INVESTMENT TRUSTS

APRIL 2025

An investment trust is a collective investment vehicle designed to make it possible for a private investor with a small sum of money to invest, to hold a **well-diversified** and **professionally managed** portfolio of investments in a **cost effective** and **tax efficient** manner.

These are **‘closed ended’** investment vehicles with a fixed number of shares available. The value of the shares is determined by supply and demand, leading to **premiums** or **discounts** in comparison to the value of the underlying assets.

This note looks under the bonnet of these structures to explain exactly how they work.

clarity

INVESTMENT TRUSTS

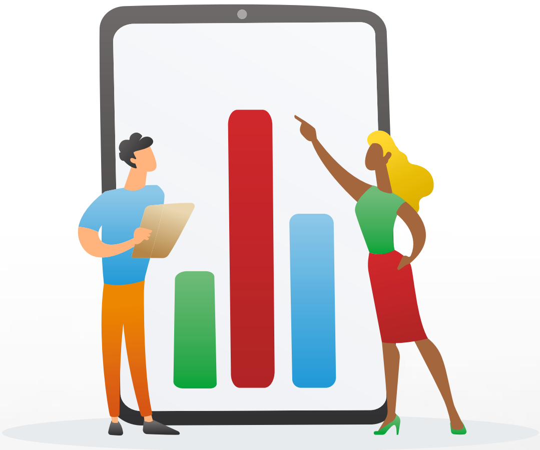
Onshore investment companies are often known as **investment trusts** (or **Venture Capital Trusts** where they conform to certain rules to be eligible for additional tax advantages). **Offshore investment companies** are often based in the Channel Islands.

Investment trusts **may not invest more than 15% of gross assets** (at the time of investment) into a single holding, whereas this limit may not apply to offshore trusts. In practise the terms are virtually interchangeable, and funds have become known generically in the last few years as investment companies. The trade body for both is the Association of Investment Companies, www.theaic.co.uk.

The first collective fund was the Foreign & Colonial Investment Trust, which was set up in 1868 to allow private clients with modest means to invest in bonds issued by companies such as the railway companies. Investment trusts **often specialise in a particular sector**, such as UK All Companies. However, the **closed-ended** structure means that investment trusts can invest in **highly illiquid sectors** without the necessity of having to allow for redemptions, as would be the case for an open-ended fund. This allows access to sectors such as Private Equity and Venture Capital Trusts (VCTs).

Investment trusts are legally structured as Public Limited Companies (PLCs) and their share prices are **listed** on the London Stock Exchange. Investors receive **shares** in the trust and are **entitled to vote** at general meetings of shareholders.

The trust is controlled by a **board of directors** which is responsible to the shareholders. It sets the investment objective and appoints an **investment manager** to manage the assets of the trust. The investment manager reports regularly to the board, which monitors performance. If the board feels that performance has been unsatisfactory it can replace the investment manager. Unlike the position with a unit trust, if the manager moves between investment houses, the board has the option to move the assets to follow the manager or to appoint a new manager. It is also possible for the directors to be replaced if the shareholders vote that they be removed, although this is rare.



DISCOUNTS & PREMIUMS

A significant feature of investment trusts is that the number of shares offered is set at launch, and can only be increased in limited circumstances. An investor wishing to buy shares in an investment trust must purchase these 'in the market', either via a stockbroker or through a share purchase scheme managed by the investment trust.

The **fixed number of shares** means that the share price in the market will reflect investor demand as well as the value of the underlying portfolio. This can lead to the situation where the share price trades at a **discount** to (less than) or a **premium** to (more than) the "net asset value" of the fund (the underlying asset value). Investment trust shares usually trade at a discount, although in times of high demand they can move to a premium. Discounts are affected by a wide range of factors and are hard to predict. Generally, however, a wider than average discount may reflect a lack of satisfaction with the investment manager or a pessimistic outlook for the investment sector the fund invests in.

A number of investment trusts have adopted **discount control mechanisms** which aim to maintain the discount fairly close to the net asset value. When the discount increases above a set level, such as 5%, the trust will buy its own shares in the market and hold these in Treasury, reissuing them when the discount has reduced. Shares bought in may also be cancelled, which reduces the number of shares available, but increases the value of each share in issue.

GEARING

An investment trust can **borrow** money (**gear**) to increase the size of its investment portfolio. The maximum level of gearing will be set by the board and is likely to be in the region of 15-25%. Most investment trusts gear up only to around 15% and some have a policy of not using gearing at all. Gearing will usually be used tactically, increasing when the manager considers that equities are relatively good value and reducing if they believe the market is fully valued or likely to fall. Gearing improves returns if the underlying investments increase in value sufficiently to more than cover the costs of the loan. However, gearing also increases the extent of any losses in a falling market and increases the risk profile of the investment.

