

| A guide to investment trusts



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The value of your investments can go down as well as up and you may get back less than you originally invested. We don't offer advice, so it's important you understand the risks, if you're unsure please consult a suitably qualified financial adviser. Tax treatment depends on your individual circumstances and rules may change. Past performance is not a guide to future performance and some investments need to be held for the long term.

| What are investment trusts?

Investment trusts are part of the family of collective investments that includes unit trusts, open-ended investment companies (OEICs) and exchange-traded funds.

By buying shares in these investment companies, which invest in a diversified pool of assets, you can spread your risk and access investment opportunities many of which you probably would not or could not find on your own.

There are several ways in which investment trusts differ from other collective investments, which we'll explore in this guide.



| How an investment trust works

Investment trusts are companies in their own right, quoted on a Stock Exchange with independent boards of directors. They have a closed-ended structure, which means there is a fixed number of shares in issue, so for every buyer there has to be a seller.

This structure can be an advantage. Unlike in the open-ended sector, an investment trust does not expand or contract in size depending on the trust's inflows and outflows. However it does mean that the price of an investment trust's shares can deviate from the value of the underlying assets, the 'Net Asset Value' (NAV).

Many investment trust managers take a long-term view with their investments. Their goal is to manage portfolios effectively in both good and bad market conditions.

Unit trusts and OEICS will have to keep investing when new money flows into their funds. And they will have to sell some holdings if investors decide to exit. In contrast, investment trusts aren't exposed to inflows and outflows of money.



What are the benefits of investment trusts?



ACCESS TO A BROAD RANGE OF ASSETS THROUGH A SINGLE PRODUCT

They can be a great way to help diversify your portfolio. Some people don't have the time or the inclination to look for multiple stocks ideas, so using an investment trust or fund can be a more convenient way of investing. You let an experienced investment manager do the hard work in picking assets in exchange for an annual fee.

There are cost benefits from being part of a collective as the total cost of the investment manager's time and effort is spread across all investors.

This helps to keep fees lower than if you were the only person paying someone to run your investments.



DIVIDEND SMOOTHING

Investment trusts are allowed to stash away up to 15% of their income each year in their revenue reserves. Essentially it is putting money away for a rainy day. It provides back-up money to sustain dividend payments during tougher stock market or economic conditions: a process known as dividend smoothing.

Many of the oldest and biggest investment companies continue to increase dividend payments year after year, partially because of this flexibility when it comes to having cash in reserve.

The Association of Investment Companies has highlighted 21 investment trusts that have increased their dividends every year for 20 years or more. Of these, 10 investment trusts boast a track record of more than 40 years of consecutive dividends hikes. These include City of London, Bankers Investment Trusts and Alliance Trust – each with 52 years of consecutive annual dividend growth.



COST BENEFITS

When you buy 10 individual shares, you will incur 10 sets of dealing costs. An investment trust will only come with a single dealing cost associated with your purchase, but potentially give you access to 10 or more companies in the underlying portfolio.

You will still have to pay an annual management fee to the investment trust manager, but this can be worthwhile to benefit from their expertise and time.



OPPORTUNITY TO INVEST IN A PORTFOLIO OF COMPANIES AT A LOWER PRICE THAN BUYING EACH ONE INDIVIDUALLY

Investment trusts often trade below the value of their net assets. We'll explain why later in this guide. Please note that investment trusts can also trade at a premium to their net assets, so there is a risk you are paying more than they are worth via the individual stock route.



EASY TO BUY AND SELL

Investment trusts trade on the London Stock Exchange in exactly the same way as individual company shares.

You can see their price at any time of the day and deal in the same way as normal shares.

In comparison, unit trusts and OEICS are only typically priced once a day. Anyone buying the latter types of funds are likely to have to wait until the next day for the trade to take place. The order would be executed at the following day's price and you would be committing to an investment with less certainty as to the cost.

What does trading at a discount or premium to net asset value (NAV) mean?

Rather than being inextricably linked to the value of the underlying portfolio, share prices of investment trusts are driven by the market. If demand is high, the shares may trade at a premium to their net asset value (NAV). But if demand is low, they are likely to trade at a discount.

