Guide to:

Investment vehicles

Investment vehicles

What are they, and what does this guide say about them?

This guide is designed to provide a summary of the key features of the different retail investment products commonly used to invest over the medium to long term in the stock markets, bond markets, commercial property, and related areas.

It does not explore the option of investing directly in any of these areas since the core issues we explore do not really apply with direct investment. We are, though, happy to discuss this if you feel you have the resources, expertise, and risk capacity to go directly to the market.

We also do not look at deposit-based investments since these are generally straightforward and do not really warrant discussion in a guide.

The objective is to identify the pros and cons of the different options and to provide some background information as part of our overall advice process.

There are a number of ways the options available differ and we focus here on the ones we feel are most relevant to an investor's decision making, rather than on the minutia.

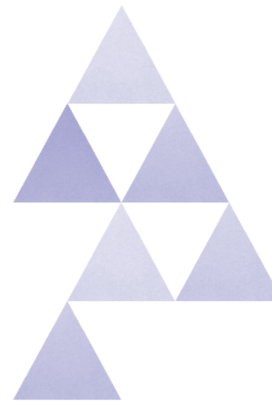
The key issues relate to:

- Taxation
- Charging structures
- Flexibility
- Income availability
- Risk, reward, and volatility.

The three broad categories of investment generally used to invest in the markets this guide relates to are collective investments, life insurance investments and structured products.

With all of these, the returns to investors are determined by the performance of the assets the investment is linked to, but the nature and extent of the relationship with the value of the underlying assets does vary, as do the attaching risks.

Collective investments



What these are and how they effect your investment strategy?

With collective investments, money from a large number of individual investors is pooled together in a fund.

The main reasons investors are attracted to this structure rather than investing directly are:

- Professional management supported by research and analysis capabilities which are beyond the reach of more or less any private investor
- Economies of scale
- Wider spread of risk than is usually possible for a private investor
- Access to markets and sectors not generally available to a private investor either due to geographic considerations or minimum investment levels.

In essence, collective investments allow a private investor to benefit from the expertise of specialist investment management companies with sophisticated global research networks and to enjoy a much wider spread, which both allows access to opportunities not otherwise available and helps mitigate risk through diversification.

The range of funds available is huge, with some very general and investing across all asset classes, but most designed to invest in particular areas, such as the UK stock market.

Due to the range, someone can use an open-ended collective investment fund to invest in anything from money markets through real asset property to bonds and, of course, shares, with the latter broken down into a wide range of sub-categories defined either by geographic area or market sector, or both.

When compared with cash deposit, a collective investment is structured so the profits enjoyed by investors are directly related to the performance achieved by their money. Cash on deposit receives interest at a rate which is not directly connected to the profits of the bank. This can, of course, result in much better returns from collective investments but it also means they go down in value as well as up, and do involve investment risk. This issue is looked at in detail in the Atkins Bland Guide to Investment Risk.

The broad category of collective investments includes many subcategories, but these are best looked at in terms of the scope of this guide in just two blocks, open-ended funds, and closed-ended funds.

With both of these, there are funds domiciled in the UK and others domiciled overseas. With the latter, tax considerations can be quite complex and, while many are tax neutral for a UK investor, some involve an element of extra taxation since tax paid internally by the fund is not always taken into account when assessing an investors liability. It is outside the scope of this guide to discuss the various types of offshore collective investment fund and doing so would lengthen this document considerably with no tangible benefit to the reader. However, it is important take care when using offshore funds that tax issues have been considered.

There are two main types of collective investment, and they are explained further overleaf.

Open-ended collective investment funds

The ins-and-outs of open-ended collective investment funds

Investments in this broad category can have a number of different legal structures, the most well-known of which are:

- Unit Trusts
- Open-ended Investment Companies (OEICS)
- Exchange Traded Funds.

These do differ in terms of how they operate and the restrictions they have on where they can invest. This detail is beyond the remit of this generic guide, but information is available on request.

For the purposes of this guide, we only need look at the core features of funds in this broad category, and these are set out below.

