Investment trusts

Investment trusts: a sector under siege

Once a highly successful vehicle for income investors, the sector has suffered as inflation took hold

Moira O'Neill NOVEMBER 10 2023

Peter Walls cannot remember a time "when passions were running this high" in the world of investment trusts.

"A sector that has been around for more than 150 years and has served generations of investors well appears to be under siege," says the manager of the Unicorn Mastertrust Fund, which invests primarily in a range of listed investment companies.

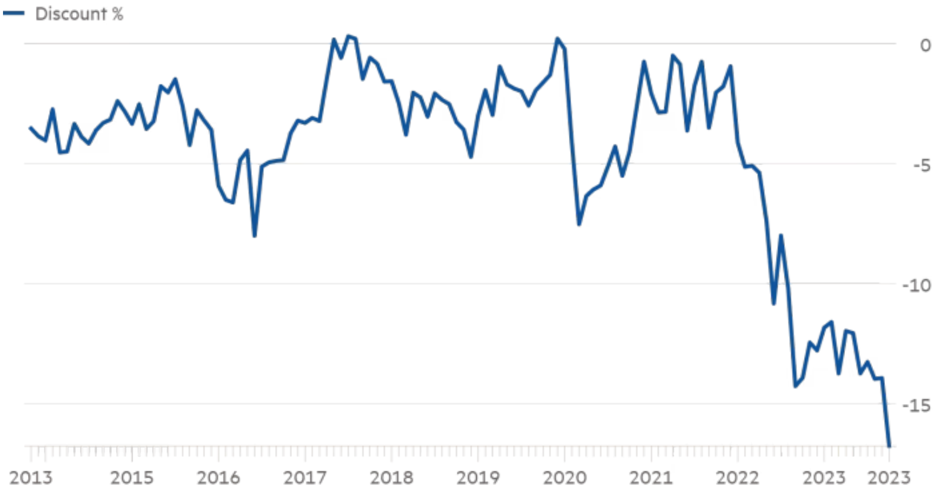
As inflation continues to erode the value of people's savings, many investors are looking to investment trusts to provide a measure of protection from economic problems. Investment trusts can offer a flow of income via dividends, or focus on growth companies that fuel investment returns if managers succeed in picking winners.

However, trusts have also suffered from high inflation, as investors have taken advantage of raised interest rates and poured money into government bonds. This means discounts to net asset value — a measure of investment trusts' health — have widened dramatically. That has put their boards under pressure.

Some market analysts believe this represents a chance to buy at the nadir of market sentiment and watch returns accumulate as the market recovers over the long term. Others worry that extreme discounts suggest deeper problems at some trusts: for these, a recovery may never materialise. As Britain's retail investors cast the net wide for reliable growth and income, should investment trusts form part of the answer? FT Money examines the outlook for the sector.

A sharp decline

Investment trust average discounts



Sources: Morningstar, AIC
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From heroes to zeroes

It wasn't like this just a few years ago. Nick Wood, head of investment fund research at Quilter Cheviot, harks back to the "good days" of 2020. "The investment trust base was on an absolute tear . . . infrastructure and renewables were on huge premiums and investment trusts were great for income investors."

But that was before inflation took off and the Bank of England introduced a succession of interest rate rises. Since investors can now get a 5 per cent "risk free" return on their cash in the bank, many feel no urgency to take on equity risk.

So the investment trust universe has seen a significant sell-off over the past 18 months, with the average discount — the gap between trusts' share prices and the net value of their assets — widening from around 2.2 per cent at the start of 2022 to 16.9 per cent by the end of October 2023, according to the Association of Investment Companies (AIC), the trust lobby group. This is the widest discount for a month-end since the last day of December 2008, when the world was in the depths of the global financial crisis and the average investment trust discount was 17.7 per cent.

How investment trusts work

Investment trusts, also called investment companies, have been around for a century and a half. Like unit trusts or open-ended investment companies, they are a type of pooled investment, managed by a professional investment manager. The difference is that investment trusts are listed on the stock exchange and have some unique features that can boost long-term performance.

An investment trust has an independent board of directors to monitor performance and look after shareholders' interests. The board chooses a professional portfolio manager and can select another if performance is poor.

Investment trusts issue a fixed number of shares at launch and are known as closed-ended funds. New share issuance is strictly controlled by the board and approved by shareholders. This allows trusts to take a long-term view and to invest in illiquid assets, which trade less easily and frequently.

In contrast, open-ended funds issue new units or shares in response to demand from investors. When investors leave, the fund may need to sell some of its investments.

