Frequently Asked Questions on Unit Investment Trust Funds

(Updated as of September 2006)

The year 2005 saw the proliferation of new trust products in the market known as Unit Investment Trust Funds or UITFs, a product which trust licensed institutions can establish, launch and operate in accordance with Bangko Sentral ng Pilipinas (BSP) Circular 447 issued on September 3, 2004. UITFs were envisioned by trust institutions to replace a popular product of the past two decades known as Common Trust Funds (CTF) which the BSP had directed to be phased out by October 1, 2006 (and October 1, 2009 for the long term tax-exempt CTFs). As early as January 1, 2005, BSP directed trust entities not to accept funds from new investors under CTF products while additional investments from existing clients were no longer allowed effective April 1, 2005. These BSP regulations were intended to align the operation of pooled funds under management by trust entities with international best practices and to ensure differentiation from bank deposits and other direct liabilities of the financial institution. To the investing public, a lot of questions come to mind. Is the UITF a better product than the CTF? If so, in what way? How do investors benefit from this product? What are the risks? To provide the market with answers to all these frequently asked questions and more, the Trust Officers Association of the Philippines has prepared this primer on the UITFs.

Question 1: What is a Unit Investment Trust Fund?

Answer : A Unit Investment Trust Fund (UITF) is an open-ended pooled trust fund denominated in pesos or any acceptable currency, which is operated and administered by a trust entity and made available by participation. Each UITF product is governed by a Declaration of Trust (or Plan Rules) which contains the mechanics for investing, operating and administering the fund.

Question 2: What does "open-ended pooled trust fund" mean?

Answer : An open-ended trust fund allows clients to invest or redeem their investments at any time subject to guidelines set forth in the UITF Declaration of Trust. Funds from various clients with similar investment objectives are pooled together into one fund, which the trustee invests in various types of securities with the aim of maximizing returns within reasonable risk levels.

Question 3: What does "made available by participation" mean?

Answer : A client invests in a UITF by purchasing units of participation in the fund. The units of participation represent the investor's proportionate share in the total value of the fund. As an investor in the fund, the client does not own any specific asset of the fund, only a proportionate share in all of the fund's assets.

Question 4: At what price may these units of participation be purchased?

Answer : Units of participation are made available to investors based on the Net Asset Value Per Unit (NAVPU) of the fund for the day. The NAVPU is derived by dividing the fund's Net Asset Value (NAV) by the number of outstanding units in the fund. NAV, on the other hand, is the sum of the market value of the investments of the fund less expenses such as taxes, fees and other qualified charges. To determine how many units of participation a certain amount of investment is equivalent to, simply divide the amount to be invested by the prevailing NAVPU for the day

Question 5: How different is a UITF from a CTF?

Answer : The main difference between a UITF and a CTF is the manner in which the NAV is calculated. CTFs are valued using the accrual method (i.e. NAV of the fund takes into account principal and interest accruing from various investments of the fund). This method generally results in a steadily increasing NAVPU. UITFs, on the other hand, follow the marked-to-market valuation method which calculates the NAV based on the estimated fair market value of the assets of the fund based on prices supplied by independent sources. The marked-to-market value takes into account the accrued interest (and dividends where the fund is invested in equities) plus unrealized gains or losses of the investments given their prevailing market prices. As such, UITF NAVPU may fluctuate depending on the volatility of the prices of various assets held by the fund.

Question 6: Why was there a need to change the valuation methodology?

Answer : The marked-to-market valuation provides the investor with a more accurate and fair value of his investments at any given time. It ensures that no participant in the fund is put at a disadvantage as a consequence of new investors coming in or of existing investors getting out of the fund. The marked-to-market methodology is in accordance with international best practices.

Question 7: Are all UITF products offered in the market the same?

Answer : No. UITF products differ in terms of portfolio mix, minimum investment amount, minimum holding period, settlement period and charges. For example, some UITFs are invested purely in fixed income securities while others may have investments in equities or stocks. Each product is governed by a specific Declaration of Trust, which contains these product mechanics. The client should choose a UITF product suitable to his investment needs.

Question 8: What are the types of UITFs available in the market?

