
Economic Perspective 1

THE INVESTMENT TRUST DISCOUNT

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The British Coal Pension Funds' bid for Globe Investment Trust, although not directly involving Scottish investment trusts, reflects an ever present threat to a substantial part of the Scottish fund management sector. Scottish fund managers account for more than a third of the UK investment trust industry and investment trusts represent the core business of many Scottish fund managers. In recent years fund managers have diversified into the management of pension funds and unit trusts but the investment trust business continues to provide a steady, dependable income and so supplies funds for expansion in other areas. This dependence on investment trust business makes it important to examine the reasons for the Globe bid and identify the processes at work with a view to taking action, if necessary, to protect the stream of income generated by the trust business.

The immediate cause of the bid for Globe lay in the acquisition of an additional five per cent shareholding by British Coal Pension Fund but the fundamental cause lies in the huge shareholdings in the trusts accumulated by pension funds and insurance companies, shareholdings which sit uneasily with the basic purposes and objectives of investment trusts. Investment trusts grew up to supply diversification and management to small investors. The declared objective of the first investment trust, the Foreign and Colonial Government Trust, was to give the investor of moderate means the same advantages enjoyed by large capitalists by investing in stocks, a pattern that has been followed by the majority of investment trusts at least until very recent years. Investment trusts offer small investors both a reduction in risk by their ability to diversify, and management expertise that is otherwise difficult to obtain. These services are of value to investors who cannot achieve the same ends as cheaply by any other means. From its early

beginnings the rising real income and wealth of the middle classes led to the prolonged expansion of the industry with a stream of new entrants and the provision of diversification and management services to an increasing circle of investors.

The expansion of the industry came to a halt however, as a consequence of the dramatic changes that have occurred in the market for investments over the last thirty years. Investment trusts now have to compete against a wide range of investment institutions offering products many of which have been designed to be simple and appeal to the small, less well informed investor. Such products are actively marketed and advertised in ways sometimes unavailable to investment trusts. Even more fundamental perhaps has been the difference in tax treatment between different savings mediums. In particular, pension funds are treated more generously for tax purposes than other investment vehicles with the result that, in general, individuals have switched from holding equities directly to holding them through institutions, particularly pension funds. Indirect holding of shares through intermediaries is more tax efficient for investors and in the long term such powerful economic forces are crucial. The consequence of these factors for the investment trust industry over time have been dramatic. Much of the traditional clientele supplied by investment trusts has been seduced away by the tax advantages of pension funds and the simplicity, marketing and ease of acquisition of unit trusts.

At the same time the management skills of the trusts have been in much less demand. When the first investment trust was formed, overseas investment was a highly risky and specialised activity. By the 1960's foreign investment was awkward because of the dollar premium but improved communications had made overseas investment much easier. The value added by investment trust

management was much smaller. The result was a reduction in the demand for the expertise of investment trust managers. Unfortunately, whilst expansion of the investment trust industry is easy since existing trusts can issue new shares or new trusts can be formed, the contraction of the industry is more problematic. Investment trusts are companies with directors and employees so that liquidation (or similar) implies painful readjustment of incomes and expenditures. Moreover, since their assets are not reduced by a fall in demand for the services trusts provide there is no compelling reason for termination. In consequence, rapid reduction in the size of the industry to reflect reduced demand for diversification and management is almost impossible.

The difficulty attached to reducing the quantity of investment trust shares in existence, coupled with a fall in demand from personal sector investors² as these investors secured diversification and management expertise from other investment products, could have only one result; a fall in the share price of the trusts. Such a fall is necessary to attract (informed) investors to hold investment trust shares in their portfolios. The share price of an investment trust is determined by the supply and demand for the trust's shares in the same way as the share price of any other company. The distinguishing characteristic of investment trusts is that the value of the underlying assets of the trust are known. Provided investment trusts offer valuable services to (uninformed) investors the value of the investment trusts own shares exceeds the value of the underlying assets. The 'premium' is not large since diversification is cheap to obtain and few managers have special investment skills that justify a large premium. The possibility of replicating trusts also acts to keep premiums down.