Trusts' shares can trade at a premium or discount to the value of their underlying investments, reflecting the level of demand for the trust. If the share price is higher than the net asset value (Nav) per share, the investment trust is trading at a premium. If below, the trust is trading at a discount.

The AIC cites a number of problems — including high inflation, interest rates and unhelpful regulation. But Thomas McMahon, investment trust research manager at research firm Kepler Trust Intelligence, thinks most of the historic discount opportunity can be put down to interest rates.

A trust with a headline yield income of 5 per cent that can be bought on a discount gives the investor an income of more than 5 per cent. "Discounts have widened to give 7 per cent income — which alongside the capital growth potential gets people interested. People are concerned about this recession and the economy but eventually they'll realise cash loses to inflation," says McMahon.

When discounts are wide, one school of investing thought holds that this is an attractive time to invest. When the appetite for more risky asset classes recovers, investors could enjoy enhanced returns from a double bonus of positive movements in the net asset value of the trust and reduced discounts.

With virtually all investment trust sectors at historically wide discounts, Peter Hewitt, manager of the CT Global Managed Portfolio Trust, an investment trust that invests in a range of investment companies, calls it "a once in a generation opportunity".

The last time discounts were this wide — at the end of 2008 — the average investment company returned 39 per cent over the next year and 119 per cent over the next five years, according to AIC data.

Mick Gilligan, head of managed portfolio services at wealth manager Killik & Co, says that of the 147 larger (£250mn market cap) investment trusts that he monitors, 70 per cent trade on discounts of 10 per cent or more. "This is a very large number of attractively valued trusts that investors can choose from. Lots of equity markets — UK, Asia, emerging — look cheap. The long-term returns from investment in these areas look bright."

Investment trusts can borrow money to buy shares or other assets. This gearing can increase returns in a rising stock market — or magnify losses when the value of the underlying investments fall. Investment trusts can also retain up to 15 per cent of any income earned and distribute cash to investors in leaner years.

Most-sold investment trusts, October 2023

Position	Company Name
1	Scottish Mortgage Investment Trust
2	Alliance Trust
3	City of London Investment Trust
4	F&C Investment Trust
5	Polar Capital Technology Trust
6	Smithson Investment Trust
7	Allianz Technology
8	Gore Street Energy
9	Finsbury Growth & Income Trust
10	3i Group

Source: Interactive Investor

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The discount flipside

But a big discount can just as easily be read as a warning to investors, not an opportunity. Investors must tread carefully when a trust is on an "extreme discount" of around 50 per cent, says Wood of Quilter. "It's telling you the market doesn't believe the valuation or the market is concerned about the ability of the trust to continue," he says.

Some sectors look riskier than others. Wood says the digital infrastructure sector includes some trusts on extreme discounts. Hewitt is avoiding commercial property trusts given the impact of hybrid working, and debt and credit trusts — "you don't know where problems will pop up". And Gilligan warns: "The portfolios of some of the global trusts look very richly valued," pointing to examples such as STS Global Growth & Income and Lindsell Train.

To avoid pitfalls, investors can consider trusts which have sold some of their assets at a premium, or are actively buying back stock. Such actions suggest the existing portfolio, which is available to buy on a discount, is more attractive than any alternative investments that the managers might select.

Another thing to watch out for is the level of debt or gearing in an investment trust. The ability to borrow to buy shares or other assets sets trusts apart from other funds. But investors need to be aware of how much the managers have been paying for that borrowing as interest rates have risen. Some trusts locked in long-term low-cost borrowing deals before interest rates rose, so are in a good place. But Pittard says: "If significantly geared, and the market perceives the amount or cost is too high, the investment company typically trades at a discount to its peers."

There are other trends contributing to the picture of a "sector under siege". One is the scarcity of investment trust launches, with just two new issues this year after a complete drought in 2022. Amid share price declines, some launches have struggled to meet a minimum size. Christian Pittard, head of closed end funds at Abrdn, says: "I believe the new issue market will recover, but it requires innovative strategies that investors cannot easily access in other wrappers like exchange traded funds and open-ended funds."

Popular investment trust buys and sells, October 2023

Position	Trust name	Buys	Sells
1	Alliance Trust	97%	3%
2	Scottish Mortgage Investment Trust	79%	21%
3	BlackRock World Mining	95%	5%
4	JPMorgan Global Growth & Income	96%	4%
5	Personal Assets Trust	95%	5%
6	RIT Capital Partners	95%	5%
7	Law Debenture Corporation	96%	4%
8	City of London Investment Trust	88%	12%
9	The Renewables Infrastructure Group	94%	6%
10	Henderson Small Companies	96%	4%

Source: Interactive Investor

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Trusts in flux

A bigger trend is increasing consolidation in the sector. Plans announced this year include the merger of Abrdn New Dawn with Asia Dragon; Henderson Diversified Income with Henderson High Income Trust; and a double merger of Nippon Active Value with Abrdn Japan and Atlantis Japan Growth. The AIC says investors want bigger, more liquid — but cost-effective — companies. Wood says: "For some of the smaller trusts, being acquired and improving management is good for shareholders."

