Adviser Knowledge Guide

Introducing investment companies

Why use investment companies?

Structural features of investment companies

Practical considerations when using investment companies

Regulation and tax

REITs, VCTs and non-UK investment companies

www.baronandgrant.com

Contents

Important Information

This document has been compiled from the Adviser Centre section of the Association of Investment Companies (AIC) website. The AIC have produced six free guides to help educate financial advisers on how investment trusts can be used to help clients achieve their financial goals.

The AIC has recently launched a new programme of study to help financial advisers, financial planners, and paraplanners strengthen their knowledge of investment companies.

The Investment Company Accreditation consists of four interactive online courses, each providing up to 45 minutes of structured CPD (3 hours in total). On completion of all four courses, participants are awarded the Investment Company Accreditation certificate, demonstrating their knowledge of the structure and features of investment companies.

We encourage all financial advisers, financial planners, and paraplanners to complete the Investment Company Accreditation.

This document is provided for information purposes only and does not constitute investment, financial, tax or other professional advice or a recommendation. It is not intended to be relied upon by you in making (or refraining from) any specific investment or other financial decisions. Relevant advice should be sought before making any financial or investment decision.

We try to ensure that the information provided is correct, but we do not give any express or implied warranty on its accuracy. We do not accept any liability for errors or omissions.

About Baron & Grant

Granton Investment Management Limited was established and incorporated by Christopher Grant and Thomas Poynton on 16th August 2019.

The name of the business was changed to Baron & Grant Investment Management Limited (B&G) when John Baron decided to join the business in July 2020. B&G received FCA authorisation on 4th January 2021.

We are specialists in managing investment trust focused portfolios, complemented by a carefully selected range of exchange-traded funds (ETFs).

This approach is different from the vast majority of investment or wealth managers, who run portfolios consisting largely of direct equities and other forms of collective funds, such as unit trusts and open-ended investment companies (OEICS). Such funds, on average, have been shown to underperform investment trusts over the long term.

We founded B&G to harness the many advantages of investment trusts for the benefit of your clients. A track record of outperformance, a bespoke service, and portfolios tailored to individual circumstances make for a powerful combination.

With the help of others, we also hope to help advisers better understand how investment trusts can achieve financial objectives and dispel some of the perceived myths that have stopped them from recommending them to clients in the past.

As a financial adviser, your clients trust you to provide them with the best investment solutions to meet their financial goals.

Company Information

B&G is a company registered in England & Wales. Registration number: 12161169.

Our registered office is at 66 Lincoln's Inn Fields, London, WC2A 3LH. Our principal office is located at 12A Main Street, Rosliston, Swadlincote, Derbyshire, DE12 8JW.

B&G is authorised and regulated by the Financial Conduct Authority. Firm Reference Number (FRN): 930300.

Our general contact number is +44 (0)1283 387070.

Our general enquiry email address is info@baronandgrant.com.

Introducing investment companies

Investment companies are a type of collective fund. Like other funds, such as OEICs and unit trusts, they provide your clients with easy access to a professionally managed, diversified portfolio of investments to spread risk.

Different types of investment company

There are around 350 investment companies listed on the London Stock Exchange, some of which have existed for more than 100 years. They include:

Investment trusts

These are investment companies that are based in the UK, and which qualify as investment trusts under HMRC rules. The first investment trust, F&C Investment Trust, was established in 1868 and is now listed in the FTSE 100.

Non-UK investment companies

These are based outside the UK, predominantly in the Channel Islands, but listed on the London Stock Exchange. They offer investors very similar benefits to investment trusts.

Real estate investment trusts (REITs)

These are listed investment companies that invest in portfolios of property. Despite the name, they are not 'investment trusts' according to HMRC's definition, but they work in a very similar way.

Venture capital trusts (VCTs)

These are investment companies that invest in small, growing UK businesses. Their investors receive a number of tax benefits. VCTs were established in 1995.

Investment companies manage more than £250 billion of assets across a range of asset classes such as equities, property, infrastructure, renewable energy, private equity and debt.

There are also investment companies with a flexible mandate that invest in more than one asset class.

Trust or company?

Terminology can be confusing. Technically, the term 'investment trusts' refers only to UK investment companies that have investment trust tax status under HMRC rules. However, the term 'investment trust' is often used to refer to any investment company, including non-UK investment companies. It isn't a problem to use the term investment trust in that broader sense as it tends to be more familiar to investors and the general public. It should be remembered that investment trusts are not trusts in the legal sense.

How investment companies are different from other funds

Investment companies have some important similarities with other funds. For example, each investment company holds a diversified portfolio of assets, professionally managed with the aim of delivering capital growth, income, or both. By buying shares in the investment company, you gain access to that portfolio of assets.

Like OEICs or unit trusts, investment companies are available to buy on the majority of adviser platforms, and can be held in tax wrappers such as ISAs or SIPPs.

However, there are some important differences between investment companies and other funds. These are the main ones.

.

Introducing investment companies

Closed-ended structure

Investment companies are 'closed-ended', whereas OEICs and unit trusts are 'open-ended'. Closed-ended funds list their shares on the stock market to allow investors to buy or sell; they do not create and cancel shares on demand like open-ended funds.

Discounts and premiums

Because investment companies' shares are traded on the stock market, their price is determined by supply and demand. This means that price can be either higher ('at a premium') or lower ('at a discount') than the value of the underlying investments.

