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Investing in the UK with investment trusts

How investment trusts can help investors in UK companies...

IN ASSOCIATION WTIH

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The UK has not had the best reputation as a destination for investors since the Great Financial Crisis. Perceived as offering sluggish growth and beset by political strife surrounding Brexit after the 2016 referendum, some investors have chosen to stay away as a result.

As you can imagine, this isn't a particularly nuanced view and it doesn't capture the opportunities the UK market has to offer. Although it's true London's large cap index has not performed amazingly well as a whole since the financial crisis, there are still plenty of companies, both in that index and further down the size scale, that have.

Identifying these companies does require a level of expertise though. It also means taking an active approach to the market that can potentially be more advantageous than simply tracking an index of the UK's largest companies.

UK investment trusts

It's for this reason that many people prefer to invest in the UK using investment trusts, instead of going it alone and picking stocks themselves.

Free to try and find the best companies, as opposed to just tracking a benchmark index, investment trust managers can focus on the firms which are more likely to outperform. This is particularly beneficial in a market that may be experiencing a cycle of poor performance.

Aside from this, trusts can also use gearing - borrowed money – to enhance returns. It's worth noting this can also have the opposite effect and increase losses if the trust managers make poor investment decisions.

UK investment trusts vs UK open-ended funds

Gearing is something that open-ended funds cannot use, for regulatory reasons. This is not necessarily a bad thing but it does mean closed-ended funds have the potential to enhance returns in a way that open-ended funds do not.

Other factors that may make investment trusts more appealing are closed-ended funds typically have to hold a larger amount of cash or other liquid assets in order to meet the need to offer redemptions to shareholders who want to 'cash in' their holdings. These assets tend to yield lower returns and stymie the fund's performance over time.

Trusts' closed-ended structure means they do not have to deal with redemptions – shareholders of a trust must find buyers for their shares on the stock market, where these shares are traded just like any other – and are thus freer to devote more funds to their underlying investments. Assuming they make the right calls, they'll see enhanced returns compared to their open-ended counterparts as a result.

Redemptions also have a negative effect on open-ended funds during periods of underperformance. Investors are more likely to remove their holdings from open-ended funds when this happens, forcing the managers to sell their most liquid holdings, which can compound the effects of a bad performance.

Trusts have no such problem which means they're better able to ride out periods of poor performance and don't have to worry about redemptions making a bad situation worse.

Different types of UK investment trusts

Focusing on high-level performance metrics does mean we can miss the fact that UK investment trusts take a range of approaches to the

market, mainly in terms of the goals they want to achieve for shareholders and the sorts of companies they invest in.

The AIC separates UK-focused investment trusts into four different categories and it's worth going through these to understand what's available to you as an investor.

UK All Companies

As its name suggests, trusts in the AIC's UK All Companies sector are free to invest in any London-listed company. That means they can mix up large companies, like HSBC or Shell, with others that are further down the market cap spectrum, like Future or Sumo Group.

Trusts in this sector may take divergent styles too. For instance, Baillie Gifford UK Growth (BGUK) invests predominantly in growth stocks. Fidelity Special Values (FSV) does the opposite and focuses instead on finding the best UK value stocks.

UK Equity and Bond Income

Equity and Bond Income trusts hold a mix of UK bonds and stocks. The ultimate goal is to try and generate capital gains and dividends for shareholders.

Ultra-low interest rates for over a decade meant that bonds became much less popular with investors, who have mainly gone deeper into the stock market to try and find higher returns.

The result of that is there is now only one Equity and Bond Income trust on the market. Henderson High Income (HHI) has some exposure to fixed income securities but, unsurprisingly given the dynamic described above, it has a much higher proportion of its holdings in equities.

However, it's plausible this will change moving forward due to the interest rate hikes that we've seen from central banks across the world since the end of 2021.

UK Equity Income

Large cap dividend payers are a prominent feature of the top end of the London equities market and many investors looking for income are happy to buy into them.

Trusts are also a useful vehicle by which to access this part of the market. That's because they're able to hold on to 15% of all dividend payments they receive each year and keep them in reserve. If there is a dip in income as a result of a drawdown in the market, a trust can use these reserves to pay out dividends to shareholders.

This ability to smooth out dividend payments during any down periods in the market arguably makes trusts a more reliable source of dividends for UK income investors than shares held directly in individual companies.

UK Smaller Companies

Arguably the most exciting area of the UK market is its small cap sector and it's here that trusts in the AIC's UK Smaller Companies sector focus their efforts.

Investors have tended to be sceptical of UK firms' ability to deliver growth, which is understandable if you focused solely on the larger companies in the market over the past decade.

But UK small caps have historically provided strong growth to shareholders and have also outperformed the wider market by some margin. A £1,000 investment in the Numis

Smaller Companies (NSC) index back in 1955 would have produced returns of £8.3m at the end of 2022. Over the same period an investment in the HSBC FTSE All-Share Index ETF would have returned approximately £1.3m.

This is another area where trusts' benefits come into play. The UK small cap market is vast and, depending on how you define 'small', comprised of about 1,000 companies. Sifting through these to sort the good from the bad is a difficult task and one that a dedicated team of analysts is extremely useful for.

You can see the value these analyst teams create as trusts in the sector averaged share price total returns of 167.7% for the ten years up until 21/12/2022, compared to total returns of 100.4% for the NSC index over the same period.

