



First Capital

**Issued by First Capital Holdings' as part of its Investor Education Series**

## **Investing in Unit Trusts: What You Need To Know**

**By Dinesh Fernando**

Navigating diverse investment tools can be perplexing for the average investor. Investor education is crucial as knowledgeable and empowered investors contribute towards a vibrant market. Unit trusts are one of many investment options available to investors. The following explores the mechanisms and types of unit trusts in the Sri Lankan market.

### **Understanding Unit Trusts**

Think of a unit trust as a pooling vehicle, where you gather relatively small investments from a large number of investors to make one large fund. This pool of funds is then invested in different financial instruments. The income earned from these investments is shared by the respective unit holders in proportion to the number of units owned.

A unit trust and portfolio of investments is typically overseen and managed by a professional Fund Management Company while an independent trustee maintains custody over all the assets. The minimum amount for investing in a unit trust can be as low as Rs. 1,000 depending on the Fund.

### **How Unit Trusts Differ From Other Investment Tools**

The biggest advantage that unit trusts offer is the diversification to a portfolio of investments, which an individual without a large base of savings will otherwise not be able to obtain on his own. A diversified portfolio has investments in a number of companies, thereby reducing risk while enhancing returns. Because of a large fund base, the asset manager will also be able to negotiate better rates, getting a higher return on his asset pool while bringing in economies of scale.

The management expertise and knowledge of the asset manager is also an added benefit of a unit trust, making it less time-intensive for the investor. An experienced fund manager will be more aware of interest rate movements and know how to minimize risk, generating higher risk adjusted returns over the long term.

### **The Role of Trustees and Regulators**

When investing in a unit trust, investors are assured of the active involvement of regulatory bodies and a high level of transparency. An independent entity is appointed as trustee and maintains custody of the Fund's assets, representing the interests of the investors. Moreover, the trustee monitors transactions carried out by the Fund on a daily basis. Financial statements are circulated regularly to investors which provide details of the Fund's progress and statement of financial performance. The Securities and Exchange Commission of Sri Lanka (SEC) licenses and regulates unit trust funds, conducts periodic on-site audits, and rigorously examines the qualifications of fund managers.

## **Types of Unit Trusts**

There are different Unit Trusts, each addressing a specific investment requirement. No single Unit Trust will cater to the requirements of all investors. It is the Asset Manager's role to match a specific fund to an investor's requirements. The main types of Unit Trusts in Sri Lanka are Income Funds, Money Market Funds, Gilt Edged Funds, and Equity Funds.

Income Funds invest in income generating investments such as government securities, debentures, commercial papers, structured debt instruments, and even bank and finance company fixed deposits. These funds are suitable for medium to long term investments, for income generation and capital growth. A well-managed Income Fund will generate higher returns over the long term than equivalent bank or finance company deposits.

Money Market Funds make similar investments to Income Funds, except that all investments mature within one year. As a result, the return on Money Market Funds is lower but its attraction is its high level of liquidity. They are good substitutes for savings accounts as your investment can be withdrawn at any time.

Gilt Edged Funds restrict investments to securities issued by the Government of Sri Lanka. Government Securities are widely considered risk-free instruments and are suitable for investors wishing to eliminate all default risks associated with an institution. They are the safest investments in terms of payment of underlying principal and interest when due. However it must be noted that Government Securities carry 'interest rate risk' and the value of instruments rise or decline based on interest rate changes.

Equity Funds invest primarily in shares listed on the Colombo Stock Exchange. Investments in listed shares have higher risks than investments in fixed income instruments and they can be expected to yield higher returns. They are long-term investments – ideally an investor should have a 5-10 year investment horizon in mind when investing in an Equity Fund.

## **Sri Lanka's Unit Trust Industry**

Unit Trusts were introduced to Sri Lanka in 1991 to provide an alternate investment for people to benefit from the capital market. The SEC as the licensing authority has the power to permit a Fund Management Company (Fund Manager) to launch a unit trust under the SEC Act.

There are currently 14 Unit Trust Management Companies in Sri Lanka operating a total of 75 funds as at 31 January 2015, while assets under management in the entire market have grown to Rs.126Bn as at 31 December 2014. The Unit Trusts Association represents the industry to the SEC, the Government and CBSL.

It also strives to maintain high professional and ethical standards in the Unit Trust Industry and disseminate information to existing and potential investors about Fund Managers, performance of current funds and the process of investing in Unit Trusts.

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## **About the Writer**

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*Dinesh Fernando has over 20 years' experience covering a wide range of financial service businesses including fund management, research, investment banking, commercial banking, and project financing. Prior to joining First Capital he was the fund manager at one of Sri Lanka's oldest unit trust management companies. Dinesh is a CFA Charterholder.*

## **Note to Editors**

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