TOPIC 8

Collective investment schemes

LEARNING OBJECTIVES

Topics 6 and 7 focused on direct investments in financial assets. In this topic we are looking at indirect forms of investment known as collective (or pooled) investments. Collective investments are arrangements that make it possible for many investors – whom do not necessarily have a relationship with or know one another – to pool and invest their assets to achieve a common objective (eg an investment return).

By the end of this topic, you should have an understanding of:

- why collective investments appeal to investors;
- legal forms of Collective Investment Scheme (CIS) or investment fund, including:
  - unit trusts;
  - investment trusts; and
  - open-ended investment companies (OEICs);
- other collective investments based on life assurance products, including endowments and investment bonds;
- friendly society plans;
- non-mainstream pooled investments (NMPIs);
- structured products;
- wraps and platforms.

This topic covers Unit 1 syllabus learning outcome U3.2 and part of U7.7.

THINK . . .

An investor who lacks the time, knowledge, confidence or experience to invest directly into the types of assets covered in Topics 6 and 7 might subscribe to a collective investment such as an investment fund instead. You may have subscribed to a collective investment yourself or you may have read about them in the media. For instance:

- Do you have a stocks and shares ISA that holds investment funds organised as unit trusts, investment trusts or open-ended investment companies?
- Have you considered using one of the collective investment vehicles listed in the learning objectives above? What made you consider this type of investment?
- Have you read media reports about the high levels of investment returns produced by some fund managers?

If the answer to all of these questions is “no”, don’t worry – this topic provides a good introduction!

8.1 Why do collective investments appeal to investors?

The main legal forms of collective investment vehicles and products are:

- unit trusts;
- investment trusts;
- investment bonds; and
- OEICs.

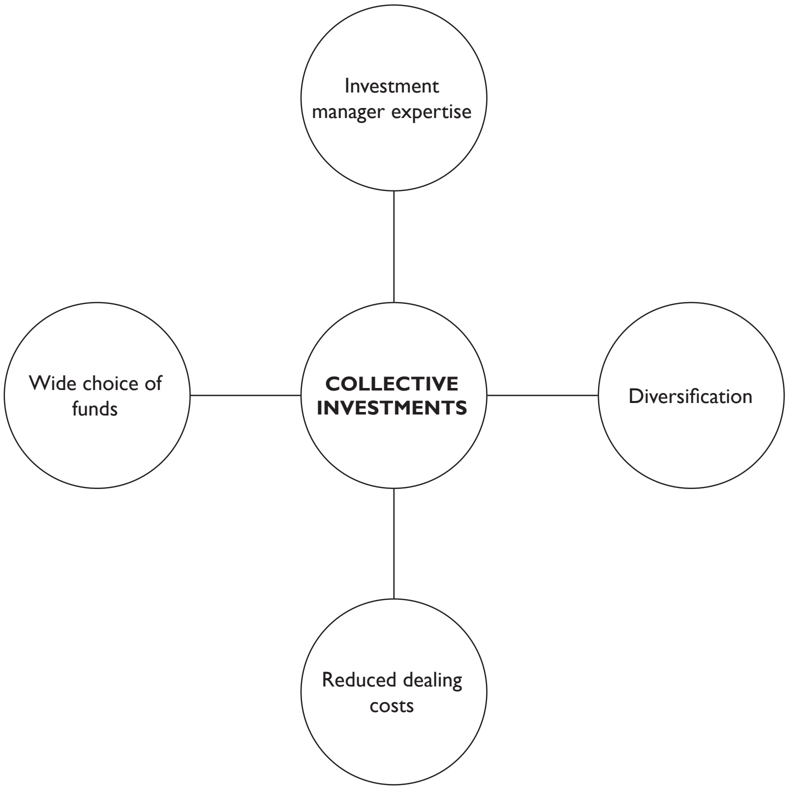
We look at each of these in more detail below.

For individual investors, collective investments offer a number of advantages, summarised in Figure 8.1 and outlined below:

- The services of a skilled investment manager are obtained at a cost that is shared among the investors. Individual investors do not need to research particular companies – nor do they need to understand and deal with the decision-making and administrative work arising from events such as rights issues.
- Investment risk can be reduced because the investment manager spreads the fund by investing in a large number of different companies; thus if one company fails, the investor loses only a small part of their investment, rather than all of it. This is referred to as ‘diversification’. Such a spread of investments could not normally be achieved with small investment amounts.
- Fund managers handling investments of millions of pounds can negotiate reduced dealing costs for their investors.

- There is a wide choice of investment funds, catering for all investment strategies, preferences and risk profiles.
- Collective investment schemes enable investors to gain exposure to assets they would not otherwise be able to access due to minimum lot/investment size (eg corporate bonds).

FIGURE 8.1 KEY ADVANTAGES OF COLLECTIVE INVESTMENTS



DIVERSIFICATION

Diversification is an important concept for investors. It involves creating a portfolio of investments that are spread across different geographical areas, asset classes and sectors of the economy. The aim is to spread risk, in the hope that poor performance of one investment will be offset by better performance in another. It is the opposite of 'putting all your eggs in one basket'. For example, if you only hold shares in a company that sells sunscreen, you are likely to make most money in a hot summer. If you only hold shares in a company making umbrellas, you will make most money if it rains. By diversifying to hold shares in both companies, you would have the opportunity to make money whatever the weather.

8.1.1 How are investment funds categorised?

Investment funds can be categorised in a number of ways, for example by:

- location, eg UK, Europe, America, Far East;
- industry, eg technology, energy;
- type of investment, eg shares, gilts, fixed interest, property;
- other forms of specialisation, eg recovery stocks, ethical investments.

Many funds are based on more than one categorisation; for example, a UK equity fund is categorised by both location and type of investment.

A further categorisation is possible:

- funds that aim to produce a high level of income (perhaps with modest capital growth);
- those that aim for capital growth at the expense of income; and
- those that seek a balance between growth and income.

