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New rules on costs could provide a boost to the sector next year, what else do we want to see?

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Nobody wants to remember the pandemic, just like nobody wants to think about Brexit, but sadly, Santa doesn't give everyone a toy[1], and life is hard. Ten years after the vote to leave the European Union, the FCA has come up with a different approach to the presentation of costs for investment trusts, finally using this 'Brexit freedom'. We have absolutely no intention of opening up that old wound by digging into who actually wrote the old legislation in the first place. However, we do think it is positive that the county's regulators, encouraged, it must be admitted, by an otherwise very unpopular government, are turning their attention to the future, to improvement, and to driving growth, rather than wallowing in defeatism, self-pity, and self-loathing, which is rapidly becoming the modern 'English vice'. In our view, these new rules are very sensible and balance a number of key considerations well. We hope it will have an impact on the sector next year by seeing larger investors taking more of an interest. We also think there are other things the authorities could do to boost the investment trust sector.

The technical bit

Professional readers will be familiar with the ins and outs of cost disclosures, but it might not be as clear to retail investors what is going on and why it matters for them, which it does. Briefly, investment trusts have previously been forced to calculate all-encompassing cost figures called the Reduction-In-Yield (RIY) and publish them on Key Investor Information Documents (KIDs). As far as retail investors are concerned, these KIDs are rather like the terms and conditions we all read thoroughly before downloading a new crypto trading app on our phones, or the risk warnings in the instructions for a drill we memorise before drilling a hole through the mains electricity. They exist (and we have reported them in all our fund research), but they are largely ignored in favour of the OCF, which is published on a factsheet and tells investors what they really want to know, which is how this closed-ended fund compares to the broader range of open-ended funds they might otherwise use.

Sadly, professional investors can't be so cavalier, and have been obliged to report these costs in the look-through calculations of any fund or portfolio they run on behalf of clients, making those which include closed-ended funds often look much more expensive. Of course, it would be possible for such a professional to simply report the higher figure and explain why it is wrong, and that might work for a retail investor knowledgeable enough to be reading KTI and managing their own money. However, a guy in a smart suit telling you the cost figure he is obliged to report is too high may well not come across well to a sceptical client with no real knowledge of the financial services sector, and many professionals would really rather not put themselves in that scenario. These regulations have contributed to declining participation in the investment trust sector by large, institutional investors, which has contributed to the reduction in the number of trusts over the past few years and discounts remaining wider than they might be.

We think the most important change to the regulation is the stipulation that it will no longer be necessary for funds of funds to include the OCFs of investment trusts when reporting the look-through costs of their funds. This removes one of the big obstacles to investment at size by large fund managers of open-ended funds. We think closed-ended funds (investment trusts for short) are no-brainers for investors with a long time horizon based on the advantages the managers have to produce superior NAV returns — namely, their ability to stay invested in a fixed pool of assets rather than raising cash to meet outflows, and taking more illiquidity risk thanks to the same feature. Additionally, the current state of the market means shares can be acquired at highly attractive discounts across a wide variety of sectors. As such, we think it's possible we could see institutional buying next year, which could be positive for share prices.

The optimistic bit

In our view, this is most likely to help those trusts on the widest discounts. One area we expect to benefit is private equity. Discounts here have been stubbornly wide, for reasons we have discussed at length in **previous notes**. Private equity trusts have historically had to report high KID RIYs, with the cost of their gearing facilities one reason. Reporting high costs will now no longer be a factor holding back institutional investors. **NB Private Equity (NBPE)**, for example, currently trades on a discount of almost 27%. Its underlying portfolio is largely invested in three sectors: Tech, Media & Telecom (22%), Consumer/e-commerce (21%), and Industrials/Industrial technology (18%), all of which are growth sectors in vogue in the public markets. **CT Private Equity (CTPE)**, meanwhile, trades on a c. 26% discount. As we discussed in **our note published last week**, the trust offers exposure to another historically high-growth area, small caps, with a portfolio of niche businesses, unlikely to be found in any public equity small-cap fund. These high-growth options now effectively offer two sources of value to the institutional buyer: the discount of the shares and the reduction to the reported OCF.

Another obvious area which could benefit is the real assets sector, which also trade on wide discounts on average. It's reasonable to think that retail investors might be intimidated by wide discounts in these sectors, given the extra complexity in understanding the assets and the NAV. On the other hand, institutional investors should be able to do the research to understand the assets and their likely value. Crucially, they are also in a position to agitate for corporate activity, whether that be buybacks, asset divestments, or wind-ups. This approach to value realisation is gathering steam across the real assets sectors, last week's sale of PRS REIT's (PRSR) portfolio being the latest example. More investors looking for this sort of action could help investors like **MIGO Opportunities (MIGO)**, which has revamped its approach to concentrate on trusts in these sectors and engage with boards to unlock the value. Greater institutional presence in the sector could see more momentum behind these trades.

