AF4 2020/2021
Investment Products
Part 1: Unit Trusts, OEICS and Investment Trusts

The milestones for this part are to:

- Understand the difference between an open-ended and closed ended fund, their similarities and differences
- Understand the key principles of a unit trust, OIC and a Property Authorised Fund (PAIF)
- Know the factors to consider in selecting a unit trust
- Understand the main features of an Investment Trust and a Real Estate Investment Trust
- Understand how a split capital Investment Trust operates

Open ended v Close ended

Investment Funds can be set up on an open or close-ended basis

- The most common types of open-ended products are **Unit Trusts** and **Open-Ended Investment Companies (OEICS)**
- The most common type of closed ended product is the **Investment Trust**

Open-ended funds are effectively large investment clubs. Their key characteristics are:

- The number of units in a unit trust or shares in an OEIC is unlimited. These can be created or destroyed to cope with supply and demand
- Investors buy and sell directly from the provider.

Close ended funds are structured as a PLC whose shares are traded on an exchange. This means:

- The number of shares is fixed.
- Investors buy and sell shares through a stockbroking service and not directly with the Investment Trust.

There are similarities between the two structures. Both:

- Allow investors to invest modest amounts but still get a high level of diversification.
- Can provide potential growth and growing income.
- Can invest in all the main asset classes
- Allow the investor to have the funds professionally managed
- Can be placed within an ISA or a SIPP

The following is a summary of the key differences that should be considered in advising which is the most appropriate structure. These will be looked at in more detail later.

Liquidity

In theory **unit trust/OEIC investors** can instruct the provider to sell their units and receive cash at any time. This is relatively simple if the fund is invested in listed securities but holding property or unlisted securities creates potential problems.

If there are more sell than buy orders, some of the fund's assets may have to be sold to pay off investors. This is difficult If the assets are illiquid such as property or unlisted securities. Property funds usually have a clause that allows the fund to stop encashments for 3 to 6 months. FCA rules prohibit an open-ended fund having more than 10% of the total fund in unlisted securities.

Investment Trust shares are listed on an exchange and can be bought and sold freely. The management is not responsible for paying sellers of the shares so is never forced to sell the fund's assets This makes it a more suitable vehicle for holding property and unlisted securities.

Valuation

For simplicity the term units will be used although with an OEIC you are buying shares. The way valuation works is the same for both.

Open ended funds trade at **net asset value (NAV)**. The price of each unit is the value of the assets in the fund divided by the number of units.

If the fund has £2 million of assets and 2 million units each unit is worth 100p. If there are net inflows into the fund new units can be created. If there are net outflows units can be destroyed.

If the fund value increases by 10%, the unit price would increase by 10%.

Prices of the fund's assets can be based on an offer basis, that is the price to buy them, or an offer basis, the price it could get by selling them.

Calculating the fund value is straight forward with listed securities as it can use that day's published prices. However, if the fund holds property or unlisted securities the value can only be a qualified assessment. The true value can only be made when the asset is sold so the unit price may not reflect the underlying value of the fund.

If an open-ended fund is forced to sell assets this can lead to a downward spiral. Selling the asset pushes down the asset's price which in turn could lower the unit price which might result in more investors wanting to cash in which in turn could result in the fund having to sell more assets,

Unit prices are calculated daily at a set time. Buying and selling is normally done on a forward basis. If the unit value is calculated at 2pm, any orders to buy or sell received after that will be based on the next valuation date, that is the following date at 2pm.

The price of shares in an **Investment Trust** is determined by the supply and demand for those shares which might be higher or lower than the net asset value of the fund.

$$\text{NAV} = \frac{\text{value of its assets less borrowings}}{\text{number of shares}}$$

If the NAV is 200p and the shares are trading at 230p they are trading at a premium, if they were trading at 180p they would be trading at a discount.

If the fund's NAV increases by 10% it does not mean that the fund's shares would rise by 10%.

Deals are made in real time, there are no set valuation points.

Buying new investments

An **open-ended fund** relies on receiving new money to buy more assets. If there are net outflows, it has no new money to purchase further assets. It can borrow up to 10% of its total assets but only on a temporary basis.

Investment Trust shares are traded on the secondary market so the fund receives no money when shares are purchased. It can though borrow freely to purchase new assets. This works well if the purchased assets increase in value but will be detrimental if they fall as the level of borrowing remains the same.

Distributing income

An open-ended fund must distribute all the income it receives to its investors.

