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What are investment trusts?

Investment trusts (also called 'investment companies' or 'companies') are like other public-quoted or listed companies such as Shell or Glaxo, but instead of managing oil or pharmaceuticals they manage investments on behalf of their shareholders. These investments can span a broad range of financial assets, such as equities or bonds, and physical assets such as property. Whatever the type of investment, the idea is that investors gain exposure to a balanced portfolio of assets which is professionally run.

This form of 'collective fund' has proved a popular way for investors to invest their savings. Trusts have been around for a long time. The first, Foreign & Colonial, was established in 1868. Today there are over 400 investment trusts in total managing around £190 billion of assets. The largest, Scottish Mortgage Trust, is a constituent of the FTSE 100 index and there are quite a few trusts which manage assets of over £1 billion in size.

Investment trusts possess an excellent performance record relative to both unit trusts and relevant benchmarks, but they also have a slightly more complex structure in comparison. This presents an opportunity for those investors who take the time to understand them. The effort can be very rewarding.

Structure and gearing

Most investors will have at least some element of their portfolios invested in funds. The concept is simple. An investor will join other investors in pooling their money and, in effect, giving it to a fund manager to invest. Such an approach is sensible as it means investors can access a diversified portfolio and so lower risk, whilst the costs are lower because they have been shared.

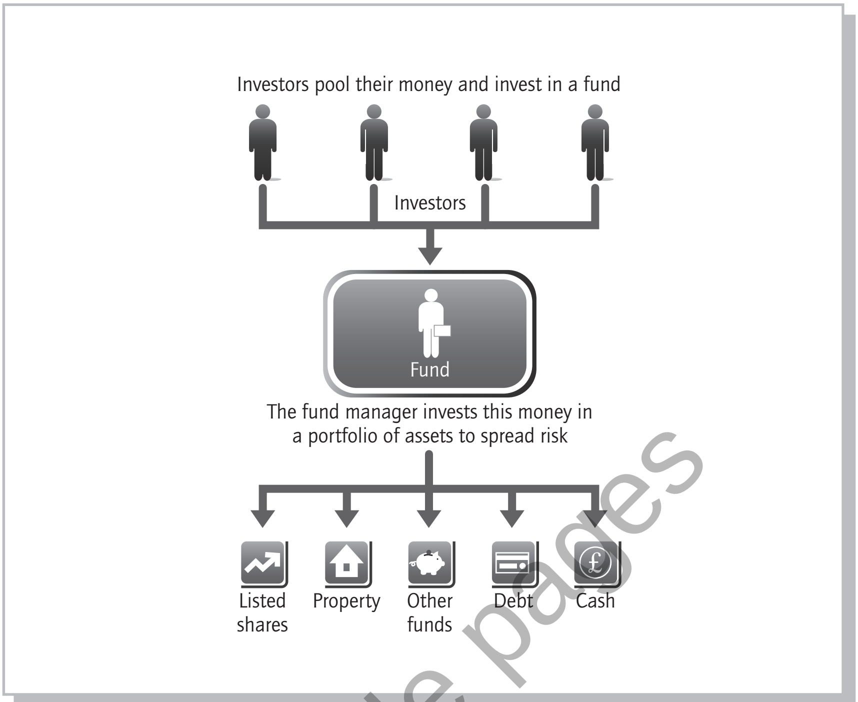

Figure 1.1 **How a collective fund works**

Source: AIC

Most funds are unit trust or OEICs – both being 'open-ended'. These are so-called because when any investor buys or sells them, they are directly adding or subtracting from the pot of money invested in that fund and managed by the manager. Assets will need to be bought and sold, depending on cash levels. In doing so, as investors buy and sell, they are creating or cancelling shares in line with investor demand.

Table 1.1 **Open-ended funds**

Before purchase	*Purchase*	*After purchase*
Fund size = £1,000,000	Investor buys 10,000 units at £1 each	Fund size = £1,010,000
1,000,000 units in issue		1,010,000 units in issue
Therefore each unit = £1		Therefore each unit = £1

There are also funds called investment trusts. These are listed or public companies and as such are 'closed-end' in that they have a fixed number of shares: they are 'closed' after the initial launch or share issue. Their shares are listed and traded on the stock exchange like other public companies such as Shell, M&S and Glaxo.

