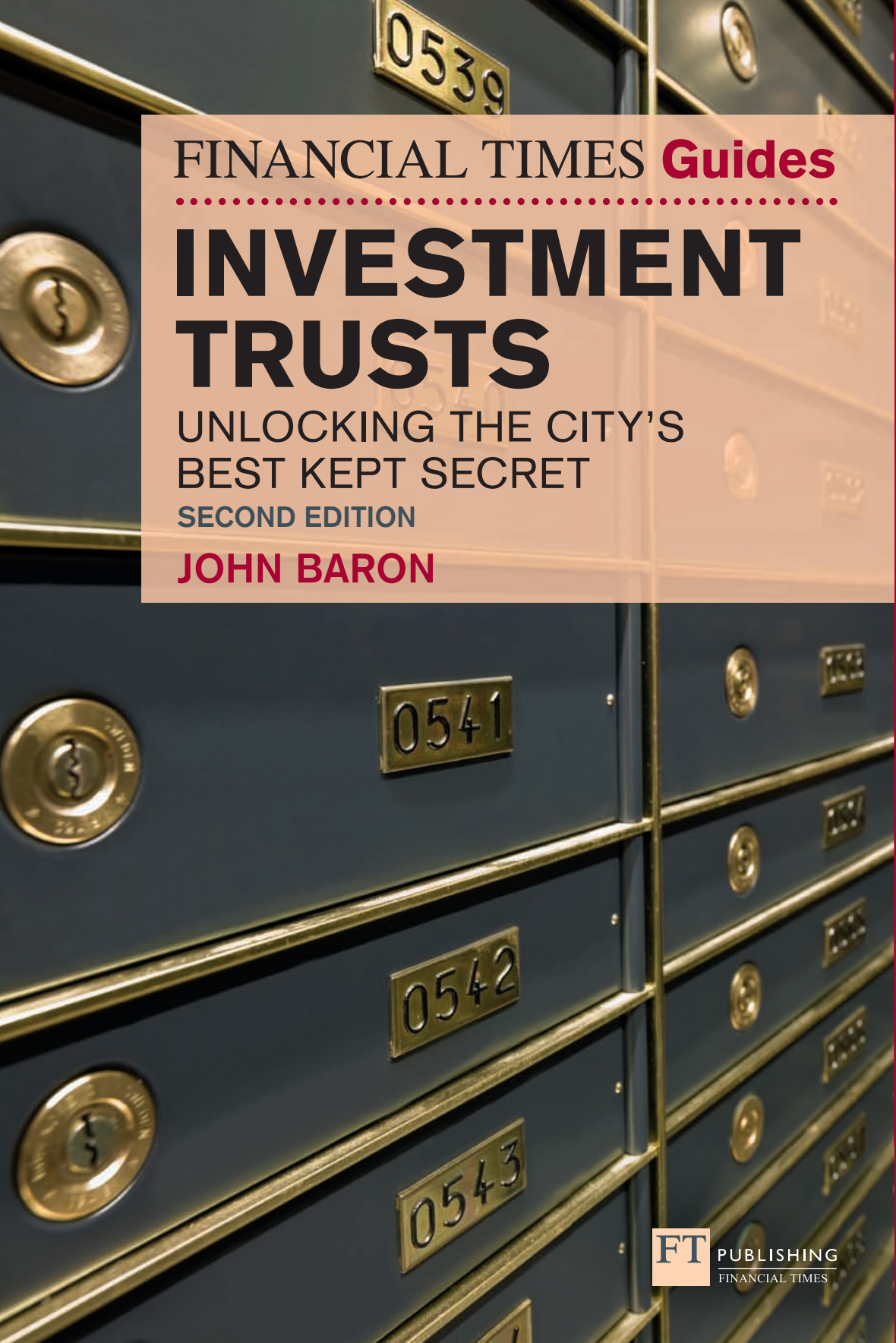

FINANCIAL TIMES **Guides**

INVESTMENT TRUSTS

UNLOCKING THE CITY'S BEST KEPT SECRET

SECOND EDITION

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The Financial Times Guide to Investment Trusts

Manager A then decides to pay back the investment trust's borrowings by selling some of its stock. Assuming its performance matches the market, the portfolio will then be worth £152 million, calculated as the £130 million portfolio rising 40% (and so equalling £182 million) minus a £30 million debt repayment.

Manager B's portfolio, again assuming performance matched the market, will be worth only £140 million – calculated as the £100 million portfolio rising 40%.