Gearing

Unlike OEICs and unit trusts, investment companies are allowed to borrow money to make additional investments (known as gearing).

Range of underlying investments

Being closed-ended means that investment companies can invest in less liquid asset classes that other funds cannot offer, such as private equity, venture capital, infrastructure and commercial property.

Governance

Investment companies have independent boards of directors who look after your clients' interests as shareholders. The board can replace the fund manager if performance is not satisfactory.

Income

Investment companies are able to hold back some of their income and pay it out at a time of their choosing. This allows them to deliver a smoother income stream over time.

Investment companies versus ETFs

At first glance, investment companies may seem similar to exchange traded funds (ETFs), given that they are collective funds whose shares are traded on the stock market. However, ETFs are open-ended, in that new ETF shares can be created or redeemed on demand – albeit only by institutional investors in very large blocks.

This ability to create and redeem ETF shares means that ETFs do not tend to trade at significant discounts or premiums – because they are quickly arbitraged away. Like other open-ended funds, they tend to invest in more liquid assets. They are not independent companies with boards of directors, but pools of assets controlled by an asset manager.

Financial advisers and investment companies

Investment companies (investment trusts) fall under the definition of retail investment products alongside OEICs, life insurance products and pension schemes. That means that independent financial advisers (IFAs) should consider them when making recommendations as part of a "sufficient range of relevant products" including different types of product (**COBS 6.2B.11**).

The number of adviser firms recommending investment companies has increased since the Retail Distribution Review came into effect in 2013. Only 580 firms purchased investment companies in 2012, but by 2024, this had increased to more than 1,700.

Financial advisers and wealth managers use investment companies to meet client needs in the following ways.

Introducing investment companies

More consistent income

Investment companies have structural features that enable them to pay a more consistent level of income.

Long-term growth

Investment companies have the potential to deliver strong long-term performance, for example when saving in a pension or saving for children.

Diversifying into less liquid assets

Because of the difficulties that open-ended funds have in holding less liquid assets, such as property and infrastructure, investment companies are often used to gain exposure to these sectors.

Tax planning

Venture capital trusts (VCTs) offer generous tax benefits, including upfront income tax relief, tax-exempt capital gains and tax-free dividends.

Why use investment companies?

Investment companies offer a range of benefits compared to open-ended funds. In this section we look at those benefits, as well as some of the risks of investment companies.

A more consistent income

UK investment trusts are able to reserve up to 15% of their income each year, rather than pay it out to shareholders as dividends. Any reserved income goes into the 'revenue reserve', which can be used to pay out dividends in future.

This means that investment trusts can reserve income in good years, then pay it out in leaner years, smoothing dividends over time.

Some investment trusts have built up impressive track records of increasing their dividends year after year. The "dividend heroes" are investment companies that have increased their annual dividends every year for at least 20 years, without a hold or a cut.

Some financial advisers use investment trusts to provide a reliable income for their clients in retirement. Clearly, income is not guaranteed, and capital is at risk. This can be weighed against the pros and cons of an annuity, which offers guaranteed income at the cost of the client's capital.

What about other investment companies?

Like investment trusts, REITs and non-UK investment companies can also reserve income, but the rules are a little different. REITs can reserve up to 10% of their income (not 15%), while there are no hard-and-fast rules for non-UK investment companies.

Strong long-term performance

Historically, investment companies have outperformed open-ended funds such as OEICs and unit trusts over the long term.

Analysis of investment companies that have the same fund managers as similar OEICs or unit trusts – so-called 'sister funds' – has shown that the investment companies tend to significantly outperform their open-ended 'sisters' over periods of five to ten years.

This should not be surprising, as investment companies have a number of tools they can use to deliver stronger performance, detailed below. However, investment companies will not always outperform open-ended funds. In particular, investment companies can be expected to underperform open-ended funds when markets fall. This is because investment companies use gearing, which magnifies returns, and because investment company discounts tend to widen when markets are falling.

Reasons that investment companies might outperform

While investment companies won't always outperform comparable open-ended funds, there are a number of reasons why they might.

Gearing

Investment companies can borrow money to invest, known as gearing. This can add to performance if returns are higher than the cost of borrowing.

Why use investment companies?

Less cash drag

Investment companies don't need to hold a buffer of cash to meet redemptions.

Fixed pool of capital

A fixed pool of capital is easier to manage, avoiding 'hot money inflows' and redemptions in market downturns.

Size and illiquidity premiums

The fixed pool of capital also makes it easier for investment companies to hold less liquid assets and smaller companies, enabling them to exploit size and illiquidity premiums

More flexibility for the manager

Fund managers can take a long-term view and time their buy/sell decisions better, without having their hand forced by inflows or outflows.

Access to less liquid assets

Investment companies have a closed-ended structure. That means they don't create shares when people want to buy, or cancel them when people want to sell. Instead, investment companies issue a fixed number of shares that are traded on the stock market.

This means each investment company has a fixed pool of capital. Contrast that with open-ended funds, which have a variable pool of capital – one that grows or shrinks as demand waxes and wanes.

The closed-ended structure makes it easier to invest in illiquid assets, such as property, private equity, infrastructure, renewable energy assets and private debt, because investors have access to a liquid market in shares being traded every day, independently of the underlying assets.

It also helps investment companies invest in assets that are traded on markets, but are less liquid, such as small or micro cap companies.