The first point is that these are collective funds, so all the features set out above apply. The money in a fund is beneficially owned by a large number of different investors and is managed on their behalf by a fund management company.

Returns are directly related to the income or growth achieved by the fund.

The main defining feature of this category of fund is that they are open-ended, which means money can be added to the fund, or withdrawn from the fund.

When someone invests, they buy units or shares in the fund at a price reflecting the underlying value of the fund's assets, with the price normally set each working day.

When they want to withdraw their investment, they sell the units or shares and get a price reflecting the value of the fund's assets on that day.

The value of the underlying assets in the fund changes on a day-by-day basis and this, in turn, results in a change in the price of the units or shares in the fund.

Some funds have different prices for buyers and sellers, but most are single priced and any charge for allocating new money is added on as a separate quoted cost. In most cases there is no fund manager charge for investing into their funds if this is done through a centralised administration service rather than by going directly to the fund manager.

Fund managers have some discretion on how units or shares are valued and will use this to protect their investors' interests. For example, the fund could be valued on the amount which could be raised if all the assets were sold, meaning less expenses involved. The fund managers might choose this basis if there are more sellers than buyers.

Alternatively, a fund could be valued on the amount it would cost to buy the underlying investments, including the expenses involved. The fund managers might choose this basis if there are more buyers than sellers.

There are annual management fees for running the fund which vary but will normally be somewhere between 0.25% and 1.5% pa.

Open-ended collective investment funds

The ins-and-outs of open-ended collective investment funds

Fund management charges are taken out before the value of the units is calculated.

Some funds take their charges from the fund's income, which reduces the amount payable to investors. Other funds take the charge from capital, paying the income in full. However, the fund must then rely on capital growth to avoid any fall in value for the investor.

There should be little difference between these charging methods in terms of overall results, since the impact is either on income paid or the value of the capital.

The funds are taxed on a relatively simple basis designed to fairly reflect the tax each individual investor would be liable for if they held their share of the fund's assets directly, rather than through the collective investment fund.

Income generated is taxed in the same way as would apply if the underlying holdings were held directly.

Increases in the value of an investment are subject to Capital Gains Tax (CGT) when the units or shares are sold, with the normal annual exempt amount available.

Since many investors do not use up their annual CGT allowance, a collective fund can be a tax-efficient way of investing when compared with some alternatives.

From the point of view of the fund management, the open-ended nature has both advantages and disadvantages.

The advantages include the fact that the fund can grow in size through new investors adding money to it, thus increasing economies of scale.

The disadvantages include the fact that a fund manager is not in control of how much money they have in the fund and this can sometimes change quickly and substantially. If a fund does well it can attract a lot of new money, possibly at a time when markets have risen a lot so are less attractive for new investment.

On the other hand, a period of poor performance can see large amounts withdrawn, forcing a manager to sell assets to raise cash just when the timing for this is particularly bad.

These factors can add challenges to fund managers which are not faced by those operating closed-ended funds and will sometimes mean an open-ended fund holds more cash than the manager would wish to otherwise, simply to ensure a sudden surge in withdrawal can be accommodated. This can be a particular problem for property funds where raising cash by selling properties can be a long-drawn-out affair.

Due to the possible problems associated with turning real estate into cash, funds investing in "bricks and mortar" property are permitted to suspend withdrawals if necessary, to allow them an opportunity to raise cash. Investors in these funds should take this into account since it could mean access to money is not available for a period of time during adverse conditions.

Closed-ended investment funds

The ins-and-outs of closed-ended collective investment funds

The most common type of closed-ended fund in the UK is usually referred to as an investment trust.

Unlike open-ended funds, these are companies quoted on the stock exchange, but which have the sole purpose of investing in assets such as the shares of other companies, real commercial property, fixed-interest debt, or other investment opportunities.

They were the first type of collective investments available, have been around since the 1860's, and offer similar basic benefits to their more recent open-ended equivalents.

Principally, they allow investors to pool their resources, enjoy economies of scale and spread their investment risks while taking advantage of the professional expertise of a fund management company.

Tax treatment is also similar to that applied to open-ended investment funds.

