PRUDENTIAL INVESTMENT MANAGERS

A guide to investing in unit trusts

A basic introduction to the world of investing in unit trusts for the South African investor

BOOK 6 OF 6

How unit trusts work

PRUDENTIAL INVESTMENT MANAGERS

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How unit trusts work

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01

How does a unit trust work?

Unit trust managers gather people's savings and use the money to buy (or invest in) a range of assets.

The managers' goal is to use their expertise to increase the total value of the unit trust (usually aiming for a certain performance target) by choosing the highest-returning assets in line with the most appropriate level of risk for that fund. Individuals should choose a unit trust that best meets their own risk and return requirements.

02

How do you make gains (or losses) in a unit trust?

Asset values for equities, bonds, property and cash held by unit trusts rise and fall over time, depending on daily stock and bond market movements, as well as interest rate changes.

These movements in turn impact the value of unit trusts invested in these assets. Unit trust investors make gains (or losses) when the total value of the underlying assets rises (or falls) – this will be the sum of gains and losses across many investments over a period.

These gains or losses are called investment returns, and are made up of three components: asset price increases (capital gains); dividends paid by companies to shareholders; and interest paid by bonds or cash. Fund performance is determined by these three elements, each of which are taxed differently (see **BOOK 4** on taxes). Refer to page 7 overleaf for an explanation of how unit trusts are priced, and page 9 for an explanation of how unit trust performance is calculated.

03

How are unit trusts priced?

The Net Asset Value (NAV) of the fund is the market value of investments, plus cash held, dividends accrued and income accrued less the liabilities due by the fund.

The value of each unit within a unit trust can be calculated by dividing the value of the fund by the number of units that have been issued. Price is determined by the NAV of the portfolio's underlying investments. Units are priced daily because the value of the underlying investments changes every day in line with market movements.

Unit trusts are priced on a forward pricing basis, which is used throughout the unit trust industry. With forward pricing, the price is established each evening, using closing prices of investments for the day. This means that when you buy or sell units you do so at the closing price of that day.
The NAV prices for unit trust funds are published daily in various daily newspapers and online sources.

04

How does the performance of a unit trust work?

When measuring performance of unit trust funds we look at the total return of the fund, which can be measured over various periods.

The total return of a fund is made up of capital gains (or losses) and income distributions in the form of interest, dividends and REIT income, that have been earned over a given period of time.

Total Return = Capital Gain/Loss + Income Distribution

The total return of a unit trust fund is directly related to the daily price of the fund. As the price rises, the fund's return increases, and as the price falls so does the fund's return. It is important to know that when prices decrease, this loss of return is only a "paper loss". This means that the loss is only seen on paper as you would only be locked into this loss when you sell your units. The reason for this is that investing in unit trusts is a medium- to long-term strategy and the fund's prices continually rise and fall over the life of an investment. Generally, the longer you can stay invested, the more likely you are to enjoy a good investment return.

05

What is an income distribution, how does it work and how does it affect the daily price of a unit trust fund?

A unit trust fund can earn income from the underlying assets that it holds. This income is referred to as "distributable income" (since it is distributed to unitholders). It consists of interest and/or REIT income and/or dividends, depending on the underlying holdings.

Unit trust expenses are deducted from income, and the net income forms part of the fund's daily unit price. The daily unit price consists of an income and a capital portion. The income portion is the fund's income less the fund's expenses divided by the number of units in issue and the capital portion is the value of the underlying holdings divided by the number of units in issue. Income declarations are made by unit trust funds (this could be monthly, quarterly, bi-annually or annually), and this is when the income at the declaration date is paid out to the investors.

When investors buy units at any point in time, they are purchasing the income that has been accrued in the daily price up to that point (as discussed above). They are effectively buying the income that the fund will distribute at a future point in time.

05

What is an income distribution, how does it work and how does it affect the daily price of a unit trust fund?

Once the fund has declared income the unit price will drop by the amount of income declared. This will generally be the income portion of the price at the declaration date. The income can either be paid out to the investor, or reinvested back into the fund. In the latter case, the client will now have a greater number of units, although the unit price will be lower as the price has dropped by the income declared as discussed above. It is important to note that reinvesting these distributions is highly beneficial due to the power of compound interest (i.e. growth on growth) over time. You will be taxed on these distributions whether you have them paid out or reinvested. This is discussed in more detail in **BOOK 4**.

Investors also need to understand that market movements will also affect the unit price, and a drop in the daily price after an income distribution will not necessarily be equal to the income distribution. The market value of the underlying assets could have dropped, resulting in a greater drop in the daily price, or vice versa, where the underlying assets have risen in value and the drop is therefore less than the income distribution.

When an investor buys units in a unit trust fund, the cost includes the income accrued up to that point in time as discussed above. When the investor sells units they are selling the income accrued up to that point in time. The income sold would form part of the proceeds for Capital Gains Tax (CGT) purposes, and the original cost would include the income bought. Therefore, income is only included in an investor’s taxable income if it is declared while the investor holds the units. If they sell units before a declaration, the profit or loss would be taken into account for CGT purposes.

