UK taxes, although they may be subject to low levels of local tax in the country in which they are established.

They are also usually subject to lower levels of regulatory scrutiny and there are less onerous demands on the Board of Directors if the company is registered offshore.

G19 Investment trusts vs. unit trusts and OEICs

Unit trusts, open-ended investment companies (OEICs) and investment trusts have much in common (see appendix 2), but there are certain differences that give each of them advantages and drawbacks.

The costs of purchasing shares in investment trusts are often lower than investing in unit trusts:

- A unit trust or OEIC may have an initial charge of 5%. On investment trusts, the charge is often only 0.2% through an ITSS, but there may be a charge for disposing of investment trust shares – which is not usually the case with a unit trust. Some unit trusts and OEICs also have very low or nil entry charges.
- The annual management charges of older investment trusts are generally considerably lower than those of most unit trusts and OEICs; but with more modern investment trusts, the annual charges are often very similar.
- On balance, although most investment trusts are cheaper to invest in than most unit trusts, each one should be looked at individually.

Although most investment trusts are cheaper to invest in than most unit trusts, each one should be looked at individually

The risk (and reward) of investing in investment trusts is often said to be greater than the risk (and reward) of investing in unit trusts

The risk (and reward) of investing in investment trusts is often said to be greater than the risk (and reward) of investing in unit trusts. There are several reasons for this:

- Investment trusts frequently trade at a discount to net asset value. The risk is that the discount might get wider. However, if the discount narrows, the shares may outperform the trust's assets. In the case of unit trusts and OEICs, on the other hand, the price of units cannot rise or fall any further than the rise or fall in value of the underlying investments.
- Discounts can widen if the market does not like the way an investment trust is being managed and there are more sellers than buyers. However, shareholder pressures may produce an improvement in performance or even a change of manager. Investors in unit trusts have no power to bring such changes about.
- Investment trusts can borrow to invest (gearing). Unit trusts and OEICs have much tighter restrictions on their borrowing powers. In certain cases, borrowing can increase the volatility and risk profile of an investment trust. At other times it can reduce the risk, if the managers use borrowings to finance the hedging of their positions, either in the market generally or in particular securities, or in currencies.

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Income from investment trusts

Investment trusts can provide higher levels of income than the equivalent unit trust or OEIC because of the discount to net asset value. The same amount of money buys exposure to more securities within an investment trust with a discount to net asset value, and as a consequence, a greater annual income.

There are several different types of investment trust securities which have specialist uses, such as shares in split capital trusts and warrants:

- Split capital shares divide out the investment returns from the trust to different classes of shareholders. The shares also involve different degrees of risk from lower-risk zeros to higher-risk capital shares.
- All investors in a unit trust or OEIC, on the other hand, have an equal entitlement to any income and capital gains, and bear the same amount of risk.
- There are some types of unit trusts and OEICs that do not exist in investment trust form, such as guaranteed/protected funds, where derivatives are used to protect investors against falling share prices, and there are some investment trusts that do not exist in unit trust and OEIC form, such as private equity trusts, which offer access to unquoted companies.

Remember that investment trusts are closed-end public limited companies and unit trusts and OEICs are open-ended funds.

Key points

The main ideas covered by this chapter can be summarised as follows:

Indirect investment products

- In a collective or packaged investment scheme such a unit trust or open-ended investment scheme (OEIC), investors participate in a large portfolio of securities or other assets with many other investors.
- With collective investments such as investment trusts or with-profit bonds, the link is less direct.
- The pooling of resources enables the scheme to invest in a wide spread of investments at a lower cost than could have been achieved by individuals acting on their own. Investors buy and sell units or shares in the scheme and not the underlying investments of the fund.

Unit trusts and OEICs: general characteristics

- Unit trusts and OEICs are every popular collective investments – often referred to as funds.
- These are categorised within a fund classification system of over 30 sectors. Each sector is made up of funds that invest in similar assets, or the same stock market sectors, or in the same geographical region.
- A range of rules restrict the investment powers of authorised funds, and these are designed to ensure that each fund is sufficiently diversified.