However, there are some significant differences between closed-ended funds and open-ended funds:

Pricing

A fundamental difference is that the value of shares in a closed-ended fund may be quite a long way adrift from the underlying net asset value (NAV) of the fund's investments.

With open-ended funds, the price of the shares or units will always closely reflect the NAV of the fund and will only deviate from this within narrow and prescribed margins, since the price is set by the fund manager with specific reference to the fund's asset value.

However, with a closed-ended fund, the price is determined by market forces and, particularly, supply and demand for the shares in the fund.

This is because when an investor decides to buy shares in a closed-ended fund, they will be buying shares from someone who is selling them. Only on the launch of a new fund, or on the issue of new shares by a fund, are new shares created.

This means that the price of shares in a closed-ended fund can move significantly away from the actual value of its assets - in either direction.

This is similar to the position with shares in an ordinary company, where the value of the company's shares is normally different from the value of the company's assets. Sometimes this leads to a take-over bid, with the buyer trying to take advantage of what it believes is an undervaluation in the marketplace. However, the real value of a trading company is far less clear cut than is the value of a collective fund which just owns quoted shares in other companies. This means the difference between the share price and NAV of the company is a moot point, whereas with a closed-ended investment fund, it is a figure which is easily calculated, and which is published.

This ability for shares to trade at a higher or lower price than the value of the assets they represent, sometimes to the tune of 30% or more lower or higher, can add considerable risk (or extra reward) and needs to be monitored carefully.

Closed-ended investment funds

The ins-and-outs of closed-ended collective investment funds

Gearing (or borrowing)

Another core difference with a closed-ended fund is their ability to borrow money to invest in other companies. This is called 'gearing'. If things go well it can increase the investment return to shareholders, but in a falling market it can cause losses to be much worse than would otherwise have been the case.

Again, this makes closed-ended investment funds potentially more risky than open-ended investment funds, even if they are invested in the same market, and care needs to be exercised to reflect this fact.

Fund management issues

These also differ from an open-ended fund because a closed-ended fund manager does not have to deal with the problems of the money they have in the fund fluctuating at the whim of investors, so does not have the liquidity issues to deal with. This is because investors buy or sell shares to each other on the stock market instead of to and from the fund itself. This is generally considered an advantage of the closed-ended structure in terms of allowing the fund manager to invest with confidence that they will not be forced to sell before they would wish to.

Buying costs

The cost of buying shares in a closed-ended fund is the difference between the buying and selling price of shares in the marketplace, plus stockbroker commission, stamp duty of 0.5% and, for investments over £10,000, a small levy to help fund the panel on takeovers and mergers.

The difference between the buying and selling prices of shares varies with market conditions and the popularity of the trust. Often it is only 1 to 2% but it can be considerably more with less popular funds. Stockbroker charges also vary, with traditional brokers charging around 1.5%. However, low-cost fixed rate terms are often available if a portfolio is operated through a central administration service.

Overall dealing charges are often similar to the charges associated with open-ended funds, but this does vary from one fund to another.

Annual management charges

The traditional position was that investment trusts tended to have lower annual management charges than an equivalent open-ended fund. This is still true in some cases, but less so following a downward trend for open-ended fund fees and the launch over recent years of a number of closed-ended funds with quite high fees, reflecting their specialist natures.

Given the variation, it is important to carry out research into this when selecting which option is best.

Closed ended investment funds

The ins-and-outs of closed-ended collective investment funds

Tax planning opportunities

While most closed-ended funds are taxed in a similar way to open-ended funds, and effectively pass-through tax liabilities to reflect those which would apply if the same assets were held directly, there are some which offer specific tax breaks and have been introduced to encourage investments in smaller enterprises.

The most common of these are:

Venture capital trusts (VCTs)

VCTs are specialist investment trusts which offer tax incentives. They invest in smaller unquoted UK companies or companies quoted on the Alternative Investment Market (AIM). This makes the funds higher risk, although this is reduced to some extent by the tax reliefs available.

