CHAPTER II Definition, Characteristics and Historical Development of Trust Companies.

Legal Definition of Trust Companies

When an individual, a group of individuals or a corporation secures the legal title to property with the obligation to administer it according to instructions for the good of another, a trust is said to be created.[1]

Thus a trust company may be said to be one which is organised "for the purpose of taking, accepting and executing such trusts as may be lawfully committed to it, acting as trustee in the cases prescribed by law, receiving deposits of money and other personal property, and issuing its obligations thereof, and lending money on real and personal securities."[2]

In fact, this definition is legally accepted. The Trust Companies Ordinance, 33 of 1949 classifies a trust company as one which acts as trustee, agent, managing agent, investing agent; to take securities, custodian, to receive and manage sinking funds, and to deposit and invest the moneys of the company in authorised investment.[3]

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1. Clendenin, Introduction to Investment, McGraw-Hill. Inc. 1960 pg.591.
2. Garcia, Encyclopaedia of Banking and Finance Bankers Publishing Co. Boston, 1962 pg.744. The term is synonymously defined, though differently phrased, in Encyclopaedia Britainica, Vol.22 pg.519.
3. These are the main items of the objects of the Trust Companies Ordinance, 33/1949, Section (8).

This graduation exercise does not attempt to deal with this form of trust company as such. This graduation exercise is intended to deal with the investment aspects of trust companies. Hence they shall be known as investment companies or investment trusts. However, both terms are as misleading as the legal definition.

Definition of Investment Companies.

Douglas Bellemore, an investment economist, describes investment companies as cooperative financial institutions

> "whose purpose is to bring together the savings of many individuals and to invest them in a diversified group of securities - either common stock or preferred stock, bonds or a combination of these securities - which have been selected by the management of the investment companies."[4]

Since the characteristics of the Malaysia investment companies are similar to those of other countries the same definition will be used to describe the investment companies of this country comprising open-end investment company[5] and closed-end investment companies.

Investment companies should be distinguished from holding companies - the former only purchase securities for the sake of investment to earn income which the latter attempt to control the management of other companies.

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4. Proehnow, American Financial Institutions pg.438.
5. Their differences between open-end and closed-end investment companies are indicated under the section of 'Classification of Investment Companies' in this chapter pg. 8. Incidentally there is only one open-end investment company in Malaysia.

Some Unique Characteristics of Investment Companies

The capital of the investment company comes from investors or shareholders who purchase the securities in the investment company because they believe that the diversification in the investment of stock will reduce the risk of capital loss and also the yield will be higher than they can receive elsewhere, given the same amount of security.

The company is obliged to sell or buy back the stock from the investors. This is true in the case of Malayan Unit Trusts Ltd. which is an open-end investment company. The unit-holder can redeem for cash at any time by selling the units to the managers of the company.

It was mentioned above that the investment company acquires securities of other companies not for the sake of controlling the management of the companies. Primarily, it just wants to diversify its portfolio so that it can avoid the control over the management of other companies.

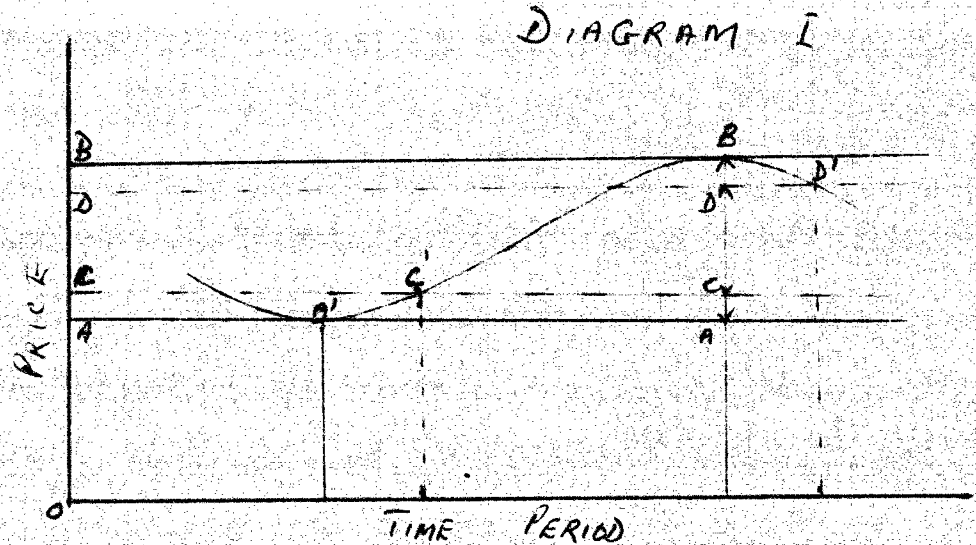
The investment company has two sources of income:

(i) the interest and dividends of the securities owned, and

(ii) the profits obtained from selling the securities above the purchased price.