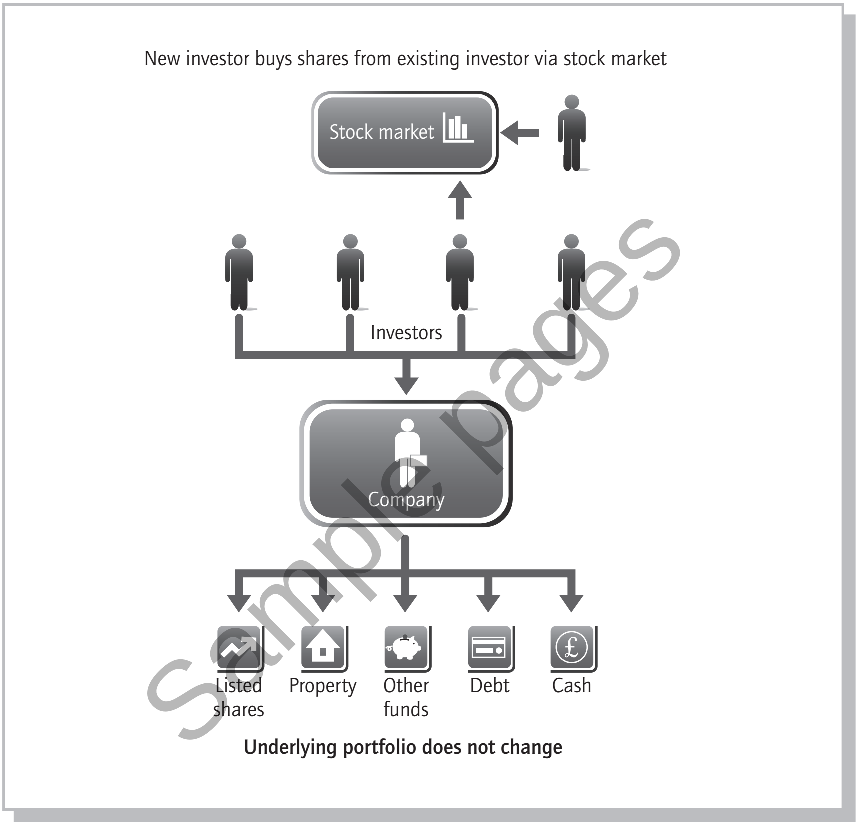

Figure 1.2 How an investment company works

Source: AIC

So, instead of specialising in the management of oil, clothes or pharmaceuticals, investment trusts specialise in the management of portfolios, typically of other quoted companies. Their purpose is to make profitable investments in financial assets for the benefit of their shareholders.

By buying the shares in Shell, M&S and Glaxo, an investor is not adding more oil, clothes or drugs for the company to manage. That is for their managements to decide. Likewise, buying the shares of an investment trust does not add to the size of the portfolio. An investor is simply buying part ownership of the company itself – not adding to the underlying portfolio – in the hope of profiting from its successful management.

Table 1.2 Closed-ended funds

Before purchase	*Purchase*	*After purchase*
Portfolio size = £1,000,000	Investor buys 10,000 shares through the stock market	Portfolio size = £1,000,000
1,000,000 shares in issue		1,000,000 shares in issue
Price – demand and supply		Share price continues to reflect demand and supply

If Shell, M&S and Glaxo manage and grow their assets well and profits increase as a result, all things being equal, this will be reflected in a rising share price to the benefit of the shareholders who own the shares. Whether these companies succeed will depend on a number of factors, such as the economic environment, the business model, their competitiveness and, above all, the quality of the management team.

Similarly, investment trusts strive to grow the value of their portfolio of stocks. Success or failure will eventually be reflected in the share price of the trust – just as it will be with other companies. Factors such as the economy, the method of research, stock selection and the investment acumen of the manager will all play their part.

Being closed-end, investment trusts can and do borrow to enhance the returns achieved on their portfolio of assets. This is called 'gearing'. Provided the portfolio rises in value more than the cost of the borrowing, then the gearing will produce higher returns – and vice versa. Investment trusts are typically 5–15% geared. This has tended to be beneficial given that markets have risen over time.

