

HL GUIDE TO FUND PRICES, SAVINGS AND YIELDS

Investors Guide – Fund Prices, Savings and Yields

PRICES & SAVINGS

Funds fall into two main categories – unit trusts and open-ended investment companies (OEICs). They share many characteristics, for example both are normally priced once per day. The price is based on the net asset value (NAV) of the underlying holdings divided by the number of units or shares in issue. Dealing for both types of fund takes place on a forward-pricing basis, which means that a buy or sell instruction is placed at the next available valuation point. For this reason investors do not know the price they will pay or receive until after the deal is completed.

Unit trusts and OEICs are both 'open-ended', which, normally speaking, means that if more investors are buying units than selling, the manager 'creates' new units. If the opposite is true, the manager 'cancels' units in the fund.

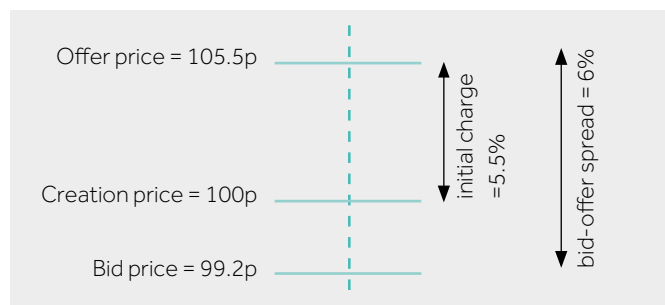
Unit trusts and OEICs differ in the way prices are displayed, and the way charges and discounts operate.

Please remember the value of investments can fall as well as rise, so you could get back less than you invest.

UNIT TRUSTS

Most unit trusts are 'dual-priced' – they have an offer (or buying) price, and a bid (or selling) price. The difference between them is known as the bid-offer spread, and is made up of the initial charge, the difference between buying and selling price of the underlying holdings, and other costs incurred by the fund (for example stockbroking commission and Stamp Duty).

Normally, the prices are calculated as follows. The manager starts with the 'creation' price, which is the cost of creating a new unit. This includes the price of the underlying holdings which need to be purchased, plus all other dealing costs borne by the manager. The initial charge is added to the creation price to give the offer price, and the bid-offer spread subtracted from the offer price to give the bid price. Here is a simple example – for ease we have assumed that creation price is 100p.



We negotiate special terms with many fund management groups which allow us to offer savings on the initial charge and reduce the price you pay per unit. In many cases we are able to offer a full saving. Please note that even if we offer a full saving, this will only reduce the price paid to the creation price, and won't entirely eliminate the bid-offer spread. In this example, a full 5.5% saving would reduce the price paid to 100p; a 5% saving would reduce the price to 100.5p.

This method is known as valuing the fund on an 'offer basis', and is used when more money is entering the fund than exiting the fund. This is normally the case as the number of units in a fund usually increases over time.

If the opposite is true, and more money is exiting the fund than entering the fund, the manager may decide to price the fund on a 'bid basis'. This uses the 'cancellation price' as the starting point. This is the price the manager receives when cancelling units by selling the underlying holdings.

The bid price is set as the cancellation price, and the bid-offer spread added to this to give the offer price. In effect the manager is reducing the initial charge – note that in the example below has reduced to 3.9%. The prices are calculated as follows (again with creation price at 100p for ease).

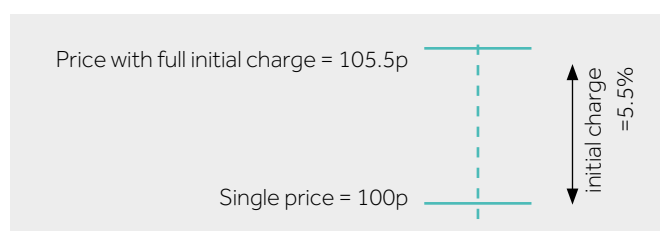
In the example below, a full saving would reduce the price the investor paid to the creation price, 100p. It appears as though our saving has reduced, but it is in fact still a full saving. In effect what has happened is that the manager has moved both the bid and offer prices downwards relative to the creation price. This can have the effect of shifting the fund's dealing costs from those purchasing units to those selling units. This makes sense when there are more sellers than buyers, and protects investors remaining in the fund.



OEICs

OEICs normally have one price for buying and selling, although some OEICs are priced in the same way as unit trusts. The initial charge is simply added to this single price when shares are purchased. Again we offer savings on the initial charge so you pay a lower price than investors who buy with no saving. Where we offer a full saving on the initial charge, buyers simply pay the fund's single price.

Unusually high levels of buying and selling may increase the fund's dealing costs and affect the value of its assets. In this case, to protect the interests of existing investors the fund manager may apply a 'dilution levy' which increases the cost of buying and selling. This is typically between 0.5% and 2%, and the proceeds are held within the fund.



