Everything you've ever wanted to know about investment trusts but were too afraid to ask

We answer our readers' questions about investment trusts...

Update
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Kepler Trust Intelligence

We had a huge response to our request for readers' questions last month, with plenty of respondents getting to the heart of important issues in fund analysis and the investment trust sector. Some of the questions were simply too far-ranging to be answered today, and have given us ideas for whole strategy articles that should be coming in the next few months. Indeed, some of the questions were so detailed the reader arguably made a start on writing the piece themselves! In this note we answer the best of the other questions we received.

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How long would you keep an investment trust that is underperforming its benchmark for before deciding a tracker is a better option. How do you decide whether to stick or twist while avoiding selling just as it's turning a corner.

Without wishing to sound blasé, I'd start by saying that in most circumstances I think both out and underperformance over a short period of time is not likely to tell one very much, and so I'm very wary of statements such as 'the first half was disappointing' or 'the portfolio has performed strongly in the last few weeks'. These can be interesting statements to file away to form a longer-term picture but treat them with caution at the point they are made.

Investment trusts have an independent board and one of its most important roles is to assess the manager's performance. If I found myself owning an investment trust that had consistently underperformed, the starting point would be to read over the report and accounts covering the period in question and see what the board has said about its assessment of the manager and what explanations are offered for underperformance. One may need to read several years of reports to establish a full picture and these should be easily accessible on an investment trust's website. Generally, one should find the relevant commentary in the chair's statement and the manager's report. One shouldn't necessarily limit one's reading to the specific period of ownership of the shares, as it may be the seeds of underperformance were planted at an earlier date.

In reading these documents it's helpful to keep in mind that a board's role is, yes, to keep the fund manager on their toes, but also to be supportive and constructive where that is appropriate. For example, if an investment trust's fund manager has a long-established and clearly communicated investment approach that eschews any investments in banking stocks, say, and this has translated to a prolonged period of underperformance, one may still find the board is supportive of this, and it is quite possible that shareholders are providing feedback to say that they don't want a change of direction. Many shareholders of investment trusts own a portfolio of several and may choose to own a contrarian one to provide some contrast and diversification. They may look at performance of a whole group rather than just at one specific trust and may be happy that their contrarian bet's underperformance is the cost of insuring against a future change in direction for the market. One may find commentary in reports that reaffirms the board's support for this strategy, and then one must decide whether one agrees with the fund manager 'sticking to their knitting'.

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It's also helpful to keep in mind that while there's a certain drama and excitement around an investment trust appointing a new fund management group due to underperformance, this is a last resort as it can be a very time-consuming and expensive process. A board may very well look to work with its existing fund manager first to see if internal personnel or process changes can help matters. Messaging around this type of thing can be quite subtle so one might need to read between the lines on phrases such as 'working closely with the manager' in the chair's statement. Statements like this are a very good indication that the board is alive to the situation and is working to resolve it.

One could also either write to the chair, contact details will often be on the website and in the report and accounts, or ask a question at the AGM and my advice here is to try to be factual and keep emotion out of it. It is very easy to be annoyed about persistent underperformance, but I think one can undermine a perfectly fair question by allowing emotion to take over. One may be in a room full of shareholders silently applauding the question, but they are much less likely to stand up in support if things get heated.

And so, as ever, the answer is 'it depends' but I would say if you have gone through the steps above and have found satisfactory answers then you should stick. If you are left feeling that the underperformance isn't well explained, or that there are no signs of actions being taken to address it, then that's probably the point to twist. Fund managers themselves face making the same decisions about their portfolio holdings all the time and its helpful to learn from them. Once you have made a decision, don't make it personal, or look back and wonder what might have been. And if things do improve in future, you can always buy back in again.

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What KPIs/measures should be considered to make the final choice between three seemingly similar investment trusts?

