EVOLVING WITH THE TIMES: 150 YEARS OF UK INVESTMENT TRUST COMPANIES

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Much has come and gone since the first investment trust company was launched in 1868 in London, a year after BNP Paribas opened its first UK branch. 150 years later, the world looks very different but that first trust, now known as the F&C Investment Trust, remains part of the UK landscape – and it has since been joined by hundreds of others.

CHANGING FORTUNES

Investment trust companies (ITCs) have had their share of tough times historically. Insurance companies unwound their large holdings in them in the years after the City of London's Big Bang in 1986, as they started developing their own investment management capabilities in-house. The gradual growth of Undertakings for Collective Investments in Transferable Securities (UCITs), and the proliferation of other UK open and closed-ended fund structures, also created an increasingly competitive environment for ITCs.

However, ITCs have made a spirited fightback in recent years. Advisers and wealth managers **bought £985 million of shares in investment trusts**[1] and other closed-end investment companies in 2018, according to the Association of Investment Companies (AIC). October 2018 saw the largest ever launch of a UK ITC, when Smithson Investment Trust raised £822.5 million[2] to invest in global small and mid-caps. ITCs and other closed-end investment companies had **£192 billion in assets in June 2019**[3].

The staying power of these structures reflects a combination of perennial strengths and continuous innovation. Fundamentally, the ITC is a closed-ended company listed on a stock exchange (including the Main Market, AIM and NEX). Following the initial offer, shares are traded in the secondary market alone. ITCs, unlike open-ended funds, are able to use leverage to raise finance, with most managers using up to 25% gearing. But over the years, managers have adapted to changing circumstance, devising different ways of raising leverage to boost returns, such as private placement notes, convertibles, subscription shares and warrants.

OPEN-ENDED FUNDS COME UNDER SCRUTINY

The advantages of the structure have recently been highlighted by the difficulties suffered by some open-ended funds; ITCs offer investors daily liquidity despite any holdings in assets classes with low liquidity. In late 2018, the Financial Conduct Authority (FCA) launched a **consultation on illiquid assets** and open-ended funds, proposing improvements in risk management and better protection of investors in open-ended funds. This issue was brought to the fore with the events surrounding the £3.7bn Woodford Equity Income Fund, which was suspended in June 2019 when the manager was no longer able to meet redemptions. In contrast, shares in the same manager's investment trust are still being traded, albeit at a wide discount.

Indeed, critics of ITCs argue that during market turmoil, share prices can fall to the point where they show wide discounts to Net Asset Value (NAV), as investors react to uncertainty by selling their shares. Automated tools on investment platforms often class ITCs as higher risk for this reason. Nonetheless, the actual investment position of the fund is not damaged through asset sales at reduced prices. "The benefit of closed-end funds is that their structure gives managers time to re-position, rather than forcing managers into short-term decisions", says William Hemmings, Head of Closed End Funds at Aberdeen Standard Investments. "The stress is taken on the share price rather than in the actual fund, which is to the benefit of shareholders."

This stabilising mechanism allows trust managers to invest for the long term, including in illiquid assets that do not have to be sold in response to sudden changes in market sentiment. This is one reason why trusts have recently gained ground with retail investors who increasingly appreciate the benefits of diversification. In the age of pension freedoms, ITCs can also be seen as a source of long-term income.

> **" Unlike Open-ended Investment Companies (OEICs), investment trusts can retain modest amounts of net income each year, which allows a smoothing of distributions to shareholders across multiple years. "**
>
> Ken Murray, Head of Investment Trust Accounting,
> BNP Paribas Securities Services

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1 "Adviser purchases of investment companies hit £985 million in 2018", AIC, 19 March 2019

2 "Smith beats Woodford with record £822m Smithson IPO, CityWire, 17 October 2018

3 AIC Industry Overview, 20 June 2019

MOVING WITH THE TIMES

This move into low liquidity asset classes began with general property trusts and continued with ever greater diversification. Aberdeen Standard Investments, for example, has two mainstream UK property trusts, a European logistics trust, a trust involved primarily in Cuban real estate, and a trust that invests only in private equity funds and unlisted investments, although the majority of its assets are in equities.

Another recent trend is the launch of infrastructure trusts, such as International Public Partnerships, which invests in the highly specialist niche of offshore energy transmission. This trend has been recognised by the AIC, whose new **sector classifications** include four segments for property, expanded from two previously. But how new is this approach? Scotland's oldest ITC, now called Dunedin Income Growth Investment Trust, was set up to invest in bonds issued by North American railroad companies, back in 1873.

> **" Trusts have tried to satisfy the changing interests of shareholders in each era, and with the real asset fundraisings at the moment, you could say that we have gone full circle. "**

William Hemmings, Aberdeen Standard Investments

Investment trust companies could also be well placed to benefit from another growing trend, Environmental, Social and corporate Governance (ESG) investing. The long-term investment horizon of ITCs are well suited to the active engagement strategies required for an integrated ESG strategy. In BNP Paribas' recent ESG Global Survey, institutional investors identified data as the biggest barrier to ESG integration particularly for issues around consistency of data across asset classes. Closed-ended structures, while facing the same challenges, only have a fixed portfolio to analyse, making it easier to develop consistent reporting for ESG-related data.

THE EFFICIENCY IMPERATIVE

For the investor, the biggest criticism of ITCs continues to be their higher fees; many have total expense ratios above 1%. ITCs can be costly to run, due both to the active management approach as well as the stand alone structure which requires each company to bear the entire cost, without the benefit of umbrella structures adopted by many open-ended funds.

As a listed company which is also an investment scheme, ITCs also bring administrative and governance requirements that can present challenges, even for the most experienced fund manager. Following a successful Initial Public Offering (IPO), an ITC is bound by the FCA's ongoing listing rules including the Disclosure Guidance and Transparency Rules (DTR) and the UK Corporate Governance Code. But due to its dual identity as an Alternative Investment Fund (AIF), investment trusts are also subject to EU directives including AIFMD, PRIIPS and others.

This is where an experienced administrator can help. An administrator can help a trust's board and its investment manager to manage the requirements of setting up the trust, and then deal with the ongoing regulatory, reporting and informational requirements that arise every quarter. BNP Paribas Securities Services looks after more investment trusts than any other provider[4], from its operational centres in Dundee and Glasgow. In combination with BNP Paribas Corporate and Institutional Banking, it can offer an end-to-end service from the point of dealing right through to statutory and regulatory reporting, and everything in between including financing and fund accounting and administration.

EVOLVE OR DIE?

Investment trusts currently constitute approximately 16% of the entire assets under managements of UK authorised and recognised funds[5]. With The Investment Association's recent 'Vision 2025' paper laying out the case for a new and revised fund regime in the UK, will ITCs continue to be part of this landscape?

With the need for diversification, adoption of ESG, and potential regulatory controls of their open-ended competitors, it seems that ITCs are well-placed to adapt to the needs of 21st century investors. "As long as they continue to innovate, investment trust companies will always have a toolkit for the future", says Hemmings.

4 Monterey Insight UK Fund report, 2018

5 Figures based on The Investment Association's "Asset Management in the UK 2017 – 18' report and AIC sector figures

FOR ADDITIONAL INFORMATION, PLEASE CONTACT

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