R02 Miscellaneous Investment Products 2020/2021

This section will cover:

- Split capital investment trusts
- Private Equity
- AIM shares
- Derivatives
- Hedge Funds
- Structured Products
- Offshore Investments
- Rent a room relief and holiday lettings

Split Capital Investment Trusts

A conventional investment trust can continue indefinitely. **Split capital investment trusts** are set up to run for a fixed period and then wind up. Different classes of shares are offered which give investors specific rights when the plan is wound up

The usual order of repayment is:

- Any borrowings (prior charges)
- Zero dividend income shares
- Income Shares
- Capital shares

- Zero's as the name implies produce no income during the life of the trust. Investors are promised a set amount at redemption date. The trust must achieve a certain investment return, **the hurdle rate** to do this. If this is not achieved, then the investor will not get back the promised amount and may get back less than they invested.
- Income shares deliver a regular fixed income during the life of the trust and a return of investment when the trust is would up. Whether this happens will depend on the trust having sufficient assets to pay the zero dividend shareholders and once this is done the trust having sufficient assets to pay off the income shareholders.
- Capital shares will receive whatever is left after everyone else has been paid which of course could be nothing.

Private Equity

Private equity can be defined as any company whose shares aren't listed on the main Stock Market.

The majority of UK companies are structured in this way as there are benefits in being incorporated rather than acting as a sole trader. These need not concern us since the owners of the business have no intention or need to offer shares to the general public.

Some large public companies have turned themselves into private ones. The perceived benefit is that they can operate free from pressures of outside investors.

Potential investors in Private Equity firms face a number of problems.

- Since the shares are not traded on the market they cannot be easily purchased or sold.
- Most deals tend to be on a matched bargain basis where a potential buyer must find someone who is willing to sell their shares.
- It is difficult to establish the right price for the shares since they aren't traded in a market. Most of the shares are usually held by the owners/directors and other shareholders may find it difficult to have any significant influence in the way the business is run.

Alternative Investment Market

Getting a listing on the London Stock market is a very involved process and businesses need a trading history. This may not be possible for smaller, younger businesses. They can raise capital by issuing shares on the Alternative Investment Market (AIM) which also acts as a secondary market.

- Unlike the main stock market there is no minimum size or trading requirements. Neither do they need minimum trading records.
- There is no requirement for any given percentage of shares to be in the hands of the public
- A company must appoint a nominated adviser (NOMAD) and a nominated broker
- Prospectuses must have a warning that AIM is designed for emerging or smaller companies.

Because these are new companies the risks of failure are higher than a long established business so investment in AIM company shares will carry a higher risk than one listed on the main stock market. Conversely there is greater potential reward in that a company may prosper and go on to be a major player in its field.

A further tax benefit applying to holdings in AIM companies is that they qualify for 100% business relief under IHT once held for two years. Effectively this means they are exempt from IHT. They can also be held in an ISA which is the one way of ensuring an ISA isn't subject to IHT

Derivatives

A derivative is an investment based on the performance of another investment without owning the underlying investment.

They are financial contracts between two parties but unlike a "normal" transaction the basis of any derivative is that it relates to something in the future. If A sells shares to B, the price is set and the shares are transferred at the same time. If though A offers to sell B shares in a company at a set price in three months' time, then it starts to take on some of the characteristics of a derivative.

The basis of the derivative market started in agriculture where a farmer agreed a price for the crop to a wholesaler or manufacturer whilst it was still in the ground. The manufacturer would pay a premium for this right to buy. This is known as a **forward**. The benefit to the both parties is that they have a fixed price. The farmer knows what he will get and the buyer knows what will be paid. Both sides are exposed to some risk. If the price falls the buyer must still pay the agreed price. The farmer carries the risk that if the market price rises above the agreed price he will still only get the agreed price.

A key aspect of derivatives in that either party can sell on the agreement. If the price of the crop has risen the buyer may elect to sell the right to buy to someone else. If the price has fallen the farmer may elect the right to sell at the fixed price to someone else.

