Information Pack

from your adviser

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The Benefits of Closed-Ended Funds & Companies over Unit Trusts

Investment Trusts and Closed-end Companies:

1. Have a Board. The Fund Manager has to report to the Board and take his remit from them. Thus the corporate governance around these trusts is more robust than with a Unit Trust where the Fund Manager reports to Trustees. A healthy market is maintained with poor performing trusts either wound up or taken over.
2. Can borrow money which is referred to as have gearing. This, if used correctly can be a major enhancer to performance and/or income generation. It can, of course, produce the opposite if not controlled correctly.
3. Do not always cost what they are worth. Value can be had in purchasing a trust at a discount. This will enhance your income as well as capital return as you can purchase more shares for the same amount of money. With Unit Trusts you pay the price they are worth. Discounts can widen and therefore have a negative impact on the growth performance however, over the medium to long term this should not be noticeable.
4. Have the ability to retain 15% of the income received to add to an income reserve that, in times of need, can be dipped into, to maintain the dividend paid, or even increase it. When BP cut the dividend it did not affect any dividend payments from Investment Trusts as they could dip into the reserve. Indeed many still managed to increase their dividend and some have done this for more than 40 years. On the other hand Unit Trusts and their like had to reduce their dividend.
5. Will not suffer as much if there is a run on the book. If large numbers of holders of a Unit Trust want out, the Fund Manager may be forced to sell some of his underlying holdings to bail them out. With Investment Trusts et al there is no need to sell any holdings and the portfolio remains as planned. Equally the Manager will not be forced to buy in at the top price. Again, proven very useful in the latest market crisis.
6. Have never paid commission to advisers thus utilising their assets purely for investing. RDR has tried to stop most commission being paid from open-ended trusts to advisers and this may narrow the gap between the two types of funds but that remains to be seen, since Investment Trusts have responded by reducing their fees further.
7. Dealing is T+1, meaning that if selling your holdings you will have the cash in your account the following day. Unit Trusts can take days.
8. Where the underlying investments are Property shares, the shareholder is never in a position where the Manager can place a moratorium on the sale of his shares for any fixed period. Compare that with holders of Unit Trusts where this can and does happen to the detriment of the investor when special circumstances arise.

Understanding Risk

We invite you to gain some insight into what is the most intriguing, fascinating, frustrating, and sometimes baffling aspect of investment.

Risk equals uncertainty. Can it be controlled? No, but its impact can be managed.

As you would expect, management of Risk in investment is not easy. Why not? Because no one actually knows for certain what will happen in the future. Everything is surmise, assessment, conjecture and judgement aided by some facts, always from the past, distilled with a measure of good or bad luck. In the investment world an understanding of Risk should help you do better.

The natural reaction of those who have created their own wealth, is they want to protect it rather than invest it. However, the fact is that to protect it, you have to invest it. Starting on the lowest rung of the ladder, how about a risk free investment? There isn't one. Even a simple savings account at a bank or building society is not without risk. You do not know what the inflation rates will be in the future or if the interest rates will protect you or compensate you from the damage done by inflation. In addition, in 2008 some banks came very close to total collapse.

The step up from savings to real investments, either direct equities or collective investments, is still an unpredictable area and always will be. The first rule is the old adage – do not put all your eggs in one basket. Ignore this at your peril.

The second rule is an extension of the first - diversify your investments. Investment trusts and Closed-end companies are collective investments that provide an excellent opportunity to diversify. A collective investment is one where there are many underlying investments in companies and the like. The Risk will be better spread than if you invest in direct equities where the collapse of a single investment can be extremely damaging. One collapse in a basket of different investments is more containable.

As Risk is something that can be managed, it follows that it can be managed to your advantage or disadvantage. We try to ensure it is managed for your benefit in the most tax efficient manner possible.

All aspects of Risk are not easy to catalogue in a neat and presentable form. However, one thing is clear. In whatever way Risk is managed, it must be transparent and identifiable.

Knowing what you have bought, and why, helps to provide peace of mind. As in most walks of life, it pays to buy quality – the expensive suit that costs twice the price will last for years and give better value in the long run – and so it can be with investments.

We endeavour to bring judgement, experience, skill and common sense to the management processes. Past performance should not be knocked. It is historic and factual but it needs to be assessed by comparison with present circumstances and likely future prospects. So, how can Risk be assessed?

