Investment Trusts - a Part 2

by Roy Colbran

Discounts

In the November issue I promised to deal with discounts and performance this time. Discounts are often seen as worrying factors and I have known people being put off from considering investment trusts at all because of their existence. On the contrary, I suggest that they are something of which private investors can take advantage. As explained in the first article, investment trust shares trade at prices determined by the market and, commonly, these are below the value of the assets underlying the share. They are then said to be trading at a discount. This is quoted as a percentage of Net Asset Value per share and shown daily in the Financial Times. As I write, I see three major generalist trusts standing at discounts of 5.0%, 8.1% and 5.1%. Historically these are on the low side and in my first draft I had figures of 8.0%, 9.3% and 11.4%. The existence of the discount simply reflects the view of the market as based on supply and demand and has no effect on the value of the assets of the investment trust. Accordingly if you buy investment trust shares standing at a discount you are getting the benefit of the underlying portfolio of assets at a cut price.

Of course, the level of discount is merely one of many factors to be taken into account in buying investment trust shares - but certainly something nice to have when purchasing. The worry you may have is that the discount may still be there, or may be even bigger, when you want to sell. Purchasers of investment trust shares are likely to be long term holders and so this should not normally be too great a worry – certainly not enough to stop one buying them. While it is difficult to produce statistical evidence to prove this, I feel that discounts tend to widen when markets are depressed and to narrow when they are buoyant. This is logical in that when the market is buoyant there is likely to be more demand for the shares than when it is down. This means that it is even more important for investment trust shares than general industrials to try to buy at times of gloom.

The more specialist trusts often trade at a bigger discount than those I have quoted. One factor influencing this may be their higher level of charges; in some cases there could be a lack of confidence in the valuation of the underlying assets. On the other hand, a few of the large trusts regularly trade at prices slightly above NAV. This implies that purchasers have so much faith in the running of the trust and the ability of the manager that they are prepared to pay above NAV in the hope of exceptional performance. One such trust is Scottish Mortgage. Its performance figures really have been consistently outstanding and so it is easy to see why the shares command a premium. Their portfolio can fairly be described as more adventurous than many and there must be a risk that one day it will take a tumble. Another is City of London which is well and very economically run but its performance has only been average and it is hard to work out why the shares command a premium.

Some Boards of Directors get worried when their shares go to a discount. They may come under pressure from shareholders, particularly institutional shareholders, to take some action. At each AGM there will normally be a resolution authorising the directors to buy back shares in the market. The prime logic of this is to push up the price and so reduce the discount. In practice it seems to me that the effect on the price of this action is only short-term and the market has to change its view of the particular investment trust to have a lasting effect on the discount. Moreover, buying back means reducing the number of shares in issue of a commodity which is in limited supply and of great potential for private investors. An

additional reason given for buying back is that redeeming shares at less than NAV has a positive effect on the value underlying the remaining shares.

Quite recently Alliance Trust came under great pressure from Elliott Advisers, who had built up a substantial position in the trust's shares, to change its policies generally and, in particular, embark on a buying back approach that they had previously resisted. If Elliott could achieve a material increase in the share price they would, of course, have a substantial profit on their investment. Their campaign has in fact been largely successful and, as a result, there have been major changes in the way Alliance Trust is run including replacement of the Chairman and Chief Executive. The fear of a similar approach by predators is naturally a significant factor influencing the behaviour of trusts' boards.

When a trust's shares go to a premium it is then possible for the directors to issue shares either from treasury or by creating new shares. This has beneficial effects in the opposite direction from buying in shares at a discount but is a much rarer event. One trust which is an exception in this respect is Personal Assets which has a provision in its Articles obliging the directors to buy or sell shares in the market with the objective of keeping the share price as close as possible to NAV. Some investors find this a particular attraction knowing that the price is unlikely to stray far from the underlying value.

New Funds

The general prevalence of discounts makes it very difficult to launch a new investment trust. The initial subscriptions have to cover the expenses of launch and those of purchasing the initial portfolio. Thus it is inevitable that the subscription price will be above the initial NAV which is not very encouraging if you expect the new trust to go to a discount in line with the market. Nevertheless Fidelity was able to launch its China Special Situations fund in 2010. Subscribers were drawn in by the reputation of Anthony Bolton and put up £466 million initially at a price of £1.00 a share. This was followed by over £200 million more in the first year. In fact, his reputation did not serve him well because after a healthy first six months he had a pretty rough period. At the end of the second year the shares at 80.8p were well below issue price. Since then, with a new manager, the fund has done well and as I write the price is now £1.86. The shares have gone to a discount of 13.7% but on an NAV of £1.97 that's not looking too bad!

High charges did not deter subscribers. The investment management is charged at 1.0% of NAV leading to an Ongoing Charge of 1.2%. However, encouraged by the AIC, it seems that performance fees don't count in this figure! In fact, in the year ending in 2016, performance fees doubled the management fee. Whatever happens to the shareholders, Fidelity certainly do well out of this fund.

Another new fund is to be launched by Daniel Godfrey, formerly Chief Executive of the Investment Association, in the first half of 2017. Having fallen out with his previous employers through acting more like a regulator than a trade body, he has decided to launch his own fund called The People's Trust which will be unattached to any one commercial entity. Charges will run at between 1.0% and 1.5% which is on the high side. It will be interesting to see how this one develops. He is reported as claiming that returns will be 7% pa.

Performance

The Association of Investment Companies ("AIC") provides a mass of statistics on its website, to the extent that at first sight they can be quite confusing. Each month the tables provide performance figures over the last one, three, five and 10 years on a total return basis for each of the trusts that is a member of the AIC (almost all of them). The trusts are grouped in sectors by type and for each sector size-weighted averages of the same performance periods are also provided. Looking at large general trusts of the type where an individual might put all or most of his equity investments, there are two important sectors, namely "Global" and "UK Equity Income". Between them these cover most of the big widely known trusts. The following figures extracted from the AIC tables show the percentage change in value over the period shown ending on 30 November 2016 for the size-weighted average of the sector.

Sector or index	3 years	10 years
Global trusts	39.1	119.2
UK Equity Income trusts	18.8	84.6
FTSE All share	15.7	69.0
MSCI World	46.2	128.4

The above figures are for NAV on a total return basis – so taking account of income. The AIC tables also show total return based on share price which differs from NAV performance due to variations in the level of discount. I prefer to quote NAV figures because they show what the manager has achieved on his own. As you can see from the figures, both types of fund have beaten the All-share index with Global being more successful than UK Equity Income - not surprising given the respective performance of the indices.

Although, representing a large sum of money, around £80 billion in total, the investment trust community is still only a small part of the total funds managed by UK houses. For example at the end of 2015 the Investment Association reported UK domiciled open-ended funds as totalling £550 billion and there is lots of other money that they manage on top of that figure. Hence we can see that the investment trust movement is not so big that it cannot overall beat average returns. It does suggest that in general investment trusts have been successful performers and may be worth trusting with some or all of your money.

This article would not be complete without my thanks to George Miller in Auchterarder who made many helpful suggestions and comments on both parts. I will undoubtedly be seeking his help in the final part in which we will provide notes on a few specific trusts with which we are familiar.

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