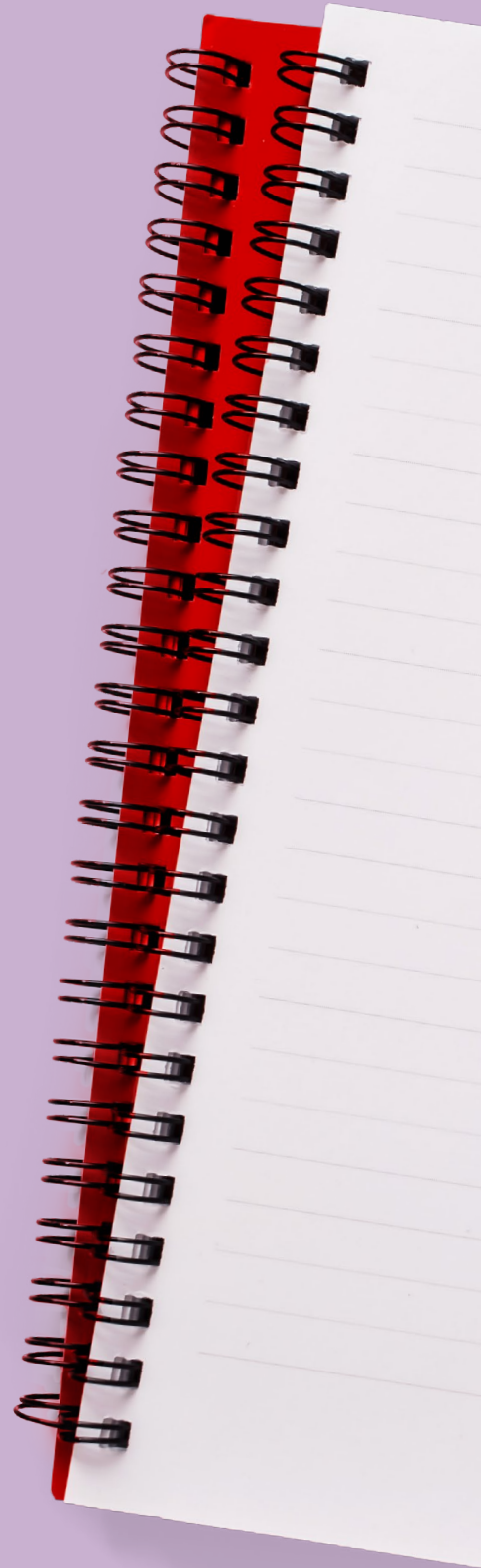
While this quirk can create an element of volatility, it also presents an opportunity for value-hungry investors. Since many investment trusts trade at a discount to the value of their underlying assets, you can in theory pay 80p for a share worth £1. In order to realise this value, the discount has to narrow from the level at which you buy in and there is a risk it could widen further.

Investment trust boards are aware of the negative impression big discounts can create and sometimes carry out share buy-backs in order to narrow or maintain discounts to NAV.

Investment trusts make regular announcements to the stock market titled 'net asset value' (NAV), which you can see on websites such as [investegate.co.uk](https://www.investegate.co.uk).

Some trusts publish these on a daily basis, others monthly or less frequently. This important piece of information shows the latest value of a trust's holdings. You can then compare it to its share price to see if the fund trades at a discount or premium to its assets.

It's not a simple case of avoid those on a premium and only buy those on a discount; a good, well-run investment can be worth backing even if the shares trade above NAV. On the flip side, many trusts trading below NAV are 'cheap' for a reason. There could be significant hurdles to clear before their valuation gap narrows.



How to calculate if an investment trust trades at a discount or premium

To better understand how the discount/premium to NAV works, let's create a hypothetical investment trust called Big Stocks Trust plc.

It owns 500,000 shares in food seller Domino's Pizza – trading at 896p; 100,000 shares in self-storage provider Big Yellow – trading at 753p; and 900,000 shares in gold miner Centamin – trading at 116.7p. The trust has no debt and 1 million shares in issue.

If you do the maths, you can work out the net asset value per share:

Domino's Pizza	$500,000 \times 896\text{p} = \text{£}4,480,000$
Big Yellow	$100,000 \times 753\text{p} = \text{£}753,000$
Centamin	$900,000 \times 116.7\text{p} = \text{£}1,050,300$
Net asset value per share	$\text{£}6,283,300 \div 1,000,000 \text{ (shares in issue)} = 628.33\text{p}$

Now let's look at the trading price for shares in Big Stocks Trust which is 599p. It means you can buy 628.33p of underlying assets for 599p, representing a 4.7% discount. You can calculate the discount as follows:
 $((628.33 - 599) / 628.33) \times 100$.

This is a simplified version of calculating discount/ premium to NAV. In reality it is much harder to calculate due to additional factors about how products are run and the frequency of information being published.



Reasons behind large discounts to net asset value

1

The portfolio contains lots of underlying assets with high levels of debt.

2

Investment trusts can trade at a big discount if investors have no faith about the ability to sell underlying assets.

3

The same applies if investors don't believe the investment trust manager has the right skills to grow the trust.