There are various other advantages to investing in less liquid assets using investment companies

Reduced risk of trading suspensions

Open-ended funds that invest in less liquid assets, such as property, have to suspend trading every so often because of redemption pressures or "material uncertainty" about valuations. We saw waves of property fund suspensions during the financial crisis, following the EU referendum in 2016, and during the Covid-19 pandemic. In contrast, investment companies trade as long as the market is open. Trading of investment company shares is suspended only in very rare and exceptional circumstances.

.

Market access

As well as property, investment companies invest in infrastructure, private equity, private debt and renewable energy assets, in addition to some more specialist asset classes such as leasing. It can be difficult or impossible to access some of these assets through other fund structures.

Diversified portfolios

Investment companies offer access to professionally managed, diversified portfolios.

Live market valuations

The share prices of investment companies are determined by supply and demand on the stock market, so the price you see is the market's view of the value of the investment company's portfolio – not the view of the asset manager or a valuer.

Why use investment companies?

Transparency and governance

Investment companies are publicly listed companies. The past performance of an investment company is easy for you to access (for example, on this website) and comparable with other investment companies, open-ended funds or ETFs. Annual reports and other disclosures provide a high level of transparency on the portfolio and investment strategy.

Long-term view

Less liquid asset classes require a long-term approach. For example, an infrastructure contract might run for 20 or 25 years, a distribution centre might have a 15-year lease, and a fast-growing private company might have to wait five to ten years to IPO. Investment companies, with their fixed pool of capital and closed-ended structure, can provide that long-term view, since their underlying portfolios are unaffected by market fluctuations.

Tax efficiency

Investment companies are a tax-efficient way to invest in a wide variety of assets. UK investment trusts and REITs offer similar tax advantages to open-ended funds such as OEICs: for example, gains and income within the fund are almost always tax-free and are only taxed at the hands of the end investor.

Like open-ended funds, investment companies can be included within ISAs, pensions and offshore bonds.

Venture capital trusts (VCTs) offer generous tax reliefs, including 30% upfront income tax relief, tax-free dividends and tax-exempt capital gains.

Risks of investment companies

Investment companies are a versatile vehicle with a long track record and strong performance. However, they do carry risks.

Some of these risks are common to any managed investment fund. For example, there is a risk to capital, any income is not guaranteed and the investment company may underperform its benchmark.

Investment companies also carry a number of risks that are not shared with other kinds of fund. You can read more about these below.

Discounts and premiums

Investment companies tend to trade at a discount or premium to their net asset value. These discounts can change, sometimes significantly. For example, you may buy an investment company when the discount is 5% but then, when you want to sell, find the discount has widened to 15%. This would mean your total return would be worse than it would have been in an equivalent open-ended fund.

Gearing

Investment companies can borrow money to invest, known as gearing. This can benefit performance in rising markets but it will magnify losses when markets are falling.

Liquidity

Investment company shares trade on the stock market. Liquidity is limited by how much people trade the shares. Generally, bigger investment companies are more liquid, while smaller ones are less liquid. There is a risk that buying or selling investment company shares may move the price – upwards for purchases, and downwards for sales.

This is more likely if large blocks of shares are being traded. You can find the average daily trading value of every AIC member investment company on the AIC website.

Corporate actions

Investment companies are publicly traded companies. They are sometimes subject to corporate actions, such as mergers, wind-ups or changes of mandate or strategy. Most of these changes are proposed by the investment company's board after consultation with shareholders, and aim to improve the outcome for shareholders. Shareholder approval is required before these changes can happen.

Structural features of investment companies

Investment companies are funds – diversified portfolios of investments that your clients can buy a stake in. However, they are also companies whose shares are traded on the stock market. In this section, we examine the structural differences between investment companies and the open-ended funds that you might be more familiar with.

Discounts and premiums

An investment company's share price is mostly driven by the value of its portfolio. However, it can also be affected by general sentiment towards the company and other factors. As a result, the share price may be higher ('at a premium') or lower ('at a discount') than the value of the underlying investments.

For example, an investment company with £100m of net assets and 100m shares would have a net asset value per share (NAV/share) of 100p. If the share price was 90p, it would be trading at a discount of 10%. If the share price was 110p, it would be trading at a premium of 10%.

Several factors can affect the discount or premium at which an investment company's shares trade, such as market sentiment, the company's reputation, marketing and PR, and whether big investors are buying or selling.

Historically, the average investment company discount has been narrower in equity bull markets and wider in equity bear markets. However, in recent years discounts have become more closely correlated with interest rates.

Discounts and premiums present both opportunities and risks. Investing at a discount that subsequently narrows could enhance returns over time, but the reverse is also true. For income investors, buying at a discount can mean securing a higher income than would be available from the underlying assets.

Discount control policies

When an investment company's shares trade at a significant discount, the board of the investment company may decide to buy back shares in order to cancel them. This can help to narrow the discount at which the shares trade, as well as increasing the investment company's NAV per share.

An investment company may buy its own shares in the open market, in the same way as any other investor. It may also use tender offers, which is common if a large percentage of the investment company's shares are being repurchased, or it can provide redemption options to investors.

Instead of cancelling the shares it buys back, an investment company might 'hold them in Treasury'. Treasury shares have no rights to capital or income, nor any voting rights. From a shareholder's perspective, the effect is the same as cancelling the shares.

Kinds of discount control policy

A discount control policy may specify that shares should be bought back when the discount exceeds a certain level, say 10% – or at the board's discretion. Other investment companies offer investors regular opportunities to redeem their shares for cash at a set discount. This is particularly common among VCTs.