Today there are recognised exchanges for issuing and trading derivatives. Derivatives are usually either'

- Futures
- Options
- Swaps

A future gives the holder the right to buy or sell an asset at a fixed point at some date in the future. It is most commonly used in commodities trading as it enables, for example, a chocolate manufacturer to buy sugar at a fixed price at some point in the future.

An option gives the holder the option to buy or sell an asset at a fixed price at some point in the future. Unlike a future, the holder does not have to buy or sell at expiry, if the option is not worth exercising then it simply expires.

This difference has a major impact on derivative investors. With an option their loss is limited to the cost of the option. With a future, the investor must close the deal by physically purchasing the underlying investment or by paying the other party a sum of money which gives them a much greater potential liability. Moreover, most future trading is done "on margin". This means that if the deal is to buy a commodity for £100K in three months' time they only need to put up 5% or 10% of the money up front. This is fine if the deal works in their favour but if it doesn't then they will need to put in more money to complete the deal.

Options and futures are subject to **counterparty risk**. This is the risk that the writer of the option may fail and be unable to complete their side of the bargain.

A swap is an agreement between two parties to exchange a series of cash flows over a given period of time. For example, with an interest rate swap A agrees to pay B a fixed rate of interest based on a notional amount of capital and B agrees to pay A a variable rate (usually LIBOR + a set number of base points)

Option terminology and practice

There are two parties to an option (or future), the **writer**, the person or organisation that offers the option and the **buyer**, the person who buys the option from the writer.

The **strike price** is the price at which the option will be exercised, for example the right to buy shares at a strike price of 420p. It is usual for option writers to offer different strike prices for individual shares. Rather than just have one option at 420p, it might have others at 410p, 430p & 440p.

The **expiry date** is the date at which the option comes to end and is the final date at which it can be traded or exercised. Writers will offer different contracts with different expiry dates. In the UK equity options expire on the third Friday of the month.

The **premium** is the price of the option. This will change throughout the whole life of the option.

A **call option** gives the right to buy shares at the strike price. A **put option** gives the right to sell shares at the strike price.

An **American style** option can be exercised at any time before the expiry date. A **European style** option can only be exercised at expiry date. Most UK equity options are American style.

In practice the standard UK equity option is for 1000 shares so if a call option to buy shares at 170p in March 2021 is priced at 13p, then an investor would have to pay £130 to buy one option. (premium x 1000)

The following is a simplified example, based on a real case of how a call option would work.

Acme Widgets PLC shares were trading at **416p** on 31 October. The following call options (right to buy) were available at that date.

Strike Price	Expiry date		
	January 17	April 17	July 17
390p	41.5p	48.5p	54.5p
440p	24.5p	32.5p	39.5p

The 390p option is **out of the money**, because the strike price is lower than the current trading price.

The 420p option is **in the money** because the strike price is higher than the current trading price.

This is how buying the January 390p call option might work out.

Price of shares at expiry	700p	416p	300p
Value of shares	£7,000	£4,160	£3,000
Cost to exercise	£3,900	£3,900	£3,900
Gain	£3,100	£260	£0
Option price	£415	£415	£415
Profit/Loss	£2,685	(£155)	(£415)
Return on investment	647%	-37%	-100%

If the investor had bought shares rather than an option, the following would have happened.

- It would have cost £4,160 to buy 1000 shares (excluding dealing costs)
- If shares had risen to 700p and he then sold the gain would have been £2,840 a return on investment of 68.2%
- If they had fallen to 300p there would be a paper loss of £1,160 but the shares can be held in the hope that the price will recover.

Warrants

These may be issued by companies as part of their share structure. They give the holder the right to buy further shares at a fixed price at a fixed date in the future. They are traded in their own right alongside the company's ordinary shares. As with a call option they have no value if the strike price is lower than the share price at expiry.

Covered warrants are issued by investment banks and are listed on the Stock market. They give the holder the right but not the obligation to buy (or sell) the underlying investments at a fixed price in the future. They are described as covered because the issuer has purchased the underlying assets.

