AIM Market

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UK-based investors looking for products into which they can diversify their portfolios beyond unit trusts and OEICs will find the traditional investment trust sector vying with the AIM Market of the London Stock Exchange for both their attention and their hard-earned cash.

Over recent years the footprint of the AIM Market has expanded; it is no longer the preserve of speculative UK technology companies looking for fairly high-risk development capital. There are now more companies admitted to the AIM Market than are listed on the Main Market. Much of this growth has come from the influx of overseas-based businesses for whom the lighter regulatory touch and increasing liquidity have been attractive, but the explosion of pure investment vehicles admitted to trading on AIM has also been a major contributory factor. Such vehicles are often established in international financial centres such as the Isle of Man in order to minimise the impact of taxation on the performance of the vehicle itself.

AIM investment companies have been established to pursue almost every size and shape of strategy, from Small-Cap stocks through carbon credits to East-European or Asian property. How do these new kids on the block match up against the established heavyweights of the investment trust world?

The reality is that they are fundamentally different propositions and it is simpler to start by highlighting such similarities as do exist. Both investment trusts and AIM vehicles are companies with a fixed share capital. Whereas unit trusts and OEICs can admit new investors and are required to redeem the holdings of existing investors from their own assets at any time at prices based on the net asset value of the investments, investors in closed-ended vehicles such as investment trusts and AIM vehicles are reliant on the trading arrangements on the Stock Exchange for both investment and realisation.

Traditionally, one of the key advantages of investment trusts over unit trusts and OEICs has been the fact that the initial cost of investment has been limited to brokers' commissions at the usual percentage rates or perhaps even a fixed price; investment in unit trusts and OEICs has usually involved an up-front commission of up to 5 per cent.

In addition, the fact that the price paid for shares in an investment trust is a market price rather than a net asset value based price means that there is the potential for arbitrage. The market price may either be higher than the net asset value (trading at a premium) or lower than the net asset value (trading at a discount). In reality the latter is far more common and the discounts are generally in the 10-15 per cent range.

This offers the potential for an investor who has bought at a discount to gain an additional advantage if (in addition to gains made by the investment trust on its underlying investments) there is an increase in demand of the investment trust's shares which results in a narrowing of the discount. However, the converse is equally applicable. If the investment trust's shares become less popular as a result of market falls, the investor risks a double hit as the value of the underlying investments falls and the loss is amplified by a widening discount.

Similar principles apply to AIM vehicles, but the liquidity in some AIM stocks is more apparent than real. The spread (i.e. the difference between the higher price at which market makers will sell shares to you and the lower price at which they will buy them from you when you want to realise your investment) can be considerable, reflecting the lack of demand and thin trading for some AIM vehicles.

Despite these similarities, AIM vehicles and investment trusts represent, in both spirit and their technical attributes, two ends of the UK financial spectrum. Investment trusts represent the old school. A large number are, and always have been, run out of Edinburgh. Notwithstanding the fallout associated with split capital structures, investment trusts are still the essence of traditional asset management; their solidity reflecting the landscape of that city.

By having a Main Market listing, being run out of the UK and complying with various stringent tests as to the nature of their investments and how they derive and distribute their income, investment trusts qualify for advantageous UK tax treatment which can enhance the returns to investors. These requirements give the managers of investment trust assets less room to manoeuvre, but investors can draw comfort from these very strictures and from the additional disclosure requirements associated with a full listing.

In contrast, AIM vehicles represent the shifting entrepreneurial world of alternative investment. The AIM Market is subject to a lighter regulatory touch and includes far more small, new and risky companies. It is inevitable that some will fail and this has resulted in some scrutiny of AIM in recent times; but confidence in the market continues to grow and this year has seen a clean out by the Stock Exchange of shell vehicles that, by common consensus, were harming the reputation of the market.

Even though AIM vehicles benefit from the AIM trading facility, they are regarded for UK tax purposes as "unquoted" companies. This means that UK taxable investors can gain certain taxation advantages from investments in AIM companies, but these are highly technical and generally confined to AIM companies that are "trading" companies. Given the risks associated with AIM, any tax advantages would be dwarfed by potential losses in any event.

So far as AIM investment vehicles are concerned, the key advantage to an experienced investor is that he can gain access to specialist managers and some degree of risk spreading in alternative asset classes and geographical sectors. However, because there are no rules as to asset diversification, leverage or charging structures, the only limitations will be those set out in the prospectus/admission document.

Investors therefore need to look carefully at the investment restrictions that will apply – and who will be monitoring them. They also need to consider that the charging structure for managers, and (in particular) any performance-based remuneration, genuinely rewards gains made by investors and aligns the managers' interests with those of shareholders. Potential conflicts of interest between managers and introducers of transactions need to be scrutinised, together with the influence of substantial founding or long-term institutional shareholders.

For those who are prepared to do their homework, the gamut of investment vehicles available on the AIM Market offers an opportunity to diversify their investments without substantial up-front charges. As the rubric always states, AIM is a market intended for emerging and smaller companies to which a higher investment risk tends to be attached and the value of your investment may go down as well as up, but the AIM Market seems to be here to stay.