Structural features of investment companies

Another way to keep discounts in check is to offer continuation votes at regular intervals: for example, every five years. In these votes, shareholders determine whether the company should continue its life or be wound up and the cash proceeds distributed to shareholders.

Though discount control policies can be effective, they shrink the size of the investment company. Beyond a certain point, buying back shares may be counterproductive if the smaller company becomes less attractive to shareholders.

Gearing

Investment companies can borrow money to make additional investments (gearing). When markets do well, this can improve returns, but when they fall, the loss will be greater than it would have been in an ungeared fund.

Not all investment companies use gearing and most use only modest levels. The average level of gearing amongst all investment companies, calculated as borrowings divided by net assets, was 9% at the end of November 2024.

Instead of borrowing money, investment companies can gear by using derivatives, or by issuing debentures or zero dividend preference shares. All these are included in the AIC's methodology for calculating gearing.

Gearing and client suitability

The AIC encourages investment companies to provide a 'gearing range', which indicates the minimum and maximum levels of gearing that a company's board would expect it to have in normal market conditions.

The AIC website also lists each company's gearing policies and borrowing limits, along with the current level of gearing, net cash and historic gearing.

Reviewing this information is useful when considering if an investment company could be a suitable investment for a client.

How gearing affects performance

Change in value of assets	0%	10%	20%	30%
-30%	-30%	-33%	-36%	-39%
-20%	-20%	-22%	-24%	-26%
-10%	-10%	-11%	-12%	-13%
+10%	+10%	+11%	+12%	+13%
+20%	+20%	+22%	+24%	+26%
+30%	+30%	+33%	+36%	+39%

The table indicates how much the net asset value of an investment company might theoretically rise or fall depending on the performance of the underlying assets and how much gearing the company has. The more highly geared the company is, the more any gains or losses are magnified.

Zero dividend preference shares

Issuing zero dividend preference shares (also called zeros or ZDPs) is one of the ways in which an investment company can gear. From the perspective of ordinary shareholders, the zeros have the same effect as borrowing money, and they are included in the AIC's methodology for calculating gearing.

Holders of zeros receive no income, only a capital gain in a set number of years. This is a fixed gain (though not guaranteed) and takes priority over the claims of other shareholders.

Structural features of investment companies

For example, an investment company may raise £100m by issuing 100m zero dividend preference shares at 100p per share. The zeros have a fixed life of seven years, after which they mature, paying fixed proceeds of 140p. Assuming the zeros are repaid in full, the investment company pays back £140 million and all the zeros are cancelled.

Zeros may be useful for clients' tax planning, because they pay no income.

Governance

Investment companies have independent boards of directors who have a legal duty to look after your clients' interests as shareholders. For an investment company, independence means that a majority of board directors must not be connected with the asset manager that manages the portfolio. Typically with an investment company, all directors are independent of the asset manager.

Led by a chairman (who must be independent) the directors meet several times a year and monitor the company's performance. It is their job to appoint a fund manager to manage the assets, and they can replace the fund manager if performance is not satisfactory.

Other duties of the board include:

- Negotiating fees with the fund manager
- Communicating with shareholders through public announcements and general meetings
- Monitoring risks to the investment company and mitigating them where possible
- Ensuring that the investment company's assets are appropriately safeguarded
- Creating and implementing a policy for tackling the investment company's discount if it is too wide
- Deciding if and when new shares should be issued

Though the board controls the company, many important decisions will require shareholder approval. Board members also have to submit themselves to re-election by shareholders at regular intervals.

Outsourced management

Typically, the board will outsource day-to-day investment management to an asset management group. abrdn, Baillie Gifford, BlackRock, Columbia Threadneedle, Fidelity, Invesco, Janus Henderson, JPMorgan and Schroders all manage several investment companies, for example. They are contractors, while the investment company is the client. The board has the right to terminate their contract after an agreed notice period, for example if performance is unsatisfactory.

However, some investment companies are **self-managed**, meaning they employ their own staff to manage the investment portfolio. Again, these managers are overseen by the board of directors and answer to them.

Trading on the stock market

Unlike open-ended funds, investment companies do not create or cancel shares when investors want to buy or sell. Instead, their shares are traded on the stock market (usually, the London Stock Exchange).

This has several consequences for investors:

Discounts and premiums

Shares do not normally trade at the net asset value, but at a premium or discount to it depending on market sentiment.

Structural features of investment companies

Real time trading

Shares trade every second the market is open, rather than just once a day. Generally, you know what price you will pay/receive before you trade (unless your platform aggregates client trades, in which case you may pay lower dealing commissions but there may be more uncertainty over the price).

Trading independent of the asset manager

The asset manager is not a counterparty to trading in investment company shares, so it can't suspend trading. Trading continues between investors even in stressed market conditions.

Bid/offer spread

There is a bid/offer spread; the larger and more liquid the investment company, the tighter the spread is likely to be.

Dealing commission and stamp duty

You will usually pay dealing commission to your platform or broker when you buy or sell. Stamp duty of 0.5% is charged on UK share purchases, and a Panel on Takeovers and Mergers (PTM) levy of £1 on transactions of more than £10,000.

Market impact

If you trade large blocks of shares in smaller investment companies, then your trade may move the price.

Income features

Investment companies offer a combination of features that can make them attractive to income-seeking investors.

