

# Introduction

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Unit trusts, open-ended investment companies (OEICs) and investment companies are all collective investment schemes, designed to allow a large group of investors to participate in a broad portfolio of shares and/or bonds. Each investor has a direct investment in the scheme that holds and manages the underlying investments.

For unit trusts and OEICs, the value of the investment in the scheme is very closely linked to the value of the underlying assets.

For investment companies (including investment trusts) that are listed on the stock exchange, the value will depend upon the price set by the market, which will take account of, but normally not match, the underlying value of the investments held.

Collective investments are widely used by individual investors and investment institutions because:

- They offer a good way to invest relatively small sums of money, because the investor's cash is pooled into a much larger fund.
- The fund managers make the initial and ongoing investment decisions rather than the investor.
- A balanced portfolio can be created at a modest cost because the fund managers will invest in a spread of investments.
- Collective investments offer access to the markets that an investor might otherwise avoid, eg technology stocks or Japanese equities.
- The individual investor's risk is reduced by the wide spread of investments in the underlying portfolio.
- The pooling of resources can enable investment in a wide spread of investments at a lower cost than could have been achieved by investors acting on their own.

Approximately £348bn was invested in unit trusts and OEICs at March 2009 and £72bn in investment companies (excluding venture capital trusts (VCTs)) at the same date.

## Unit trusts

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Unit trusts were once the most popular collective investment in the UK. Their origins go back to the 1930s and there are now about 740 unit trusts and 1,650 OEICs from which investors may choose.

Until recently the number of unit trusts has been declining, as trusts were converted into OEICs and fewer new trusts were launched. The situation is now stabilising, with OEICs currently accounting for 63% of the OEIC/unit trust total by value.

### Structure

Unit trusts are collective investment funds, with each investor's entitlement defined by the number of units that they hold. Unit prices are normally calculated daily and are based on the value of the underlying investments. As the name suggests, unit trusts are established as a trust, with a legally binding trust deed made between the trustee and the unit trust manager.

The two parties have distinctly different roles:

- The trustee holds the assets of the trust on behalf of unit holders and is often itself the custodian for the trust's underlying investments. The register of unit holders is set up and

maintained by the trustees. Trustees are regulated by the Financial Services Authority (FSA) and normally belong to one of the major banking groups. 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 unit holders' best interests.

- The manager is responsible for the day-to-day running of the unit trust, including promotion, investment and administration. The manager must be authorised by the FSA to conduct investment business in the UK. Usually the investment management of the trust will be undertaken by the manager or a sister company, but in a few cases investment management may be delegated to an external manager. It has become increasingly common for unit trust managers to sub-contract administration, such as dealing, to a specialist third-party company.

The division between the roles of the manager and the trustee gives considerable protection to investors.

## **Investment rules**

In order to be promoted in the UK and obtain exemption from capital gains tax (CGT), unit trusts must be authorised by the FSA. The authorisation rules include a set of regulations designed to ensure that each unit trust has a proper spread of investments and that those investments are readily realisable.

Unit trust managers have traditionally been permitted to invest in equities, bonds, gilts and cash. Since 1991, they have also been able to establish funds investing in warrants, commercial property, and futures and options. In 2004, these provisions were extended by the FSA following new European Union (EU) rules on collective investment funds. All funds have had to comply with the new set of FSA rules since 12 February 2007.

Although the original permission to launch commercial property and futures and options funds is nearly 20 years old, until the last couple of years very few such funds were launched. While 2005/06 saw a boom in property funds, the market remains dominated by equity and bond funds.

Broadly speaking, these funds can invest in any official EU stock market or any non-EU market that the unit trust manager and trustees believe meet satisfactory regulatory and liquidity requirements.

In addition, there are rules to ensure that trust investments are sufficiently diversified:

- An actively managed unit trust that invests in equities or bonds is prohibited from holding more than 10% of the total value of the fund in the shares of any one listed company. A trust which replicates a stock market index may hold up to 20% in any one company (or 35% in exceptional circumstances).
  - The trust can hold only four shares that represent the maximum 10% holding if it is not a tracker fund.
  - Any other shareholding must not exceed 5% of the fund.
  - In effect, this means that a unit trust that is not an index tracker must have a minimum of 16 holdings. In reality, most unit trusts have a pool of between 50 and 100 shares and some may hold several hundred.
- A single unit trust cannot hold more than 10% of any one class of a company's voting shares. Additionally, where a fund management group runs a range of trusts, the group's overall holding of a company may not exceed 20%.

