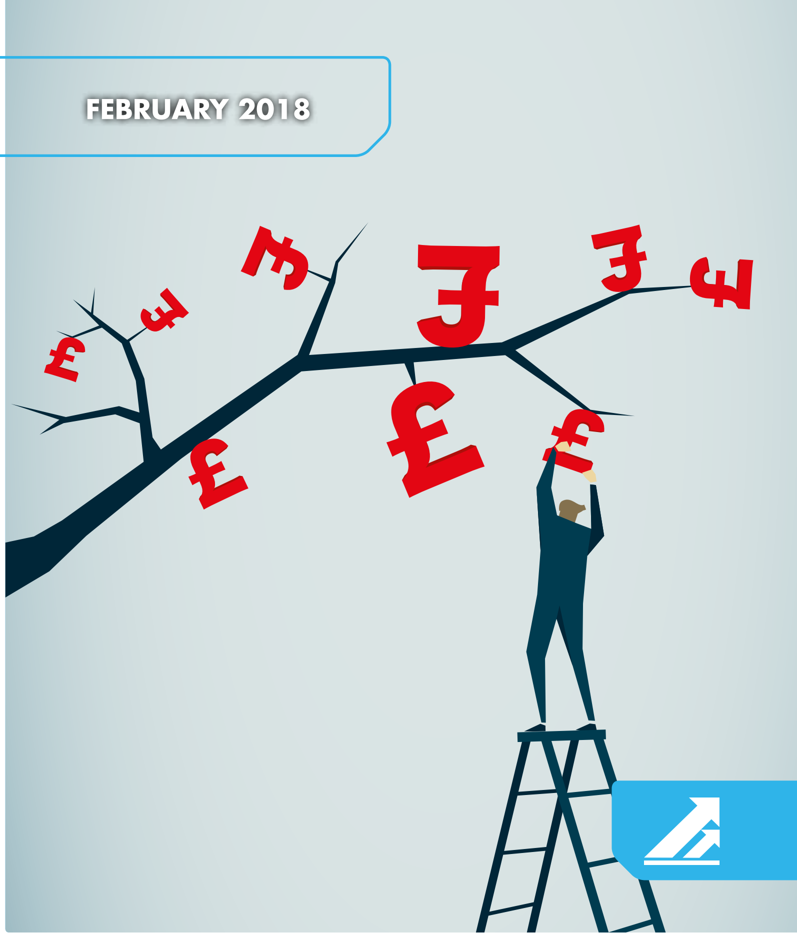
Orchid Financial Services Ltd



Investment trusts

An introduction to investment trusts.

The popularity of investment trusts has increased markedly over the past few years.

Research from the Association of Investment Companies, the trade body for the investment trust industry in the UK, revealed that financial advisers put a record amount of money into investment trusts in 2015.

While this has a lot to do with the growth of the platform market and the availability of investment trusts via advisers, understanding how investment trusts operate and the opportunities they present is essential for every serious investor.

This guide will provide the information you need to know before putting your money into investment trusts – what they are and what benefits and risks are involved.

What are they?

'Closed-ended' funds

Investment trusts are similar to other collective investment schemes, such as open-ended investment companies (OEICs) and unit trusts, in that they enable investors to pool their money together within a single fund. The capital is then invested in a variety of assets, such as stocks and bonds.

Investment trusts differ from OEICs in that they are 'closed-ended funds'.

Whereas unit trusts can continuously expand by creating and selling new units of the fund (known as an 'open-ended fund'), investment trusts have a limited number of shares.

Traded on the market

Shares in investment trusts are bought and sold on the stock exchange in the same way as company shares.

They trade when the stock market is open for business and sell at the prevailing price at that exact moment in time.

Like public companies, investment trusts must conduct an **initial public offering** in order to float their shares on the stock market.

The trusts' share prices will then rise and fall on the market according to supply and demand.

In comparison, units or shares in an open-ended fund are relatively straightforward to sell; most funds allow investors to sell at any time they wish at the daily published price for each fund.

Discounts and premiums

The share price of an investment trust does not necessarily reflect the net asset value of the trust (the total value of assets held by the trust).

Like any public company, the share price of an investment trust is determined by supply and demand.

When these two values diverge, the investor will either purchase shares at a discount or at a premium.