Risk Grades

The universe of closed-end funds has its own unique grading system of Risk Assessment for each fund. This should be taken as a guide only. Nevertheless, it is a good place to start.

The Risk Grades and their categories are:-

Risk Grade	Degree of Risk
2	Low
3	Below Average
4	Slightly Below Average
5 – 7	Average
8	Slightly Above Average
9	Above Average
10	High

All closed-end funds on our Approved List are similarly risk graded using the above scale. They are regularly checked against the grades allocated by myself and practitioners in the closed-end funds industry. The risk grade of a particular trust can vary over time.

There are two equally important factors. One is your own Personal Risk Profile (PRP) that is decided by completing the Attitude to Risk Questionnaire and pulled from the same Risk Grades. The other is that the portfolio is constructed so that its weighted overall Risk Grade matches your chosen Personal Risk Profile, as close as possible.

As an example, if you choose a PRP of 8, most closed-end funds in your portfolio will have a Risk Grade of 8 or less. A few will have a Risk Grade higher than 8. However, the overall Risk Grade of the portfolio will not be more than 8 so as to match your Personal Risk Profile. Generally, the higher the risk the better the return and therefore, from time to

time, the portfolio will need to be trimmed back to keep the overall risk grade of the portfolio within the chosen PRP. Equally, a higher risk will mean more volatility, and therefore may be better suited to a longer term for investing.

Explanation of Risk Grades

So as to give you a guide as to how the Risk Grades are applied to assets in practice, We have set out below some examples of the kind of trusts or sectors that fall within them.

You will see it is difficult to find investment trusts at a lower Grade than "Average". However, "Average" does cover a wide geographical field.

Grade Examples

2	Cash
3	Fixed Term Cash
4	Possibly some global growth trusts not on our Approved List
5-7	Some Global trusts, Infrastructure, standard mainstream UK trusts, European mainstream trusts, UK and European Bonds & Utilities and defensive or capital preservation trusts
8	Some Ordinary Shares in Splits, Asian income, some UK and European Smaller Companies, UK and European commercial property and some Global trusts
9	Emerging Markets, Far East, Japan and Eastern Europe, some Ordinary Shares in Splits, Technology and Private Equity
10	Single country funds in Emerging Markets e.g. Brazil, Russia, India & China, Capital shares in Splits, subscription shares and warrants

Diversity

The next stage is to understand that if Risk equals Uncertainty, the way forward is to reduce it as much as possible. The only satisfactory way to do this lies in having "Diversity". The thing about diversity is its diverse nature. This may appear blindingly obvious, but it is not well understood. Diversity has many levels at which it should be applied.

An example of what not to do, that is more common than you would suppose:

It is fairly common to see in the trade magazines a "diverse portfolio" in which an investor had invested ten years previously but he was disappointed it had not performed better. When analysing the portfolio, there is normally a mixture of unit trusts, some closed-end funds and direct equities, totalling about 15-30 holdings. It gives the impression of diversity but, in reality, it was exactly the opposite.

First, he had invested everything in the UK. The rest of the world was an unknown quantity. Geographically, there was no diversity. Everything was in one country.

Secondly, after checking some of the holdings, it transpired that they were all invested in FTSE 100 companies. The investor felt comfortable investing in large newsworthy companies he recognized and could read about daily. Not only was there just one category of investment – equities – but this was limited only to larger UK companies. There was nothing in medium sized or smaller companies, commercial property or Bonds. Again, no diversity.

What was the investor's investment focus? Investment was only in one investment category, and only one UK sector within it; the diversity was non-existent. Risk had been somewhat reduced by the client increasing the number of investments. Ironically, the client thought he had reduced Risk. He had, but not far enough due to the absence of diversity in other sectors and countries which resulted in a poor return.

If the investor never changed any of his investments, what might have been an actively managed portfolio, became passively managed. In fact, it would not have been managed at all so that, in effect, it merely becomes a tracker of the FTSE 100 Index.

After many years of experience, provided the client chooses an appropriate PRP by the same measure as the Risk Grade guidelines for funds, he/she should be well satisfied with the result over the medium to long term with the portfolio adopting the following fundamentals:-

- The portfolio's overall risk profile should match the client's PRP
- The portfolio should be constructed on a global basis
- The investment aim should be to provide a total return
- Considerable diversity must be woven into the structure
- Investment objectives of the funds should be known
- The sectors in which the funds invest should be ascertainable
- The investment horizon must be for the medium term (5 years) and longer

Much of what has been said so far is from the personal perspective of the client. How we advise on and choose investments to fit the above criteria calls on our experience and skill. The company website covers other angles from our perspective such as our investment style. The more you know about what we can do for you and how we do it, the better.