Profits made from derivatives are taxed as Capital Gains. Losses can be offset against any gains.

Hedge Funds

There is no one accepted definition of a hedge fund but it can best be described as a fund that aims to make money in both rising and falling markets. A traditional fund will buy assets in the belief that they will rise in value. If they fall the fund value will also fall.

Most hedge funds will share the following characteristics:

- High initial investment required.
- It will make use of derivatives.
- It is often highly leveraged (it will have borrowed heavily)
- It will borrow shares, sell them and hope the price will fall so they can buy them back at a lower price. They will then give them back to the body that lent them for the original price. (short selling)
- It will take an active position in companies trying to influence management to dispose or acquire parts of the business.
- It may have lock in periods where investors cannot realise their investment.
- High charges including performance fees.

Whilst a hedge fund is unlikely to be suitable for many private investors what are termed **absolute return funds** try to offer something similar. Most collective investments will take a "long" position, that is they buy shares with the aim that these will rise in value. An absolute return fund also does that but in addition has a short selling strategy. Either using put options or borrowing securities that it then sells it aims to make money whether the market is rising or falling. The performance of these funds has been mixed and critics have pointed out that these managers have got to be good at both identifying which securities will rise and which will fall.

Structured Products

A structured product can be described as one which aims to give a potential return with little or no risk of capital loss to the initial investment.

The main characteristics of these are:

- They have a fixed term, most commonly for five years.
- It is usually impossible to access the original investment before the end of the term.
- There is a guarantee of capital or income and sometimes both.
- The minimum and maximum return is usually specified
- Returns are usually based on the performance of an index.

Whilst structured products will vary from one provider to another there are two main types.

- The first offers a return at the end of the term linked to the performance of an index. Typically this would be the FTSE 100 and investors would be offered 100% (or another

figure) of its increase over the term. Therefore if the FTSE grew by 50%, an original investment of £10,000 would return £15,000. If the FTSE 100 is less that it was at the start of the term, the investor will be paid back what they originally put in.
- The second offers a guaranteed income per year and the return of the original investment at the end. However, the return is only guaranteed if a selected index achieves a set return. If it fails to do this the amount returned will be less than the original investment.

Whilst the product will state that returns are linked to the FTSE 100, investors are not placing their money into shares. Instead the product is usually made up of two financial instruments. These are a zero-coupon bond which returns the original capital and an option which will provide the growth.

These products can look attractive especially in times of high market volatility as it appears the investor cannot lose. There are several disadvantages:

- Even if the original investment is returned at the end of the term the investor has lost the income they would have received if they had simply put the money on deposit.
- The fund produces no income as would be the case if the money was invested in a unit trust or OEIC.
- It is usually impossible to access the money before the end of the term
- The term cannot be extended so any gain is crystallised at maturity even if the market is growing
- If the zero-coupon bond does not produce the expected return, the original capital may be lost.
- As it uses a derivative to produce the gain there is a counterparty risk.
- The tax position on the investor will depend on the structure of the product. Many are structured as non-qualifying life policies so a gain will incur additional 20% income tax on a higher rate tax payer.

Offshore Investments

An offshore product is one that is set up outside the UK
As such the product itself is outside the scope of HMRC but this does not mean that a UK resident investor will escape tax.

There are three main offshore products to consider.

- Deposit accounts
- Offshore Funds (Unit Trusts & OEICS)
- Offshore Bonds

Deposit accounts

- These are usually based in the Channel Islands or the Isle of Man.
- Gross interest is paid

- UK tax residents are liable for income tax in just the same way as a UK based account.
- As no tax will have been deducted they must declare this to HMRC although the PSA can be used.
- Being based outside the UK the investor does not have UK protection if the institution fails

Offshore Funds

- These are normally set up as OEICS
- No CGT is payable until the holding is sold or disposed but any income will be taxable
- HMRC are concerned that it would be advantageous not distribute the income and let it accumulate within the fund, to avoid this they split offshore funds into two classes

    - Reporting Funds
    - Non Reporting Funds

- Reporting funds distribute at least 85% of any income to the investors. It therefore becomes liable for tax in the normal way. Note though that there would not be a 10% tax credit on any dividend distribution. When a gain is made the investor can use their annual exemption as appropriate.

