FitchLearning

Chapter 12

Investment Products

6-10 questions

2. Collective Investment Vehicles

Pooled investments

- What is a collective investment scheme?
  - An investment vehicle allowing investors to pool their assets
  - Differing objectives: income, capital growth, combination of the two
  - Short-term (money market) and long-term (equity, debt, hybrid) funds
- Advantages of collective investment schemes
  - Many average investors are not able to:
    - Allocate the time to manage their portfolios themselves
    - Have the expertise to construct, monitor and adjust their portfolios themselves
    - Benefit from economies of scale – cheaper costs
    - Diversify as well as with pooled investments
    - Handle the administration that goes with portfolio management
- Disadvantages of collective investment schemes
  - Costs – initial charge and on-going fund management costs
  - Risk – returns are not guaranteed
  - Lack of control – investor loses their choice of individual investments
  - 'Star' managers – may move

Further information

	Direct investment	Collective investment schemes
Choose the holdings	The investor	A fund manager
Handles fund administration	The investor	A fund manager
Diversification	Difficult to be diversified	Funds have 80+ holdings
Investment research	Often lack experience/skills	Experience and expertise
Monitoring and rebalancing	The investor	The fund manager
Small and large investments	Small investments more limited	Low minimums, more flexible
Economies of scale	Investor does not benefit	Investor benefits
Fund management charges	None	Investor pays an annual charge

2. Collective Investment Vehicles

- Definition of collective investment scheme (CIS)
  - Unit trusts
  - Open ended investment companies (OEICs): now referred to by the FCA as investment companies with variable capital (ICVCs)
- Regulated CIS
  - UCITS status
    - A regulated CIS may apply to FCA to seek UCITS (Undertaking for Collective Investments in Transferable Securities) status
    - Such schemes can then be marketed throughout the EEA
  - Non-UCITS retail funds (NURS)
    - Permitted to market themselves to the UK general public
  - Qualified investor schemes
    - Regulated funds that can only be marketed to professionals
- Unregulated CIS (hedge funds)
  - Do not meet FCA investment criteria
  - Trustees are authorised persons
  - Cannot be freely marketed in the UK

Further information

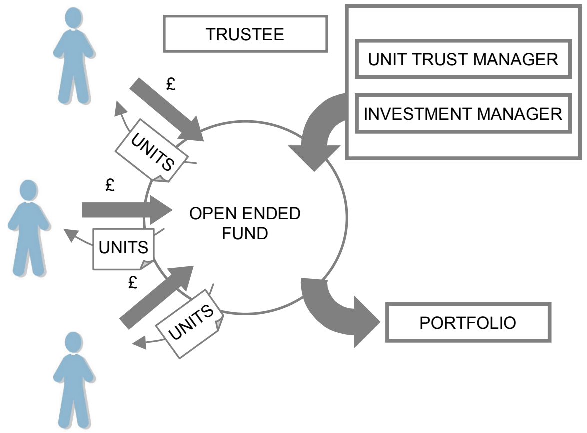
Collective investment schemes in the UK

- Regulated
  - Authorised
    - UK Funds
  - Recognised
    - UCITS (Europe)
    - Designated
      - Jersey
      - Guernsey
      - Isle of Man
      - Bermuda
- Unregulated (e.g. hedge funds)

Application is made to the FCA by the Manager and the Trustee, which should be determined within six months.
The Manager and Trustee must:
- Both be authorised
- Be incorporated in the UK or another EEA member state
- Have a place of business in the UK
- Be independent of one another

2. Collective Investment Vehicles

Unit trusts: features



Further information

FCA rules

The rules include:

- How the unit trust is set up and the contents of its ‘constitutional documents’ (the trust deed);
- The types of investment that can be held
- The liquidity and ease of valuation/trading of investments
- The maximum exposure to a single issuer

The rules are intended to protect investors in unit trusts.

2. Collective Investment Vehicles

Unit trust pricing

- Units in a unit trust are not transferable
- When units are sold to investors they are either created or obtained from the ‘fund manager’s box’
- The portfolio is valued once every business day at the valuation point to give the Net Asset Value (NAV) of the fund
- To cover costs the manager will either place a spread around the NAV or price them at the NAV with an additional bill

Types of units

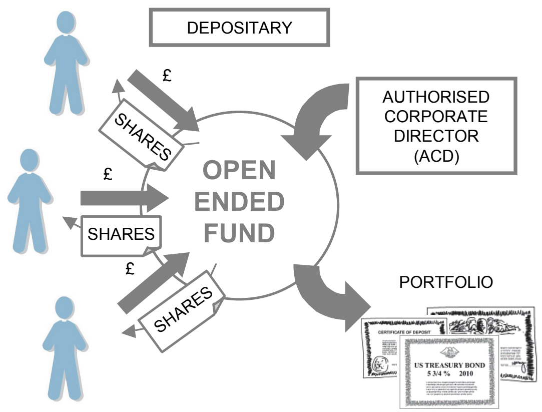
- Income = Income distributed, capital gains realised on redeeming the unit
- Accumulation = Both compounded income and capital gains realised on the redemption of the unit