Dividend smoothing

Open-ended funds are required to pay out all the income they receive from their portfolio every year. Investment trusts, on the other hand, can reserve up to 15% of their income, which enables them to hold back some income in good years to pay it out in leaner ones. This has led to some investment companies, known as **'dividend heroes'**, being able to increase their dividends for 20 years in a row. Some of these track records extend to more than 50 consecutive years of dividend increases

Gearing

The ability to borrow to invest means that some investment companies are able to pay a higher income (assuming the yield on the assets they invest in is higher than the cost of the borrowing).

Wider range of income sources

Investment companies can invest in a wide range of assets, including illiquid assets. Assets like property, infrastructure, renewable energy and private debt may offer a higher income than conventional equities and bonds, or an income stream that is not correlated with the income from conventional asset classes. This may help when constructing an income portfolio for your clients.

Structural features of investment companies

Paying dividends out of capital profits

Investment companies are not restricted to paying dividends only from the income they receive from investments. They can also use the profits they make when they buy and sell investments. Only a handful of mainstream investment companies take advantage of this ability. Dividends distributed from capital profits are taxed like any other dividend.

Different kinds of income distribution

Most investment companies pay out income in the form of dividends, but a few pay out different kinds of distribution, which can affect how your client is taxed.

Practical considerations when using investment companies

If you haven't used or recommended investment companies before, there are several practical considerations to bear in mind before doing so. In this section, we explain the fees and charges of investment companies, look at what a research process might include, and discuss the important question of platform availability.

Fees, costs and expenses

Fees and costs vary widely between investment companies. As you would expect, they tend to be lower among investment companies that invest in mainstream equities, and higher in alternative sectors.

There has been an ongoing debate for a number of years around the disclosure of investment trust costs within retail products and services. Previously, trusts were subject to the Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation and the Markets in Financial Instruments Directive (MiFID), both adopted directly into UK law before Brexit.

UK-listed investment trusts operate on exactly the same basis as all other publicly traded shares. As listed corporate entities, investment trusts have share prices. Investors in investment trusts buy shares, pay the share price, and then sell shares and receive the share price.

They have expenses (including management fees) that are deducted from their NAVs, but known expenses are discounted in the share prices of listed corporate entities. This is as true for investment trusts as it is for the shares of any other corporate entity like Shell, BP, Marks & Spencer or Next.

No other listed share is required to disclose its expenses as a percentage of NAV and separately display this to an investor as being a direct deduction from their portfolio value. This is because these costs are already reflected in their share prices. Investors receive the share price, not the NAV.

In acknowledgement of the issue, the FCA issued forbearance in November 2023 to give investment trusts greater ability to explain their costs and charges to consumers. On the 19th September 2024, HMT and the FCA issued new regulatory forbearance to temporarily exempt investment trusts from complying with cost disclosure requirements, with the aim of bringing in wider reforms in 2025.

On the 7th October 2024, the government published draft legislation for a new Statutory Instrument called 'The Packaged Retail and Insurance-based Investment Products (Retail Disclosure) (Amendment) Regulations 2024'.

The draft bill seeks to permanently exclude investment trusts from PRIIPS and MiFID regulation and proposes that they will not have to produce a Key Information Document (KID), a standardised information document prepared for products within the scope of the PRIIPs.

A striking line from the draft bill said, *"It is broadly accepted by industry and the government that the single aggregated figure that is being produced under current EU-inherited rules is not an accurate representation of the actual cost of investment in shares in an investment trust."*

External costs

External costs include dealing costs and taxation. They are not costs that are taken out of the assets of an investment company. Instead, they are borne by investors when they buy, sell or hold investment company shares. These costs are not included in the ongoing charge presented on the AIC website, or in other cost disclosures made by the investment company.

Practical considerations when using investment companies

Some external costs are levied by your platform or broker, such as **dealing commission** and any **custody charges** for holding investment company shares. The **bid/offer spread** is an implicit cost that is borne by investors when they trade shares.

Taxes and levies include **stamp duty** of 0.5% when you buy shares in a UK investment trust (not applicable to non-UK investment companies, investment companies quoted on AIM, or newly issued shares) and the Panel on Takeovers and Mergers (PTM) levy of £1 on transactions of more than £10,000.

Income and capital gains from investment companies are taxable in the normal way unless investment company shares are held within an ISA or a pension.

Researching investment companies

Researching investment companies is like researching other funds. As with open-ended funds, they are divided into a number of sectors for convenience and ease of comparison, so it makes sense to narrow down your research to a particular sector.

As with open-ended funds, you will want to consider an investment company's mandate, strategy and investment process. You can look at the fund manager's track record and tenure, and assess past performance versus a benchmark and/or sector peers. You can also review the fees and costs (see above). For income-focused clients, dividend yield and history will be important.

However, there are some additional elements to add to your research process for investment companies, over and above those you would consider for open-ended funds.

Discount or premium

Although the discount or premium should never drive an investment decision, it should be considered. Caution should be used in buying investment companies on high premiums, and for any discount or premium that differs greatly from the sector average, you may want to investigate the reason for this difference. The AIC website allows you to compare the current discount or premium of an investment company with its history (under the 'Performance' tab of an investment company's information page). You may also want to find out if the investment company has a discount control policy and how effective this has been in reducing discount/premium volatility in the past.