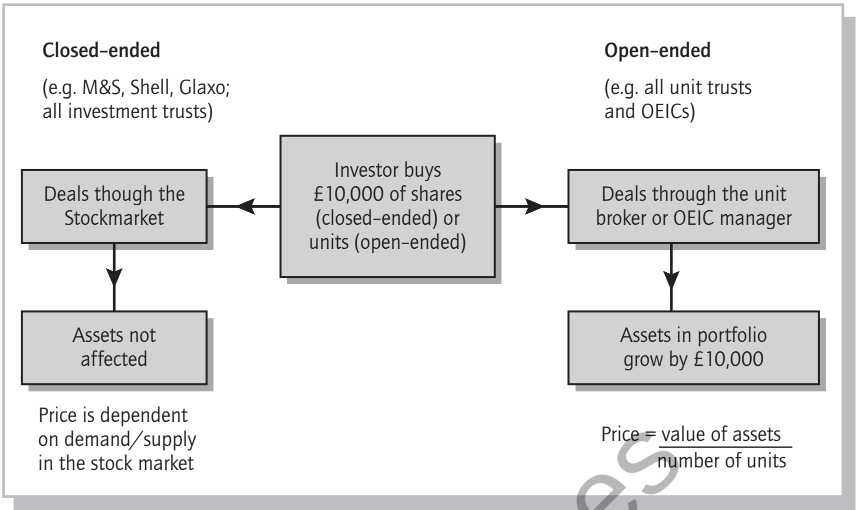

Figure 1.3 How closed-end and open-ended funds compare

Value and calculations

In the case of investment trusts, the assets are the portfolio holdings. A common way of pricing this value for each trust is by referring to the Net Asset Value (NAV), the net value of the portfolio's assets (after including cash and deducting debt) divided by the number of shares in issue.

$$\text{NAV} = \frac{\text{Net value of the portfolio's assets}}{\text{Number of shares in issue}}$$

By way of example, let us assume that today the total value of ABC investment trust's portfolio of shares and cash is £100 million – there being no debt. There are 100 million shares of ABC in issue. The NAV is therefore £1.00 (£100 million value divided by 100 million shares). If, in future, the value of the underlying portfolio was to rise to £120 million because the portfolio had risen, then the NAV would rise to £1.20.

The NAV is a useful way of relating the value of the portfolio to the share price and is one of the factors closely watched by investors when evaluating an investment trust. The NAV should be used when comparing performance within a trust's peer group and with unit trusts.

Discounts and premiums

Being closed-end, and therefore having a fixed number of shares, the share price of an investment trust is not dictated by the underlying value of the assets under management (the NAV) but rather by the extent to which investors wish to own the shares of the trust itself. Trading in the shares does not affect the value of the NAV as is the case with unit trusts.

As such, the share price can be more or less than the NAV. If it is less, the trust is said to be *trading at a discount* (see Table 1.3). Most investment trusts trade at a discount to NAV. Presently, discounts average between 5–10%. This effectively means that an investor is buying £1's worth of assets for 90–95p.

Table 1.3 How discounts/premiums are calculated

NAV	100p	100p	100p	100p
Share price	100p	90p	80p	110p
Discount/ premium		10% discount	20% discount	10% premium
Shown as		−10%	−20%	10%

Source: AIC

This discount reflects the fact that historically institutions have been sellers and that costs would be incurred if an investment trust was to be wound up. It may also reflect the fact that investment trust prices can be a little more volatile than those of open-ended funds. This is because their price is not only affected by movements in their NAV (like open-ended funds) but also by movements in the discount (unlike open-ended funds). Investors may therefore be seeking compensation or a margin of comfort for holding investment trust shares.

A discount to NAV is not necessarily an opportunity. A large discount may, for example, also reflect low confidence in the fund manager – perhaps because of poor performance – or a dislike of the trust's focus on a particular region or sector. It can also reflect the fact that the investment trust is not communicating its investment strategy well to the market. Investors do not like uncertainty.

