

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, U3.4, U3.5 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.

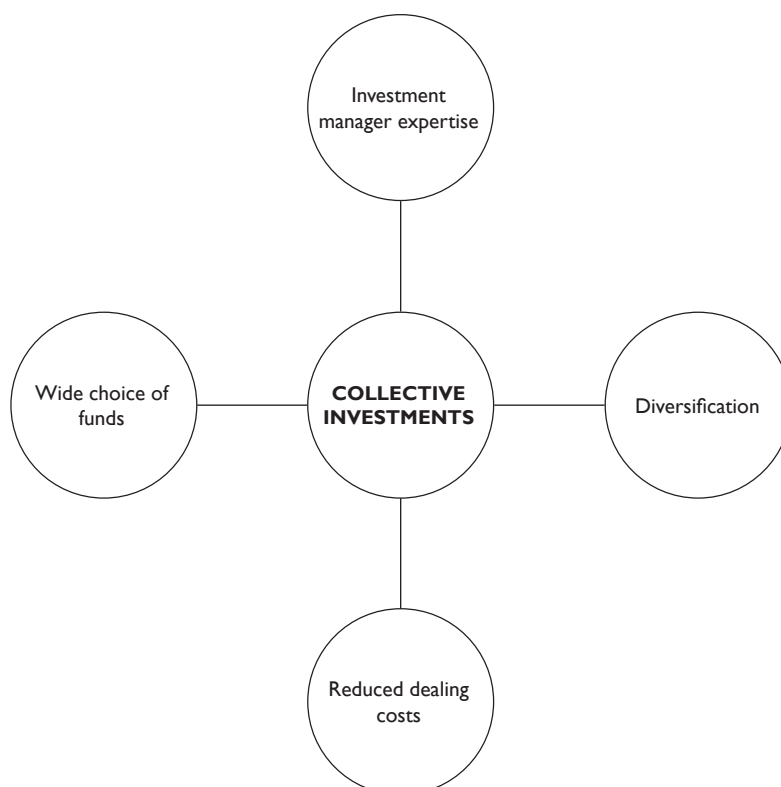
We look at each of these in more detail below.

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.

- 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 more money in a hot summer. If you only hold shares in a company making umbrellas, you will make more 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-interest trust where investment is mainly in interest-yielding assets. An equity trust pays a dividend, while a fixed-interest 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 types of unit:

- **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 where 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

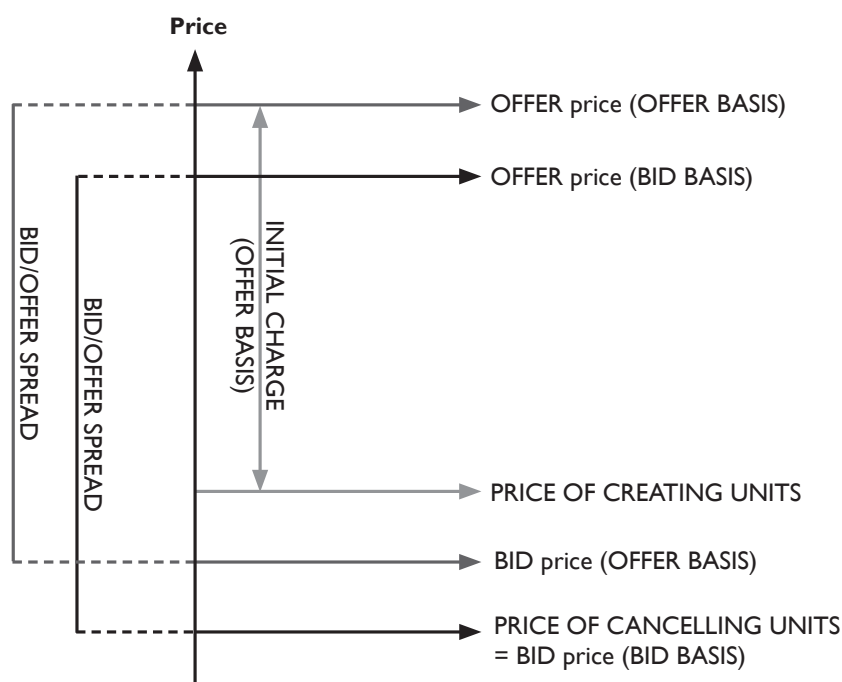
at which units may be bought and sold, using a method specified in the trust deed. Unit prices are directly related to the value of the underlying securities that make up the fund.

