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 4 OF 6

## The costs of investing in unit trusts: fees and taxes

PRUDENTIAL INVESTMENT MANAGERS

# Contents

The costs of investing in unit trusts: fees and taxes

BOOK 4 OF 6



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## 01

## What are the different costs and types of fees associated with investing in unit trusts?

**There are a number of different types of charges associated with investing in unit trusts, whether you invest directly via a unit trust company or indirectly through a Financial Adviser or Linked Investment Services Provider (LISP). Legislation requires disclosure to investors from all service providers on their fees and charges, and these are usually disclosed on all marketing material. All the service fees described here exclude an additional 15% VAT charge.**

## TOTAL EXPENSE RATIO (TER)

The TER measures the direct total costs involved in managing a unit trust, and is a good way to compare the cost of investing in different unit trusts. A transparent measure, it is published regularly by all unit trust management companies for each of their unit trusts. The TER includes costs like management fees, trustee fees, legal and audit fees and other operating expenses. It is expressed as a percentage of the average net asset value of the portfolio. Note that a higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TERs. It is also important to note that the TER typically does not include fees charged by a Financial Adviser or LISP platform.

### Transaction Cost (TC)

TC is a measure of the costs associated with the buying and selling of underlying assets within a unit trust.

### Total Investment Charge (TIC)

The TIC is the sum of the unit trust's TER and TC.

01

What are the different costs and types of fees associated with investing in unit trusts?

# INITIAL FEES

**Initial fees are sometimes levied on new investments when purchasing units by a lump sum, top-up or debit order.**

Initial fees are deducted from the amount invested in the unit trust fund prior to the investment being made. As a result, the actual amount invested will be lower than the initial amount.

| Unit Trust Company | Financial Adviser (IFA) | LISP |
|---|---|---|
| Prudential does not charge initial fees, nor do most other companies. Otherwise these fees are negotiable, up to a maximum of 3%. | Negotiable, up to a maximum of 3%. Some IFAs prefer to discount an initial fee in favour of a higher ongoing fee.* | Most LISPs do not charge any initial fees. Otherwise these fees are negotiable, up to a maximum of 3%. |

*At Prudential, we recommend that if the ongoing adviser fee is more than 0.5% (excluding VAT), the initial adviser fee should not exceed 1.5% (excluding VAT).

# 01

What are the different costs and types of fees associated with investing in unit trusts?

## ANNUAL FEES

### Charged by the unit trust company

This is an ongoing annual management fee that is levied by the unit trust company for administering the fund and managing the investments.

### Charged by the IFA

Usually these fees are taken by the sale of the investor's units in a fund. As investors contract directly with their IFAs, this fee is negotiated with the IFA directly and agreed to upfront.

### Charged by the LISP platform

Different platforms use different fee structures. Platform fees are levied by the LISPs to pay for administration. A part of the annual management fee charged by unit trust companies may also be passed on to the LISP to remunerate the LISP for administering the investment, as well as for marketing the unit trust company's funds. These volume-based "rebates" are then passed on to investors in order to reduce the platform fee. There is a current move in the industry towards "clean priced" funds. A clean pricing structure clearly segregates the different fees applicable. With clean pricing, a unit trust company's fees are paid to the unit trust company, administration fees to the administrator and advice fees to the Financial Adviser.

# 01

What are the different costs and types of fees associated with investing in unit trusts?

## SWITCHING FEES

Switching fees may be charged if an investor switches from one fund to another in a different unit trust management company. Prudential does not charge any switching fees between its unit trusts, but some management companies and investment platforms charge a fixed fee for each switch. Most do not charge for switching between funds within the same management company.

## EXIT FEES

This is a fee you may pay if you sell an investment within a certain period (i.e. within the first year), and is based on the original capital invested as well as growth of the fund. Prudential does not charge exit fees for its unit trusts. However, some management companies may do so.