If investment trusts do not offer valuable services to (uninformed) investors the price of the trusts will fall. In the simplest case when investment trusts can be liquidated immediately, the maximum fall in share price will be to the value of the trust's assets less the costs of liquidation. The costs of liquidation are generally small and rarely more than ten per cent of the market value of the trust and yet we observe that investment trust prices frequently stand at more than a ten per cent 'discount' to their asset values. The cause is the difficulty in

liquidating or otherwise reducing the number of trusts and hence the amount of diversification services on offer to investors. The investment trust's own fund managers see their trusts as a continuing entity offering useful services to investors³ and to this end they actively resist closure. Interlocking directorships, long management contracts, cross shareholdings and special classes of capital are some of the many ways that predators can be halted. The difficulty in reducing the number of trusts has a consequence for the pricing of investment trust shares. The price is not a random phenomena determined in isolation. The price is set relative to other securities in the market. In particular, investors in any company expect to be offered a return that relates to the market risk assumed. If an investment trust imposed no management charges whatsoever and offered no value added to investors (the managers had no special management abilities) the return of the trust would exactly correspond to its market risk. However, investment trusts charge for their services. These charges reduce the return below that appropriate for the risk assumed. Indeed, since the management are difficult to displace, on acquisition of an investment trust the investor can be confident of having to pay management charges for years into the future. The result is that, on average, the market value of the trust falls by the capitalised value of these costs.⁴ The overall result is, in general, a sizeable discount to net asset value (NAV).

At the same time however, the trust sector does adjust to changed circumstances with a steady, if sometimes slow, stream of mergers, takeovers, liquidations and unitisations. For any investor purchasing an investment trust there is a positive probability of early exit as a result of corporate change affecting the existence of the trust. When such a change comes about the discount is greatly reduced or removed, and market prices must reflect such possibilities. The probability of structural readjustment acts to reduce the discount.⁵

In short, in the absence of (uninformed) investors wishing to buy diversification and management services investment trust shares offer a return commensurate to the risk taken on. If the managers have particular investment skills the additional return they can generate more than offsets the charges involved and the shares stand at a premium to net asset value (NAV). If the managers do not have any such skills, the return on the trust's

assets after meeting management costs are too low to support a price close to NAV and the price falls. The extent of this fall is affected by the perceived difficulty of removing the managers and distributing the assets of the fund to the shareholders.

If this view of investment trusts is correct what implications does it have for Scottish fund managers? If we rule out liquidation and takeover at the outset since these do not benefit Scottish fund managers (although they may benefit Scottish investors) three possibilities are apparent; to offer valuable investment management services to investors; to coax back into purchasing investment trust shares private sector investors who are willing to pay (through a reduction in returns) for diversification and management; and to reduce the discount by reducing the costs associated with management.

Aspects of these policies can already be seen at work. Over the last year there has been a flood of new, specialised investment trust issues offering investors particular management skills such as investment in Thailand. Unfortunately, any such move to provide specialised management is likely to fail. If the overseas stock market in question takes off then UK institutions will find it desirable to develop their own skills in this area. If the market fails to develop the investment trust will remain small and may well not be economic. The problem is that investment management is in general a low value added business. Unusual investment skills are difficult to develop and attempts to offer specialist services to institutional investors by investing in (easily) tradeable assets is almost certainly doomed to failure. To provide value added fund managers need to specialise in activities and investments that are not easily replicated. Venture capital may be one such area.