- Trusts investing more than 35% in UK government fixed interest securities (gilts) have a minimum requirement to invest in at least six different issues of stock. No single stock holding can exceed 30% of the value of the fund.
- Trusts may hold up to 20% of their value in units or shares of a single collective investment scheme (eg other unit trust or OEIC). In effect this means a fund of funds must hold at least five separate collective funds.

While the diversification rules sensibly protect investors from over exposure to one company, in the past they sometimes caused problems for index tracking funds when a constituent company represented more than 10% of the index. However, the general 10% ceiling on individual investments was raised to 20% for index tracking funds from 1 November 2002.

The FSA rules make it possible for funds to be 100% invested in commercial property and to go short (ie effectively sell securities that they do not own).

## Categories of trust

The range of investment areas covered by unit trusts is extensive: the investor can choose anything from a UK blue chip trust to a trust investing in high-yielding corporate debt. The Investment Management Association (IMA) groups unit trusts and OEICs into 31 categories representing different investment objectives (see table below). The general yardstick for inclusion in a particular category is that the fund must have at least 80% of its assets invested in the associated sector.

Inevitably there can be grey areas between categories and the final choice of category rests with the unit trust manager, although the IMA now has an independent monitoring process to ensure compliance. Despite the large number of categories, one of them – the UK All Companies category – accounts for around 20% of all funds by value. The IMA regularly reviews category definitions and has a long-term aim to reduce the total number of categories to 25.

<b>IMA investment fund categories</b>	
<b><i>Funds principally targeting income – immediate income</i></b>	
UK Gilts	Sterling Corporate Bond
Global Bonds	Sterling High Yield Bond
UK Equity and Bond Income	UK Index-linked Gilts
Sterling Strategic Bond	
<b><i>Funds principally targeting income – growing income</i></b>	
UK Equity Income	UK Equity Income and Growth
<b><i>Funds principally targeting capital – capital growth/total return</i></b>	
UK All Companies	Europe excluding UK
UK Smaller Companies	European Smaller Companies
Japan	Cautious Managed
Japanese Smaller Companies	Balanced Managed
Far East including Japan	Active Managed
Far East excluding Japan	Global Emerging Markets
North America	Global Growth
North American Smaller Companies	UK Zeros
Europe including UK	

***Funds principally targeting capital protection***

Money Market

Protected/Guaranteed Funds

***Specialist sector***

Specialist  
Technology and Telecommunications

Personal Pensions

The fund categories give only a broad guide to the unit trust's investment activity and philosophy and should be treated with caution. For example, property funds fall into the Specialist sector alongside funds investing in India and global health companies. Within each category, there may be funds which invest in smaller companies, recovery situations, 'mid-cap', blue chip, ethical investments and so on. Funds can also change category over time, even if they retain the same name.

These factors need to be borne in mind when considering performance between sector funds: the higher performer may well have achieved its superior results by taking greater investment risks, possibly in a different sector.

## **Unit trust fund taxation**

Authorised unit trusts are principally subject to a modified version of the corporation tax regime. For investors, this has the important effect of allowing annual management expenses to be offset against income other than UK equity income, ie annual charges are effectively tax relieved, provided that there is sufficient non-UK equity income.

- For 2009/10, the underlying corporation tax rate on income received by a unit trust, be it dividends, rent or interest, is 20%. This is the rate of tax payable by a unit trust.
- Dividends paid by a unit trust are currently generally accompanied by a 10% tax credit.
- UK dividends are received by a unit trust as franked investment income and therefore flow through to dividends payable by the unit trust with no further tax liability. In other words, the trust is 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.
- Special rules apply to the first unit trust dividend payment to the investor. Under a process called 'equalisation', part or all of this may be treated as a tax-free return of the original invested capital.
- The tax treatment of funds holding property has changed with legislation in the Finance Act 2008. Such funds are now able to elect for a similar treatment to real estate investment trusts (REITs – see page 16, "Real estate investment trusts (REITs)"), but only if they are structured as OEICs. There have been no changes made yet by property unit trusts.
- The 2009 Budget announced that a new optional tax structure for unit trusts (and other authorised investment funds) would come into effect on 1 September 2009. This will allow funds, subject to certain conditions, to elect to divide distributions into two parts: UK dividend and non-dividend (interest). The dividend element would be treated as now, while the non-dividend element would effectively be paid out as interest, with 20% reclaimable tax deducted for individual investors. The main beneficiaries of the change would be non-taxpaying investors, which includes individual savings account (ISA) managers and pension managers.