If the share price is more than the NAV of the underlying portfolio, then the trust is said to *trade at a premium*. There may be a good reason – the fund manager may be well respected or the underlying focus of the portfolio may be very much in fashion. But investors should be aware that, as buyers, they are effectively paying more in order to obtain exposure than investors who buy at discount.

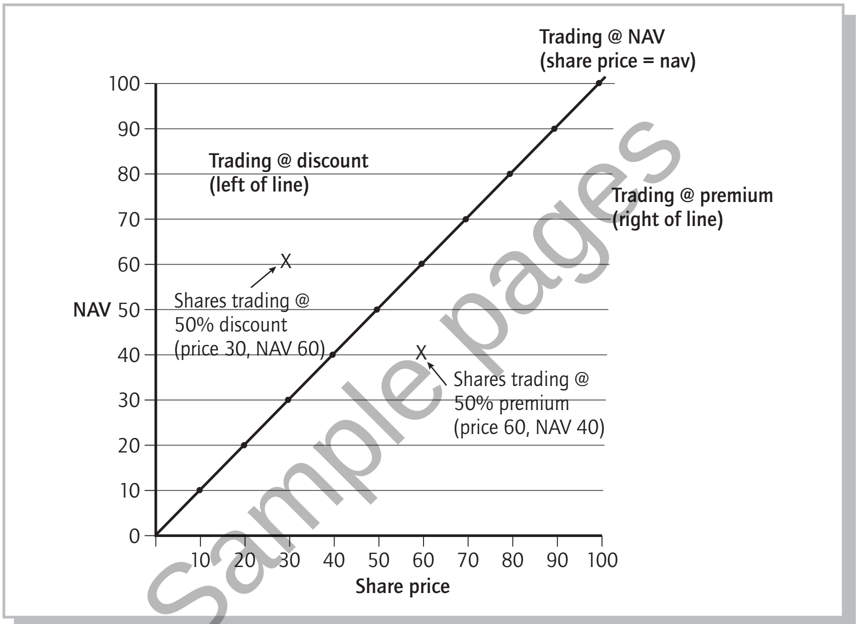

Figure 1.4 **NAV and share price**

The fact that share prices trade at discounts or premiums to NAV can present both opportunities and risks for investors. Such valuations are a key determinant in deciding whether trusts represent good value at any given point. This is something covered in later chapters. For the moment it is important to recognise that the characteristic of discounts and premiums does not exist with unit trusts and OEICs, and that investment trust shares are traded by investors so their prices will vary depending on supply and demand.

Price and size

Being public companies, the price of investment trusts is decided by how keen investors are to own the shares – there being a limited number. As with the price of most things in limited supply, the price will rise if there are more buyers than sellers, and vice versa.

By comparison, being 'open-ended', there is no limit on how many shares (or units) can be created by unit trusts or OEICs if the demand exists. Prices are dictated directly by the value of the underlying portfolio and not by investor demand. The individual unit price is decided by the value of the fund divided by the number of units in existence, and not by the extent to which investors want to own the shares.

Being public companies, the size of investment trusts in terms of market capitalisation is therefore decided by the number of shares in issue multiplied by the price of those shares. For example, if XYZ investment trust has 100 million shares in issue, a share price of £1.50 equates to a market cap of £150 million. By comparison, the size of unit trusts and OEICs is decided by how much money investors have placed in that particular fund.

Investment trusts vary in size enormously. The largest have a market capitalisation of around £8,000 million, whilst some of the smallest come in under £10 million. The larger ones tend to have a global remit and access all the major markets. These are typically suitable for investors with smaller portfolios who may just want to start with a few trust holdings. The smaller trusts tend to have more specialist briefs such as smaller companies, bonds or any number of alternative asset classes.

Range and reach

All public and listed companies invest in and manage a portfolio of assets appropriate to their remit. Just as Shell specialises in a range of assets related to oil and energy, and M&S in clothes and food, different investments trusts tend to specialise in certain categories of financial assets, be they equities, property, bonds, private equity, renewable energy, infrastructure and so on.

Whatever the asset class, the fund manager's objective will be the same: to outperform the appropriate benchmarks for the benefit of shareholders through prudent management of the portfolio's assets. And being over 400 in number, investment trusts offer a huge range of investment opportunities covering all global markets and a diverse variety of asset classes. The investor is spoilt for choice.

