

Equity Unit Trusts vs. Direct Share Portfolio and Equity Index-Tracking Investments

As financial advisers, we are sometimes asked the question: Do general equity unit trusts provide better returns than direct share portfolios or equity index-tracking investments? Some have questioned the value of unit trusts, arguing that, over the long term, the average unit trust does not in fact out-perform the stock-market index against which its performance should be measured, especially when one takes into account the fees implicit in unit trusts. Below, we examine the issues in more detail.

The first issue is that of tax. The tax on a direct share portfolio is more onerous than that applied to unit trust investments. Capital Gains Tax (CGT) is not payable when a unit trust portfolio manager restructures the portfolio by selling an underlying share. This assists unit trust portfolio managers to focus on managing their portfolios without being distracted by tax issues. Therefore, as a unit trust investor, one would only incur CGT once, when one sells one's units in a unit trust. In addition, the South African Revenue Service currently allows an annual exclusion of R17,500 on the sum of one's net capital gains in a given tax year. Any net gain would therefore be then further reduced by the R17,500 exclusion benefit. This also allows investors to defer tax for as long as they hold the units.

The case is different, however, when one holds a direct share portfolio. In such a case, each disposal of shares constitutes a taxable event. The question then arises as to whether the gain or loss is deemed to be either of a revenue nature, and therefore subject to income tax at one's marginal rate, or of a capital nature. According to the SARS Tax Guide concerning such matters, the question is a subjective one, determined by a number of complex factors, the most important of which is the shareholder's intention. As a broad overview, if the proven investor intention was to hold the shares as a way to produce long term growing dividend income, then any profit on sale of shares would be deemed to be of a capital nature, but if the intention was to resell the shares at a later stage for profit, such profit would be of a revenue nature. Even if the latter intention was secondary or alternative, the gain may be considered revenue and not capital in nature. However, if one holds the shares in question for over 3 years, regardless of any other considerations, the disposal will be subject to capital gains tax, and not income tax. Whilst further discussion on the tax treatment of share disposals is beyond the scope of this discourse, the point remains that trading shares held in a direct share portfolio is onerous in terms of tax, compared to holding units in an equity unit trust.

Risk is also a factor to consider. General equity unit trusts are well diversified and invest in a large number of underlying shares. This diversification will likely result in lower volatility compared to a narrower selection of shares that one may find in an individual direct share portfolio. On the other hand, greater diversification of share selection progressively increases the prospect of simply shadowing the performance of the stock market indices, thereby potentially restricting the level of outperformance generated by a general equity unit trust manager, net of fees, compared to, say, equity index instruments. A direct share portfolio is not limited by the restrictions of the regulations governing unit trusts. For example, the requirement that a South African unit trust must hold at least 5% of the portfolio in cash at all times detracts from the performance of a general equity unit trust in a rising equity market.

Another issue is the scale of trading costs incurred in buying and selling shares. In terms of fees, unit trusts are subject to brokerage costs upon purchase and sale of shares, and charge management and administrative fees. They are likely to be more expensive than index-tracking investments. However, stockbrokers charge brokerage fees for trading activity, administration fees and may also charge management fees, depending on the mandate of the brokerage

Cape Town
Tannery Park, 21 Belmont Road
Rondebosch
PO Box 312
Rondebosch
7700
Telephone: (021) 689 4314
Facsimile: (021) 686 3446
E-mail: roselaros@wfam.co.za

Johannesburg
Unit 1, Waterfront House, Waterfront Office Park
Cnr West & Republic Road, Ferndale, Randburg
Suite 036, Private Bag x 10026 Randburg
2125
Telephone: (011) 504 9810
Facsimile: 086 686 7171
E-mail: anitamarrian@wfam.co.za

account when dealing with direct share portfolios. Furthermore, because of larger trading volumes in an institutionally managed unit trust, brokerage fees within a unit trust may be negotiated lower than those brokerage fees that apply to small individual direct share portfolios. The question then arises: does the performance achieved by unit trust managers justify the fees they charge?

