TOPIC 7

Other direct investments

LEARNING OBJECTIVES

Topic 6 introduced the main financial asset classes and some forms of direct investment. In this topic we continue to explore direct investments.

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

- what equities are and how they are traded and taxed;
- how the returns on equities are assessed;
- other methods of financing companies that provide investment opportunities, including rights issues, scrip issues and preference shares;
- the advantages and disadvantages of investment in property, both residential and commercial;
- ways of investing in the money market.

This topic covers Unit 1 syllabus learning outcomes U2.3, U2.4, and parts of U3.1 and U7.7.

THINK . . .

Some of the asset classes and forms of investment covered in this topic might be new to you. But you will almost certainly have come across share dealing and property investment before. For instance:

- Do you or your friends or family members own shares in an individual company? Do you know why they chose to buy those particular shares?
- Have you heard or read news reports about significant falls or rises in stock market indices around the world, such as the FTSE 100, the Dow Jones or the Nikkei?
- Have you seen or heard reports about the share price of a particular company rising or falling dramatically in response to a news event that affects them?
- Do you own a property that you rent out?

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The investments covered in this topic receive a lot of attention in both the financial and mainstream media; your studies for UKFR should help you to understand these reports better.

7.1 What are equities?

Equities, also known as ordinary shares, are the most important type of security that are issued by UK companies. They can be, and are, bought by private investors, but most transactions in equities are made by institutions and by life and pension funds.

Holders of ordinary shares (shareholders) are in effect the owners of the company. The two main rights that they have are to:

- receive a share of the distributed profits of the company as income in the form of dividends; and
- participate in decisions about how the company is run, by voting at shareholders' meetings.

KEY TERMS

SECURITIES

Financial assets that can be traded. They can be divided into two broad classes: those that represent ownership (equities) and those that represent debt (such as gilts and corporate bonds).

DIVIDEND

A portion of a company's profits that is distributed to shareholders. The level of dividend available is dependent on the profitability of the company and strategic decisions such as the need to reinvest profits to expand the business.

The rights attaching to shares of the same class can sometimes differ from company to company, even though the shares normally have the same major characteristics. It is therefore prudent for investors to find out precisely what rights attach to a particular share. These rights are set out in the company's articles of association; this is a public document and can be examined at the registered office of the company or at Companies House.

Direct investment in shares is higher risk because the failure of the company can result in the loss of all the capital invested. This risk can be mitigated by investing across a range of shares in different companies operating in different sectors. There are several products to enable investors to do this, such as unit trusts. We will be focusing on these in Topic 8.

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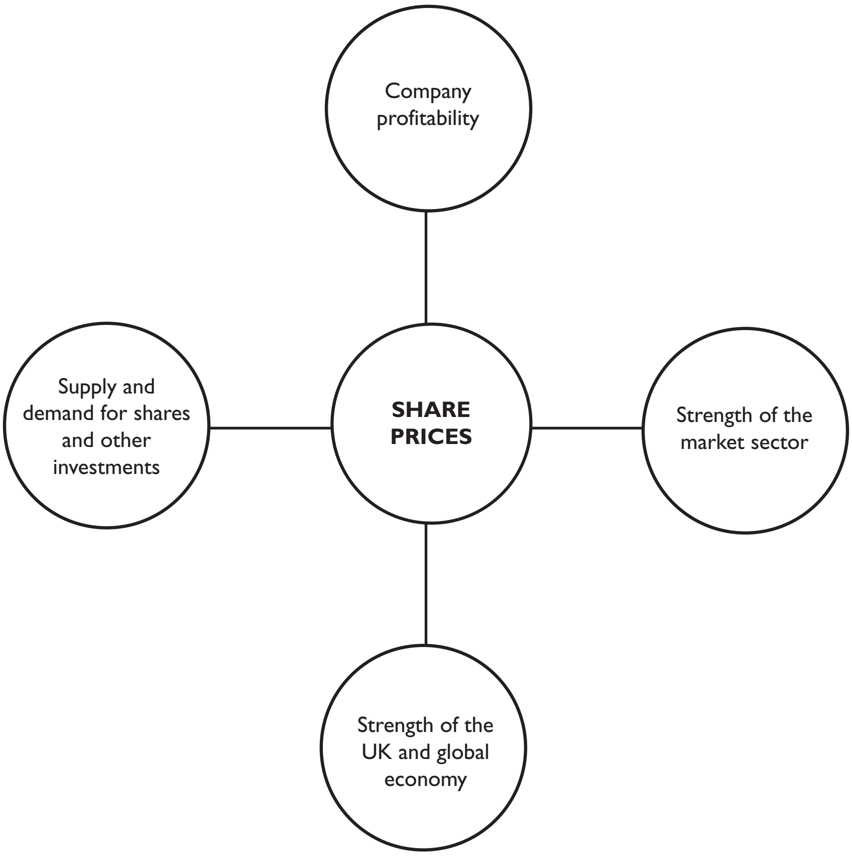
The prices at which shares are traded depend on a range of factors, as indicated in Figure 7.1.

