



The Association of Investment Companies



Introduction to Investment Companies

In a nutshell, investment companies are companies that invest in a diversified portfolio of assets to make money for their shareholders. Investment companies can be investment trusts, venture capital trusts, and offshore and AIM traded investment companies.

Investment companies pool investors' money and employ a professional fund manager to invest in a wider range of assets than most people could practically invest in themselves. This way even people with small amounts of money can gain exposure, at low cost, to a diversified and professionally run portfolio, spreading the risk of their investment.

Investment companies are listed on a stock exchange and there are over 400 investment companies in the UK responsible for the management of billions of pounds worth of assets on behalf of investors.

How do they work?

A diversified portfolio of assets

Investment companies hold a broad range of assets, which can include shares, securities, and property. This means your investment is diversified and is not exposed to the fortunes of just one or a few investments.

Closed-ended

Investment companies are listed on a stock exchange and therefore raise money for investing by issuing shares. Generally, this happens once – when the company is created. This makes them closed-ended: the number of shares the company issues and therefore the amount of money raised to invest is fixed from the start.

Investment objectives

These companies specialise in what they aim to achieve for their shareholders. Some try and maximise income. Others aim exclusively for capital growth. Some companies aim to provide a combination of income and capital growth. Companies often specialise in particular sectors and types of company. Some might specialise, for example, in biotechnology companies or alternative energy producers. Others specialise in investing in companies from certain parts of the world, for example the UK or Japan. All companies have investment objectives that will be clearly stated in their literature.

A board of directors

Each investment company has a board of directors which meets several times a year and monitors the company's performance. The board has a legal duty to uphold the interests of its shareholders.

Fund management and fund management groups

The board appoints a fund manager who makes the day-to-day decisions about what shares and other investments to buy and sell. Most companies are managed by an external fund management group, which may provide fund management services to a number of companies.

Companies that have no external fund management firm involvement are called 'self-managed'. This means the board of directors selects and employs a salaried fund manager (or managers) directly.

What are the benefits?

Allows you to pool your money

When you purchase shares in an investment company you pool your money with all the other investors' money, providing potential economies of scale, in terms of dealing costs and administration.

Allows you to spread your risk

Each investment company owns a range of investments, so buying shares in only one company effectively gives you a diversified portfolio. As you're not dependent on the success of just one or two investments, this spreads your risk. However, it must be remembered that investment company shares are equity investments and the price of the shares and the income from them can go down as well as up.

Uses professional management

Each investment company uses professional fund management expertise.

May have low internal charges

Most investment companies have low internal charges. Because the boards must act in the interests of shareholders, they work to ensure that 'costs' or the company's internal charges are not excessive and that the interests of shareholders are looked after. Low charges within the company means more of your money is working for you right from the start of your investment.

Allows you to invest small amounts

You can invest small lump sum amounts or even invest monthly. Most companies have savings and investment schemes, some of which start from as little as £30 each month.

Put all these benefits together and you have an effective and cost-efficient investment vehicle in order to gain exposure to a diversified portfolio.

How do investment companies differ from other collectives?

There are other kinds of collective investment vehicles – for example, unit trusts and open-ended investment companies (OEICs). However, investment companies have several special features that make them unique.

Board of directors

Each investment company has a board of directors whose duty it is to look after the interests of the shareholders – in other words, the interests of you the investor.

The directors are directly answerable to the shareholders. Shareholders may, if they wish, challenge the actions of the directors, call for changes, and vote against certain issues at the AGM and any other special shareholder meeting.

Closed-ended

Investment companies are closed-ended funds. This means that the amount of money which the company raises to invest is fixed at the start by issuing a set number of shares to investing shareholders. Having a stable pool of money to invest enables the fund manager to plan ahead. Every investor looking to purchase or sell shares must be matched to a potential seller or buyer, via the stockmarket, before a transaction can take place; so the company's own investments are not affected.

What is the share price?

The share price is the value of the share at a given moment. It is determined by the balance between demand and supply on the stockmarket. There is commonly a difference between the buying price and the selling price which is known as the market spread. The mid-market price is calculated at the mid-point between the buying and selling prices and is commonly used to calculate price related data.

Gearing

Investment companies can borrow to purchase additional investments. This is called 'financial gearing'. It allows investment companies to take advantage of a long-term view on a sector or to take advantage of a favourable situation or a particularly attractive stock without having to sell existing investments.

The idea is to make a high enough return on the investments purchased to be able to cover the costs of the loan and then to make a profit on top. Obviously, the more a company borrows, the higher the risk it's taking – but the greater the potential returns.

Financial gearing works by magnifying the company's performance. If a company 'gears up' and then markets rise and the returns on the investments outstrip the costs of borrowing, the overall returns to investors will be even greater. But there is a downside to gearing too. If markets fall and the performance of the assets in the portfolio is poor, then losses suffered by the investor will be also be magnified. The use of gearing can affect both the capital returns and the company's revenue and dividend potential.

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If an investment company 'gears up', it can usually borrow at a lower rate of interest than individuals or other kinds of companies. This is because the borrowings are secured on the company's portfolio. Not all investment companies use financial gearing and many of those that do only use it to a very limited extent and levels of gearing vary from company to company. Companies that do use significant levels of gearing can be subject to sudden and large falls in value. In extreme cases shareholders could lose all their money.

The ability to adjust gearing is a decision taken by the fund manager and the board of directors in accordance with the company's gearing policy.

Other investment vehicles are unable to borrow to purchase additional investments to the same extent as investment companies.

