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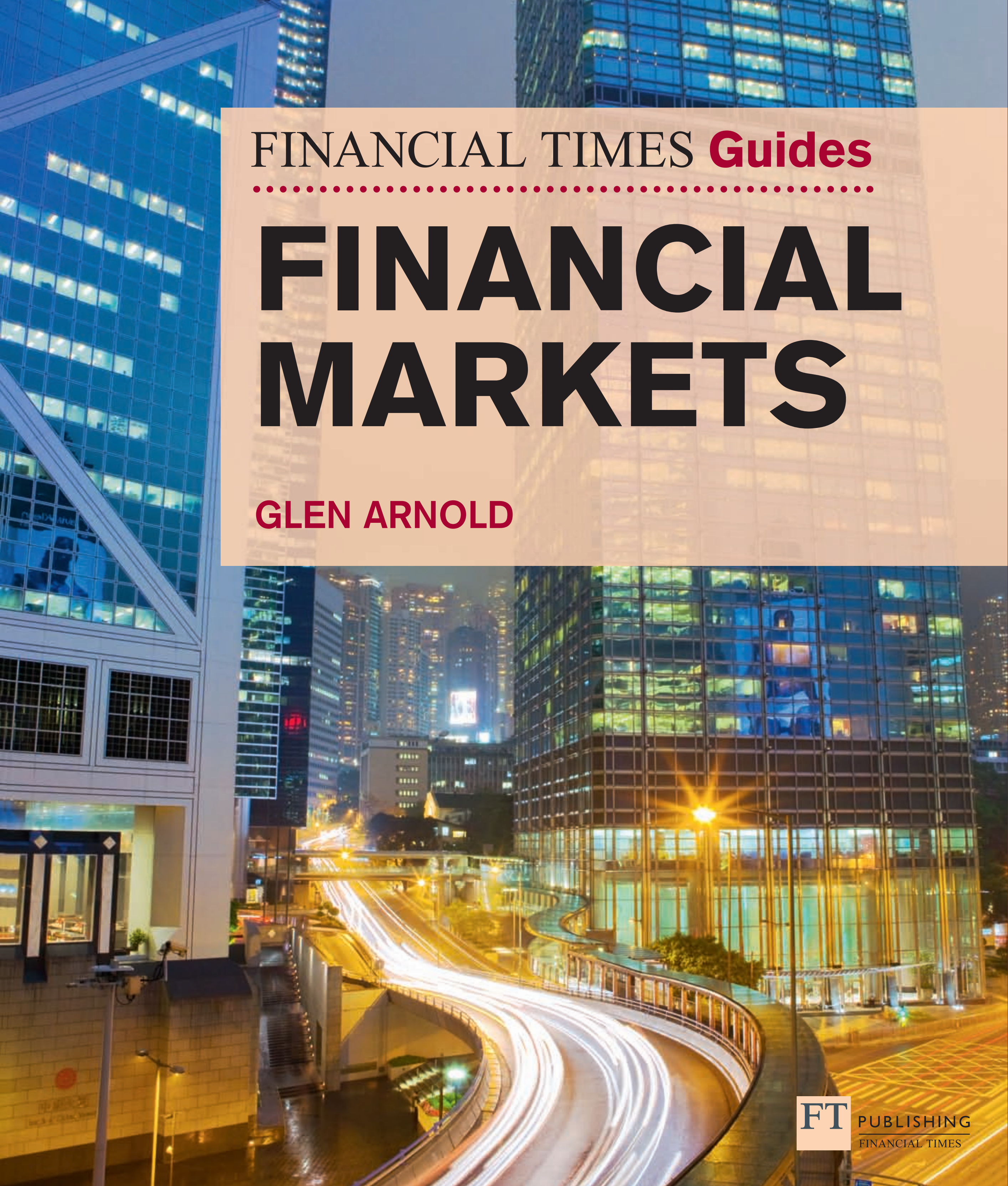
FINANCIAL MARKETS