Speculation for profit of this nature is more practised in the closed-end company than the open-end company. Usually, the investment committee will 'buy in the depression and sell in the boom' and they do better than those who invest when confidence is high and prices are buoyant.

The closed-end companies also attempt to follow this axiom but they usually cannot do very well. They buy when the prices of the securities are rising from the depression and sell them when the prices have just begun to fall from the boom. This is illustrated in the diagram below.



OC' and OD' are the beginning of the rise and fall of the price of shares respectively. It will be observed that the profit margin is CD.

OA' and OB are where the price of shares are at its depression and boom respectively. By selling the shares when the price is at OB if purchased at OA, the profit margin is AB.

The time period taken for the two cases above is the same. Hence any company will inspire to obtain the profit margin AB.

The closed-end company will usually be the one that makes a profit margin of CD. This is due to the fact that though the management is good, it usually is not comparable to open-end company which has qualified and experienced personnel in that field.

The principle of leverage or gearing is applied to all closed-end companies and not to the open-end company i.e. the Malayan Unit Trusts Ltd. which is bound by the trust deed not to raise loan for investment purposes but may increase its paid up capital for expansion purposes. It is discussed more fully in the later part of the chapter.

Classification of Trust Companies (or Investment Companies)

What have been said above are directed to the general investment companies in Malaysia. There are only two types of investment companies or trust companies: (a) closed-end investment companies and (b) open-end investment companies. The distinction is somewhat made clearer in the following diagram:

DIAGRAM II

Trust Companies or Investment Companies

- Investment Trusts or Closed-end Investment Companies
  - Investment Trusts Non-leverage or no gearing
  - Investment Trusts Leverage Type or gearing
- Unit Trusts or Open-end Investment Companies also known as mutual funds
  - Flexible Trusts
  - Fixed Trusts

Note: This is the general set-up of trust companies as practised almost everywhere in advanced chambers.
In Malaysia, only those that are boldly boxed are in operation.

In Malaysia, the closed-end companies are called investment trusts such as Goonchen Investment Trust Ltd. and Soong and Saw Investment Trust Ltd. There is only one open-end company and this is the Malayan Unit Trusts Ltd. It is also known by other names such as mutual funds in the United States. It is called the unit trust in United Kingdom and Australia.

There are variations to the types of unit trusts. One of them is the fixed type of unit trust and the others fall within the general description of flexible trust.

The unit trust, says Merriman, is a trust "similar to a will or marriage settlement to which there are three parties."[6] The first party is the management committee of the company. This group is the investment committee and board of directors. The second party is the trustee. The trustee of Malayan Unit Trusts is the Chartered Bank (M) Trustee Ltd.[7] The third party is the unit holders who occupy the position of beneficiaries under the Trust Deed. The fundamental principle is that the Malayan Unit Trusts Ltd. deposit with the Chartered Bank the portfolios of the Malaysian Stock Exchange securities. The public is then invited to buy fractions of this block which are known as units. The minimum a person may buy is 100 units and thereafter in multiples of 50 units.

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6. Merriman, Unit Trusts and How They Work, Pitman & Son, London 2nd Ed (1960), pg.11
7. The choice of Chartered Bank is something historical. The reason being that when Cooper Brothers Ltd., (a chartered accountant firm) was handling the Malayan Units Trusts the choice fell on the Chartered Bank because of its strong financial position and reputation. So when South East Asia Development Corporation took over the Malayan Units Trusts, it did not take the trouble to change the trustee and hence the position of the Chartered Bank as trustee remains.

Issuance of Stock

Investment trusts or closed-end companies have a relatively fixed capital structure. Initially, they have to issue a certain amount of stock (mainly ordinary shares) as paid-up capital. Unless conditions and circumstances warrant the issuance of additional stock, the management will usually not issue any additional stock. However, if the management intends to increase the paid-up capital, the management has to notify the Registrar of Companies from whom the permission must be obtained and is usually granted under normal circumstances. At present all the companies are privately owned. Hence the shases of trust companies can hardly be purchased by 'outsiders'. Only the respective shareholders of these companies have the first preference. The admission of new shareholders is subject to the consent of the board of directors as spelt out by the memorandum.

Until now all shares issued out are ordinary stock. There is not even one of these companies that had issued out preference or debentare stock.

The amount of investment trusts' shares available for purchase is limited to the issued capital.

