Section 2

Financial assets

Introduction

Few people today hold their financial wealth in cash. While we still sometimes read of people with large quantities of notes and coins stored in their homes, this is increasingly rare. At the very least they generally keep their money mainly in bank and building society accounts. Many people have wealth stored in the form of property, such as houses or works of art.

When people have more money than they need to spend immediately, they tend to invest it with a view to making a profit, thus becoming part of the chain of intermediation described in Section 1.1.1.

Section 2 looks at a range of what might be described as *direct* investments, as distinct from *indirect* investments in financial assets (eg collective investments such as unit trusts), which are covered in Section 3.

Section 2 covers part 2 of the syllabus for Unit 1. The assets covered in Section 2 are deposit-type investments, fixed-interest securities such as gilts and corporate bonds, shares (and other forms of corporate financing) and property. We describe the nature of each type of asset, with its features and benefits, its advantages and drawbacks, and how it is affected by taxation of income and capital gains.

© ***ifs*** *School of Finance* 2008

2.1 Deposits

Deposit-based investments are those in which the capital element is fixed but the income from the investment may vary.

Investors place money in deposit-based savings accounts for a number of reasons. Some consider their capital to be secure. In one respect this is true, ie the amount of capital invested remains intact, but inflation reduces the value of capital and, in times of high inflation, the value of their deposits can quickly be eroded in real terms.

There is also the risk of loss of capital if the institution becomes insolvent. This is rare with banks and building societies, but is not unknown. In the event of insolvency, investors may be able to reclaim some of their funds through the Financial Services Compensation Scheme.

The convenience of the ready accessibility of banks and building societies is a strong reason for investors to deposit money with them; it is believed that, to some extent, inertia inhibits an investor's search for a more rewarding home for their deposits.

If the reason for saving or investing money is for a short-term purpose (next year's holiday or a new car, perhaps) then few would argue that a deposit-based savings account is a sensible place in which to invest the money. It is prudent to have a part of an investment portfolio that is easily accessible in, for example, a no-notice deposit account; this is often referred to as money put by for a 'rainy day'. Institutional investors maintain a part of each of their funds in readily accessible form.

2.1.1 Bank accounts

In general, banks offer three types of interest-bearing account:

- deposit accounts;
- money-market deposit accounts;
- interest-bearing current accounts.

 © *ifs School of Finance* 2008

2.1.1.1 Deposit accounts

These are among the most straightforward types of account that banks offer. Depositors (whether individuals or corporate bodies) can invest from as little as £1 with no maximum, and receive a return on their investment in the form of interest.

Interest is normally variable and is usually linked to the bank's base lending rate. It is calculated daily and added to the account on a periodic basis (ie quarterly, half-yearly or yearly).

Some deposit accounts offer higher interest rates provided that a certain minimum investment is made. Deposits can be subject to notice of withdrawal, with the typical notice period being seven days. Often the requirement for notice will be waived subject to a penalty, which is normally equal to the amount of interest that could be earned over the notice period.

Deposit accounts may be considered as an investment of funds kept for an emergency or otherwise in case of need. Over the longer term, however, they have proved to be unattractive when compared with asset-backed investments.

2.1.1.2 Money-market deposit accounts

These accounts usually attract a higher rate of interest than ordinary deposit accounts. The rate of interest reflects current money-market interest rates and may vary according to the amount invested. There are two basic types of money-market account: fixed accounts and notice accounts.

- *Fixed accounts* are term deposit accounts, where a sum of money is invested for a fixed period during which time it cannot normally be withdrawn. This period can vary from overnight to five years. The rate of interest is normally fixed for the whole period.
- *Notice accounts* have no fixed term but, as the name implies, there is a requirement on the investor to give an agreed period of notice of withdrawal. Similarly, the bank must normally give the investor the same period of notice of a change in interest rate. A typical period of notice could be anything from seven days to six months, although 12-month notice periods are available.

Money-market deposit accounts may be suitable for individuals with very large amounts of cash to place on short-term deposit until they commit the cash to other purposes.

See also Section 2.7 (money market instruments).

© *ifs School of Finance* 2008

2.1.1.3 Interest-bearing current accounts

Interest-bearing current accounts provide an investor with immediate access to his funds without loss of interest. These accounts provide a range of services such as a cheque book and guarantee card, cashpoint facilities and overdrafts.

Interest-bearing current accounts for the mass market are a relatively recent phenomenon and have developed as a result of increased competition between the banks and building societies. Interest rates on current accounts are generally very low although higher rates may be available on accounts processed through telephone call centres or the Internet.

Many banks have, for several years, offered high-interest cheque accounts. As the name implies, higher rates of interest are available with these accounts that, as a consequence, have higher minimum levels of investment, typically from £1,000 to £10,000. These accounts are normally free of charges subject to the minimum balance being maintained. Some accounts, however, allow only a limited number of cheques to be drawn in a given period without charge.

2.1.1.4 Taxation

Interest paid on bank deposit accounts has tax deducted at a rate of 20%. If the gross interest rate is, for example 4%, the actual net rate received is 3.2%. Lower and basic rate taxpayers have no further liability. Higher rate taxpayers will be liable for an additional 20%.