GLEN ARNOLD



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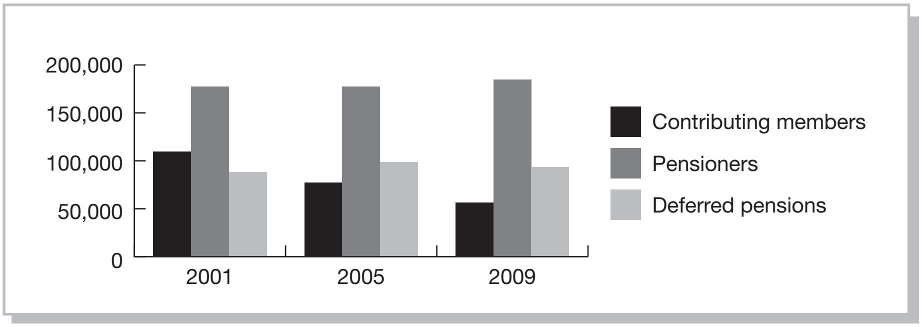

Exhibit 7.5 **BTPS pension membership 2001, 2005 and 2009**

Source: *BTPS Annual Reports*

BTPS have adjusted their investments to try and improve their asset return. Exhibit 7.6 shows some of their largest investments held directly by the scheme at the end of 2009 expressed as a percentage of the total investment assets of the scheme.

Investment	*Asset class*	*Market value (£m)*	*% of total investment assets*
LGIM UK Equity Index	Pooled investment vehicles	2,506	7.4
LGIM Europe Large Cap Equity Index	Pooled investment vehicles	1,358	4.0
LGIM North America Equity Index	Pooled investment vehicles	1,297	3.8
LGIM Japan Equity Index	Pooled investment vehicles	981	2.9
UK Treasury 2.5% Index Linked 2020	Index linked	658	1.9
LGIM Asia Pacific Equity Index	Pooled investment vehicles	575	1.7
Milton Keynes Shopping Centre	Property	264	0.8

Exhibit 7.6 **Some of BTPS's largest investments (2009)**

Source: *BTPS Annual Report 2009*

Regulations

In the UK, the **Pensions Regulator** is empowered by the government to regulate work-based pension schemes, and has wide-ranging powers to enforce its decisions. Its aim is to protect members' benefits and encourage high standards in running pension schemes. It has powers to compel companies to inject additional money into their pension schemes and to remove trustees should a conflict of interest get in the way of them acting solely for the pension fund members. The regulator also tries to limit the claims made by failed schemes on the Pension Protection Fund.

In the UK the **Pension Protection Fund (PPF)** was established in 2005 to compensate members of defined benefit pension funds should their company fail and be liquidated, leaving insufficient assets in the pension scheme to cover its pension liabilities. The PPF pays out up to 90 per cent of what has been promised, up to a maximum of £29,897.42 a year. The cash to finance the PPF comes from a levy imposed on all eligible pension funds.

Defined contribution pension scheme members lose out if fraud or theft occurs, and may then be eligible for compensation from the PPF, but they cannot claim compensation for shortfalls in the fund (unlike defined contribution members). Their contributions are invested with the hope that they will provide an adequate pension, so although the eventual pension will vary according to the ability (and luck!) of the pension fund managers, their individual fund cannot be in deficit other than through fraud or theft.

Collective investment

The idea of **collective investment (pooled funds)** has been around since around 1800. Its concept is simple; money from a group of people is gathered together and put into a range of investments. This reduces the risk of total loss for all contributors by enabling them to invest in a far wider range of investments than they could individually. Worldwide, collective investments are responsible for vast amounts of funds (see Exhibit 7.7), an astonishing $24 trillion administered by 65,735 funds. About half of these assets and funds are in the US. The UK contains over 2,000 funds responsible for £449,500 million.

Collective investment offers some significant advantages to the investor:

- First, a more diverse portfolio can be created. Investors with a relatively small sum to invest, say £3,000, would find it difficult to obtain a broad spread of investments without incurring high transaction costs. If, however, 10,000 people each put £3,000 into a fund there would be £30 million available to

