The Charity Law & Practice Review

COMMON INVESTMENT FUNDS
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The writer's direct involvement with common investment funds goes back about four years, when he was one of those at Kleinwort Benson who first discussed their ideas with the Charity Commissioners. This culminated in the launch of an index-tracking UK equity fund and a fixed interest fund in July 1994, and an index-tracking overseas equity fund in May 1995.

Most charity investment managers will be broadly familiar with common investment funds, since, with over £2 billion invested in them, they have come to play a major part in charity investment management. By way of reminder, common investment funds are similar to ordinary unit trusts in that:

* they represent an efficient and administratively simple means of obtaining the spread of investment that is desirable for reducing risk, particularly for smaller portfolios;

* they are open-ended, in other words new units are created and existing units are cancelled as unit-holders invest in or take money out of the fund; and

* the prices at which unit-holders buy and sell units are based upon the net asset value of the underlying investments.

The Charity Commissioners are in the process of reviewing the legal structure of common investment funds, and may have far-reaching consequences. Nevertheless, as things stand, there are certain differences between common investment funds and unit trusts that are worth highlighting. Unit trusts are under the control of a manager, who appoints an independent corporate trustee, whose role is to see fair play between the parties concerned. Common investment funds are different; fair play is of course paramount here too, but it is arrived at by means of a different and arguably better route.

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Common investment funds are constructed as charities by means of a scheme drawn up by the Charity Commissioners, the purpose of which is to define the powers of the trustees, including their powers of investment. As with charities generally, these trustees must be individuals and it is they who carry ultimate responsibility for the common investment fund's affairs. It is they who appoint the fund manager, and the Charity Commissioners insist that no trustee should have any connection with the fund manager. The fund manager is in effect merely the hireling of the trustees and is not in a position to exercise the level of influence that fund managers usually claim over, for example, unit trusts. One illustration of this (it is to be noted) is that no common investment fund bears the name of its fund manager.

All this has a number of consequences:

- first, as part of the process of being set up by the Charity Commissioners, each common investment fund is registered and so has a charity registration number;

- secondly, from the point of view of regulation, common investment funds are effectively the current responsibility of the Charity Commissioners. When the Financial Services Act was written, common investment funds were specifically excluded. As a result, the Charity Commissioners have had to adopt a quasi-regulatory role almost by default. This has had a number of consequences, to which it will be necessary to revert later on;

- thirdly, common investment funds are open only to charities. The definition of a charity for these purposes is an institution that is established for charitable purposes and is subject to the control of the High Court of England and Wales. So, for example, a Scottish charity does not qualify; and

- specifically as regards investment, common investment funds have a number of conspicuous advantages over unit trusts, namely:

    - they qualify as special range investments under the Trustee Investments Act 1961. With the repeal of the Act under consideration, the relevance of special range status may disappear, but under the current law it means that when a charity subject to the Act invests in a common investment fund, considerations of the split between narrower and wider range investments do not apply. This provides otherwise constrained charities with greater flexibility in the construction of their portfolios. The special range status of common investment funds also means that charities investing in them do not have to seek advice in the way that they are required to by the Trustee Investments Act with most other forms of investment;

- distributions of income from the fund are made gross, that is without the deduction of UK tax. This avoids the need for charities to reclaim any tax in respect of their holding;

- they do not suffer stamp duty (currently at the rate of ½%) when buying UK-registered ordinary shares; and

- management fees are generally lower. The average management fee charged to common investment funds is around ½% per annum, whereas for a typical authorised unit trust the annual fee is 1% or more. The principal reason for this is that unit trusts are designed primarily for the retail market and the managers have to charge higher fees in order to cover their higher costs.

The standard view is that common investment funds are only for smaller charities. While it is undoubtedly the case that for smaller charities they are likely to be the most suitable form of investment, there is no reason why this should apply to smaller charities only. There are still too many charities out there who feel that they must have their own segregated portfolio but who do not really need one. There are plenty of common investment funds to choose from and it should be possible to find a selection that matches most charities' investment needs.

In all there are now over twenty generally available common investment funds in existence. While some of these are balanced funds, in that they invest across the whole range of investment categories, most funds have a clear objective of investing solely in equities or fixed interest securities. It is normal to include M & G's Charifund, which is in fact an authorised unit trust that has been recognised as a charity. In this respect it is unique: it was set up in 1960 and since then the Charity Commissioners have refused to register any more unit trusts as charities in the same way.

A list of the major funds is to be found in the quarterly list published by the WM Company. This provides a lot of useful information, including the identity of the manager, launch date and fund size, and it is to be noted that, not surprisingly, there is a close correlation between age and size. This WM sheet also gives the yield on each fund, the asset breakdown of the equity funds and a short description of each fund's investment objective.