Interest can be paid gross if the depositor declares that he is a non-taxpayer by completing form R85. Alternatively, non-taxpayers can reclaim any tax deducted and 10% taxpayers can reclaim the additional 10%.

2.1.2 Building society accounts

Building society accounts have long been the home for investors' surplus funds. They have offered competitive rates of interest in various types of account such as ordinary share accounts, high-interest-bearing accounts and term accounts. The main difference between a bank and a building society is in their legal structure. Building societies are mutual organisations and are owned by their members (investors with share accounts and borrowers), whereas banks are limited companies owned by their shareholders.

- *Ordinary share accounts* offer instant access without penalty but pay a lower interest rate than notice accounts.

 © *ifs* School of Finance 2008

- *Notice accounts* offer access to money within 7, 30, 60 or 90 days. Societies may allow immediate access to these accounts but will usually charge a penalty equal to the interest earned over the notice period.

Tiered interest rates are often available on building society accounts. Basically, the larger the investment, the higher the rate paid, but should the investment level fall into a lower tier, the interest rate will be reduced.

In addition, building societies may offer monthly income facilities on all their accounts. For this facility, it is a usual requirement to have a higher minimum level of investment.

Building societies, along with banks, provide the appropriate investment for those investors who have short-term investment needs but also require immediate access to their funds.

2.1.2.1 Taxation

Currently, all building society deposit accounts subject to tax are taxed the same way as bank deposit accounts (see Section 2.1.1.4).

2.1.3 Offshore deposits

The term 'offshore' is usually applied to any investment medium, whether bank or building society account or other form of investment, which is based outside the UK in a country that offers a more advantageous taxation of investments. Such countries, sometimes referred to as *tax havens,* include the Channel Islands, Luxembourg and the Cayman Islands.

Offshore investment can potentially expose the investor to greater risk than a similar onshore investment. Firstly, the account may not be denominated in sterling and will therefore be at risk of adverse currency movements if the investment is to be converted back to sterling at some point. Secondly, not all offshore accounts are protected by investor protection schemes. Investors should check what protection is available through local regulatory regimes.

Offshore investments may be useful to an investor who needs money to be available outside the UK, eg someone who owns a property abroad or who plans to move abroad in the future.

The interest on an offshore deposit will be paid gross. A UK resident must declare the income to HM Revenue and Customs. Overseas interest is taxable in the hands of UK residents (unless they are not ordinarily resident or domiciled in the UK). They may, however, be able to obtain relief from some or all of this tax under a double taxation agreement if the interest has been taxed overseas.

There are specific rules governing whether or not an individual is resident or non-resident as far as his liability to UK taxation is concerned (see Section 1.3.3.1). Care should be taken to determine an investor's residential status.

2.1.4 Cash ISAs

Individual savings accounts (ISAs) are a form of tax-efficient personal savings scheme. ISAs can take a number of forms, which are described in Section 3.2.4.

One form of ISA is the cash ISA: it is basically a means of obtaining tax-free interest on a bank or building society deposit account, subject to certain limits and regulations. National Savings and Investments also offers a cash ISA.

The maximum investment in a cash ISA is currently £3,600 per tax year.

2.1.5 National Savings and Investments

National Savings and Investments (NS&I) offers a range of saving and investment products on behalf of the government. The risk associated with the products is very low because all products guarantee the return of any capital invested.

There are NS&I products to suit most types of investor, with different terms, interest rates and taxation. Full details of the range of deposit-based savings and investments offered can be obtained from the Post Office or by visiting the National Savings and Investments website at **www.nsandi.co.uk**.

A brief summary of the main products is included below.

© *ifs School of Finance* 2008

2.1.5.1 Easy access savings account

This is a 'card and PIN' based account. It has a tiered interest-rate structure and interest is paid gross but is taxable. It is available to anyone aged 11 or over, subject to a minimum balance of £100.

2.1.5.2 Investment account

This account may be opened by anyone over the age of seven and, for those under this age, a parent or legal guardian may open the account.

The account pays a variable rate of interest at rates that are tiered in seven levels, from under £500 to £50,000 and beyond. The interest is paid gross but is liable to income tax.

2.1.5.3 Income bonds

Income bonds offer regular monthly income. The income bond has no term and capital can be withdrawn at any time. Interest is paid up to, but not including, the day it is withdrawn.

The interest rates are variable and are tiered according to the amount of money invested. Interest is paid gross but is liable to income tax and must be declared.

2.1.5.4 Guaranteed income bonds

This is a lump-sum investment for a fixed term of one, three or five years, paying a fixed rate of interest depending upon the term chosen. Interest is paid monthly, net of basic rate income tax. They are available to anyone over the age of 16.

2.1.5.5 Guaranteed growth bonds

This is a lump sum investment for a fixed term of one, three or five years. Interest is calculated yearly but added to the investment at the end of the term. Interest is paid net of basic rate income tax. They are available to anyone over the age of 16.

© *ifs School of Finance* 2008

2.1.5.6 Guaranteed equity bonds

This is a lump-sum, fixed-term investment with growth potential linked to the FTSE 100 index, while guaranteeing the security of the original capital invested. Income is paid gross, but is liable to income tax and must be declared. They are available to anyone over the age of 18. Each issue of guaranteed equity bonds is only available for a limited period.