## PERFORMANCE FEES

For certain unit trusts, asset managers charge performance-based fees that are linked to the performance of the unit trust fund. A performance fee may be charged if a fund's performance exceeds its benchmark. Prudential charges performance fees for the **Prudential Dividend Maximiser** and **Prudential Equity Funds**.

VIEW PERFORMANCE FESS

# 02

## How tax-effective are unit trusts?

### Unit trusts are highly tax-effective investments

It is prudent to consider tax planning as part of a holistic approach to your financial planning and future. You should consult with your Financial or Tax Adviser to get advice that is appropriate to your specific circumstances and find out how tax may influence your choices.

**WANT EVEN MORE TAX-EFFICIENCY?**

Consider investing tax-free with Prudential. Visit our website to see our range of tax-free unit trust funds. While you're there, why not use our tax-free investment calculator to work out how much you could be saving by using this investment vehicle.

INVEST TAX-FREE

TAX-FREE CALCULATOR

# 03

## How Capital Gains Tax (CGT) affects you

**Capital gains are triggered when you sell units from a unit trust, if the value of those units has increased since the date you invested.**

Unit trusts calculate CGT based on the Weighted Average Base Cost method. The difference in the base cost and the amount when you withdraw your money or disinvest is known as a capital gain (or a capital loss if the value of the units has declined). Capital gains are taxable in your hands in the tax year in which you sell the units. Individual taxpayers enjoy an annual exclusion on any capital gain (the current annual exclusions can be found in the latest SARS tax tables on page 13). You will be provided with an IT3(c) tax certificate at the end of each tax year if you have made a capital gain or loss on your investment.

### WHAT IS CGT?

A capital gains tax is a tax on the profit realized on the sale of a non-inventory asset. The most common capital gains are realized from the sale of stocks, bonds, precious metals, real estate, and property.

SOURCE: SARS

# 04

## Are there CGT implications when I switch between funds?

**Yes, there are CGT implications when you switch between funds, as you will be selling units in one fund and purchasing units in another fund. Switching between funds too often can erode returns, and so should be avoided.**

# 05

## How income tax and withholding taxes affect you

**You are taxed on the income distributions that you earn within your investment. If you choose to reinvest the regular distributions from the unit trust, it is important to note that the income still accrues to you for tax purposes. Your unit trust management company will provide you with an IT3(b) tax certificate at the end of each tax year detailing all the local and foreign interest, dividends and REIT income you have received.**

# 05

## How income tax and withholding taxes affect you

**Local interest income** is subject to income tax, and is taxed by the Receiver of Revenue at the investor's marginal rate of tax. Individual taxpayers enjoy an annual exemption on all South African interest income they earn from, for example, unit trusts and bank accounts. The current annual exemptions can be found in the latest SARS tax table on **page 13**.

**REIT income** is subject to income tax; this income is taxed by the Receiver of Revenue at the investor's marginal rate of tax.

**Local dividend income** is subject to Dividend Withholding Tax (DWT). This dividends tax is withheld from your investment by the entity that is paying the dividend and paid over to SARS on your behalf. The current DWT rate of tax can be found in the latest SARS tax table on **page 13**.

**Foreign interest income** received by individuals from foreign companies is subject to income tax; this income is taxed by the Receiver of Revenue at the investor's marginal rate of tax.

**Foreign dividend income** received by individuals from foreign companies is subject to tax at a maximum effective rate that can be found in the latest SARS tax table on **page 13**.

05

## How income tax and withholding taxes affect you

**Foreign tax credits** combat the double taxation on foreign taxes levied on foreign income earned by South African tax residents. South African tax residents are taxed on their worldwide income, which creates the potential for foreign income to be taxed both in South Africa and in the country where it was earned. The credit is limited to the maximum of the tax in South Africa.

**Local interest withholding tax** is imposed on interest from a South African source payable to non-residents.

### ASSET CLASSES AND ASSOCIATED INCOME DISTRIBUTIONS*

| Asset Class | Interest Income | Dividend Income | REIT Income |
|---|---|---|---|
| Equity | × | ✓ | × |
| Property | ✓ | × | ✓ |
| Bonds | ✓ | × | × |
| Cash | ✓ | × | × |

*Please note that in order to confirm the type of income distribution received from a particular unit trust fund, you should consult with your Financial Adviser or the managing company of the unit trust fund, as they can differ from the typical distributions above.

