

Understanding investment trust charges

THE TRUTH ABOUT CHARGES

Investment trusts have long enjoyed a reputation for low charges.

You'll probably weigh up many factors when choosing investments. Analysing your investment objectives, time horizons and attitude to risk come first. Past investment performance, length of service of the manager and the strength and reputation of the provider are also fundamental. Charges and fees usually come further down the list but they are still worth investigating.

Recently we've seen much more emphasis being given to charges - and rightly so. But it's also important to note that low cost doesn't always equate with quality. Especially as it can be difficult to compare charges like-for-like. It's easy to be fooled by attention grabbing headline figures and advertising claims like 'no charge' - but this usually just refers to the initial charge. It's worthwhile looking at all the charges in detail because, over the long-term, annual charges and other expenses can have a more significant effect on your fund's performance than the one-off initial charge.

Over the next few pages we look at how investors can benefit from low charges and the impact of annual charges and total expense ratios on fund performance.

A quick guide to the different types of charges on investment products:

It is important to distinguish between the charges that are made within the investment trust and the extra charges that are external to the fund.

■ Charges made within the fund itself

These include the annual management charge (or staff costs), auditors and custody fees, directors' fees and marketing costs. These charges within the fund are known as the Total Expense Ratio or TER. The TERs quoted by the AITC are calculated by Fitzrovia International Ltd which has extensive expertise in this area. Fitzrovia's aim is to calculate TERs which are consistent and comparable across investment trusts and other funds.

There has also been a growing trend among collective investment funds over recent years to introduce performance-related fees for fund managers. The basic principle for reward is one of outperformance of a relevant benchmark, set out by the board of directors. Fund research company Fitzrovia International has made a study of performance fees and concurs: "The basic concept of investors paying more for truly superior investment management can be described unequivocally as a fair one, provided the incentive fee is properly constructed and reflects 'real' index-beating performance."

■ Extra charges made outside the fund

These are charges that usually occur at the time of the transaction.

- (i) **The 'spread'** - the difference between the buying and selling prices set by independent marketmakers. The spread varies according to the number of shares being purchased and the availability of the shares on the market.
- (ii) **Dealing charge** - for actually carrying out the transaction in the shares (including stamp duty for purchase only).
- (iii) **Charges to buy and sell a wrapper product** - if you buy or sell through an ISA, pension or other saving and investment plan, there are likely to be additional administration charges.
- (iv) **Exit charge (sale only)** - sometimes known as the withdrawal/switch or transfer fee for a sale through an ISA, pension or other saving and investment plan.
- (v) **Charges for advice** - if you choose to take professional financial advice there will either be the IFA's fee to pay or the IFA will receive commission from the product provider. Commission can be paid up-front (known as initial commission) and/or annually (known as trail commission).

INVESTMENT TRUST CHARGES: WHAT YOU NEED TO KNOW

Investment trusts have long enjoyed a reputation amongst investment professionals and advisers for offering good value to investors. Investors can have their savings professionally managed in an investment trust often for a fraction of the cost of other investments.

Investment trusts are one of the most transparent investment vehicles around. In fact, one of the key roles of an investment trust's independent board of directors is to ensure that the fund's internal charges aren't excessive and that the interests of shareholders are looked after.

But what exactly are all the costs?

1. Charges made within the fund, included in the Total Expense Ratio

The Total Expense Ratio is a way of expressing the operating expenses incurred inside the fund over a year. These include:

- Annual management charge/staff costs:
These vary depending on the fund but you can generally expect to pay between 0.25% and 1% a year for the external management of your investment trust. The staff costs you would pay for self-managed funds will be at the low end and may even be as low as 0.15% per annum. If you choose a tracker fund, charges can be as low as 0.25% a year. And, the rate of investment trusts' annual charges are often reduced as the total size of the investment trust increases - you'll find more about this later in the factsheet.
- Other Expenses:
These can include auditors' and custody fees, directors' remuneration, marketing and promotion costs and secretarial costs. These are mostly charged against the revenue account, but some may go to the capital account. These fees are usually clearly identified in the report and accounts of the investment trust.

2. Charges made within the fund, not included in the Total Expense Ratio

The Total Expense Ratio, as calculated by Fitzrovia, excludes the following costs which may appear in the expenses section of the report and accounts of the investment trust company: stamp duty, brokers' commissions, bank interest, performance fees, restructuring costs and any loss/gain on currency.

INVESTMENT TRUSTS ARE DIFFERENT

Investment trusts have a board of directors who are responsible for looking after the interests of shareholders, the owners of the company.

They are directly answerable to the shareholders who can vote directors off the board if they don't look after shareholder interests.

Therefore, boards ensuring lower charges can bring significant advantages to investors, especially as investment trusts are so versatile. They can be used in a variety of financial planning situations including: investing for children, ISAs and pension provision.

However, many providers of pensions and ISAs have to make additional charges for running these tax efficient wrappers which are not part of the investment trust's internal charges and therefore are not included in the annual report - so it's necessary to check the key features document if you're thinking about an investment trust pension or ISA.

To learn more about investment trusts and how they can help you make the most of your savings please call us free on **0800 707 707** or visit our website at **www.itsonline.co.uk** for further information.

