Cream of the crop

We identify those trusts that use the distinctive features of investment trusts to the full...

Update
29 October 2024

As analysts, we get a certain thrill from diving deep into the world of investments, poring over data points, and crafting complex insights. Our goal is always to provide our readers with thoughtful perspectives, whether it's on the latest market trends or unique strategies. But this time we thought it would be helpful to take a step back and consider the key question of why to invest in trusts at all.

With absolutely no bias (as investment trust analysts!), we believe closed-ended vehicles are excellent options for long-term investments. Their unique features, often absent in open-ended funds, offer meaningful diversification and the potential for strong returns over time.

In this article, we'll explore five key distinguishing features of investment trusts – gearing, discounts, income consistency, exposure to hard-to-reach opportunities and the role of boards – highlighting trusts along the way that we believe leverage these features in distinctive ways. Whether you're new to investment trusts or a seasoned investor looking to refresh your perspective, we hope these examples will showcase how trusts can offer more than meets the eye.

And if you're eager to dig deeper or find a trust tailored to your needs – whether it's for income, capital growth or options investing across the market-cap spectrum – our **Fund Finder** tool can help streamline your search.

A borrowing balancing act

Gearing can be a potent tool in an investment trust's arsenal, allowing managers to borrow capital to potentially enhance returns and income during favourable market conditions. It is generally not something that open-ended funds can employ. However, whilst it can magnify gains on the upside, it also amplifies losses on the downside, making its careful management a key focus for investment trust boards. In collaboration with portfolio managers, each board sets a gearing limit, and strategies for using leverage, borrowing or gearing can vary widely across the sector.

One interesting approach to gearing is that used by **BlackRock World Mining (BRWM)**. Managers Evy Hambro and Olivia Markham prefer to employ gearing modestly, typically maintaining it around 10% in normal market conditions, with the average being 12.4% over the last five years. Gearing is employed through an overdraft and a loan facility, allowing the managers flexibility to capitalise on opportunities, should they arise. The standout feature of the managers' strategy, though, is their use of gearing to invest in bonds, debentures and royalties, providing shareholders with a higher, more diversified yield. Notably, they are actively looking for opportunities to grow royalty exposure – current exposure includes gold royalties Franco-Nevada and Sandstorm Gold – which help lock in long-term income streams, as well as diversifying the trust's revenues and providing more resilience during volatile markets.

Shires Income (SHRS), by contrast, employs its gearing differently. Part of its borrowed capital is used to fund an allocation to preference shares, a type of perpetual fixed-income instrument that pays dividends indefinitely, provided the issuer remains solvent. These preference shares account for around 20% of the portfolio and offer an average yield of 7.5%. By using gearing to fund this allocation, the beta of SHRS's portfolio is

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reduced, whilst retaining the ability to maintain a high level of income. Consequently, this allocation affords the managers greater flexibility to invest equity stocks with varying yields, including areas of the market less common in more traditional equity income-focussed strategies like small- and mid-caps. These stocks may exhibit lower yields but often offer higher dividend growth potential, and the managers currently see compelling value in this area for both income and capital growth.

Not all trusts use traditional gearing facilities, though. **Fidelity Emerging Markets Limited (FEML)** takes a different path. Rather than using traditional borrowing facilities, the managers employ effective gearing through derivatives, taking out both short and long positions to express their views on a company or market. This approach enables them to gain additional market exposure or profit from falling asset prices, giving them a unique edge in the AIC Emerging Markets sector. In an environment of higher rates, where debt costs can weigh heavily on weaker companies, FEML's ability to short these vulnerable companies can generate differentiated sources of alpha, making it less reliant on market direction for returns.

Trust discounts, marked down but not out

For regular readers of Kepler research, it's probably no surprise – given how often we've highlighted the issue – that the broader investment trust sector has been trading at persistent discounts for several years now. Whilst discounts can signal market scepticism, they can also present compelling opportunities. If an investment trust is trading at a 15% discount, it's like buying £100 worth of assets for £85: a bargain, right? Of course, discounts can widen, but wide discounts present potentially attractive entry points for investors and can boost returns meaningfully if discounts narrow over time. And ultimately, discounts always narrow one way or another, even if it takes corporate action, in the worst cases, to bring the share price closer to NAV.

One interesting opportunity at the moment is in technology. Semiconductor stocks (and semiconductor-related stocks), fuelled by surging demand from artificial intelligence, have performed exceptionally well over the last couple of years, driving strong returns, which has made the sector look expensive. But an investment trust like **Allianz Technology Trust (ATT)** offers a potential solution. ATT's portfolio includes top industry names like NVIDIA, as well as differentiated large- and mid-cap stocks that often harbour greater growth potential. Currently trading at discount of 13.0%, wider than its average over five years of 7.1% and the sector's average of 8.0%, investors can gain exposure to this high-performing sector (supported by a number of structural drivers) without the hefty price tag of directly buying shares like NVIDIA or Monolithic Power Systems (both existing trust holdings), which trade at a historic price-to-earnings ratio of around 66x and 105x, respectively.