FUNDS DENOMINATED IN A FOREIGN CURRENCY

Most funds are denominated in sterling. However, where a fund is denominated in a foreign currency we calculate the sterling price and display it on our website. To ensure consistency, the sterling price for all funds is calculated at 4pm on each UK business day and is based on the prevailing exchange rates at that point. The price you pay when you deal will be determined by the exchange rate applied by the fund manager at the point your fund is valued (the 'valuation point'). If the exchange rate we use differs from that the fund manager applies, because the exchange rate has moved between the valuation point of your fund and 4pm, or for any other reason, then the price displayed on our website may be slightly different from that arrived at by the fund manager on any given dealing day. The price for funds denominated in foreign currencies that are displayed on our website should therefore be viewed as indicative only.

YIELDS

Before looking at each type of yield in detail it is important to make a few points that apply to all yield figures.

Yields are not the same as interest rates. If, for example, a bank pays 2% interest, you will receive 2% a year until the interest rate changes (or the bank fails).

Yields, by contrast, offer an indication of what you might receive, but they are not guaranteed. There are two reasons for this:

Firstly, yields are based on the income paid over the last year (for equity funds) or a snapshot of the assets held at any one time (for bond funds). Over time the fund manager will change the underlying holdings to try and maximise returns and so the income paid will vary too. The fund manager will be keen to improve the level of income each year or at least maintain it, but there are no guarantees that this will be achieved.

Secondly, there is no guarantee that companies will pay the same level of dividends to their shareholders year-on-year. Hopefully they will pay more, but they could pay less or even none at all. Similarly a company could default on an income payment for a corporate bond.

It is also important to note how the Annual Management Charge (AMC) is paid. Charges can either be made against the capital of a fund or the income received. Where charges are made to capital it means the fund can pay a higher level of income, but it reduces capital growth potential.

Finally, please remember that capital values of stock market investments, as well as yields, can fall as well as rise and therefore you could get back less than you invest.

There are number of ways that yields are calculated; the method used will differ depending on whether the fund invests in shares or bonds and its distribution policy.

FUNDS INVESTING IN SHARES

Historic Yield – The Historic Yield is calculated by looking at the income the fund has paid over the last year and dividing it by the current price.

For example:

Income paid by each unit over the last year: 4.2p
Current price of each unit 100p
Historic Yield = $4.2 \div 100 = 0.042$ or 4.2%

FUNDS INVESTING IN BONDS

Distribution Yield – The Distribution Yield is an estimate of the income that may be expected to be paid over the next twelve months divided by the current unit price. Funds can make distributions in one of two ways:

(i) The coupon method:

If the fund makes distributions using the coupon method it will simply pay out the interest it receives from the underlying holdings. Any future capital gain or loss on the price of the bonds held by the fund is not factored into the yield calculation.

(ii) The effective method:

In addition to paying out the interest it receives from the bonds in its portfolio, a fund that distributes using the effective method will also take into account the fund manager's estimate of any future capital gain or loss on the underlying bonds before making payments to investors.

For example:

A fund buys a bond for 96p that is due to redeem at 100p in a year's time. In that time the bond will also pay interest of 5p. Over the next year the fund will therefore receive a total return of 9p for every 96p invested: 5p interest and 4p capital growth.

Calculating the yield using the coupon method:

Income paid over the next year: 5p
Current price of each unit: 96p
Distribution Yield = $5 \div 96 = 0.052$ or 5.2%

Calculating the yield using the effective method:

Income paid and capital growth over the next year: $5p + 4p = 9p$
Current price of each unit: 96p
Distribution Yield = $9 \div 96 = 0.094$ or 9.4%

Please note, these are examples only; they consider one bond in isolation. In practice, a fund will hold a mixture of bonds, many of which will not be held to their redemption date, and some of which might default. There are therefore many different factors which, taken together, will ultimately determine an investor's net income.

If the fund's AMC is taken from income, its effect will be included in the distribution yield, but not if the AMC is taken from capital. To see the effect of the AMC in these cases, it is necessary to look at the Underlying Yield.

Underlying Yield – The Underlying Yield is calculated in much the same way as the effective method for the distribution yield. It therefore includes the effect of any future capital gain or loss, assuming bonds are held to redemption. Unlike the Distribution Yield, it will always include the effect of the fund's AMC, regardless of whether those charges are taken from income or capital. Therefore, if a fund makes distributions on an effective basis and its AMC is taken from income then the Underlying Yield will always be the same as the Distribution Yield.

OTHER METHODS OF CALCULATING BOND FUND YIELDS

You might also see two other yields quoted. These are more common for offshore funds.

Running Yield – This figure is calculated by looking at the income that may be expected to be paid over the next twelve months by the bonds held, and dividing this by the current unit price. It will include the effect of the fund's AMC only if the charge is taken from income. It is therefore exactly the same as the Distribution Yield calculated using the coupon method (see above).

Gross Redemption Yield – The Gross Redemption Yield is calculated in almost exactly the same way as the Underlying Yield (see above). It therefore takes account of any future capital gain or loss, assuming the bonds in the portfolio are held to redemption, and always includes the effect of the fund's AMC whether it is made against income or capital.

The principal difference between the Gross Redemption Yield and the Underlying Yield is that whereas the Underlying Yield calculates the future capital gain or loss using the purchase price of each bond, the Gross Redemption Yield uses the current market price.