Tax

- Income from bond coupons and bank interest taxed 20% corp. tax
- No capital gains tax

2. Collective Investment Vehicles

ICVCs: Features



2. Collective Investment Vehicles

A UCITS fund has specific investment restrictions which limit how much of the fund value can be invested in a single organisation

Investments	% of CIS fund that can be invested
Deposit in a single institution	Max 20%
Securities from a single issuer	Max 5% (can be 10%)
Units in CIS from a single fund	Max 20%
Government securities from a single issuer	Max 35%

They also place a limit on how much of the organisations issued securities can be owned

Investments	% of a single institutions securities owned
Non voting shares	Max 10%
Debt securities	Max 10%
Money market instruments	Max 10%
CIS Units	Max 25%

Further information

Maximum 10% in non-approved securities. Remaining 90% in approved securities:

Approved securities

- Listed on an EEA exchange
- Traded on an eligible market
  - Market within the EEA
  - Market the officiants agree is eligible after considering if it is:
    - Regulated
    - Recognised
    - Operates regularly
    - Open to the public
    - Adequately liquid

2. Collective Investment Vehicles

Unit trusts vs. ICVCs

	Unit Trust	ICVC
Legal status	Trust	Company
Pricing	One or two-way	One-way
What the investor buys	Units	Shares
Managed by	Manager	Authorised corporate director
Assets held by	Trustee	Depositary

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Keeping on target

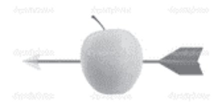
Which of the following is false concerning unit trusts and ICVCs?

A. They always operate on single price

B. Valuation is calculated by taking the value of the portfolio divided by the number of shares or units

C. Box management is permitted, although a negative box is prohibited

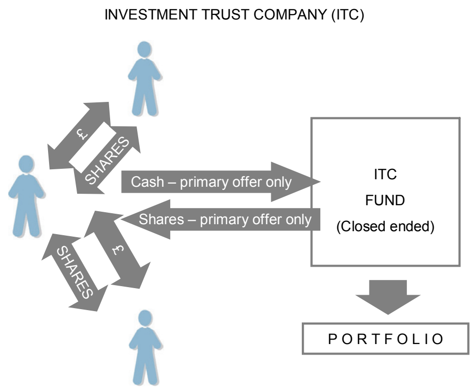
D. Reports must be sent to investors every six months



2. Collective Investment Vehicles

Investment trusts: features

- A company not a trust
- Trades on a secondary market (real-time pricing)
- Closed ended



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Further information

Gearing

Gearing is borrowing funds to invest as well as investing shareholders' funds. It is useful when investments do well, as the returns are magnified. Losses, however, are magnified as well.

ITs have few restrictions on gearing and are limited only by the company's own internal rules

Answer to the question on the previous slide:

A

They always operate on single price

2. Collective Investment Vehicles

- ITCs: Buying and selling shares
  - Prices dictated by supply and demand
  - Can trade at a premium or discount to net asset value (NAV)
- Gearing risk
  - ITCs can borrow to reinvest in the fund
  - Can increase potential profits
  - Can increase potential losses

- ITCs: Conventional
  - These run like a normal company with an indefinite life
  - Two basic classes of share
    - Ordinary
    - Preference

Keeping on target

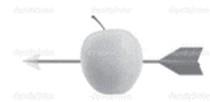
Which of the following best describes an investment trust company?

A. It is a unitised collective investment scheme

B. It is a listed company that buys shares in other companies

C. It is a tax shelter for certain types of investment

D. It is an open ended investment vehicle



2. Collective Investment Vehicles

ITCs: Split capital

- Set up for a specified period of time after which the portfolio is liquidated.
- Three basic classes of share:
  - Zero dividend
    - No income
    - First shareholder to be paid
    - Redeemed at a pre-specified value if the funds are available
  - Income shares
    - Distributions based on profits
    - Paid after zeroes
    - Typically have a pre-specified redemption value
  - Capital shares
    - Typically no income
    - Last in order of payout
    - Receive any residual funds after all other investors are paid
- Packaged units
  - A unit that represents a portfolio based on a mixture of the above

Answer to the question on the previous slide:

B

It is a listed company that buys shares in other companies.