Answer : UITFs are established and managed based on a set of investment objectives and strategies, and these have varying levels of risks and returns. UITFs may be denominated in Philippine Peso, US Dollars and acceptable third currencies and are generally classified into four major types:

a. Money Market Funds - These funds are invested principally in short term, fixed income deposits and securities with a portfolio duration of one year or less.
b. Bond Funds – The mandate of these funds is to invest in a portfolio of bonds and other similar fixed income securities with portfolio duration which may exceed one year. These may further be classified into Intermediate Funds (where the fund mandate limits the duration up to 3 years), Medium Term Funds (where the fund mandate allows a duration of up to 5 years) and Long Term Funds (where the fund mandate allows a duration of greater than 5 years).
c. Balanced Funds – The mandate of these funds is to invest in a diversified portfolio of bonds and stocks where investments in stocks shall be up to a maximum of 40% to 60% of the fund.
d. Equity Funds – The mandate of these funds is to invest substantially in equities. Cash may be kept for liquidity and portfolio re-balancing purposes.

Question 9: Can a client invest in more than one type of UITF?

Answer : Yes. Clients may diversify their investments across various UITFs as long as the mechanics of the funds are suitable to their requirements.

Question 10: Which type of UITF is suitable to an investor?

Answer : When choosing a UITF, you should identify your needs and goals and match them against the investment parameters of the product. To determine the clients' suitability to a fund, the following factors have to be considered: investment capacity (amount available for investment), investment horizon (how long a client can stay in the fund), risk profile (how much risk the client is willing to take) and investment objective (what the investors seeks to achieve by making the investment, e.g. whether client wants income or capital growth).

Question 11: Who can invest in a UITF?

Answer : Any person, association, corporation, entity or firm who/which has the legal capacity to contract or establish a trust may invest in a UITF product.

Question 12: Is there an indicative or guaranteed rate of return for UITF products?

Answer : Since UITFs are subject to the marked-to-market valuation method, the NAVPU may fluctuate depending on the volatility of the market. As such, indicative rates cannot be quoted by the trustee. Yields are variable and cannot be guaranteed. Historical performance of the fund may provide an indication of how well the trustee is managing the fund but this is not a guarantee of future performance.

Question 13: How do investors keep track of the value of the UITF investment?

Answer : The NAVPU of the fund is generally made available on a daily basis (or as prescribed in the

Declaration of Trust) at the office of the trustee, its branches or through the TOAP website <www.uitf.com.ph> or the trust entity's website. To determine the value of the UITF investment, simply multiply the NAVPU by the number of units of participation acquired.

Question 14: How much will an investor get when the UITF investment is redeemed?

Answer : The investor can calculate the proceeds of his UITF investment by simply multiplying the number of units being redeemed by the applicable NAVPU for the day. Generally, the NAVPU is already net of the trust fees, taxes and qualified charges. However, there may be additional charges to the client such as early withdrawal charges in cases where the client redeems his UITF investment prior to the completion of the minimum holding period required by the trustee.

Question 15: How does a participant determine how much he earned from the UITF?

Answer : The difference between the value of the units of participation at the time of purchase and the value at the time the units are redeemed determines how much an investor earned (or the loss incurred) from the UITF investment. As the fund value increases, each participant earns more. Also, the longer a client stays invested in the fund, the better his chances of earning more since the underlying investment outlets become less prone to market volatility over time.

Question 16: How does an investor determine the return on the UITF investment?

Answer : The client's return on investment can be determined using the following formula:

$$\text{Return on Investment} = \frac{\text{Proceeds of investment} - \text{Initial investment}}{\text{Initial investment}} * 100$$

Where:
Proceeds of investment = Applicable NAVPU x number of units of participation (less early withdrawal charges, if any)
Initial investment = Amount invested

Question 17: How can an investor compare the performance of various trust entities?

Answer : All trust entities offering UITF products are required to publish the fund's prevailing NAVPU as well as the year-on-year and year-to-date return on investment (ROI) in major dailies at least once a week.

$$\text{Year to Date (YTD) ROI} = \frac{\text{NAVPU (current)} - \text{NAVPU (last year's end figure)}}{\text{NAVPU (last year's end figure)}} * 100$$

$$\text{Year on Year (YOY) ROI} = \frac{\text{NAVPU (current)} - \text{NAVPU (same date of previous year)}}{\text{NAVPU (same date of previous year)}} * 100$$

The YTD ROI presents the absolute returns of the fund from the end of the previous year. The YTD ROI cannot be compared to rates offered by deposits, government securities or other money market products which are usually expressed on an annualized or per annum basis, unless the returns for a full year (i.e. Jan 1 to December 31) are being derived. The YOY ROI may however be considered an annualized return as the period covered is always one full year. It should be noted however that historical returns of a fund are purely for reference purposes and do not guarantee similar future results.

