CHAPTER IV:

Policies and Practices of Trust Companies

In this chapter, the discussion is centred around the management of trust companies, the policies (including objectives) and practices of the companies as well as an evaluation of the performance of the trust companies.

Management and Fees

One of the principal advantages of purchasing trust company's shares is the shifting of responsibility of investment to more expert management. The investors (or shareholders) of the investment trust do not have a say in the management except in the general meeting held yearly where they elect the latter. The management is left independently to manage the company. In the case of unit trust, the unit holders[1] similarly do not have a say in the management of the company. They merely place their funds with the management who will invest according to their own discretion.

In both types of trusts, the management is paid a compensation. With regard to the unit trust the compensation comes from two sources:

(1) loading charge or service charge

(2) the management fees.

1. Unit-holders should be distinguished from shareholders. Unit holders are the investing public who pool in funds

The management of the investment trust does not have the service charge, it is only given management fees annually.

The service charge of the unit trust ordinarily ranges from four to nine per cent.[2] This percentage represents the entire cost of buying and selling investment. The units are reduced at asset value without charge. When the unit holder purchases the units he is, in fact, purchasing the diversified portfolio and the expert management.

The management fee is fixed at half of one percent per annum of the net asset value. In the case of the Malaysian Savings Fund[3] it is ten percent flat.

In the investment trust the operating expenses are rather fixed. This distinguishes it from the unit trust where the management is paid according to their ability to earn for the unit holders and the sales of units.

Investment Requirements of Trust Companies

In analysing the financial position of trust companies the investment trust has mostly ordinary shares. On the liability side are loans or overdrafts usually from banks.

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for investment while the shareholders are the actual owners of the company who contribute to the paid-up capital.

2. The actual percentage is not given because it is a business secret. However, the range of four to nine percent is obtained from calculation on Appendix II (a), ~~(b) and (c)~~ prices and the method of computing is $\frac{S-B}{B} \times 100$

3. A fund managed by Malayan Unit Trusts Ltd.

As far as minimum requirements are concerned, this kind of analysis shows very moderate need for stability of investment income. The operating expenses of trust companies are small compared to total income because there is annual distribution of dividends.

The investment trust has to cover only the operating expenses. It may have to pay interest on the loans or overdrafts from other financial institutions usually banks because the rate of interest is lower.

The funds of the investment trust are not subject to withdrawal whereas funds of the unit trust are subject to withdrawals. Shareholders of the investment trust who submit shares for redemption are entitled only to its prices prevailing in the market. If however, the securities are sold at a loss it is the withdrawing shareholders who sustain this loss and not the company as a whole.

In the case of unit-trust, it provides funds for the withdrawing unit holders from the proceeds of new sales of units. This is some sort like a 'replacement' or a transfer of title without liquidating the securities from the portfolio. Should there be any increase in redemption of units for cash than the 'replacement' obviously the unit trusts will be forced to reduce the holding of the securities and vice versa.

<u>Marketability of Shares</u>

These two types of trust companies have different needs in the marketability of shares.

The unit trust which guarantees to repurchase back the units from the unit holders must confine its investment to mainly highly marketable securities. Already the Malaysian Stock Exchange is considered thin[4] (as is the case with newly developing countries). Thus, if the unit trust were to confine its investment to highly marketable securities in the existing thin stock exchange market, the situation will be very depressing.

However, this need not be so for an investment trust but, the degree of marketability depends on the policies and practices adopted by the management.

The Attractiveness of Unit Trust

An unit trust may appear attractive to the public in many ways such as the composition of securities in the portfolio and the half yearly dividends. Investing in highly marketable securities by the unit trust is also one of the attractivenesses.

Some investors consider appreciation in the value of the securities as sound investment. Others may look at high dividends/distributions as sound investment.

High dividend - earning securities are usually risky. The type of securities which involves less risk usually earns low dividends. There seems to be a conflict in the investment policy and is more so in a unit trust than in investment trust. The investment policies of the former are more

4. The stocks traded in the exehange market are limited to a few companies.

influenced and limited whereas in the case of investment trust the primary motivation is to do a good job.

From this it can be deduced that the unit trust will invest primarily in the shares of well-established companies such as Chemical Company (Malaysia) and Shell. It has also to choose those shares which will earn good dividends such as tin shares and to be fully invested i.e. keeping as little cash as possible[5].

The process of investment can be summarised into three parts:

(a) the analysis and selection of a list of stock for current investment

(b) the formulation of an investment policy, and

(c) the selection of a portfolio.

Investment Policies of Trust Companies

Trust companies may be classified according to the investment policies they pursue. They may also be classified according to the degree of financial risk represented by the type of securities in their portfolio. One common feature of its policy, however, is that all the trust companies do not channel their funds into one industry. In fact the policy followed is that of diversification in all the industries consisting primarily of tin, rubber and manufacturing industries.

5. Please refer to the Auditors' Certificate of the Malayan Unit Trusts in Appendix V, p. 79

Apart from this there is one trust company (Soong and Saw Investment Trust) which invests heavily in properties and realty.