Unit trusts

- The trustee/depositary ensures that the investors' interests are protected:
  – they check that the manager's actions are in line with the regulations, the trust deed and the scheme particulars; and
  – they hold or control the holding of the assets of the fund on behalf of the investors.
- The manager/ACD manages the assets of the fund in accordance with the fund's investment objectives. They are responsible for the day-to-day running of the fund, including the promotion, investment and administration.
- Unit trusts are required to publish annual and half-yearly reports.
- Authorised unit trusts are principally subject to the corporation tax regime.
- A unit trust regularly receives income from the underlying investments of the fund, and this is usually distributed to unitholders half-yearly. The first distribution a unitholder receives consists of the income that has accrued from the date of purchase up to that distribution date, together with an equalisation payment, which represents the income that was included in the price paid for the units.
- Net income of a unit trust must be allocated (i,e. applied for the benefit of unitholders) and is usually distributed at least annually.
- Tax position needs to be considered:
  – Investor: income tax on distributions.
  – Dividend distributions paid to trustees.
  – Interest distributions from non-equity unit trusts.
  – Interest distributions paid to trustees.
  – Reinvestment of dividends and interest.
  – CGT payable on profits made by a taxpayer who disposes of units.
- Since 1 September 2009, AIFs have been able to be treated as a tax elected funds (TEF).
- One of the most popular reasons for investing in unit trusts is that they can pay an income and also offer the potential for capital growth.
- Many trusts allow the unitholder to choose between income receipt or reinvestment by offering income and accumulation units.
- As income comes into the fund and the accounting date approaches, the unit price rises to reflect this.
- There are generally no extra charges for investing in a unit trust ISA offered by the manager, beyond the usual charges that apply to the unit trusts themselves.
- There is usually a minimum holding requirement of £500 or £1,000 in each fund, which is set by each management group.
- Most unit trust groups have now switched to non-certificated units. As it has become increasingly common for the manager and trustee to no longer issue certificates.
- To sell units, an order is placed with the management group, which will then issue a contract note.

- Share exchange schemes are offered by a number of unit trust management groups. These allow investors to exchange existing shareholdings in public companies for an equivalent value in the fund's units.
- Each unit in a unit trust represents a proportional share of the property of the scheme. The valuation of units is achieved, in broad terms, by valuing the underlying securities and cash held by the fund, adjusting for income and charges and then dividing by the number of units in existence.
- Unit trust managers have to calculate unit prices according to FSA regulations.
- Charges cover most of the costs of managing and administering the fund, such as investment management costs, marketing costs and intermediary commissions, registration and other administration.

Open-ended investment companies (OEICs)

- An open-ended investment company (OEIC) is a diversified collective investment vehicle similar to a unit trust. Like a unit trust the underlying investment area will be specified, e.g. UK equities. It is an investment company with variable capital (ICVC).
- An OEIC is not an investment trust or a trading company.
- The OEIC equivalent of the unit trust manager is known as the authorised corporate director or ACD.
- OEIC's scheme operator must report to holders twice a year and is responsible for issuing the accounts.
- ISAs are able to hold OEICs under the same constraints as unit trusts.
- An OEIC is like other open-ended funds such as unit trusts. Investors buy shares in their chosen fund and the value of each share of the same class represents an equal fraction of the value of the securities and other assets in that fund.
  - The price of each share therefore reflects the total net value of the assets of the fund relating to that share class, divided by the number of those shares in issue – the NAV per share.
- Advantages to OEICs:
  - For the investment industry, the most important advantage is that this type of open-ended fund structure is the most widely recognised type of collective investment in Europe: OEICs are capable of being marketed internationally in a way that is virtually impossible with unit trusts.
  - The OEIC regulations permit multiple share classes, which allows more flexible charging and currency structures than are possible with unit trusts, although COLL allows different classes of units or shares for all types of funds.
  - The OEIC structure allows management groups to offer umbrella funds. These give the investor a choice of funds covering a range of investment objectives, each sub-fund offering or issuing a different class of share within the company. Switches between funds therefore become a simple matter of share exchange, often at nil cost.
  - From the manager's viewpoint, the umbrella structure also makes it easier to create new funds, the interest in which is represented by another class of share.
- Tax position of OEICs is essentially the same as for unit trusts.

