# R02: Collective investments 2020/21
# Part 2: Close ended funds

Like an open-ended fund these enable modest amounts to be invested in a wide range of assets this creating more diversification.

A close ended fund is set up as a company whose shares are traded on a recognised exchange. The following are the most common examples.

- Investment Trusts
- Exchange Traded Funds
- Real Estate Investment Trusts

They are all traded in "real time". Whilst the price of unit trusts and OEICS are set once a day, the price of these products changes on a minute by minute basis.

## Investment Trusts

An investment trust is a listed company that invests in the shares of other company. Investors buy shares in the Trust in the anticipation of regular dividends and an increase in the 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 is usually delegated to a management team.

As it is a closed 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) This is the total asset value divided by the number of shares or units. With an investment trust NAV is calculated in the same way but the share price may be different.

ABC investment trust as £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.

This is because the share price is set by the demand for them in the market and whilst influenced by the NAV it is not determined by it.

The premium or discount is calculated by this formula:

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

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

300-260p/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 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 is allowed to borrow. This is known as gearing which increases the risk.

An IT borrows £1m at 4% to buy more assets.
A year later the assets have increased to £1.25m. It has incurred £40,000 of interest and having repaid the loan its assets have increased by £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 loss would therefore be £650,000

Since the IT is not responsible for paying out to investors it can take a longer term view as is not forced to sell of any of its holdings as in the case with a unit trust or OEIC.

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

Investment trusts date back to the 19th century and sometimes their name does not give any indication of its investment philosophy. For example Scottish Mortgage Trust has invested heavily in US tech stocks and has been one of the best performers in 2020. At the time of writing it is the 31st largest company in the FTSE 100.

## Exchange Traded funds (ETFs)

An ETF is a widely used investment in the USA and is becoming more common in the UK. It has some of the characteristics of an OEIC, some of an Investment Trust.

- An ETF is **similar** to an Investment Trust in that investors buy and sell shares in the ETF on the stock market.
- An ETF is **different** from an Investment Trust in that the price of the shares will always be close to the net asset value (NAV) of the fund. With an Investment Trust the price of the shares can trade at a premium or discount.

There are two bodies within an ETF.

- The **ETF** itself which owns the underlying assets.
- An **Authorised Participant (AP)** which is authorised to create and redeem shares in the ETF. This could be a bank, a market maker or another financial institution.

Neither body deals with individual investors as shares are bought and sold on a recognised exchange.

Unlike an Investment Trust the share price of an ETF should not differ that much from the Net Asset Value of the underlying assets. The details of how this works are outside the scope of R02 but in basic terms it is done through the ETF and the Authorised Participant being able to swap shares in the fund for ETF shares. In practice this is carried out through automated trading.

The benefits for an individual investor in buying ETF shares rather than a unit trust or OEIC index tracker can be summed up as follows

- Lower costs
- Prices are calculated in real time whereas the price of an OEIC is set once a day
- Although the investor is buying shares no stamp duty is payable.
- Because the ETF doesn't deal with the retail investor it does not have to sell shares to cope with increased sell orders. An OEIC may be forced to sell some of its underlying assets in similar circumstances

Although they originally just tracked an index, in recent years a wider range of ETFs have become available including commodity ETFs.

Originally ETF were mainly index trackers but in recent years a wider range have become available including commodity ETFs. These enable investors to get a wide spread of more exotic investments through the purchase of one share. Care though must be taken because some ETFs are “synthetic”. This means that they are not backed up by the underlying asset but use derivatives.

## Real Estate Investment Trusts

The traditional way of indirectly investing into property is to buy property company shares or to invest in an open-ended property fund. The latter suffers from liquidity issues. If too many investors wanted to get their money out it might have to sell property (and also defer payment). There is also the problem of valuation since until the property is sold, its value can only be an estimate. Holding property company shares removes the liquidity risk but is not tax efficient. Its profits come partly from rents it received which are subject to corporation tax. Investors receive dividends but cannot receive pure rental income.

A REIT is a closed ended PLC whose shares are listed and traded on the stock market. This means the price of the REIT shares will depend on the demand for these shares rather than the underlying assets. However unlike an open ended property fund there are no liquidity

issues since the shares are tradeable just like any other company. The sale of the properties within the trust is exempt from CGT although the investor must pay CGT on any gains they make when the shares are sold.

Provided the REIT pays out 90% of rental income to the investors the income is treated in a special way. This is called **Property Income Distribution (PID)** (sometimes called the tax-exempt element because the REIT does not pay tax on this) which represents the rental income and taxed as non-savings income. If the REIT is not held within an ISA or SIPP 20% will be deducted before being paid to the investor. The remaining element is classed as **Non PID** (also called non-exempt) and taxed as dividend income. No tax will be deducted and the dividend allowance can also be used.

Shares in an Investment Trust, ETF or REIT can all be held within an ISA or SIPP.

## Open ended or closed ended, which is better?

There is no simple answer to this question but one key factor is the issue of **Liquidity**. That is the ability of an investor to encash the investment on demand.

Investors in open-ended deal directly with the fund manager and in most instances an investor will receive payment within a few days of receiving the sale order. This is possible if the underlying assets can be easily liquidated as with with equity or bond funds but can be problematic if the fund is invested in property or unlisted securities. Property is illiquid and may take time to sell. Unlisted securities are not traded on an exchange so cannot easily be sold. In fact the FCA prohibits an open ended fund for holding more than 10% of the fund's value in unlisted securities.

It is easier for a close ended to hold these assets as the management is not responsible for paying investors so they don't need to sell any of the underlying assets. Since the shares are traded on an exchange, investors can get back their money by simply selling the shares.