Jargon buster: What is an investment trust?

We explain what an investment trust is and how it works...

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Our new series aims to bust some of the jargon in the investment company industry, so investors can become a bit more well-versed in the lingo used. We'll start with the basics: investment trusts have been around for 156 years, but what exactly are they?

Investment trusts can, rather confusingly, have a multitude of different names. They can also be called investment companies, or closed-end funds.

Investment trusts are a kind of investment fund – what's known as a collective investment. They allow a wide range of investors (including retail investors, pensions funds and wealth managers) to pool their money together to invest in a ready-made portfolio of assets.

Investment trusts are listed on the London Stock Exchange in their own right, meaning that when they are launched they go through an initial public offering process to raise their initial capital. Investors can then buy and sell in the same way they would Microsoft or Shell, for instance.

The investment company must appoint an independent board of directors, which in turn hires an investment management company to run the portfolio on a day-to-day basis. The portfolio manager decides which assets to buy for the investment company and the board holds the manager to account for their decisions.

The portfolio manager reports to the board, whose job it is to act in the best interests of shareholders. The board, ultimately, can terminate the investment management company's contract and replace them with a new manager if performance is poor or an unexpected circumstance crops up, like the portfolio manager retiring.

Investment trusts hold annual general meetings, which allow shareholders to listen to and ask questions of both the board and portfolio manager, and to vote on proposals such as the election of board members, any change in investment strategy or whether the trust should continue trading.

In theory, an investment trust can invest in almost any asset that it wants. Trusts lend themselves particularly well to assets that cannot be easily and quickly sold, such as commercial properties, large, public infrastructure and privately owned companies.

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This is because, unlike a traditional open-ended fund, they do not have money flowing in and out every day. Instead of having to create new units every time someone wants to invest and redeeming existing units every time someone wants to sell, trusts have a fixed number of shares in issue that only changes if the trust issued new shares or buys back its own.

The drawback of this structure means that investment companies' share prices are often either higher or lower than their net asset value, meaning the trust can be seen as either expensive or cheap.

That's all on investment trusts for now. We will cover discounts and premiums in a later jargon buster.

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