2.1.5.7 Savings certificates

Savings certificates are of two main types: fixed-interest and index-linked. The fixed-interest certificates pay a fixed rate of interest throughout the chosen term of two years or five years. The index-linked certificates (currently available in three-year and five-year terms) differ in that their value increases with inflation as well as offering interest.

The certificates are available for investments of between £100 and £15,000.

Interest is paid gross and carries no liability to personal income or capital gains tax. Certificates are therefore particularly attractive to higher rate taxpayers. For example, the rate of interest on the 89th issue of five-year fixed-rate certificates is 3.00%. This is equivalent to a gross rate of 3.75% to a basic rate tax-payer and 5.00% to a higher-rate tax-payer.

2.1.5.8 Premium bonds

Premium bonds provide investors with a regular draw for tax-free prizes, while they retain the right to cash in the bond.

The minimum purchase is £100 and the maximum is £30,000 per person. Prizes are drawn each month and can be worth up to £1 million. Winnings from premium bonds are tax-free.

The bonds can be encashed at any time, subject to eight working days' notice.

2.1.5.9 Children's bonus bonds

The children's bonus bond is a lump sum investment intended to be retained for at least five years. Anyone over 16 may purchase a bond for anyone under 16. The bond should be encashed no later than the child's 21st birthday because no interest is payable after that age.

© *ifs School of Finance* 2008

The interest rate is fixed for the first five years and a bonus is added on the fifth anniversary. A final bonus is added on the child's 21st birthday.

2.2 Fixed-interest securities

2.2.1 Government stocks

Gilt-edged securities (commonly known as gilts) are British government securities and represent borrowing by the government. Gilts are safe investments because the government will not default on interest or capital repayments.

A gilt is categorised primarily according to the length of time left to run until its redemption. The redemption date is the date on which the government must buy back the gilt at its original issue value or *par value,* normally quoted as a nominal £100. Each gilt pays interest on the par value at a fixed interest rate known as the *coupon*.

Most gilts have a specific redemption date; some have two dates between which there will be redemption on a date selected by the government, at its discretion.

The categories are as follows:

- *short-dated gilts*: also known as shorts, these are gilts with less than five years to run before redemption;
- *medium-dated gilts*: also known as mediums, these are gilts with between 5 and 15 years to run before redemption;
- *long-dated gilts*: also known as longs, these are gilts with over 15 years to run before redemption;
- *undated gilts*: gilts with no redemption date at all are redeemable at any time subject to the government's discretion. The government is, however, under no obligation ever to redeem them.

The above definitions come from the financial press. The UK Debt Management Office, which issues gilts, defines short and medium gilts as follows:

- *short-dated gilts:* 0–7 years;
- *medium-dated gilts*: 7–15 years.

Index-linked gilts are gilts where the interest payments and the capital value move in line with inflation. The redemption value and the interest paid are therefore index-linked. For the investor this means that the purchasing power of his capital and interest received will remain constant, unlike all other fixed-interest stock where inflation erodes the purchasing power of fixed-interest payments.

A gilt-edged stock with a coupon of 5% and a redemption date in 2021 might be designated as 'Treasury 5% 2021'.

Interest on gilts is normally paid half-yearly, so the holder of £10,000 nominal of Treasury 5% 2021 would receive £250 in interest every six months. The interest is paid gross, but is subject to income tax at the investor's highest rate.

Gilts cannot be redeemed by investors prior to the redemption date but can be sold to other investors. The price at which they are sold depends on a number of factors: the level of market rates of interest; nearness to the redemption date; supply and demand.

Gilt prices are quoted either *cum dividend* or *ex dividend*. If a stock is bought cum dividend, the buyer acquires the stock itself and the entitlement to the next interest payment. If, however, the stock is bought ex dividend, then while the buyer acquires the stock itself, the forthcoming interest payment will be payable to the previous owner of the stock (ie the seller).

Any capital gains made on the sale of gilts are entirely free of capital gains tax (CGT).

Example

A higher rate taxpayer buys £100,000 par value of Treasury 5% 2019 at a price of 80.0, ie he pays £80,000 for the stock.

He receives annual interest of £5,000 (actually £2,500 per half year), which represents a yield of 6.25% on his investment of £80,000.

The interest is paid gross but he must pay tax of 40% on it, leaving him with net annual interest of £3,000.

Later he sells the stock for £90,000. There is no capital gains tax to pay on his gain of £10,000.

 © *ifs School of Finance* 2008

2.2.2 Local authority stocks

Like the government, local authorities can borrow money by issuing stocks or bonds, which are fixed-term, fixed-interest securities. They are secured on local authority assets and offer a guaranteed rate of interest, paid half-yearly. The interest is paid net of the basic rate of income tax (20%). Higher rate taxpayers are liable for a further 20% tax and non-taxpayers can reclaim any tax paid. The bonds are not negotiable and have a fixed return at maturity.

Return of capital on maturity is guaranteed but these are not quite as secure as gilts since there is no government guarantee.

2.2.3 Permanent interest-bearing shares

Permanent interest-bearing shares (PIBS) are issued by building societies to raise capital. They pay a fixed rate of interest on a half-yearly basis. Interest is paid gross, although it is taxable as savings income according to the investor's tax status.