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

- The **creation price** is the price at which the unit trust manager creates units.
- 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 has a 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 has a 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

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.

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.

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

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-interest or non-equity fund and all 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 corporation 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 income 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-interest (or non-equity) funds

Income from a fixed-interest fund is classed as savings income. The income is paid gross, without deduction of tax. Where the income 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 and the dividend allowance is £500. 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 £500, leaving £9,920 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:

$$£500 @ 0\% = £0$$

$$£9,920 @ 8.75\% = £868$$

$$£3,730 @ 33.75\% = £1,258.88$$

Total tax on dividend = £2,126.88



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 =

$£500 @ 0\% = £0$

$£10,770 @ 20\% = £2,154$

$£1,730 @ 40\% = £692$

Total = £2,846

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's assets less its liabilities, 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, and this suggests a lack of demand for

the shares. Where the share price is higher than the NAV, the investment trust is said to trade at a premium, indicating demand for the shares.

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 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.

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.

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 the same as that described for equity unit trusts.

As with unit trusts, fund managers are exempt from corporation 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.

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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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 the 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 I

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 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.

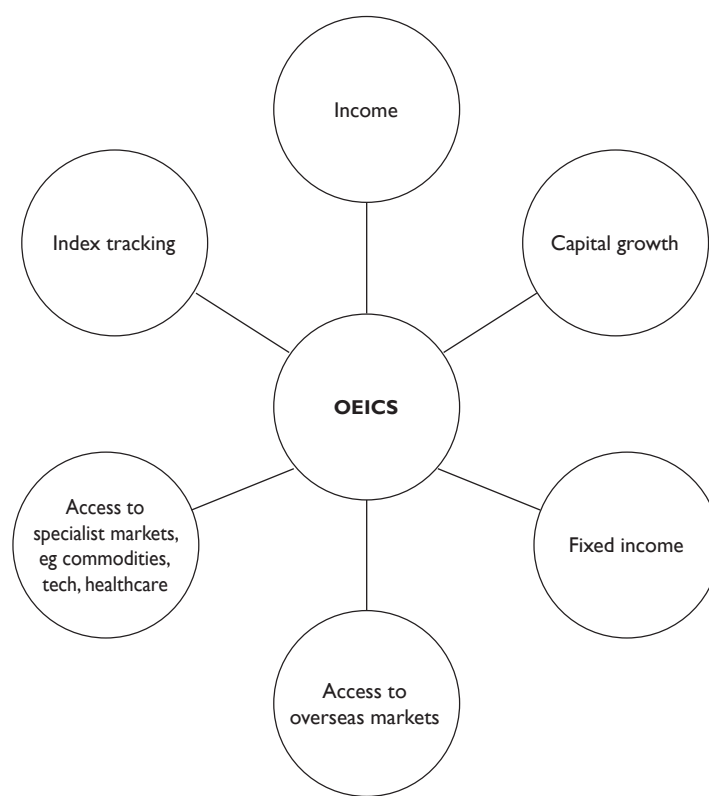
The role of overseeing the operation of the company and ensuring that it complies with the requirements for investor protection is carried out by a depositary, who is authorised by the FCA. The role of the depositary is very similar to that of the trustee of a unit trust.

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. There will be a liability to income tax for basic- and higher-rate taxpayers if total savings income exceeds the investor's starting-rate band for savings income (where available) and personal savings allowance. Additional-rate taxpayers will be liable to income tax on the full amount paid.
- 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 corporation 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 tax 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 long-term investor who would like reasonably easy access to their funds.
- A long-term investor who is happy to give notice to withdraw funds.
- A low-risk investor who requires a guaranteed income.
- 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.

