

# An Investment to Trust?

By Graham Spooner, Investment Adviser.

In 1868, while Thomas Edison was applying for the first patent for the electric voice recorder and a French astronomer named Pierre Janssen was discovering helium, Foreign and Colonial Investment Trust was launched, with investments across the globe.

Since then this somewhat forgotten sector has experienced many ups and downs and its demise has been predicted on many occasions only for it to reinvent itself.

An investment trust can borrow money to increase the total fund available for investment. This is called gearing. Gearing can improve a trust's performance, especially in rising markets,

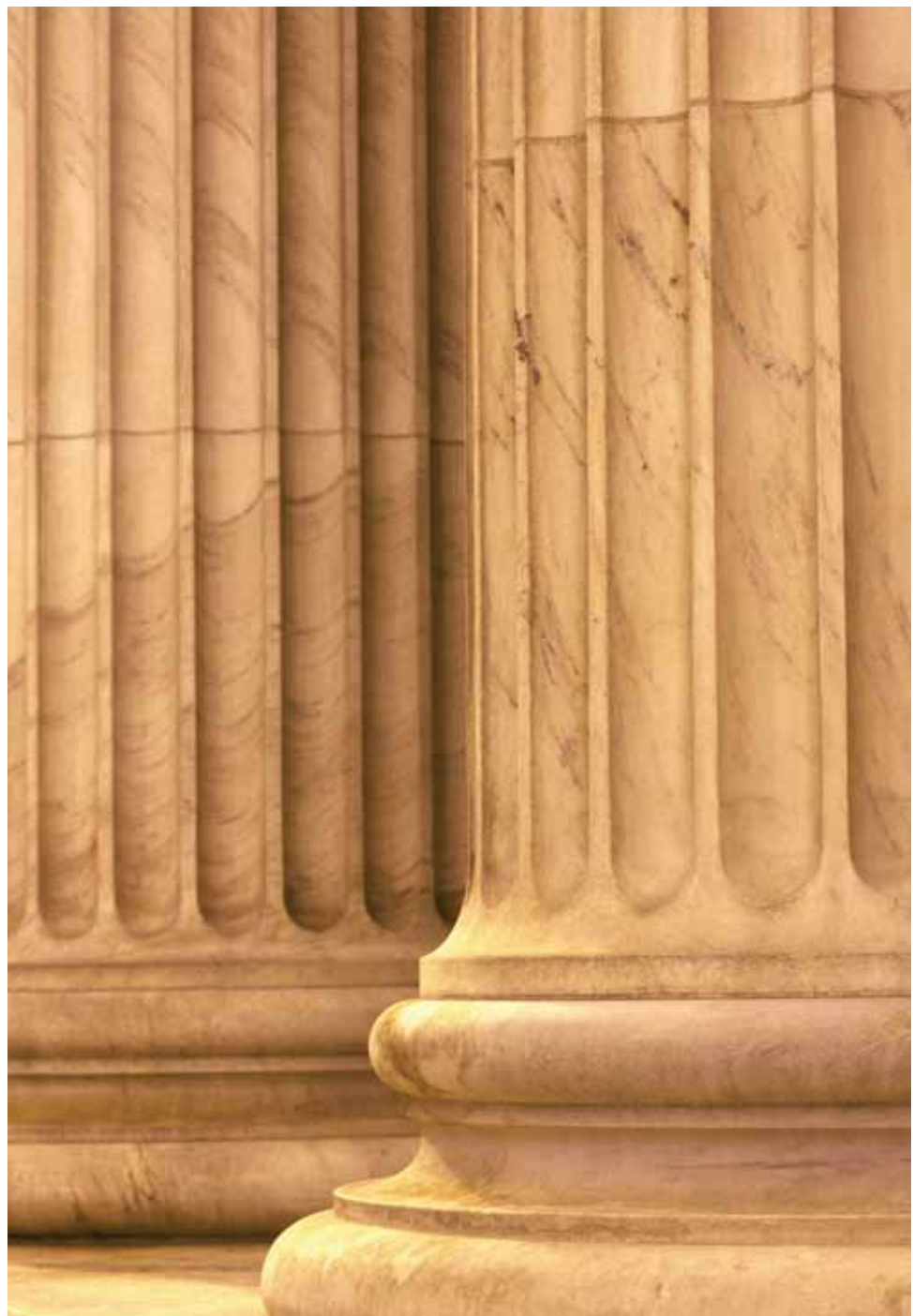
although of course it can lower performance when the markets fall. However, not all trusts are geared and this option is used conservatively by most trust managers.

## So what is an investment trust?

Investment trusts are quoted companies that invest in other companies and their shares. Unlike its better known, younger, open-ended cousin— the unit trust— which expands and contracts in size according to demand, the investment trust is a closed-ended fund, meaning it has a fixed number of shares in issue. Therefore the share price fluctuates with supply and demand, market movement, and the value of the net assets. As a result, and combined with the potential to use gearing to which we refer later, investment trusts are somewhat riskier than investment funds.