The second possibility is to woo the private investor. This is already a feature of investment trust policy. The introduction of savings schemes to encourage the purchase of investment trust shares and the marketing of trusts through intermediaries paying commission for sales of shares has almost certainly resulted in the reduction of the average level of the investment trust discount. As informed institutional investors perceive a change in the market for the trusts and the return into the market of the traditional investment trust clientele they

recognise that the price of the trust will rise. The result is a higher probability of early exit at or near NAV and consequently the discount narrows. However, whilst the outlook for the trusts has improved a sizeable discount remains and as such will continue to make investment trusts an attractive target. For the discount to shrink further it is necessary for informed investors to be convinced that the proportion of private sector shareholders will continue to expand rapidly. This is not impossible. The growth of the unit trust market shows what is possible but it must be remembered that until the life assurance companies moved into the unit trust market in a big way in recent years with their very considerable marketing muscle, the unit trust industry was smaller than the investment trust industry. Use of financial intermediaries and improved marketing whether by specialisation, innovation or advertising can certainly help investment trusts, but it is to be doubted if it is enough in the short to medium term to reduce the discount to a level low enough to deter all predators.

A reduction in management costs is the third possibility. A direct reduction in management charges is unlikely. The trend in recent years has been upwards and with the costs imposed by increased regulatory requirements is unlikely to fall. However, it would be possible to create more competitive conditions in the investment trust industry by reducing the length of management contracts, introducing periodic reviews by the shareholders of whether the trust should continue, and reducing wasteful turnover. An objective of all investment trust directors should be to identify the interests of the trust's fund managers with the interests of the investment trust's shareholders. One possibility might be the issue of options to fund managers contingent on narrowing the discount. Another might be partial payment to fund managers in deferred investment trust shares with deferment dependent on the level of the discount. Such measures are unlikely to be popular with fund managers. Many fund managers probably prefer to take their chances and hope (or try and ensure) that their trusts are not taken over. The assault on Globe suggests that this may be wishful thinking. There remain more assets in the sector than private sector investors wish to hold. Until more such investors are attracted into holding investment trust shares causing a reduction in the discount investment trusts will continue to make an attractive target for

predators.

Although not always possible one strategy for beleaguered fund managers is to unitise their investment trusts. Unitisation generally involves significant early redemptions but despite this it is an attractive option for the fund managers because it enables them, in general, to greatly increase charges and to retain funds under management without fear of predators. The disadvantage is that it involves accepting that marketing and not investment skills are the key to success. And yet, this is precisely the direction in which investment trusts must move if they are to succeed in reducing the discount by appealing to uninformed investors. The need is for investment trusts to recognise that they are competing in an expanding but very competitive savings market. If they are to be successful they must develop their marketing and distribution skills. Until they do the discount is likely to persist and trusts will be attractive victims for predators. Diatribes against pension funds are not the answer. Nor is statutory proscription of investment trust takeovers. The discount has to be reduced and the Scottish trusts should concentrate their energies on actively marketing themselves to the private sector.

Footnotes

1. It was thought, for example, that investment trusts could not advertise because of the ban on companies promoting their own shares under the Prevention of Fraud (Investment) Act.
2. It would be more accurate to distinguish between informed and uninformed investors

where the informed investors are typically institutions and realise that diversification can be cheaply achieved and that management is generally of limited value in contrast to uninformed investors who have no such knowledge.

3. This is clearly illustrated by the recent furore over Globe Investment Trust. One might be forgiven at times for believing that the whole future of the investment trust industry was at stake and that millions of small investors were going to be deprived of a home for their assets. Whilst Globe has a large number (42,000) of shareholders small investors do not own the majority of shares and could find an equally attractive home in many of the 200 or so trusts that remain.
4. The extent of these costs cannot be estimated with certainty since current management charges are only one aspect of management costs. Hidden management costs arise from excessive turnover and poor dealing whilst the general rise in charges over the last ten years may be expected to continue.
5. The discount will also be affected by uncertainties over the valuation of assets. The extent of these uncertainties is generally small but the difficulties are illustrated by the augmentation of Globe's valuation with the addition of £44 million for its fund management operations. In the absence of a market price the value of these assets remains uncertain and open to argument.