Investors should also note that PIBS rank below ordinary accounts in priority of payment, should a society become insolvent.

2.2.4 Corporate bonds

Corporate bonds are similar in nature to gilt-edged stocks, but they represent loans to commercial organisations rather than to the government. They normally have a fixed redemption date, a specified redemption value and a fixed interest rate, and – like gilts – they can be bought and sold at prices that reflect market rates of interest.

They are considered higher risk than gilts because they do not have government backing, and they therefore tend to offer higher yields.

2.3 Equities and other company finance

When companies need to raise money in order to commence or to expand their business, there are various ways in which this can be done. Section 2.2.4 above introduced corporate bonds, which is one way of borrowing money for a fixed period at a fixed rate of interest. Other types of loan, either secured or unsecured, can also be used and the most common way for companies to be funded is through the issue of shares. These methods of company financing are described in the following sections.

2.3.1 Ordinary shares

Ordinary shares, also known as **equities**, are the most important type of security that UK companies issue. They can be, and are, bought by private investors, but most transactions in equities are made by institutions and by life and pension funds.

Holders of ordinary shares (shareholders) are in effect the owners of the company. The two main rights that they have are:

- to receive a share of the distributed profits of the company in the form of dividends;
- to participate in decisions about how the company is run, by voting at shareholders' meetings.

The rights attaching to shares of the same class can sometimes differ from company to company, even though the shares normally have the same major characteristics. It is therefore prudent for investors to find out precisely what rights attach to a particular share. These rights are given in the company's Articles of Association, which is a public document and can be examined at the registered office of the company or at Companies House.

Direct investment in shares is considered to be high risk because the failure of the company can result in the loss of all the capital invested. This risk can be mitigated by investing across a range of shares and the products available to facilitate this (such as unit trusts and investment trusts) are described in Section 3.2.

The prices at which shares are traded depend on a range of factors, including:

- the profitability of the individual company;

© *ifs* School of Finance 2008

- the strength of the market sector in which it operates;
- the strength of the UK and worldwide economies;
- supply and demand for shares and other investments.

In the short term, share prices can fluctuate both up and down – sometimes quite spectacularly – but in the long term, investment in equities and equity-linked markets has outpaced inflation and has provided higher growth than deposit-type investments.

2.3.1.1 Buying and selling shares

The Stock Exchange has been London's market for stocks and shares for hundreds of years. Government stock, share capital and loan capital, overseas shares and options are all traded on this market.

There are two markets for shares: the main market (for which full listing is required) and the Alternative Investment Market.

2.3.1.1.1 The main market

The main market allows companies to be quoted on the Exchange if they conform to the stringent requirements of the Listing Rules laid down by the FSA, acting in its capacity as the UK Listing Authority (UKLA).

For a full listing (ie a listing of the main market), a considerable amount of financial and other information is required to be disclosed accurately. In addition:

- the applicant company must have been trading for at least three years;
- at least 25% of its issued share capital must be in the hands of the public.

2.3.1.1.2 Alternative Investment Market (AIM)

The Alternative Investment Market, which started in 1995, is an additional, separate market on the London Stock Exchange. It is mainly intended for new, small companies with the potential for growth.

Its purpose is to enable suitable companies to raise capital by issuing shares and it allows those shares to be traded. In addition to the benefit of access to

public finance, companies will enjoy a wider public audience and enhance their profiles by joining the AIM.

Rules for joining the AIM are fewer and less rigorous than those for joining the official list (the main market) and were designed with smaller companies in mind.

2.3.1.2 Returns from shares

2.3.1.2.1 Risk and reward

Shareholders in a limited liability company do not have a liability for the debts of the company. The company has a separate legal identity and is itself liable for its debts. Shareholders do, however, run the risk that the value of their investment in the company could go down or even, in the event of a liquidation, be lost altogether. In line with the broad rules of risk and return, therefore, it might be expected that the potential for high returns would also be a feature of the share market. It is certainly true that, on average and over the longer term, equity markets have far outpaced the returns available on secure deposit-based investments.

2.3.1.2.2 Assessment of financial returns

The financial returns that shareholders hope to receive from their shares are of two forms: the growth in the share price (capital growth) and the dividends they receive as their share of the company's distributable profits (income). There are a number of measures that can be used to assess the success of investment in a company's shares and to predict future performance. Some of these measures are as follows.

- *Earnings per share*: this is equal to the company's net profit divided by the number of shares, but it is not normally the amount of dividend to which a shareholder is entitled on each of his or her shares. This is because a company may choose not to distribute all of its profits: some profits may be retained in the business to finance expansion, for instance. This in turn leads to the concept of dividend cover.
- *Dividend cover*: this factor indicates how much of a company's profits are paid out as dividends in a particular distribution. If, for example, 50% of the profits are paid in dividends, the dividend is said to be covered twice. Cover of 2.0 or more is generally considered to be acceptable by

 © ifs School of Finance 2008

investors, whereas a figure below 1.0 indicates that a company is paying part of its dividend out of retained surpluses from previous years.