Unit trust and OEIC management services

- Most fund management groups now offer at least one multi-manager product to help investors achieve greater diversification. Main types are:
  - fund of funds, which invest directly into funds managed by other managers; and
  - manager of managers funds, which appoint specialist investment managers to look after different parts of the portfolio to a particular brief.
- Fund supermarkets offer a variety of funds from a number of different management groups, but the decision of which funds to buy is generally left to the investor or their adviser.
  - They usually offer their own ISA wrappers, allowing investors to hold funds from a range of providers which would otherwise only be possible at additional cost, e.g. via a self-select plan.
- Wrap account is a platform that can provide access to any underlying fund or other type of investment and can administer any of the product wrappers an investor may wish to use. It can also allow an investor to follow an investment strategy across their whole portfolio, regardless of providers or products.
  - It typically makes an explicit charge for its services. In contrast, wrap supermarkets generally charge the investment product providers rather than make direct charges to the investment client.

Offshore funds
• The FSA recognises offshore funds under various sections of the Financial Services and Markets Act 2000 and this has a bearing on how they can be marketed in the UK.
• For a UK resident and domiciled investor, the tax benefits of holding offshore funds are marginal and based mainly on possible tax deferral.
• Offshore funds can be very useful for non-UK domiciled investors, or UK domiciled investors who are non-residents, as income is only taxed in the UK when it is remitted to the UK.
Closed ended funds/investment trust companies
• Investment trust companies are listed on the London Stock Exchange with a number of independent market makers.
• They have independent boards, and are regulated by company law and not under the Financial Services and Markets Act.
• As closed-ended companies they have a fixed capital structure, which has its advantages and disadvantages. – It means the share price is influenced by supply and demand, so it does not always exactly reflect the value of a trust's assets, which adds somewhat to the risk and potential rewards. When a trust is trading at a discount, this can provide a buying opportunity. – The advantage of a closed-ended company is that the investment managers can take a longer-term view of their investments. They can invest in more illiquid securities and markets because they know they will not be forced sellers.
• Unit trust and OEIC managers must be prepared to liquidate holdings if investors want their money back. However, if they are doing well they will have the benefit of regular new inflows of money for investment.
• An investment trust manager does not necessarily have to sell existing investments in order to purchase new investments, as they can borrow money for investment or can organise an additional share issue.
• Investment trusts offer smaller investors easy, low cost access to a wide range of stock markets around the world.
• Unit trust managers, on the other hand, can offer cash funds and derivative-based funds.
• Different types of investment trust shares are available to meet different investment objectives.
• Some zeros can provide low-risk capital growth, while income shares can pay an above average yield.
• Most investment trust managers offer cost-effective savings and investment schemes and ISAs.
• The differences between investment trusts, unit trusts and OEICs should be considered carefully when assessing an investment portfolio.
• The investor's objectives and attitude to risk must be taken into account.
• The effect of narrowing discounts, lower costs and the ability to 'gear' an investment trust should mean that an investment trust performs better than a comparable unit trust or OEIC in a rising market.
• Investment trust managers can borrow money to buy shares and other assets if they see a good investment opportunity but do not have sufficient free capital available to take advantage of it. This is known as financial gearing.
• Providers of investment trust savings schemes and ISAs have to supply investors with a Key Features document.
• Investment trust shares can be bought and sold either through a stockbroker, or through the managers via an investment trust savings and investment scheme (ITSS).
• Investment trust dividends are paid either by means of a cheque sent directly to investors, or transferred into an investor's bank account.
• Investment companies established in countries outside the UK are not subject to UK taxes, although they may be subject to low levels of local tax in the country in which they are established.

Question answers

6.1 Major banks and insurance companies.

6.2 The bid-offer spread is the difference between the buying and selling prices expressed as a percentage of the buying price. The maximum bid-offer spread is the aggregation of:

- underlying market spread;
- commission and stamp duty as appropriate;
- the manager's initial charge.

6.3 Most UK resident and domiciled investors prefer reporting funds. The main advantages of a reporting fund are that the dividends are paid gross and any capital gain on a sale is subject to the normal CGT rules.