These are the obvious beneficiaries, but we think it could also help some large and liquid equity trusts like **Scottish Mortgage (SMT)**. SMT is large enough for institutional investors to be able to take meaningful positions. Its size means it is relatively cheap on an OCF basis, but the latest KID RIY it published was c. 50bps higher than its current OCF. It can now be bought at a discount and contributes nothing to the look-through costs of a fund of funds. Its holding in SpaceX should make it particularly desirable at the moment, with that company reported by Bloomberg to be mulling an IPO next year at a $1.5tn valuation, which would make it the sixth largest company in the world and far and away the global leader in an industry with massive growth potential. (Indeed, we wonder if getting a piece of SpaceX pre-IPO is the real reason Saba is so persistent in attacking its stablemates Baillie Gifford US Growth (USA) and Edinburgh Worldwide (EWI).)

The pessimistic bit

These changes to cost disclosure rules should be good for the sector. They introduce some welcome clarity for retail investors. Previously, investors coming across the RIY will have had quite some work to do to understand how it is calculated and how it differs from the OCF, why there are two figures and ultimately which one they should pay attention to! A lot of ambiguity has been removed. Most importantly, the new regulations open the sector back up to institutional investors who can invest at size and move discounts meaningfully.

However, if we metaphorically turn to sub-paragraph 1c of appendix 10a in sub-clause 23x, version 3, we can see that there remains work to be done. Wealth managers, one of the most important buyers of investment trusts, are subject to different rules under MiFID, which means they will likely still have to aggregate the charges of closed-ended funds in their client portfolios. The FCA has said it will review these rules, but for the time being, they appear to stand. This means that this important source of demand for investment trusts is likely to remain under pressure.

It's also important to remember that there are other barriers to institutional and wealth manager investors investing in the sector. The consolidation of wealth management into larger firms operating larger model portfolios means many WMs are restricted to investing in larger and larger funds, leaving more of the investment trust sector sub-size. There was also a lot of investment made in alternatives when interest rates were near zero, which left investors nursing losses and may lead to reticence to get involved. And finally, persistent inflation and weak economic growth are likely to slowly sap the retail investors' ability and willingness to invest, and with fixed mortgages slowly rolling over. So, while we think these cost disclosures will have a positive impact on the sector, it won't be transformative on its own.

The two-bit

Which leads us to the Christmassy bit of this essay about calculating the expenses of listed companies in order to generate a six-letter acronym for the paperwork. If cost disclosure isn't enough, what could move the needle next year? Here are some more radical solutions.

- MPs to be forced to invest 100% of their pensions into the trusts trading on the widest discounts in the sector. This should give fresh impetus to net zero and might even persuade Richard Tice of its merits.
- Junior ISA contributions doubled by HMRC if they are invested in 3x leveraged ETFs tracking any trust geared over 20%. This should give the next generation a taste for investment trusts and decrease the average age of shareholders, much desired by boards.
- Directors to be chosen by lot, taking inspiration from how Athens chose magistrates. This would make annual general meetings much more entertaining.
- The managers of the 11 best-performing trusts in 2026 will face Australia for the Ashes next time round. We can only imagine the level of skulduggery these natural winners would employ on the pitch, and we assume a number of their friends have MCC memberships and would be strategically placed in the Long Room to take the Aussies out mid-innings and give us a chance (the sales teams would probably do it). This would get some decent press coverage without dipping into marketing budgets.

Conclusions

Most of our analysis focusses on fundamentals, meaning the quality of the assets held by an investment trust and the outlook for those assets. However, technical factors are very important to consider when looking at discounts. What might seem like a relatively small change to some obscure legislation could therefore be very significant if it leads to some extra buying pressure. We think the investment trust sector could be particularly sensitive to any inflows right now, given how poor the technical picture has been for some time, with reduced demand from wealth managers and institutions, and given how attractive the shares in some sectors look on such wide discounts. These just happen to be those sectors which most might suit institutional investors. Given the discount situation, we think it is hard to see why you would choose an open-ended fund over a closed-ended fund right now, if they are placed on a level playing field, which the new regulations do. There are still other issues to deal with, which means we expect a stream of buying rather than a flood, but there are reasons to be optimistic for 2026, even if there aren't for the 2027 Australian tour of England.

[1] Editor's note – this has been censored and rewritten under the online safety act given the proximity to Christmas

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