

OBJECTIVES AND FUNCTIONS OF UNIT TRUSTS

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The subject of Unit Trusts has roused considerable interest in recent times. Unit Trusts are defined as an investment trust that purchases stock exchange securities, etc., the total holding being divided into units, which are sold to the public at a price based on the market value of the whole portfolio. The managers will repurchase units from the public at any time at a price slightly below the current offer price. Unless otherwise stated the dividends on the securities held are pooled and distributed to unit-holders at stated intervals, usually half-yearly.

Unit trusts are intended to appeal to small investors because the units are usually in small denominations and may be spread over a hundred or more companies, thus minimizing risk; the investor also benefits from the expertise of the managers in choice of investments. Generally they are operated according to detailed rules laid down in a trust deed agreed between the manager of the scheme and an independent trustee, usually a bank or insurance company, which acts as a custodian trustee for the unit-holders.

In this note A.B.T. Wijeratne, who holds a Masters Degree from Colorado State University, USA, and is a member of the American Finance Association and Financial Management Association, comments on the functioning of Unit Trusts.

Unit trusts are established to invest the money of numerous individuals in "securities" of various types for the benefit of these individuals. Broadly defined, a security represents evidence of property rights. That is, a security represents a claim on an asset and any future cash flow that the asset may generate. The security itself is usually a document which identifies the investors rights or claims. When talking about investments, we typically think of securities as shares and fixed deposits or other types of savings certificates. Usually a fixed deposit or any other savings certificate indicates that the investor should receive certain interest and principal payments at specified times. A share certificate indicates that the investor owns a certain number of shares of a company and therefore has a claim to a certain percentage of the cash dividend and other distributions made to the company's shareholders. The unit trusts pay a fee to a management company consisting of professionals in the field of investments. These professionals manage the unit trusts/funds which are derived from selling "shares" to individuals.

Unit Trusts offer investors several advantages. First, because of their large size, they offer broad diversification across security types and industries not generally possible for small investors. Furthermore, these trusts offer investors liquidity in the form of ready marketability or an ability to redeem shares with the trust itself. Finally, unit trusts provide full-time professional investment management that may result in performance superior to what might be

generated by the individual investor.

Investors obtain three types of income from owning unit trusts shares —

- (i) Cash dividend or interest disbursements
- (ii) Capital gains disbursement
- (iii) Changes in the funds net asset value per share from capital gains and cash dividends not distributed to the share owners under above (i) and (ii).

Unit trusts are conduits from savings to investments. The trusts combine the savings of many people into one large diversified investment portfolio. But no single investor owns any particular asset. Instead, an investor who has purchased a certain percentage of the unit trusts total shares owns that percentage of every asset and every liability the trust obtains.

These unit trusts can be basically divided into two types, called open-end unit trusts and closed-end unit trusts. In a open-end unit trust the number of shares issued is not fixed. Further, the unit trusts shares are not quoted in a security exchange but the fund managers buy and sell shares of the unit trust. Investors can cash in their shares in the fund whenever they wish, at the net asset value per share on that day. The net asset per share equals the value of the trusts total assets after liabilities are divided by the total number of shares outstanding on that day. Thus the net asset value per share fluctuates every time any asset experiences a change in its market price.

The unit trusts state specific investment objectives in their prospectus. For example, the main types of funds are growth funds, income funds, balanced funds, industry-specified funds, liquid asset funds, etc.

Growth Funds:

These funds tend to invest in company shares and are willing to take some risks to obtain share portfolios which are expected to yield large capital gains.

Income Funds:

Investment in stocks and various savings forms of certificates that pay high cash dividend and coupon interest is the objective of income funds. Risky shares, offering potential capital gains, tend to be avoided in favour of 'blue-chip' investments.

Balanced Funds:

These funds generally hold a well diversified portfolio. It divides their holdings between fixed-income securities and low-risk common shares of well established companies in order to avoid the risk of loss. These conservative funds usually have the lowest rate of return.

Industry-specified Funds:

These funds are obviously specified in selected industries such as banking, health care, natural resources, insurance companies etc.

Liquid Asset Funds:

These unit trusts are also called money market funds because they invest in short term, low risk securities issued by banks, other companies and treasury bills etc.

Closed-end unit trusts differ in several aspects from that of open-end trusts. First, as their name implies closed-end funds cannot sell more shares after their initial offering, thus the size is limited. Second, the shares of closed-end unit trusts are not redeemable at their net asset value, as are the shares in a open-end trust. Instead the shares of the closed-end trusts trade on security exchanges at market prices that may be above or below their net asset values. These two distinctions between the closed-end and open-end trusts are essentially the best way to define the closed-end trusts. Further, unlike open-end unit trusts closed-end trusts have diversification and investment objectives that differ over a much wider range than that of open-end unit trusts.