6.4 The board of directors runs an investment trust; this may be either as a self-managed trust or by the directors employing an external management company.

6.5 If the share price is 210p and the NAV per share is 200p, the shares are trading at a premium of 5%.

Self-test questions

1.	For an OEIC, who is responsible for establishing and maintaining the register of unit holders?
2.	What percentage of a securities fund must be in ‘approved’ securities?
3.	What must the register for a unit trust contain?
4.	What does a UCITS certificate permit the fund manager to do?
5.	What does an equalisation payment represent?
6.	What is the typical annual management charge for a unit trust?
7.	What is an investment trust?
8.	List the principles laid down by the FSA for a company seeking a listing as an investment trust.
9.	Name the two types of investment trusts.
10.	What does the redemption yield measure?
11.	What are the main characteristics of zero dividend preference shares?
12.	What is ‘financial gearing’?
13.	Summarise the tax position of investment trusts and investment trust dividends.

You will find the answers at the back of the book

Appendix 6.1: Characteristics of retail and qualified investor schemes (QIS)

<table>
<tr><th rowspan="2">Fund attributes</th><th colspan="2">Retail</th><th rowspan="2">Qualified Investor Scheme</th></tr>
<tr><th>UCITS</th><th>Non-UCITS</th></tr>
<tr><td>Permitted subscription</td><td>All UK investors and EU passport</td><td>All UK investors</td><td>Institutional and expert investors</td></tr>
<tr><td>Different share classes</td><td colspan="2">Yes</td><td>Yes</td></tr>
<tr><td colspan="4">Investor relations</td></tr>
<tr><td>Investor approval</td><td colspan="2">Fundamental changes (extraordinary resolution)</td><td>Fundamental changes (ordinary resolution)</td></tr>
<tr><td>Notification to holders</td><td colspan="2">Significant changes to be notified pre event. Other important changes to be notified pre or post event</td><td>Significant changes to be notified pre event</td></tr>
<tr><td colspan="4">Investment and borrowing powers</td></tr>
<tr><td>Assets</td><td>Transferable securities, deposits, derivatives, money market instruments, CIS</td><td>As UCITS plus gold, property and a wider range of non-UCITS CISs</td><td>As non-UCITS plus other financial assets (precious metals and commodities contracts on regulated markets)</td></tr>
<tr><td>Prudent spread of risk
• Unapproved securities
• Unregulated CIS
• Regulated CIS
• Index replicating funds</td><td>UCITS limits apply
– 10%
– None
– 20% (in any one CIS)
– 20–35%</td><td>Other specified limits
– 20% (aggregate with unregulated CIS)
– 20% (aggregate with unapproved securities)
– 35% (in any one CIS)
– 20–35%</td><td>Spread of risk per fund documents</td></tr>
<tr><td>Concentration</td><td>10% (securities/ debentures) 25% (CIS units)</td><td>n/a</td><td>n/a</td></tr>
<tr><td>Borrowing</td><td>10% (temporary)</td><td>10% (permanent)</td><td>100% of NAV (subject to adequate cover)</td></tr>
<tr><td colspan="4">Operating duties and responsibilities</td></tr>
<tr><td>Deferred redemption</td><td colspan="2">Yes for daily priced schemes</td><td>Yes</td></tr>
<tr><td>Limited redemption</td><td>No</td><td>Yes (per fund documents, and subject to reasonable basis) – 6 months maximum</td><td>Yes (per fund documents, and subject to reasonable basis)</td></tr>
<tr><td>Limited issue</td><td colspan="2">Yes</td><td>Yes</td></tr>
<tr><td>Price calculation</td><td colspan="2">NAV Single or Dual pricing (swing price mechanism allowed)</td><td>NAV (per fund documents)</td></tr>
<tr><td>Frequency of price calculation</td><td>At least twice monthly</td><td>At least twice monthly (or monthly if limited redemption arrangements)</td><td>As per fund documents</td></tr>
</table>