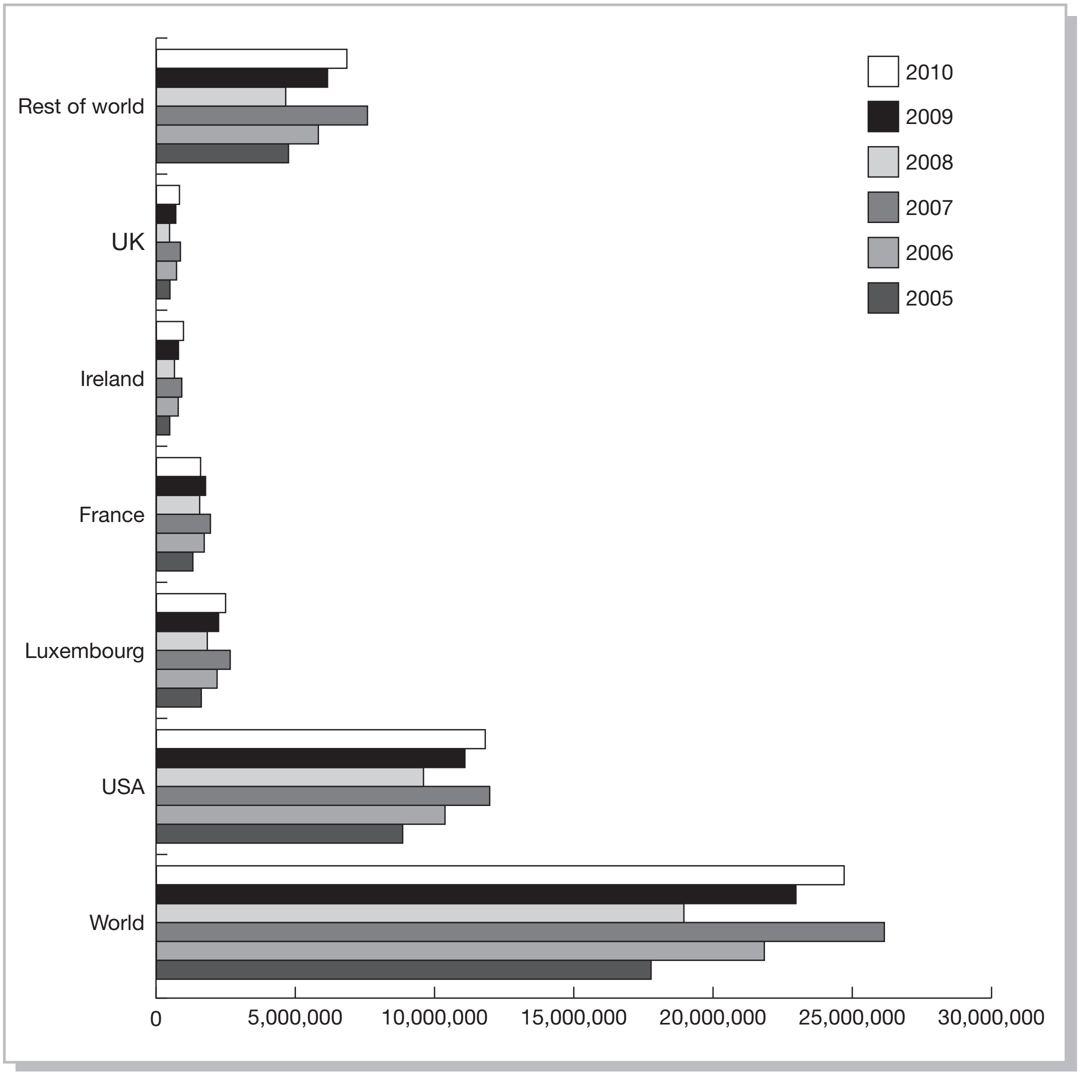

Exhibit 7.7 **Worldwide mutual (collective) fund assets in millions of dollars**

Source: Investment Company Institute, www.ici.org

invest in a wide range of securities. A large fund like this can buy in large quantities, say £100,000 at a time, reducing dealing and administrative costs per pound invested.

- Second, even very small investors can take part in the stock markets and other financial markets. It is possible to gain exposure to the equity, bond or other markets by collective investing for a small amount (e.g. £30 per month).

- Third, professional management removes the demanding tasks of analysing and selecting shares and other securities, going into the market place to buy, collecting dividends, etc., by handing the whole process over to professional fund managers.
- Finally, investment can be made into exotic and far-flung markets, South American companies, US hi-tech, Chinese technology, etc. without the risk and the complexities of buying shares direct. Collective funds run by managers familiar with the relevant country or sector can be a good alternative to going it alone.

These advantages are considerable but they can often be outweighed by the disadvantages of pooled funds, which include high fund management costs and possible underperformance compared with the market index. Also collective investors lose any rights that accompany direct share investment, including the right to attend the company's AGM or receive shareholder perks, and lose the fun of selecting their own shares with the attendant emotional highs and lows, triumphs and lessons in humility.

