

INVESTMENT COMPANIES

MADE SIMPLE GUIDE





Read all of our Made Simple Guides online at <https://www.plsa.co.uk/Resources/Made-Simple-guides> or scan the QR code below



ACKNOWLEDGEMENTS

Written and the sponsored by the Association of Investment Companies (AIC) and independently reviewed by the Pensions and Lifetime Savings Association. We would like to thank the AIC for its help in producing this guide.

For more information on the AIC, individual investment companies, sector statistics, and insights into the sector please visit:

www.theaic.co.uk or contact enquiries@theaic.co.uk

aic The Association of Investment Companies

For professional clients, qualified investors only. This guide is for information only. It is not legal or investment advice.

Published by the Pensions and Lifetime Savings Association
© First published: May 2023

CONTENTS

Why read this guide?	4
What are investment companies?	6
Case study: Securing the benefits of real estate investment.	11
Your questions answered	14
Trustee checklist	19



WHY READ THIS GUIDE?

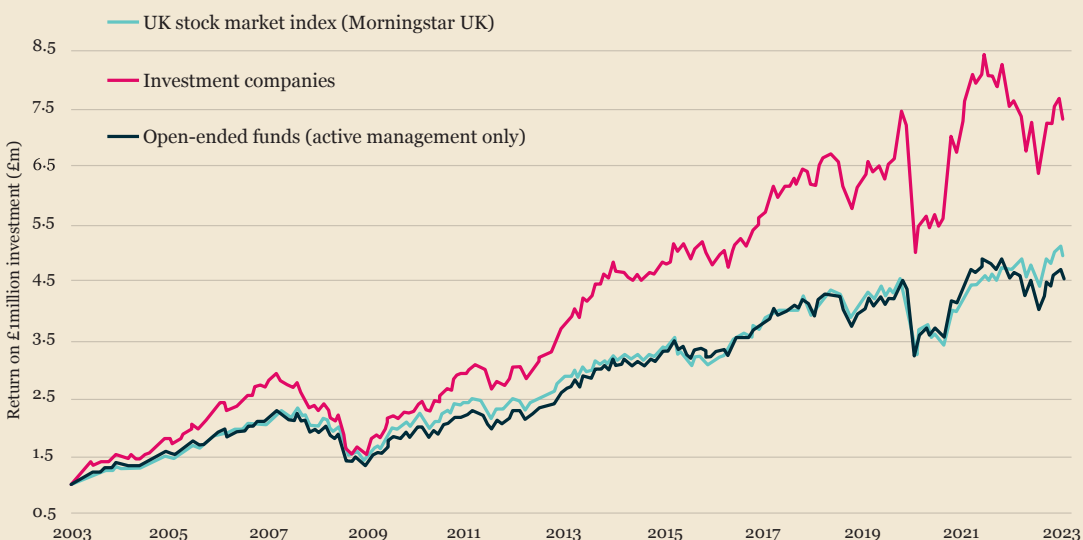
THE PERFORMANCE OF INVESTMENT COMPANIES, OFTEN KNOWN AS ‘INVESTMENT TRUSTS’ OR, WHERE THEY INVEST IN PROPERTY ‘REAL ESTATE INVESTMENT TRUSTS (REITS)’, SHOWS THAT LONG-TERM EXPOSURE TO THE SECTOR COULD SUIT THE NEEDS OF A WIDE RANGE OF PENSION FUNDS AND THEIR BENEFICIARIES.

Investment companies can offer schemes superior returns and additional diversification. The structure incorporates several advantages which, when combined, and compounded over time, help deliver strong long-term performance. Higher interest rates, changing inflation expectations and liquidity problems in other funds all provide a justification for giving the sector another look.

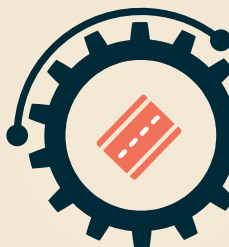
While the past is not a guide to the future, looking back at the sector’s record can offer insights to inform a strategic view of investment options.

Exposure to UK equities used to be a significant element in pension scheme asset allocation, although the sums dedicated to this asset class have reduced significantly over the years. In the early 1970s, and from the mid-1980s until the turn of the millennium, average allocations were over 50%. Since 2000 the allocation has steadily fallenⁱ. Since 2010 the average has sat below 20%. Today some estimates put it under 5%ⁱⁱ. Irrespective of the level of investment in UK equities, trustees and their advisors will want to consider the best way to achieve their desired allocation, the quality of the structures used and how these factors may affect returns for beneficiaries.

FIGURE 1: UK EQUITY RETURNS COMPARED BY INVESTMENT STRUCTURE



Source: AIC/Morningstar. Data to 31/3/2023





A pension scheme using investment companies, starting in January 2012 to gain actively managed exposure to UK equities would, on average, have secured a 48% higher return compared with an index tracker. It would have outperformed actively managed open-ended funds (OEFs) by 61%ⁱⁱⁱ. This was achieved across a variety of market conditions.

This record suggests that the fundamental pros and cons of competing investment structures should be considered when reviewing a scheme's investment approach and that it is worth exploring if investment companies should be part of scheme holdings. These questions are not only relevant for domestic or international equity exposure. Investment companies have much to offer trustees considering options to invest in 'alternative' assets, which are an increasing part of the investment company sector.

24% of Defined Contribution (DC) pension schemes already have some allocation to Real Estate Investment Trusts (REITS).^{iv} Any scheme with these holdings could use other types of investment company to purchase other assets, be they listed or private.