Different share classes

Investment companies which issue only one class of share are commonly known as 'conventional' investment companies. Certain investment companies issue different classes of shares to meet different investors' needs. The companies that issue different kinds of shares for this purpose are called split capital investment companies (splits). The different classes of share have varying rights and entitlements within the company.

Some split shares aim to pay regular dividends for investors who want an income. Others aim to pay out only a capital amount at the end of the company's life. Splits will provide gearing to their share classes through their capital structure, called 'structural gearing'. This type of gearing is due to the order of priority and entitlements of the shares within the structure. Shares within the structure will have varying levels of risk.

Other kinds of collective investment vehicles can't offer this split structure within one fund. Splits can be complex investment vehicles and investors need to ensure they fully understand the structure before investing.

Learn more about splits

To learn more about splits ring 0800 085 8520 for a copy of our factsheet on split capital investment companies. It is also available on our website at www.theaic.co.uk

Discounts and premiums

The price of shares in an investment company is determined by the stockmarket. The share price is often different to the NAV (the underlying investments held by the company). The difference between the share price and the NAV is known as a discount or premium. These terms are defined below. It is more common for an investment company to trade at a discount than a premium.

What is Net Asset Value (NAV) per share?

Simply the NAV per share is the available shareholders' funds divided by the number of shares in issue. The shareholders' funds are the net value of all the company's assets having deducted liabilities.

Discount

If the share price of an investment company is lower than the NAV per share the company is said to be trading at a discount. The discount is shown as a percentage of the NAV. For example, if the NAV is 100p and the share price is 90p then the discount is 10%.

If the discount narrows there is the potential for enhanced returns. The discount may also widen during the period of your investment, although this will not necessarily lead to a loss on your investment when you come to sell.

Premium

If the share price of an investment company is higher than the NAV per share, the company is said to be trading at a premium. The premium is shown as a percentage of the NAV. For example, if the share price is 110p and the NAV is 100p then the premium is 10%.

Why does a share trade at a discount or a premium?

There are various reasons why a company's shares trade at a premium or discount to NAV. These include: market sentiment towards a particular type of investment or market the company invests in, past performance under a particular manager or the market not understanding the true value of the company. Sometimes demand for a company's shares is low and as a result the price can fall.

The prices of OEICs and unit trusts are calculated depending on the value of their assets, so you can never buy them at a discount to NAV.

How to choose an investment company

There are hundreds of investment companies to choose from, but you can narrow the choices by being clear about why and how you're investing. It is important not to base your decision solely on the basis of a company's past performance as this is not a guide to its future performance.

What do you want from your investment?

Do you want a regular income or are you putting money away for a number of years so it can grow – or do you need a combination of income and capital growth? There are a wide choice of investment companies with specific objectives ranging from a return of high income without capital growth to capital growth only, and other investment companies aim to provide both income and capital returns.

Remember that a company's objectives may not be met. You are not certain to make a profit and may not get back the full amount of your investment in terms of capital. Any income from your investment is not fixed and could fall.

How much risk do you want to take?

Roughly speaking, the level of risk you might be prepared to accept depends on how long you can tie up the money. If you've got time on your side, you can view your investments over the longer term and you may be able to take relatively more risk in exchange for the possibility of higher returns.

Investment companies are primarily intended as long-term investments. As with all equity investments, it is important not to be a forced seller: allow yourself to choose a time to sell that is advantageous to you. Investment companies offer a range of exposure to risk through portfolio and market diversification, use of gearing and capital structure.

Do you want to invest in a particular sector?

Many investment companies only invest in a specific geographical or industry sector, which allows you to choose particular parts of the world or types of company. You can view the range of sectors and companies on our website.

Lump sum or regular investments?

If you have a lump sum available to invest, you can either buy shares in an investment company directly through a stockbroker, an execution only dealing service or via a wrapper product. If you want to make small regular payments, you need to invest via a wrapper product such as an ISA, pension or a savings and investment scheme. Most investment company shares are available through these schemes which are usually run by the management companies of the relevant investment company.

One of the advantages of regular saving is known as 'pound-cost averaging'. Buying your shares monthly smoothes out the highs and lows in the share price over time. This is because you buy fewer shares when prices are high and more when prices are low, thus taking away some of the risk of market timing. The AIC website www.theaic.co.uk has further information on wrapper schemes.

How to invest

Investing with advice

You can go to a professional financial adviser, who will give you advice on what to invest in. Together you can work through all the factors that affect your decision, including your needs and available funds, the performance figures for different companies, and the outlook for different sectors. Your adviser can then advise you on whether investment companies are a suitable investment for you and how to make your investment.

The AIC website www.theaic.co.uk has further information about getting financial advice or you can find a Certified Financial Planner by calling the Institute of Financial Planning on 0117 945 2470 or by going to www.financialplanning.org.uk.

Investing without advice

If you are prepared to select your own investment company you can choose whether to go direct to a stockbroker or an execution only dealing service to buy shares for you. Or you can approach a fund management group to invest via a wrapper product. The AIC website www.theaic.co.uk has further information on wrapper schemes.

Summary

Investment companies can be a good way for smaller investors to benefit from an effective and cost-efficient investment vehicle and to gain exposure to a diversified portfolio. The flexibility and accessibility of investment companies can make them suitable for a wide range of financial planning objectives because of their low minimum investment levels and spread of risk.

For further information

Visit our website

Our website is a good place to start if you want to learn more about investment companies and find detailed information on all our member companies. You can find it at www.theaic.co.uk.

Information factsheets

The AIC publishes a range of factsheets which are available free of charge by calling 0800 085 8520 or can be downloaded from our website.



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