Open-ended investment vehicles (OEIVs)

OEIVs are a type of collective fund that does not have restrictions on the amount of shares (or 'units') the fund will issue. If demand is high enough, the fund will continue to issue shares no matter how many investors there are; the size of the fund is dictated by the amount of investment in it. The value of each share is dictated by the net asset value (NAV) divided by the number of existing shares. The NAV is defined as the total value of assets at current market value less any liabilities. Open-ended funds must buy back shares when investors wish to sell. The most common types of OEIVs are unit trusts, open-ended investment companies (OEICs), exchange traded funds (ETFs) and mutual funds.

Unit trusts

Unit trusts are issued in Australia, Ireland, the Isle of Man, Jersey, New Zealand, South Africa, Singapore, and the UK, and sold in units not shares. The first to be issued was in 1931 by M&G. According to the Investment Management Association (IMA) in 2011 there were 737 funds in the UK managing £220.8 billion: see Exhibit 7.8 for the 10 largest funds. They are administered by a trustee (usually a bank or insurance company rather than a single person) who is

		£ billion
1	Fidelity Investments	22.40
2	Threadneedle Investments	12.53
3	Scottish Widows Unit Trusts Managers	11.98
4	Invesco Perpetual	11.70
5	Legal & General Unit Trust Managers Ltd	10.89
6	M&G Group	9.29
7	Schroder Investments Ltd	9.25
8	Halifax Investment Fund Managers Ltd	8.44
9	Gartmore Investment Management Plc	6.61
10	SLTM	6.00

Exhibit 7.8 **The managed assets of the 10 largest fund providers in the UK**

Source: www.incademy.com

the legal owner of the trust's assets and runs the trust on behalf of its investors, appointing managers and making sure that the trust is run responsibly.

The value of the units is determined by the market valuation of the securities owned by the fund. So if, for example, the fund collected together £1 million from hundreds of small investors and issued 1 million units in return, each unit would be worth £1. If the fund managers over the next year invest the pooled fund in shares which increase in value to £1.5 million the value of each unit rises to £1.50.

Unit holders sell units back to the managers of the unit trust if they want to liquidate their holding. The manager would then either sell the units to other investors or, if that is not possible because of low demand, sell some of the underlying investments to raise cash to redeem the units. Thus the number of units can change daily, or at least every few days. There is no secondary market trading in unit trusts as all transactions are carried out through the trust managers.

Pricing

The pricing of unit trusts is divided into two parts, the bid price and the offer price. The offer price, the price a new investor has to pay, is calculated by valuing the investments underlying the fund once a day.[5] The bid price, the price a seller receives, is usually set 5–6 per cent below the offer price (for funds invested in shares). The difference between the bid and offer prices is called the spread and pays for two things; firstly, fund administration, management of the investments, marketing, as well as commission for selling the units; secondly, the market makers' spreads and brokers' commissions payable by the fund when it buys and sells shares.[6]

Most unit trusts are now priced on a forward basis, which means that the price paid by a buyer of units will be fixed at a future time (often 12.00 noon this day or the next day) so a buyer may not know the exact price at the time that they send a buy order. Some funds still charge the *historic* price, taking the value from the last daily valuation.[7]

Charges

There are three charges:

1. Initial charge ('sales' or 'front-end' charge). This is included in the spread between the bid and offer prices. So if the fund has a spread of 6 per cent it might allocate 5 per cent as an initial charge. Some unit trusts have dropped initial charges to zero – particularly those investing in interest-bearing securities (bonds, etc.) and **tracker funds** (those that do not try to spot shares that will outperform the market, but merely invest in a broad range representative of a stock market index – also called **passive funds**).
2. Annual charges. The annual management fee is typically 1.00–1.8 per cent. A further charge of about 0.2 per cent covers legal, custody, audit and other administration costs. Over time the annual fees have a larger effect in reducing the value of the investment than the initial charge.
3. Exit charges. Some funds make an exit charge instead of an initial charge if the units are sold within, say, the first five years.

[5] The current market price of the investments currently held plus dealing costs, management expenses and other charges is divided by the number of units in issue to give the maximum offer price that the trust can charge.
[6] Recently unit trusts have been given the option of single pricing, with charges shown separately. Most still have a bid–offer spread.
[7] Some use a mix of historic and forward pricing.