As a general rule, trustees must apply all the net income of a fund for the benefit of unit holders usually by way of a distribution. Income may also be retained in the fund and added to capital for the benefit of holders of accumulation units. However, the income is still taxable on the investor. At current levels of market yields and annual management charges, some trusts – particularly those investing overseas – do not pay any dividends because they have no distributable income.

Within a unit trust, capital gains are exempt from CGT. This means that disposals of investments by the unit trust can be made without any tax liability.

## **Unit trust investor taxation**

Generally speaking, for the individual investor all income and capital gains are taxable. Income distributions from equity unit trusts and income accumulations 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, ie 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.
  - A basic rate taxpayer need take no further action. The tax credit fully covers their tax liability. In this context, being a basic rate taxpayer means that taxable income is below the higher rate tax threshold (£37,400 for 2009/10) when the value of the gross dividend is added onto all other income for the year and tax allowances are deducted.
  - Non-taxpayers cannot reclaim the tax credit from HM Revenue and Customs (HMRC).
  - A higher rate taxpayer needs to pay an extra 22.5p tax by assessment – bringing the total liability to 32.5% of the gross dividend.
- Interest payments from cash and fixed interest unit trusts are subject to income tax at the rate of 20%.
  - This tax is deducted at source, so a gross interest payment of 100p would be paid as 80p net, with 20p tax deducted.
  - Non-taxpayers can claim tax back in full.
  - 10% taxpayers can partially reclaim tax.
  - Higher rate taxpayers are subject to a further 20% charge.

If a fund elects for the new tax structure described in the previous subsection, the two components will each be taxed separately as dividend and interest income as described above.

For all types of unit trust, CGT may also be payable on any profits made by the taxpayer who sells units. The profit is calculated as follows in 2009/10:

- The original acquisition costs less equalisation, including expenses, are deducted from the sale proceeds.
- Generally, realised losses can be deducted from realised profits.

Taper relief and indexation relief are no longer available following the move to a flat 18% tax rate for capital gains.

## **Charges**

Unit trusts levy charges to cover the costs of managing and administering the fund, such as investment management costs, marketing costs and intermediary commissions, registration and other administration. There are two principal charges to be considered when investing in a unit trust:

- The initial, preliminary or 'up-front' charge, paid on the purchase of units.
  - For the majority of equity funds this charge is between 3.5% and 5.5%.
  - Gilt and corporate bond funds often have a slightly lower initial charge, typically around 3%–4%.
  - 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, eg before five years have elapsed from the date of purchase.
- Rebating initial commission, which at around 3% makes up the bulk of the initial charge, has become common.
- A fee-based adviser may rebate all of the initial commission.
- Discounts on charges by managers are also common for large investments.
- Many internet-based fund supermarkets also substantially discount the initial charge or remove it completely.
- The annual management charge, which is paid throughout the period of the investment.
  - For the majority of equity funds this charge is between 1.25% and 1.75% a year.
  - Gilt and corporate bond funds usually have a lower annual charge, typically around 1%–1.25%.
  - For index tracking funds, the annual charge may be only 0.5% or possibly even less.
  - Not all trusts deduct annual charges from their income.
  - Some do not have sufficient income, particularly if they hold overseas assets, and therefore take their charges from capital.
  - Other trusts targeting income seekers also deduct charges from capital to maximise income payments.
  - This approach reduces scope for capital growth and, in high income funds, can lead to capital erosion.

Many investment management groups pay a ‘trail’ commission of around 0.5% a year out of the annual management charge. Very few intermediaries will rebate any of this commission.

The stated annual management charge will not usually cover all the costs of running the trust. Often there will be additional charges levied, eg for custody and audit fees. These usually total in the region of 0.1%–0.2% a year, but may be much higher for some specialist overseas trusts.

The level of charges is determined by commercial rather than regulatory considerations. Until the latest change to its rules, the FSA did not permit performance-related fees. These are now starting to appear in a handful of specialist funds.

## **Dealing and pricing**

The unit trust management group will usually set a minimum investment level of £500 or £1,000, with minimum additional top-ups of about the same level. There is no maximum investment limit, because unit trusts are ‘open-ended’, creating or cancelling units according to demand. The investor can buy or sell in several different ways – by telephone, via the internet, by sending in a coupon from a newspaper or dealing through an authorised financial adviser. Increasingly, dealing is run through investment platforms, which offer a single administrative facility for the funds of a wide variety of investment groups.