The introduction of schemes such as ISAs has reduced their popularity but some 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 corporation tax on its investment returns. This can be compared with a conventional endowment on which the life assurance company would pay corporation 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. 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?

Broadly speaking, a higher-rate taxpayer will pay an additional 20 per cent income tax on their gain and an additional-rate taxpayer an extra 25 per cent. The gain is the surrender value plus any withdrawals previously made that have not already been taxed, less the original investment.

Top slicing, which enables the gain to be averaged over the term of the policy, is used to facilitate use of the personal savings allowance (where available). Top slicing is also used where the gain takes a basic-rate taxpayer into a higher tax band. Where top slicing results in the gain remaining in the basic-rate tax band, no further income tax is payable as the liability of a basic-rate taxpayer is deemed to have been met at source.

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 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

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).

8.10 Sustainable finance

The terms 'sustainable finance', 'socially responsible investing', 'ethical investing' and 'green investments' appear frequently in the media and are often used interchangeably.

In short, sustainable finance is about taking into account environmental, social and governance (ESG) material factors when making investment decisions. A material factor is one that is likely to affect the profitability of a firm. For example:

- A material environmental factor could be paper recycling for a publishing house.
- Material social factors could relate to how a firm treats its employees. Are they an inclusive employer? Do they pay a fair salary?
- Governance factors relate to how a firm is run. Does it pay its fair share of taxes? Does it have an ethics code? Is it transparent in its communications?

There are both potential advantages and disadvantages for those considering sustainable investment as illustrated in Table 8.1.

TABLE 8.1 POTENTIAL ADVANTAGES AND DISADVANTAGES FOR SUSTAINABLE INVESTMENT

Potential advantages	Potential disadvantages
Ethical funds meet the needs of clients who would like to use their funds for the wider good	Investing solely in ethical funds restricts an investor’s portfolio, meaning a lack of diversification
Firms who take ESG seriously are often forward-looking and may well be more successful than their peers	Companies that score highly against ESG criteria tend to be small and medium-sized companies Such companies can be more volatile than larger companies, which could leave an investor exposed to greater losses than they might otherwise experience
Many socially responsible funds have performed well	Many socially responsible investment (SRI) funds are actively managed, meaning they can be subject to higher charges There is the potential risk of ‘greenwashing’ or firms making unsubstantiated sustainability claims for products

FACTFIND

The FCA had concerns that firms were making exaggerated or misleading sustainability-related claims about their investment products (known as greenwashing).

As a result, 'PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels' has been introduced to help consumers navigate the market for sustainable investment products and to enhance consumer trust. The requirements include regulations on naming and marketing for investment products, an anti-greenwashing rule, and the introduction of four labels to help consumers navigate the investment product landscape. There are additional requirements for disclosure information, both at the product and entity level, aimed at institutional investors and consumers seeking more information. Distributors must also ensure that product-level information, including the labels, is readily available to consumers.

These rules apply from 31 May 2024 and you can find out more here: www.fca.org.uk/publication/policy/ps23-16.pdf.

8.11 Cryptoassets

Cryptoassets are a digital representation of value, the ownership of which is cryptographically proven (using computer code). Cryptoassets do not generally have equivalent physical manifestations. 'Coins', for instance, only exist notionally. Bitcoin was the first cryptocurrency and it remains by far the biggest, most influential and best-known cryptoasset (GOV.UK 2023).

8.11.1 How do cryptoassets work?

The easiest way for a user to conduct a transaction using cryptoassets is to create a digital wallet, similar to an online bank account. This generates a pair of digital keys: one public (essentially the account number), one private (the user's PIN). The keys are used to send and receive transactions; they are a means of identifying the parties to a transaction and proving their ownership over the assets they intend to transact.

Transactions are recorded using distributed ledger technology (DLT). Distributed networks eliminate the need for a central authority to check for invalid transactions. Participants around the world, connected through a peer-to-peer network, compete to solve complex puzzles to validate transactions. All verified transactions are recorded on an electronic ledger.