The type of securities secured by these companies are primarily ordinary shares. They do not invest in government securities because the income derived is low compared to other types of securities. The aim of Investing in trust companies is to get a high income otherwise the management might as well leave the investment in government securities to the individuals.

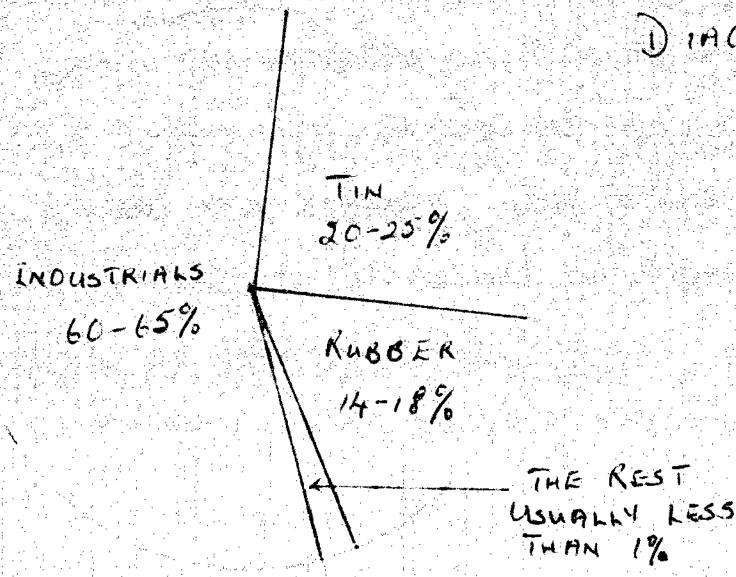
All the trust companies, except Soong and Saw Investment Trust, show a decline in the investment in properties because since 1963 the dividends from properties have always been on a decline.

These trust companies have certain investment objectives and the main ones are capital appreciation and high income. As indicated earlier, investment with the hope of capital appreciation rarely brings high income and vice versa. Hence, a compromise between these two objectives is arrived at. The policy is thus affected by these objectives so much so that investment covers the three major industries, namely tin, rubber and industrials. The rest such as property forms an insignificant portion of the investment of trust companies.

Investment in tin is significant because it can bring in dividends of 30 to 40 percent on the capital per year and rubber is in the range of 15 to 24 percent. The industrial shares generally have a low dividend of 6-10 per cent but have a good capital appreciation.

To strike a balance between capital appreciation and high dividends is to invest in all these three major industries. The amount of funds invested are in the proportions shown in the diagram.

DIAGRAM III



This diagram shows the general allocation of funds in the various industries by the trust companies except one investment trust.[6]

<u>Unit Trust</u> - It can be designated as ordinary stock funds. The general characteristic of the ordinary stock funds is the policy of diversified investment in ordinary shares as indicated by the portfolio of the Malayan Unit Trusts in Chapter V and Appendix V.

Investment in unit trusts is strictly a long term investment and has little regard for cyclical and intermediate

6. From interviews with top officers of the trust companies, the writer is given these approximate figures. It is, therefore, not 100 per cent accurate.

price fluctuations. That being so, prospective investors, wishing to invest through Malayan Unit Trusts, must have a view of long term investment.

The marketability of the securities affects the investment policy. It must invest in securities of high grade marketability because when the unit holders want to redeem the units for cash, the company is obliged to do so and the only alternative left is to dispose of some of these securities for cash to pay the unit holders. The share market is thin and apparently the unit trust cannot operate very well as compared to those of developed countries.

Investment Trusts - Most of the investment trusts here invest in ordinary stocks. It is emphatically stated that it is not worth to invest in government securities because the return is low. Though the investment is diversified, the diversification is not as significant as that of the unit trust.

Some investment trusts invest more in certain public companies. It is simply a policy of aggressive concentration because they feel that certain companies are favourable for investment.

Whereas the unit trust is more tolerant of price fluctuations, the investment trust is not. In fact, it is aggressive towards market price fluctuations. With the fluctuations in the market prices of shares, the tendency is to vary the holding of shares in the invested companies so as to realise a profit. Undervalued shares are bought and will possibly be sold when there is price appreciation.[7]

Special Services of Trust Companies

The only common service of the investment trust and the unit trust is to help the investors to earn more income. Each has its own approach. Apart from this the investment trust does not perform other services for the shareholders. But it is not so in the case of the unit trust.

When units are purchased on a large scale, it is only reasonable that the service (or loading) charge should be reduced, thus making the shares available at a lower price. Of course, it does not affect the distribution of income which is on a pro rata basis.

The unit trust operates a savings plan under which the investors make periodic payment. The amount is then invested in trust shares and the service charge is ten per cent. In this way the fund (Malaysian Savings Fund is the only one) will always be fully invested. Any dividend accrued to this are re-invested to buy additional shares. For a small additional cost the investors may insure himself for the amount invested with reducing term insurance.[8] He need not have to

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7. Please refer to page 10 of Chapter II for a discussion of the principle of leverage
8. Please refer page 55 of Chapter V.

pay directly - the premium is deducted from his savings.