FIGURE 7.1 FACTORS AFFECTING SHARE PRICES



In the short term, share prices can fluctuate both up and down – sometimes quite spectacularly – but in the long term, investment in equities and equity-linked markets has outpaced inflation and has provided higher growth than deposits.

7.2 How are shares bought and sold?

The Stock Exchange has been London's market for stocks and shares for hundreds of years. Shares, issued by UK and overseas companies, gilts, corporate bonds and options are all traded on this market. There are two markets for shares: the main market (for which full listing is required) and the Alternative Investment Market.

7.2.1 The main market

To be listed on the main market, companies must conform to the stringent requirements of the Listing Rules laid down by the Financial Conduct Authority (FCA), acting in its capacity as the UK Listing Authority (UKLA).

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For a full listing, a considerable amount of accurate financial and other information must be disclosed. In addition:

- the applicant company must have been trading for at least three years;
- at least 25 per cent of its issued share capital must be in the hands of the public.

The London Stock Exchange, like most stock markets, is both a primary and secondary market.

- **The primary market** is where companies and financial organisations can raise finance by selling securities to investors. They will either be coming to the market for the first time, through the process of 'going public' or 'flotation', or issuing more shares to the market. The main advantages of listing include greater ease with which shares can be bought or sold, and the greater ease with which companies can raise additional funds.
- **The secondary market** is where investors buy and sell existing securities. It is much bigger than the primary market in terms of the number of securities traded each day.

7.2.2 Alternative Investment Market

The Alternative Investment Market (AIM), which started in 1995, is mainly intended for new, small companies with the potential for growth.

Its purpose is to enable suitable companies to raise capital by issuing shares, and it allows those shares to be traded. In addition to the benefit of access to public finance, companies will enjoy a wider public audience and enhance their profiles by joining the AIM.

Rules for joining the AIM are fewer and less rigorous than those for joining the official list (the main market) and were designed with smaller companies in mind.

SHARE INDICES

It is possible to measure the overall performance of shares by using one or more of the various indices that are produced. These include the following:

- **FTSE 100 Index** (commonly known as the Footsie) – this is an index of the top 100 companies in capitalisation terms; each company is weighted according to its market value.
- **FTSE 250 Index** – the next 250 companies by market capitalisation after the FTSE 100.

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- **FTSE 350 Index** – the FTSE 100 and FTSE 250 companies combined.
- **FTSE All-Share Index** – this is an index of around 600 shares, split into sectors. It measures price movements and shows a variety of yields and ratios as well as a total return on the shares.

MARKET CAPITALISATION

The market value of a company, calculated by multiplying the number of shares in issue by the share price.