Principles of Leverage

Investment trusts belong to the leverage or gearing category. The essential facts in the leverage are the ratio of the stock to the capitalisation of the corporation and the relationship paid on the securities to the rate of return earned on the assets of the corporation. The leverage is said to be considerable if the ratio of the stocks to the total capitalisation is high and the investment trust pays a low rate of interest on the borrowed funds but obtains a higher return from the borrowed funds for investment.

The principle of leverage will enable a higher rate of return than they would earn if the entire capitalisation was in the form of stock.

The principle of leverage implies greater risk because the possibility of loss is greater.

The principle of leverage is illustrated below with reference to one of the investment trusts.

Goonchen Investment Trust Ltd. - Illustration

Borrowed Funds	Rate of Interest	Interest charged
$1,000,000	8%	$80,000
	Return on Investment	Total
$1,000,000	11·5%	$115,000
Income Margin	3·5%	$35,000

<u>Note:</u> The data are hypothetical but the principle used here by this company is similar.

From this illustration, it can be seen that the management will get an income (after deducting payment of interest) of $35,000.

This example also serves to illustrate one point made above. The chances of making a loss of $1,000,000 is greater than previously where there was no investment. Hence a greater risk is involved.

Now supposing that rate of interest is 8% and the return on investment is 7.5% then undoubtedly the management is going to make a loss of 0.5% on the $1,000,000 which is $5,000. Unless the income earned from the borrowed funds is greater than the interest paid, the management will not consider getting loans from the popular source, the bank.

Incomes and Expenses

When it comes to expenses of the investment trusts they are paid out by the companies themselves just like any ordinary company. This is different from the unit trust where the unit holders pay a service charge. The service charge is meant to cover the present expenses with a small sum left accumulating for the future management of the company.

The incomes of the investment trust, are intended to meet their annual expenses whereas the unit trust may recover out of either the capital or the income of the fund, a sum based on the percentage of the half yearly value of the trust fund and also in addition to the initial service charge.

Purpose of Trust Companies

Most of the investment trusts are set up with a view of setting aside some form of property for their children. The management set up investment trusts because their children (who are the major shareholders) can always dispose of the shares in the Stock Exchange market at any time. It is, in fact, the most liquid asset apart from cash. Yet it often brings in quite stable high income in the region of 10% to 12% * of their capital per annum.

* This figure is obtained from one of the interviews with one of the managing directors of the investment trust.

The only one unit trust company, set up in 1959, is geared at channelling the meagre and moderate savings of the small and average wage-earners to boost the Malaysian economy. Had it not been for the unit trusts, a great portion of the money now invested would have been hoarded because of the conservative nature of the people.

Historical Development of Trust Companies

Overseas

The first trust company in Malaysia had its beginning in 1959. The idea came from the Australian investors residing in the country.

Apparently the idea of trust company had its origin in Belgium (Société Générale de Belgique, 1822) and subsequently similar organisations were formed in Switzerland and in France. Still later in the 1860's the trust company movement started in England, expanded steadily for 20 years and reached the height of its development in the boom period of the 1880's. During the formative stage there was little regulation on the activities of the trust companies and unsound and speculative practices prevailed. The financial crisis of the 1890's had retarding influences and there were trust company failures.

It would seem that the pioneer in the field of investment trust in London appeared in the Foreign Colonial Government Trust formed in 1868. Its purpose was to provide the investors of moderate means the same advantages as the large capitalist in reducing the risk of investing in Foreign and Colonial stocks by spreading the investment over a number of different stocks. It was also hoped to provide a reasonably good income for the investors.

By 1886 there were 12 such trusts with a capital of £6,500,000 whose securities were listed on the London Exchange. It was estimated that by 1890 there were between 50 and 60 of these trusts in Edinburgh and London. Although the growth in these institutions were less rapid after 1890, from 25 to 30 investment trusts were organised between 1890 and 1913.

It was estimated that by 1931 there were 190 or more of such trust companies with a total paid-in capital of over £225 million.

It was comparatively recent that the investment trust appeared in the United States. Prior to World War I there were several companies and funds in United States having some characteristics of the British investment trust, but the movement was not developed until the 1920's.

In its initial stage there was evidence that owing to the lack of experience in this new method of investment which had crossed the Atlantic, the management was much restricted and the trust's technical development was slow.

The early American companies were drawn up on comparatively conservative principles like the British trusts, but as their emphasis was on security, these did not appeal to the pioneering and speculative American outlook. Some of the trusts, in search of maximum capital appreciation, were formed with a multiple capital structure[8] and with a bias towards a high gearing leverage.