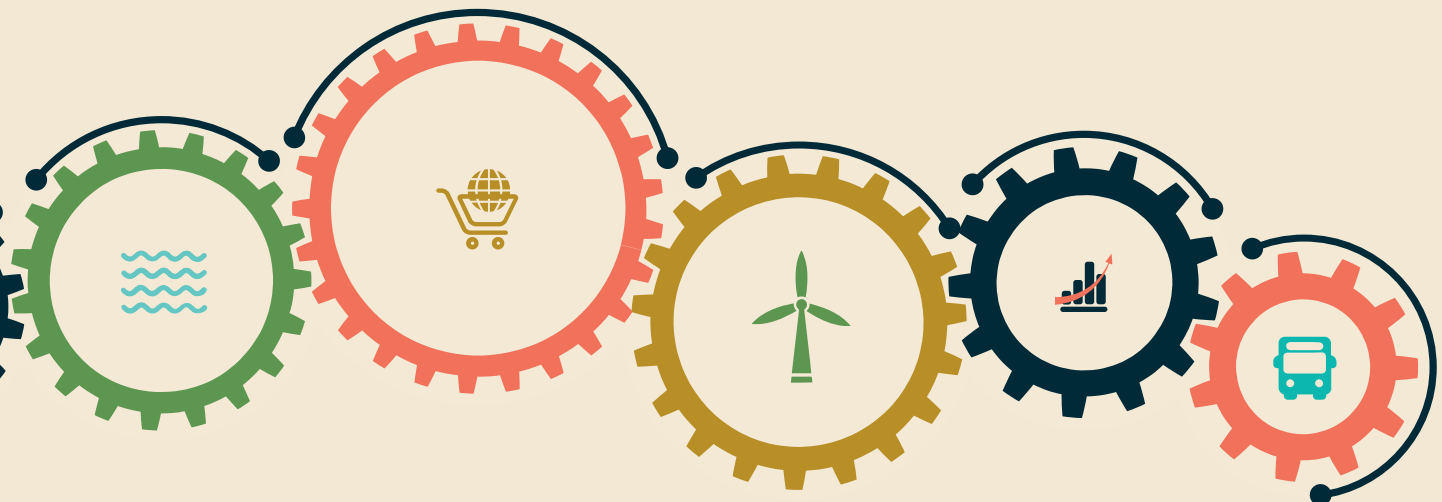
This guide also explores questions which trustees may have before they take steps towards using investment companies to deliver their investment objectives.

I hope it will help start a conversation between pension fund trustees and their advisers about whether, and how, investment companies can be considered as part of the investment mix.

Thank you for your time and willingness to engage with this debate.

A handwritten signature in black ink, appearing to read 'Richard Stone'.

Richard Stone
Chief Executive
Association of Investment Companies



WHAT ARE INVESTMENT COMPANIES?

INVESTMENT COMPANIES ARE COLLECTIVE INVESTMENT FUNDS. THEY OFFER ACCESS TO A DIVERSIFIED PORTFOLIO (WITHIN AN ASSET CLASS OR ACROSS A VARIETY OF ASSET CLASSES). THEY ARE DESIGNED TO SPREAD RISK AND SECURE AN INVESTMENT RETURN.

The sector is made up of 377 companies with over £260 billion of assets under management. Their investment strategies target income and growth, or a combination of both. They differ in important respects from other funds.

CLOSED-ENDED AND OPEN-ENDED STRUCTURES

Investment companies are closed-ended funds. They have a fixed, or 'permanent', pool of capital. Trading in their shares is achieved via the stock market.

This is very different from 'open-ended' funds, which are commonly held by pension funds. Open-ended funds (OEFs) have variable capital, meaning that as they receive investment, they grow larger. The operator creates units and cash is added to the fund's portfolio. This cash is then invested into the target assets. When investors leave an OEF the manager pays the redeeming investors in cash. If cash is not readily available, the manager is likely to sell assets. The assets of an OEF grow or reduce according to whether more investors are entering or leaving the fund.

Investment companies work very differently. They raise capital when they are launched. The number of shares in issue at any one time is fixed: the amount does not depend on whether there are investors wanting to buy into or exit their investment.

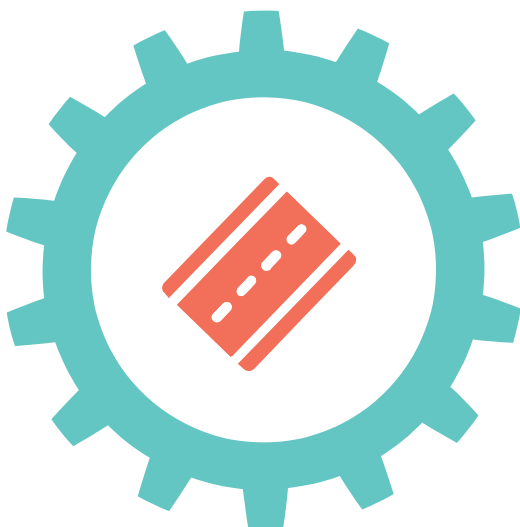
Investment companies can increase the number of shares available by issuing more shares. They can decrease the number by buying them back and cancelling them. However, this is done when it suits the company and its shareholders. The company controls the process; it is not determined by the prevailing demand for the shares.

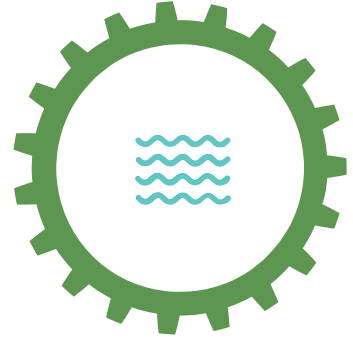
Investors buy and sell shares in the investment company via a broker or platform. This process does not involve the company or its asset manager. The balance of trading does not force the company to buy or sell assets from the underlying portfolio. This is a key difference with OEFs.

The closed-ended/permanent capital structure offers significant investment advantages.

Strong adherence to the investment fundamentals: Market conditions, and investor sentiment, does not force changes in the composition of the portfolio. Assets are bought or sold according to the asset manager's view on whether they are the best option to deliver the investment strategy. There is no redemption requirement which could put pressure on a manager to sell holdings.

