Investment Trusts - a Primer part I

by Roy Colbran

Dee O'Hara recently invited me to talk about investment trusts to one of his innovative and successful investment gatherings in Brighton. As a result of this experience I realised that understanding of the way these companies function and their potential benefits is, perhaps, not as widely spread as I thought. Accordingly I have turned my presentation into a series of articles for The Private Investor.

Although commonly known as investment trusts (and referred to as such in this article) they are not actually trusts at all but properly called investment companies. They are *plcs* like any other – except that their business is to run a portfolio of investments for the benefit of their shareholders – normally this is their only business and many of them are very long established. I first encountered investment trusts back in the early 1960s when I had a spell in the investment department of a life assurance company. At that time the idea of a life company buying equities was still exceptional and the one I worked for felt direct equities were a bit too adventurous for them but investment trusts were OK.

The normal pattern for these companies is to have a small board of directors, these will usually all be independent and mainly people with a considerable investment history. They then employ a manager to invest their portfolio at a fee, usually a percentage of total net assets. The manager will commonly be one of the large fund management houses such as Henderson, Baillie Gifford and JP Morgan. However, there will always be an individual within the management house with overall responsibility for the particular portfolio. A few investment trusts are self-managed; that is they employ their own in-house staff to manage their investments and the leader of the team is likely to be one of the directors.

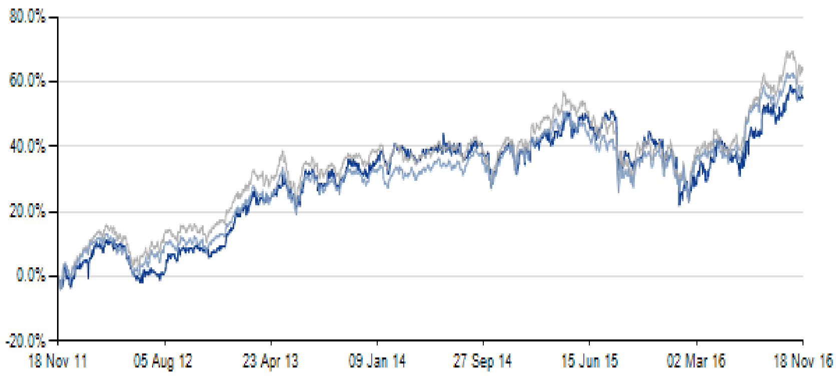
The trust's investment portfolio will, of course, pay dividends which the company will collect and then distribute to their own shareholders by way of quarterly or half yearly dividends after deducting the expenses of managing and administering the company. Usually they keep back a small part of their income to build up small reserves so that they can even out fluctuations in their own income. It can only be a small part because by law they must distribute at least 85% of their income to their own shareholders. In return for meeting this requirement no capital gains tax is payable on sales by the manager within the portfolio. Naturally, a sale of the trust shares by a shareholder is subject to the normal capital gains tax rules.

Each investment trust has its own style. Many are general, that is aiming to cover more or less the whole market, some with emphasis on UK and some looking to a worldwide basis. Some however are more specialist - concentrating, for example, on technology stocks or on one particular country's markets such as Japan or China. The latter can be useful for people who generally want to run their own portfolios but feel that they need specialist help with particular areas of the market. As a generalisation, specialist funds tend to have higher charges than general ones. All of these companies' shares are bought and sold via stockbrokers or other intermediaries in the usual way like any other publicly quoted ordinary share and the usual dealing expenses apply. There is a special section on the share prices page in the FT.

The market value of their total net assets is normally calculated daily and this figure, divided by the number of shares in issue, gives the Net Asset Value per share which figure is quoted in the FT. However, unlike open-ended funds, the prices at which one can buy or sell depend on the market. Most commonly you will find that the share price is a bit below the NAV (this is called standing at a discount) but in some cases the share price will be above NAV (standing at a premium).

Obviously there is a cost in investing in investment companies compared with running your own direct portfolio - management doesn't come free – and you have to consider whether this is acceptable to you for the other advantages it brings. For this purpose you should look at the managers' fee scale which you will find tucked away somewhere in the Report and Accounts. In there you will also find the Ongoing Charges Ratio which is the regular ongoing cost of running the company overall expressed as a percentage of average total net assets. I used to aim to buy only trusts where this figure was no more than 0.5%. While this has become more difficult there are still some companies that pride themselves on keeping the figure this low. After a period of increasing costs, there are now small signs of a reducing trend, possibly spurred on by greater attention to cost in the press.   I am also pleased to see that performance fees are going out of fashion. These are where the manager is paid an additional fee if his results beat a certain pre-arranged formula. A lot of people now consider that these are simply paying twice for doing the same job and the manager should be doing his best anyway.

Investment companies have a number of advantages over open-ended funds:



'They actually perform!'

Chart - Brunner Investment Trust

1. Being close ended means the manager knows just how much he has available to invest and is untroubled by the need to run a cash float, or even sell stocks, if there is a run of withdrawals. For example retail investors with Hendersons were reported as having withdrawn £1bn in the three months following the Brexit vote. Hendersons themselves had to generate the cash to pay this out of their funds whereas selling an investment trust share in the market has no impact on the manager.

2. They can gear up, in other words they can borrow to fund extra purchases if they feel that is appropriate. Of course, they have to get it right for this to be a benefit but they are the experts and have very good security to back their loans and so should be able to borrow relatively cheaply.

3. Having an independent board means that the manager has to report regularly to a group

who are mostly experts in investment. In the extreme they can sack the manager. Normally there is no corresponding body with open-ended funds and not the same close scrutiny of the results. This does not mean that the directors are a serious constraint on the manager; normally they set overall guidelines and very much leave the manager to run the show.

4. There is transparency with detailed annual reports showing the holdings, relating how the manager has operated in the past year and how he sees the future. Good half yearly reports are also provided. If you hold the shares direct you can go to the AGM and meet the manager and the board and ask questions.

5. The charges are usually less than with open-ended funds

6. They actually perform!

Next time I will discuss the impact of discounts and premiums and some figures about performance. In the third and final article I will provide some notes on a few selected investment companies with which I am familiar.

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