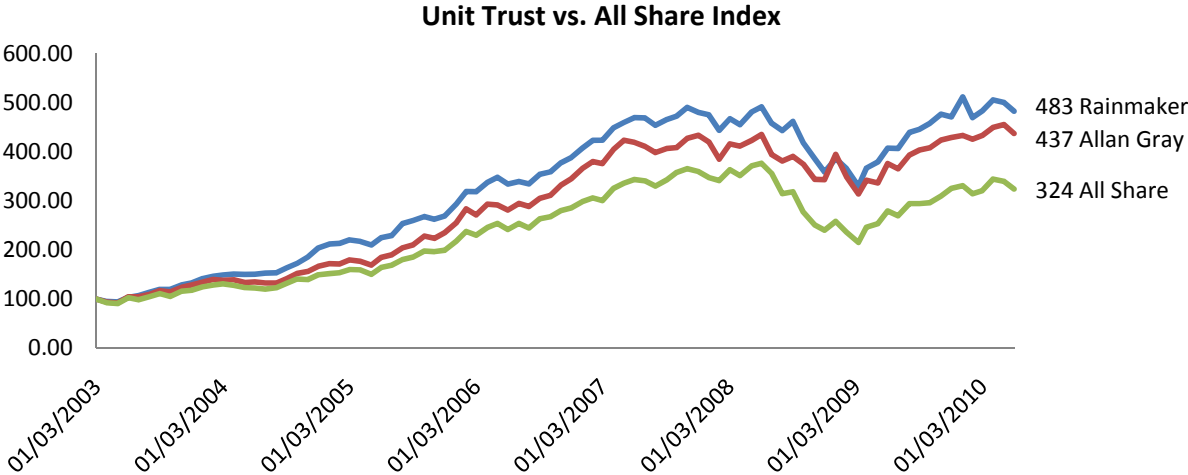
Research carried out by Daniel, Grinblatt, Titman and Wermers (1997) indicated that some mutual funds outperform their benchmarks, but the average performance is close to their respective benchmark index performance.

With regards to direct share portfolios, research of Finnish investors by Dr P Joakim Westerholm and M Kuuskoski (LTA [The Finnish Journal of Business Economics] 2/03) drew the following conclusions in respect of investors in Finland over the period 1995-2000:

- The smallest (by value of portfolio) active investors underperform mutual funds. Medium size active investors also underperform mutual funds, net of costs;
- The largest investors (for example, large pension funds) outperform mutual funds ;
- Large investors have a different investment strategy to the other two groups of investors. Small- and medium-size investors have similar strategies and produce close to the average market return. The large investors adopted a longer-term approach compared to the small- and medium-size investors and are less active;
- For all groups of investors, direct share portfolios are less diversified and more volatile than the well diversified mutual fund portfolios.

We now compare how South African general equity unit trusts have done in comparison to the JSE All Share (All Share) index. In answering the question of whether clients should be investing in direct share portfolios, index-trackers or unit trusts, we have decided to adopt a “real-time” approach. By this we mean that we have tracked the performance of the actual unit trusts which we have deployed in the portfolios we manage. We have taken this approach because it demonstrates the results of the investment choices one makes. In this regard, it is also important to measure a unit trust’s performance against its peers by using, for example, the mean performance of Domestic Equity General Funds over a comparable period.

Below is a graph of the performances of the Allan Gray Equity Fund (Allan Gray) and the Nedgroup Rainmaker Fund (Rainmaker), both of which we have consistently recommended as suitable vehicles for investors desirous of investing in equities, versus the All Share Index (All Share). We have measured all-in performance (that is, including reinvestment of investment income) from 1 March 2003, with all prices / indices rebased to 100.



Westerholm and Kuuskoski found that the average investor in their survey achieves the best risk/return relationship by mimicking the relevant market index, and that the best strategy seems to be one of 'buy-and-hold'. This is important because, if we look at the graph above, it is clear that the unit trusts in question have significantly outperformed the All Share index.

In our experience, there is a wide range of small- to medium-size private client direct share portfolios – there are those which are mainly passive and seldom traded, those which are managed by the individual owner of the shares, and there are those which are managed by an external professional manager. Notwithstanding this wide range of portfolio types, to the extent that the JSE All Share Index represents a proxy for the average small- to medium-size direct share portfolio, one could draw the conclusion that, over the longer term, an investment in a well chosen equity unit trust has proven to produce superior performance, net of fees, compared to a JSE All Share index-tracker fund and an average small- to medium-size direct share portfolio (even *before* the issue of taxation is taken into account).

Conclusion

We believe that a carefully selected suite of unit trust investments is likely to produce better returns, *over the longer term*, than an index-tracker investment or an average direct share portfolio, (especially when the incidence of taxation is taken into consideration in an actively-traded direct share portfolio). A well selected equity unit trust will be more tax-efficient, and is also likely to provide a less volatile, more diversified portfolio than a more concentrated direct share portfolio.

We recommend that clients with direct share portfolios should monitor their ongoing all-in performance, and compare this against the performance of other equity investment vehicles, such as comparable general equity unit trusts.