- 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 giving details of the purchase.

- Telephone and internet orders normally require payment once the contract note has been received by the client or their adviser.
- Key Features documents must be supplied to the investor, detailing charges and the other main aspects of the trust.

A unit trust certificate detailing the investor's holding is not mandatory, and the trust deed need not oblige the manager to issue one.

- Almost all unit trust groups have 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 or dividends are reinvested.
- With no certificate, proof of purchase is simply the contract note; proof of ownership is entry on the register.

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

The prices at which a unit trust is bought and sold are calculated on a per unit basis according to complex FSA regulations, which determine the highest price at which units can be sold and the lowest price at which the manager can repurchase units.

The majority of unit trusts quote two prices:

- The investor buys units at the higher buy price, frequently called the 'offer' price.
- The buy price will include the manager's initial charge.
- The investor sells units back to the manager at the lower sell price, often referred to as the 'bid' price.
- The range between the two prices is called the 'spread'. It will usually be higher than the level of the initial charge because of the factors taken into account when calculating the two prices, eg stockbroking commissions and stamp duty.
- A small number of unit trusts, mostly index tracking and cash funds, operate on a single price, with no buy-sell spread.

The time of day when trust prices are set is the choice of the manager. Most choose midday. Unit dealing can either take place at:

- Historic prices, ie the last calculated price, or
- Forward prices, ie the next calculated price.

The majority of unit trust managers now deal forward, which is generally regarded as fairer to all parties.

In November 2002, the FSA gave permission for unit trusts and OEICs to be offered as limited issue funds (LIFs). These funds have a restricted number of units or period of issue, and are typically used for specialist sectors or where some form of guarantee or capital protection is offered.

The FSA rules also now allow trusts to defer redemption for up to six months if they are invested in property or offer some form of guarantee. Together, these two changes should have meant that more fund groups launch protected (ie quasi-guaranteed) funds in the UK rather than, as present, out of Dublin. However, very few have appeared so far.

## Open-ended investment companies

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An OEIC, sometimes called an investment company with variable capital (ICVC), is a diversified collective investment vehicle very similar to a unit trust. OEICs are a common form of structure for investment funds in continental Europe, and now account for nearly 70% of UK open-ended investment funds by number.

For some while there was a steady flow of unit trusts converting to OEICs, but the speed of transition was much slower than was originally expected. More than twelve years after OEICs first appeared, there are still well over 700 unit trusts in existence.

### Structure

The legal structure of an OEIC is the main difference between it and a unit trust, although to the investor little difference may be visible.

- An OEIC structure is that of a company constituted by an instrument of incorporation and managed to maximise investment returns for investors.
- 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.
- The investors' interests in the fund are represented by shares in the fund company (very similar to units in a unit trust).
- The capital of the company is open-ended, to ensure that issues to and redemptions by investors are met by corresponding increases and decreases in the company's share capital and assets.
- Like unit trusts, OEICs must be authorised by the FSA if they are to be marketed in the UK.

OEICs may be constructed in a variety of ways. These include the use of 'umbrella' structures, with a range of sub-funds covering individual investment areas. Some OEICs also have multiple share classes for each fund, typically retail and institutional classes with differing charges and investment minimums. Until April 2004, unit trusts had not been able to offer different classes of unit in the same fund.

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.
- Day-to-day management issues such as pricing and dealing.
- The preparation of accounts.
- The management of investments.

The OEIC equivalent of the unit trust trustee is the depositary, although the two roles are not identical. The depositary is an independent 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.
- The ACD's exercise of the OEIC's investment and borrowing powers.
- Safekeeping of assets.

## **Investment rules**

The investment rules for OEICs are now the same as those for unit trusts.

## **Categories of fund**

OEICs cover the same range of investment categories as unit trusts.

## **Fund and investor taxation**

The tax regime for OEICs is basically the same as that which applies to unit trusts. Switches between share classes of different sub-funds will give rise to a potential CGT liability.

## **Charges, dealing and pricing**

OEICs are subject to initial and annual charges at similar levels to those which apply to unit trusts. However, the approach to fund pricing adopted by most providers is different.

The price of each share in an OEIC reflects the NAV of the assets of the fund, divided by the number of shares in issue – the NAV per share. For example, if the OEIC holds a portfolio of securities that, together with net income, is worth £25 million, and there are 10 million shares, the NAV per share is £2.50.