FACTFIND

There are numerous websites that provide up-to-date information on share prices, including the website of the London Stock Exchange itself:

www.londonstockexchange.com

FIGURE 7.2 PARTICIPANTS IN THE MARKETS

Individual and institutional investors, eg pension funds, life assurance companies	Banks and other traders	Governments, public institutions, corporations	Investment banks
• Invest money	• Issue, buy or sell shares or derivatives	• Issue securities, eg gilts, corporate and local authority bonds	• Facilitate issues of new securities

OVER-THE-COUNTER (OTC) TRADING

OTC trading is not very common between individual private investors, but is common between institutions. They trade large blocks of securities with little publicity about the price paid or the company(ies) whose shares are being traded. This form of trading is sometimes called ‘dark pools’.

MiFID II introduced stricter requirements for all trading venues to ensure the fair and orderly functioning of financial markets. New reporting requirements have increased the amount of information available and are expected to reduce the use of dark pools and OTC trading. More information can be found at: www.esma.europa.eu/policy-rules/mifid-ii-and-mifir.

7.3 Returns from shares

Shareholders in a limited liability company do not have a liability for the debts of the company. The company is, legally, a separate entity from its owners and is liable for its own debts. Shareholders do, however, run the risk that the value of their investment in the company could go down; if the company goes into liquidation they could lose their investment altogether.

So, given that those who invest in equities run the risk of potentially losing all their investment, we might expect that they would also expect to receive higher returns than they could get from investing in deposit-based investments, where their capital is protected. It is certainly true that, on average and over the longer term, equity markets have generally outpaced the returns available on secure deposit-based investments.

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EX-DIVIDEND SHARES

Dividends are usually paid half-yearly. Because of the administration involved in ensuring that all shareholders receive their dividends on time, the payment process has to begin some weeks before the dividend dates. A ‘snapshot’ of the list of shareholders is made at that point, and anyone who purchases shares between then and the dividend date will not receive the next dividend (which will be paid to the previous owner of the shares). Once the date has passed when the administrative process of paying the dividend starts, the shares are said to be ex-dividend (or xd). The share price would normally be expected to fall by approximately the dividend amount on the day it becomes xd.

Alternatively, a share may be paid cum-dividend, which means that it is purchased before it goes xd, and the purchaser receives the next dividend payment.

7.3.1 Assessment of returns

The financial returns that shareholders hope to receive from their shares take two forms:

- the growth in the share price (capital growth); and
- the dividends they receive as their share of the company’s distributable profits (income).

There are a number of measures that can be used to assess the success of investment in a company’s shares and to predict future performance. Some of these measures are as follows.

Earnings per share

This is equal to the company’s post-tax net profit divided by the number of shares, but it is not normally the amount of dividend to which shareholders are entitled on each of their shares. This is because a company may choose not to distribute all of its profits: some profits might be retained in the business to finance expansion, for instance. This in turn leads to the concept of dividend cover.

Dividend cover

This factor indicates how much of a company’s profits are paid out as dividends in a particular distribution. If, for example, 50 per cent of the profits are paid in dividends, the dividend is said to be covered twice. Cover of 2.0 or more

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is generally considered to be acceptable by investors, whereas a figure below 1.0 indicates that a company is paying part of its dividend out of retained surpluses from previous years.

Price/earnings ratio

As its name suggests, the price/earnings (P/E) ratio is calculated as the share price divided by the earnings per share. It is generally considered to be a useful guide to a share's growth prospects. If the market is operating in an efficient manner, then the P/E ratio should give an estimate of a company's future potential to generate returns for shareholders.

As P/E ratios vary between market sectors, the P/E ratio should only be used to compare shares in the same or similar categories. A share that has a high P/E ratio compared with those of other shares in the same category or in comparison with the sector average is in demand. Such a share is likely, as a result, to be relatively more expensive than others within the same market sector while offering the prospect of higher-than-average earnings in the future. A comparatively low P/E ratio indicates that the share is not in high demand.

