Introduction to Investing in Funds

CHARLES STANLEY *Direct*

Collective investments such as unit trusts and investment trusts remain a popular way to invest.

How do you choose where and how to invest?

Some investors are highly active and enjoy researching and choosing individual shares, bonds and other investments. However, this 'hands-on' approach can have disadvantages. For instance, it can be difficult to obtain enough diversification without incurring high transaction costs, and it can be a challenge to devote enough time to monitoring a portfolio consisting of many different holdings.

This is where collective funds such as unit trusts and investment trusts can offer a convenient solution. These spread your money – and risk – across dozens of different companies and are either managed by a professional fund manager with a defined strategy or designed to simply track an index.

For instance, an equity fund manager typically selects a range of shares, usually 50 to 100, which means less reliance on the performance of any one company. The same applies to other asset types such as bonds or properties. Specific or 'idiosyncratic' risks can be partially mitigated through diversification – not having 'all your eggs in one basket'.

Collective funds can be a cheaper way to invest too. By pooling your money with other investors, you could save money compared to building a portfolio of individual shares yourself, especially if you are investing a modest sum. Paying dealing commission on many individual stocks can add up.

Importantly, you can also gain the expertise of a professional with an established investment process. Active fund managers often engage directly with company management and will analyse a business thoroughly to work out whether its shares represent good value. Although they can and do make mistakes, such as selecting stocks that underperform, they can also sometimes keep you from major pitfalls. Meanwhile, passive funds simply invest in the largest constituents of an index, meaning no human judgments and usually lower costs.

Unit Trusts and OEICs

Unit trusts, and OEICs (Open Ended Investment Companies) are the most common way of pooling investors' money and investing it in a range of assets. The difference between unit trusts and OEICs is in their legal structure - unit trusts are established as trusts whereas OEICs are incorporated as companies, though in practice they are very similar. There are also 'offshore' equivalents of unit trusts and OEICs based in European countries such as Ireland, the most common type being SICAVs.

Being open ended both unit trusts and OEICs expand and contract the number of units or shares in issue according to investor demand: The more people invest the bigger the fund gets, and the manager buys assets with inflows or raises cash to fund outflows accordingly. The price of each unit fluctuates according to the value of the underlying assets and is usually calculated and announced daily.

There are two main types of unit: income and accumulation, often abbreviated to 'inc' and 'acc'. Income units pay out any income generated by the underlying assets whereas accumulation units add this income to the value of the unit, effectively reinvesting the income for you.

Investment Trusts

Unlike unit trusts and OEICs, investment trusts are 'closed ended' funds, which means there is a set number of shares in them. They are traded on the stock market and the price is dictated by supply and demand rather than a calculation of the underlying asset values. This means they can trade at a 'premium' or a 'discount' to their inherent value. Another key difference is that invest-ment trusts are incorporated as companies in their own right and traded on a stock exchange – so like any individual share there is continuous pricing during market hours and you pay stock broking fees when buying and selling.

Many investment trusts can borrow to invest, which most unit trusts and OEICs can't. This can magnify investment returns, but it can also result in greater falls when markets go down. This coupled with the impact of supply and demand on the share price means investment trusts are typically more volatile (have bigger ups and downs) than an equivalent unit trust or OEIC. This could be either an added risk or an opportunity, depending on how you see it.

Investment trusts cover most of the same sectors as unit trusts and OEICs, but there is often more variation in terms of objectives. For instance, they are more likely to cover more esoteric areas, or assets that are difficult to buy and sell such as specialist property, private equity or 'frontier' markets like Africa. A closed-ended structure for these areas is preferable as otherwise fluctuating demand for units would mean the regular buying or selling of underlying assets, which could be difficult to achieve at a desirable price.

Exchange Traded Products (ETPs)

ETP is the collective term encompassing Exchanges Traded Funds (which track the performance of indices of stocks) Exchange Traded Commodities (which enable investors to track one or a selection of commodities), Exchange Traded Currencies (which track the relationship between a pair of currencies) and Exchange Traded Notes (ETNs) that are based on other, often more complex, indices or assets.

ETPs are passively managed – they are designed simply to replicate the performance of an index or with relatively low cost. They do this either by physically holding the assets underlying the index or by holding derivatives – special financial contracts based on the price of an asset. Like investment trusts ETPs are closed ended and are traded on a stock exchange so they can be bought and sold at any time during market hours. Stock broking fees apply when buying and selling.