Funds can also be categorised according to their management style:

- Actively managed funds (sometimes referred to simply as ‘managed funds’) use the services of a fund manager(s) to make decisions on asset selection and when holdings should be bought or sold.
- Passively managed or tracker funds will seek to replicate the performance of a particular stock market index, such as the FTSE All-Share. A manager may be used but it is also possible that asset selection is computerised.

MANAGED FUNDS

The term ‘managed’ fund can also be used as a marketing term to describe a fund that is comprised of holdings allocated across some or all of the other funds a company offers. Most companies offer one or more managed funds – for example, ‘managed growth’ or ‘managed income’. In this context the manager’s role in a company’s managed fund tends to involve deciding on the way fund investments should be allocated between the company’s other funds.

8.2 What are unit trusts?

A unit trust is a pooled investment created under trust deed. An investor will generally consider a unit trust as a means of trying to produce a better return than could have been achieved elsewhere. They can invest a lump sum in the unit trust, make regular contributions, or a mixture of both.

A unit trust is categorised as an equity trust where the underlying assets are mainly shares, or as a fixed-income trust where investment is mainly in interest-yielding assets. An equity trust pays a dividend, while a fixed-income trust pays interest.

A unit trust is divided into units, with each unit representing a fraction of the trust's total assets. It is 'open-ended', so if lots of investors want to buy units in it, the trust manager can create more units. (Not all types of collective investment are 'open-ended'; investment trusts, for example, which we look at later in this topic, are 'closed-ended'.)

Unit trusts may offer the following units:

- **Accumulation units** automatically reinvest any income generated by the underlying assets. This would suit someone looking for capital growth.
- **Distribution or income units** split off any income received and distribute it to unit holders. The units may also increase in value in line with the value of the underlying assets.

The unit trust aims to produce a return by selecting investments that will grow in value and/or generate income. If this happens, the unit price will increase, meaning that the investment, when encashed, will be worth more than it was at outset. A key role of the manager is to select investments that will achieve the trust's objectives in terms of income and/or growth.

> **WHAT IS A TRUST?**
>
> In general law a trust is an arrangement whereby one person gives assets to another (the trustees) to be looked after in accordance with a set of rules (specified in the trust deed). A unit trust is similar in that the trust deed details the investment rules and objectives of the scheme. The investor effectively gives their money to the trustees who will in turn allow the fund manager to use it to meet the trust's objectives. The trustees will ensure that the manager is fulfilling their obligations under the trust deed.

8.2.1 How are units priced?

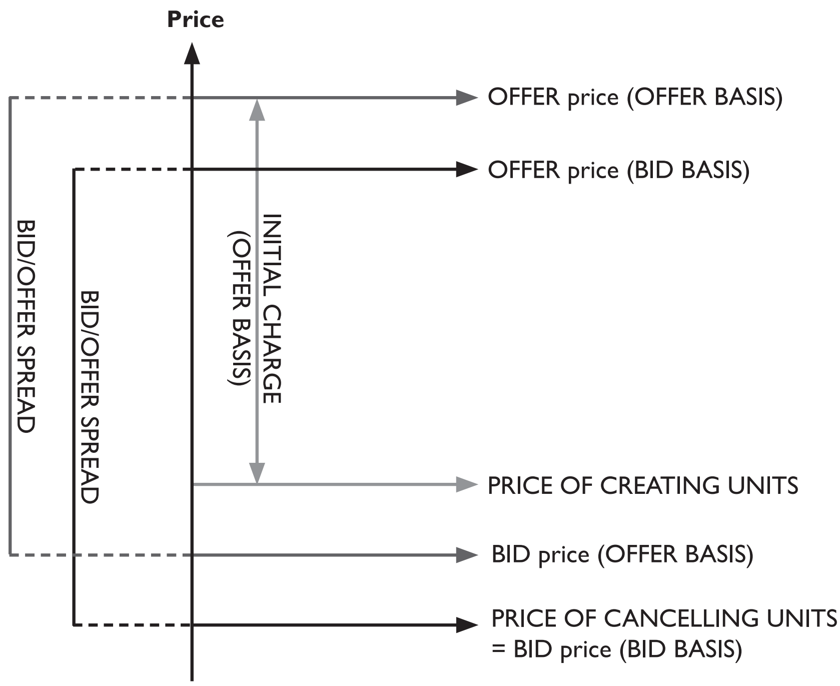
To price the fund, the manager will calculate the total value of trust assets, allowing for an appropriate level of costs, and then divide this by the number of units that have been issued. On a daily basis, managers calculate the prices at which units may be bought and sold, using a method specified in the trust deed. Unit prices are directly related to the value of the underlying securities that make up the fund.

There are four important prices in relation to unit trust transactions:

- The **creation price** is the price at which the trustee/depositary creates units on behalf of the unit trust manager.
- The **offer price** is the price at which investors buy units from the managers.
- The **bid price** is the price at which the managers will buy back units from investors who wish to cash in all, or part, of their unit holding.
- The **cancellation price** is the minimum permitted bid price, taking into account the full costs of buying and selling. At times when there are both buyers and sellers of units, the bid price is generally above this minimum level, since costs are reduced because underlying assets do not need to be traded.

The different prices and the associated spreads are shown in Figure 8.2.

FIGURE 8.2 PRICING BASIS FOR UNIT TRUSTS



Some unit trusts use bid and offer prices, with the difference between them (known as the **bid–offer spread**) being between 3 per cent and 5 per cent. Some unit trust managers, however, have moved to a single-price system with no bid–offer spread on the unit price. While the mechanism for determining the single pricing is more complex, for an investor a single price is considered simpler to understand.

BID–OFFER SPREAD

The difference between the price at which a unit is offered to an investor (offer price) and the price at which the fund manager will buy it back (the bid price).

SINGLE PRICING – UNIT TRUSTS

In a single-price system the price is arrived at through consideration of the net flows of the fund – in other words whether, on a net basis, more subscriptions are being made into the fund or whether more redemptions are being taken from the fund. Where the value of subscriptions is greater than redemptions, the fund is said to be in **net inflow**. Similarly, where redemptions are greater than subscriptions, the fund is said to be in **net outflow**.