The P/E ratio should be viewed in conjunction with other indicators; a share with a high P/E ratio is not necessarily a good purchase as expectations of future earnings growth may already have been factored into the share price, and a share with a low P/E ratio may have been overlooked.

IN BRIEF

Earnings per share (EPS) = post-tax net profit ÷ number of shares

Dividend cover = how much of company profits are paid as dividends

P/E ratio = share price ÷ earnings per share

You can find more information on tax legislation and rates at: assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/983376/Budget_-_Overview_of_tax_legislation_and_rates__OOTLAR_.pdf.

7.3.2 Taxation

As we saw in Topic 3, dividends are paid without deduction of tax but are subject to income tax. Everyone is entitled to a dividend allowance (DA). If an individual's aggregate dividend income in a tax year falls within the DA, no tax is payable. If dividend income exceeds the DA, it is taxed at different rates depending on the tax band into which it falls.

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Gains realised on the sale of shares are subject to capital gains tax (CGT), although investors may be able to offset the gain against their annual CGT exemption.

%

TAXATION OF DIVIDEND INCOME

Sophie has taxable earned income of £31,700 and receives dividend payments of £9,000 in the current tax year.

The tax payable is worked out in a set order of priority:

1) Earned income.

2) Dividend income.

Let's assume higher-rate income tax is paid on taxable income above £37,700, that dividend income is taxed at 8.75% for basic-rate taxpayers and 33.75% for higher-rate taxpayers, and that the DA is £2,000.

Sophie's tax is calculated as follows. (Remember that taxable income is after the personal allowance has been deducted.)

Her earned taxable income all falls within the basic-rate tax band and there is £6,000 of the basic-rate tax band remaining (£37,700 – £31,700 = £6,000).

So, the first £6,000 of her dividend income falls in the basic-rate tax band. However, the first £2,000 is covered by the DA, so no tax is payable on that amount.

The remaining £4,000 within the basic-rate band is taxed at 8.75 per cent = £350.

This leaves £3,000 in the higher-rate tax band, which is taxed at 33.75 per cent = £1,012.50.

The total tax payable on Sophie's dividend income is £1,362.50.

Note that the dividend income falling within the basic-rate band, even where covered by the DA and not taxed, does use up a portion of the basic-rate band. Therefore, in the example, £3,000 is subject to higher-rate tax rather than a further £2,000 of Sophie's dividend income being taxed at the basic rate.

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FACTFIND

Check the current arrangements for taxation of dividends at:

www.gov.uk/tax-on-dividends/overview

Check the current CGT rates and exemptions at:

www.gov.uk/capital-gains-tax/overview

7.4 What other ways of investing in companies are there?

7.4.1 Rights issues

Stock Exchange rules require that, when an existing company that already has shareholders wishes to raise further capital by issuing more shares, those shares must first be offered to the existing shareholders. This is done by means of a rights issue offering, for example, one new share per three shares already held, generally at a discount to the price at which the new shares are expected to commence trading. Shareholders who do not wish to take up this right can sell the right to someone else, in which case the sale proceeds from selling the rights compensate for any fall in value of their existing shares (due to the dilution of their holding as a proportion of the total shareholding).

7.4.2 Scrip issues

Scrip issue, also known as a bonus issue or a capitalisation issue, is an issue of additional shares, free of charge, to existing shareholders. No additional capital is raised by this action – it is achieved by transferring reserves into the company's share account. The effect is to increase the number of shares and to reduce the share price proportionately.

7.4.3 Preference shares

As with ordinary shares, holders of preference shares are entitled to dividends payable from the company's profits. They differ from ordinary shares in that they are generally paid at a fixed rate, and holders of preference shares are eligible for any dividend payout ahead of ordinary shareholders. Many preference shares are cumulative preference shares, which means that if dividends are not paid, entitlement to dividends is accumulated until such a time as they can be paid.

Preference shares do not normally carry voting rights, although in some cases holders may acquire voting rights if their dividends have been delayed.