The phenomenal growth of the investment trust was during the late 1920's. So rapid was the growth that the number of companies was estimated to have exceeded 1,000 and had assets of more than $U.S. 7 billion in 1929. They were no better than the average stock buyers because of poor management. The expenses were often high. Reserves were not provided and because of this many of the investment trusts failed and the total assets shrank to $2,800 million in 1932. By 1940 less than 600 trusts had survived and in the same year the famous Investment Company Act of 1940 was passed.

The interest was revived so much so that the Stock Exchange Commission of the United States reported that there were 453 registered firms with total assets of $170 billion in 1958.

Unit Trusts: The first unit trusts were probably created in 1924 but it was only after 1929 that they attained popularity. Its slow start in the 1920's was due to the fact that the control on management did not provide the possibilities for capital appreciation.

The reappearance of the fixed trust in Britain occurred in 1928-9 when American trust organisation marketed their units through agents in England. The first unit trust, started by the British investors in April 1931, was the Municipal and General Securities Co. Ltd. It was the pioneer of the unit

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8. It consisted of various types of shares such as ordinary shares, preference shares, debentures etc.

trust movement in Great Britain.

However, the British unit trust started in a more favourable environment than its American cousin because the founders had time to reduce the weaknesses of the American framework. The following table shows the growth of the unit trust up to the commencement of the Second World War.

1931	1	1936	71
1932	3	1937	77
1933	8	1938	96
1934	33	1939	98
1935	54		

Source: Merriman, op.cit, p.7

During the War time, there was no selling of units and the creation of new unit trusts were channelled into War Loans.

In 1951 the first unit trust quotation appeared on the London Stock Exchange.

The sales of the investment for the 5 years, 1953-57 were as follows:

1953	£154,724,000
1954	£165,398,000
1955	£273,182,000
1956	£326,424,000
1957	£351,728,000

Source: Merriman, op.cit.p.6.

In Switzerland where in 1931 August was launched the first European unit trust; trust funds have grown to an amount estimated to exceed £150 millions in 1958.

Canadian Investment Fund Ltd. is acclaimed the first mutual fund (or unit trust) in Canada and had funds amounting to $83,821,000 at the end of 1957.

The pioneer company in Australia is the Australian Fixed Trusts (Victoria) Ltd. It was started in 1936 and had £A25 millions of invested funds in 1958.

Development of Trust Companies in Malaysia

In Malaysia, the idea of trust investment is relatively new. The first trust company (a unit trust company) is the Malayan Unit Trusts Ltd. which was registered in August, 1959. It was started by Australian investors with a paid-up capital of $10,010 and has increased to $100,000. It is now a wholly owned subsidiary of the South-East Asia Development Corporation.

Initially it was set up as a business venture but was later turned into a unit trust.

Though the paid-up capital has increased by approximately ten times, the new unit holders have not increased by the same proportion. This is due to the high rate of illiteracy and the conservative idea of keeping one's own money rather than letting other people invest with it.

Since there are 193* public companies traded in the Malaysian Stock Exchange, it is apparently not good to lure the setting up of more unit trusts.

Thus it can safely be said that the Malayan Unit Trusts Ltd. will probably be the only unit trust in Malaysia in the near future until such time when the economy is more developed.

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* As listed in the Gazette, Stock Exchange of Malaysia and Singapore, Vol. VI No. VI. (7th June, 1966)

However, in 1962, two investment trusts[9] were formed and were subsequently followed by other trust companies.[10] Altogether there are eight investment trusts in Malaysia.[11]

The existance of only these few trust companies may be due to one main factor i.e. the lack of management skill in the trust business. The first two investment trusts were originally set up as trust companies with a view of creating trusts for their children. Later, however, those turned out to be investment trusts in characteristics because all the capital are invested in shares and those seemed to earn them good incomes in the form of dividends. Later still, they were involved in share speculation.

The investment trust needs a big fund for its investment. It does not want to invite public investors to pool in funds since it is a private company.[12] The amount it has for investment is the amount of paid-up capital unless the banks or other institutions are willing to make loans to the company. Hence it requires a large paid-up capital. This is another factor which discourages the setting up of more trust companies.

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9. Goonchen Investment Trust Ltd. and Soong and Saw Investment Trust Ltd.
10. Malayan Securities Trust Ltd., Malayan Investment Trust Ltd. Timor Investment Ltd., Lebing Investment Ltd. Koh Investment Trusts Ltd. and Tiger Trusts Ltd.
11. This information is taken from a survey conducted by the Statistics Department, Kuala Lumpur in 1965.
12. All the investment trusts are private companies.

In the case of the unit trust expert guidance and skill of management are required. The 'technical knowledge' in this field is a new idea to the Malaysians and hence the reason for the small growth.

In conclusion, it can be said the trust investment movement is still in its infant stage. With many obstacles in its path, it is very unlikely that the movement will gain much momentum.