Leveraging the benefits of investment trusts

James de Uphaugh, Portfolio Manager of the Edinburgh Investment Trusts

The City of London is world-renowned for its innovations. One of the earliest that still flourishes today is the investment trust, which offers particular advantages to more sophisticated investors. Sometimes referred to as the City's best-kept secret, the advantages that investment trusts offer help explain why they have been around for over 150 years. Today there are more than 400 investment trusts, covering a wide range of asset classes.
They have immense potential to add value to investors' portfolios if one avoids the more fashionable areas where new issuance tends to congregate.

A 'closed-ended' vehicle

An investment trust is a company listed on the stock exchange that invests in financial assets on behalf of its shareholders. It is called a 'closed-ended' fund because, like other listed companies, the number of shares is largely static (they can conduct share issues and buy-backs). This is unlike a unit trust, for example, in which units can be created and redeemed daily, according to investor demand. Shares can be bought directly from an investment trust when it is launched, or when it seeks to raise more money through a fresh issue of shares. Once it has been launched, shares in an investment trust can be purchased in the 'secondary' market, i.e., from the stock exchange on which they are listed via a stockbroker or an online share platform. Like many markets, it tends to be in the second-hand arena that the best opportunities abound.

Appealing to the right investors

Investment trusts have several advantages that should appeal to the right investors. These include diversification and economies of scale – investors can benefit from a share in a trust that invests in a broad range of equities, bonds or real estate assets, something which would be prohibitively costly or even impossible as a single investor.

Professional fund managers allocate and monitor investments on behalf of investors and investment trusts typically have low total expense ratios thanks to scale economies and independent boards that oversee the cost effectiveness of the trust.

Good governance is also a feature of independent boards of directors, which have powers to replace fund managers if, for example, performance is unsatisfactory over a prolonged period or there is style drift.

In such volatile times, investment trusts can also offer relative stability. While investors may trade in or out of an investment trust, the underlying portfolio of assets can remain more stable. This allows a fund manager to invest for the long term without having to cater for potentially disruptive investors' inflows and outflows, which open-ended funds must address.

By law, investment trusts must distribute 85% of their investment income as dividends, and many have excellent track records in maintaining and increasing dividends. This means investment trusts are also ideal income vehicles for those looking for this option.

The benefits of discounts

In addition to these advantages, two features of investment trusts make them appropriate vehicles for investors in the current environment.

First, many investment trusts can now be purchased at substantial discounts. Their prices can fluctuate just like other shares, rising when investors are confident in the strategy and falling when doubts prevail. The uncertainty that has been seen in financial markets in recent years has driven many investment trust prices significantly below the net asset values (NAVs) of the underlying portfolios. Again, this is a key difference from open-ended funds, which are priced at NAV. UK stocks have been particularly out of favour with international investors since Brexit, so investment trusts offer a 'double discount'. When investor confidence recovers discounts should narrow, enhancing potential returns.

Second, because investment trust managers are allowed to borrow money (like any PLC, and again unlike open-ended funds) and invest the proceeds if they are optimistic about market conditions, this means they can buy more financial assets for every pound of shareholders' funds. This will also magnify returns in rising markets (and will dilute them in falling markets).

As an example, in 2021 we refinanced the Edinburgh Investment Trust debt on a long-term basis at very low levels. Effectively this was gentle gearing at strategically and strikingly low rates.
There are thousands of investment vehicles to choose from, while financial markets themselves are becoming ever more complex and faster moving. But the advantages offered by investment trusts certainly mean they merit consideration for any portfolio, especially to invest in the market in which they are most at home – the UK.

For a comprehensive list of common financial words and terms, see our glossary at: http://www.edinburgh-investment-trust.co.uk/glossary

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Key Risks

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