For example, if an investment trust raised £100 million through shares, it may wish to raise a further £10 million by borrowing. This would result in the trust holding an investment portfolio of £110 million and having debts of £10 million. This process is known as gearing, and in this example the trust is 10% geared.

The example below shows how gearing could work.

Investment trust A has no gearing. A £100,000 portfolio is divided into 100,000 shares, meaning the value of each share is £1.

If £100,000 is invested in equities, which over a year increase in value by 25%, the portfolio will now be worth £125,000. Each share would now be worth £1.25, a 25% increase.

If £100,000 is invested in equities, which over a year decrease in value by 25%, the portfolio will now be worth £75,000. Each share would now be worth £0.75, a 25% decrease.

Investment trust B is 10% geared. A £110,000 portfolio less £10,000 debt is divided into 100,000 shares, meaning the value of each share is £1.

If £110,000 is invested in shares, which over a year increase in value by 25%, the portfolio will now be worth £137,500, less £10,000 debt, total net asset value of £127,500. Each share would now be worth £1.275, a 27.5% increase.

If £110,000 is invested in shares, which over a year decrease in value by 25%, the portfolio will now be worth £82,500, less £10,000 debt, total net asset value of £72,500. Each share would now be worth £0.725. An investor would therefore have seen a 27.5% decrease in the value of the investment.

Borrowings are usually obtained through issue of a debenture or bond, by borrowing from a bank, or issue of zero dividend preference shares, or by a combination of these methods.

INCOME

Unlike unit trusts, which must distribute all the income they receive, after allowing for costs, investment trusts can hold some income back from year to year. This enables them to build up reserves amounting to, in some cases, several years' worth of dividend payments. These reserves are used to top up dividends in years when the fund's income is relatively low, allowing for a progressive dividend policy. Many investment trusts have a record of annual increases in dividend rate over more than 10 years, with a number having increased their dividend every year for over 40 years.

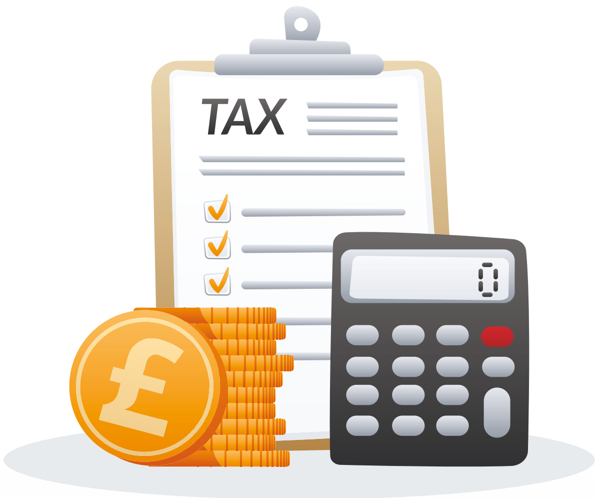
TAXATION

Income, in the form of interest, rent or from overseas, received by the investment trust is subject to corporation tax. No tax is effectively paid on the receipt of UK dividends. Annual management expenses are offset against income (other than UK dividends), and so can be tax-relieved, provided there is sufficient non-UK equity income. Internal capital gains are exempt from taxation.

The investor is liable to income tax on income from the trust and capital gains tax on gains made when shares are sold.

SPLIT CAPITAL INVESTMENT TRUSTS

Most investment trusts have a standard share structure where each share has equal entitlement to the dividends and proportion of the assets. However, in the 1970's, the taxation of investors, institutional and private, meant that some shareholders preferred income, while others preferred capital growth, but no income. The investment trust market responded by creating trusts with different classes of shares. These are Split Capital Investment Trusts, or 'splits', which differ from most conventional investment trusts by having a fixed life to maturity, when all investments will be sold, proceeds distributed between investors in accordance with their rights granted at outset, and the trust closed or rolled over into a new vehicle.



CHARGES

Initial costs incurred by investors will include:

- The market **bid/offer spread** on the shares, which is set by the market-makers and depends on supply and demand.
- In addition, there may be a separate **dealing charge** made by the stockbroker or share scheme with which the investment is placed.
- **Stamp duty** is payable on all share purchases, including those in investment trusts, which is currently 0.5%.

A number of the investment trust houses operate a share save scheme, which may have little or no cost other than the bid/offer spread and stamp duty. Online execution-only stockbrokers often charge in the region of £3-10 per deal, with several offering special rates for regular purchases of the same fund.

In addition to the initial charges incurred, the investment trust makes an **annual management charge** for running the fund. The charges vary, with some of the larger, long-established global trusts charging as little as 0.5% per annum, whilst some more specialist trusts in niche sectors may be relatively expensive. The fixed capital structure can make an investment trust relatively cheap to run, and enable the managers to levy low annual charges. However, the Ongoing Charges Figure (OCF) should also be compared, as this figure reflects the more 'hidden' charges and enables comparison with other funds in the same sector, or with a unit trust.