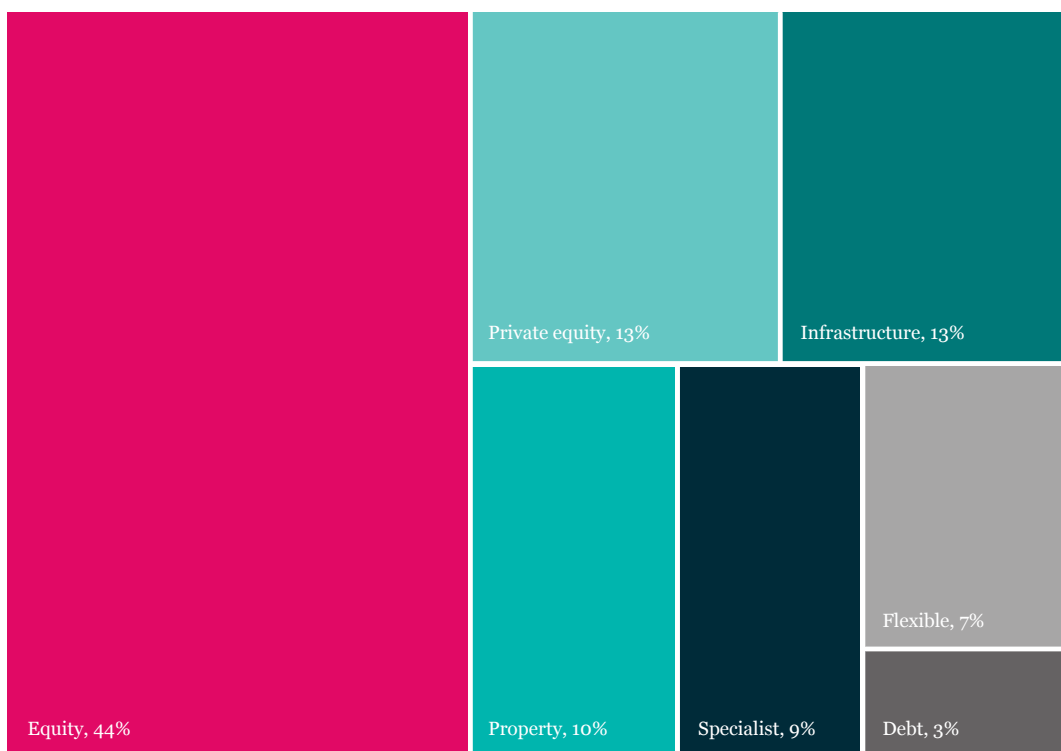
In contrast, where there are sustained redemptions from OEFs, managers may sell assets with long-term attractions where they offer the best route to raise money quickly to pay exiting investors. A similar issue arises where OEFs receive strong inflows of money. Cash received must be invested irrespective of the merits of the investment opportunities.





Options for diversification: Investment companies offer a wide range of asset classes and strategies. Many of these are not available using an OEF.

FIGURE 2: INVESTMENT COMPANY SECTORS (BY ASSETS)



Source: AIC/Morningstar. Data to 31/03/2023.

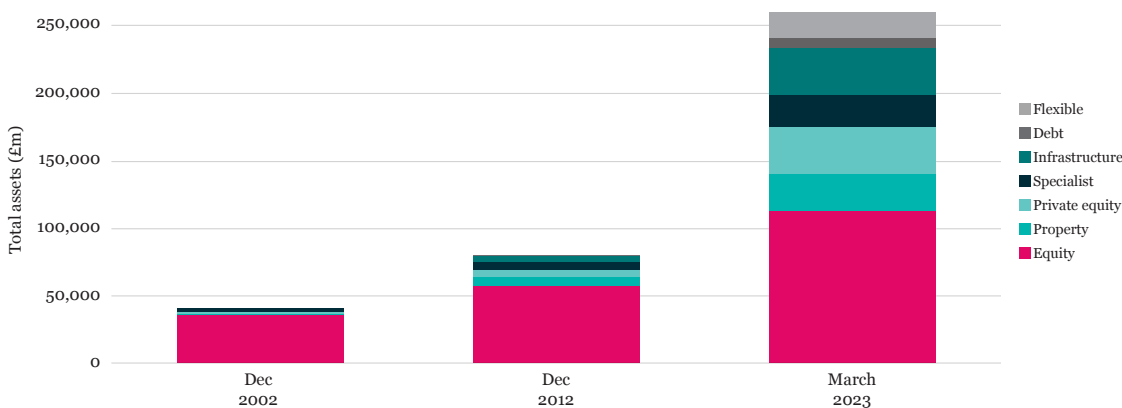
Asset classes include private equity, renewables, infrastructure, and less liquid debt. Private equity and infrastructure are now the two largest alternative asset classes available within the investment company sector. Investment companies have also pioneered new asset classes such as music rights. The sector's exposure to these 'alternatives' continues to increase.

The sectors shown above can be further divided into more specific investment options and strategies. Infrastructure, for example, includes a sub-sector of renewable infrastructure (energy storage, renewable generation etc.) which may help to deliver scheme sustainability preferences as well as providing a return. The property sector includes tailored strategies, such as logistics.

Options for diversification using investment companies will only increase as interest in alternative asset strategies develops and new companies are launched.



FIGURE 3: INCREASING INVESTMENT COMPANY DIVERSIFICATION



Source: AIC/Morningstar. Data to 31/03/23.

Full exposure: Investment companies are fully invested in the target assets. OEFs, particularly those holding less liquid assets, such as real estate, may hold cash for liquidity management purposes alongside the target assets. For example, OEFs holding real estate have tended to hold 20% or more of the portfolio in cash^v. This means that investment companies and OEFs targeting the same sectors may have a different return profile. Even small increases in exposure to cash can have a big impact on returns when compounded over time.

Controlled gearing: Investment companies have the capacity to gear. That is, to borrow to invest in assets. They aim to generate a long-term return greater than the cost of debt (which, in recent years, has been exceptionally low by historical standards). If the cost of debt is, say, 3% and the return on the assets is 5%, once the debt has been serviced the investors benefit by the difference. In this hypothetical example, an additional 2%. Of course, if the performance is negative, then the investment company must service the debt out of other resources. This reduces the return to investors. So, gearing can magnify risks and losses, but also provides the potential for increased returns.

The sector uses gearing modestly. Half of investment companies do not use gearing at all. Of the 172 companies that do, half of them (85 companies) have gearing of less than 10%^{vi}. So, for these companies, for every £1 million of shareholders' funds, the company has borrowed less than £100,000. Other specialist structures, such as limited liability partnerships, use gearing far more aggressively, with gearing over 100%. Investment companies tend to be far more conservative. Gearing levels are disclosed and can easily be monitored. Even modest gearing creates the capacity for greater returns over the longer term.

An investment company's decision to gear creates no obligation to provide capital to the company irrespective of how the investment performs. The gearing is self-contained. There is no call on the assets of the pension fund or obligation to provide collateral.

