Jargon buster: What are revenue reserves?

We run the rule over investment trusts' revenue reserves...

Update **13 February 2025**

Our new jargon-busting series has covered some of the basics of investment trusts, such as dividend yields, which we covered last week. This week, we'll explore dividends further by explaining revenue reserves.

Many of the investments that you can buy have the ability to pay out dividends and investment trusts are no different in that regard, but they do have some handy advantages on the income front.

Take open-ended funds as an example. These funds must distribute all of the income that they receive from their underlying holdings out to their investors each year. Investment trusts can do this, but they don't have to. Trusts are only required to distribute a minimum of 85% of the income they receive to shareholders. The remaining 15% can be held back in 'reserve'.

What is the revenue reserve?

When times are good and dividends are easy to come by, an investment trust can hold back up to 15% of the natural income they receive in the form of dividends. If they choose to do this, they use it to top up their revenue reserves. The revenue reserve can then be drawn on when times aren't so good and dividend payments from their underlying holdings are lower than usual.

This is the reason why there are so many investment trust dividend heroes (we'll come onto this in a later jargon buster). Take Covid, for instance: companies across the world decided to cut, scrap or postpone their dividend payments because of either lost income or regulatory intervention. Thus, many open ended funds and investment trusts didn't receive enough revenue that year to pay the same level of dividends to shareholders as the year before.

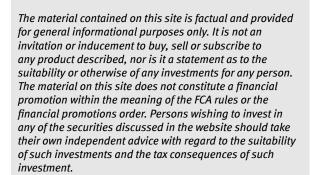
However, some frugal investment trusts that had built up their revenue reserves, and were thus able to pay out what they lost in natural income from their reserves, and thereby either maintain their dividend, or even slightly grow it.

Mythbusting

There is one point that I want to make here that some might not realise: the revenue reserve is not a literal pot of cash sitting in

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the bank that an investment trust can dip into when needed; it is merely an accounting convention.

Instead of being a ring-fenced amount of money, the revenue reserve actually constitutes an otherwise indistinguishable part of a trust's assets, and is invested in whatever else the trust is invested in.

When the time comes for the trust to utilise a portion of its revenue reserve to top up its dividend, the manager must sell a portion of the trust's portfolio, equal to the amount of the reserves the trust wishes to pay out as a dividend to release the funds.

Board's decision

The point should also be made that all decisions relating to the dividend are made by the board of directors, not the investment manager. It is purely at the discretion of the board whether the trust fully distributes income or retains up to 15%, or whether revenue reserves are used to support a trust's dividend.



In many cases the dividend history of a trust represents the 'track record' of a board, and many are keen to maintain that track record if possible. Hence, the 19 investment trust dividend heroes, trusts that have increased their dividends for 20 consecutive years or more. Many of these will have used their revenue reserves to keep their impressive records going through periods such as the dotcom bust, the global financial crisis and the coronavirus pandemic.

What revenue reserves can tell you about an investment trust

If it's income you're looking for from your investment trust portfolio, it's worth familiarising yourself with the amount of revenue it has in reserve. The industry convention is to express revenue reserves as a multiple of the last year's full year dividend (see table below). If it's held back a healthy amount in previous years, then the chances are it will be able to maintain or potentially increase its dividend payments even when stock markets are crashing and dividends are falling. As with anything though, there are no guarantees.

You can find information on revenue reserves on the AlC's website. I'll leave you with a starter for 10: below is a list of investment trusts yielding more than 2.5% with the highest revenue reserve dividend cover.

Keeping It In Reserve

| INVESTMENT TRUST | SECTOR | DIVIDEND YIELD (%) | DIVIDEND COVER (YEARS) |
|--------------------------------|-------------------------------|-----------------------|------------------------------|
| HICL Infrastructure | Infrastructure | 7.16 | 11.56 |
| Schroder Real Estate | Property – UK Commercial | 6.54 | 6.61 |
| Target Healthcare REIT | Property – UK Healthcare | 6.78 | 3.53 |
| Majedie Investments | Flexible Investment | 3.07 | 2.85 |
| Marwyn Value Investors | UK Smaller Companies | 9.24 | 2.82 |
| Aberforth Smaller Companies | UK Smaller Companies | 3.53 | 2.52 |
| Templeton Emerging Markets | Global Emerging Markets | 2.92 | 2.5 |
| Baillie Gifford UK Growth | UK All Companies | 2.87 | 2.39 |
| Lindsell Train | Global | 6.06 | 2.26 |
| UIL Limited | Flexible Investmen | 6.93 | 2.04 |

Source: Association of Investment Companies



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