The net flow of the fund is relevant in determining the single price because a fund that is in net inflow will need to purchase assets with the net subscription proceeds and so will be priced closer to the offer price to reflect the cost of purchasing these assets. Similarly, where the fund is in net outflow, the single price will tend towards the bid price to reflect the cost of the fund selling assets in its portfolio to generate cash, which can be used to pay redemption proceeds.

In cases where the value of subscriptions and redemptions is similar and the fund is receiving neither significant inflows or outflows, the single price will tend towards the mid-price. Although rare, they may impose an exit charge if units are sold within, for instance, three or five years of purchase.

FORWARD AND HISTORIC PRICING

When buying or selling shares directly, the process is instant: the stockbroker quotes a price based on the current market and, if the investor accepts, the deal is done at that price. There is no such market for unit trusts as units are sold by/ sold back to the fund manager themselves. At the end of each dealing period, usually daily, the manager will value the fund and determine the unit price.

The purchase of units in a unit trust is not an instant process as application forms need to be completed, sent off or emailed, and then administered before the investment is made. Units are generally priced on a forward pricing basis. Under forward pricing, clients buy or sell in each dealing period at a price that will be determined at the end of the dealing period. The prices published in the financial press are therefore only a guide to investors, who do not know the actual price at which their deal will be made.

Before forward pricing became standard practice there was a system of historic pricing: the price of units was determined by the closing price at the end of the previous dealing period. Fund managers are still permitted to use historic pricing if they wish, subject to the proviso that they must switch to forward pricing if an underlying market in which the trust is invested has moved by more than 2 per cent in either direction since the last valuation.

Historic pricing is no longer favoured because of concerns over the potential for market timing – where investors seem to benefit from the ‘lag’ in changes to the price of a unit trust relative to the value of the underlying assets into which the unit trust invests. For instance, a new investor who becomes aware of a significant increase in the value of assets into which a unit trust invests between one valuation and another, may subscribe to the unit trust at a historic unit price in the knowledge that the unit price will significantly increase at the next valuation point to reflect changes in the value of the assets in the unit trust’s portfolio. Similarly, an existing unit trust investor who becomes aware of a significant fall in the value of assets into which the unit trust invests may redeem from the unit trust at a historic price on the basis that, had they waited until the next valuation point, the price they would have received for their redemption would be significantly lower.

8.2.2 How are units bought and sold?

Unit trust managers are obliged to buy back units when investors wish to sell them. There is consequently no need for a secondary market in units and they are not traded on the Stock Exchange. This adds to the appeal of unit trusts to the ordinary investor, because the buying and selling of units is a relatively simple process.

Units can be bought direct from the managers or through intermediaries. They can be purchased in writing, by telephone or online: all calls to the managers' dealing desks are recorded as confirmation that a contract has been established.

Purchasers may receive two important documents from the managers:

- **The contract note** – this specifies the fund, the number of units, the unit price and the amount paid. It is important because it gives the purchase price, which will be needed for capital gains tax (CGT) purposes when the units are sold.
- **The unit certificate** – this specifies the fund and the number of units held, and is the proof of ownership of the units.

In cases where investors subscribe to a unit trust through an intermediary, their holdings may be confirmed on a non-certificated basis. Instead, investors will receive a regular statement outlining the number of units held and their current value from the intermediary (eg a fund supermarket) rather than directly from the unit trust manager.

In order to sell units, the holder signs the form of renunciation on the reverse of the unit certificate and returns it to the managers. If only part of the holding is to be sold, a new certificate for the remaining units is issued. If the holding is non-certificated, the investor may be asked to sign a separate form of renunciation.

8.2.3 How are unit trusts regulated and managed?

In the UK, unit trusts are primarily regulated under the terms of the Financial Services and Markets Act 2000, and must be authorised by the Financial Conduct Authority (FCA) if marketed to retail investors. The FCA specifies rules aimed at reducing the risks associated with unit trusts. The rules require that a unit trust fund is suitably diversified and specify that the fund cannot borrow an amount of more than 10 per cent of the fund's net asset value and, even then, only for a temporary period.

The trust deed places obligations on both the manager and the trustees. The manager aims to generate profit for the unit trust provider from the annual management charge and dealing in units. The trustees' overall role is to ensure investors are protected and that the manager is complying with the terms of the trust deed. The role of trustee is usually carried out by an institution such as a clearing bank or life company.

Manager's responsibilities

- Managing the trust fund in line with the trust deed
- Valuing the assets of the fund
- Fixing the price of units
- Offering units for sale
- Buying back units from unit holders

Trustees' responsibilities

- Setting out the trust's investment directives
- Holding and controlling the trust's assets
- Ensuring that adequate investor protection procedures are in place
- Approving proposed advertisements and marketing material
- Collecting and distributing income from the trust's assets
- Issuing unit certificates (if used) to investors
- Supervising the maintenance of the register of unit holders

The trustee usually also acts as the depositary, in which case they would also be subject to regulatory obligations applicable to depositaries.

CHARGES

Two types of charges are applied to unit trusts:

- The **initial charge** covers the costs of purchasing fund assets. The initial charge is typically covered by the bid-offer spread.
- The **annual management charge** is the fee paid for the use of the professional investment manager. The charge varies but is typically between 0.5 per cent and 1.5 per cent of fund value. Although it is an annual fee, it is commonly deducted on a monthly or daily basis.

8.2.4 How are unit trusts taxed?

Authorised unit trusts fall into two main categories:

- If more than 60% of the underlying investments within a unit trust are cash or fixed-interest securities, such as UK gilts or corporate bonds, the fund will be classed as a fixed-income or non-equity fund and any income distributions will be treated as interest payments.
- If less than 60% of the underlying investments are cash or fixed-interest securities, the fund will be classed as an equity fund and all income distributions will be treated as dividends.

In both cases there is no tax on gains within the fund, meaning that the investor may be liable to capital gains tax if they make a gain when encashing the investment.

Equity-based funds

For equity-based unit trust funds, the tax treatment is the same as for shares. Income is paid without deduction of tax. Where an investor's total dividend in a tax year is less than the dividend allowance (DA), there is no income tax on the dividend.