These are:

- 30% income tax relief on subscriptions at launch. This relief is withdrawn on shares that are disposed of within 5 years, other than to the investor's spouse, or on death. The relief is given as a tax-reducer, so you must have paid enough income tax to get the relief

- No liability to higher rate tax on dividends

- No liability to CGT. Capital gains on the sale of shares in a VCT are not taxable.

Because a VCT invests in smaller companies, the individual risk of values falling is relatively high. This is reduced by the overall spread which can be achieved with a VCT, but the spread can vary significantly from one fund to another.

Many investment trusts, especially those in higher risk markets such as small companies, can trade at a wide discount to their underlying asset value and this has been particularly true of VCTs in the past. This is probably partly because of low liquidity which reflects the lack of demand in the secondary market. This is understandable since demand tends to focus on new issues where the 30% tax relief is available.

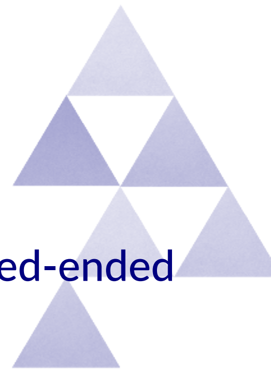
Enterprise Investment Schemes (EISs)

This is similar to a VCT but differs in risk since it invests in a single enterprise, rather than in a portfolio of different companies. Risk can be mitigated by spreading money amongst a range of EIS investments and it is possible to do this with a portfolio managed by a specialist third party management group. However, each individual EIS is high risk.

The tax reliefs include those applying to a VCT but with a 3-year qualifying holding period, rather than 5 years. In addition, an EIS can be used to defer a CGT liability arising from the sale of another asset, can give tax relief on losses and once held for at least 2 years, could be excluded from assessment for Inheritance Tax in the event of death.

The tax benefits can, therefore, be considerable and these can help mitigate the risks, but EIS investing is only usually suited to those prepared to accept a high level of risk to their capital.

Life insurance investments



What are these and how do they differ to open-ended and closed-ended investment funds?

Most life insurance companies offer lump sum investments structured in a similar way to an open-ended collective investment fund. These are commonly known as life insurance investment bonds. However, while they have some similar features to collective investment funds, there are also some very significant differences.

One of these is that they are not structured in a way which facilitates such easy movement from one company to another as applies with a collective investment. This means they tend to be treated as standalone investments giving access to a range of funds available from the life insurance company rather than an ingredient in a portfolio of different funds.

In some cases, the fund range is limited to those managed by the one company but in others the company has recognised that investors want choice and the ability to spread their investments, so they now offer funds managed by a selected range of different companies, albeit with this usually very restricted.

As well as offering funds structured in a way similar to a collective investment fund, many life insurance companies offer what are known as 'With Profits' funds.

With these, the price of units in the fund does not accurately follow the underlying asset value and go up and down each day to reflect this. Instead, it will rise at a pre-determined rate, which is normally reviewed and adjusted each year. This rate is normally referred to as the 'bonus rate' and is designed to be a very conservative estimate of the return the fund is expected to achieve.

In fact, the actual return is always unknown in advance and the value of the underlying fund will inevitably go up and down, so the concept is to operate a process which attempts to smooth the peaks and troughs normally associated with investments in real assets.

When money is withdrawn from a With Profits fund, there will usually be an adjustment to reflect (to some extent) the difference between the actual performance of the fund in the period the units have been held and the growth achieved by the added regular bonuses.

If the difference is positive this would be a 'terminal' or 'final' bonus, whereas if it is negative it would be via a 'market value adjustment' (MVA).

Due to the risk of an MVA on surrender, With Profits funds are not the low-risk investments many holders believe they are, and they generally carry the same risks as a normal fund invested in a similar portfolio of shares, bonds, and property. These risks are, however, somewhat disguised by the way the unit price is shown to steadily rise.

While most bonds can apply an MVA at any time, some have guarantees or fixed anniversary dates, usually after 10 years, where no MVA will be applied regardless of market conditions. In addition, there is normally no facility for a company to apply an MVA on surrender due to a plan holder passing away or for regular withdrawals up to a pre-set limit.