- The assets contained in the OEIC are valued at their mid-market price. Unlike the unit trust pricing process, for an OEIC there is no allowance made for the dealing costs of buying and selling securities or price spreads on securities within the portfolio.
- The OEIC's NAV single price applies both to investors purchasing shares in the fund and to those selling shares back to the ACD.
- Shares are purchased from the ACD at the single price, plus an initial charge to cover commission, sales and management expenses. Thus, whereas a unit trust price spread may be more than the initial charge, for an OEIC the difference between buying and selling costs is purely the initial charge.

A charge called the dilution levy can be added to the cost of share purchases or deducted from the proceeds of 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 is applied if there are unusually large inflows and/or outflows of funds. There are no FSA rules about precisely when the dilution levy can be applied and practice varies greatly between funds.

While unit trusts can adopt the OEIC pricing structure, virtually all deal with this inflow/outflow pricing problem by manipulating the prices at which units are dealt, within the FSA maximum and minimum. The result is the same, but in a unit trust it is much less transparent.

Aside from the pricing difference, 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. OEICs are allowed to issue bearer certificates, which are convenient for some investors (eg non-UK domiciled shareholders).

## **Conversion of unit trusts to OEICs**

There has been a flow of managers converting their unit trusts to OEICs, because there is an exemption from stamp duty on transfers currently in place.

- Conversion can be achieved without the need for a unit holder meeting, unless 5% of the unit holders request one.
- In practice, most unit trust managers who want to convert hold meetings and provide unit holders with comprehensive information about the process. The conversion is no more – or less – complicated than ordinary unit trust mergers.

Investors benefit little from conversions, although switching between funds may become cheaper. The main appeal is for fund managers, who gain a structure that is more readily marketable in the EU than unit trusts.

## Investment trusts and investment companies

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Investment trusts are the oldest form of collective investment. The first trust was created in the 1860s and there are now about 315 investment trusts and companies managing assets of around £71.8 billion (as at March 2009). VCTs (see page 1, “Enterprise Investment Scheme and Venture Capital Trusts”) are also classed as investment trusts and there are 124 such trusts with £2.2 billion invested.

The investment trust sector fell out of favour in the 1970s and at one point seemed destined for extinction. However, interest revived in the 1980s and 1990s as new structures, including offshore investment companies, were developed and greater efforts were made to attract the private investor. Offshore investment companies now account for about £25.2 billion of assets.

### Structure

Investment trusts are not trusts, but public companies listed on the London Stock Exchange and subject to Companies Act legislation. Their principal activity is to invest the funds they control according to their own investment policy.

Investment trusts are close-ended funds, unlike unit trusts and OEICs. This means that they have a fixed number of shares in issue at any time. The shares are bought and sold on the stock market in the same way as other listed companies.

An investment trust is run by its board of directors, which usually consists of around five members. The directors can undertake the investment management themselves, but nowadays it is more common for the directors to employ a management company to undertake the investment management and also provide other services, such as administration, registration and accountancy.

An investment trust may only issue one class of share, or it may issue a number of different classes of shares, each with their own entitlements. Trusts with these more complex capital structures are known as split capital investment trusts. They can be designed to appeal to many different types of investor:

- Some share classes provide pure capital growth in forms that range from the safe to the very risky.
- Some share classes provide relatively high levels of income in various forms.

There is no such thing as a typical split capital investment trust, although virtually all of them have a limited lifespan, initially of between five and ten years. In theory, normally all the classes of shares are redeemed at the end of the trust’s life. In practice, there will usually be a replacement trust launched or an extension proposed, both to help investors avoid a CGT charge and to stem the outflow of funds from the investment managers.

Around the turn of the century, newly launched split capital trusts adopted a wide range of structures and investment approaches. As many as 40 of these trusts encountered financial difficulties, eg being forced to suspend dividend payments, and 26 were forced into administrative receivership or liquidation because of poor stock market conditions. It is important that prospective investors in split capital investment trusts are made aware of the potential risks, particularly when they may be attracted by high income returns. In late 2004, the FSA agreed a compensation scheme for some split capital trust investors, but it did not cover all trusts and only offered limited payments to zero dividend preference share investors.