These plans are attractive to many people. . The ten per cent of service charge is admittedly high but not excessive. With the insurance plan, the investor can be absolutely sure of getting back his investment. This bridges the needs of many prospective investors.

For those who are tax conscious they need not have to worry. Every unit holder will be given a tax exemption voucher when he receives the distributions. Adjustments will have to be made if the tax amount exceeds a certain percentage.

There are plans which ensure the investors that their dividends can be re-invested if he so desires. Apparently so far, no concession in terms of money or preference is made yet. In case a trust fund expires (the earliest is the First Malayan Fund expiring in 1969) the investors can have their investment transferred to other funds.

Distribution and Taxation

The investment trust has two sources of income.[9] The income is then distributed to the shareholders in the form of dividends. Usually the income is between 8 to 12 per cent per annum. A portion of the income is set aside as reserves and the rest is distributed annually.

The distribution of the unit trust is done twice a year. This is because the dividends from the invested

9. Please refer to page 6 for the sources of income.

companies are collected all the year round.

The statement given for distribution is in terms of the number of dollars per hundred units. Usually it is between four to six dollars per hundred units per distribution.[10] This is the gross distribution. Probably the distributional income to unit holders may increase in the near future. This is due to the fact that economic conditions may be good with the ending of confrontation.[11]

The Malaysian tax structure follows closely that of the British and Australian. Every individual is taxed only once. In United States there are instances of double taxation.

Investment trust pays a flat forty per cent tax just like any ordinary company. It appears to be that there is double taxation because the invested company pays forty per cent tax and the dividends are passed to the investment trust which is again taxed. This will be grossly unfair. Adjustment is thus done. Any dividend from the company to the investment trust will be exempted and any income from speculation will be taxed accordingly. Hence, if the income is only from dividends of shares then the investment trust more or less acts as collecting and distributing centre of the dividends. The individual is taxed - here it is the personal income tax. Again adjustments are made in such a way that no investor will have to pay tax twice.

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10. Refer Appendix V page 78
11. Confrontation is an unofficial war by Indonesia on Malaysia and which affects the economy of both countries.

In the case of unit trust, the function as collecting and distributing centre is more obvious except that it places a service charge. The unit trust collects the dividends from the various invested companies and after deducting a certain amount for service charge, it passes the rest of the income as dividends to unit holders who will have to pay the personal income tax. Here again, as in the investment trust exemption is permissible only if the unit holder produces a tax exemption voucher to that effect from the trustee up to a certain amount.

Trust Companies and the Small Investor

Individuals in the lower and middle income groups cannot afford to pay the fees charged for the small accounts by the investment counsellors except that handled as common trust funds. Expert advice on investment is only available to wealthy investors and these people form the investment trust.

Investment advice is also available to the less wealthy people through the unit trust on a small percentage of half of one per cent. By so placing their funds (or savings) with the unit trust, the investors can obtain diversification of investment and good management. It should be noted that the individual small investor cannot diversify his fund because it is not significant enough.

These small investors buying units from the unit trust find that three problems are partly solved.

(i) The problem of proper selection - This problem is getting more difficult as the Malaysian economy is constantly changing. That this is so is because of industrialisation taking place in Malaysia. Proper analysis takes time as it involves specialised statistical information and interpretation of information. Without these proper selection of security may not lie possible.

(ii) The problem of diversification - Small investors cannot secure adequate diversification at reasonable low cost as it is quite expensive to buy one share in one company.[12]

The unit trust solves this problem through the common trust fund which invests money in many varied companies.

(iii) The problem of timing - Bad timing can cause to lose a lot of money. Unit trust helps solve this problem in two ways: firstly, the wide diversification will overrule the price changes of shares and, secondly, since the management is expert in this field, it may be able to analyse the situation which is not available to the small individual investor.

Evaluation of Performance

The primary analytical problem is that of evaluating the quality of management which can be measured in terms of results

12. A certain fixed minimum fee has to be incurred for brokerage, commission, etc.

or performance.

In the case of the unit trust, the investment policy is that of a balance between capital apprecation and income. Since the initiation of the First Malayan Fund, the price of each unit still exceeds one dollar and the income for the unit holder is between \$4 to \$6 per hundred units per distribution which is quite high. This amount is the gross distribution before tax. Therefore it can safely be said that the First Malayan Fund performs well. The same applies to the Second and Third Malayan Funds but, of course, a glance at the prices and the distributions will show that the First Malayan Fund has the best performance. The Malaysian Commerce and Industry Fund is not good for the investor to invest because the prices very ofteh fall below \$1·00 per unit. This may be due to the fact that this Fund was the last of four funds to be launched.

The performance of the investment trust can be evaluated on the same basis as in the unit trust. In this case the capital appreciation is not in terms of price per unit but in terms of the increase or decrease in total net asset i.e. the total value of all shares. Both the shareholders and unit holders receive returns.

In most cases there is a slight capital appreciation. This is due to the fact that the shareholders are more conscious of getting high income so long as there is no capital depreciation. Investment trust usually does not have much funds for investment except the paid-up capital unless it is able to obtain loans from other financial institutions.