Our reader highlights that "in most Trust sectors there are multiple options to consider before selecting which to buy". He suggests an example in the Renewables sector, asking how to differentiate between three trusts to illustrate the point - **Greencoat UK Wind (UKW)**, **Renewables Infrastructure Group (TRIG)** and Downing Renewables & Infrastructure Trust (DORE).

Firstly, when comparing investment trusts there are no singular set of KPIs that offer a consistent way of helping make an investment choice. It is useful to ascertain what alpha the managers have achieved historically, but working out whether it is likely to persist is a tougher ask. It is important to consider the nuances of an investment style and the sort of performance this is likely to lead to in different environments. Alpha can be very variable, and depend on market conditions. We would argue it is much more valuable to find a manager which can be expected to perform in a very consistent way, even if this means underperforming in certain environments, than one which has seemingly always outperformed. Understanding the sources of alpha allows an investor to build a portfolio with diversified sources of potential outperformance.

One KPI I would be hesitant to use is the discount. The three trusts suggested are a good illustration. On the surface, these trusts all offer roughly the same broad opportunity, but with discounts to NAV of 12%, 20% and 34% respectively (at the time of writing). One of the hard lessons I have learnt over the years is that when it comes to discounts, in many cases discounts to NAV can be entirely unrelated to the future prospects of the company. In other words – the market is very far from being perfect. However, at other times the discount IS telling you something. The problem is that it is hard to tell when a discount is justified or not! My advice generally is to ignore the discount, and try to evaluate whether you'd like to own the portfolio (or NAV) first and foremost, and whether you rate the manager's prowess in adding value over time, over and above the fee that they are charging. If you like the NAV and the manager, AND the trust is trading on a discount to NAV, then this is a bonus, although only a potential bonus as the discount could widen or not narrow.

In the case of the example above, research reveals that in terms of differentiating KPI's, UKW offers the highest prospective underlying total returns from the portfolio (in terms of the headline discount rate) of 9%. However, the portfolio is solely focused on wind farms in the UK. By comparison, TRIG's discount rate of 8.3% and DORE's discount rate of 7.7% arguably reflects their diversified portfolios, amortisation of structural debt and portfolio mix – with exposure to solar and in DORE's case, hydro assets, which are progressively less risky (and therefore offer a commensurately lower return). Portfolio diversification can in some cases only be optical, and many readers will

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be familiar with the theory of 'di-worse-ification'. In my view, the reason UKW has outperformed the other two, is partly a result of investing in assets which give higher returns in aggregate than the others. Of course, the risk is that UK specific economics / politics / geographic factors negatively affect UKW, which has no exposure to other regions. So far this risk has been worth taking, and the new labour government promising to be a "clean energy super power", it seems a fair bet that the risks of being exposed to the UK only, remain fair.

Clearly, each of these prospective returns is based on a set of assumptions on energy generation, inflation, interest rates and the useful lives of assets, not to mention what other investors are paying for similar assets. If any long-term assumptions change, then investors must expect a different NAV return. Comparing the assumptions underpinning each trust is very hard and complex, and in some cases impossible to do given the level of transparency given by the managers. These are key determinants of the likely future returns, and so rather than try to gaze into a crystal ball, the main job of an analyst or investor is to monitor how closely manager expectations are met by reality. If a trust's portfolio routinely misses expectations, then this is potentially a signal that valuations don't reflect reality, and that returns may be lower in the future (or vice versa).

In summary, in our view, the different discounts of the three trusts in the example given reflect the varying total returns expected, but also the quality of their portfolios. DORE has a very large number of small renewable assets, which one might argue are of a lesser institutional quality than the other two trusts. In my view this is the main reason why the discount is considerably wider than the peer group. Unfortunately for the reader asking the question, only time will tell which KPI's were red-herrings, and which were crucial determinants of the best performing trust. We would encourage readers to assemble as many facts as possible before making an investment decision, and if investing life-changing amounts of money, to seek financial advice before investing.

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What happened to split level trusts, and why?

