The benefits of investing in debt

James de Uphaugh, Manager of the Edinburgh Investment Trust

'Never a borrower nor a lender be' is an old maxim to which many subscribe, but when it comes to investment trusts, borrowing can offer clear benefits.

While interest rates have risen steadily in recent months, over recent years some investment trusts have taken the opportunity offered by the historically low-rate environment to borrow at low rates in the expectation that their investment returns will exceed the cost of the debt.

Like several other types of savings vehicles, investment trusts offer the opportunity to invest in portfolio of stocks by holding shares in a single investment. But their ability to borrow is a virtue of their legal structures as companies and is a key distinguishing feature versus, for example, conventional unit trusts, which cannot borrow.

Some investment trusts use revolving credit facilities – overdrafts – to borrow. These are by definition shorter term and the interest rates charged may be more volatile and higher than the base rate. Another option is for a trust to issue fixed rate 'bonds', which are IOUs sold to investors and which pay an annual 'coupon' as interest before paying back the debt after a fixed term of perhaps five, 10 or 25 years.

Investment trusts are also known as closed-ended funds because, like companies, and in the absence of share issues or buybacks, a fixed number of shares are in issue. This more stable structure means investment trusts can take a long-term view and use debt – gearing – to increase exposure to stock markets and hopefully boost returns.

The potential benefit to shareholders of trusts that use lower cost gearing is that there is an increased likelihood that returns will outpace the cost of borrowing, in turn boosting shareholder returns.

Those trusts that used the pre-2022 low interest rate environment to secure long-term fixed rate debt are also now better insulated against the current interest rate increases.

In the '80s and '90s, many investment trusts took on multi-decade debt that they thought at the time was attractively priced. For example, long-dated bonds maturing with coupons of 7% or 8% were not uncommon and in the late 1990s may have seemed a good option. However, with the benefit of hindsight, this is clearly a high hurdle to add value for shareholders as it requires near double-digit steady investment returns of more than 7.5% for investors to benefit.

In contrast, two years ago when gilt yields were low, the Edinburgh Investment Trust, which we manage at Liontrust, refinanced its long-term debt fixed for an average of 25 years with

a coupon rate of 2.4%. Strategically we are more comfortable with this long-term, low-cost debt which should enable us to enhance long-term shareholder returns.
However, any borrowing comes with risks. The most obvious one is simply that leverage will mean greater losses when asset values fall. Clearly an important risk control for any investment trust manager is the consideration of this factor, even if we accept that short-term market moves are themselves inherently hard to predict.

Further, an investment trust may need to sell part of its portfolio to reduce the levels of debt and stay within tolerances set by lenders. However, given that the reason it is breaching such covenants is probably because the value of its assets has fallen, a trust might then have to sell assets at the worst possible time to do so.

When investing it is worth considering what assets an investment trust holds. If an investment trust holds unlisted assets, then keeping leverage within a debt covenant might be hard because it proves harder to sell the unlisted assets to reduce the overall debt. In contrast, where there is a portfolio of listed equities, trusts have the flexibility to ‘repair’ their way out of challenging times.

Not all investment trusts borrow to gear their investments – and investors should be alert to the risks and rewards that come with leverage. Attitudes to risk will determine in large part which investment trusts are suitable for different investors. But delegating the decision to gear investments to professional fund managers is one of the advantages of investment trusts and in the current environment, it might even benefit investors through higher long-term returns.

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

EDINBURGH
INVESTMENT TRUST

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested. The issue of units/shares in the Edinburgh Investment Trust may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term. The portfolio may invest in smaller companies. These stocks may be less liquid and the price swings greater than those in, for example, larger companies. The Company borrows money to invest in the stock market within prescribed limits with the aim of enhancing returns. The use of borrowings may increase the volatility of the NAV and may reduce returns when asset values fall. The Company may invest in derivatives. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of the company than if the underlying investment was held instead.

Disclaimer

This communication is issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business. This is a marketing communication. Before making an investment, you should read the relevant Articles of Association and the Key Investor Information Document (KIID), which provide full product details including investment charges and risks. These documents can be obtained, free of charge, from www.liontrust.co.uk or direct from Liontrust. Always research your own investments and if you are not a professional investor please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances.

This should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. The investment being promoted is for shares in a company, not directly in the underlying assets. It contains information and analysis that is believed to be accurate at the time of publication, but is subject to change without notice. Whilst care has been taken in compiling the content of this document, no representation or warranty, express or implied, is made by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified. It should not be copied, forwarded, reproduced, divulged or otherwise distributed in any form whether by way of fax, email, oral or otherwise, in whole or in part without the express and prior written consent of Liontrust.

[23/343]