The AIC points out the increasing presence of activist investors on investment company share registers, which it says shows that "some, at least, recognise the value in the sector". Walls points to Saba Capital, which has built stakes in several companies as a predator to watch.

For investors without new funds to invest in, one option can be the "sister" investment trusts to some open-ended funds — conventional unit trusts or mutual funds — that follow the same investment goals and are managed by the same fund manager.

Wood says: "If you own an open-ended fund, it's a good time to be switching to the equivalent investment trust." He gives the example of the Fidelity European Fund and Fidelity European Trust. Both have the same managers and the investment trust is trading on an 8 per cent discount. Alternatively, for investors holding funds without a "sister" trust, one option might be to consider an investment trust with a different manager but similar remit.

For an investor, it will always be impossible to call the bottom on prices. But those with available cash can lower their risk by spreading money between a few discounted trusts. McMahon says: "If you could force yourself to invest in five to 10 diversified investment trusts and forget your password for five years, it's likely you would do well. Looking back, it will have been a good time to have bought in."

Investment trust insights

Someone starting to invest in investment trusts might look first to the AIC's Flexible Investment or Global sectors for highly diversified holdings that give exposure to different assets and stock markets around the world.

Dzmitry Lipski, head of funds research at Interactive Investor, says: "Given current market volatility investors should consider multi-asset fund strategies with a focus on capital preservation." Here he likes Capital Gearing Trust (on a 4 per cent discount). "The trust has a big emphasis on US Treasury inflation-protected securities or bonds (Tips). Such bonds offer protection when stock markets fall, as well as providing a shield against inflation," he says.

Meanwhile, several experts highlight UK equity trusts as a good area for bargain hunters. Peter Hewitt, manager of the CT Global Managed Portfolio Trust, believes if investors buy Aberforth Smaller Companies, Henderson Smaller Companies, Law Debenture Corporation or Fidelity Special Values, "all well-regarded trusts with big discounts and good dividend yields", they will make money on a two- to three-year view. He says: "Underlying this theme is an equity market that is hugely out of favour. No market is cheaper. Sentiment is horrendous but it won't always be. All you need is for it to improve to be average."

Analysts at Kepler Trust Intelligence point out with the rise of passives, stock market returns have been increasingly concentrated in the US technology giants. But investors who want to diversify their portfolios have plenty of options among trusts. They suggest BlackRock World Mining (on a 4 per cent discount) provides an "interesting and very different source of returns" when compared with the tech sector.

Elliott Hardy, a research analyst at Winterflood, highlights opportunities in infrastructure. BBGI Global Infrastructure (on a 10 per cent discount) is his recommendation for core infrastructure exposure with its "all-weather" portfolio. Its cumulative dividend growth has outpaced CPI inflation since it listed in 2011.

Mick Gilligan of Killik & Co thinks social infrastructure trusts HICL Infrastructure (at a 21 per cent discount) and International Public Partnerships (with a 19 per cent discount) also look particularly attractive. "These trusts generate cash flows that are linked to inflation," he says:

Hewitt has been a recent buyer of trusts that invest in private equity. He says: "It's a great way for individuals to get hold of an area they can't get exposure to." Nick Wood, head of investment fund research at Quilter Cheviot, also likes this sector, recommending Pantheon International and HarbourVest Global Private Equity, which are "very highly diversified and on 40 per cent discounts" and HgCapital, "a good performer on a double-digit discount".

Meanwhile, Hewitt is staying with what he calls the "secular growth trusts" that give investors exposure to technology, biotech and healthcare. For exposure to the mega techs in the US and the artificial intelligence story, he likes Alliance Technology and Polar Capital Technology (both on 13 per cent discounts).

Scottish Mortgage Trust is another way to get exposure to secular growth themes. In October, for the first time since June 2019, it fell from the top slot as the best selling trust on Interactive Investor's platform and was one of the top "sells" for the month. Its exposure to unquoted investments has been blamed for its persistent discount to Nav — now at 15 per cent. But Hewitt says: "It has some fantastic, interesting holdings and it's not going down any more."

Moira O'Neill owns shares in Capital Gearing, F&C Investment Trust, Henderson Smaller Companies and Scottish Mortgage