Blockchain is the most widely known DLT network. It comprises transaction entries called ‘blocks’ that confirm and record users’ transactions. Each block is cryptographically connected to the previous block in the blockchain through a ‘hash’ (a digital fingerprint). This creates an auditable trail of the transaction. Blockchains are generally publicly available and transparent. Transactions are time-stamped on the blockchain and mathematically related to the previous ones; they are irreversible and impossible to alter.

The UK Cryptoassets Taskforce (CATF) report identified three different categories of cryptoasset:

- **Exchange tokens** – these are not issued or backed by any central authority and are intended and designed to be used as a means of exchange. They tend to be a decentralised tool for buying and selling goods and services without traditional intermediaries.
- **Utility tokens** – these tokens grant holders access to a current or prospective product or service but do not grant holders rights that are the same as those granted by specified investments. Although utility tokens are not specified investments, they might meet the definition of e-money in some circumstances (as could other tokens).
- **Security tokens** – these are tokens with specific characteristics that mean they provide rights and obligations akin to specified investments, like a share or a debt instrument as set out in the Regulated Activities Order (RAO).

(FCA, 2019)

8.11.2 Regulation of cryptoassets

Up until 2023, while the FCA had oversight to check that cryptoasset firms had effective anti-money-laundering (AML) and terrorist financing procedures, generally cryptoassets were not regulated by the FCA.

That changed with the FSMA 2000 (Financial Promotion) (Amendment) Order 2023, which came into effect on October 8 2023 and brought qualifying cryptoassets within the FCA’s remit for financial promotions.

A qualifying cryptoasset is any digital representation of value or contractual rights that is cryptographically secured, transferable and fungible. This may include exchange tokens, such as bitcoin, but there are exceptions for digitally issued fiat currency, such as central bank digital currencies (CBDCs), and for cryptoassets that meet the definition of electronic money or existing controlled investments.

‘Fungibility’ refers to the ability of an asset or good to be easily exchanged with other assets or goods of the same kind.

The rules apply to all firms that market qualifying cryptoassets to UK consumers, irrespective of the firm’s geographical location.

Firms wishing to promote cryptoassets in the UK to retail consumers must now be authorised or registered by the FCA or have their marketing approved by an authorised firm. They must have clear risk warnings in place and ensure adverts are clear, fair and not misleading.

To further protect consumers, firms must also implement a 24-hour cooling-off period for first-time investors, client appropriateness testing (ensuring clients have the appropriate knowledge and experience to invest) and client categorisation features.

Direct offer financial promotions can only be made to certain categories of investors:

- restricted investors;
- high-net-worth investors; and
- certified sophisticated investors.

FACTFIND

The FCA's final guidance on cryptoassets can be found here:

www.fca.org.uk/publication/finalised-guidance/fg23-3.pdf

A discussion paper on fiat-backed stablecoins that may be used as a form of payment has since been published.

A stablecoin is a type of cryptocurrency that is designed to maintain a consistent value in relation to a particular asset or a group of assets. This provides a sense of stability when compared to the high volatility of unbacked cryptocurrencies.

Fiat-backed stablecoins are a particular type of stablecoin that maintains a stable value of the cryptocurrency by referencing one or more specific fiat currencies, such as the US dollar or the British pound sterling. To achieve this, it may also require holding such currencies.

The paper focuses on how the FCA may regulate the issuance and custody of fiat-backed stablecoins and the use of these stablecoins as a means of payment. The paper can be found here:

www.fca.org.uk/publications/discussion-papers/dp23-4-regulating-cryptoassets-phase-1-stablecoins



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 the purpose of top slicing?

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.

References

FCA (2019) *Guidance on cryptoassets feedback and final guidance to CP 19/3* [pdf]. Available at: www.fca.org.uk/publication/policy/ps19-22.pdf

GOV.UK (2023) *Factsheet: cryptoassets technical* [online]. Available at: www.gov.uk/government/publications/economic-crime-and-corporate-transparency-bill-2022-factsheets/fact-sheet-cryptoassets-technical



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.