We trust you have found this document informative and that it gives you confidence to seek our advice and entrust the management of your investments to us. Risk is a peculiar thing as in investment and market terms, when Risk appears to be at its highest, it is usually at its lowest and vice versa.

Understand Risk. Be comfortable with it. Accept it as inevitable. Use it to your advantage. Do not fear it to your detriment.

A final thought – the greatest risk of all is never to take one – a philosophy which we hope the reader shares with us.

Understanding Yield

For deposited money, the term used is "interest". Capital on deposit never grows. The amount of interest is determined by rises or falls in the interest rates. For equity investment, the term used is "yield".

A dividend is measured in pence per share. The yield is the dividend over the share price. The amount of the yield for each closed-end fund is published daily and determined largely by the share price. If the share price goes down, the yield goes up and vice versa. When the share is bought, the yield will be near to the last yield quoted. That yield remains static, subject only to Dividend Growth or a cut in the dividend rate.

In a Bear Market the yields are generally high as values are low, and visa versa in a Bull Market. When buying holdings in the latter, one cannot obtain the same level of income one did in the Bear Market without adding stocks that probably have a higher risk level.

Dividend Growth

This is determined by the level of dividends received by the Fund Manager from the companies in the Trust's Portfolio. If the Fund Manager receives larger dividends there should be positive Dividend Growth thus making your yield increase from the point of purchase. Conversely, the dividend rate can be cut but this is a rare occurrence.

Simple Example (No Gearing)

You buy a share at 50 pence with a yield of 5%. The share price doubles to £1. For a new investor who buys the shares at £1, the published yield will show a drop of half to 2.5%. However, your yield remains unchanged at 5% on the amount invested. Of

course, as you bought the shares at 50 pence, you will make a capital gain (if sold) in addition to the income you received.

If after you bought the shares, the price halves to 25 pence. For a new investor who buys the shares at 25 pence, the published yield will show an increase to 10%. Your yield remains unchanged at 5%. However, as you bought the shares at 50 pence, you will make a capital loss (if sold) but you will have had the income. This helps to cushion the fall somewhat, especially if held over a number of years.

Increasing your Income

It is very important to increase your income to win the battle against inflation. Apart from an increase in dividends from Dividend Growth you can increase income by reinvestment. The dividends can soon add up and be used to purchase more income providing funds. The power of reinvested income, and its effect on performance, should never be underestimated.

Buying and Selling Stock

If you sell shares, making a capital gain, and re-invest the net proceeds to produce more income, you will have realised value and be able to increase your income by the percentage of your gain, i.e. a gain of 30% will, when reinvested, enable you to achieve a 30% increase in income on the amount originally invested. This assumes the yield on your new shares is the same as on the old shares when you bought them and possibly, but not necessarily, the new shares would be slightly riskier.

Important Points to Note if you Wish to Withdraw Income on a Regular Basis

- Your ability to increase income mainly depends on the rate of Dividend Growth
- Currently, ignoring cash, a total of 0.8% (before discounts) is deducted each year as total Management Fees. If you want 4% income pre tax, it means we must achieve a yield of 4.8%.
- The total Management Fee is calculated on the value of the portfolio. As the value increases, the amount of the annual charges increases and vice versa. Although generally the yield remains fixed, subject to Dividend Growth or Reduction, over time the net income swept to you will reduce as the value of your portfolio rises and higher fees are paid from your account. There is generally less net income left to be paid to you.

- When you open your Account, it will usually have some spare cash (capital) and, initially, annual charges will be paid from this. However, eventually this "capital" cash will run out and then the charges will be taken from your income stream before the balance is swept out to your bank account.
- These problems mainly arise in a Bull market as and when new investments are bought. In a Bull Market capital values grow and yields reduce. In a Bear market capital values reduce and yields increase when purchases are made.
- There are ways to help overcome the problem of less income being available to be swept to your bank account. Clients should consider my two SEI templates that are specifically designed to not only maintain the income, but also to increase it over time as close as possible to inflation, if not ahead of it.