2. Collective Investment Vehicles

Unit trusts vs. investment trust companies

	Unit trust	Investment trust
Legal status	Trust	Company
Pricing	Net asset value	Supply and demand
Market	Primary	Secondary
What the investor buys	Units	Shares

2. Collective Investment Vehicles

Exchange traded products (ETP)

- Incorporated as an ICVC, but tradable on the secondary markets.
  - Two broad types
    - Exchange traded fund (ETF)
      - Equity based
    - Exchange traded commodity (ETC)
- Characteristics:
  - ETPs are open-ended (priced at NAV)
  - ETPs are essentially tracker or index funds (diversified)
  - ETPs are traded on the secondary markets (real time pricing)
  - ETPs have very low charges
  - ETPs are not subject to stamp duty
  - ETPs can be shorted

Hints

Exchange trade products such as exchange-traded funds (ETFs) are constituted as OEICs, but traded on the secondary markets.

ETPs are becoming increasing used by smaller investors as an efficient way to gain access to emerging markets and commodities.

2. Collective Investment Vehicles

Other methods of indirect investment

- Private client funds
  - Personal account with a brokerage
  - Types of fund
    - Execution only
      - The client instructs and the broker executes
    - Advisory dealing
      - The client generally instructs but may ask the broker for advice
    - Portfolio advisory
      - The broker reviews the client's objectives and provides advice. The client makes the final decision
    - Portfolio discretionary
      - The broker reviews the client's objectives and makes all decisions on investment strategy under blanket permission provided at the start of the relationship

2. Collective Investment Vehicles

Other methods of indirect investment

- Structured products
  - Two or more investments combined
    - Generally a security and a derivative
  - Examples
    - Callable/puttable/convertible/index-linked/commodity-linked bonds
    - Structured deposit
      - Offering an attractive rate of interest is a referenced entity meets a set target
      - For example, 6% p.a. if FTSE100 stays above 6500pts
    - Structured capital protected product
      - For example a zero coupon bond and a long option
    - Structured capital at risk product
      - Sacrificing capital protection for additional gain

Further information

Wrap accounts

A wrap account (or wrap service) is a means of consolidating and managing an investor's investment portfolio and financial plans for a fee.

An extensive range of UK and offshore funds and assets, including: CIS, Investment Trusts, equities, gilts, cash, structured products, VCTs, Hedge Funds, ETPs and other investment products.

The investor can allocate these assets to tax wrappers, including ISAs and pensions plans.

Both investors and advisers can then view a holistic picture online of the complete portfolio – all in one place, from anywhere in the world – 24/7.

3. Hedge funds and private equity

Unregulated schemes

Hedge funds

- Characteristics
  - Short selling
  - Borrowing to enhance gearing
  - Use of derivatives
- Classifications
  - Event driven
    - Takeovers, mergers, restructuring, etc.
  - Market neutral
    - Arbitrage activities
  - Long/short funds
  - Tactical (Speculative) trading
    - Systematic
    - Discretionary
  - Funds of funds

Further information

Fees for hedge funds

Fees can be very high

- Fixed fee: typically 1%-2% (can be as high as 5%)
- Management fee: typically 20% to 25% of the portfolio return

Often there is a high water mark to reach if the management fee is to be achieved.

2. Hedge funds and private equity

Private equity funds

- Two broad categories
  - Venture capital
    - New, innovative but highly risky companies
  - Buy-outs
    - More established companies, typically plcs
    - Large capital investment
      - Leveraged buy-out
- Charges
  - Fixed fee
  - Management fee (carried interest)
    - Hurdle rate

4. Pension funds and life assurance companies

Pension schemes

- Occupational pension schemes
  - Salary related (defined benefit e.g. final salary, average salary)
  - Money purchase (defined contribution e.g. 5% of salary)
- Personal pensions/stakeholder pensions
  - Money purchase schemes

Further information

There has been a significant shift by employers from defined benefit pension plans to defined contribution

4. Pension funds and life assurance companies

Overview

- Insurance companies
  - Life assurance
    - Term endowments
    - Whole of life
  - General insurance

Further information

Qualifying and non-qualifying policies

Investments in life funds can be qualifying or non-qualifying

- Qualifying policies – require regular scheduled payments.
- Non-qualifying policies – receive an irregular unscheduled lump sum(s)

Summary: Investment Objectives

	Young pension fund	Mature pension fund	Life assurance company	General insurance company
Investment horizon	Long-term	Short-term	Long-term	Very short-term
Attitude to short term risk	Positive	Negative	Positive	Very negative
Liquidity	Low	High	Low	Very high
Liabilities	Real	Real/nominal	Nominal	Nominal
Asset choice	• Equities • Property • I-L gilts	• Bonds	• Equities • Property • Bonds	• Cash • Money market instruments