The advantage of ETPs, and a reason for their increasing popularity, is that they can track the performance of almost any asset or group of assets, including areas that would be too expensive or inconvenient to buy any other way. For instance, to track a sector such as financials or mining an investor can purchase a single Exchange Traded Fund rather than having to buy all the stocks in the sector individually. Similarly, rather than buying a bar of gold (and having to pay for safekeeping), an investor can buy an Exchange Traded Commodity that tracks the bullion price.

The risks of ETPs vary significantly. Not only do they invest in all sorts of different areas, some of which can be exceptionally volatile, but they have a variety of different structures which makes it very important to understand what you are buying. ETP's based on derivatives have additional risks attached. For instance, if a 'counterparty' to the derivatives transaction (often an investment bank) runs into trouble there is a chance the ETP could lose money. For full details relating to the risks of a particular ETP you should read the relevant Key Investor Information Document (KIID) and Simplified Prospectus.

Active versus Passive

Broadly speaking there are two types of investment funds – 'active' and 'passive'. Active funds employ managers to try and select the best performing investments, whereas passive investments such as trackers, or many exchange traded products (ETPs), simply aim to replicate the performance of an index, say, the FTSE 100, usually by holding all or most of the constituents.

Some people are staunch advocates of active investing, whereas for others cost is always the most important consideration – and that generally means going down the passive route where charges are generally lower. However, over the long term a passive approach is almost guaranteed to marginally underperform its benchmark due to charges. It also means the largest weightings are automatically given to the largest components in the index, which can sometimes lead to unwanted imbalance. An active approach, meanwhile, aims to beat the market by taking different stock, sector or, if appropriate, geographical weights.

It is often said that a good proportion of active managers fail to outperform their given benchmark over the longer term. Some are inconsistent stock pickers; others don't sufficiently control risk. However, some that combine thorough research with a disciplined, repeatable process have succeeded over the longer term. Identifying such managers is the aim of our active fund research.

Trackers and other passive funds represent a particularly good strategy for areas where few managers consistently beat the index. For example, large US companies have vast numbers of analysts researching them, making it more difficult to uncover an angle that no-one else has thought of. In sectors such as smaller companies, however, there is much less coverage from the investment community. This is perhaps where active management can work best, uncovering stocks or areas that the wider market doesn't fully appreciate.

The main sectors

Unit Trusts and OEICS are categorised by the Investment Association (IA) into around 30 different sectors, which define the areas in which they can invest.

This helps investors identify investments that might meet their needs and compare similar funds with one other.

Funds in different sectors are exposed to different risks, for example a fund investing overseas can be subject to currency risk – that the foreign currency weakens against the pound, potentially reducing returns. In addition, funds within the same sector can take varying approaches, so investors should always make sure they have read the fund's Key Investor Information Document (KIID) before investing. Below is a summary of some of the more popular sectors:

UK All Companies - funds in this sector invest in UK shares and tend to have a bias towards the FTSE 100, which represents the largest companies on the market. The overall objective is usually long-term capital growth, though there may be several different styles applied such as looking for cheaper 'value' stocks or focussing on high growth areas.

UK Equity Income – these funds invest mainly in UK shares with above-average dividend yields, aiming to provide a rising income alongside growth. Many of the UK's largest and most popular funds are in this sector and it is common for investors to use them at the core of their portfolios.

UK Smaller Companies – funds investing here aim to harness the higher growth potential of smaller companies. However, the risks are also higher, and funds are typically more volatile.

Global – These funds invest in shares from around the world including the UK America, Europe and emerging markets. If you are looking to diversify your investments away from the UK this sector is worth considering.

Global emerging markets – many funds in this area invest in equities from various emerging nations, the largest being China and India. Emerging markets are less mature than those in the developed world, so these funds should be considered high risk and a long-term investment horizon is essential.

Sterling Corporate Bond - these funds mainly invest in UK corporate and government bonds (the debt of these entities) and pay a regular income to investors. There is limited exposure to higher risk, high yield bonds.

Sterling High Yield Bond – funds in this sector concentrate on higher yielding but higher risk company bonds. They generally pay more income but with more risk to capital than other corporate bond funds.

Sterling Strategic Bond – managers of these funds are free to choose from a wide range of bonds with a view to maximising total returns (growth plus income). They don't have to produce a certain yield so may not be appropriate for investors whose priority is regular income.

It is important not to put all your eggs in one basket by committing too much of your portfolio to one area. A spread of funds from different sectors is easy to achieve and can reduce risk while still aiming to generate decent returns.

