

## Introduction

We have produced these notes because many investors hold zeros in their portfolios, having been attracted by their apparent low risk, high levels of return and tax advantages.

However, we have not previously advised any of our clients to invest in zeros, **nor do we currently feel able to make a positive recommendation** for clients to invest in zeros.

## Split Capital Investment Trusts

Before we can begin to understand zeros we need to recognise that they are a form of 'split capital' investment trust (often simply referred to as a 'split'). An investment trust is a company which invests in other companies.

Companies can issue more than one share class with different rights, risks and potential rewards attaching to each. The idea behind a split comes from the fact that **some investors primarily want capital growth and others primarily want income.**

The first recognised split capital investment trust was launched in 1965 when tax on income was particularly high. It was the **Dualvest Trust managed by Drayton Montagu** and had two share classes – income and capital shares.

The **income shares took all the income** produced by both the income and the capital shares after charges and costs and were entitled to a return of the original capital when the fund was wound up. The **capital shares took all the surplus capital growth** from both the income and the capital shares.

The **tax planning advantages** can be seen from the fact that **one class of share was liable for income tax** while the **other class of share was only liable to capital gains tax.**

## What are Zeros?

Zero stands for **Zero Dividend Preference Share**. We can see from their description that they are **part of the 'split' that does not produce any income**, just capital growth.

They differ from the original capital growth part of the 'split' in that they have **the added security of a 'promise' by the investment trust to provide a pre-determined return on a fixed date.**

This promise is assisted by the fact that **preference shares take priority over ordinary shares** on the winding-up of a company.

So zeros share the benefits of capital shares in a split but **overcome the two problems faced by holders of capital shares**. The return is 'certain' and they do not have to wait in line for the income shareholders to get their capital return first on winding up.

Zeros therefore **offer an investor a pre-determined growth in capital over a set period of time**. They receive no income but are entitled to repayment before other classes of equity when the company reaches its winding up date.

As an investment trust's assets may fall in value, **the return from a zero cannot, however, be guaranteed** and the promised fixed levels of capital growth specified at the beginning of the trust's life could be at risk.

## What are the Problems with Zeros?

The underlying problem for many investors is that **zeros were often promoted as low risk, high return investments**. That in itself should set alarm bells ringing for experienced investors who know that **risk and reward are directly linked**, so that the only way to have a chance of receiving a high return is to take a high risk.

Part of the problem is that **until recently zeros had an excellent track record** and it was possible to declare that 'since the introduction of zeros 20 years ago, no investment trust zero has ever failed to honour its original obligations to zeros'. **Sadly and rather spectacularly, that is no longer the case.**

The problem has been particularly acute for more recent zero issues, many of which carry a heavy bank debt. Once zeros represented the only debt taken on by a split. But they have now become **just another layer in a complex tier of borrowing.**

Under such circumstances, it would be **the bank debts that were first in line for redemption** rather than the holders of the zeros.

## The Zeros Most Affected

Even where zeros have not borrowed heavily themselves many **have invested in other heavily 'geared' assets** (ie those with large amounts of debt). Zeros have, therefore, fallen into two main camps – those with borrowings and holdings in other highly geared shares and **those that have neither of these characteristics**, with a range of risk profiles in between.

## The Most Important Criteria

When considering an investment in zeros there are particular criteria that should be considered so that you can decide whether the likely risk is acceptable.

**We should emphasise again, however, that we do not feel able to make a positive recommendation for clients to invest in zeros at the present time.**

- A Redemption Yield** - This is the return on the current market price of the share, expressed as an annual percentage, assuming that the share is held until wind up. **The higher the yield the more closely you would have to look at the underlying assets.**
- A Share Cover** - Has the company sufficient assets to meet the zero's final claim at wind up? This is the ratio by which the shareholders' redemption value is covered by the assets of the company available at wind up. **The higher the value the lower the risk of capital loss.**
- A Total Debt Cover** - The ratio by which the shareholders' redemption value and prior charges and all future capital charges are covered by the assets of the company available at wind up. **The higher the value the lower the risk of capital loss.**
- A The Hurdle Rate (Share Price)** - This indicates the required annual growth rate of the total assets if there is to be sufficient cash to repay the shareholders the current share price. The lower the value, the lower the risk of capital loss. **Negative values are particularly attractive.**
- A The Hurdle Rate (Redemption Price)** - This indicates the required annual growth rate of the total assets if there is to be sufficient cash to repay the shareholders the pre-determined redemption value. The lower the value, the lower the risk of capital loss. **Negative values are particularly attractive.**
- A Years/Months to Wind Up** – It is important to consider the remaining life of the company. Since the asset cover relates to the final claim, **it is important to know how long the company has to its wind up date.**
- A Ownership of Other Highly Geared Investments** – As we have seen, the demand for higher yields has caused some trusts to invest in other highly geared trusts. The hurdle rates and asset cover figures **do not allow for gearing inbuilt into other trusts.**

## Conclusion

Investors in zeros need to **understand the structure of zeros**; they need to **accept that they are, in reality, a high risk investment**; and they need to be **prepared to take that risk** as part of their overall investment strategy.

For our part, **we do not believe that there is yet enough historical data** to predict much about the future of zeros and as a result of this we do not currently feel able to make a positive recommendation for clients to invest in zeros.

## Useful Sources of Information.

- A The Association of Investment Trust Companies** – [www.itsonline.co.uk](http://www.itsonline.co.uk)
- A Information and research** on split capital investment trusts – [www.splitsonline.co.uk](http://www.splitsonline.co.uk)
- A Published company announcements** and press comments – [www.hemscott.net](http://www.hemscott.net)
- A Press releases on investment trust activities** – [www.trustnet.com](http://www.trustnet.com)

## Risk Factors

An investment into a zero or other form of split capital investment trust will not be suitable for all investors.

The value of a zero or other form of split capital investment trust can go down as well as up, as too can the 'income' distributions from them.

You may get back less than originally invested.

Where past performance is mentioned please note that the past is not necessarily a guide to future performance.

### For Further Info

If you already have an investment in zeros and you would like to discuss your options please contact us via one of the following:

Tel: **01483 204600**  
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