If a company has to be wound up, there would generally be only a limited amount of money available to repay debts and shareholders. In this situation,

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the claims of creditors are repaid in a set order of priority. Shareholders rank lowest in the order of priority and are therefore most at risk of receiving nothing at all; however, holders of preference shares have a higher claim than holders of ordinary shares.

7.4.4 Convertible preference shares

Convertibles are securities that carry the right to be converted at some later date to ordinary shares of the issuing company. Traditionally they were issued as corporate bonds (with a lower rate of interest than conventional corporate bonds because of the right to convert to equity). In recent years, they have been increasingly issued as convertible preference shares.

CHECK YOUR UNDERSTANDING

Convertible preference shares were traditionally issued as corporate bonds – can you recall what a corporate bond is? Try to write a brief summary that includes:

- why companies issue bonds;
- the form in which an investor receives income from a bond; and
- what the risks are to the investor.

Look back to Topic 6 to see how accurate your summary is.

7.4.5 Warrants

Warrants give the holder the right to buy shares at a fixed price at an agreed future date. The attraction is that they give the holder rights at a fraction of the cost of the shares themselves. At the date when the warrant can be exercised, it will be exercised if the share price is above the price at which the shares can be bought under the terms of the warrant. If the share price is at or below the terms offered by the warrant, it will not be worth exercising the warrant and it will lapse.

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7.5 Residential property

The vast majority of investors will only ever own residential property. For most people this does not extend beyond the purchase of their own home, although an increasing number of people are buying residential properties specifically as an investment.

Property investment has a number of benefits and advantages, including the following:

- Property is a very acceptable form of security for borrowing purposes.
- The UK property market is highly developed and operates efficiently and professionally.

On the other hand, there are a number of pitfalls and disadvantages of which inexperienced investors in particular should be made aware, including the following:

- Location is of paramount importance and a badly sited development may prove a problem.
- The property market is affected by overall economic conditions – in times of recession, letting properties may be difficult and property prices may fall.
- Property is a less liquid form of investment than most others.

As with direct investment in shares, direct investment in property can be a risky business for the small investor, although the advent of buy-to-let mortgages (see section 7.6) has made it easier. For those with smaller amounts of capital and those who wish to spread the risk, property bonds might be appropriate: the underlying fund is invested in a range of properties and shares in property companies.

The purchase of property is subject to stamp duty land tax and a premium applies where the property is not the only one owned.

Income from property, after deduction of allowable expenses, is subject to income tax. It is treated as non-savings income for tax purposes. On the disposal of investment property, any gain is liable to CGT, but any capital expenditure on enhancement of the property's value can be offset against taxable gains.

7.6 Buy to let

Recent tax crackdowns have had a significant impact on the once buoyant buy-to-let (BTL) market in the UK, although a number of landlords hold portfolios of BTL properties.

Benefits offered by BTL investment, beyond the general benefits conferred by property ownership, are summarised in Figure 7.3.