An **Investment Trust** can decide how much dividend it pays to its shareholders. This can be advantageous since it can choose to pay less than it has received in a good year so it can maintain the dividend in a year when dividends are poor.

Taxation

- Gains made by the investor on both open-ended and closed-ended are subject to CGT.
- There is no tax liability on gains made within the fund
- Income distributions from a unit trust/OEIC will be based on the underlying assets. Income from Bond funds are taxed as savings income, equity funds taxed as dividend income
- Income from Investment trusts are always taxed as dividend income

Unit Trusts and OEICS in more detail

Unit trusts and OEICS are regulated under the Undertaking for the Collective Investment of Transferable Securities (UCITS)

- It may not invest more than 10% of the fund in a single asset.
- Up to four assets can be held up to the 10% limit.
- No other asset can comprise more than 5% of the fund value
- It can hold up to 10% in unlisted securities and 20% in another collective investment scheme.
- It cannot borrow on a permanent or continuous basis but may borrow 10% of the fund on a temporary basis.

There are some specialist funds that should be noted:

Fund of Funds and **Multi Manager Funds**

- A fund of funds invests directly into funds managed by other managers.
- A fettered fund only uses funds from the same management group.
- An unfettered can select from different providers.

- With a Manager of managers, specialist managers are appointed to look after different parts of the portfolio.
- The overall manager decides on the appropriate mix
- Who appoints other managers to run that part of the portfolio.

Property Authorised Investment Fund. (PAIF)

An open-ended fund is not particularly suitable for investing in property due to liquidity and valuation issues. To get round these problems some funds have restructured as a PAIF. To qualify it must

- Operate a Property Investment Business
- Report income in three streams
- Not permit corporate bodies to hold more than 10% of the fund

They will normally meet the first requirement by investing in **Real Estate Investment Trust** shares.

The three income streams are
- Property Income
- Interest
- Dividends

Property income is paid net of 20% tax unless held in an ISA or SIPP. The other two streams are paid gross.

Assessing suitability of an open-ended fund

The following factors should be considered:

- The underlying assets in the fund
- The fund's aims and objectives
- Investment style. Growth or Value
- Has there been any "investment shift"? e.g. the manager is now taking a higher risk approach.
- Liquidity issues
- The "churn" rate. How often is the manager trading within the fund
- Past performance
- Chosen benchmark
- Charges

There are also **Unregulated Collective Investment Schemes (UCIS)**

These cannot be offered to the general public but can be offered to

- Certified high net worth investors defined as someone with an annual income of more than £100,000 and net assets (excluding main home) of £250,000.
- Sophisticated investors
- Self-certified sophisticated investors
- Existing investors in UCIS

Close-ended Products in more detail

The products are:

- Investment Trusts, both conventional and split capital
- Real Estate Investment Trusts

Investment Trusts

An investment trust is a listed company that invests in the shares of other company. Investors buy shares in the company in the anticipation of regular dividends and an increasing share price. Taxation is the same as any other share.

As with any other company it is run by a board of directors although day to day running will be delegated to a management team.

As a close-ended company, the number of shares is fixed. Unlike a unit trust or an OEIC it cannot issue new shares or cancel them to cope with supply and demand. A unit trust or OEIC will always trade at Net Asset Value (NAV) whereas Investment Trust shares trade at a premium or discount.

ABC investment trust has £50 million of assets and has issued 25 million shares. The NAV is 200p. The share price is 180p and as this is lower than the NAV the shares are described as trading at a discount. If the shares were trading at 210p they would be trading at a premium.

The premium or discount is calculated by this formula:

- For premium: Share price less NAV/NAV
- For discount: NAV less share price/NAV

Grand Union investment trust is trading at 300p and its NAV is 260p. They are trading at a premium so the calculation is: 300p-260p/260p = 15.38%

General investment trust is trading at 160p and its NAV is 210p. They are trading at a discount so the calculation is: 210p-160p/160p = 31.25%

Purchases and sales of an investment trust are conducted through stockbrokers or a stockbroking service rather than from the investment trust itself which has several consequences. As the company gets no further capital once the initial shares have been sold, if it wishes to buy further assets it has borrow. This is known as gearing and it increases both the potential return and loss.

An IT has assets of £10m and borrows £1m at 4% to buy more assets.

A year later the assets it bought with this loan have increased to £1.25m. It has incurred £40,000 of interest and having repaid the loan the net gain is £210,000.