If gearing within an investment company creates unacceptable risks, then it can be avoided by holding companies which choose not to use this feature of the structure.



Reliable liquidity: Stock market trading is dependable. Even during the most economically turbulent period of the Covid-19 pandemic, markets remained open.

OEF liquidity depends on the fund being able to raise cash to pay for redemptions. In tough markets this can be a challenge. When cash cannot be raised, action must be taken to ensure fairness to investors. In the most difficult circumstances this can involve fund suspensions. In recent years suspensions have been common for property funds. Investment companies have not been affected in the same way by market turbulence. They may trade on wider discounts, but investors have the choice of whether to sell or not.

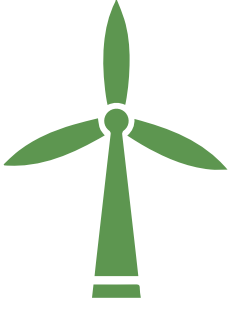
Innovations in the open-ended sector have been designed to maintain redemption offers, including in difficult markets, for less liquid assets. The Long Term Asset Fund (LTAF) is intended to address the balance between offering reliable redemption and holding less liquid assets. To achieve this LTAFs will have notice periods of at least 90 days before cash can be taken from the fund. They will offer dealing opportunities no more than once a month. Investment companies holding the same assets will have shares admitted to trading on the stock market which can be transacted on any business day.

GOVERNANCE

Each investment company is overseen by a board of directors. The directors have legal duties to run the company in the interests of its shareholders. Investment company boards usually outsource the day-to-day operation of the company (portfolio management, administration etc.) to one or more external providers, most commonly a UK authorised asset manager. The UK Listing Rules require the board to be independent of the external manager. These arrangements help deliver significant investor benefits.

Running the company in the long-term interests of shareholders: For an investment company, the ‘consumer’ and the ‘owner’ are the same. This focusses the decision-making process on the long-term interests of shareholders. This means the board takes decisions without a potential conflict of interest between customers and owners.

Value for money: The board negotiates fees and service levels with suppliers to deliver the investment mandate and secure value for money. This process has seen many fee reductions in recent years. This has included reducing the basic fee (usually charged as a percentage of assets under management). Other approaches have included adopting ‘tiered’ fees, where the board agrees a lower fee rate on the management of assets over a certain threshold of assets. This secures economies of scale (and is not an arrangement seen in the open-ended sector). Another clear trend has been removing performance fees.



In 2022, 27 boards negotiated new fee arrangements, which have reduced overall costs for shareholders. This is a continuation of a longer trend. Between 2018 and 2023, 163 companies have agreed lower fee arrangements (involving a mix of the approaches set out above). Given trustees' caution about performance fees, it is notable that 30 companies removed these arrangements since the start of 2016.

The board's options are not limited to fee negotiations. Other changes might include enhancing the resources devoted to servicing the mandate or adjusting the mandate itself to deliver a better long-term outcome for shareholders. More fundamental measures include replacing an underperforming manager or merging the company with another. Companies can be liquidated if the board concludes that the best option is to return capital to the shareholders. These decisions will be taken with investor interests in mind: some (such as liquidations) require shareholder agreement.

Equal treatment: All shareholders in the same class of shares (most investment companies only issue one share class) get the same treatment, paying the same fees.

Shareholder democracy: Shareholders get to vote on key issues affecting the company, including changes of investment policy, share issuance, whether to wind up or continue the company and the appointment of directors.

Transparency: Stock market rules require transparency. Where market or other commercial developments could affect the value of the company, this information must be disclosed. The market sets the company's share price based on public information.

FIGURE 4: KEY FEATURES OF OEFs AND INVESTMENT COMPANIES

OPEN-ENDED FUND	INVESTMENT COMPANY
Open-ended (no. of shares varies)	Closed-ended (no. of shares fixed)
Redemption via the product provider	Shares traded on public stock market
Dealing frequency according to terms	Daily dealing
Dealing at Net Asset Value	Dealing at market price
Typically invested in liquid assets	Both liquid and alternative assets offered
May use cash buffers to manage redemptions	Fully invested in target assets
No independent board	Independent board
No shareholder democracy	Shareholders vote on critical issues
Multiple share classes	Usually one share class

CASE STUDY: A BETTER WAY TO INVEST IN REAL ESTATE?

SOME PENSION FUNDS SEEKING EXPOSURE TO PROPERTY HAVE USED OEFs FOR THIS PURPOSE. INVESTMENT COMPANIES OFFER A POTENTIALLY ATTRACTIVE ALTERNATIVE.

ACCESSING LIQUIDITY

Open-ended property funds are usually marketed as daily redemption vehicles. This is consistent with pension scheme needs to rebalance portfolios and cater for transfers etc. Daily redemptions have been delivered in good markets. Daily redemption has been less dependable in uncertain market conditions. Open-ended property funds have suffered significant, prolonged periods of suspension in recent years.

One or more (sometimes all) daily traded property funds have been suspended for nearly two and a half of the last 10 years - a quarter of the entire period.

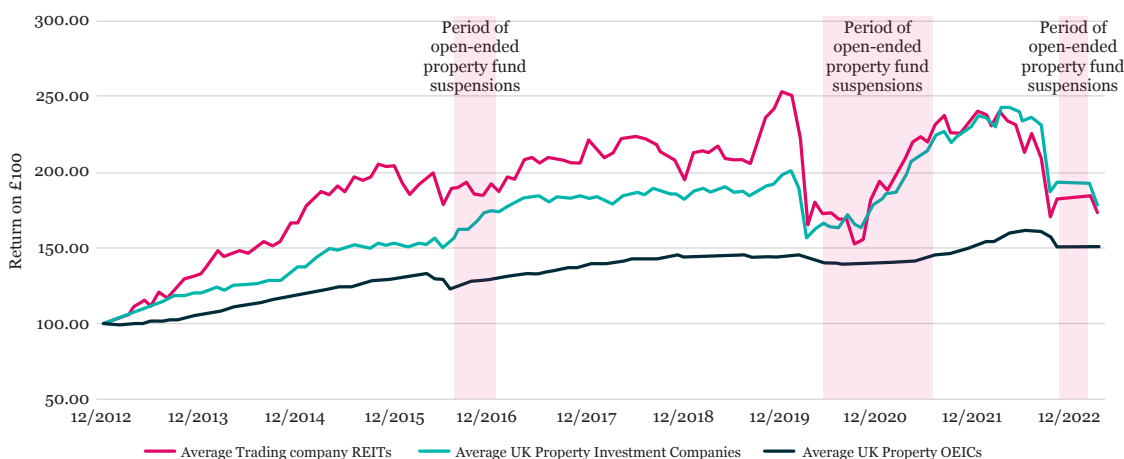
Trading in large parts of the open-ended property sector was suspended after the Brexit vote. Real estate OEFs also suspended during the Covid-19 pandemic. The reason given by some funds was '*material uncertainty*' of asset values. Where assets cannot be valued with confidence, suspension protects investors so that departing investors are not over/underpaid (either result being unfair). However, this is only part of the story. One of the largest OEF property funds suspended in December 2019 – before Covid-19 had affected the UK. The whole sector remained suspended long after material uncertainty over valuations was resolved. This reflected liquidity pressures within the sector, where assets could not be sold swiftly enough to manage the demand for investors to leave.