Question 18: When does the investor get the proceeds of the UITF investment?

Answer : Payment to the investor will depend on the settlement period prescribed by the trustee. This may vary depending on the nature and settlement convention of the investments of the UITF product.

Question 19: In what instruments can a trustee invest the fund?

Answer : The character and kind of investments which may be made by the trustee depend on the investment parameters set forth in the UITF Declaration of Trust or Plan Rules. BSP regulations, however, prescribe that UITF fund investments shall be limited to: (a) Bank deposits (b) Securities issued by or guaranteed by the Philippine government or the BSP (c) Tradable securities issued by the government of a foreign country, any political subdivision of a foreign country or any supranational entity (d) Exchange listed securities · Marketable instruments that are traded in an organized exchange (e) Loans traded in an organized market and

(f) Such other tradable investments as the BSP may allow.

Question 20: How will the investor know where the fund is invested?

Answer : A list of prospective and outstanding investment outlets of the fund shall be made available to the UITF clients. The list of investment outlets shall be updated quarterly.

Question 21: How much do trustees charge UITF investors?

Answer : The trustee shall charge the fund for management fees, taxes and qualified expenses. The management fee shall differ for each type of fund and will cover the costs of investment research, management, marketing and routine administrative expenses of the trustee

Question 22: What are the risks of investing in a UITF?

Answer : A client investing in a UITF product should be prepared to absorb the following potential risks: (a) interest rate risk – the potential for an investor to experience losses due to changes in interest rates; (b) market/price risk – the potential for an investor to experience losses due to changes in the market prices of securities (e.g. bonds and equities); (c) liquidity risk – the inability to sell or convert assets into cash quickly or where conversion to cash is possible but at a loss; and (d) credit risk – the risk of loss due to a borrower or issuer's failure to repay principal and/or interest on securities issued.

Because the assets of the UITF are valued based on the prevailing market prices, yields and potential yields cannot be guaranteed. There is a possibility of incurring losses in the UITF if the client withdraws in a scenario of generally declining market prices, even if the fund is invested in government securities. It should be noted that investments in government securities, although considered credit risk free in the domestic market are also subject to interest rate risk, market risk and under extreme volatile conditions, to liquidity risk. Should this situation arise, clients may, however, opt to defer their withdrawals until market conditions become more favorable.

Being a trust product, there is no guaranty on the principal and income of the investments and losses, if any, shall be for the risk of the UITF investors. UITFs are governed by BSP regulations but are not deposit products, hence are not covered by the Philippine Deposit Insurance Corporation (PDIC). Historical performance of a fund may be used for reference purposes only and do not guarantee similar future results.

Question 23: Why should one invest in a UITF?

Answer : Investors in UITFs can avail of the following benefits:

- **Diversification.** By participating in a UITF, risks are spread out across the various investments held by the pooled trust fund. Diversification comes in the form of various types of investments, issuers and tenors. UITFs are required to observe its exposure in a single entity and its related parties to 15% of the market value of the fund, except in the case of government securities.
- **Liquidity.** While it is advisable to stay invested in the UITF for a longer period of time, clients can redeem units of participation at any time. The fund will not have difficulty redeeming such units of participation because UITF investments are limited to marketable or tradable securities.
- **Affordability.** UITFs generally have low minimum investment requirements. Additional investments may be made in tranches as funds become available to the client.
- **Better earnings potential.** Greater earnings potential is achieved without having to invest large sums of money. There are opportunities for potentially higher returns due to possible marked-to-market gains on top of accrued income from investments. UITFs provide access to financial instruments not readily available to retail investors.
- **Exempt from reserve requirements.** UITFs are not subject to reserve requirements imposed on bank deposits and CTFs.
- **Professional fund management.** Participating in a UITF allows clients to gain access to the expertise and services of seasoned fund managers who are able to actively monitor the markets for possible investment opportunities.
- **Transparency.** Trust entities are required to publish the UITF NAVPUs at least weekly, allowing you to compare investment performance of various fund managers. Each UITF is subject to a separate annual audit by an independent auditor acceptable to the BSP, the results of which may be made available to investors. In addition, each UITF is required to have a BSP accredited third party custodian, who is tasked with safekeeping the securities of the UITF and performing independent

marking-to-market of such securities.

- **Regulated product.** The management and administration of UITFs are governed by the Bangko Sentral ng Pilipinas.