Where dividend income is in excess of the DA, then the income is taxed at different rates based on which tax band it falls into.

Fixed-income (or non-equity) funds

Interest from a fixed-income fund is classed as savings income. The income is paid gross, without deduction of tax. Where the interest is received by a non-taxpayer, falls within the starting-rate band for savings, or falls within the PSA of a basic- or higher-rate taxpayer, then no tax is payable. Taxpayers who have used their PSA are taxed on the excess income and are required to declare the income to HMRC through self-assessment.

%

TAX PAYABLE ON DIVIDEND INCOME FROM A UNIT TRUST

These calculations use illustrative rates and bands.

John has earned income of £39,850 and receives a unit trust dividend of £14,150 in the current tax year, giving him a total income of £54,000. His personal allowance is £12,570. His dividend income is taxed as follows.

Dividend income is taxed after earned income so the personal allowance is deducted first from John's earned income:

£39,850 – £12,570 = £27,280

Basic-rate income tax band is £37,700 and £27,280 of this is used up by the earned income. This leaves £10,420 of the basic-rate income tax band.

Dividend income is £14,150 and so £10,420 of this falls into the basic-rate income tax band. The dividend allowance covers the first £2,000, leaving £8,420 on which tax is due at the basic rate of 8.75 per cent.

The remaining £3,730 of the dividend income falls into the higher-rate tax band.

Thus the total tax due on John's dividend income is:

£2,000 @ 0% = £0

£8,420 @ 8.75% = £736.75

£3,730 @ 33.75% = £1,258.87

Total tax on dividend = £1,995.62

TAX PAYABLE ON INTEREST FROM A FIXED-INCOME TRUST

%

These calculations use illustrative rates and bands.

Jane has earned income of £39,000 and receives interest from a fixed-income unit trust of £13,000 in the current tax year.

Total income = £39,000 + £13,000 = £52,000

Interest is classed as savings income and is taxed after earned income, so the personal allowance is deducted first from Jane's earned income:

£39,000 – £12,570 = £26,430 taxable income.

Her taxable earned income uses up £26,430 of the £37,700 basic-rate tax band. This leaves £11,270 of the basic-rate band and so the first £11,270 of savings interest falls into this.

Of this £11,270, the first £500 is covered by the personal savings allowance because Jane is a higher-rate taxpayer and the remainder is taxed at the basic rate of 20 per cent.

The remaining £1,730 interest falls into the higher-rate band and is taxed at 40 per cent.

Thus total tax on interest =

£500 @ 0% = £0

£11,270 @ 20% = £2,254

£1,730 @ 40% = £692

Total = £2,946

Jane will declare this income on her self-assessment tax return.

!

Remember – information such as income bands, tax rates and allowances change regularly. You must make sure you are using the current information, for example at:

www.gov.uk/government/publications/rates-and-allowances-income-tax

8.2.5 What are the risks of investing in a unit trust?

The legal constitution of a unit trust helps to mitigate risk of fraud because the trustees have a responsibility to ensure there is proper management.

The risks involved in investing in a unit trust are lower than those for an individual investing directly into equities on their own behalf because a unit trust is a pooled investment. Unit-trust funds will typically invest in a spread of between 30 and 150 different shares.

The actual risk will depend on the type of unit trust selected. The wide range of choice means that there are unit trusts to match most investors' risk profiles. A cash fund will carry similar risks to a deposit account, while specialist funds that invest in emerging markets, for instance, are high risk by their very nature. Overseas funds carry the added risk of currency fluctuations.

Unit trusts provide no guarantee that the initial capital investment will be returned in full or that a particular level of income will be paid.

8.3 What are investment trusts?

Investment trusts are collective investments but, unlike unit trusts, they are not unitised funds. In fact, despite their name, they are not even trusts. They are public limited companies whose business is investing (in most cases) in the stocks and shares of other companies. As a company, an investment trust is established under company law and operates as a listed plc; its shares are listed on the stock exchange. A unit trust and an OEIC (see section 8.4) must be FCA authorised. An investment trust, by contrast, must meet FCA requirements to gain a stock market listing, and it is governed by rules in its memorandum and articles of association.

As with all companies, shares are sold to investors. The number of shares available remains constant – the company does not create more just because investors want them – so an investment trust is said to be 'closed-ended' (in contrast to the open-ended nature of unit trusts and OEICs).

8.3.1 Investing in an investment trust

Investing in an investment trust involves purchasing shares in the investment trust through:

- a stockbroker;
- a financial adviser; or
- direct from the investment trust manager.

Similarly, to cash in the investment, it is necessary to sell these shares, via a stockbroker or back to the investment trust manager directly.

The shares trade at a single price but dealing fees are added to any purchase and deducted from any sale. An annual management charge is also payable, typically between 0.5 per cent and 1.5 per cent.

The share price of an investment trust depends to some extent on the value of the underlying investments, but not so directly as in the case of a unit trust: the price can also depend on a number of other factors that affect supply and demand.

NET ASSET VALUE PER SHARE

Total value of the investment fund divided by the number of shares issued.

The share price of an investment trust may be more or less than the net asset value (NAV) per share. Where the share price is less than the NAV the trust is said to be trading at a discount, meaning that an investor should achieve greater income and growth levels than would be obtained by investing directly in the same underlying shares. Where the share price is higher than the NAV, the trust is said to trade at a premium.

8.3.2 Gearing

Because investment trusts are constituted as companies, they can borrow money to take advantage of investment opportunities – this is known as gearing or leverage. This facility is not open to unit trusts or OEICs, which are only permitted to borrow money over the short term and against known future cash inflows.

GEARING

The level of debt as a percentage of a company's equity. It is a way of measuring the extent to which a company's operations are funded by borrowing rather than by shareholder capital.

Gearing enables investment trusts to enhance the growth potential of a rising market, but investors should be aware that it can equally accentuate losses in a falling market. The ability to 'gear up' is one of the reasons why investment trusts are viewed as being riskier than a similar unit trust or OEIC. Some investment trusts are described as being 'highly geared' or 'highly leveraged', which means they have a high level of borrowing relative to the assets they hold; the investment trust will be pursuing high returns but there is the risk of being unable to service interest and/or repayments on borrowings.