# 06

## 2020/2021 tax tables for investing

**The table below is based on the 2020/2021 South African revenue service (SARS) Tax Tables.**

| Source of Income | Tax Rate | Annual Exemptions |
|---|---|---|
| Capital Gains | Individuals: 18% | Individuals and special trusts: R40 000 per annum |
| Local Interest Income | Taxed at the individual's marginal tax rate | Under 65: R23 800 per annum<br>65 and over: R34 500 per annum |
| REIT Income | Taxed at the individual's marginal tax rate | N/A |
| Local Dividend Income | Withholding tax rate of 20% | N/A |
| Foreign Interest Income | Taxed at individual's marginal tax rate | N/A |
| Foreign Dividend Income | Maximum effective rate of 20% | N/A |

SOURCE: SARS

# 07

## An example of how capital gains tax (CGT) is calculated

**CGT was implemented in South Africa on 1 October 2001; prior to this date capital gains were not taxable in South Africa.**

A capital gain or loss is determined by deducting the original cost (base cost) from the market value of the units at date of sale. The base cost for investments made before 1 October 2001 (valuation date) was calculated as the average repurchase price for the last five trading days before the valuation date. The base costs as published by the industry should be used, which are available on the **ASISA website**. For unit trusts purchased on or after 1 October 2001, the actual cost incurred in purchasing the units should be used to calculate the base cost. Industry practice is to make use of the Weighted Average Base Cost method.

The weighted average base cost method is simply the weighted average price paid for the units. An average unit cost is calculated after each purchase of units by adding the cost of the newly purchased units to the cost of the existing units and dividing this figure by the new total number of units. When the units are sold the gain for that transaction would be the difference between the weighted average base cost at that time and the sale price multiplied by the number of units sold.

$$\text{Weighted average base cost} = \frac{\text{(cost of new and existing purchases)}}{\text{(new total number of units)}}$$

# 07

## An example of how capital gains tax (CGT) is calculated

### EXAMPLE

This example is calculated in rand for ease of reference, the cost per unit is usually shown in cents. Units in a unit trust are purchased on the dates indicated below:

| Transaction Date | Investment Value (ZAR) | Cost per Unit (ZAR) | Number of Units (Investment value / cost per unit) |
|---|---|---|---|
| 01/02/2020 | R200 000 | R11 | 18 181.82 |
| 01/03/2020 | R100 000 | R12 | 8 333.33 |
| 01/04/2020 | R50 000 | R13 | 3 846.15 |
| 01/05/2020 | R150 000 | R14 | 10 714.29 |
| **Total** | **R500 000** | | **41 075.59** |

**On 1 June 2020, the unit price is R15**

- The investor repurchases R300 000 by selling **20 000 units (R300 000 / R15)**
- The weighted average unit cost is **R500 000 / 41075.59 = R12.17**
- The base cost of 20 000 units is **R243 400 (20 000 * R12.17)**
- The capital gain is **R300 000 – R243 400 = R56 600**

**Based on the 2020/21 SARS Tax tables:**

- **R40 000** of this R56 600 is exempt from CGT
- Leaving a taxable capital gain of **R16 600 (R56 600 – R40 000)**
- Using the maximum effective tax rate for individuals of **18%**
- The total CGT payable is therefore **R2 988 (R16 600 * 18%)**

# 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 4 ends here

PLEASE READ BOOK 5:

*After investing: what you should know*

READ NOW

OTHER BOOKS IN THIS SERIES:

*Book 1: An introduction to unit trusts*
*Book 2: Ways to invest in unit trusts*
*Book 3: The costs of investing in unit trusts: fees and taxes*
*Book 6: How unit trusts work*

## Ready to get started?

INVEST NOW IN UNDER 10 MINUTES!

INVEST NOW

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