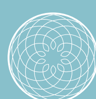
As a fresh faced near-graduate, my second job in the City was working as a lowly data analyst for David Thomas, a gregarious and highly intelligent ex-Naval engineer, who was at the centre of the split capital investment trust world. So one might argue I'm in a good position to answer this!

As with all good ideas that subsequently go wrong, at their heart, split capital investment trusts are a brilliant concept. Simply put, a split capital trust allows different shareholders to get different financial exposures to a single portfolio of assets. A FTSE 100 Index income share might give shareholders all of the income from the FTSE 100 but no capital growth, whilst the capital share would give all of the capital growth, and none of the income. Assuming a capital structure at the outset of 50% income and 50% capital shares, income shareholders get twice the income of the FTSE 100 Index, and capital shares twice the capital growth, all things being equal. The idea being that each share will be highly attractive to each group of shareholders, such that the trust as a whole would consistently trade at a premium to NAV.

Of course, the devil is in the detail, and as the split capital market developed different innovations crept in (including the hefty use of bank debt to further gear split capital trusts), and complexity bred complexity when trusts started to invest in each other's shares. In the end, it was good old leverage that burst the bubble. When stock markets started to fall early in the new millennium, LTV ratios for bank borrowings started to look exposed. At inception, many of the capital shares (or 'ordinary income' shares) most exposed to capital growth (or losses) required c. 7% per annum growth in the trust's portfolio to break even (after interest costs, the capital entitlements of higher-ranking shares, and management fees etc). When markets fell, the growth required became rather too heroic; confidence evaporated, and the price of zero dividend preference shares fell (the lowest risk element of the capital structure), prompting worries and questions being asked of the regulator. In the end, the reputation of the investment trust sector was called into question. Markets recovered, and some investors who had bought highly geared shares for next to nothing, made fortunes.

The fallout from the 'splits crisis', but also the low interest rate environment , has meant few split trusts exist today.

NB Private Equity Partners (NBPE) is technically a 'split', in that it has a relatively modest slice of ZDPs in its capital structure as a form of fixed rate borrowing. It has said it will repay its last tranche of ZDPs in October. Chelverton UK Dividend (SDV)'s ZDP matures in 2025, but the newly formed Aberforth Geared Value and Income (AGVI) has



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ordinary shares and ZDPs and illustrates that split capital trusts aren't dead and buried. This fixed life company was formed in July 2024 by the rollover of the previous fixed life vehicle, which coincidentally delivered almost exactly the same total returns for ordinary and ZDP shareholders over its seven-year life of 26.8% and 26.5% (or c. 3.4% per annum each). Given the gearing involved, the total return for the ordinary shares was lower than the managers expected, with strong income growth but a loss in capital. The UK stock market malaise is the main reason for an underwhelming performance, but arguably sets the scene for a more exciting return for the successor vehicle. AGVI will run until 2031 (a seven-year life), with the ordinary shares at the start with relatively high gearing of 37.5% and an expected dividend yield of 4–5%. At the issue price, the ZDPs offer a prospective 7% per annum total return, a significant increase from the 3.4% prospective total return of the previous iteration. We will be publishing a full note on the new trust in the coming weeks.

For the right trust, and in the right circumstances, I hope that splits might once again become a more pervasive feature of the trust universe. Hopefully history will remember the key lesson – to avoid excessive leverage (including that hidden in underlying investments).

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Can investment trusts narrow their discount? Buying back shares does not seem to work.

We've agreed as a team that this is the answer that could most easily turn into a very long essay, and it's also a topic that can start some quite heated debates, so I'll try to boil it down to the essentials. The mostly hypothetical answer is 'yes', if an investment trust keeps buying shares back until there's no one left who wants to sell, it can eliminate its discount. There are a small number of investment trusts that do this, and generally manage to keep their discount (or premium) within a very tight range. But there are several reasons why an investment trust may not be able to take this approach. The main ones are as follows:

Gearing. This is one of the key advantages of an investment trust, but most investors prefer gearing to be used conservatively. Buying shares back will increase gearing. A trust could of course repay some debt and re-adjust but think about those trusts that locked in long-term low cost gearing a few years ago. The opportunity to borrow money at those rates may not come back around for many years. Further, some forms of gearing are quite expensive to repay early, so it's not always possible to make the case that buying shares and repaying debt is actually positive for remaining shareholders. A trust considering buying shares back that has gearing has to weigh these factors against each other.