Table 5.1 **Two trusts with different gearing levels**

Trust	*Portfolio value*	*Borrowings*	*Invested in market*	*Portfolio value after 40% market rise*	*Debt repaid*	*Portfolio end value*
A	100	30	130	182	−30	152
B	100	0	100	140	0	140

However, in recognising that gearing typically assists when markets are rising, it is perhaps even more important to recognise that gearing usually detracts from performance when markets fall because the larger-sized portfolio makes for greater losses. So it is important for investors to comprehend how the level of gearing can affect performance before deciding whether to invest or, indeed, whether to stay invested.

Example

Let us assume in the example above that all remains as before except that the markets fall 40%. Manager A's portfolio will be worth £48 million, calculated as the £130 million portfolio falling 40% (and so equalling £78 million) minus the £30 million debt repayment.

On the other hand, Manager B's portfolio will be worth £60 million, calculated as the £100 million portfolio falling 40%.

Table 5.2 **Two trusts after a market fall**

Trust	*Portfolio value*	*Borrowings*	*Invested in market*	*Portfolio value after 40% fall*	*Debt repaid*	*Portfolio end value*
A	100	30	130	78	−30	48
B	100	0	100	60	0	60

In reality, investment trusts tend not to gear up by as much as 30%, but the example illustrates the point. Assuming 100 million shares in existence and no further debt after the repayment of the £30 million, in the two examples above, the Net Asset Value (NAV) for manager A would be £1.52 and £0.48 respectively, and £1.40 and £0.60 for Manager B. The figures highlight the extent which gearing can contribute to NAV volatility and by extension share price volatility.

But a further variable needs to be considered when evaluating gearing – and that is the actual cost of the borrowed money. The portfolio will benefit in relative terms if its total return exceeds the total cost of the debt. Conversely, the portfolio will suffer if its returns trail the cost of the debt. This is an obvious point to make but one worth repeating nevertheless, particularly if expensive debt has been taken on by an investment trust.

Managers can gear their portfolios in a variety of ways, but typically gearing is executed as follows:

- Via fixed-term borrowings that need to be redeemed at a certain point, usually after some years.
- Via variable short-term borrowing – variable in the sense that, within an agreed limit, the investment trust can vary the amount of the facility used depending on opportunities. This has become more common in the current low-interest environment.
- In both cases the interest rate charged can be variable or fixed.

The logic in practice

Whichever method is chosen, it is important to understand that gearing magnifies NAV returns and therefore adds to the volatility of the share price. Table 5.3 illustrates how the NAV of an investment trust might theoretically rise or fall depending on the performance of the underlying assets and the extent of gearing employed. If a trust is 30% geared, a rise of 20% in the underlying assets will result in the NAV rising 26% – and vice versa.

Table 5.3 How gearing affects performance

		0%	*10%*	*20%*	*30%*
Change in value of assets	−30%	−30%	−33%	−30%	−39%
	−20%	−20%	−22%	−24%	−26%
	−10%	−10%	−11%	−12%	−13%
	+10%	+10%	+11%	+12%	+13%
	+20%	+20%	+22%	+24%	+26%
	+30%	+30%	+33%	+36%	+39%

The table indicates how much the net asset value of an Investment company might theoretically rise or fall depending on the performance of the underlying assets and how much gearing the company has. The more highly geared the company is, the more any gains or losses are magnified.

Source: AIC

If the gearing has benefited the portfolio, then borrowings can be repaid from the enhanced profits. But of course, as also illustrated by Table 5.3 above, it can work in the opposite direction. Gearing can also magnify losses on the way down as returns have to accommodate a greater exposure to the market and the cost of the debt.

Extent

In general, gearing is not extensively used in the investment trust sector as managements and boards tend to be conservative. An analysis last year of the entire sector suggested that only around 10% of trusts used gearing of 20% or more. Most mainstream equity trusts had gearing which fell well short of 20%, whilst around half of trusts were not employing any gearing at all.

The commercial property sector is the main exception, perhaps because of the nature of the asset. The more secure the asset (in this case, bricks and mortar), the less the associated risk when borrowing against those assets. But even here, gearing levels are more conservative than they used to be and the refinancing by trusts has taken advantage of the low interest rate environment.

Another exception is the fixed-interest sector. This is because many of these trusts use gearing to create a larger portfolio in order to pay out a higher dividend – hence the attractive yields. And their gearing ranges

reflect this reality. Companies such as City Merchants High Yield (CMHY), CQS New City High Yield Fund (NCYF) and Invesco Enhanced Income (IPE) have limits of 30%, 25% and 50% respectively.