Investment companies traded via the stock market throughout these periods. They did suffer share price falls when conditions were tough, but investors had the choice of liquidity if they wanted to exercise their option to sell.

INVESTMENT RETURN AND VOLATILITY

Over the last ten years the performance of investment companies investing in property has steadily overtaken OEFs in the same market. This was achieved in good and poor markets (see Figure 5).

FIGURE 5: PERFORMANCE OF PROPERTY INVESTMENTS COMPARED (AVERAGE RETURN)



Source: AIC/Morningstar. Data to 31/03/23



Figure 5 also shows how trading company REITs have performed over the same period. These equities share some of the features of investment companies holding property. Both are exempt from UK corporation tax on rental income and capital gains from selling qualifying property businesses. They are traded on the stock market and have similar governance arrangements.

Some are similar to investment companies but, because of their internal management structure, have not been identified as funds. Others are not pure collective investment vehicles and are more active in developing real estate. Development activity brings with it additional operational risks. Trading REITs are not subject to the same type of regulation, including, for example, the need to provide retail investors with Key Information Documents (KID), which identify the costs of investment. The difference in cost disclosure may encourage some schemes to hold trading REITs because the expenses within the company are not included in the cost cap applying to default Defined Contribution Pension schemes. The fact that trading REIT costs are not disclosed does not mean that these expenses do not arise: the difference is that they are less transparent than when they occur within an investment company REIT.

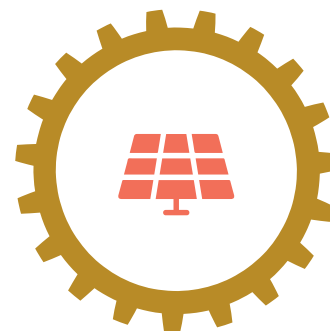
However, holding trading REITs brings with it other issues to consider. Average trading REITs' performance has been positive over the last ten years and outperformed their investment company counterparts for some of that period. The last few years has seen both sectors achieve similar returns. Over the period as a whole, trading REITs have been significantly more volatile. Lower volatility may be an important consideration for trustees, particularly where their scheme is likely to experience high or growing levels of drawdowns and as general economic conditions are becoming more uncertain.

As economic conditions have become more testing in the last two years, the outperformance of trading REITs has been lost, and the sector has continued to exhibit much higher levels of volatility.

DIVERSIFICATION

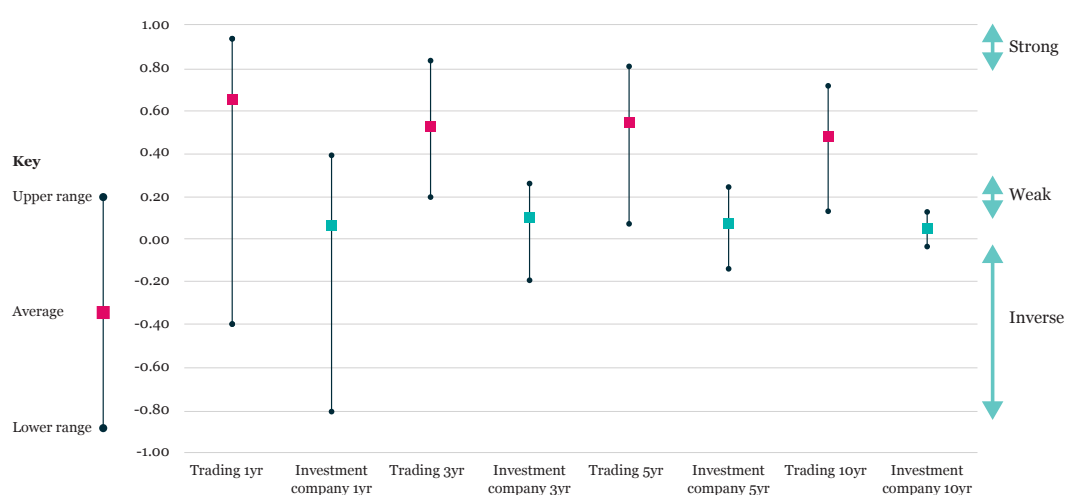
Diversification to manage portfolio risk is a well established process and holding property is an important component in offsetting equity market risk.

Open-ended property funds may provide some diversification from equities. However, the reason for this is partly explained by their level of cash exposure, as cash is uncorrelated with the market. The amount of cash held in these funds is not predictable. In times of net outflows, cash holdings are likely to fall. In times of inflows, they may rise - movements out of the control of investors.



Investment company REITs also offer diversification in the stock market in a way that OEFs do not. This diversification is greater than that provided by trading company REITs.

FIGURE 6: CORRELATION OF REITS WITH UK STOCK MARKETS COMPARED



Source: AIC/Morningstar. Data to end 31/03/2023

A fairly strong positive correlation would be 0.8. Weak positive correlation would be in the range of 0.1 to 0.3. In every period shown investment companies holding property have been significantly less correlated with UK stock markets than their trading REIT counterparts. The average correlation has been lower. Also the range of correlation (high to low) has been narrower and lower for investment companies.