Underlying assets. Investment trusts are prized for their ability to own assets that may not themselves be very liquid. Buying shares back constantly requires a trust to be able to raise cash on any given day and this might not be easy if the trust owns a portfolio of smaller companies, or property, or infrastructure etc.

Peer Group. If an entire peer group is trading at a wide discount, a single investment trust may find it difficult to narrow its discount on its own. At some point, if one investment trust is at a 5% discount, say, and its entire peer group is at a 20% discount, no matter how much investors love that particular trust, the relative value of a 20% discount will lead some to sell and buy one of its discounted peers. It may also be the case that large investors own several trusts in a peer group. If they wish to reduce their exposure to that peer group, which one will they sell? The one buying shares back at a narrow discount, or the one on a 20% discount? A trust can rapidly find itself acting as a cash point for investors who just want to reduce their exposure to an asset class.

It's perhaps helpful to re-frame the statement 'buy-backs don't work' as I think it depends on what it is one wants from a buy-back. As we've looked at above, it's not always easy to constantly buy shares back and simultaneously deliver on some of the most prized aspects of an investment trust but buy-backs do deliver an enhanced NAV for shareholders, and enhanced earnings per share, which might feed through to a higher dividend. If the objective of buying shares back is to first, enhance shareholder value and second, potentially narrow the discount, then one can say with more certainty that they do work. But to permanently remove a discount using buybacks alone, an investment trust needs very high confidence it can raise cash on any given day in order to step in and buy shares.

This might be a disappointing answer, but let's think about an alternative scenario. Open-ended property funds don't trade at a discount, but over more than one cycle in the 21st century investors have found themselves locked in with no ability to sell, as those funds have found it impossible to sell property to meet redemption requests, or have been forced to sell what they can, which may

well be their best assets. In contrast, investors in listed property trusts have experienced very wide discounts but have been able to sell, even if they don't like the price. Further, those wide discounts have acted as the catalyst for M&A activity which has unlocked some of those discounts.

I know the question is principally 'can investment trusts narrow their discounts?' and so far I've really only answered the 'share buy-backs don't work' part. There are some other things to think about in answering the first part. Readers will have noticed a number of investment trusts undertaking so-called tender offers recently. A tender offer is essentially a very large share buy-back executed on a single day with every shareholder invited to participate at a pre-agreed discount. This is usually a very low single-digit discount designed to make the transaction cost-neutral. While tender offers don't narrow the discount per se, the ability to sell some or all of one's shares at very close to asset value has, at least for those that wish to sell, narrowed the discount to almost net asset value. Readers will also know that many investment trusts these days pay a dividend funded from capital. Mathematically this is the same thing as handing every shareholder a little piece of the NAV every year, without a discount, so again while the share-price discount may not have narrowed, one is receiving a small payment with the discount removed. These and other techniques are not perfect, but as one can see from the three topics above, it's not always easy to square the features of investment trusts that can lead to outperformance, with the desire to keep the share price close to NAV at all times.

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When buying ITs through my platform Interactive Investor, why do some trusts attract a stamp duty charge whilst others don't?

Share trading on UK investment trusts is exactly the same as any other UK company, i.e. it attracts stamp duty, but there are a number of investment trusts that are actually Guernsey- or Jersey-based companies and share trading on these does not attract stamp duty.

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What are the different ways to manipulate the number of shares in a trust that need shareholder approvals in shareholder meetings and are there any that shareholders should be particularly sensitive about?

