Uncovered: Brokers lift forbidden skirts

Here's an investment story you're not supposed to know about. By Mark Story

By Mark Story, Auckland

Issue 16 / Monday, 1 May, 2000

Print this page   Email to a Friend

There's an investment vehicle out there your financial adviser is not telling you about, your broker is forbidden to market to you and your fund manager will advise you to avoid. This vehicle is UK-based but still capital-gains tax free, consistently out-performs local funds, and charges 80% lower fees than usual managed funds. It's called a UK Investment Trust: and here's why it's worth trying.

Cheaper to own

Like unit trusts and super funds, UK investment trust companies (ITCs) are collective investment vehicles. They pool money with that of others and invest according to declared investment aims. Usually it's in shares of companies listed on stock exchanges globally. But unlike unit trusts and super funds, ITCs are public companies listed on the London Stock Exchange.

This means investors who buy shares in ITCs become shareholders just as if they're buying shares in, say, British Telecom. This means ITCs are cheaper to administer than unit trusts, which typically appoint a third-party fund mana-ger. Based on the research of Cameron Watson, research manager with broker Craig & Co, the average annual expenses on local unit trusts are 80% higher than UK investment trust companies. Moreover, their privileged status under UK law exempts ITCs from capital gains tax.

Too good to be true? Not according to Peter Irwin, CS First Boston's resident UK investment trust company expert. He's mystified as to why New Zealand investors love giving money ($2 billion so far) to third-party fund managers instead of going directly to the investment source. "Not only are they paying more tax and higher fees, they're entrusting their money to inferior management expertise," he says.

That's phooey, says Graham Rich, managing director of managed fund research house Morningstar. He says ITCs may have a tax advantage, but doubts there's much else that separates them. In fact, he lambasts brokers and investment advisers who milk the tax advantage to woo unsuspecting investors into ITCs.

More bang for your buck

Actually, there's more to it than merely tax. Irwin has two more criticisms about unit trusts. For one thing, unit trusts are priced to reflect the net value of underlying assets. In other words, for every $1 invested there's $1 in underlying assets. Not so with ITCs. They trade at either a premium or discount to net asset value (NAV) depending on market sentiment, just like any other public company. Like most shares, ITCs typically trade at a discount to NAV. This means, for every $1 someone invests, they're buying a greater amount in underlying assets.

Second, he says, unit trusts are open-ended, meaning when you enter or exit a fund you directly affect how much money is available to the fund manager. This means the investment strategies of fund managers are materially influenced by the buy and sell decisions of the trust's investors, says Irwin. The end result? Investors may be withdrawing funds during a market downturn which would force the fund manager to sell to fund these withdrawals.

"Unfortunately, it is during periods of market weakness that fund managers prefer to buy. But because of cash flow requirements, they're often forced to sell. When the market is booming, and caution should prevail, the fund manager is often swamped with money to invest and obliged to buy at the top of the market. Over the long term, this has a detrimental affect on overall performance."

ITC shares, by contrast, are bought and sold through the stock market. And the investment manager is not involved in the sale and purchase of these ITC shares. This allows the manager to concentrate entirely on managing the shareholder's portfolio of investments' and there's no need to alter the portfolio to fund investors' buying or selling decisions.

Better performance

So does all this efficiency show in overall fund performance? You bet. Outstanding they may have been, but the performance from New Zealand's 10 best-performing unit trusts for the year to December 31, 1999, look sick compared with the performance of ITCs (see table 1).

In fact, the best ITC achieved a return 10 times higher than that of our best unit trust. Compare average annual returns over the past five years and the six best performing ITCs outperform the six best performing New Zealand-based unit trusts with similar aplomb (see table 2).

So does this mean all open-ended investment vehicles are fundamentally flawed? Yes and no, says Graham Rich. He says whether they are or not depends on the investor's requirements and the nature of underlying assets. He says while UK ITCs may have outperformed local unit trusts, it's easy to find offshore unit trusts, especially those in emerging markets, Asian and technology sectors, with even higher returns.

When it comes to disclosure to investors, David van Schaar-denburg, general manager of research house IPAC, says ITCs simply aren't in the game. "Open-ended fund managers are a lot better at managing cash than [Craig & Co] Watson gives them credit for. And this really isn't a problem unless the fund receives a mass exodus. They also offer greater transparency with pricing and Web site information. Closed-ended funds only tend to disclose information at defined intervals."

Van Schaardenburg also says while ITCs do outperform local unit trusts, the real danger is not making apples-with-apples comparisons. Without the tax break, he doubts if brokers like Watson and Irwin would even bother selling them.

Why you'd never know

But if ITCs are outstripping local unit trusts, why is so little known about them? Two reasons. Firstly, like all other listed companies, they're prevented by law from advertising or promoting the sale of their shares. Secondly, many investment advisers are loath to recommend them because the commission paid is around half the 2% to 5% paid on unit trusts.

"UK investment trust companies are the perfect portfolio investment. But due to the volatility surrounding the technology sector, investors shouldn't just blindly buy and hold. They need to take a long-term view, but also take a 'top-drawer' approach by eyeballing performance regularly," says Watson.