8.3.3 How are investment trusts taxed?

At least 85 per cent of the income received by the fund managers of investment trusts must be distributed as dividends to shareholders. As it is constituted as a company, an investment trust pays income in the form of dividends. The taxation situation is broadly the same as that described for equity unit trusts.

As with unit trusts, fund managers are exempt from tax on capital gains. Investors are potentially liable to CGT on the sale of their investment trust shares, in the event that their gain, when added to the value of their other gains realised in a tax year, exceeds the CGT annual exempt amount.

8.3.4 What is a split-capital investment trust?

Sometimes known as split-level trusts or simply as splits, split-capital investment trusts are fixed-term investment trusts offering two or more different types of share. The most common forms of share offered are:

- **income shares** – these receive the whole of the income generated by the portfolio but no capital growth;
- **capital shares** – these receive no income but, when the trust is wound up at the end of the fixed term, share all the capital growth remaining after fixed capital requirements have been met.

Most companies will also offer shares with differing balances of income and growth, so as to meet different investor objectives.

8.3.5 What is a real estate investment trust?

Real estate investment trusts (REITs) are tax-efficient property investment vehicles that allow private investors to invest in property while avoiding many of the disadvantages of direct property investment (see Topic 7). One particular advantage is that stamp duty reserve tax is charged at 0.5 per cent on purchase; the rates of stamp duty for direct property purchase are much higher.

REITs (pronounced “reets” to avoid confusion with rights) became available in the UK from January 2007. Similar schemes operate in a number of other countries, particularly the USA and Australia.

In the UK, REITs pay no corporation tax on income or growth for the property rental portion of their income, provided they meet the requirements listed in Figure 8.3.

FIGURE 8.3 QUALIFYING FEATURES OF REITS

R	• At least 75 per cent of their gross income must be derived from property rent. • The remainder can come from development or other services but corporation tax is charged on income and gains made here.
E	• At least 90 per cent of their profits must be distributed to their shareholders net of basic-rate tax. Higher- and additional-rate shareholders will have to pay additional income tax. • Dividends can be paid in cash or as stock dividends (ie the allocation of further shares) and are taxable at dividend rates.
I	No individual shareholder can hold more than 10 per cent of the shares.
T	Single-property REITs are only allowed in special cases – such as, for example, a shopping centre with a large number of tenants.
S	They can be held in ISAs, Junior ISAs, Child Trust Funds and self-invested personal pensions.

CHECK YOUR UNDERSTANDING 1

Some students find it challenging to get to grips with these products. To help you, note down at least three ways in which an investment trust differs from a unit trust.

8.4 What is an OEIC?

An OEIC is an 'open-ended investment company' – a limited liability company that pools the funds of its investors to buy and sell the shares of other companies and deal in other investments.

To invest in an OEIC, the investor buys shares in the company; there is no limit to the number of shares that can be issued, which is why it is described as 'open-ended'. The open-ended nature of an OEIC means that the fund can expand or contract, depending on whether new shares are being issued in response to demand, or being redeemed if investors wish to sell. The value of the shares varies according to the market value of the company's underlying investments. An OEIC may be structured as an 'umbrella' company that is made up of several sub-funds. Different types of share can be made available within each sub-fund.

OEICs have been popular in other parts of Europe for many years and have been available in the UK since 1997. They share a number of characteristics with unit trusts and investment trusts. For instance, as with unit trust and investment trusts, investments can be made by lump sum, regular contribution or a combination of both. One difference to note, however, is that while both investment trusts and OEICs operate as companies, an investment trust can borrow money to finance its activities but an OEIC can only borrow for short-term purposes.

8.4.1 How are OEICs regulated and managed?

An OEIC is established as a limited liability company under a structural framework set by HM Treasury (not under trust) under the Open-Ended Investment Companies Regulation 2001 (as amended) and associated FCA rules. Unlike an investment trust (unless it is self-managed), OEICs must be authorised by the FCA; there is a great deal of common ground between the FCA's regulations for OEICs and those that apply to unit trusts

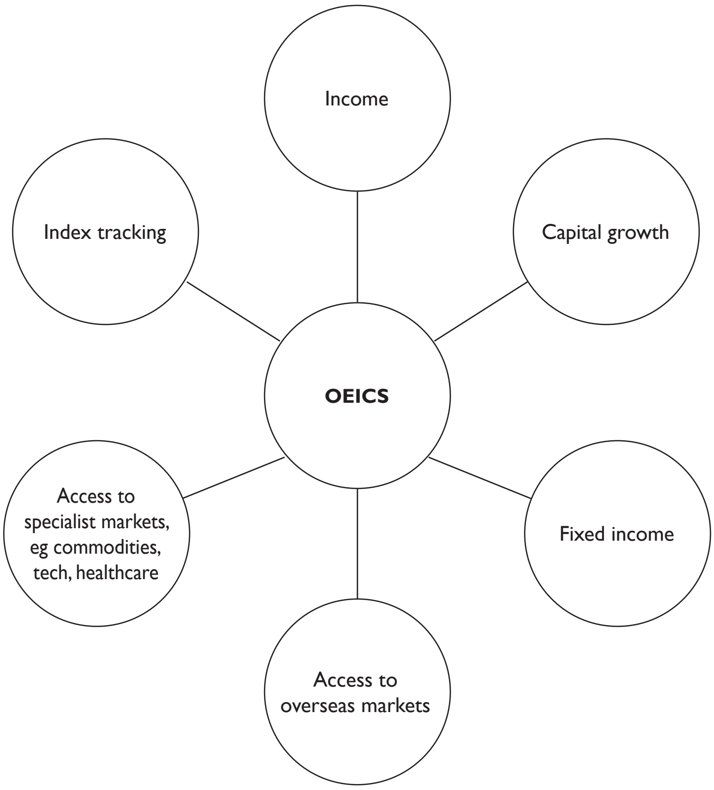
The role of overseeing the operation of the company and ensuring that it complies with the requirements for investor protection is carried out by a depositary, who is authorised by the FCA. The role of the depositary is similar to that of the trustee of a unit trust.