Investment trust boards have also become increasingly proactive in recent years, not just by buying back shares to manage discount volatility but also implementing a range of strategic measures to narrow discounts more meaningfully. A prime example is **Schroder Japan (SJG)**, which invests primarily in listed Japanese equites. Over the last five years (to 21/10/2024), SJG has delivered strong NAV total returns of 47.3%, outperforming the TOPIX returns of 33.9%. Despite this outperformance, the trust's discount remains wider than its five-year average, prompting the board to take decisive action.

The board has bought back shares on occasion, but it's gone beyond that more recently. After averaging 12.7% dividend growth over the past decade, the board unveiled an enhanced dividend policy aimed at paying out 4% of the average NAV each financial year. This positions the trust as an appealing option for income seekers looking to diversify their portfolio and tap into the exciting reform story in Japan. Additionally, despite demonstrating relative outperformance over the last five years, the board also announced a new performance-conditional tender offer. The deal is that if the trust fails to deliver performance at least in line with the benchmark over a five-year period from 31/07/2024, it will put to shareholders a proposal for a tender offer of 25% allowing them to exit a portion of their investment at NAV, less costs. We think this shows conviction in the manager Masaki Taketsume, as well as providing further incentive to continue delivering alpha through his high-conviction, bottom-up stock selection approach.

Another example of proactive board action is **Templeton Emerging Markets (TEM)**. TEM's current discount of 15.6% exceeds its five-year average of 12.0% and the board believes this does not adequately reflect the trust's strong performance over the years. In response, it has announced four key initiatives aimed at improving the rating of its shares by significantly increasing the scale of future distributions to shareholders through a buyback programme, a commitment to maintaining a 5p-per-share dividend (totalling a minimum distribution of £278m over the next five years), a new conditional tender offer and reduced management fees. We think this reflects the board's conviction and could make the current discount attractive, particularly if TEM continues to perform well and outlook for emerging markets improves.

Discount

	CURRENT	12-MONTH AVERAGE	FIVE-YEAR AVERAGE
ATT	-13.0	-10.7	-7.1
Morningstar Investment Trust Technology	-11.9	-10.7	-8.0
SJG	-14.8	-10.7	-12.0
Morningstar Investment Trust Japan	-12.6	-9.9	-7.2
TEM	-15.6	-13.7	-12.0
Morningstar Investment Trust Global Emerging Markets	-13.2	-10.9	-10.1

Source: Morningstar, as of 21/10/2024

We've also seen the board of **Asia Dragon Trust (DGN)** take decisive action this week. DGN announced a full strategic review of its future prospects earlier in the year, which has concluded with a plan to combine with **Invesco Asia Trust (IAT).** Once completed, this combination will create the Invesco Asia Dragon Trust, with an anticipated NAV of over £800m. This increase in scale may lead to its inclusion in the FTSE 250, a move that could attract greater attention from tracker funds and institutional investors, and could potentially lead to a narrower discount range. Under the terms of the combination, DGN investors will also have the option to withdraw up to 25% of their capital in cash at a 2% discount, offering a partial, immediate solution to the discount.

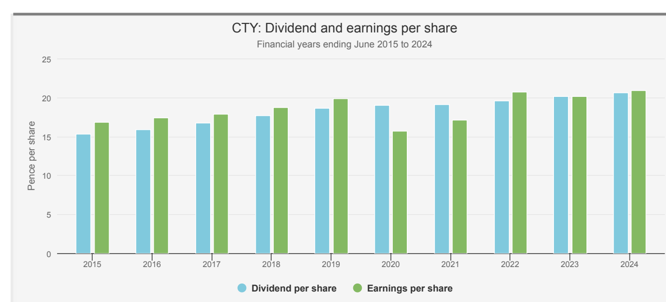
As it stands, we think the proposed combination reflects proactive board action, signalling the potential for a more competitive, accessible trust with a diverse investor base and an attractive outlook for future growth, supported by a well-resourced team with a strong performance track record. Additionally, it's likely to result in lower charges as Invesco has committed to reducing its management fee to enable the trust to target ongoing charges of less than 0.7% a year in future – potentially making it the cheapest trust in its sector.

Dividend machines

The most consistent income payer in the sector is **City of London (CTY)**, which holds the impressive distinction of delivering increased dividends for the longest consecutive period of any trust in the wider sector. Its 58-year track record of annual dividend increases underscores one of the key advantages of investment trusts – the ability to use income reserves to ensure smoother dividend payouts, even during tough market periods.