Generally, the share price of an investment trust will trade at a discount to net asset value (NAV). If a trust is trading at a discount of 5% that means that in theory you can buy assets worth £1 for 95 pence. If the share price is exactly in line with the underlying investments then it is trading at par. If the share price is higher than the NAV then it is trading at a premium. This can happen if the fund manager is considered exceptional or, more often, in bull markets.

There is a wide range of trusts available covering areas such as Global Growth, UK Growth, Smaller Companies, Europe, Far East, Emerging Markets, Private Equity and Property, as well as others. Each trust has an independent board of directors to oversee its management. Unlike a fund, an investment trust carries no initial charge and annual management fees tend to be lower but other charges apply such as dealing commission and stamp duty.



## Example of the magnifying effect of gearing

An investment trust has £50 million of investors' money and £50 million of borrowing providing a total of £100 million available for investing.

If the value of the fund falls by 10% the £100 million initial investment drops to £90 million.

Borrowing remains at £50 million, leaving £40 million belonging to investors.

So the investor's equity has actually gone down by 20%, thus magnifying the loss.

Gearing is usually reported by a gearing figure. An investment trust that is not geared has a gearing figure of 100. A gearing figure over 100 shows the proportion of its total investments that the trust has borrowed. A gearing figure of 120 shows that the borrowed money amounts to one sixth of the trust's total investments. So the higher the figure, the higher the risk involved.<sup>1</sup>

**This new period of turbulence follows a recent mini boom for the sector, on the back of new funds formed to invest in hedge funds, private equity and property.**

As 2008 drew to a close the investment trust sector was again under pressure on the back of the poor performance of its funds, which has led to a drop in liquidity, a widening of discounts to NAV and still lower share prices. According to data from the European Fund and Asset Management Association, the recent market turmoil has hit the sector harder than other fund types. In the first 9 months of 2008 assets dropped by 30.8% to £47.5 billion. Following November, the sector fall was 38.4% compared with 32.4% for companies in the FTSE All-Share Index. Discounts have widened across all sectors and in some sectors have reached extreme levels. In

November the average discount to NAV for trusts investing in European property was 85%, in private equity funds 59% and in hedge funds 25%.

This new period of turbulence follows a recent mini boom for the sector, on the back of new funds formed to invest in hedge funds, private equity and property. These relatively illiquid assets were judged to be better in closed-ended structures, which would help alleviate the need to sell assets whenever investors wished to redeem/sell. In addition there have been widely reported problems for open-ended property and hedge funds, which have had to close redemptions to limit forced selling of assets.

The problems in the Investment Trust sector are many. As in many markets liquidity in the sector has fallen resulting in a number of trusts being ejected from the FTSE All-Share index due to their reduction in value. Also, a number of large banks have withdrawn from the sector, leaving it to smaller, niche houses that are unable or unwilling to take on large positions. Another factor is the decline of activist funds that would often prey on trusts with large discounts (by putting pressure on the trust to realise value).

For some followers of the sector these problems may at some point lead to opportunity. Investment trusts can be an attractive way to play any market recovery. In the past, when there has been a market rebound, the effect of narrowing discounts and the use of gearing has led to the sector outperforming.

## How can we help?

We recommend that investors considering investment trusts make use of the Internet to gain up-to-date information from the relevant management house. Latest manager reports will highlight the main holdings in a trust's portfolio along with views on the market and past performance. The Share Centre Advice team also has a list of core recommendations, the majority of which are obtained from a specialist investment trust broker with whom we have close ties.

Currently our favoured trusts include: Alliance Trust and Monks for global growth, Schroder UK Growth and Schroder UK Mid and Small, BlackRock

## At a glance

An investment trust invests in other companies' shares.

It has a fixed number of shares in issue.

It can trade at a discount, at par, or at a premium to its net asset value per share.

It can borrow money to increase the investment capital.

It is a higher risk investment than funds.

Greater Europe, Schroder AsiaPacific and JPM American, as well as other more specialist trusts. It must be remembered that the value of stock market investments can go down as well as up and that investors may get back less than their initial investment.

We can provide you with detailed information for all the investment trusts available through The Share Centre. For example, for Monks we can tell you that this trust is down 46% compared to a 25% fall for its benchmark index, FTSE World, over the past six months (as at 8 December). Even though the fund manager was cautious on the markets he still had a high exposure to oil and oil service companies and moved back into banks a little too early. At the beginning of November the fund had gearing of 117%, of which 62% was in equities, 21% in bonds and 17% in cash.

Having survived 140 years there is every chance that investment trusts will continue to be an investment option for personal investors in the future, but they are again facing uncertain times and a period out of the limelight looks likely.

## Find out more

For more information on investment trusts contact our Advice team on 01296 41 43 45

<sup>1</sup>Gearing is expressed differently in relation to investment trusts than it is in relation to companies (as defined on page 7).