An authorised corporate director, whose role is much the same as the manager of a unit trust, manages the OEIC. The role of the corporate director is to:

- manage the investments;
- buy and sell OEIC shares as required by investors;
- ensure that the share price reflects the underlying net asset value of the OEIC's investments.

The range of OEICs is similar to that of unit trusts, as Figure 8.4 indicates.

FIGURE 8.4 TYPES OF OEIC



SINGLE PRICING – OEICS

The share price of an OEIC is established by dividing the total value of its assets by the number of shares currently in issue. This is, essentially, the same approach as that used to establish the unit price of a unit trust.

In many unit trusts, the units have a different bid and offer price. Shares in an OEIC are single priced. Some OEICs opt to use 'swing pricing', which is a method through which the single quoted price of an OEIC 'swings' towards a de facto bid or offer price. The swinging of the price takes account of the transaction costs the OEIC incurs buying assets when there are net inflows (ie net subscriptions into the OEIC) or net outflows (ie net redemptions from the OEIC). The bid price takes account of the cost of the OEIC selling assets to generate cash to pay redemptions, whereas the offer price takes account of the cost of the OEIC buying assets with subscription cash. You might recall from your reading on unit trusts that some of these now offer single pricing, too.

CHARGES

In addition to the cost of buying the shares, the OEIC will levy:

- **an initial or buying charge** – which is added to the unit price and is normally in the region of 3 per cent to 5 per cent of the value of the individual's investment;
- **annual management charges** based on the value of the fund – the range of annual management charges is typically between 0.5 per cent for indexed funds and 1.5 per cent for more actively managed funds;
- **a dilution levy** – this may be added to the unit price on purchase of shares or deducted from the price on sale of shares in situations where there are large flows of funds into or out of the OEIC.

Other administration costs may also be deducted from the income that is generated.

8.4.2 How are OEICs taxed?

The tax treatment of UK-based OEICs is exactly the same as that for unit trusts. In terms of income, an OEIC will be classified as either fixed-income or equity-based. If it is fixed-income, the interest is paid without deduction of tax but is subject to income tax as savings. If an OEIC is equity-based, a dividend is paid, again without deduction of tax. There will be a further liability for income tax for basic-, higher- and additional-rate taxpayers if total dividend income exceeds the investor's dividend allowance.

Fund managers are not subject to tax on capital gains, although individual investors may be liable to pay CGT when their shares in the UK OEIC are encashed.

OFFSHORE FUNDS

Where a fund, whether a unit trust or an OEIC, is based offshore, a UK resident investor will still be liable for taxation on income and gains.

If the offshore fund reports all the annual income attributable to an investor, whether the income is distributed or not, it is referred to as a 'reporting fund'. The tax treatment is as above: the investor will be liable for income tax on the income and CGT on any gain on disposal.

If the offshore fund does not report the attributable income, it is referred to as a 'non-reporting fund' and the investor will pay income tax, rather than CGT, on any gain on disposal.

8.4.3 What are the risks of investing in OEICs?

The risks associated with investing in an OEIC are similar to those of investing in a unit trust:

- An OEIC is subject to the same FCA rules on diversification and fund borrowing as apply to unit trusts, and these rules help to reduce risk.
- As an OEIC is a pooled investment employing the services of professional investment managers, the degree of risk is lower than it would be for an individual investing directly in equities.
- Risk is also mitigated by the spread that can be achieved for a relatively small investment.

There is, however, no guarantee that the value of the original capital investment will be maintained, nor is there any guarantee as to the level of income that will be generated.

CHECK YOUR UNDERSTANDING 2

Make sure you understand the key differences between unit trusts, investment trusts and OEICs. Create a table like the one below and fill in the missing information. You will find a completed version at the back of this book.

Name	Constituted as . . .?	Investment type?	Open/ closed?	Borrowing allowed?	Pricing	Initial charge	Annual charge	Control
Unit trust								
Investment trust								
OEIC								

CHECK YOUR UNDERSTANDING 3

Unit trusts, investment trusts and open-ended investment companies are most suitable for which profile of investor?

a) A long-term investor who would like reasonably easy access to their funds.

b) A long-term investor who is happy to give notice to withdraw funds.

c) A low-risk investor who requires a guaranteed income.

d) A high-risk investor who likes to play the stock market.

8.5 Endowments

Endowments are a type of investment based on life assurance. They combine life assurance and regular savings. A lump sum is either paid if the life assured dies during the term or, if they survive to the end of the term, it is paid at maturity.

In the 1970s and 1980s endowments were very popular, being used both as repayment vehicles alongside interest-only mortgages or as savings schemes in their own right. The introduction of schemes such as ISAs reduced their popularity but many plans remain in existence.

Endowments vary according to the nature of the underlying investment structure, and common types are with-profits and unit-linked. As long as premium payments are maintained, with-profits endowments are comparatively low risk as they offer the guarantee of at least a minimum value at maturity. Unit-linked plans do not carry such a guarantee and the value at maturity depends on how the underlying investments perform.

Because endowments are commonly encountered as a repayment vehicle for an interest-only mortgage, these products are detailed as part of the coverage of mortgages in Topic 13.

8.5.1 Friendly society plans

Friendly societies date from the eighteenth century when they were established as mutual self-help organisations. Over time they have evolved, with many now offering a range of financial services.

A friendly society is able to market a tax-exempt savings plan, effectively an endowment with tax benefits, because the friendly society pays no tax on its investment returns. This can be compared with a conventional endowment on which the life assurance company would pay tax on some income and gains within the fund.

As there is preferential tax treatment, the amount that can be saved is limited to £270 per year (as a lump sum), £25 per month or £75 per quarter. The plan is set up over an initial ten-year term and there is no tax upon encashment.

Friendly society plans are often marketed as savings plans that enable parents and grandparents to save on behalf of their children and grandchildren.