4

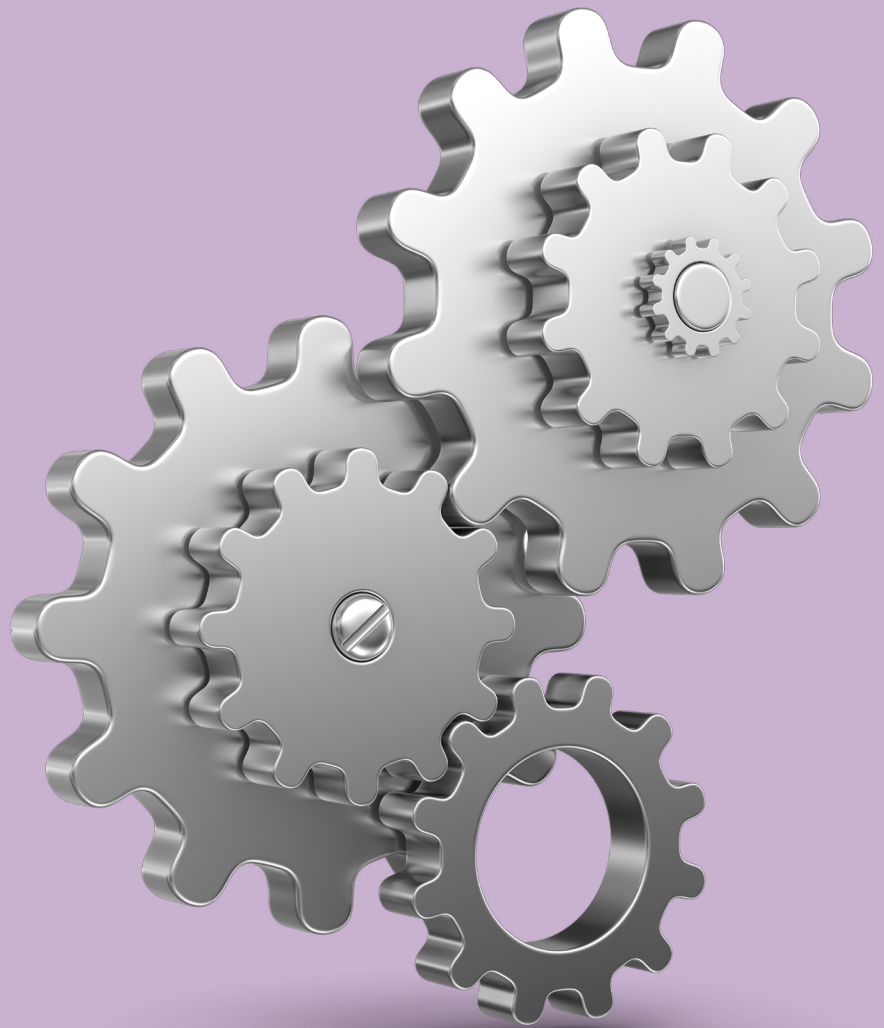
A sector might be out of fashion and investors believe the investment trust manager may lose interest, not be able to generate value from the trust, or not be able to sell any of the underlying assets – hence a big discount.

5

Market disbelief in the stated net asset value figure. In particular, this can apply to stakes in private companies where valuations are often based on previous fundraisings and where there is doubt that future fundraisings will be done at the same or higher valuation levels.

What does it mean when an investment trust uses gearing?

Investment trusts can borrow money to make additional investments. This is known as gearing. The investment trust manager hopes to make enough money to cover both the costs of servicing the debt and making a profit on top. Gearing is good and bad. It offers the chance to boost an investment trust's profit but also increases the risks. Not every investment trust uses gearing; most only use modest levels.



How do you research and choose an investment trust?

You can find this information on our website by visiting youinvest.co.uk/shares/investment-trusts or by visiting the fund manager's own website.

Some investment trusts will explicitly invest in income-generating assets like companies with generous dividend yields or fixed income products like corporate bonds. They will collect the income paid by the underlying assets and distribute most of the cash to shareholders as dividend payments, either monthly, quarterly, half-yearly or annually.

Other investment trusts will be focused on growth. This means investing in assets, most likely individual company shares, that the manager believes will grow in value – and therefore lift the value of the investment trust in time.

You may also find investment trusts that focus on specific geographic areas or certain industry sectors.

DID YOU KNOW?

Each investment trust will publish a list of its top 10 holdings and explain its investment style in a consumer-friendly factsheet.



Can I make choosing investment trusts easier?

It can be a bit of an uphill battle to understand investment trusts. So if you're looking to deepen your knowledge of investment trusts, our website has some useful articles and videos. To help you with your research, we've drawn up our Investment trust select list - a list of 20 trusts each of which has been chosen by our investment specialists.

You can find these resources by visiting youinvest.co.uk/markets/investment-trusts.

Just remember, it's essential you do your own research as well, and our Investment trust select list isn't a personal recommendation.

DID YOU KNOW?

AJ Bell have an Investment trust select list, to help find one that's right for you.

How do you deal in investment trusts through AJ Bell Youinvest?

Investment trusts can be bought and sold in the exactly the same way as individual company shares. You can buy investment trusts through a SIPP, a Stocks and shares ISA, a Lifetime ISA or a Dealing account. They trade on the London Stock Exchange and their prices are driven by market demand.

What are the costs of buying and owning an investment trust?

The cost of buying an investment trust through AJ Bell Youinvest is the same as for an individual company share (£9.95 each time you buy and sell online). You'll also pay our custody charge, which is the charge for holding an investment in your account. For investment trusts, this is 0.25% of their value (capped at £7.50 per quarter for ISAs and Dealing accounts and £25 per quarter for SIPPs).

The manager of the investment trust also levies a charge – although this is built into the price. You can find information about their charge by looking for the phrase 'Total Expense Ratio' or 'Ongoing Charges'. These state how much you should reasonably expect to pay as an investor from one year to next and include all professional, management, audit and custody fees.

This charge does not include performance fees, as these can vary depending on how well or badly a fund performs. Many investment trusts don't charge a performance fee.

OPEN AN ACCOUNT

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