Multi asset and multi manager funds

The sectors listed above feature funds that invest in specific asset classes and areas. However, there are also funds that invest across different areas and regions. These are known as multi-asset funds, and they can be a convenient solution for the smaller investor looking to access a balanced portfolio with a given level of risk in a single fund.

Asset allocation and investment selection is decided by the overall manager and the portfolio can be invested in individual stocks, bonds and other assets or in collective funds that invest in various areas – or a combination. They can incorporate both active and passive strategies.

An extra layer of management typically increases costs, but multi-manager and multi-asset funds can be a good choice for first-time investors in need of a simple, diversified way to invest in the stock market and/or other asset classes. They could also be a core holding for more experienced investors, around which other holdings can be added. There is more information on Charles Stanley's range of multi asset funds here.

Charges

When investing in funds it is important to consider charges, as they inevitably impact long term performance. For unit trusts and OEICs there is sometimes an initial charge – although this is very rare these days. When you buy investment trusts and ETPs, however, stockbroking commission will be charged plus government stamp duty.

Every fund and collective investment has annual charges to cover running costs and, if applicable, the expertise of the fund management team. For unit trusts, OEICs and ETPs the annual charge is calculated daily and factored into the price. For investment trusts it can be taken in a number of ways but will always be reflected in the net asset value (NAV) of the trust. Charges vary considerably from a small fraction of a percent for trackers to more than 1% or more for actively managed funds. Specialist investment areas may incur higher on-going charges reflecting the additional costs involved with that asset class.

For unit trusts and OEICs it is common for two figures to be quoted – the annual management charge (AMC) for the charges associated with fund management, and the Ongoing Charges Figure (OCF) which also covers all the other administrative expenses of running the fund such as custodian, audit and regulatory fees, but not dealing fees. On the Charles Stanley Direct website, we display a Total Ongoing Charges figure, which incorporates the OCF and other costs, notably underlying transaction costs involved in running the underlying portfolio. This is the most comprehensive figure available.

You should also be aware of performance fees. Some funds, particularly investment trusts, take an extra charge if returns meet certain targets. If performance fees have been taken in the past year this should be reflected in the OCF or TOC figures. All charges are stated in the fund's Key Investor Information Document or detailed on the fund's factsheet.

How to buy funds

Most investors buy and hold funds through an investment platform such as Charles Stanley Direct. This allows you to choose from a wide range of providers and keep all your funds in one place and keep track of them easily online. Investments platforms or 'supermarkets' charge for this administration and custody service. Our highly competitive charges are shown here.

It is possible to invest in funds with as little as £500 as a lump sum. For ETFs and investment trusts there is no minimum, though the dealing charges become proportionally higher the less is invested. Most unit trusts and OEIC funds will also accept regular savings from £50 a month. This can reduce the risk of volatility through 'pound-cost averaging'. In other words, as the fund's value moves up and down, the investor averages their cost of purchase. This can work well for assets that experience a weak period of performance but subsequently recover – although there are no guarantees and you could get back less than you invest.

How to hold funds

Using Charles Stanley Direct it is possible to buy and hold funds in a number of ways. An Investment Account where you can hold a wide variety of shares, funds, gilts, bonds and more is the most straightforward.

However, tax-efficient vehicles should generally be prioritised; specifically, Individual Savings Accounts (ISAs) and Self Invested Personal Pensions (SIPPs). These could save income and capital gains tax and boost long term returns. They can also hold virtually the same range of investments, so it doesn't mean narrowing down your options. Just think of them as a 'wrapper' around your portfolio.

Each year's ISA allowance allows investments to be sheltered from capital gains and income tax. Alternatively, for saving for retirement you make wish to consider a SIPP, which offers income tax relief on contributions depending on your circumstances. For most people a pension is the most tax-efficient means of saving for retirement, but an ISA provides more flexibility to access money when needed. For children a Junior ISA is available with a lower annual allowance.

Choosing collective investments

There are thousands of collective funds available so it can be difficult to know where to start. To help we have created our Foundation Fundlist to provide some ideas for your own research. It rep-resents our preferred investments across the major sectors for new investment and comprises funds where we believe the manager has the potential to outperform over the long term, as well as a selection of passive funds.

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The Taxation of pensions is based on individual circumstances and may be subject to change in the future.
The information contained within this article is based on our understanding of current UK tax provisions, which is subject to change, and the benefits of which would depend on your personal circumstances.
Investors should be aware that past performance is not a reliable indicator of future results and that the price of shares and other investments, and the income derived from them, may fall as well as rise and the amount realised may be less than the original sum invested.

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