8.6 Investment bonds

Investment bonds are collective investment vehicles based on unitised funds; although they often appear similar to unit trusts because of their unitised structure, they are actually very different.

Investment bonds are available from life assurance companies and are set up as single-premium, whole-of-life assurance policies. An individual who wants to invest does so by paying a single (lump sum) premium to the life company.

If an investment bond is unit-linked, the investor then receives a policy document showing that the premium has purchased (at the offer price) a certain number of units in a chosen fund, and that those units have been allocated to the policy. In order to cash in the investment, the policyholder accepts the surrender value of the policy, which is equal to the value of all the units allocated, based on the bid price on the day when it is surrendered.

Investment bonds are attractive to investors because of the:

- relative ease of investment and surrender;
- simplicity of the documentation; and
- ease of switching from one fund to another – companies generally permit switches between their own funds without charging the difference between bid and offer prices.

The range of available funds is similar to those offered by unit trusts and investment trusts.

As an alternative to a unit-linked structure, some companies offer with-profits investment bonds, in which premiums are invested in a with-profits fund (see section 11.5.2 for more information about with-profits funds). If a with-profits bond is cashed in within a specified period after commencement (typically five years), the amount received is likely to be less than the value of the units.

In the event of the death of the life assured, the policy ceases and a slightly enhanced value (often 101 per cent of the bid value on the date of death) is paid out.

8.6.1 How are investment bonds taxed?

The funds in which the premiums are invested are an insurance company's life funds and their tax treatment is different from that of unit trusts. In particular, they attract internal tax at 20 per cent on capital gains (whereas unit trust funds are exempt) and this tax is not recoverable by investors even if they themselves would not pay capital gains tax.

The taxation system for policy proceeds in the hands of the policyholder is complex. Policies may be qualifying or non-qualifying with tax consequences, particularly for higher- and additional-rate taxpayers as 20 per cent tax is deemed to have already been paid within the fund. Investment bonds are non-qualifying policies.

QUALIFYING AND NON-QUALIFYING LIFE POLICIES

Life assurance policies are designated as 'qualifying' or 'non-qualifying' policies for tax purposes. The benefit of a qualifying policy is that there is no tax liability on the proceeds of the plan on death or maturity; a non-qualifying plan may result in a tax liability for higher- and additional-rate taxpayers. The criteria for qualifying policies is summarised in Figure 8.5.

FIGURE 8.5 QUALIFYING CRITERIA FOR TAX PURPOSES

Premiums

Must be payable annually, half-yearly, quarterly or monthly and set up for at least ten years

Discontinuing payment of premiums

If premiums cease within ten years, or three-quarters of the original term if this is less than ten years, the policy becomes non-qualifying

Sum payable on death

Must be at least equal to 75 per cent of the total premiums payable

Balance of premiums

Premiums in any one year must not exceed twice the premiums in any other year, or one-eighth of the total premiums payable

CHECK YOUR UNDERSTANDING 4

What is the key feature of investment bonds that makes them non-qualifying policies?

Any tax liability at the end of the bond's life is determined by 'top slicing'. Top slicing is the way of determining what tax is due for UK residents by calculating the average return over the term of the bond, so that the whole gain is not taken into consideration in one single year. If top-slicing were not permitted then the whole gain, built up over the term of the policy, would be added to income in the year the policy ends and taxed accordingly. Top-slicing allows the gain to be averaged over the term. It is not exact as gains do not build in an even manner year on year, but it is a fair system of assessing any tax liability.

IN BRIEF

TOP SLICING

1) The gain on the policy (surrender value + withdrawals that have not already been taxed – original investment) is calculated.

2) This gain is divided by the number of complete policy years the investment has been in place.

3) This gives the top-sliced gain, which is the average gain for each policy year that the plan has been in place.
4) The average gain is multiplied by the number of complete policy years and added to the planholder's taxable income in the year of surrender to establish whether or not any tax beyond the 20 per cent taken within the fund is due.
5) There are several possible outcomes when the top-sliced gain is added to taxable income:
   - If the individual's taxable income remains in the basic-rate band, then no tax is due on the gain as the 20 per cent deemed to have been deducted within the fund satisfies the individual's personal liability.
   - If taxable income exceeds the basic-rate band, then tax is due at 20 per cent on the portion of the top-sliced gain falling into the higher-rate band (this means that the higher-rate taxpayer is paying tax at 40 per cent on the gain once the 20 per cent deemed to have been deducted within the fund is taken into account).
   - Tax of 25 per cent is charged on any portion of the top-sliced gain falling in the additional-rate band (this means that the additional-rate taxpayer is paying tax at 45 per cent on the gain once the 20 per cent deemed to have been deducted within the fund is taken into account).

If, in the year when the plan is surrendered, the planholder is a higher-rate or additional-rate taxpayer (or becomes a higher- or additional-rate taxpayer by virtue of the addition of the top-sliced gain to other income), the gain may be subject to tax. The gain will be the surrender value plus any withdrawals previously made that have not already been taxed, less the original investment.

Unlike investment trusts and unit trusts, investment bonds do not normally provide income in the form of dividends or distributions, but it is possible to derive a form of 'income' from them by making small regular withdrawals of capital (ie by cashing in some of the units allocated to the policy). Investors can withdraw up to 5 per cent of the original investment each year without incurring an immediate tax liability, regardless of whether the investor is a basic-, higher- or additional-rate taxpayer. This 5 per cent allowance can, if not used, be carried forward and accumulated, up to an amount of 100 per cent of the original investment.

These withdrawals are tax-deferred, not tax-exempt: when the investment ends, on maturity, death or encashment, a tax liability may arise.

8.7 Non-mainstream pooled investments

Collective investment schemes may only be sold to the general public in the UK if they adhere to regulations relating to investment and promotion set out in the FCA Handbook (the content of the FCA Handbook is covered in Topic 17).