3. Extra charges made outside the fund

■ Initial charges:

These can vary from nil to around 4% depending on the type of investment trust you choose, whether you decide to take advice and how you buy them. You can buy investment trust shares through a stockbroker, an IFA, an execution only share dealing service, a Fund Manager's saving and investment scheme or an ISA or pension product.

The cheapest way to buy is almost certainly through a Fund Manager's savings scheme - and it may come as a surprise that these can be used for lump sum investments as well as regular savings. Most schemes have a minimum investment starting from £50 a month (and some are prepared to accept even smaller amounts, for example £25 a month) and one-off lump sums of just £250.

By investing monthly you also avoid committing all your savings to the vagaries of the stock market on any particular day. This drip-feeding of money means that every month you buy shares in a particular investment trust company, so you take advantage of any share price volatility to smooth the overall price you pay over time. This is called 'pound cost averaging'.

■ Stamp Duty:

Stamp Duty of 0.5% is payable on all share purchases by investors.

Sometimes you do need to look at the detail

The Total Expense Ratio figure can appear small and insignificant. But, remember, you're bearing this cost year in and year out for as long as you hold your investment. Costs mount up and, over the medium to long-term, have the effect of dragging down the performance of the fund and the income paid to you or re-invested in the fund.

Should I just choose the fund with the lowest TER?

Unfortunately, it's not that simple. Charges are only one of the factors to take into account. Some of the best performing funds have higher charges than some of the worst performing funds.

TOTAL EXPENSE RATIOS - WHAT THEY ARE AND WHY THEY'RE IMPORTANT

A Total Expense Ratio is simply a single percentage figure showing the proportion of a fund's assets that is consumed by the operating charges incurred in the fund in the period under review, usually a year. That's not just the annual management charge but also all the other expenses of running a fund we highlighted earlier.

Providing this information for investors is a statutory requirement in the US mutual fund industry where the Securities and Exchange Commission "recommends that investors assess a fund's costs, which can have an enormous impact on returns." In the UK investors buying a packaged product such as a savings plan, an ISA or a pension will receive a key features document. This will include projections stating the impact of charges (both initial and annual) over a period of time on a hypothetical investment using a pre-determined growth rate. This information is provided when the investment is made.

The difference between the Total Expense Ratio (TER) and the annual charge

Even when a figure (say 1%) is quoted as 'the annual charge' it's usually only the charge made for the investment management of your fund. It doesn't include other costs such as directors' fees, custody and audit fees. The TER is a single percentage showing the proportion of a fund's assets consumed by all annual operating expenses.

Here's an example:

(This fund example is for illustrative purposes only and does not represent a specific investment trust)

An investment trust has average net assets over a year of £24,336,692.

The quoted annual management charge is 1.3% - this equals £316,377 over a year.

But the actual total of all operating expenses over a year equals £553,000. This would be expressed as a TER of 2.27%.

Source: Fitzrovia International.

So, when you're comparing different types of investment products, TERs are a fairer and far more accurate indicator of charges and their effect on your fund's performance rather than simply relying on the quoted annual management charge.

For comprehensive figures on TERs visit our website at www.itsonline.co.uk

According to Fitzrovia, UK and Global Growth investment trusts with net assets of £1 billion or more have an average Total Expense Ratio of 0.36%.

Source: Fitzrovia International Post-Tax NAV TER October 2001.

Large investment trusts are a very efficient way of managing money. They are owned by shareholders for the benefit of shareholders and their independent boards of directors ensure that economies of scale benefit investors, not the fund manager.

We've seen that differences in cost can have a big impact on fund performance. Charges however, are only one factor to take into account when choosing investments but, over time, lower charges are likely to help funds produce superior returns. And, investment trusts have a significant head start - particularly when it comes to those all-important annual charges and expenses suffered in the fund.

WHAT TO DO NEXT

Choosing investments can be complex. You'll need to decide why you are investing and for how long - do you want income, capital growth or a combination of the two? You also need to consider your appetite for risk and whether you want to invest in a specialist sector (such as emerging markets or technology) or whether you would prefer to stay closer to home with an investment in the UK.

Only then can you draw up a short list of the investment funds that suit your criteria - maybe selecting those with a proven track record or particularly good prospects for the future. When you've got your short list of funds you can start comparing their TERs.

Here we've been able to give only a brief outline; an expert will be able to give you more detailed advice relating to your particular circumstances.

For further information...

Visit our website

Our website is a good place to start if you want to learn more about investment trusts and how they can help you get the most from your savings. It also gives Total Expense Ratios for all investment trusts. You can find them on www.itsonline.co.uk

Contact an Independent Financial Adviser

If you would like any further information or advice, you should contact an Independent Financial Adviser (IFA). You can get the details of three IFAs in your area by calling 0800 707 707.

Look out for this symbol



Investment trusts regularly advertise in the national and financial press - just keep your eyes open for the symbol above.

Information factsheets

The AITC publishes a range of factsheets which are available free of charge by calling 0800 707 707.

- its for investment trusts
- its for income or capital growth
- its understanding risk
- its split capital investment trusts
- its for pensions
- its for children
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For investment trust performance statistics visit www.itsonline.co.uk



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