Gearing

The AIC website provides three useful pieces of data on gearing for its member companies: the current level of gearing, historic gearing and gearing range. The historic gearing is the highest and lowest levels of gearing over the past three years. The gearing range is the minimum and maximum levels of gearing expected to be used in normal market conditions. This last piece of data is particularly useful when assessing whether an investment company will be suitable for a client.

NAV returns

NAV returns are performance figures for investment companies that exclude the effect of the discount/premium and any discount/premium changes. In other words, they are the returns of the underlying portfolio of the investment company. When researching investment companies, NAV returns can give a clearer picture of the performance actually achieved by a fund manager.

Practical considerations when using investment companies

Share price returns, on the other hand, are affected by the change in discount or premium of investment company shares over a given period, which is not under the fund manager's direct control.

Liquidity

The AIC website gives average daily trading values for all member investment companies on the 'Overview' tab of an investment company's information page. Larger investment companies usually have more shares traded and a narrower bid/offer spread. Liquidity is more important for institutional investors than for advised clients, whose trades are unlikely to have significant market impact. Larger investors in investment companies will tend to exclude investment companies below a certain size (market capitalisation) from their consideration.

If you are less familiar with investment companies and liquidity is a concern for you, you can start by considering larger and more liquid investment companies.

Research sources

You can access investment company data on the AIC website (for free), or you can use your usual research tools, such as FE Analytics or Morningstar Advisor Workstation. Investment company annual and semi-annual reports are another valuable source of information, along with monthly or quarterly factsheets where relevant. Reports and factsheets can be easily accessed on the AIC website for every AIC member company.

Platform availability and costs

The FCA Handbook states that independent financial advisers must take steps to ensure that the platforms they use offer a comprehensive selection of investment products (**COBS 6.2A.4A**).

Fortunately, investment company shares are available on the vast majority of adviser platforms.

Charges associated with holding investment companies on platforms vary from one platform to another. They typically include dealing charges for buying and selling shares, administration charges based on a percentage of assets held on the platform, and (more rarely) a fixed charge for adding certain investments to a client's portfolio, including investment companies.

Regulation and tax

In this section, you'll find a simplified summary of the laws and regulations that protect investors in investment companies. While the taxation of investment companies is very similar to that of open-ended funds, there are a few differences to bear in mind, also covered below.

How investment companies are regulated

Investment companies operate in a broad and sophisticated regulatory regime designed to protect investors and ensure appropriate levels of governance and transparency.

Given the wide range of different regulatory protections, we can only provide a basic overview of the main elements here. This guide focuses on the position that applies to most AIC member companies, namely a fully listed investment company which complies with the AIC Code of Corporate Governance and outsources its management to an external UK-based asset management firm ('the fund manager') which acts as the company's Alternative Investment Fund Manager.

Company law and the independent board

Being formed under company law, investment companies are owned by and run for the benefit of their shareholders. Unlike other funds, an investment company is governed by a board of directors who are under legal duties to look after the interests of the company's shareholders.

Shareholders get to vote on the appointment of these directors on a regular basis. Under the Listing Rules, this board of directors must be independent of the fund manager. This means that a majority of directors on the board must be independent, and the chairman must be independent.

Investment companies are also required to prepare financial statements each year which are audited by an independent auditor.

Corporate governance rules

Under the Listing Rules, companies are required to report against a corporate governance code, such as the UK Corporate Governance Code. However, members of the AIC can report against the AIC Corporate Governance Code, which has been endorsed by the Financial Reporting Council as a means of meeting their corporate governance reporting obligations.

As part of meeting its governance obligations, an investment company will establish an Audit Committee made up entirely of independent non-executive directors. A key function of the Audit Committee is to review and report on the adequacy of the company's internal control and risk management systems.

Listing Rules

The Listing Rules ensure that the investment company abides by certain general principles such as acting with integrity and treating shareholders of the same class equally. It also sets more specific obligations, such as rules regarding the composition of the board to ensure that it is capable of acting independently of the fund manager and the requirement to publish an investment policy and ensure that assets of the company are managed in accordance with that policy at all times.

The Listing Rules are set and enforced by the FCA.

Regulation and tax

The fund manager

The day-to-day management of the company will be outsourced to the fund manager, which will be authorised by the FCA.

In addition, the fund manager will usually act as the company's Alternative Investment Fund Manager (AIFM) under the Alternative Investment Fund Managers Directive (AIFMD). The AIFMD is an extensive piece of regulation which imposes many rules on the AIFM in respect of risk management in relation to the investment company.

One key requirement is for an independent depositary to be appointed. The depositary is similar to a custodian and has obligations to hold the assets of the company and keep them safe, but also has additional oversight obligations to ensure that the rules of the AIFMD are being complied with.

Under the terms of the AIFMD, the depository is held to a strict standard of liability for any loss of assets that it is holding in custody and can be compelled to make restitution for such losses or other losses that arise due to its own negligence or fraud.

Obtaining redress

It is important to remember that poor investment performance, of itself, does not provide the basis for compensation. For compensation to be due, it would have to be shown that a loss arose due to the negligence, fraud etc of a particular party. Due to the regime outlined above, these types of problem are extremely rare.

If there were an issue which resulted in financial loss to the company and which was the fault of the fund manager, or another supplier to the company, this would usually affect all shareholders. It would therefore be for the independent board to take action on behalf of all shareholders to seek redress. Given the resources available to the board, this can be a more practical way to address such issues than shareholders taking legal action themselves and ensures that all shareholders can receive any compensation that may be due.