In our view, CTY's record is remarkable, even though underlying earnings haven't risen every year. CTY has had made effective use of the investment trust structure, which allows it to retain up to 15% of each year's income in reserve. This reserve can then be drawn upon in leaner years to smooth dividends if revenues subsequently fall. For instance, when companies worldwide were forced to cut or suspend dividends during the pandemic, CTY was able to maintain its record of consecutive increases, despite a significant fall in revenue, as shown below.

Fig.1: DPS & EPS



Source: Morningstar

Aside from consecutive dividend increases, we think **CT Private Equity (CTPE)** stands out as a differentiated player in the income/dividend space. The private equity sector is experiencing wide discounts, prompting some boards to announce formulaic capital allocation policies that seek to allocate a proportion of future realisation proceeds towards capital returns through buybacks. However, the board of CTPE generally sees the dividend as a more equitable way of returning capital to shareholders, and whilst it has bought back shares on occasion, the preference is to return capital through a strict, formulaic approach to paying dividends. Consequently, this focus, alongside the managers' investment process, has resulted in a historic dividend yield of 6.5%, attractive versus peers in the sector but also the wider trust sector.

Moreover, by favouring dividends as the primary means of returning capital we think CTPE provides a more predictable and transparent flow of income, particularly valuable for income-focussed investors who prioritise regular payouts over potentially unpredictable gains from buybacks. Furthermore, whilst buybacks can help manage discounts in the short term, they do not necessarily build long-term value in the same way that consistent dividend payments can. A risk worth bearing in mind is the illiquidity of the underlying assets, which, depending on the timing of the company's other cash flows, may see CTPE use debt to fund the dividend, in turn increasing the gearing.

We think **JPMorgan UK Small Cap Growth & Income (JUGI)** is another compelling option, as its board introduced a new enhanced dividend policy in early 2024 (recent update **here**). JUGI's portfolio comprises UK equities at the lower

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end of the market-cap spectrum, typically the types of businesses that reinvest to fund future growth, rather than paying out an income. However, we believe that JUGI's new approach has widened the appeal of the trust, as it allows investors to generate an attractive income return from an asset class not typically associated with it, which can help diversify income streams amongst a broader portfolio.

Dividend Profile

	YIELD (%)	FIVE-YEAR DIVIDEND GROWTH P.A. (%)	DIVIDEND COVER (×)
City of London	4.7	2.1	0.5
AIC sector average	4.1	3.1	N/A
CT Private Equity Trust	6.5	14.3	1.6
AIC sector average	2.1	10.8	N/A
JPMorgan UK Small Cap Growth & Income	3.0	12.8	0.2
AIC sector average	3.0	4.6	N/A

Source: AIC, as of 21/10/2024

Off the beaten path, investing where some investors simply can't

One of the key advantages of investment trusts is their ability to grant access to opportunities that would otherwise be difficult or even impossible for individual investors to reach on their own. These often include private companies, specialised sectors and real assets like property and infrastructure – areas that generally provide diversification and sources of returns distinct from traditional equity markets.

Take **BH Macro (BHMG)** as an example. Brevan Howard, one of the top hedge fund managers of all time, based on cumulative lifetime gains, is renowned for its successful strategy of delivering strong, asymmetric returns, with strong returns when broader market conditions are poor. A key feature of the trust's strategy is that the bulk of capital to invest is allocated to around 10–15 senior traders, each an expert in their respective field, employing vastly different approaches to the market. This creates a well-diversified portfolio exposed to global fixed-income and FX markets, alongside peripheral exposures to equity, credit, commodities and digital assets, with NAV returns historically uncorrelated to equities and bonds.

This broad exposure and skilful management make it a highly differentiated investment opportunity – one that's impossible for individual investors to replicate on their own – and makes BHMG a compelling option for those seeking exposure to hedge fund-style strategies and market segments typically beyond the reach of standard retail portfolios.

Another notable example is CTPE, making its second appearance. Its differentiated strategy steers it away from solely investing in the 'mega-deals' that typically make the headlines. Instead, it employs a hybrid approach to investing, with long-term commitments made to lower mid-market managers – akin to the UK's small-cap universe – and over 40% of the portfolio represented by co-investments. Whilst the managers prefer this space because there is less competition for deals, they also note that they retain the ability to identify opportunities with significant organic growth potential. CTPE mitigates risk through diversification, with exposure to over 500 underlying companies led by around 50 different private equity management groups – a level of coverage not easily attainable for retail investors, in our view.

