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Edison Explains

Investment trusts

What are investment trusts and what role do they play for funds?

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Investment trusts have existed in one form or another since the 19th century, when the F&C Investment Trust was launched in 1868. There are 23 investment trusts that have been around for over a hundred years, surviving both world wars and many market crashes.

Since their inception investment trusts have acted as collective investments, where money from a range of investors is pooled together and invested by a fund manager.

Pooling funds gives investors access to a more diversified portfolio of investments than they would be able to garner by themselves. For this service, funds charge investors an annual fee, normally between 0.5% and 1.5% of an individual's investment in the fund, as payment to the manager.

How do fund managers operate?

Fund managers may invest in shares, debt instruments (such as bonds), property, or a mix of the three. They can also invest in other 'real' assets, such as infrastructure projects, and unlisted companies (private equity).

A manager's investments must generate a level of capital growth or income for shareholders to receive a return on their investment in a fund. Capital growth is the increase in value of an investment, and shareholders may also be rewarded through share dividends and/or interest income.

Fund managers in both open- and closed-ended funds may look at the constituents of a market index to find investment opportunities, or they may follow a more unconstrained or index-agnostic approach. When measuring investment performance, they may also compare the returns of the fund to those of a market index.

Managers may try to beat an index through active management, or passively track an index such as the FTSE 100 or S&P 500 (index trackers). Funds may also aim to provide positive returns to the investor, regardless of whether markets are going up or down, as an absolute return.

Edison's insight

'Investment trusts may be less widely understood than their open-ended counterparts, but are as relevant today as when they were first launched more than 150 years ago. This is underlined by the fact that 2018 – in spite of the difficult stock market environment – saw the largest-ever trust launch, Smithson, which raised £823m.' Sarah Godfrey, Edison investment companies analyst

What is the difference between open- and closed-ended funds?

Investment trusts are also known as closed-ended funds. Despite having been around for some 63 years longer than their more numerous open-ended alternatives, they have attracted less investment.

Investment trusts have a fixed number of shares in issue, which is why they are defined as closed ended. In contrast, 'open-ended' funds grow and shrink according to investor demand, issuing new shares or units when money comes in from investors, and cancelling them when investors wish to withdraw their money.

Open-ended funds encompass both unit trusts and open-ended investment companies (OEICs). These two types of open-ended funds are broadly similar, with a few subtle differences, such as that unit trusts are governed by trust law and OEICs by company law.

Why have closed-ended funds received less investment than their open-ended cousins?

Until the beginning of 2013 most open-ended structures paid commission to financial advisers, whereas investment trusts did not, meaning advisers had a greater incentive to buy them on behalf of their clients. This preference for open-ended funds has continued post 2013, in spite of the banning of commission payments as part of the Retail Distribution Review.

According to the Association of Investment Companies (AIC), closed-ended funds had £183.9bn of investment in 401 vehicles at the end of January 2019. This compares to c. £1.5tn in more than 2,000 UK-domiciled open-ended funds, according to the Investment Association.

As well as being less heavily marketed by fund groups, closed-ended funds have specific characteristics that make them more complex than the 'what you see is what you get' nature of open-ended funds, which may also account for some of the disparity.

Why are open-ended funds considered less complicated?

An open-ended fund's price broadly matches the fund's net asset value (NAV), making it easy to understand; hence the term 'what you see is what you get'.

By comparison, closed-ended funds have a fixed number of shares, meaning that rather than growing or shrinking with demand like an open-ended fund, the share price will go up or down according to investor appetite.

As a result, a closed-ended fund's share price may not exactly match the value of its underlying assets (NAV), depending on investor demand.

If the share price is higher than the NAV, the trust is said to be trading 'at a premium', whereas if the share price is lower, it is trading 'at a discount'.

Closed-ended funds, in general, tend to trade at a small discount to NAV rather than a premium, meaning that investors can buy exposure to the underlying assets at less than their true worth.

However, buying shares at a discount is only beneficial to an investor if the difference between share price and NAV is smaller when they come to sell the shares than when they bought them (notwithstanding any changes in the value of the investment).

How are investment trusts structured?

An investment trust is structured as a company and listed on a stock exchange such as the London Stock Exchange. Investment companies are functionally the same as investment trusts, but are usually incorporated outside the UK in jurisdictions such as the Channel Islands. As listed companies, both types of closed-end fund therefore have a board of directors, which is a feature not shared by open-ended funds.

An investment trust's investment policy is set by the board, and they ensure it is adhered to. Boards appoint fund managers and have the power to seek a new manager if the fund underperforms.

A trust's board must also decide the gearing policy (gearing is the extent to which a trust can borrow money to invest). Boards may also implement a discount management policy to ensure the share price does not deviate too far from the value of the trust's underlying assets (NAV).

Board members are usually independent of the investment trust and may have specific expertise in areas such as accountancy, or experience in the region or asset class in which the trust invests.

What kinds of investment trusts are there?

The largest investment trust is Scottish Mortgage with £7.9bn of total assets, according to the AIC. However, F&C Investment Trust is the oldest and was launched in 1868.

Investment trusts cover a wide range of equity investment strategies, from global generalists such as The Brunner Investment Trust to single-country specialists such as Fidelity China Special Situations, and single-sector funds such as Worldwide Healthcare Trust.

Away from mainstream equities, there are multi-asset funds such as Aberdeen Diversified Income and Growth Trust, as well as those focusing on more specialist and alternative areas.

Much of the new launch activity in the years since the global financial crisis has tended to focus on income-generating alternative asset classes. These include collateralised loan obligations (CLOs), such as those held by Marble Point Loan Financing, which was launched in February 2018.

Specialist property funds such as PRS REIT, launched in May 2017, are also widely traded, as are renewable energy infrastructure-focused funds such as Gresham House and Gore Street, both of which launched energy storage funds in 2018.

However, alternative funds are nothing new. Tetragon Financial Group, which began as a CLO fund but has become more diversified, was launched before the crisis, in 2007, while many private equity funds, such as Princess Private Equity Holding, date back to the late 20th century.

Some trusts have very concentrated portfolios, such as Finsbury Growth & Income Trust, with only 22 holdings. However, some are highly diversified, such as Lowland Investment Company, with its 118 holdings.

The fact that both these trusts are in the UK equity income sector illustrates the range of approaches available among funds that may seem outwardly similar and underlines the importance of researching all options before making an investment decision.