- *Price/earnings ratio*: as its name suggests, the *P/E ratio,* as it is commonly known, is calculated as the share price divided by the earnings per share. It is generally considered to be a useful guide to a share's growth prospects: a ratio of 20 or more, for example, indicates that a share is doing well and can be expected to increase in value in the future. Such a share is likely, as a result, to be relatively more expensive than others within the same market sector. A low ratio – less than about 4 – indicates that the market feels that the share has poor prospects of growth.

2.3.1.3 Taxation of shares

Dividends are received by shareholders net of 10%, with a tax credit equal to the amount deducted. Non-taxpayers cannot reclaim this deduction; lower rate and basic rate taxpayers have no further liability, but higher rate taxpayers have to pay sufficient additional tax to bring their tax paid up to the special higher rate applicable to dividends (32.5% of the grossed-up dividend).

This extraordinary system was introduced to smooth out the effect of the abolition of advance corporation tax (ACT) from 6 April 1999.

Example

- An investor who is a higher rate taxpayer receives a net dividend of £900 from shares in a UK company.
- The grossed-up dividend is £1000.
- She must pay a further 22.5% of the gross dividend, ie a further £225.

Gains realised on the sale of shares are subject to capital gains tax (CGT), although investors may be able to offset the gain against their annual CGT exemption allowance.

2.3.1.4 Ex-dividend

Dividends are usually paid half-yearly. Because of the administration involved in ensuring that all shareholders receive their dividends on time, the payment process has to begin some weeks before the dividend dates. A 'snapshot' of the list of shareholders is made at that point, and anyone who purchases shares between then and the dividend date will not receive the next dividend (which will be paid to the previous owner of the shares). During that period, the shares are said to be ex-dividend (or xd). The share price would normally be expected to fall by approximately the dividend amount on the day it becomes xd.

2.3.1.5 Share indices

The Stock Exchange Daily Official List gives the closing prices of all listed securities on the previous day. The *Financial Times* and other newspapers produce daily lists of the share prices of most companies, making it easy to check up-to-date share prices.

It is possible to measure the overall performance of shares by using one or more of the various indices that are produced. These include:

- Financial Times *Ordinary Share Index (FT Index)*: this is an index of 30 major industrial companies' shares, which represent around one-quarter of the market value of UK equities;
- *FTSE 100 Index* (commonly known as the 'Footsie'): this is an index of the top 100 companies in capitalisation terms. Each company is weighted according to its market value;
- *FTSE Actuaries All-Share Index*: this is an index of around 900 shares, split into sectors. It measures price movements and shows a variety of yields and ratios as well as a total return on the shares.

2.3.1.6 Rights issues and scrip issues

- *Rights issue*: Stock Exchange rules require that, when an existing company that already has shareholders wishes to raise further capital by issuing more shares, those shares must first be offered to the existing shareholders. This is done by means of a rights issue offering, for example, one new share per three shares already held, generally at a discount to the price at which the new shares are expected to commence trading. Shareholders who do not wish to take up this right

© *ifs School of Finance* 2008

can sell the right to someone else, in which case the sale proceeds from selling the rights compensate for any fall in value of their existing shares (due to the dilution of their holding as a proportion of the total shareholding).

- *Scrip issue*: also known as a *bonus issue or a capitalisation issue,* this is an issue of additional shares, free of charge, to existing shareholders. No additional capital is raised by this action – it is achieved by transferring reserves into the company's share account. The effect is to increase the number of shares and to reduce the share price proportionately.

2.3.1.7 Preference shares and other shares

- *Preference shares*: as with ordinary shares, holders of preference shares are entitled to dividends payable from the company's profits. Preference dividends are generally at a fixed rate; in the payment hierarchy, they rank after loan interest but ahead of ordinary share dividends. Many preference shares are *cumulative preference shares,* which means that if dividends are not paid, entitlement to dividends is accumulated until such a time as they can be paid. Preference shares do not normally carry voting rights but, in some cases, holders may acquire voting rights if their dividends have been delayed.

  In the event of winding up a company, preference shares rank behind loans but ahead of ordinary shareholders' claims.

- *Convertibles*: these are securities, issued by companies to raise capital, which carry the right to be converted at some later date to ordinary shares of the issuing company. Traditionally they were issued in a form that effectively made them a loan (with a lower rate of interest than conventional debt because of the right to convert to equity) but, in recent years, they have been increasingly issued as *convertible preference shares*.

© *ifs School of Finance* 2008

2.3.2 Loan stock

As well as issuing shares, companies can seek loans for use in their business. They can borrow from banks or other lenders. They can also issue what are known as *loan stocks* and *debentures*. These types of borrowing are usually over the longer term, which helps the company to make long-term business plans. Loan stocks and debentures are issued on specified terms, including the rate of interest payable by the issuing company (and when that interest is payable) and the redemption date. They are usually issued at a fixed rate of interest.

Loan stocks and debentures are essentially the same, that is, borrowings by the company on certain terms, but, as is the case with shares, it is important to ascertain the precise rights and obligations of a particular borrowing. Broadly speaking, loans that are secured in some way – perhaps on the company's property – are normally referred to as debentures, while those that are not are simply called loan stocks.