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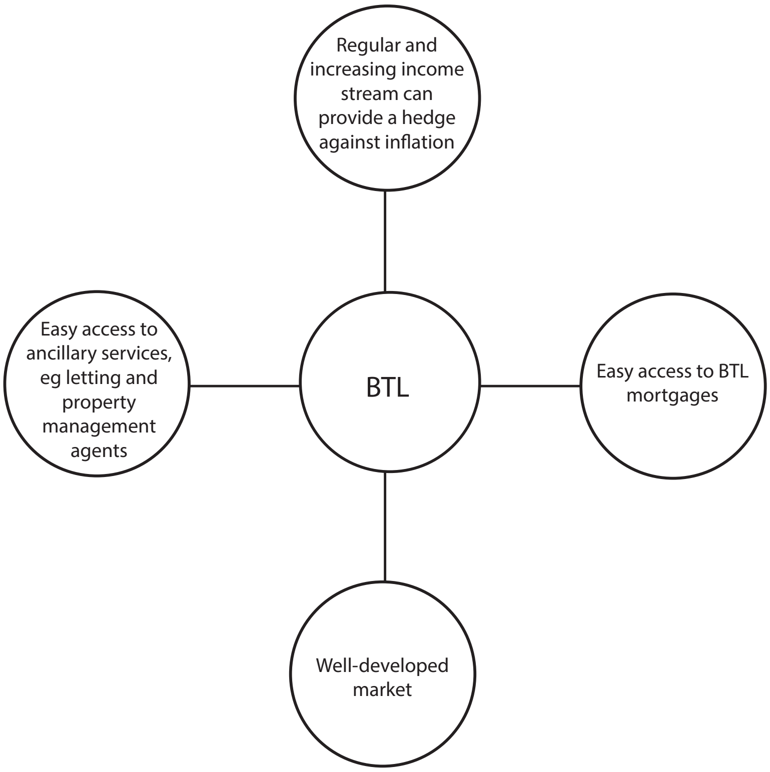
FIGURE 7.3 WHAT MAKES BUY TO LET ATTRACTIVE TO INVESTORS?



There are also a number of risks:

- Accessing the market can be difficult, as investment costs are high and there are additional costs associated with arranging a mortgage, legal fees and stamp duty land tax.
- Property is an illiquid investment, meaning that it may be difficult to generate funds if they are required at short notice.
- There may be void periods when the property is untenanted, meaning that income is reduced or ceases.
- There is the risk that tenants may damage the property, leading to additional costs.
- Legal fees may be incurred to remove unsatisfactory tenants.
- The property will require ongoing management and maintenance; these services can be outsourced but the costs would reduce overall yield.

The government became increasingly concerned at the growth of the BTL sector and the way in which this reduced the availability of affordable housing for first-time buyers. Consequently, a number of measures were put in place that reduced the attractiveness of BTL as an investment.

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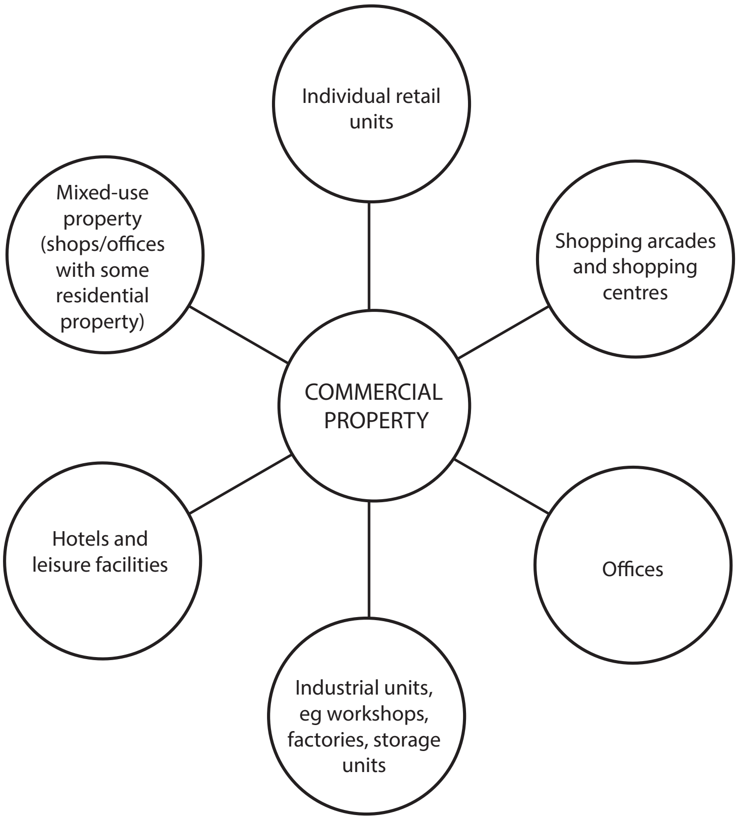
- **Tax relief** – previously, a BTL landlord could deduct the full cost of mortgage interest from their BTL income when calculating profits. This effectively gave tax relief at the landlord's highest marginal income tax rate in respect of the interest costs. Changes were phased in from April 2017–20, which mean that tax relief is limited to a tax credit at the basic rate only.
- **Wear and tear** – up until April 2016, landlords were able to claim an annual wear-and-tear allowance on the cost of furnishings in the property. This has been replaced by a furniture replacement relief that only allows the actual cost of replacing furnishings to be offset against profits.
- **Stamp duty land tax** – as mentioned in section 7.5, second properties are now subject to an SDLT surcharge purchase.