For a long-term investor wishing to avoid day-to-day fluctuation in capital values, a With Profits bond might have attractions. However, the possibility of an MVA being applied when capital is withdrawn, and the likelihood of bonus rates staying low in the future, are negative factors.

While the above are significant differences between a life insurance bond and a collective investment fund, the most important difference is in the way they are taxed, which differs between onshore and offshore bonds.

Life insurance investments

What are these and how to they differ to open and closed ended investment funds?

Taxation of onshore life insurance investment bonds

This is a fairly complex area, but the core issue is that all investment returns are treated as income for tax purposes, even if some or all have actually been generated by capital gains rather than interest, share dividends or property rent.

In addition, none of any tax deducted at source can be reclaimed, even if the investor would not otherwise be liable to it.

This means that, for the majority of investors, a life insurance bond is not tax efficient since they pay tax on capital gains which they would not pay otherwise due to their yearly tax-free allowance.

On top of this, the way tax is assessed means the structure can result in a higher rate tax liability on withdrawal, even for someone who has only ever been a basic rate taxpayer whilst the bond was held.

One of the most misunderstood aspects of a life insurance bond relates to the facility to withdraw up to 5% of the original investment and have this treated as a return of capital rather than income, until the total treated this way reaches 100% of the amount invested (20 years of withdrawing the maximum which can be treated this way of 5% per annum).

We have found that many investors with these insurance bonds wrongly believe the 5% withdrawals are tax-free, presumably because of poor communication from the salesperson who sold them the bond.

In fact, by treating the 5% as a return of capital, H M Revenue and Customs are simply delaying the point when the income withdrawn is treated as such for tax purposes, and this can catch out the unwary by causing a large amount to be classified as income in a single year, typically when the bond is surrendered. This is an example of how a life insurance investment bond can create a higher rate tax liability even for someone who is normally a basic rate taxpayer.

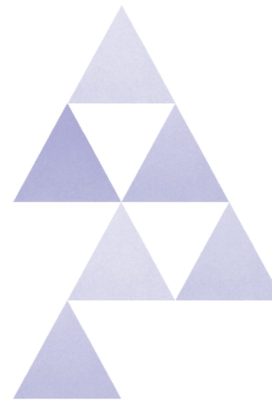
The risk of a higher rate liability arising because all investment return can be treated as arising in a single year, is mitigated by something called ‘top slicing’ relief. This is a process whereby the gain on a withdrawal which exceeds the cumulative 5% p.a. treated as a return of capital is divided by the number of whole years the bond has existed, or since the last chargeable event happened. Only the divided amount is added to other income to assess someone’s tax rate. In most cases this facility does eliminate the problem of higher rate tax, but not in every case.

As a result of these potential tax issues, care should be applied when deciding if this type of investment is suited to your tax position, and when considering any withdrawals if you already own a life insurance investment bond.

Specialist advice on the tax treatment and suitability of an investment bond is important and more details are available if required.

Life insurance investments

What are these and how to they differ to open and closed ended investment funds?



Taxation of offshore unit-linked life insurance bonds

These are the offshore version of the bonds described above, and the core difference is that the companies are not liable to UK taxes, so all gains are treated as untaxed income rather than as having already paid basic rate tax.

However, any investment return from UK share dividends has actually suffered UK taxes, and income from other sources may have suffered withholding tax. Since these taxes are not accounted for when assessing a tax liability on withdrawal, there is usually an element of double taxation unless someone is able to exit the investment without paying any tax. This might be possible if they are tax resident in a country with tax haven status or are resident in the UK but have no other income so can use their personal allowance to receive income without a tax liability.

Since the taxable event arises on withdrawal rather than on a year-by-year basis, there can be situations where the much-reduced tax at source is an advantage, but for most UK residents it will turn out to be a disadvantage due to the issue of paying tax on some income which has already had tax deducted.

Generally, the only time an offshore bond is likely to be a viable option in terms of tax planning is where money can be withdrawn without a tax liability or, in some cases, where the policy owner would have been liable for higher rates of tax during the years the bond was held but is able to withdraw the money later on with a lower tax rate applied. This can, for instance, be the case with some trusts.