The most common powers investment trusts take, which are almost universal, are the ability to buy back 14.99% of shares in issue or to issue up to 10% of new shares. These are very standard powers that are usually renewed annually at the AGM and will be accompanied by stipulations that shares will only be bought back at a discount to net asset value and only issued at a premium to net asset value. These are really the key shareholder protections, as they prevent any dilution of value and as a result are very uncontroversial powers widely accepted as part of the 'toolbox' available to an investment trust to help alleviate discount and premium volatility. There's another question specifically about buy-backs in this piece which dives a bit further into that topic.

There are several other ways that shares can be either bought back or issued, including tender offers or placing programmes. I won't list out all the various flavours of these as they are essentially all just larger scale versions of either buy-backs or share issuance and the key with all of these is that they require shareholder approval. Because it is extraordinarily unlikely that shareholders would approve either buying shares back or issuing shares in a way that would dilute their existing holdings, these types of transactions will be structured to avoid that, so again, shares will only be issued at a premium or bought back at a discount.

In the real world, the most potentially sensitive area is around the waiver of pre-emption rights that are attached to, for example, large placings of new shares. Pre-emption is an important principle for some shareholders, as it gives them a right of first refusal over any new shares issued. Providing a waiver on these rights for smaller amounts

of shares, say 10%, is accepted practice in the industry, but sometimes one may see larger share issues where existing shareholders are given pre-emption rights. One is not obliged to take these up, but some investors feel it is important to be given the option and make it a condition of approving any transaction.

In a very small number of cases one may see transactions that absolutely do dilute shareholders. These are very rare and I can only think of a handful over many years. In this tiny sample, the most common thing is a discounted rights issue. This is where a trust has an overwhelmingly pressing need to raise new equity and the only way it can do it is to offer new shares at a very large discount. Usually the argument in favour of such a rights issue is that without it, the trust will suffer even more damage. Existing investors may therefore choose to take up their rights in order to protect their existing investment, or alternatively may choose to accept the dilution as the cost of saving the company from worse consequences. Most investment trust investors will never experience a discounted rights issue.

In all cases, these transactions require the board to give shareholders a clear explanation of the reasons for the transaction, and what its effects will be, and so while it is true that the overwhelming majority of such transactions will not dilute shareholders, it's always good to stay vigilant and to make sure to read those documents.

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How are daily share-price movements affected by a trust's discount and premium?

There are some investors who specifically focus on investment trust discounts and trading those, and so fluctuations in discounts can lead to increased trading activity, which may then move the price. This type of activity was much more prevalent in the years preceding the financial crisis, when the costs of running such a strategy were much lower, but the era of low interest rates, and relatively low discounts has curtailed a lot of this activity until more recently when it seems that investors are once more paying attention to trading discount volatility. Nevertheless, the overwhelming direction of discounts and premiums is still set by more conventional investors, who are probably less focused on day-to-day fluctuations in discount and less likely to respond to a small move.

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Which is more attractive, a dividend based on a percentage of NAV or one paid out of revenue per share?

I think the two can co-exist quite happily and help an investor build a more diversified portfolio. One of the key challenges for traditional equity income investors is the limited number of companies and countries one can invest in to get a relatively high dividend. The UK equity income investment trust sector has built up an enviable record of increasing dividends every year, but make no mistake, without the ability to use revenue reserves, that track record would not look quite so unblemished as there have been times over the years when the main dividend paying companies in the UK have not been able to increase dividends. Revenue reserves aren't, by the way, a bank account where dividends from previous years are safely held but are just an accounting construct. The revenue reserve is invested as part of the net asset value and when a trust uses its reserves, it comes off the net asset value in just the same way as a dividend paid as a percentage of NAV does. So, while they may be called different things, they aren't so different in terms of their effect on the end investor.