LOOKING TO THE FUTURE

Pension scheme allocations to property may well change in the future. Many factors, such as the reliability of OEF redemption, higher interest rates, and the asset allocation decisions of schemes will influence these decisions.

Nonetheless, where property exposure is part of the asset mix, there is a case for looking again at whether investment companies could provide an attractive option for gaining access to these investments.

Property has been highlighted here, but the merits of holding other assets, including listed securities and other alternatives, such as private equity, unquoted debt and infrastructure using investment companies also deserves similar reevaluation.

YOUR QUESTIONS ANSWERED

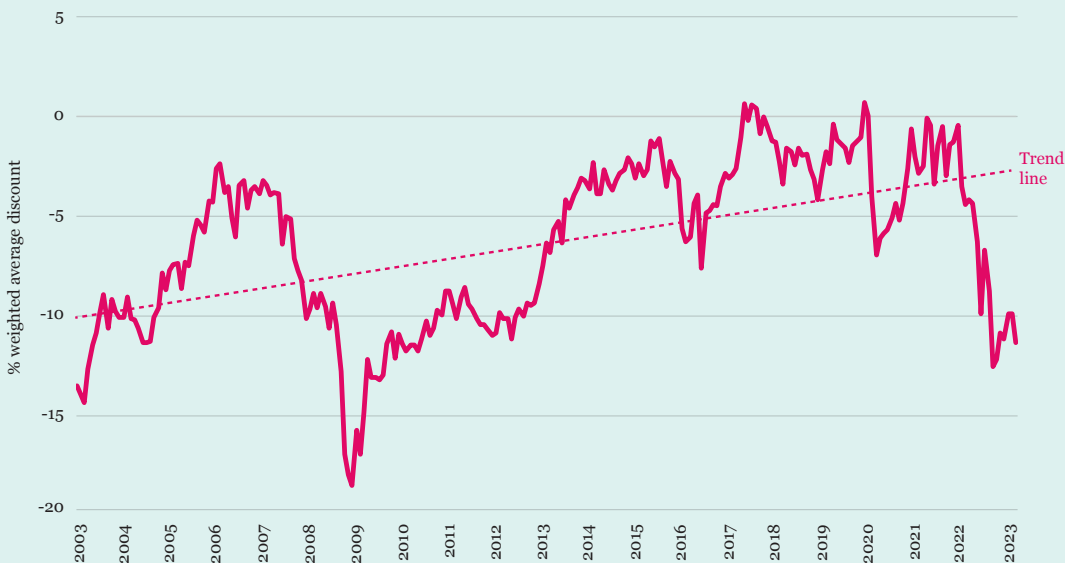
Q: WHAT IS A 'DISCOUNT'?

Investment company shares trade at the market price. This price will usually differ from the market value of the portfolio's assets.

Investment companies publish asset values (net of liabilities) on a regular basis. This Net Asset Value (NAV) is a key component in determining the share price. For listed equities NAVs are published daily. NAVs of companies holding private assets, such as property or private equity, may be published monthly, quarterly or every six months. The stock market price is also influenced by investor sentiment towards the asset class, investment style or manager and the prevailing level of demand.

These factors mean that shares will trade at a premium (higher) or discount (lower) to the portfolio's NAV. The trend across the sector has been to narrower discounts. This is the result of new approaches to discount control management and attraction of certain asset classes, which have meant that some companies have traded at a premium. Narrower discounts mean investors more reliably capture the performance of the underlying assets.

FIGURE 7: AVERAGE INVESTMENT COMPANY SECTOR DISCOUNT

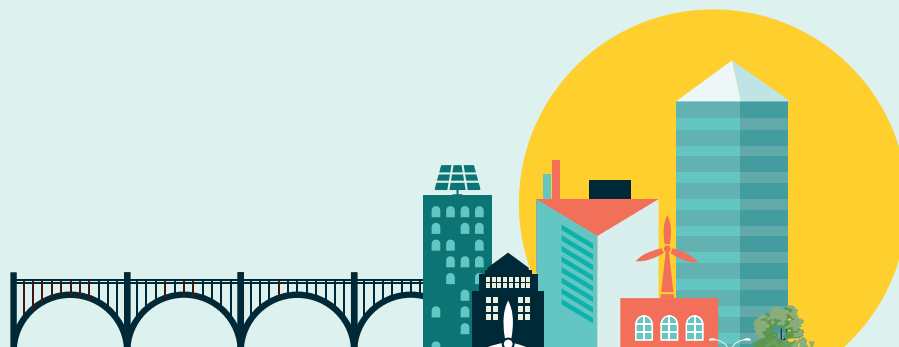


Source: AIC/Morningstar. Calculated at each month end. Data up to 31/03/23

Discounts do tend to widen in periods of market turbulence. The chart shows this effect during the financial crisis in 2008/9; after the Brexit vote; at the start of Covid-19 and following Russia's invasion of Ukraine and the emergence of higher inflation. When certainty increases discounts tend to narrow.

Q: WHAT ARE THE IMPLICATIONS OF DISCOUNTS FOR INVESTING?

Existing investors tend to prefer stable or narrowing discounts. For those contemplating investment, discounts can be an opportunity. In effect, they allow investors to purchase assets for less than they are valued.



Where an investor is seeking income, purchasing at a discount can provide an enhanced yield. If assets worth £1 are yielding 5%, an investor buying them at a share price of, say, 90 pence (a 10% discount) is securing a yield of 5.5%.

The pros and cons of shares trading at a different price from the NAV should be balanced against other factors, including the investment advantages of a permanent capital structure and independent governance. The implications of discounts tend to reduce where investment company shares are held over the longer term.

Q: ARE INVESTMENT COMMITMENTS REQUIRED?

Other closed-ended funds, such as limited partnerships, do require investors to commit to provide further capital, perhaps to pay management fees or make further investments. Shareholders in investment companies have no obligation to make further investments in shares. They can buy or sell according to their investment preferences.