Structured products

How do these fit in with the other products available?

These are often complex investments designed for a fixed period of, typically, 5 to 6 years and offer either a high level of income or a potential gain if the stock market index or other investments to which they are linked perform well enough.

While the plans are structured to produce specific outcomes depending on the performance of one or more investment, share or index, they rely on contracts with counterparties to ensure these are delivered. There is, therefore, the added ingredient of counterparty risk. This is because the plans rely on the parties concerned being able to meet their liabilities and deliver on their contracts.

Counterparty risk has caused problems in the past, with the collapse of Lehman Brothers in the USA in 2008 a prime example and may do again. Great care is therefore needed when considering a structured product to assess the real level of risk, which may be greater than first appears when reading a product brochure.

While there are a wide range of styles and features, for the purpose of the generic guide we only need to consider the core features, and these are best dealt with by breaking down this class of investment into two categories – 'capital at risk' and 'capital protected'.

Structured Capital at Risk Products (SCARPs) or Precipice bonds

Most SCARPs are designed for growth and do not produce any income. Typically, they offer gains higher than the rise in the index being used up to a cap, and the return of the full investment as long as the index doesn't fall below a certain level. Sometimes index prices are averaged over all or some of the period and often there are quite complex trigger points which determine results.

However, a key issue is that if the index or other investment they are linked to fails to achieve the required target, capital is lost. The loss can be much more substantial than the level of any fall in the underlying index, since it is triggered by specific market levels. This is the reason for the original name of 'Precipice Bonds' - the capital value can fall off a cliff if market conditions disappoint.

Generally speaking, the plans are designed to offer a possible return above that from the underlying markets to which they are linked, but only if market performance falls within a pre-set range. If markets out-perform this, the cap may well mean not all gains are enjoyed, while if markets underperform there is often also a gearing effect whereby this will have an exaggerated downward impact on the value of the investment at maturity.

Although index levels are usually averaged over a period to mitigate the impact of a sudden market fall just before the investments maturity date, the fact that these have set maturity dates also adds to the risk since it means an investor is forced out despite market conditions, and cannot sit tight after a market crisis and await a recovery.

Due to the risks to capital, these investments need to be treated with caution and are often high risk but, in some cases, they can provide very attractive returns and be a useful ingredient in a diversified investments strategy.

Structured products

How do these fit in with the other products available?

Capital protected structured products

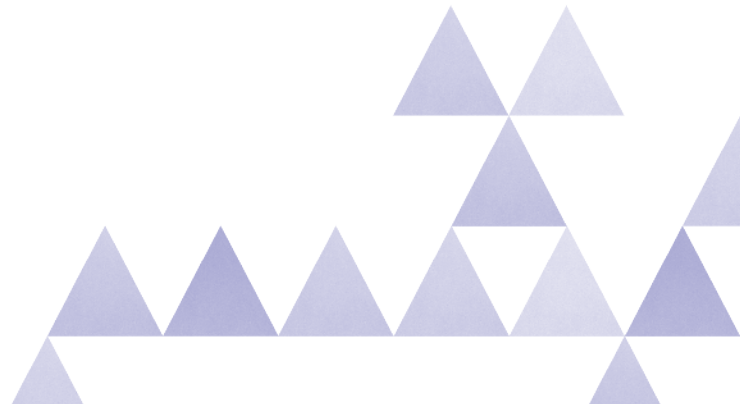
These operate on the same basis as SCAPRs but are designed to return the original investment in any event, even if the index or investment to which they are linked falls.

Reflecting the protection against downside risk, the upside is lower than the potential upside from other investment options linked to the same market area, including those linked more directly such as a collective investment fund.

While they are designed to protect against downside risk, these are often complex investments and returns are not guaranteed, since the protection measures are only as good as the financial security of the companies providing them.

As with SCAPRs, care is needed when assessing if a structured product is suitable to a specific investor's needs or capacity for risk.

Important notes



Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates

Past investment performance is not a reliable guide to the future

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted

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The value of most investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.

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