Investment companies are not covered by the Financial Services Compensation Scheme (FSCS), as the FSCS is designed to provide compensation where an individual, who is a customer of an authorised firm, has a claim against that firm which it is unable to pay (e.g. due to going bust).

Investment companies are not authorised firms and investors in investment companies are shareholders, not customers. Investment company shareholders are therefore in the same position as shareholders in any other listed company and exercise their rights collectively through the board of directors.

If investment company shares are held on a platform which is provided by an authorised firm, then the FSCS applies to the platform. Should that platform fail, any financial loss in respect of investors' holdings in investment company shares could be eligible for compensation from the scheme, assuming the other conditions of the scheme were met.

Regulation and tax

Investment companies and the NMPI rules

Non-mainstream pooled investments (NMPIs) are investments that independent financial advisers cannot recommend to their ordinary retail clients. These may include open-ended funds, ETFs and investment companies.

However, if an investment is an 'excluded security', then it will not be considered to be an NMPI and therefore can continue to be recommended to ordinary retail clients, subject to normal suitability requirements. The majority of the shares and securities issued by AIC members will be excluded securities, as they are issued by investment trusts, REITs and VCTs or other companies which meet the relevant conditions to be excluded.

However, as the definitions of NMPI/excluded security are complicated, the AIC publishes a list of those shares and securities which AIC member companies have confirmed to the AIC are 'excluded securities'. This list is updated monthly. Where the member company has made a public statement on this issue, we include a link to this statement.

If an investment company share or security does not appear in this list, this does not necessarily mean that it is an NMPI. It may be that the company is not a member of the AIC, or has yet to make a statement confirming its position. You should contact the company or its manager if you require further information on this point.

The taxation of investment companies

Investment companies, like other funds, are designed to be tax-efficient investments. Little or no tax is paid by the investment company itself; instead, investors pay tax when they receive income or realise a capital gain on their investment.

Like open-ended funds or ETFs, investment companies are eligible for inclusion in tax wrappers such as ISAs and pensions. They can also be included in offshore bonds.

The key differences between the taxation of investment companies and other funds, such as OEICs and unit trusts, relate to two areas: stamp duty on the purchase of some investment company shares, and the different tax treatment of income from UK REITs, VCTs and some investment companies that invest in bonds or debt.

Stamp duty

Stamp duty reserve tax, to give it its full name, is charged at 0.5% on the purchase (but not sale) of investment company shares. Stamp duty does not apply to shares in non-UK investment companies, or to shares quoted on AIM. It is charged only when shares are bought on the secondary market; if you buy newly issued shares, for example in a VCT, there is no stamp duty to pay.

In addition to stamp duty, there is a Panel on Takeovers and Mergers (PTM) levy of £1.50 on any transactions of more than £10,000, both purchases and sales.

Regulation and tax

Tax on income from UK REITs

A UK REIT is a type of investment company that buys properties and rents them out. REITs pay no corporation tax on profits from their rental business as long as they distribute 90% of these profits to shareholders. When shareholders receive property income distributions from the REIT, they must pay income tax (not dividend tax) on those distributions at their marginal rate, unless the REIT shares are held in a tax wrapper such as an ISA or pension.

Tax on income from VCTs

VCT dividends are not taxable.

Income streaming

A small number of UK-based investment trusts that invest in bonds, loans or other forms of interest-producing assets distribute income under 'income streaming' rules introduced by HMRC in 2009.

These rules allow income that derives from interest (as opposed to dividends) to be distributed to investors without the investment company needing to pay corporation tax on that income. Investors who receive those distributions must pay income tax (not dividend tax) on them at their marginal rate, unless the shares are held in a tax wrapper such as an ISA or pension.

Not all investment companies that hold interest-producing assets make use of the income streaming regime. This may be because they are not tax-resident in the UK and not subject to UK corporation tax, or because they hold only a small part of their portfolio in interest-producing assets.

REITs, VCTs and non-UK investment companies

The AIC's members largely fall into four categories. There are UK investment trusts, real estate investment trusts (REITs), venture capital trusts (VCTs) and non-UK investment companies.

All of these are diversified, closed-ended funds with their shares listed on the London Stock Exchange. They are also companies in the legal sense, with independent boards of directors. However, there are some important differences between them that relate to tax, legal structure and the payment of income. This section explains these differences.

Non-UK investment companies versus UK investment trusts

The non-UK investment companies that are members of the AIC are very similar to UK investment trusts. Like UK investment trusts, they are companies whose shares are listed on the London Stock Exchange, subject to the LSE's Listing Rules – which means the same standards for disclosure and transparency.

Most non-UK investment companies with an LSE listing are based in Guernsey or Jersey. A handful are based in other jurisdictions such as Bermuda, the Cayman Islands, the Isle of Man and Luxembourg.

While the detailed tax rules of these jurisdictions are different from those of the UK, the end effect for a UK investor is very similar. In both the UK and the other jurisdictions, policymakers allow the fund itself to pay little or no tax, recognising that gains and distributions are taxed in the hands of shareholders.

Shares in non-UK investment companies, like those of investment trusts, may be held in ISAs and pensions. They may also be held in tax-efficient insurance wrappers, such as life insurance and capital redemption policies and life annuity contracts.

There is no stamp duty to pay when you buy shares in a non-UK investment company. For UK investment trusts, this is levied at a rate of 0.5% on share purchases.

Why are some investment companies based outside the UK?