Some loan stocks are issued that give the holder the right to convert the loan into ordinary shares of the issuing company. There is no obligation to do so and if the option is not exercised the loan continues unchanged.

Interest rather than dividends is payable on both types of debt and normally should be payable whether or not sufficient profit has been made by the company. The holders of these types of debt are creditors of the issuing company and so, in a winding-up, take priority over the shareholders. On the other hand, the loan stock and debenture holders do not have the right to vote at company meetings.

The interest on stock is paid net of 20% tax. Basic and lower rate taxpayers have no further liability; higher rate taxpayers are liable for a further 20%; and non-taxpayers can reclaim.

The risk inherent in these types of debt is related to the viability of the issuing company, its prospects and strength. Loan stocks have a greater level of risk than debentures because they do not have the backing of security.

© *ifs School of Finance* 2008

2.4 Real estate

In broad terms, investment in real estate falls into three categories:

- ♦ residential property;
- ♦ agricultural property;
- ♦ commercial and industrial property.

The vast majority of investors will only ever be involved in residential property. For most people this does not extend beyond the purchase of their own home, although an increasing number of people are buying residential properties specifically as an investment.

Property investment has a number of benefits and advantages, including:

- ♦ property is a very acceptable form of security for borrowing purposes;
- ♦ the UK property market is highly developed and operates efficiently and professionally;
- ♦ rents (and therefore capital values) tend to move with money values and consequently provide a good hedge against inflation;
- ♦ professional property management services are readily available.

On the other hand, there are a number of pitfalls and disadvantages of which inexperienced investors in particular should be made aware, including the following.

- ♦ There is the risk of being unable to find suitable tenants or that tenants will prove to be unsuitable.
- ♦ Location is of paramount importance and a badly-sited development may prove a problem.
- ♦ The property market is affected by overall economic conditions – in times of recession, lettings may be difficult and property prices may fall.
- ♦ Property is less readily marketable than most other forms of investment.
- ♦ Investment costs tend to be high and can include management fees, legal charges and stamp duty.

As with direct investment in shares, direct investment in property can be a risky business for the small investor, although the advent of buy-to-let mortgages (see Section 2.4.2) has made it easier. For smaller amounts of capital and for those who wish to spread the risk, there are property bonds where

© *ifs* School of Finance 2008

the underlying fund is invested in a range of properties and shares in property companies. Another alternative is real estate investment trusts (see Section 3.2.2.3).

2.4.1 Taxation

Income from property, after deduction of allowable expenses, is subject to income tax. It is treated as earned income for tax purposes, ie the basic 10% rate band does not apply. On the disposal of investment property, any gain will be liable to capital gains tax (CGT); but any capital expenditure on enhancement of the property's value can be offset against taxable gains.

2.4.2 Buy-to-let

Despite some dramatic falls from time to time, the overall trend in UK house prices over the last 30 years has been strongly upwards. The early 2000s saw dramatic rises in the price of property in the UK. One unfortunate consequence of this is that young people and other first-time buyers now find it difficult to afford to purchase a property, especially in the south-east of England, which has seen significant increases. In times of economic downturn, this effect is worsened by an uncertain job market that makes it difficult for people to commit to large mortgages.

The situation can be eased if there is a reasonable supply of good quality properties to rent but traditionally the UK has had a shortage of private rental property particularly compared to most other European countries, for instance. There are a number of reasons for this, including the following.

- Historically, lenders viewed loans to buy property to let as being commercial rather than residential loans – even if the property was to be let for residential purposes. This meant higher rates of interest than for standard mortgage loans on owner-occupied property.
- Rental income was traditionally excluded from a borrower's income when assessing his or her ability to make the mortgage repayments.

Buy-to-let is an initiative designed to stimulate growth in the private sector of the rental market. The aim is to encourage private investors to borrow at competitive interest rates with a view to investing in rental property that should give them a reasonable expectation of sustained income and capital growth. Lenders involved in this scheme will now take potential rental income

 © ifs School of Finance 2008

into account and will charge interest rates broadly in line with those for owner-occupation mortgages.

The scheme is the result of a joint initiative by the Association of Residential Letting Agents (ARLA) and mortgage lenders. Alliance and Leicester, Halifax and NatWest were instrumental in the early stages, although many more banks and building societies now offer buy-to-let mortgages.

This change in policy results from the knowledge that a buy-to-let scheme will be professionally managed. For many schemes, it is a requirement that an agent who is a member of ARLA should be involved in:

- selecting suitable properties;
- selecting suitable tenants;
- arranging appropriate tenancy agreements (normally Assured Shorthold Tenancies);
- managing the properties.

Gross rents for buy-to-let properties are typically 125%-150% of the monthly mortgage payments. There are of course other costs, such as agents' commission/fees, insurance and maintenance costs.

Rental income is subject to income tax but the cost of insurance, agents' fees, maintenance etc can be offset as a deduction against tax. The initial cost of furniture, fixtures and fittings cannot be deducted, but a wear-and-tear allowance of 10% per year may be allowed.

2.4.3 Commercial property

Investment in commercial property covers almost anything that is not defined as wholly 'residential'. This includes:

- individual retail shops;
- shopping arcades and shopping centres;
- offices;
- industrial units, ie factories, workshops and storage units;
- hotels and leisure resorts;
- mixed-use property – shops/offices, perhaps including a residential element.