Shifting to renewable energy infrastructure, **Greencoat UK Wind (UKW)** provides another strong example of accessing hard-to-reach segments of the market, with UKW's portfolio consisting primarily of wind farms across the UK. It boasts a portfolio of 49 operating wind farms, a strong dividend yield of 7.4% (which stands out against

Correlation Versus Sectors And MSCI World Index

CORRELATION MATRIX			
Investment	1	2	3
1. BH Macro	1.00		
2. Morningstar Investment Trust Hedge Funds	0.50	1.00	
3. MSCI World	-0.47	-0.04	1.00
Investment	1	2	3
1. CT Private Equity Trust	1.00		
2. Morningstar Investment Trust Private Equity ex 3i	0.40	1.00	
3. MSCI World	-0.02	0.31	1.00
Investment	1	2	3
1. Greencoat UK Wind	1.00		
2. Morningstar Investment Trust Renewable Energy Infrastructure	0.43	1.00	
3. MSCI World	-0.07	-0.35	1.00

Source: Morningstar, as of 30/09/2024
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savings rates and long-term bond yields), and double-digit prospective total returns based on relatively conservative long-term energy price and inflation expectations. We think this makes UKW not only a way for investors to tap into a complex part of the market but also a provider of a differentiated source of income and capital returns.

These types of trusts clearly offer access to otherwise hard-to-reach markets, but they also play a vital role in portfolio diversification. Their low correlation to traditional equity markets, as shown below, demonstrates their potential as a source of differentiated alpha. Not only are these trusts negatively correlated to the MSCI World Index, but they also display low correlation within their respective sectors. With varying return profiles, approaches to income and the use of things like gearing, we think these trusts are compelling options for investors looking to diversify their sources of alpha and reduce dependence on broader market trends.

Behind the curtain, the role of boards

The board of an investment trust plays a critical role in protecting investor interests, with one of its key responsibilities being the negotiation of competitive fee structures. In some cases, boards have secured performance-related fee structures, aligning the manager's compensation with investor outcomes. This structure incentivises managers to focus on delivering alpha, as they only get paid when they outperform.

We've seen boards work closely with managers to introduce varied charging structures that set certain trusts apart. These strategies not only help keep costs competitive but also align interests and attract a broader investor base. For example, Prashant Khemka, founder of WhiteOak Capital Partners, has employed a differentiated charging structure for two trusts under his management: **Ashoka India Equity (AIE)** and **Ashoka WhiteOak Emerging Markets (AWEM)**. Their latest OCFs stand at 0.32% and 1.94%, respectively.

Prashant has designed a team and compensation structure that aligns the interests of the management team with those of investors. Rather than a traditional management fee, the trusts have a performance fee. The managers accrue charges only if they outperform their respective benchmarks, 30% of the excess NAV returns over the MSCI India IMI benchmark for AIE and 30% of any excess NAV returns over the MSCI Emerging Markets benchmark for AWEM, both calculated over three-year periods.

Whilst this can result in higher performance fees during periods of strong performance, there will be no impact from management fees on shareholder returns should they underperform. Furthermore, these fees are paid in shares, a good demonstration of the managers' commitment to the trust's success and incentive to deliver strong alpha. As Prashant succinctly puts it, "We only get paid if we outperform. The alignment of interest is strong because we can't just sit on our laurels and expect to get paid."

Fidelity Japan (FJV) provides another notable example. FJV's latest OCF, including its management fee, is 1.00%. The management fee includes a base rate of 0.7%, which can vary up to 0.2% in either direction, depending on whether the trust's NAV outperforms or underperforms the TOPIX index over a rolling three-year period. Whilst this style of performance fee is not uncommon, the structure is, as Fidelity are willing to give up some of the fee, allowing for a partial refund of charges in the event of underperformance. Due to recent underperformance, the board noted in FJV's latest results for the six months to June 2024 that the variable element of the management fee saw it reduced by £244,000, or approximately 28% of the base management fee over the period.

In our view, these performance-related charging structures are attractive, as they increase the alignment of interests between shareholders and managers, and incentivise alpha generation. Furthermore, the presence of independent boards means managers will ultimately be held to account, whatever the charging structure.

Conclusion

We believe investment trusts have long distinguished themselves as vehicles built to navigate the market's ebbs and flows, often providing investors with exposures and return profiles that differ significantly from open-ended funds. This article reaffirms that many trusts across the sector not only possess these features but also use them in distinctive ways to remain a compelling option for an investor's portfolio. Whilst the sector has faced challenges in recent years – from persistent discounts to cost disclosure debates – these distinctive qualities continue to offer a source of genuine diversification for investors. Whether it's income consistency across a market cycle or exposure to hard-to-access assets, investment trusts are well-positioned to enhance a broader investment strategy or serve as valuable complements to other assets, helping bolster a truly global and diversified portfolio. And if you're eager to dig deeper or find a trust tailored to your needs our **Fund Finder** tool can help streamline your search.

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