For those first starting their investment journey and those who may want to hold only a few investments, there are the large generalists such as Scottish Mortgage, Alliance and F&C Investment Trust. These can roam the global markets and make asset allocation and market decisions on behalf of the investors. If cautious about the outlook, these trusts can take defensive action such as raising cash levels. But their brief is essentially to invest in equities (the shares of other public companies) for the long term.

For those more experienced and whose personal wealth allows a greater spread of trust holdings, then the world is your oyster. Investors can create a portfolio of trusts to reflect their risk tolerances, income requirements, time horizons and market outlook. There are investment trusts to suit every financial goal. For example, trusts invested in the UK market offer choices and combinations of growth, income growth and high income, large and small companies, together with a wide variety of other asset classes.

Looking abroad, all the markets are covered from trusts covering continents to individual countries. These include 'emerging' markets and 'frontier' markets, such as the remote parts of Africa. One can also combine themes. For example, if income is important but an investor also wants overseas exposure, then the two can be combined. There are trusts offering exposure to Latin American, European and Far Eastern companies with decent dividends, to name just a few regions.

Furthermore, a growing number of trusts focus on an increasing variety of themes – life sciences, renewable energy, infrastructure and technology are but a few. And globalisation has resulted in many of these themes needing to be pursued across national boundaries. Investment trusts have the full coverage.

Indeed, some have access to assets classes that open-ended funds simply cannot replicate to the same extent. This is because the constant changes in money flows seen by unit trusts are not best suited to illiquid assets – one example being private equity. The closed-end nature of trusts also can make for unique investment remits, one example being RIT Investment Trust (RIT), which is the personal investment vehicle of Lord Rothschild.

Such has been the proliferation of asset classes and choice that in May 2019 the Association of Investment Companies (AIC) revamped its investment company sectors following an industry-wide consultation. Its new list of sectors and constituents now comprises 13 new sectors, 15 renamed sectors and 31 sectors which are unchanged. These are listed below, in aggregate, showing the extensive number of investment trust categories available to the investor.

Table 1.4 New sectors

New sector name	*Sector description*
Asia Pacific	Invests in the shares of larger quoted Asia Pacific companies
Asia Pacific Income	Invests in the shares of larger quoted Asia Pacific companies, or high yielding securities, for a high income
Asia Pacific Smaller Companies	Invests in the shares of smaller quoted Asia Pacific companies
Debt – Direct Lending	Invests in direct lending
Debt – Loans and Bonds	Invests in general loans and bonds
Debt – Structured Finance	Invests in structured finance
Growth Capital	Invests in unquoted shares. Generally takes non-controlling stakes in early to maturing companies.
Property – Debt	Invests in property debt
Property – UK Commercial	Invests in UK commercial property
Property – UK Healthcare	Invests in UK healthcare property
Property – UK Residential	Invests in UK residential property
Royalties	Invests in royalties
Technology and Media	Invests in technology and media

Source: AIC

Table 1.5 **Renamed sectors**

New sector	Old sector
Biotechnology and Healthcare	Sector Specialist: Biotechnology and Healthcare
Commodities and Natural Resources	Sector Specialist: Commodities and Natural Resources
Country Specialist: Asia Pacific ex Japan	Country Specialists: Asia Pacific
Country Specialist: Europe ex UK	Country Specialists: Europe
Environmental	Sector Specialist: Environmental
Financials	Sector Specialist: Financials
Infrastructure	Sector Specialist: Infrastructure
Insurance and Reinsurance Strategies	Sector Specialist: Insurance and Reinsurance Strategies
Leasing	Sector Specialist: Leasing
Liquidity Funds	Sector Specialist: Liquidity Funds
Property – Europe	Property Direct – Europe
Property – Rest of World	Property Direct – Asia Pacific
Renewable Energy Infrastructure	Sector Specialist: Infrastructure – Renewable Energy
Infrastructure Securities	Sector Specialist: Utilities

Table 1.6 **Unchanged sectors**

Name of unchanged sector	Sector description
Country Specialist: Latin America	Private equity
Europe	Property securities
European Emerging Markets	UK all companies
European Smaller Companies	UK equity and bond income