Historically, some investment companies that invested in property or fixed income opted for a non-UK tax base to avoid being subject to double taxation (once inside the company and again when shareholders received dividends or sold their shares). However, since the UK's introduction of REITs in 2007 and the income streaming regime in 2009, companies that invest in these assets can now be based in the UK without incurring a corporation tax liability.

Naturally, an investment company's choice of jurisdiction will depend on factors such as the ease of doing business, costs and convenience. Several non-UK jurisdictions are well established within the funds industry and make an attractive home for investment companies even where they offer little or no tax advantage over the UK.

Real estate investment trusts (REITs)

Investment companies that invest in property may or may not be structured as UK real estate investment trusts **(UK REITs)**. When the term REIT is used in this guide, it refers to UK REITs only.

REITs are investment companies that:

- Own commercial or residential property and rent it out

REITs, VCTs and non-UK investment companies

- Are obliged to distribute 90% of the profits they make from their rental business to shareholders
- Do not have to pay corporation tax on profits or gains from the rental business

Tax on REITs

Shareholders in REITs pay income tax, not dividend tax, on distributions from rental income. The general idea is that they are taxed as though they owned the properties themselves. Of course, if REIT shares are held in a tax wrapper such as an ISA or SIPP, no tax is paid on the distributions, making REITs a tax-efficient way to invest in property.

Because of the tax-efficiency of the REIT structure, almost all investment companies that invest in UK property have elected to become REITs – even if they are incorporated in other jurisdictions, such as Guernsey or Jersey.

A company that is incorporated in Guernsey or Jersey can opt into the UK REIT regime without changing its country of incorporation. Wherever UK REITs are based, they are treated for tax purposes as if they were based in the UK, with one exception: there is no stamp duty to pay when buying shares in non-UK investment companies.

Not all property investment companies are REITs

Not all investment companies that invest in property are REITs. Generally speaking, if investment companies invest in non-UK property, they will not use the REIT structure. The REIT structure will be used when it is beneficial to shareholders.

Not all REITs are investment companies

Some REITs, such as British Land, Land Securities and Big Yellow Group, are trading companies. Their main business is developing property rather than renting it out. These trading company REITs are not eligible to be members of the AIC and you won't find their details on the AIC website.

Venture capital trusts (VCTs)

Young, innovative businesses often struggle to raise finance to help them expand. **VCTs** help to bridge this 'finance gap' by allowing smaller investors to pool their resources and invest in a diversified portfolio of businesses to spread risk.

Though the companies VCTs invest in start small, and are high risk, they can become household names in the future, helping to create jobs and economic growth. So the government offers generous tax benefits to compensate your clients for the risks involved.

Upfront income tax relief

This is offered at 30%, provided that VCT shares are held for at least five years. This means, for example, that an investment of £10,000 in new VCT shares could reduce a client's income tax bill by £3,000 for the year in which the shares were bought. If the shares are sold before five years has elapsed, the tax relief will be clawed back by HMRC.

No capital gains tax

The disposal of VCT shares does not attract capital gains tax. By the same token, no relief is available on losses.

REITs, VCTs and non-UK investment companies

Tax-free dividends

VCT dividends are tax-free. This is an important relief as many established VCTs pay dividends. A typical target yield for a VCT is 5%, and special dividends may be paid in some years, for example if there is a particularly successful exit. Dividends are of course not guaranteed and may be cut or cancelled without warning.

The VCT rules

In return for providing these incentives, the government requires that within three years of a VCT raising money, it must invest 80% of that money in 'qualifying companies'. Broadly speaking, qualifying companies are UK businesses that are less than seven years old and below a certain size. They are companies that would be likely to struggle to raise financing for growth from banks or institutional investors.

VCTs as investment companies

In many ways, VCTs are like other investment companies. They are quoted on the London Stock Exchange with boards of directors who are independent from the fund manager. All the usual rules of disclosure and transparency apply. They are closed-ended funds, so they do not create new shares when investors want to buy in. Instead, each VCT decides how much new money to raise each year. Some VCTs may not raise any money at all in some years, if they feel they have sufficient cash in the portfolio to take advantage of any investment opportunities that may arise.

If a VCT is popular, it may complete its fundraising very quickly, sometimes within weeks or even days. If you are interested in fundraisings from a VCT manager, you can ask to be put on that manager's distribution list. You can also use websites like **Tax Efficient Review** or **Wealth Club** to keep track of VCT fundraisings.

Many VCTs offer to buy back their shares from investors at a set discount to the net asset value. This can provide a useful way to exit the investment, if the five-year minimum holding period has elapsed. However, VCTs are best seen as long-term investments.

Registered Office: 66 Lincoln's Inn Fields, London, WC2A 3LH

Principal Office: 12A Main Street, Rosliston, Swadlincote, Derbyshire, DE12 8JW

www.baronandgrant.com 01283 387070 info@baronandgrant.com

Christopher Grant MCSI - Chief Executive Officer

D: 01283 387070
M: 07900 050306
E: chris.grant@baronandgrant.com

John Baron CBE MCSI - Chair of Investment Committee

D: 01283 387070
E: john.baron@baronandgrant.com

Tom Poynton Chartered MCSI - Executive Director

D: 01283 387031
M: 07458 109961
E: tom.poynton@baronandgrant.com

Harvey Hosein Chartered MCSI - Investment Associate

D: 01283 387030
M: 07458 109960
E: harvey.hosein@baronandgrant.com