- Non reporting funds do not distribute income and when a gain is made, HMRC will tax it as income with no allowance for annual exemption

Bill and Ben each own an offshore fund, Bill's is a reporting fund whereas Ben's does not.

They encash both making a gain of £40,000. Both are higher rate tax payers

Bill's liability is:
£40,000 less £12,300 = £27,700 @ 20% = £5,540

Ben's liability is:

£40,000 @ 40% = £16,000

Offshore Bonds

- These are investment Bonds (equivalent to non qualifying life policies) that are set up outside the UK
- As such the fund is not subject to UK tax although some tax may be applied in the country where it is established. This cannot be reclaimed or offset against the UK tax that is due.
- When a chargeable event occurs, e.g the bond is fully encashed, the gain becomes liable to income tax.
- Since no UK tax has been applied within the fund the investor is liable for income tax at either 20%, 40% or 45% depending on their other income

Technically the gain under an IB is taxed as savings income so it can in principle use both the 0% starting rate and the PSA. This can be useful for a minor child.

A grandparent sets up an offshore investment bond for a grandson. The benefits are paid to the grandson on their 18th birthday. At that point the grandson has no other income so the gain could absorb his PA, the 0% starting rate and his PSA.

Rent a room relief

Rent a room can only be used by a resident landlord, whether or not they own the home. It can also be used by a bed and breakfast or guest house owner. It cannot be used for homes converted into separate flats.

This relief lets individuals let out a room or rooms in their house. The scheme allows a tax free income of £7,500 per house per year. If the ownership is in joint names the allowance is split equally between the couple. The income can also include any amounts received for meals and services such as cleaning and laundry.

The tax exemption is automatic if the total income is less than £7,500. If the income is more the owner must complete a tax return and then opt into the scheme and claim the allowance. Obviously any income over £7,500 will be taxed as the owner's non-savings income.

If the scheme is used the landlord cannot offset any expenses against the rental income.

Theresa takes in paying guests into her home and in 2020/21 she earns £12,500. She calculates her expenses are £4,000. Opting into rent a room means that £5,000 of her income will be taxable (£12,500 less £7,500). If she keeps to the "normal" basis £8,500 of her income will be taxable (£12,500 less £4,000)

To qualify the property:

- Must be part of the resident landlord's main home.
- must be in the UK
- must be let as a residence. A part that is let out as an office would not qualify. However, the scheme can be used if the lodger works at home in the evening or at the weekend or is a student who is provided with study facilities.
- The area let out cannot be a self-contained. It could not be claimed this if there was a flat with its own separate entrance within the he house.
- must be furnished.

Holiday Lettings

The principle of the holiday lettings regime is that the property is let for a series of short term lets. Whilst it doesn't need to be in a holiday resort the lettings mimic the typical holiday pattern in that there is a high turnover of tenants. The principle benefit is that the profit is treated as trading income rather than property income.

To qualify the property:

- Must be in the European Economic Area
- Must be furnished and let on a commercial basis
- It must be available for 210 days a year
- It should be let for 105 days a year (if more than one property this can be averaged)
- It should not normally be let for more than 31 days at a time. Letting for longer than 31 days does not disqualify its holiday lettings status but any such let will not count towards the 105 day requirement

The tax benefits are:

- It is treated as a trade for the purposes of loss relief. Any losses can be offset against future profits from the same holiday lettings business but not other income.
- Capital Allowances can be used.
- It is considered as relevant earnings for pension contributions.
- If a property is sold and reinvested in another one, holdover relief on CGT applies.
- Entrepreneur relief is available

It is also possible that it may qualify for Business Relief. To get this the owner must be offering some additional services such as providing meals or arranging local excursions. There are no hard or fast rules so each case will be considered individually by HMRC.