© *ifs School of Finance* 2008

Commercial property tends to provide reasonably high rental income together with, in general, steady growth in capital value.

The main advantages are:

- ♦ regular rent reviews, with typically no more than five years between each;
- ♦ longer leases than for residential property;
- ♦ more stable and longer-term tenants;
- ♦ typically lower initial refurbishment costs;

Drawbacks may include the following:

- ♦ the higher average value means that spreading the risk is more difficult;
- ♦ commercial property does not generally show the spectacular growth in value that can sometimes be achieved in residential property;
- ♦ if the investment is to be funded by borrowing, interest rates may be higher than for residential loans.

Lenders often carry out detailed investigations before lending for the purchase of commercial property, checking on:

- ♦ the quality of the land and property;
- ♦ the reputation of builders, architects and other professionals involved;
- ♦ the suitability of likely tenants.

2.5 Commodities

Commodities have been traded for thousands of years, particularly metals (such as silver and gold) and foodstuffs (including wheat and other grain crops). In modern times the concept of a commodity has been broadened considerably and now includes, for instance, electricity, timber and even future royalties on music and other artistic work.

For the modern investor, commodities offer a number of opportunities, both directly and indirectly.

- ♦ Investment in precious metals, particularly gold, is available even to small investors through the sale, by various governments, of gold coins such as South African krugerrands.

© *ifs School of Finance* 2008

- A lot of trade in commodities is carried out through the medium of 'forward contracts', ie binding agreements made now under which one party must sell and the other party must buy a specified amount of a commodity at a specified price on a particular date in the future. Other, more sophisticated, commodity derivatives have also been developed, primarily to enable farmers and other producers to hedge their risks (for instance the risk of a crop failure). The majority of trading in the commodity derivatives markets is now done by people who have no need of the commodity itself: they make a profit by speculating on the price movements of the commodities through the purchase and sale of derivatives.

2.6 Foreign exchange

Most countries have their own individual currency, eg the UK uses sterling (£), the EU states within the eurozone use the euro (€) and the USA uses the US dollar ($). Individuals and companies within each country (or group of countries, in the case of the euro) use the domestic currency within that country's boundaries. When transactions take place between individuals and companies from different currency areas, purchasers and investors need to obtain the appropriate foreign currency. For instance, if a UK company buys components from a French supplier, the UK company wants to pay in sterling but the French supplier wants to receive payment in euros. So the UK purchaser needs to exchange sterling for euros and this is done on the foreign exchange market.

The foreign exchange market is an international market where currencies are exchanged. The main participants in the market are banks, central banks and other financial institutions, which need to transfer one currency into another either on their own account or on behalf of their customers. The market is not situated in one place but is the result of all buying and selling transactions originating from bank dealing rooms all over the world. Technology has made it possible for the market to take place on a 24-hour basis. Millions of individual transactions are thus taking place every hour and the changing price of one currency in terms of another reflects all the amounts demanded and supplied.

The two main reasons why individuals or companies need to exchange currency are international trade and investment. As regards trade, there is a huge international trade in both goods and services.

© *ifs School of Finance* 2008

- *Goods*: companies in different countries purchase raw materials, components and finished goods from each other. For example, the UK imports cars from Japan and Germany and exports Scotch whisky all over the world.
- *Services*: companies buy financial services from banks and insurance companies in other countries and deliver their goods overseas using foreign-owned transport; individuals go to other countries for the purposes of tourism or education.

The amount of money being transferred for investment purposes is even greater than that being transferred for trading purposes. International investment can be split into short-term and long-term.

- *Short-term* – a company that has a temporary surplus needs to invest it, if only for a short period, in order to earn a return. It will invest money in a country that currently has the highest interest rates.
- *Long-term* – individuals and companies buy shares and make longer-term loans to borrowers in other countries. A company may wish to invest in *overseas expansion by opening a branch in another country.*

Currency speculators trade in the currency markets on their own account. They aim to make profits by anticipating changes in exchange rates and buying/selling at the appropriate time. A speculator might spend £1 million on buying US dollars at an exchange rate of 55p and then exchange the resulting $1,818,182 back into sterling when the rate changed to 57p, making a profit of £36,364.

George Soros, perhaps the world's most renowned currency speculator, caused a sensation in September 1992 when he sold around $10 billion worth of sterling in anticipation of Britain's devaluation of sterling. The devaluation happened as Britain withdrew from the European Exchange Rate Mechanism (ERM), and it is believed that Soros made over a billion dollars in one day's trading.

© *ifs School of Finance* 2008

2.7 Money market instruments

Money market instruments is a generic term used to describe a number of forms of short-term debt. Interest is not normally paid during the term of the transaction, the rate of interest being determined by the difference between the amount invested/borrowed and the amount repaid.

In order to illustrate the nature of these instruments, we will describe three of them: Treasury bills, certificates of deposit, and commercial paper.

