More on Investment Trusts

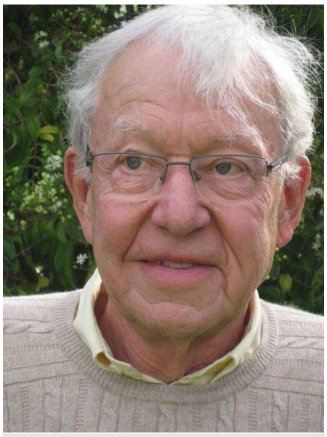
by Roy Colbran

Buybacks

As Amin reminds us above, in the May issue we saw his arguments against and in favour of buybacks by investment trusts set out in consecutive articles. However, I would like to suggest that Mohammed Amin's reasoning in his article in favour deserves a little closer examination. His figures assume a static situation whereas, as we all know, prices are moving up and down all the time. This can, of course, work both in favour of and contrary to the buyback calculation and thus should probably be regarded as neutral.

When it comes to providing the cash to carry out the buybacks Investment trusts do not have a flow of surplus cash for this or any other purpose (see below). It follows that the money required must either come from capital raising or from realisations from the asset portfolio. I suggest that there is a cost to be offset against the gains in net assets per share that Mohammed Amin calculates. There will be the actual expenses of sale and the cost of selling at bid price when the shares are probably valued in the portfolio at mid-market. Furthermore, one of the strengths of investment trusts as opposed to open-ended funds is that the manager can run his portfolio without having to look over his shoulder at the possibility of units being sold back and him having to have a cash float for the purpose. If the manager knows that the directors are liable to demand money for buybacks at any time that must be a constraint on his freedom to invest as he thinks best.

The only investment trust that I am aware of that uses Mohammed's argument in its annual reports is Witan. Maybe the others are less convinced and confine themselves to the usual justification of what is euphemistically called "discount management". In practice it appears that the effect of buying back on the discount levels is far less assured than generally assumed. At best it seems to me short lived.



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Does anyone really know the reasons why some trusts are to be found at substantial discounts and others run to a premium? For example, in the annual report issued in March 2016 the Chairman of Foreign & Colonial, which has over the years been active in buying back, proudly told us how their policy had reduced the discount to 7%. Not long after it was hovering either side of 10% and as I write stands at 14.0% after a day of post-referendum falls. Yet over 10 years this Trust, established in 1868, has reduced the number of shares in issue by almost one-third for the purpose of controlling the discount.

All the foregoing is short-term! The gain of less than 1% in NAV per share calculated by Mohammed Amin involves reducing the number of shares in issue by 10%. I believe that the real purpose of investment trusts is to provide a long-term route for private individuals to get the benefit of investment in ordinary shares in the most efficient and economical way possible without running their own portfolios. Now that the commission system has been abolished IFAs have every reason to recommend investment trusts rather than the poorer-performing unit trusts.

Scouring the internet indicates that there is about five times as much money in open-ended retail funds as in investment trusts. So if there is an apparent lack of demand for the latter it must be due to lack of understanding or lack of promotion. I hope that the Boards of the trusts that have been so active in buying back can now concentrate their efforts on making sure that the benefits they offer are more widely understood rather than reducing their size even further.

Cash Flow

Investment Trusts are allowed, indeed encouraged by their SORP, to split the allocation of their management fees and finance costs between capital and income according to "the Board's expected long-term split of returns in the form of capital gains and income respectively". Some trusts go so far as to allocate 75% of these costs to capital. Among those doing so are Foreign and Colonial, Scottish Mortgage and Witan (No doubt there are others but I looked at only 9 reports before putting pen to paper). Indeed Witan then allocates the whole of the substantial performance fees to capital. I sometimes wonder how auditors can sign up to a true and fair view. At the other extreme the much maligned Alliance Trust allocates only relatively small sums to capital and Law Debenture nothing at all.

Although charged in the accounts against capital these costs must still be paid in cash. I have found it interesting to see the extent to which dividends and current costs are being paid out of dividend and other current income and so how far they are being paid out of capital. (These figures are not available directly from Income and Cash Flow statements and have to be calculated.) For example Foreign and Colonial dips into capital to the extent of some £18m to pay its dividend costing £53m. For Merchants Trust the respective figures are £7m and £26m. On the other hand for my second favourite trust, Temple Bar, the dip into capital is just £1m to pay £26m. And Law Debenture more than fully covers its dividend out of current income but they have the trustee business running alongside and generating profits.

Since performance is measured on a total return basis it is certainly arguable that all this doesn't matter although it is probably desirable to be aware that one's income is coming to some extent from capital gains. Personally I was quite shocked to see the extent to which growing dividends come from capital.

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