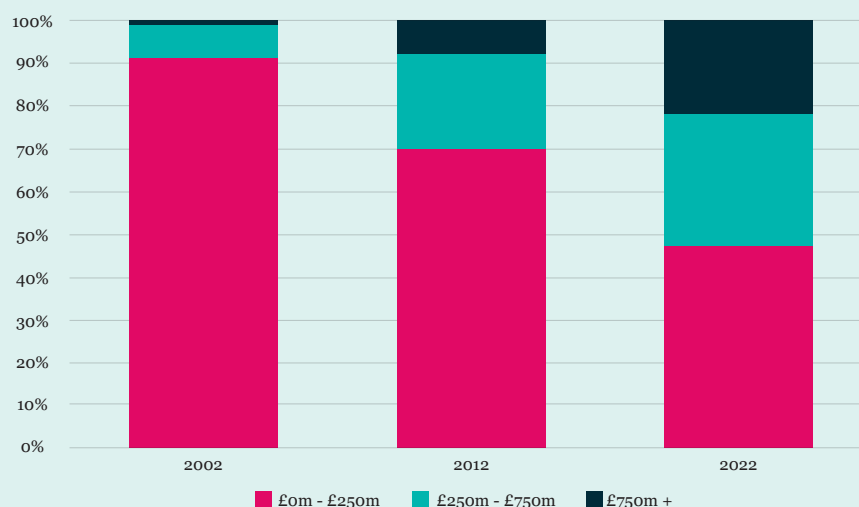
Q: HOW MUCH LIQUIDITY DO INVESTMENT COMPANIES OFFER?

UK stock markets offer reliable trading. They continued to operate as expected, for example, during the height of the Covid-19 economic turbulence.

Pension schemes considering investment companies will nonetheless consider their liquidity needs when making investments. Trustees and managers will want to be sure that any shares they hold can be traded, as required, in an orderly way, without affecting the share price. The view of any individual company share would be informed by its individual liquidity profile.

The growth in the market capitalisation of investment companies means that more of the sector could meet the liquidity needs of a wider number of pension schemes.

FIGURE 8: INCREASING SIZE OF INVESTMENT COMPANIES



Source: AIC/Morningstar. Data to end Dec 2022.



In 2002, 90% of investment companies had market capitalisations of less than £250 million. Companies of this size now represent less than half of the total market capitalisation of the sector. Just over 20% of the sector is made up of companies with market capitalisations of over £750 million.

To look at this another way, investment companies now make up 93 of the largest 350 companies listed in the UK. Four of the largest 100 listed companies are investment companies. The shares of companies with a higher market capitalisation tend to be traded in higher volumes and therefore offer more liquidity.

A scheme's advisors and asset manager can manage a scheme's liquidity requirements in several ways. They might limit exposure to larger investment companies. The manager could plan to buy several companies offering similar exposure and investment strategies, spreading liquidity demands over more than one stock. This could also provide diversification benefits. The manager could also manage the flow of trading by selling the shares in batches over a few days.

The liquidity offer of investment companies can be compared with other structures, notably those offering access to alternative assets.

Once launched, LTAFs will offer access to illiquid assets. LTAFs will offer dealing opportunities once a month and impose notice periods of at least three months. The price received by investors leaving an LTAF will be determined at the end of the notice period, not at the point when a redemption request is made. The value of assets may rise or fall during that period.

Schemes considering OEF property funds, LTAFs or investment companies for alternative exposure will need to compare the merits of each when considering which might meet their liquidity, and other, needs.

Q: WHEN SHOULD WE CONSIDER USING INVESTMENT COMPANIES?

Interest in alternatives is one reason to consider investment companies but they can also offer a different option for equity exposure.

Where active management of quoted shares is sought, investment companies have demonstrated that the structure can offer strong returns (see Figure 1).

Investment companies may also be a particularly attractive choice where schemes are seeking access to smaller companies, frontier markets, or mixed asset strategies.

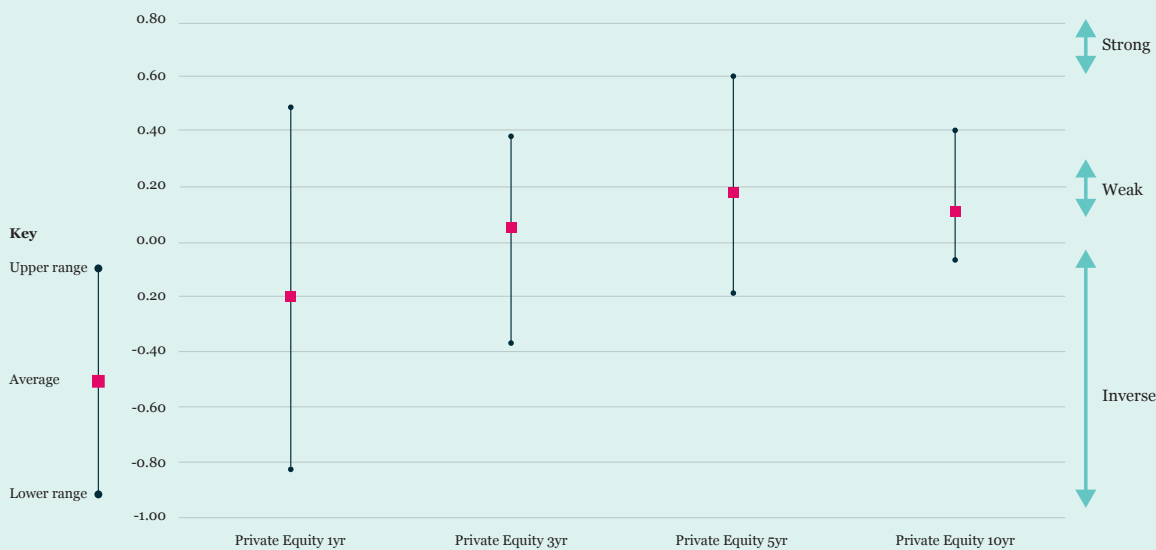
Q: DO INVESTMENT COMPANIES PROVIDE GENUINE DIVERSIFICATION?

It is sometimes claimed that listed investment companies correlate with stock markets more than their underlying assets. This view is not supported by the evidence.

Of course, an investment company with significant holdings in UK listed companies will exhibit a strong positive correlation with the UK market. However, this is the exception. Where the investment company holds different assets, the shares will not exhibit the same relationship.

As shown in the discussion above, investment company REITs, with direct investments in real estate, have a weak correlation with the UK stock market (see Figure 6). This is to be expected as they target very different assets.