The main classes of share – not all of which each trust will have – are:

- Income shares, which pay out broadly all the income received by the investment trust after expenses and interest. When the trust is wound up, the shares receive a set low capital return, typically equal to the original issue price.
- Highly geared or ordinary income shares, which do not have a fixed redemption value, but instead have a wind-up value based on the assets remaining in the trust after other higher ranking liabilities (eg bank debt) have been cleared. The shares tend to offer higher yields than income shares, but carry a greater risk of capital loss at redemption.
- Annuity income shares, which offer a high income level but only a nominal redemption amount, eg 1p for every 100p share.
- Capital shares, which have no entitlement to any income, but which benefit from the bulk of the assets on wind-up, after repayment of higher ranking liabilities, eg income shares.
- Zero dividend preference shares (zeros), which pay no income but offer a predetermined rate of return when the trust is finally wound up. Zeros rank ahead of other shares for repayment at redemption, but may stand behind other liabilities, notably bank debt. The returns are not guaranteed: if investment performance is poor, zero shareholders may receive less than their anticipated redemption value. Any gain on sale or redemption of zeros is subject to CGT, which makes them particularly attractive for higher rate taxpayers.

The complex nature of these structures, to which are often added bank borrowing and loan stocks, makes it virtually impossible for anyone other than an investment professional to fully understand the potential risks and rewards.

Investment companies have a very similar structure to investment trusts, but generally do not meet all the HMRC rules to be classed as an authorised investment trust (see below). Most investment companies are based offshore.

## **Investment rules**

Investment trusts face none of the restrictions on investment that apply to unit trusts and OEICs, although most will adopt similar internal rules to ensure adequate diversification. However, for a UK investment trust company to gain HMRC approval and hence freedom from CGT, it must receive at least 70% of its income from shares and other securities and hold no more than 15% of its value in a single company.

A growing number of new investment companies (not HMRC authorised investment trusts) have circumvented these restrictions by setting up in Guernsey (or similar tax havens) and obtaining a London Stock Exchange listing. This has been a popular route for trusts investing directly in commercial property. In 2007, all new investment company launches were offshore.

Investment trusts can borrow money and use the cash to increase the level of funds they can invest. This is known as gearing or 'leverage' (in the USA). Gearing is worthwhile if the return that the managers can achieve is greater than the interest costs that they have to pay on the borrowings. The borrowings can take the form of:

- Loan stock.
- Overdrafts or short-term bank loans.
- Long-term bank loans.
- Debentures.

- Foreign currency loans.
- Preference shares.

The advantage of gearing is that in a rising market a geared portfolio can outperform a more conventional ungeared portfolio. The corollary is true in falling markets.

For tax purposes, an investment trust manager can offset the interest against the income from the underlying investments, other than UK equity income. An individual who attempts to do the same thing would not obtain any tax relief on such borrowings. Gearing increases the potential volatility of investment trusts.

## Categories of trust

The Association of Investment Companies (AIC) classifies investment trusts into 43 categories (excluding VCTs). These are similar to the unit trust and OEIC categories, but there is an absence of bond funds, as authorised investment trusts are not tax-efficient vehicles for holding bonds. In their place are a greater number of specialist categories, some of which are very thinly populated.

<b>AIC Investment trust categories</b>	
➤ Global Growth	➤ Property Direct UK
➤ Global Growth & Income	➤ Sector Specialist: Canadian Income Trusts
➤ Global High Income	➤ Property Specialist
➤ Global Smaller Companies	➤ Sector Specialist: Biotechnology/Life Sciences
➤ Hedge Funds	➤ Sector Specialist: Endowment Policies
➤ UK Smaller Companies	➤ Property Direct Asia Pacific
➤ UK Growth	➤ Sector Specialist: Commodities and Natural Resources
➤ UK Growth & Income	➤ Sector Specialist: Forestry & Timber
➤ North American Smaller Companies	➤ Sector Specialist: Environmental
➤ UK High Income	➤ Sector Specialist: Financials
➤ North America	➤ Sector Specialist: Litigation
➤ Japan	➤ Sector Specialist: Infrastructure
➤ Asia Pacific including Japan	➤ Sector Specialist: Liquidity Funds
➤ Asia Pacific excluding Japan	➤ Sector Specialist: Small Media, Comms & IT Cos
➤ European Smaller Companies	➤ Sector Specialist: Mezzanine Finance
➤ Japanese Smaller Companies	➤ Sector Specialist: Securitised Debt
➤ Europe	➤ Sector Specialist: Technology Media Telecoms
➤ European Emerging Markets	➤ Sector Specialist: Zero Dividend
➤ Private Equity	
➤ Global Emerging Markets	
➤ Country Specialists: Asia Pacific	
➤ Latin America	
➤ Country Specialists: Europe	
➤ Property Direct Europe	
➤ Property Securities	

The main criterion for category membership is that a trust has at least 80% of its assets invested in the sector.