Schemes that do not fulfil the criteria for regulated collective investment schemes are classified as non-mainstream pooled investments (NMPIs). The FCA Handbook defines an NMPI as:

- a unit in an unregulated collective investment scheme (UCIS);
- a unit in a qualified investor scheme;
- a security issued by a special vehicle, unless an excluded security;
- a traded life policy;
- rights or interest in any of the investments listed above.

NMPIs may invest in non-traditional assets. Such investments carry a higher risk. Also, if the provider is based abroad, an investor may have limited recourse to the Financial Ombudsman Scheme and the Financial Services Compensation Scheme (see Topic 25). For these reasons, NMPIs are only considered suitable for a very small group of high-net-worth individuals. The FCA does not generally permit the marketing of NMPIs to retail customers.

8.8 Structured products

The defining characteristic of structured products is that they offer some protection of the capital invested (up to 100 per cent in some cases), while enabling investment in underlying assets that have the potential for higher returns but are also higher risk (such as ordinary shares). They appeal to investors who are cautious about direct exposure to the possible downside of stock markets but who would like to share in the growth possibilities.

The FCA classifies structured products as either deposits or investments in its Handbook in a number of ways.

CHECK YOUR UNDERSTANDING 5

We have already covered structured deposits. How much can you remember about them? Try to write a brief summary that includes:

- how a structured deposit differs from a deposit in an ordinary savings account;
- what benefit structured deposits offer to investors.

Then look back to Topic 6 to see how accurate your summary is.

8.8.1 Structured capital-at-risk products (SCARPs)

A SCARP is defined as a product other than a derivative that provides an agreed level of income or growth over a specified investment period and displays the following characteristics:

a) The customer is exposed to a range of outcomes in respect of the return of initial capital invested.

b) The return of initial capital invested at the end of the investment period is linked by a pre-set formula to the performance of an index, a combination of indices, a 'basket' of selected stocks (typically from an index or indices), or other factor or combination of factors.

c) If the performance in b) is within specified limits, repayment of initial capital invested occurs. If it is not, the customer could lose some or all of the initial capital invested.

8.8.2 Non-SCARP structured investment product

A non-SCARP investment is one that promises to provide a minimum return of 100 per cent of the initial capital invested as long as the issuer(s) of the financial instrument(s) underlying the product remain(s) solvent. This repayment of initial capital is not affected by the market risk factors in b) above.

8.8.3 The risks associated with structured products

There are a number of risks associated with structured products including:

- counterparty risk;
- market risk;
- inflation risk.

The products are also complex, with terms varying widely between providers.

Before investing in a structured product, an individual should ensure they understand the risks involved and how the product works, particularly in terms of the returns offered and the conditions that need to apply for specific returns to be provided.

8.9 Wraps and platforms

Wrap accounts are a long-established feature in the US and Australia, and were introduced into the UK in the early 2000s. The basic premise of a 'wrap' account is that one provider sets up an internet-based platform to hold all of the investor's investments within one framework, enabling the investor to see all relevant information in one place. The wrap account allows the investor to analyse and quantify the holdings according to value, tax treatment and product type.

Wraps are generally offered by independent financial advisers, who levy charges in addition to any individual fund management charges that apply to the investments held in the framework. Most wraps are able to hold any class of asset or fund on behalf of the investor.

A fund supermarket is designed to provide access to a wide range of funds, such as OEICS, unit trusts and ISAs, but not investment trusts. The investor has a ‘general investment account’, which is exposed to the UK tax regime (apart from any ISAs that are included, as they are tax-free). The investors pay a charge for the service: either a flat fee or a percentage of funds held – this is how the fund supermarket makes its money.

Both wraps and fund supermarkets are often referred to as ‘platforms’, but they are different. A wrap offers all the same investments as a fund supermarket, plus a range of other investments, such as investment trusts, offshore investments and direct equities (shares).

THINK AGAIN . . .

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- for unit trusts, investment trusts, OEICS and investment bonds:
  - describe how the product works?
  - explain how it is taxed?
  - explain what the key risks are?
- summarise the features that make a life assurance policy a qualifying policy for tax purposes?
- explain what ‘top-slicing’ is and how it works?

Go back over any points you don’t understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

Test your knowledge

?

Use these questions to assess your learning for Topic 8. Review the text if necessary.

Answers can be found at the end of this book.

1) With regard to unit trusts, what does the term 'open-ended' mean?

   a) Clients can buy more units.

   b) The fund manager can create an unlimited amount of units according to demand.

   c) The fund manager does not need to value the units.

   d) There is flexibility in the taxation of units.

2) A unit trust fund's assets are owned and controlled by the fund manager. True or false?

3) Who is responsible for payment of capital gains tax on any gain realised on the encashment of a unit trust?

   a) The unit holder.

   b) The trustees.

   c) The unit trust company.

   d) The fund manager.

4) An investment trust is best described as:

   a) a unit-linked, single-premium whole-of-life policy investing solely in shares.

   b) a trust that invests solely in fledgling companies.

   c) a company that invests in the shares of other companies.

   d) a partnership that invests in gilts.

5) How can a private individual invest in an investment trust?

   a) The investment trust manager creates more units.

   b) By purchasing shares of the investment trust company on the stock exchange.

   c) The fund manager issues new shares.

d) By completing an application form for a share account and submitting it to the investment trust trustees.

6) What potential benefit does gearing offer to an investment trust that is not available to a unit trust or OEIC?

7) How are shares in an open-ended investment company priced?

a) There is a bid and offer price based on the underlying value of the shares.

b) Shares are based on a historic valuation.

c) There is one price, based on the value of the assets divided by the number of shares.

d) There is a cancellation price at which all shares are traded.

8) What rate of tax is deemed to have been deducted from the investment fund underlying an investment bond?

a) 0 per cent.

b) 10 per cent.

c) 20 per cent.

d) 40 per cent.

9) Investment bonds are attractive to investors because withdrawals are tax-free. True or false?

10) Noah is a higher-rate taxpayer and is considering a range of investments. He wants to know which investment, out of unit trusts, investment trusts or OEICS, would be most likely to help him meet his objective of achieving capital growth. What would you advise?

a) A unit trust.

b) An investment trust.

c) An OEIC.

d) Any of the above.