06

Why does a unit trust have different unit classes, and what are they?

A unit trust fund can have different classes of units. This allows a unit trust company to charge different types of investors (companies, individuals, etc.) different fees within one fund. Each class of units is open to different types of investors, has different minimum investment amounts and also has different fee structures.

CLASSES OPEN TO INDIVIDUAL INVESTORS

A Class
This is the default class for funds launched after June 1998. The minimum investment amounts are reasonably low to attract individual investors.

T Class
This is the "tax-free" class introduced by Prudential from 1 March 2015 to offer investors a separate class of unit trusts that is exempt from taxes on capital gains, dividends and interest. It also has different fees compared to the A Class.

CLASSES OPEN TO INSTITUTIONAL INVESTORS

B & D Classes
This class is open to institutions like pension funds with large amounts to invest.

Glossary of unit trust terminology

VIEW ONLINE

Term	Definition
ASISA - Association of Savings and Investment South Africa	The industry body which assists the FSCA with the regulation of the financial services industry. Its members include most South African financial services providers, including asset managers, insurers and banks.
Beneficiary	A person who derives advantage from something, especially a trust, will, or life insurance policy.
Capital gain/loss	The increase (or decrease) in the price of an asset such as equity, property or other investments that leads to a profit (or loss) when it is sold.
Capital Gains Tax (CGT)	A tax levied on profit from the sale of an asset such as equity, property or other investments when it is sold.
Cession/To cede	Legally, the formal giving up of rights. Also, to give away ownership of something.
Collective Investment Schemes Control Act, No. 45 of 2002 (CISCA)	CISCA regulates the administration, management and sale of collective investments.
Compound interest	Interest added to the principal of a deposit or loan so that the added interest also earns interest from then on. This addition of interest to the principal is called compounding.
Dividend income	Income from dividends paid to shareholders in a company.
Financial Services Conduct Authority (FSCA)	A unique and an independent institution established by statute (Financial Services Board Act, 97 of 1990), to oversee the South African non-banking financial services industry in the public interest. The FSCA is responsible for ensuring that the regulated entities comply with the relevant legislation, as well as capital adequacy requirements to promote financial soundness of these entities and thereby protecting the investing community.
Fund of Funds	A fund that is comprised of holdings in other funds (and therefore not invested directly in the underlying assets).
Institutional investors	Corporate investors such as pension funds and medical aids.
Interest income	Income received from investments such as bonds and money market instruments (cash) that pay interest.
Linked Investment Services Provider (LISP)	A platform run by a financial services company offering a variety of investment products, including unit trusts, from different asset managers.

Term	Definition
Multi-asset fund	A unit trust that invests in more than one type of asset. For example, balanced funds can invest across most asset classes.
NAV price of a fund	The Net Asset Value (NAV) of a fund is the market value of investments, plus cash held, dividends accrued and interest accrued, less the liabilities due by the fund. The value of each unit can be calculated by dividing the value of the fund by the number of units that have been issued.
Participatory interest	Units owned by an individual in a unit trust fund.
Principal	The amount originally invested or deposited in an account or fund.
Rand-cost averaging	The technique of buying a fixed rand amount of a particular investment on a regular schedule, regardless of the share price. More shares are purchased when prices are low, and fewer shares are bought when prices are high.
REIT/REIT income	A Real Estate Investment Trust (REIT) is a type of listed property company that is governed by strict regulations in terms of its structure and operations. Distributions paid by REITs to shareholders are taxed as income, at the individual's marginal income tax rate.
Return/Total return	The percentage gain or loss in the value of a unit trust over a period of time. The total return includes both income/distributions paid to the investor and the change in asset value (capital gain).
Standard deviation	Also known as risk/volatility. This measures the amount of variation or difference in the monthly returns on an investment. The larger the annualised monthly volatility, the more the monthly returns are likely to vary from the average monthly return (i.e. the more volatile the investment).
Total Expense Ratio (TER)	The TER measures the direct costs involved in managing a unit trust. The TER shows the charges, levies and fees relating to the management of the portfolio and is expressed as a percentage of the average net asset value of the portfolio, calculated for the year to the end of the most recent completed quarter.
Weighted average base cost method	This method is used to calculate the base cost for CGT purposes. It is the weighted average price paid for the units.
Withdrawal	To take money from an account or investment; also known as redemption/repurchase.
Yield	The income return on an investment; specifically, the interest or dividends received from an asset. This is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

A guide to investing in unit trusts

Book 6 ends here along with the series.

OTHER BOOKS IN THIS SERIES:

Book 1: An introduction to unit trusts
Book 2: Ways to invest in unit trusts
Book 3: All about assets, risk and returns
Book 4: The costs of investing in unit trusts: fees and taxes
Book 5: After investing: what you should know

For more information, speak to your financial adviser or contact our Client Services Team on 0860 105 775 or query@prudential.co.za.