7.7 Commercial property

Investment in commercial property covers almost anything that is not defined as wholly residential (see examples in Figure 7.4).

FIGURE 7.4 WHAT IS COMMERCIAL PROPERTY?



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Commercial property tends to provide reasonably high rental income together with, in general, steady growth in capital value. The main advantages are:

- regular rent reviews, with typically no more than five years between each;
- longer leases than for residential property;
- more stable and longer-term tenants;
- typically lower initial refurbishment costs.

Drawbacks may include the following:

- the higher average value means that spreading the risk is more difficult;
- commercial property does not generally show the spectacular growth in value that can sometimes be achieved in residential property;
- if the investment is to be funded by borrowing, interest rates may be higher than for residential loans.

Lenders often carry out detailed investigations before lending for the purchase of commercial property, checking on the:

- quality of the land and property;
- reputation of builders, architects and other professionals involved;
- suitability of likely tenants.

AGRICULTURAL PROPERTY

A further category of property investment is agricultural property – farmland. An investor may buy the land and run the farm themselves to generate income or let out all or some of the land to a third party, thus providing rental income. There is the prospect of capital growth but the market for agricultural land is highly specialised and demand limited; liquidity is therefore a major concern.

One of the benefits of owning agricultural property is agricultural relief for inheritance tax. This relief applies to the land, growing crops and farm buildings. Relief is available for up to 100 per cent of the inheritance tax liability for owner-occupied farms, or 50 per cent where the owner has let out the land.

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7.8 Money-market instruments

'Money-market instruments' is a generic term used to describe a number of forms of short-term debt. Interest is not normally paid during the term of the transaction, the rate of interest being determined by the difference between the amount invested/borrowed and the amount repaid.

In order to illustrate the nature of these instruments, we will describe three of them: Treasury bills, certificates of deposit, and commercial paper.

7.8.1 Treasury bills

Treasury bills are short-term redeemable securities issued by the Debt Management Office (DMO) of the Treasury. Like gilts, they are fundraising instruments used by the UK government, but they differ from gilts in a number of ways. Two major differences are:

- Treasury bills are **short term**, normally being issued for a period of 91 days, whereas gilts can be long term or even undated;
- Treasury bills are **zero-coupon securities**, ie they do not pay interest. Instead, they are issued at a discount to their face value or par value (the amount that will be repaid on their redemption date).

As with gilts, Treasury bills are considered to be very low-risk securities, the risk of default by the borrower (the UK government) being so low as to be effectively zero. For example, a Treasury bill may be issued for £9,850 with a 'par value' of £10,000. The investor makes a guaranteed £150 on their £9,850 investment over 91 days, representing just over 6 per cent pa return, with no risk (£150 ÷ £9,850 x 100 = 1.52% over three months).

Because they are such short-term securities, changes in market rates of interest have little impact on the day-to-day prices of Treasury bills unless the changes are significantly large.

Throughout their term, Treasury bills can be bought and sold, and there is a strong secondary market, provided mainly by financial institutions as there is no centralised marketplace. The price tends to rise steadily from the issue price to the redemption value over the 91-day period, but prices can also be affected by significant interest rate changes, or by supply and demand.

TREASURY BILLS

Short-term redeemable securities issued at a discount to their face value. Also known as T-bills.

