INVESTMENT TRUSTS PASS THE COVID CHALLENGE, BUT WHAT'S NEXT?

Investment trust companies (ITCs) may be the UK's oldest fund structure, but they have proved themselves particularly resilient in the wake of Covid-19. We examine why they are well-suited to withstand market stresses, and key considerations for managers interested in setting up an ITC.

Investors faced a difficult time in 2020, but investment trust companies (ITCs) enjoyed a good year. Discounts to the underlying value of assets widened sharply at one point, but closed 2020 at a razor-thin 0.4%[1] – the narrowest in more than 20 years. While UK dividends fell 44% to £61.9bn, **investment trusts paid an extra £87 million in dividends in 2020**[2], with 85% of income-paying investment companies – mainly ITCs, but including some other closed-end funds – held or increased their dividends[3]. Overall performance was also strong and industry assets rose to an all-time high of £237bn in February 2021.[4]

So what is the key to their recent success?

THE KEY TO RESILIENCE: STRUCTURAL DESIGN AND LOW-COST FINANCING

Open-ended funds have faced considerable scrutiny in 2021, in particular those investing in illiquid assets such as commercial property. Several of these suspended trading in 2020 and in prior years, as they faced difficulties in meeting investor redemptions.

ITCs were saved from problems in 2020 due to fundamental elements of their structure. Firstly, ITCs are listed companies, so investors sell their shares in the open market rather than buying or selling directly from the fund manager. This means that managers have more flexibility to invest in more illiquid or long-term assets, without having to worry about meeting frequent investor redemptions. When markets are volatile, as has been the case during parts of 2020, ITCs have weathered the storm of redemptions and avoided having to sell assets to raise cash.

As for dividends, ITCs' record in 2020 was impressive but not unusual: they have shown a strong dividend record during previous crises too. This is based on their ability, as with any listed company, to retain net income for reserves which can be drawn down when needed to fund dividends.

Investment trusts offer another unique advantage; **they can use long-term debt to increase returns** by putting money in assets likely to return more than the cost of debt, a process known as gearing.

"The historically low levels of interest rates globally have enabled managers to access much cheaper financing than in previous years. Many investment trusts have taken the opportunity to unwind more expensive gearing and lock in to new, cheaper borrowing options"

Ken Murray, Head of Investment Trust Accounting at BNP Paribas Securities Services.

INNOVATION BOOST

"Investment trusts have remained as innovative as ever during the pandemic", says Murray. For example, October 2020 saw the launch of Home REIT, which raised £240 million to invest in accommodation for the homeless[5]. 2020 also saw the £100 million launch of Triple Point Energy Efficiency Infrastructure[6], which seeks to reduce carbon emissions by investing in making energy systems more productive. These launches reflect the growth in awareness of social issues around homelessness and the drive for environmental efficiency and carbon reduction, both of which have come to the fore during the pandemic.

However, not all funds have performed well. For example, trusts that invest in aircraft leases lost value because of the massive reduction in flights. While ITCs have experienced sector-specific impacts in this way, their inherent design has enabled these trusts to continue trading and prepare for better times ahead. Instead of a forced sale of assets at rock-bottom prices and a suspension in trading, they took the strain through the share price.

1 Association of Investment Companies, March 2021. https://www.theaic.co.uk/aic/news/press-releases/85-of-income-paying-investment-companies-increased-or-maintained-dividends

2 Link Group, March 2021 https://www.linkgroup.eu/insights/publications/investment-trust-dividend-monitor/

3 See above

4 Figure on Association of Investment Companies website. Available at: https://www.theaic.co.uk/

5 CityAM, October 2020 https://www.cityam.com/real-estate-investment-trust-home-reit-raises-240m-through-ipo-to-fund-accommodation-for-homeless/

6 Morningstar, October 2020 https://www.morningstar.co.uk/uk/news/AN_1602709674971001600/in-brief-triple-point-energy-efficiency-raises-gbp100-million-in-ipo.aspx

WHERE NEXT FOR INVESTMENT TRUSTS?

While some ITCs have raised large IPOs in recent years, with the largest nearing £1bn[7], the sector remains a relatively small part of the UK's overall funds under management. At the same time, UK open-ended funds face their own issues surrounding liquidity, and the UK regulator and industry bodies have been examining how best to facilitate investment into illiquid assets in a more sustainable and scalable way.

The Investment Association has proposed its own solution: the Long Term Asset Fund, designed specifically as an open-ended vehicle for investments in illiquid assets. The IA does not define a standardised notice period, and provides an example of "a dealing frequency consistent with the nature of the underlying assets held within the fund", in the case of a fund that allows redemptions every two years.[8] This would create a new structure quite distinct from both ITCs and existing open-ended funds that permit daily dealing. On one hand, this structure could end the liquidity mismatch suffered by open-ended funds investing in illiquid assets. On the other, it would tie up investors' money for much longer than an ITC investing in similar assets.

The UK government has recently set out its intention to support the launch of Long-Term Asset Funds in late 2021[9]; are we about to enter a new era in the UK fund sector, and will this challenge the popularity of ITCs?

Whatever challenges ITCs face in the future, their record in 2020 suggests that they are well-placed to cope. In a year when the UK economy suffered its sharpest decline on record, ITCs proved extremely resilient. With over 150 years' of successful trading, their structural strengths look set to keep them a popular model in changing economic climates.

7 Which Investment Trust, October 2018 https://whichinvestmenttrust.com/smithson-raises-822-5m-to-become-largest-ever-investment-trust-ipo/

8 Investment Association, June 2020 https://www.theia.org/media/press-releases/ia-lays-out-vision-future-investment-management-industry

9 Investment Week, January 2021 https://www.investmentweek.co.uk/news/4026103/uk-government-commits-2021-ltaf-launch

TOP 5 QUESTIONS FOR MANAGERS INTERESTED IN SETTING UP AN INVESTMENT TRUST

BNP Paribas Securities Services is the **UK's leading investment trust administrator, by both asset value and number of trusts**[10]. We can offer end-to-end service for new ITCs from dealing through to reporting, including financing, fund accounting and administration. With dedicated relationship management, client service and operations teams in three locations across the UK, BNP Paribas Securities Services understands intimately the challenges of setting up and operating an ITC and can support managers throughout the process, which can be quite different from that of an open-ended fund.

For managers interested in setting up an ITC, here are five questions that we would recommend asking your administrator:

1. What is the typical timeframe for launching an ITC and the key milestones? What support can you provide through the launch process?
2. Given fee pressure, what are the cost benefits that can be offered by bundling services across areas such as custody, depositary and fund administration?
3. What are the statutory and regulatory reporting requirements, and how do they differ from those for an open-ended fund?
4. If I already manage open-ended funds, are there any benefits to using the same provider across these funds and a new investment trust?
5. What experience and scale do you have in supporting ITCs?

10 Monterey Insight UK Fund report, 2020

FOR ADDITIONAL INFORMATION, PLEASE CONTACT

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