The same is true with investment companies holding private equity, another asset class commonly held to provide diversification and as a source of superior long-term returns.

FIGURE 9: PRIVATE EQUITY INVESTMENT COMPANIES AND UK STOCK MARKET CORRELATION

Source: AIC/Morningstar. Data to 31/03/2023

A correlation of 0.8 represents a strong correlation. A weak positive correlation would be in the range of 0.1 to 0.3.

The evidence demonstrates that investment companies can, and do, provide genuine diversification from UK stock markets. Each investment company should be considered on the merits of the diversification it offers and how this relates to the wider portfolio held by a scheme.

Q: DO THEY OFFER VALUE?

Many investment companies are very competitive when compared with their open-ended counterparts.

Alternative assets cost more than traded securities to research, transact, and manage. This highlights the importance of considering the potential for returns, and additional diversification, after costs.

Performance fees are a sticking point for many pension schemes. There is a debate about how well-structured arrangements can deliver better long-term outcomes for investors. If trustees remain unconvinced, 76% of companies in the investment company sector do not use performance fee arrangements.

It is also far from clear that current cost disclosures are really meeting investor needs. Regulatory anomalies mean that trading REITs disclose no costs. Investment company REITs do. In many respects the true expenses of running these businesses are the same. The pros and cons of competing options (whether they are OEFs, trading REITs or investment company REITs) should be considered, not just the explicit cost disclosure.

Similar issues arise in other areas, such as infrastructure or renewable energy. Trading company shares may provide a superficial attraction because of cost disclosure but an investment company may provide other advantages in terms of the investment strategy, diversification, and performance potential.

Each investment company, and the alternative option, should be considered on its merits. Looking past the headline cost figure, trustees may take reassurance from the role of the board in scrutinising costs and seeking value for services provided to the company.

Q: CAN INVESTMENT COMPANIES SUPPORT OUR ESG OBJECTIVES?

Investment companies can help secure Environmental, Social and Governance (ESG) objectives. Most companies use ESG factors in their assessment of risk. Others also seek specific ESG outcomes.

Investment in industries supporting net-zero is a growing investment company trend. The fastest growing sectors in recent years have been investment companies dedicated to renewable infrastructure and power.

Q: DO INVESTMENT COMPANIES PROVIDE INCOME?

Investment companies can target capital growth, income, or a combination of the two, depending on their investment objectives.

Investment companies pay dividends. Investment companies have the flexibility to invest in a wide range of income producing assets. They can hold a proportion of income back in periods when the portfolio is securing high levels of income. These income reserves can then be paid out in periods when sources of income are weak. Investment companies may also pay dividends out of capital profits.

The sector's capacity to pay dividends was used to good effect during the Covid-19 pandemic. More than four-fifths (85%) of equity income-paying investment companies increased or maintained their dividends in 2020. Out of 129 equity investment companies yielding more than 1%, 182 (64%) increased their dividends to shareholders in 2020 with 28 (22%) maintaining the same pay-out as in 2019. By way of comparison, of the 700 open-ended funds yielding over 1%, 159 (23%) increased their dividends in 2020.

The record of investment companies in this area can be seen in the AIC's list of 'dividend heroes', which highlights companies which have increased their dividend for each of the last 20 years. Some have increased dividends for more than 50 years consecutively. The next generation of dividend heroes has increased dividends for over 10 years.

That said, dividends are never guaranteed, and they can fall or rise. It is the responsibility of investment company boards to decide on a dividend strategy that is in the best interests of shareholders.

Q: CAN INVESTMENT COMPANIES BE HELD ON PLATFORMS?

Yes. Any platform which can offer access to trading company equities is likely to offer access to the sector.

Q: HOW CAN I GET FURTHER INFORMATION ON INVESTMENT COMPANIES?

Investment companies publish an annual report and accounts and an interim report and accounts. Most will also have a KID which sets out the features of the product, its risks, charges, and information on performance. Each will also have a factsheet, issued by the asset manager.

The sector is widely covered by independent research.

Advisers to pension schemes will have access to a full range of information on investment companies, which is provided via data terminals and other professional investment solutions.

TRUSTEE CHECKLIST

The sector is also covered in detail on the AIC website (www.theaic.co.uk). It includes information on individual companies as well as providing research tools and educational materials.

TRUSTEES MAY WISH TO CONSIDER THE FOLLOWING ISSUES WHEN REVIEWING WHETHER THEIR SCHEME SHOULD CONSIDER EXPOSURE TO INVESTMENT COMPANIES.

- Does the investment company sector offer exposure to investment strategies or asset classes (particularly alternative asset classes) which could help achieve the scheme's investment objectives and strategy?
- What are the investment benefits and risks of integrating investment companies into the investment approach?
- How do the pros and cons of using investment companies compare with competing options, such as OEFs, LTAFs, Exchange Traded Funds (ETFs) etc?
- For alternative assets in particular, how does the liquidity profile of investment company shares compare with the liquidity available for other collective investment options? What are the implications of these differences?
- Can the risks of using investment companies be appropriately managed (for example, by excluding individual companies with certain features or holding several different shares)?
- Can your service providers (e.g. platforms) accommodate holdings in direct equities? If not, does the investment case for using investment companies justify securing the capacity to invest in direct equities?
- What governance considerations might affect your appetite to utilise an investment company (e.g. board independence and diversity, ESG policy etc.)? Is this factored into your consideration of possible investment options?
- What additional information would be helpful to inform a review of the use of investment companies?

-
- i Rates of return for FCA prescribed projections. Financial Conduct Authority. September 2017. page 28
 - ii Pension fund exposure to UK equities has plummeted since 2000. FT/Ondra. Asset management newsletter. Harriet Agnew. 6 March 2023
 - iii Outperformance calculated according to data shown in Figure 1
 - iv What role could alternative assets play in DC investment strategies in the future? Pension Policy Institute. Page 9. March 2023
 - v Source: AIC/Morningstar
 - vi Source: AIC/Morningstar





**Pensions and Lifetime
Savings Association**

24 Chiswell Street
London EC1Y 4TY

T: 020 7601 1700
E: plsa@plsa.co.uk

www.plsa.co.uk

May 2023

This guide is for information only and is not
advice about investment and must not be
relied upon to make any financial decisions.