Treasury bills are purchased in large amounts, and they are not, therefore, generally of interest to small, private investors. They are held in the main by large organisations (particularly financial institutions) seeking secure short-term investment for cash that is temporarily surplus to requirements.

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7.8.2 Certificates of deposit

Certificates of deposits (CDs) are issued by banks and building societies. They are in effect a receipt to confirm that a deposit has been made with the institution for a specified period at a fixed rate of interest. The interest is paid with the return of the capital at the end of the term. Terms are typically three months or six months, although depositors who require a longer term can often obtain CDs that can be 'rolled over' for a further three or six months on specified terms. The amounts deposited are typically £50,000 or more.

There are significant penalties for withdrawals before the end of the term. However, because certificates of deposit are bearer securities, they can be sold to a third party if the depositor needs the funds before the end of the term.

Banks may also hold CDs issued by other banks, and they can issue and hold CDs to balance their liquidity positions. For example, a bank would issue CDs maturing at a time of expected liquidity surplus, and hold CDs maturing at a time of expected deficit.

KEY TERMS

CERTIFICATE OF DEPOSIT

A 'receipt' confirming that a (substantial) deposit has been made with a bank or building society for a fixed period at a fixed rate of interest.

BEARER SECURITIES

Securities that are deemed to be owned by whoever physically possesses the document that confers ownership, rather than ownership being determined by an entry on a register, etc.

7.8.3 Commercial paper

Businesses need to borrow for a variety of purposes. When they need funds for investment in their longer-term business plans, they may issue corporate bonds. When they wish to borrow for working capital purposes, however, they can issue commercial paper. The transactions are for very large amounts, with most purchasers being institutions such as pension funds and insurance companies. Commercial paper can be placed directly with the investors, or through intermediaries.

The commercial paper market offers cheaper borrowing opportunities for companies that have good credit ratings, but even companies with lower credit ratings can issue commercial paper if it is backed by a letter of credit from a bank that guarantees (for a fee) to make repayment if the issuer defaults.

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KEY TERMS

COMMERCIAL PAPER

An unsecured promissory note – ie a promise to repay the funds that have been received in exchange for the paper.

WORKING CAPITAL

Funds available for the day-to-day running of the business, calculated as current assets minus current liabilities.

Most commercial paper is issued for periods of between 5 and 45 days, with an average of around 30 to 35 days. Firms that need to retain funds for longer than this regularly roll over their commercial paper – the advantages of this are:

- flexibility; and
- the fact that the rate of interest is not fixed for a long period.

THINK AGAIN . . .

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

For instance, can you:

- explain what shares are and two ways an investor can expect to make money from investing in shares?
- describe three ways of assessing the performance of shares?
- summarise the measures the government has taken to make buy to let a less attractive option for investors?
- describe the main features of Treasury bills, certificates of deposit and commercial paper?

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.

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Test your knowledge

?

Use these questions to assess your learning for Topic 7. Review the text if necessary.

Answers can be found at the end of this book.

1) Direct investment in shares is low risk for individual investors because, over the long term, equity markets have outpaced inflation. True or false?
2) Name three factors that can affect share prices.
3) What are the implications for the purchaser of buying shares ex-dividend?
4) A share with a low P/E ratio is likely to be more expensive than other shares in the same market sector. True or false?
5) If a company distributes 25 per cent of its profits in the form of dividends to its shareholders, what would the dividend cover be?
   a) 4.
   b) 8.
   c) 10.
   d) 25.
6) What is the difference between a rights issue and a scrip issue?
7) Elliott is considering investing in a buy-to-let property. He thinks this is a good way to achieve a high return. What are the main drawbacks that Elliott should be aware of?
8) How can a buy-to-let investor claim relief for wear and tear on furniture?
9) Treasury bills are zero-coupon securities. What does this mean?
10) Commercial paper is generally issued for a term of between three and six months. True or false?

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