Name of unchanged sector	*Sector description*
Flexible Investment	UK equity income
Global	UK smaller companies
Global Emerging Markets	VCT AIM Qquoted
Global Equity Income	VCT generalist
Global High Income	VCT generalist pre-qualifying
Global Smaller Companies	VCT specialist: Environmental
Hedge Funds	VCT specialist: Healthcare and biotechnology
Japan	VCT specialist: Healthcare and biotechnology pre-qualifying
Japanese Smaller Companies	VCT specialist: Infrastructure
Latin America	VCT specialist: Media, leisure and events
North America	VCT specialist: Technology
North American Smaller Companies	

The changes followed a year-long review of investment company sectors which was overseen by the AIC's independent statistics committee of brokers, research analysts and data providers. The AIC conducted the review in consultation with its members to ensure its investment company sectors were as clear and helpful as possible for investors.

Several of the new sectors reflect the greater numbers of investment companies investing in alternative assets. The amount of money invested by investment companies in alternative assets has grown by 92% over the past five years, rising from £39.5 billion in 2014 to £75.9 billion in 2019.

For example, *Sector Specialist: Debt* has been separated into three new sectors, *Debt – Direct Lending*, *Debt – Loans and Bonds* and *Debt – Structured Finance*. Similarly, companies in the *Property Direct – UK* and *Property Specialist* sectors have been reclassified as *Property – UK Commercial*, *Property – UK Healthcare*, *Property – UK Residential* and *Property – Debt*.

To accompany the revised list of sectors, the AIC has issued new sector descriptions so investors can easily understand what each sector invests in. The AIC has also published detailed explanations of each sector's characteristics. Further details can be found on its website.

At the time, Ian Sayers, Chief Executive of the AIC said:

> *We undertook this review to ensure that investment company sectors accurately reflect the shape of the industry today. Recent years have seen significant growth in investment companies investing in alternative assets, such as property, debt and infrastructure and the emergence of new asset classes such as leasing and royalties. Our new sectors allow investors to find and compare companies with similar characteristics easily . . . (and) will play a useful role in helping inform investors' decisions.*

Governance and cost

Like other listed companies, investment trusts are overseen by an independent board of directors who are chosen or re-elected by shareholders at their annual general meetings (AGMs) to represent their interests. The board is accountable to the shareholders for the appointment of the manager, the performance of the company and for the general running of, what is after all, their company.

Like other closed-end companies, all investments trusts are regulated by the Listings Rules of the stock exchange on which they are listed and by company law. The Financial Conduct Authority (FCA) has responsibility for the Listing rules but it does not regulate investment trusts. It does, however, regulate open-ended funds.

As for the cost of investment trusts, as with any listed share, there will be brokerage commission to pay when dealing and usually Stamp Duty to pay on purchases. Investors should check these dealing costs with their broker or platform provider as they can vary significantly and, in some cases, will vary according to the number of deals undertaken over a specific period.

The managers appointed by the board of directors will charge a fee for managing the portfolio, all such costs, including dealing and administration charges, sourced from the trust's assets. As a guide, management fees can vary from around 0.3% for the very large trusts to over 2.0% for specialist ones. We will look at this in further detail later. The AIC's website also contains a lot of useful information in this area.

Pros and cons

In conclusion, because trusts are closed-end in their structure, their managers are not forced to buy or sell investments simply because investors are buying or selling the shares. They are also particularly well suited for the more illiquid asset classes which require a longer-term perspective, such as property, private equity and small companies.

Together with the prudent use of gearing, this focus on the market rather than short-term investor money flows makes for better portfolio management over time. This helps to explain why investment trusts have performed better than their benchmarks and the open-ended funds which dominate the retail market.

A key disadvantage is their share price volatility because, like other listed companies, the price is largely governed by supply and demand for the shares. Prices are not directly linked to the portfolio's NAV. Lack of liquidity for smaller trusts can occasionally be another reason. Both are compounded when there is short-term market volatility.

These are all reasons why investment trusts are best suited to the long-term investor. The next few chapters will pursue these characteristics in a little more detail. They will also introduce further nuances when it comes to our understanding of this slightly more complex but ultimately rewarding financial instrument.