The big advantage of traditional equity income trusts is that they focus on a progressive dividend, i.e. one that increases each year regardless of where the NAV has gone. Anyone investing to use the income to live off will obviously be drawn to this as their income hopefully rises with inflation. Further, the types of companies that pay dividends could be considered more conservative businesses less likely to give investors unpleasant surprises. There have been times though when this is very much not the case, with the financial crisis being the big example, and so it seems sensible that any income investor should consider some diversification. This is where trusts that pay dividends from capital may have a role to play, as these trusts more often than not invest in different companies and markets.

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I'd go one step further and say that with average life expectancy being so long past retirement, investors may have the opportunity to continue to target more growth-orientated strategies in their portfolio. Trusts that offer dividends paid from capital very often have more growth-orientated strategies but offer investors a convenient way to draw some income at the same time. Of course, the main difference is that the dividend will rise and fall with the NAV and investors will need to think about how much tolerance they have for that within an overall portfolio.

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I am attracted by the idea of your quantitative fund ratings, partly because I feel they are your most unbiased content, but I don't feel I fully understand them and I regret that some trusts are excluded from them. I have a few questions on how they work. Is a growth rating intrinsically better than an income and growth rating as equity income trusts are sometimes awarded a growth rating?

Neither is better, but we want to highlight the trusts that have done the best in two categories. The first is capital growth. This is fairly self-explanatory; we want to highlight those which we think have produced the track record that would appeal to investors looking to grow their capital over the long run. The second is income growth. Here we are looking to identify those that have the best track record of delivering a steady and rising dividend while also growing capital. We think this sort of profile suits two main categories of investor: those who are in drawdown and taking an income from their investments, but who expect to be doing so for many years; and those who want a more steady, lower-volatility way of generating high total returns, thanks to the income growth component.

This means that when identifying the income growth winners, we consider the performance of the trusts in terms of total returns too, using the same screens we do for the growth ratings. We then additionally consider the track record in growing the dividend over time, as well as the current yield.

Given this methodology, the best equity income trusts are likely to qualify for a growth rating too. The award we give the trust depends on which category we think best describes what the trust is trying to achieve, and this is one area in which our judgement enters the equation. It is also possible for a trust with an equity income mandate to have a yield which is too low to pass our screens, or to have had a poor track record of growing dividends. In this way, it may qualify for a growth rating but not an income growth rating, no matter what sector it sits in.

Is there any order between rated trusts in each category or are they just all recommended?

All trusts get a score between 1 and 100, so there is an underlying table, but we award the top 20 a rating in each category. In our view, there is little value in ascribing high value to such small differences in performance – unlike in the Olympics.

I believe your fund ratings exclude private equity trusts. Is there some reason why you could not add an 'alternative growth' rating to cover the AIC sectors Private Equity and Growth Capital, possibly amongst others?

The challenge is coming up with a quantitative system for rating private equity trusts. Our ratings are based on NAV total returns, reflecting the performance of the manager and the strategy. This means there is a problem when it comes to the NAVs of private equity trusts, which are estimated. It simply doesn't make sense to place the same weight on the volatility, downside characteristics and other ratios when they are derived from estimated NAVs rather than a daily, factual calculation of prices paid. Each manager will have a slightly different approach. While they may all be perfectly valid and justifiable when it comes to giving a reasonable estimation of a current value, it clearly doesn't make any sense to rank trusts based on calculations on data calculated in different ways. Nor is it appropriate to treat the data as capable of delivering the same precision as daily market prices are. This is all before you consider the fact that some trusts will report NAVs at different frequencies, which is another factor making comparisons less valid. As they are not always estimated at the same time, we don't have the same number of data points for each trust, and we can't distinguish how different portfolios have responded to the same events. For the alternative asset sectors, which also don't have

market-derived NAVs, we have come up with a simple way of assessing the income and long-term NAV protection delivered by the trusts which we think has some value given how recently these trusts were established. But in our view the sort of sophisticated calculation required to deliver a useful rating for private equity trusts isn't achievable given the lack of precision in and verification of the NAVs.

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