A discount occurs when an investor purchases shares when they are priced lower than the value of the trust's assets.

Conversely, an individual who invests when the share price exceeds the value of the underlying assets does so at a 'premium'.

Gearing

Another key difference between funds and investment trusts is the latter are able to borrow money for further investment. This is known as gearing.

This enhanced buying power enables trusts to take up investment opportunities without having to sell other assets to fund the purchase.

This can result in a trust buying large quantities of assets, thus producing either greater returns or greater losses (depending on the performance of the asset) vis-à-vis ungeared funds.

Fees

Investment trusts are generally seen as being cheaper than their open-ended cousins, and this was certainly the case a few years ago.

Before 2013, open-ended funds often charged commission fees while investment trusts did not, making them a more cost-effective investment option.

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Investment trusts

The practice of charging commission was abolished in 2013 and the costs of investing in open-ended funds have since become cheaper and more aligned with investment trusts.

You will likely encounter the following fees when investing in closed-ended investment companies:

Management fees are charged by the investment manager for their services of managing the trust's assets.

Annual charges are fees (usually between 0.5% and 1%) charged to cover the annual cost of running the trust.

Performance fees are an additional fee charged by some trusts if the trust's investment performance exceeds expectations.

Why are investment trusts attractive?

Stability

Closed-ended investments are generally more stable than their open-ended equivalents.

Unit prices of open-ended funds are directly linked to the net asset value and will therefore fall in value when the portfolio dips.

The fund manager may be forced to sell assets in order to redeem investors wanting to exit the fund.

In comparison, the share prices of closed-ended investments are not directly linked to the net asset value due to their fixed capitalisation.

This means that the investment managers of investment trusts are not under pressure to sell assets in the event of a market sell-off, and are not required to maintain cash reserves to meet future redemptions.

Investment trusts are therefore usually more financially stable during market sell-offs.

Board of directors

Due to being public companies, each investment trust has a board of directors.

The board of directors oversee the performance of the investment manager, ensuring they always act in the best interests of the investors and in line with the investment trust's objectives.

Should the trust significantly underperform or if the manager is judged to not have acted accordingly, the board may decide to replace them.

Dividends

Most open-ended funds pay out all of the dividends produced in a given financial year. Investment trusts are different.

Instead, closed-ended investments can retain up to 15% of shareholders' dividend income and pay it out when assets are underperforming and returns are lower. This may mean taking the occasional lower return.

However, should the trust suffer losses in the future, the remaining dividend income will reduce the negative impact on the trust's returns.

What are the risks involved?

There are three aspects of risk you should assess before investing into a closed-ended investment trust:

The assets

Like investing in a fund, asset risk accompanies investment. Different trusts will invest in assets with varying levels of risk.

Some will buy high-risk, potentially high-yield assets, while others will stay low risk and low yield.

Some will hold mainly liquid portfolios (comprised of assets that are easy to sell), while some will buy mainly illiquid assets, such as property.

Always know what kind of assets the trust invests in and how risky they are.

Discount and premium

Closed-ended investments are more complex than open-ended funds due to the frequent divergence of the share price from the net asset value.

It is imperative to know the trust's net asset value before investing. This way you will understand whether you will be purchasing shares at a discount or a premium.

Gearing

Nearly all investment trusts use gearing to some extent – it's a benefit of this particular structure.

However, whether or not gearing is more of an advantage or a disadvantage usually depends on your investment strategy and your appetite for risk.

As previously explained, gearing allows the investment manager to purchase additional assets on credit if they believe they will perform well in the future.

Should the investment manager make the correct calls, returns from investment trusts will be greater.

However, should the manager make bad investments, investment trusts may prove more hazardous than open-ended funds.

Investing in greater quantities of poor assets will amplify your losses as some investment trusts use gearing to varying extents, while some do not.

How to invest

All shares in investment trusts are listed on the stock market, and you usually buy them through an intermediary. These include:

- stockbrokers
- investment platforms
- some financial advisers and intermediaries
- an investment trust savings and investment scheme
- directly from the trust investment managers.

Contact us to discuss your investment strategy.

Important Information

This document is solely for information purposes and nothing in this document is intended to constitute advice or a recommendation.

You should not make any investment decisions based on its content. Investments can fall as well as rise in value and you may not get back the amount you invested.

While considerable care has been taken to ensure the information contained in this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information.