Finally, it shows the performance record of each fund, measured in terms of total returns after expenses over six months, one year, two years etc., as well as the return on the comparative index. It is preferable to leave these numbers to speak for themselves, since it would be unfair if one were to comment on them in any detail. However, there are two points worth making. First, for anyone inclined to make a comparison between the fund returns and the index returns one should repeat the point that the fund returns are calculated after expenses. Secondly, readers might be interested to know how comparable unit trusts performed on a like for like basis over the same period. For the five years to the end of December 1995, the average annualised return, as calculated by Micropal, for the UK equity growth and income authorised unit trust sector was 14.6%, which is behind all four common investment funds that have been in existence for that long. For authorised gilt funds the comparable figure was 11.7%, which again is behind all four common investment funds that have been in existence that long. It will be seen from both these numbers that, while allowance has to be made for the small sample size of common investment funds, they have done rather better than their unit trust competitors.

While looking at the choice of funds available, it is right perhaps also to mention that common investment funds have a close relation, common deposit funds. These have the same legal structure as common investment funds, but the trustees' powers over the property of the fund extend only as far as making cash deposits or buying certain cash instruments.

As indicated at the outset, it took Kleinwort Benson a long time to gain approval for their funds, and it seems to be the case that the Charity Commissioners can be somewhat nervous about approving new funds. As a result, if one wants to launch a new fund, one has to be persistent. The three funds launched by Kleinwort Benson were allowed through for three reasons. First, the firm had an existing client base for whom the particular funds made sense, so it was possible to convince the Commissioners that there was already a genuine need for them. In other words, there was no question of just launching these funds for the firm's own benefit. Secondly, by introducing the first index-tracking common investment funds and the first, universally available, pure overseas equity fund, the firm was increasing the range of investment choice available to charities and it would have been hard for the Charity Commissioners to argue that this was not worthwhile. Finally, the funds were lucky enough to assemble an excellent board of trustees, and this gave the funds useful credibility with the Commissioners.

The main cause for this Commissioner nervousness is something which has already been mentioned, namely that the Commissioners, almost by default, have found themselves to be acting as quasi-regulator for common investment funds. And the issue is whether they should rid themselves of this responsibility, since it was not the original intention. Some time ago, it is understood, they approached the Securities and Investments Board to suggest that the SIB should formally take on the role, but the SIB has said no, at least for the time being.

In response to this the Charity Commissioners have embarked on a thorough review of how common investment funds should be structured. A second reason for this review is that the Commissioners have come under increasing pressure to allow common investment fund trustees to be paid for their services, which currently, because the Commissioners have tended to look at common investment funds primarily as charities and not as investment vehicles, is not allowed.

One approach which, it is believed, the Commissioners are considering, is to require new common investment funds to adopt the trustee structure of unit trusts, which would presumably make it harder for the SIB to say no to acting as their regulator. The principal consequence of this is that it would involve the appointment of a corporate trustee, who would also take on the role of custodian.

There are two disadvantages to this approach. First, it would increase costs, not least because corporate trustees would demand more in the way of payment than individual trustees, even assuming it were permissible to pay the latter. The second, and arguably more significant, disadvantage is that it would mean that common investment funds would lose their distinctive nature. A great strength of common investment funds is that the trustees are in charge. It is they who appoint the fund manager and, being individuals and fully aware of their obligations, they take a close personal interest in ensuring that everyone's interests are properly protected. As an aside, it is interesting to note that in many ways their position is not unlike that of the independent directors of an investment trust and, after all, investment trusts have survived for over one hundred years. In the case of unit trusts the position is the other way round, in that the manager appoints the trustee. As a result, the manager is free to exercise more control over the fate of the trust than in the case of common investment funds. For these reasons, other than to allow the remuneration of trustees, there is arguably not much to be gained from changing the present trustee structure of common investment funds; if anything, the reverse.

To anyone talking to investing charities, it is clear that charity trustees also feel that their interests are better protected in a common investment fund than in a unit trust. In part this is because of this relationship between the trustees and the manager, as already discussed. However, to come back to the question of who should be responsible for regulation, there is no doubt that charities take enormous comfort simply from the fact that common investment funds are supervised by the Commissioners. It would be a shame if this were lost by handing over responsibility to the SIB.

Finally, it should be said that common investment funds have much to offer to charities. They have a number of advantages over other forms of investment, they have a good performance record, they have a unique structure that protects the interests of unit-holders, and the range of funds to choose from is getting wider all the time. The writer is convinced that, as an investment vehicle for charities, they will continue to grow in importance.