Please Remember

Deposited cash never increases its capital value. The interest might be added to the capital each year but don't think the deposited capital is increasing. It is not. All you are doing is adding froth (income) to the beer (capital). You do not increase the amount of the beer in the glass – that remains the same. Since you can never truly increase your capital, the opportunity to increase your income by re-investing capital gains is denied to you. To make matters worse, inflation erodes the spending power of your capital and income, year on year, on a cumulative basis. With inflation at say 3% you lose 26% of your spending power over 10 years, at 5% it is 40%.

We have referred above to total Management Fees being 0.8% p.a. for Income accounts. However, many clients do not pay the full rate owing to the discounts available on Transact's annual charges. These discounts can benefit clients especially for families where the accounts are linked together for discount purposes.

Finally, please remember that Income is a vitally important part of the total return.

Understanding Treatment of Cash

New Cash is vitally important. This Cash can be placed in a Pooled Deposit Facility (PDF) within the GIA. PDFs are ring fenced from being mixed with cash for investments. If Cash is placed in the GIA or any Facility within it, net interest is credited monthly.

Check the interest rate you are receiving for local deposited cash at your bank or Building Society for instant access. This will be calculated on a tiered basis, i.e. the more you deposit the higher the rate and vice versa. If the rate you are currently getting is less than

Transact's gross interest rate, which is calculated on a pooled basis i.e. £1 receives the same interest rate as £1m, then you should consider adding the cash to your PDF but discuss this with us first.

This is especially important for smaller amounts on deposit as the interest rates at your local bank will be very low. Your cash is pooled with cash from other investors at Transact. The pooled interest rate is likely to be near to the Bank Rate. This will be a tremendous improvement on the miserable interest rate you will receive for cash deposited at your bank.

As interest is paid monthly, it is compounding with each monthly payment.

Transact pay income tax at the standard rate (where applicable) on all interest unless you are a non-taxpayer and currently take a charge on cash which is the same as the annual charge on investments.

Risk Warnings in respect of certain Geared Investment Trusts relating in the main to Split Capital Investment Trusts (FCA – Conduct of Business Rules)

Splits are specifically designed to serve the differing needs of shareholders.

Income shares will suit those who want income only, with repayment of a fixed amount per share on wind up.

Capital shares are for those who do not want income from their investment and are prepared to take a higher risk stance not knowing what capital return, if any, they might collect on wind up when they are last in the queue for payment.

Ordinary Income shares are for investors who want to receive a higher than normal income (comprising income from their share of the funds plus the income which the Zeros have foregone) plus the potential of a capital gain.

Zeros are for investors who do not want income, and waive their entitlement to it, in return for the expectation of receiving a somewhat modest, but known, capital return on wind up. Sometimes Zeros are knows as **ZDPs** – **Zero Dividend Preference shares** – which is exactly what they are. Shareholders in Zeros are first in the queue (after the bank, if any) to receive payment.

These Rules came into force on 30th September 2004 concerning investment trusts that

A. use or propose to use gearing as an investment strategy and/or
B. invest or propose to invest in other investment trusts (and some offshore equivalents) which use or propose to use gearing as an investment strategy and
C. where the overall result of this gearing is that the value of the investment trust share is likely to be subject to fluctuations which are significant compared with the likely fluctuations of the underlying investments

"Gearing" in relation to plain vanilla trusts (only one share class), means "Borrowing". In relation to Splits, it can mean either "Borrowing" and/or "the creation of different classes of shares which have a varying order of priority for payment on wind up".

Under the Listing Rules, a Split Capital investment trust may invest up to 10% of its assets in other Splits provided those trusts do not invest more than 15% of their assets in other Splits ("underlying gearing"). All our approved Splits either do not invest in other Splits or, if they do, they mainly invest under about 3% of the value of their assets. We regard under 3% as being "de minimis".

"Significant" in (C) above has not been defined by the FCA.

As "significant" has not been defined, Pigotts Investments has adopted a common sense approach to the meaning of "significant" and applied it to the nature of Splits. It is for the adviser to assess what degree of "significance" would make the purchase of a Split advisable and what would make it unadvisable. This has really always been the case.

Most plain vanilla investment trusts use or may use gearing with the intention of enhancing performance. Some also invest in other investment trusts that use or may use gearing. All Splits are also geared by their very nature because of their different share classes and order of priority for payment on wind up.

To help clients' better understanding of Splits, a very complex subject, it is intended that further information is added to that already provided on the Splits that are recommended.