If the assets had fallen to £750,000 it would have to repay the loan plus the interest, a total of £1,400,000. Its net loss would be £650,000

Since the IT is not responsible for paying out to investors it can take a longer-term view than a unit trust/OEIC manger. With the latter if there is a surge in investors wanting to cash in their investment, the manager may be forced to sell some of the fund's holdings.

It can also hold unlisted shares. These can be attractive as they have the potential for high growth if they continue to expand and eventually go public. They can be difficult for individual investors to access and are generally illiquid. However, if they are owned by an investment trust this removes the investor's liquidity risk.

Unlike a unit trust or OEIC it does not need to pay out all the dividends it receives which seems to be a disadvantage, but it enables the trust to retain dividends in good years to maintain dividend payments in years when returns aren't as good.

To assess the level of risk of an Investment Trust, investors need to find out what investments it holds. The Scottish Mortgage Investment Trust or the British Empire Investment Trust, both real companies, don't tell the potential investor much about what assets they hold.

In fact **Scottish Mortgage** was the 35th ranking company in the FTSE 100 in July 2020 and was one of the best performers, partly because it had significant holdings in both **Tesla** and **Amazon.** Whilst it has had stellar returns (up 56% in the 12 months to July 2020) it could be argued that it has a high risk profile that might not be appropriate for some investors.

Split capital investment trusts

Most Investment Trusts are **conventional** and can continue indefinitely. S**plit capital investment trusts** run for a fixed period, usually seven years and then wind up. Different classes of shares are offered which different rights to investors when the trust is wound up. They are also tradeable throughout the life of the trust.

The usual order of repayment on winding up is:

- Any borrowings: loans taken out by the trust
- Zero dividend income shares
- Income Shares
- Capital shares

Zeros produce no income during the life of the trust. Investors are "promised" (but not guaranteed), a set amount at redemption date. To do this the trust must achieve a certain investment return, **the hurdle rate**. If this isn't achieved, then the investor will not get back the original promised amount and may not get back their original investment.

Income shares deliver a fixed income. The amount of capital returned at the end (and whether this is the same or lower than the original investment) will depend on the zero dividend shareholders being repaid which in turn will depend on the hurdle rate being achieved. If there is insufficient to pay off the zero holders, the income shareholders will receive less than their original investment.

Capital shares will receive whatever is left after everyone else has been paid which of course could be nothing.

Real Estate Investment Trust (REIT)

The traditional way to invest indirectly into property is to buy the shares of a property company or to invest in a property fund. Both have disadvantages. A property company receives rent from its properties but these cannot be paid directly to the investor. They are a factor in determining its profits part of which is paid out as dividend.

An open-ended fund suffers from liquidity issues as it might have to sell property (and also defer payment) if too many investors want to get their money out. There is also the problem of valuation since until the property is sold, its value can only be an estimate.

A REIT is a close-ended PLC whose shares are listed and traded on the stock market. The sale of the properties within the trust is exempt from CGT although the investor will be liable for

CGT on any gains they make when the shares are sold. REIT shares can be placed into an ISA or a SIPP.

To qualify:

- 75% of its profits must come from rental income
- 75% of its asset must be involved in property rental
- 90% of rental received must be distributed to investors

Provided it meets these conditions the income paid to investors is treated in a special way. The **Property Income Distribution** or **PID** represents the rental income and is taxed as non - savings income. It is sometimes described as the "tax exempt element" as the company does not pay tax on this income. The remaining element is **non PID** and taxed as dividend income. Note that if the REIT is not held within an ISA or pension, 20% tax will be deducted from the PID before being paid to the investor.

The price of the REIT shares is determined by supply and demand for the shares rather than the value of the underlying assets.

That concludes this part so you should now:

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- Understand the key principles of a unit trust, OIC and a Property Authorised Fund (PAIF)
- Know the factors to consider in selecting a unit trust
- Understand the main features of an Investment Trust and a Real Estate Investment Trust
- Understand how a split capital Investment Trust operates

Further reading

Open ended v Close ended

https://www.ftadviser.com/investments/2020/02/13/guide-to-closed-ended-vs-open-ended-funds/

https://infoforinvestors.com/academy/beginners/closed-vs-open-end-funds/

Investment Trusts

https://www.fidelity.co.uk/planning-guidance/about-investment-trusts/?p=0&c=10

https://www.capital-investment.co.uk/split-capital-investment-trusts/

Real Estate Investment Trusts and PAIF

https://www.moneyadviceservice.org.uk/en/articles/indirect-property-investments

https://documentcloud.adobe.com/link/review?uri=urn:aaid:scds:US:aa625ac6-3c43-46c1-b4e8-e3238078f827