Appendix 6.2: Investment trusts, OEICs and unit trusts compared

Feature	Investment trust	OEIC	Auth. unit trust
Legal structure	Listed plc governed by a Memorandum and Articles of Association. (Not a trust in the legal sense.)	Limited liability company governed by an instrument of incorporation.	Legal trust governed by a trust deed.
Stock Exchange listing required?	Yes.	Optional.	No.
Introduction	FSA listing particulars.	Prospectus.	Scheme particulars.
Nature of fund	Closed-ended, i.e. fixed number of shares in issue at any one time.	Open-ended, i.e. fund expands by the issue on demand of additional shares or contracts by the redemption on demand of shares.	Open-ended, i.e. fund expands by the issue on demand of additional units or contracts by the redemption on demand of units.
Management	May be self-managed or management may be provided under contract by an external authorised investment management firm. Has independent board of directors.	Has directors who may be individuals or companies but must include an authorised corporate director (ACD). The directors are responsible for managing the company's business by the contract with the ACD as the manager of the company. The ACD may obtain the assistance of any third party to perform its functions.	Has a manager (usually an authorised investment management firm).
Taxation	Exempt from tax on capital gains made within the company. Unfranked income charged to corporation tax generally at 30%, after deducting management and other administration expenses and interest cost of borrowing. Expenses cannot be offset against franked income.	Exempt from tax on capital gains made within the company. Unfranked income charged to corporation tax at 20%, after deducting management and other administration expenses (no corporation tax is payable where income is paid out as an interest distribution). Expenses cannot be offset against franked income.	Exempt from tax on capital gains made within the fund. Unfranked income charged to corporation tax at 20% after deducting management and other administration expenses (no corporation tax is payable where income is paid out as an interest distribution). Expenses cannot be offset against franked income.
Capital structure	Can issue different classes of shares, including preference shares and also debentures and warrants. Can have a split capital.	Can offer different classes of ordinary shares subject to approval of the FSA. (In the case of an umbrella OEIC, the assets of one sub-fund cannot be 'ring-fenced' from the liabilities of other sub-funds.)	Can issue income and accumulation units and different classes of units in the same way as an OEIC, e.g. retail and institutional.

Appendix 6.2: Investment trusts, OEICs and unit trusts compared

Feature	Investment trust	OEIC	Auth. unit trust
Regulation	• Companies Act; • FSA listing rules; • ICTA 1988 s.842; • External investment manager and ITSS/ISA operator authorised under the Financial Services and Markets Act 2000.	• Structural framework provided by Treasury regulations; • authorised by the FSA; • operational issues and special corporate code administered by the FSA; • manager (ACD) and depositary authorised by FSA; • marketing regulated by the FSA.	• Unit trust authorised by FSA; • manager and trustee authorised by the FSA; • marketing regulated by the FSA.
Investment restrictions	Almost unlimited range of investments, subject to company's articles and approval of board.	Acceptable investments specified by the FSA.	Acceptable investments specified by the FSA.
Method of valuation	Listed investments at market price; unlisted investments at directors' valuation.	Defined by regulation.	Defined by regulation.
Frequency of valuation	Usually monthly, although weekly and daily valuations are increasing.	Usually daily, though may be more than once a day.	Usually daily, though may be more than once a day.
Investors' holding	Shares.	Shares. (Shareholder has no beneficial interest in the assets of the OEIC.)	Units.
Pricing	A function of demand and supply for the shares: the price of the shares is not directly related to the value of the assets in the portfolio. Dealing charges are separate. Share prices usually stand below NAV. Prices are quoted at any time by a number of different independent market-makers.	Single pricing reflects the valuation of assets in the portfolio (NAV) with charges shown separately. From 6 October 2006, funds can adopt single or dual pricing.	Prices are usually set daily by managers, based on FSA regulations. Dual pricing with initial charge incorporated in offer (buying) prices. A number of trusts now have single pricing.
Purchase/sale	• Through an independent stockbroker; or • through an investment trust manager in the case of an ITSS or ISA; or • through a financial adviser who has access to a manager's dealing service.	• Through the manager (company salesperson) for lump sums and regular savings; or • through a financial adviser (tied agent or independent).	• Through the manager (company salesperson) for lump sums and regular savings; or • through a financial adviser (tied agent or independent).