2.7.1 Treasury bills

Treasury bills are short-term redeemable securities issued by the Debt Management Office (DMO) of the Treasury. Like gilt-edged stocks (gilts – see Section 2.2.1), they are fund-raising instruments used by the UK government, but they differ from gilts in a number of ways. Two major differences are:

- Treasury bills are short-term, normally being issued for a period of 91 days, whereas gilts can be long-term or even undated;
- Treasury bills are 'zero-coupon' securities, ie they do not pay interest. Instead, they are issued at a discount to their face value or par value (the amount that will be repaid on their redemption date).

As with gilts, treasury bills are considered to be very low-risk securities, the risk of default by the borrower (the UK government) being so low as to be effectively zero.

Because they are such short-term securities, changes in market rates of interest have little impact on the day-to-day prices of treasury bills unless the changes are significantly large.

Throughout their term, treasury bills can be bought and sold, and there is a strong secondary market, provided mainly by banking organisations as there is no centralised market-place. The price tends to rise steadily from the issue price to the redemption value over the 91-day period, but prices can also be affected by significant interest rate changes, or by supply and demand.

Treasury bills are purchased in large amounts, and they are not, therefore, generally of interest to small private investors. They are held in the main by large organisations (particularly financial institutions) seeking secure short-term investment for cash that is temporarily surplus to requirements.

© *ifs* School of Finance 2008

2.7.2 Certificates of deposit

Certificates of deposits (often known as CDs) are a method of facilitating short-term larger scale lending – typically for periods of three months or six months, and for amounts of £50,000 or more. Depositors who require a longer term can often obtain CDs that can be 'rolled over' for a further three or six months on specified terms.

They are issued by banks and building societies, and are in effect a receipt to confirm that a deposit has been made with the institution for a specified period at a fixed rate of interest. The interest is paid with the return of the capital at the end of the term.

Certificates of deposit are *bearer* securities, which means that repayment on the specified terms will be made to the bearer of the certificate on the maturity date. So, if the depositor needs money before the end of the term, the certificate can be sold to a third party.

Banks may also hold CDs issued by other banks, and the issuing and holding of CDs can be used by banks to balance their liquidity positions. For example a bank would issue CDs maturing at a time of expected liquidity surplus, and hold CDs maturing at a time of expected deficit.

2.7.3 Commercial paper

Businesses need to borrow for a variety of purposes. When they need funds for investment in their longer-term business plans, they may issue corporate bonds (see Section 2.2.4).

When they wish to borrow for working capital purposes, however, they can issue *commercial paper,* which is an unsecured promissory note (ie a promise to repay the funds that have been received in exchange for the paper). The transactions are for very large amounts, with most purchasers being institutions such as pension funds and insurance companies. Commercial paper can be placed directly with the investors, or through intermediaries.

The commercial paper market offers cheaper borrowing opportunities for companies that have good credit ratings, but even companies with lower credit ratings can issue commercial paper if it is backed by a *letter of credit* from a bank that guarantees (for a fee) to make repayment if the issuer defaults.

© *ifs School of Finance* 2008

Most commercial paper is issued for periods of between five and 45 days, with an average of around 30 to 35 days. Firms that need to retain funds for longer than this regularly roll over their commercial paper – the advantages of this are (i) flexibility and (ii) the fact that the rate of interest is not fixed for a long period.

© ***ifs*** *School of Finance* 2008

 © ***ifs*** *School of Finance* 2008

Test your knowledge and understanding with these questions

Take a break before using these questions to assess your learning across Section 2. Review the text if necessary.

Answers can be found at the end of this unit.

1. To what extent can deposit accounts be said to be 'secure'?

2. What rate of tax, if any, is normally deducted at source from building society accounts?

   (a) None.

   (b) 10%.

   (c) 20%.

3. Give two reasons why offshore investments may be more risky than similar onshore products.

4. What is the minimum age at which a person can take out a National Savings and Investments guaranteed income bond?

   (a) 11.

   (b) 16.

   (c) 18.

5. What is the difference between the taxation of interest on government stocks and of that on local authority stocks?

6. The price/earnings (P/E) ratio of a share indicates the relationship between the share's current price and the most recently declared dividend. True or false?

© *ifs School of Finance* 2008

7. How can a company raise additional finance for expansion without borrowing?

8. What is the normal distinction between debentures and other loan stocks?

9. What change of attitude by lenders led to the establishment of the buy-to-let market?

10. What type of tenancy agreement would normally be used for a buy-to-let property?

© ***ifs*** *School of Finance* 2008

Answers

1. Apart from the small chance of a bank or building society failing, the capital is secure, but the real value of the capital will be eroded by inflation. The amount of interest could fall on variable interest accounts.
2. (c) 20%.
3. If not denominated in sterling, the value of capital and income will be subject to currency fluctuations. The local regulatory regime may not be as strong as that of the FSA in the UK.
4. (b) 16.
5. Interest on government stocks is normally paid gross (but it is taxable), whereas that on local authority stocks is paid net of 20% tax.
6. False. It relates the share price to the earnings (net profits) per share. Profits are not necessarily all distributed as dividends.
7. By a rights issue of new shares to existing shareholders.
8. Debentures are normally secured on company assets.
9. Lenders began to treat buy-to-let business as residential rather than commercial, applying different underwriting principles and lower interest rates.
10. Assured Shorthold Tenancy.

© *ifs School of Finance* 2008

© ***ifs*** *School of Finance* 2008