Case Study

Invesco Perpetual UK Smaller Companies (IPU)

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Invesco

Company: Invesco Fund Managers Limited

Launched: 1988

Managers: Jonathan Brown (2011) and Robin West (2014)

Ongoing Charges: 0.95% including annual management fee (as at 31/01/2023, Source: Invesco factsheet)

Dividend policy: Targets 4% of year end share price, paid quarterly

Benchmark: Numis Smaller Companies + AIM ex Investment Companies Index[1]

One investment trust that's active in the UK small cap market is Invesco Perpetual UK Smaller Companies (IPU). Managers Jonathan Brown and Robin West sort through a universe of about 1,000 stocks and aim to provide long-term total return for shareholders.

The trust managers typically hold between 70 to 90 stocks and believe the small cap market provides opportunities to find quality businesses at reasonable prices.

In practice, that means looking at companies which have had a period of underperformance but have a plan in place to turn things around, firms which have a strong idea and are looking to roll it out more widely, consolidation stories, structural growth stocks, and businesses that are highly cash generative and produce a strong return on capital - a measure of how efficient a company is at using its money to generate profits.

The managers' knack for picking out attractively valued companies was illustrated neatly in 2021, as eight of its holdings were taken over, all at premiums to their share prices. Of course, investors should keep in mind that past performance is not a guarantee of future success.

1) What is the trust's goal?

IPU's goal is to achieve long-term total return by investing in small and medium-sized UK equities.

2) What kind of stocks do the managers like?

Trust managers Jonathan Brown and Robin West tend to prefer companies that are industry leaders with strong balance sheets, which have the potential to double their earnings in five years. They also tend to like businesses which can perform well, regardless of the wider economic environment or market conditions.

3) Are investment decisions driven by a particular investment style?

IPU is a more growth-oriented investment trust and its investments are driven by four themes.

Roll up / Roll out: these are companies that have a strong business idea and are either about to roll it out or have already done so and are looking to consolidate their role in the industry they're active in.

Cash compounders: these are stocks which are more cash generative than the market average, as well as producing a stronger return on capital.

Structural growth: these are higher growth stocks that are both active in a sector that's experiencing strong growth but which also have a strong management team and balance sheet.

Self-help / Recovery: arguably the most value-oriented companies in the IPU portfolio, these are companies that have gone through a period of underperformance but which have shown signs, perhaps via a change in management, that they are going to turn things around.

4) How many stocks does the trust typically hold?

The trust typically holds between 70 to 90 stocks. This range is not fixed and the trust may vary the number of stocks outside this range.

5) What is the trust's dividend policy?

IPU aims to pay a dividend equal to 4% of the year-end share price. The payments are made up of 100% of income of the portfolio, supplemented by a payment from capital. Dividends are paid quarterly.

Investors should keep in mind that dividend policies and future dividend payments are determined by the Board and are not a guaranteed.

6) What are the trust's ongoing charges?

0.95%

7) Does the trust have performance fees?

IPU does not have performance fees. The portfolio managers are invested in the company, so their interests are aligned to shareholders.

8) How much attention do the managers pay to their benchmark, and to what extent are absolute returns important?

Although the trust managers are conscious of delivering outperformance, their investment decisions are not driven by the benchmark. The priority instead is to deliver a high level of total returns for investors, with investment decisions driven by the processes described above.

9) How much does the trust deviate from its benchmark?

The trust deviates meaningfully from its benchmark, with differences across sector allocations and valuations.

10) Does the trust use gearing and if so is it structural or opportunity led?

IPU's managers take a more conservative approach to gearing than some other investment trusts. They operate a traffic light system whereby they are given indicators of when may be an opportune moment to use gearing. The trust has the ability to use gearing to the lesser of 30% of net assets or £25m.

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[1]The benchmark index for this investment trust changed on 01/02/2022 from the Numis Smaller Companies ex Investment Companies Index (total return) to the Numis Smaller Companies + AIM ex Investment Companies Index (total return).

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

When making an investment in an investment trust you are buying shares in a company that is listed on a stock exchange. The price of the shares will be determined by supply and demand. Consequently, the share price of an investment trust may be higher or lower than the underlying net asset value of the investments in its portfolio and there can be no certainty that there will be liquidity in the shares.

The Invesco Perpetual UK Smaller Companies Investment Trust plc invests in smaller companies which may result in a higher level of risk than a product that invests in larger companies. Securities of smaller companies may be subject to abrupt price movements and may be less liquid, which may mean they are not easy to buy or sell.

The use of borrowings may increase the volatility of the NAV and may reduce returns when asset values fall.

The product uses derivatives for efficient portfolio management which may result in increased volatility in the NAV. In addition, some companies are suspending, lowering or postponing their dividend payments, which may affect the income received by the product during this period and in the future.

Important Information

For more information on Invesco Perpetual UK Smaller Companies Investment Trust plc, please refer to the relevant Key Information Document (KID), Alternative Investment Fund Managers Directive document (AIFMD), and the latest Annual or Half-Yearly Financial Reports. Further details of the Company's Investment Policy and Risk and Investment Limits can be found in the Report of the Directors contained within the Company's Annual Financial Report.

Invesco Fund Managers Limited.

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