## Investment trust fund taxation

UK investment trusts that have been approved by HMRC are not subject to any tax on gains made from the sale of shares in their portfolios. This puts them on an equal footing with unit trusts and OEICs.

Investment trusts are not subject to any additional tax on franked income, ie dividend payments from other UK companies. However, trusts do have to pay corporation tax on unfranked income.

This is income from sources such as foreign share dividends, interest from gilts and bank deposits, and underwriting commission. Trusts can reduce their tax liability by offsetting their own expenses – interest paid on borrowings and management fees – against the unfranked income. As the mainstream rate of corporation tax is 28%, it is unattractive for investment trusts to receive large amounts of unfranked income, eg interest from fixed interest securities or dividends from overseas companies, which cannot be offset against expenses.

Most of the more recently launched investment trusts have been incorporated in the Channel Islands, but listed on the London Stock Exchange to facilitate dealing and promotion. The advantage of the Channel Islands approach is that the trust does not have to pay corporation tax on its unfranked income and so is not constrained in its investment holdings. Going offshore also avoids HMRC investment restrictions (see above).

In response to the migration offshore, in 2008 the Treasury launched a consultation on revised tax treatment for investment trusts, which would allow a more favourable tax treatment of interest. From 1 September 2009, legislation contained in the Finance Bill 2009 will effectively allow UK investment companies to opt for the interest income which they distribute to become taxable on the investor rather than at corporation tax rates within the company. This is likely to prompt the launch of a number of investment companies focusing on fixed interest securities, a sector which has so far only been addressed from offshore.

## **Investment trust investor taxation**

Income and gains from UK investment trusts are currently taxed in the same way as income and gains from equity unit trusts. For investment companies based in the Channel Islands, the taxation principles are the same for the individual investor, although there is a minor difference in the treatment of income.

For 2009/10, dividends from offshore investment companies are deemed to be paid with an accompanying non-reclaimable 10% tax credit. Thus basic rate taxpayers have no further liability on the amounts they receive and higher rate taxpayers are liable to 22.5% of the deemed gross payment (ie payment received + 10% tax credit). Non-taxpayers have nothing to pay.

If an investment company takes advantage of the new elective regime, the interest element distributions will be paid to individual investors with a reclaimable 20% tax deduction.

## **Charges and dealing**

Investment trusts and companies levy annual management charges in a similar way to unit trusts and OEICs. For the older trusts, annual charges can be much lower than the unit trust norm – under 0.5%. However, most trusts launched in the last ten years have had annual charges similar to those of unit trusts and OEICs.

The average total expense ratio (TER) excluding performance-related fees for 239 conventional investment trusts is 1.41%, with 27% of trusts having TERs of below 1%, according to research published by the AIC.

Investment trusts also frequently levy performance fees in addition to their annual charges. There are no initial charges per se for investment trusts. However, an investor dealing in an investment trust may suffer a number of costs:

- If the investor is buying newly issued shares, there will normally be expenses associated with the issue that are deducted from the monies raised by the trust. These could be as high as 6% of the capital raised.
- If investors are buying or selling shares through a stockbroker, they will be subject to stockbroking charges. These vary from under £10 for an execution-only internet deal to 1.85% of the deal value through an advisory broker.

- There is a spread between the buying and selling price of shares, which depends upon the market liquidity of the trust involved. The gap can exceed 10% for shares in illiquid trusts, eg some split capital trusts.
- Stamp duty will be payable on the purchase of UK investment trusts at a rate of 0.5%. Offshore investment companies do not attract stamp duty.
- Many investment trust groups operate savings schemes through which lump sum or regular investments can be made. Typically these schemes make no or very small (eg 0.2%) stockbroking charges for purchase and levy a small flat charge on sale (eg £10). However, if the purchasing investor is advised by an intermediary there may be an additional up-front charge of 3% to cover the adviser's commission.

## Pricing and net asset value

The prices of investment trusts are determined by demand and supply. Unlike unit trusts and OEICs, this means that the price may be more or less than the value of the investments underlying their holding.

That underlying value, the NAV, is the value of an investment trust's investments per ordinary share, after taking into account all liabilities. NAVs are calculated daily by investment trust specialists and published in some daily newspapers.