If we advise you to buy a Split, then details of the Split, the Zeros and the Share Class you are being recommended to buy will be sent to you before the date of purchase. The reason Zeros are included (as we do not buy them normally) is that, as they are the first to be paid on wind up, after repayment of any bank debt, a buyer of any other share class in the same trust needs to assess if it is likely that the Zeros will be paid their entitlement in

full on wind up. Their entitlement is a known fact from Day One so that it is not too difficult to assess their chances of payment given the current value of the assets attributable to them, the rate at which they have to grow, and the time left to wind up. What is missing however, is the future performance expectations.

It should be pointed out, especially in the case of Splits, that the very reason they are bought is because there may be "significant" fluctuations in value compared with the likely fluctuations of the underlying investments. Such fluctuations are beneficial when they enhance performance in a rising market and detrimental when they add to underperformance in a falling market.

However, for the Ordinary Income shares, the constancy of a sustainable income stream, during all weathers, contributes greatly towards achieving a total return on wind up or if the shares are sold before then.

Unless stated otherwise, we will treat all our Investment Trusts and Splits as coming within the new Conduct of Business Rules and therefore clients will be sent the details, as described above, as near as possible to the date of purchase.

The risks assessed when considering the purchase of a Split are:-

(a) The amount & terms of the bank loan (if any) and likelihood of it being repaid
(b) The degree (so far as it is possible to ascertain it) of any underlying gearing i.e. investments which the trust has in other Splits
(c) The likely effect that any prior charges and share classes might have on the ability of the Ordinary Income shareholder to be able to receive back the cost of their shares on wind up

As to Risk (a), much is said about the risks of gearing but very little about the benefits. If a Fund Manager has borrowed money from the bank, on reasonable and flexible terms, at a favourable time in relation to market conditions, then, in a rising market, gearing will add an extra layer of outperformance. The reverse is also true. In a falling market, gearing will accelerate underperformance and if the borrowing terms are too high and fixed, this will exacerbate the problem.

Risk (b) is the highest risk as it is mainly an untraceable factor, although the extent of investment in other Splits is now limited by the new Listing Rules.

However, Risk (b) is removed entirely as our Splits do not invest in other Splits or, if they do, mainly at only "de minimis" levels.

Risk (c) is discussed in the details of the Splits that will be sent to you.

It should be appreciated that the reason Splits were invented in the 1960's is just as valid now as it was then.

It is all a question of taking a balanced view of risk and reward in this area.

An example of balancing risk with reward is Zeros. It was this share class which was most damaged by the Splits debacle at the beginning of the century. Clients have been advised to buy Zeros in exceptional cases, normally being very defensive, but we have normally thought that, in usual market conditions, the reward does not justify the risk. That generally remains our opinion.

Timing in the purchase of Splits is important and we are highly selective in the few Splits we recommend. Our Approved List includes only Splits we think are top quality, managed by fund managers experienced in managing Splits who have a record of outperformance.

During the life of a Split, there can be periods of significant share price fluctuations. During these periods, it is sometimes more beneficial to consider the amount of the Net Asset Value rather than the share price.

Treatment of UK & Non-UK Dividends for Standard Rate and Higher Rate UK Taxpayers

The removal of tax credits has meant that the previous idea of holding gross paying dividend trusts (those registered offshore) in ISAs and SIPPs, to retain the full dividend and not pay any income tax has been thwarted. Now all dividends are paid gross and this levels the playing field.

All UK dividends are received gross now and there is an annual dividend allowance, currently of just £2,000, before tax is paid depending on your income tax bracket. Standard rates are at 7.5%, next is 32.5% then 38.1%. Now it is imperative to put all but £2,000 of dividends into ISAs and SIPPs, regardless of whether on or offshore.

ISAs

As stated above, a Higher Rate taxpayer saves 32.5% or 38.1% tax on dividends.

Income is not counted as income by HMRC thereby it can be used to help prevent a standard rate tax payer straying into the higher rate tax brackets.

Retired investors over age 65 also benefit because ISA income does not reduce their extra tax free Age Related Personal Allowance. Normally, if their annual income exceeds the Total Income Limit, it results in the Age Related Personal Allowance being cut by £1 for every £2 of income received until it is the same as the normal Personal Allowance. This means they pay an effective tax rate that is the average of the standard and higher tax rates on income over the Total Income Limit up to a further amount that is twice the difference between the Age Related Allowance and the Personal Allowance! Who said tax was easy! However, ISA income is not counted towards this limit.

N.B. Please remember that share prices can go down as well as up and that the investor may not receive all his investment back. Past performance is not a guide to future performance.