- While the market determines the share price of an investment trust, that price will bear some relationship to NAV.
- In practice, most investment trusts trade at a discount to their NAV. The typical current discount level is around 9%, ie a share with a NAV of 100p will be trading at 91p. The discount has the effect of boosting income: the investor paying 91p for a share still receives the income from 100p of assets.
- Discounts vary over time and are influenced by a range of factors. If a sector falls out of favour, discounts tend to widen. For example, at present some private equity trusts trade on a discount of close to 80%. At the peak of the Asian crisis in 1998, some Asia Pacific trusts were trading at discounts of one-third: 100p of assets were for sale at 67p.
- Few trusts trade at a premium (ie in excess of NAV), and those that do rarely maintain their premium for very long. One reason is that there is no point in the investor paying over the odds for access to investment management if that same skill is often available at what is effectively NAV by investing in an OEIC or unit trust.
- Premiums tend to be most common on trusts with very strong performance records or those that track indices.
- In capital terms, the performance for the investor is enhanced if the discount narrows. For example, the NAV of an investment trust increases from 100p to 150p per share, an increase of 50%. But the share price increases from 80p (a discount of 20%) to 135p (a discount of 10%). So, although the underlying shares are increased by 50%, the value of the investment trust shares increases by nearly 69%.
- Conversely, if investment trust discounts widen, the performance of the investment trust is depressed in comparison with the performance of the underlying assets. For example, the NAV of an investment trust also increases from 100p per share to 150p per share, but the price when they were bought is 90p (a discount of 10%). When they are sold the price is only 120p, because the discount has widened to 20%. The investment trust managers have performed identically, but the profit for the shareholders is significantly lower.
- The possibility of premiums and discounts increases the volatility of most investment trusts compared to unit trusts and OEICs, where fund price and NAVs move in tandem.

# Real estate investment trusts (REITs)

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REITs first appeared in January 2007, when legislation in the Finance Act 2006 came into effect. As the name suggests, REITs primarily invest in property, which can be commercial and/or residential.

## Structure

REITs are UK registered companies, listed on a recognised stock exchange. They normally consist of two elements:

- *A tax-exempt component* from which the REIT must derive at least 75% of its total profits and which must represent at least 75% of its gross assets. At least 90% of the profits of the property rental business must be paid out by way of dividend. The ratio of rental income to loan interest must be at least 1.25:1 if a tax charge is to be avoided.
- *A taxable component* that deals with ancillary property services and associated development. This pays corporation tax in the normal way.

## Investor taxation

Dividends from the tax-exempt component are paid subject to a 20% tax deduction for individual investors, which can be reclaimed by non-taxpayers and, in part, by 10% taxpayers. Higher rate taxpayers will have an additional 20% liability on the grossed up dividend.

Dividends from the taxable component are treated as any other dividends, ie paid with a non-reclaimable 10% tax credit.

CGT applies in the normal way to REIT shareholdings.

The major advantage that REITs offer over listed UK property companies is that there is only one layer of taxation (at the investor level) for the exempt element. Listed property company investors suffer double taxation – corporation tax and then their own tax. For this reason, many property investors, such as pension funds, currently either invest directly or via offshore funds.

REITs are eligible investments for ISAs, child trust funds and self-invested pension arrangements.

## Company conversion

Existing property companies have been able to convert into REITs since 1 January 2007. There is a one-off corporation tax charge for the conversion, equal to 2% of the market value of assets transferred into the tax-exempt component. Twenty UK listed property companies have so far converted into REITs, including four that are members of the FTSE 100.

To judge by the experience in other countries with REITs, the UK's listed property company sector will be very much smaller in a few years' time: in terms of market capitalisation, £15.9bn is already held in REITs (as at April 2009).

The idea has been floated that some companies with large property portfolios, eg some high street retailers or pub chains, may move their property assets into REITs, but none have so far done so and in current market conditions none are likely to do so in the near future. One property company, concentrating on local retail property, joined the main market in May 2007 and converted to a REIT almost immediately. There have been no other 'new' REITs, although a number of existing REITs are now undertaking rights issues.

Some fund management groups have suggested that the offshore investment company structure remains more attractive. It must also be said that property is not top of investors' wishlists at present, which means there is no interest in launching new investment vehicles.

## Conclusion

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There is a wide range of collective investments available to the UK investor, covering all the major equity and fixed interest markets. While there is almost nothing to choose between unit trusts and OEICs in their pricing and tax treatment, investment trusts and investment companies are a very different proposition. All four types of fund can normally be held in ISAs.

Anyone contemplating the purchase of a collective investment fund should seek independent advice before acting, unless they are experienced in investment matters.

*This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.*