Safeguards

These gearing limits ensure safeguards are in place so that investment trusts do not over-borrow and in doing so unduly raise the risk profile of the company beyond that agreed with the board and shareholders. Managers cannot just borrow what they please. Restrictions on the extent of borrowing are stipulated by the independent board of directors and confirmed by shareholders at the annual general meeting.

Should managers wish to borrow beyond the agreed limits they have to seek permission – and justify their requests. The board of directors will scrutinise proposals on behalf of shareholders and make the appropriate recommendation to shareholders. Meanwhile, the board will be monitoring the manager's use of the existing debt facility to ensure it remains within agreed bounds.

'Net' and 'Negative' gearing

One further thought relating to cash levels. Although a trust can be 10% geared (it has borrowed and used funds equivalent to 10% of its equity), investors need to recognise that the level of cash held within the portfolio needs to be accounted for when assessing the level of gearing and risk. Cash acts as a counter to borrowed money and so reduces gearing. Therefore, the trust mentioned above is not geared at all if its cash level amounts to 10%.

In recognising the importance of this, the most widely quoted gearing figure used by the investment trust sector is the 'Net gearing' figure. This is now the industry standard. This figure has already netted off the cash element to ascertain the true invested exposure. Investors do not have to adjust the figure for the portfolio's cash position as it has been calculated for them.

Investors also need to be aware that gearing takes effect not when the borrowing facility or debt is arranged, but when it is used – an obvious point but sometimes forgotten all the same. Theoretically, if such a facility is not

utilised and therefore no assets have been bought with borrowed money, and the portfolio contains a cash level of 15%, the trust can be said to have 'negative gearing'.

All in all, investors need to be aware of the extent of the borrowing facility, the amount of debt being deployed and the level of cash being carried by an investment trust in order to assess the extent to which gains or losses can be amplified. In the vast majority of cases, the debt level is relatively benign. Those trusts which are geared do not usually exceed 10–15%. In the hands of an experienced management team, such levels have proved a positive over time.

The issue of sentiment

The market is usually cognisant of the minority of cases where gearing levels are particularly high as, falling markets aside, gearing can be unhelpful in other ways than just hindering performance. If an investment trust is highly geared, it will usually be viewed with caution by investors given the added risk and expected volatility should markets see turbulence. Such sentiment will affect the share price and make for discounts which reflect the perceived risk.

Meanwhile, high and multi-tiered debt can make for complexity when evaluating the NAV, and this can also put investors off. Even analysts can struggle to quantify quickly how such debt can affect portfolio performance under different market scenarios, particularly if the multi-tiered debt is being serviced at different interest rates. Investment trusts are increasingly aware of this and some are trying to simplify their debt structures.

Those investors seeking yield from investment trusts which have used gearing to assist in the generation of income also need to understand them well. A high level of gearing can bring into question the sustainability of the dividend should markets fall significantly. In the end, debt has to be repaid or re-serviced, and the cost can usually only be financed from the portfolio's assets. Debt is rarely a positive influence unless markets rise.

Furthermore, investors should not take too much comfort from the low cost at which investment trusts are borrowing or refinancing their debt,

and therefore see gearing as an unblemished positive. This low interest rate environment, courtesy of an excess in debt and sluggish economic growth, has encouraged most financial assets to rise in price. This may continue but returns may be less than before, assuming markets do not fall. Investors should approach gearing with caution, regardless of its cost.

And examine carefully deceptively cheap investment trusts as they may be cheap for a reason. Always look under the bonnet. Most brokers' lists or publications highlight gearing, but investors should not buy without knowing the facts and they should always keep an eye on changes. Investment trusts do need a little more monitoring than open-ended funds for this reason. We will touch upon gearing again when we consider discounts in the next chapter.

Understanding 'splits'

In addition to various forms of bank lending, there is another form of gearing which is less recognised but no less powerful in its potential to enhance or detract from returns – and that is the gearing generated within 'splits'. These are investment trusts which are subject to a particular capital structure which employ Zero Dividend Preference shares ('ZDPs' or 'zeros') as a form of borrowing again to assist the returns generated by the underlying assets. In this case, the remaining class of share being the Ordinary Income shares.

Their predecessor

Splits used to be commonly known as split-capital investment trusts, and there is a little history to this sub-sector. Split-capital trusts resembled ordinary trusts in that they managed a portfolio of investments on behalf of shareholders. However, they typically issued more than one type of share, unlike conventional trusts which issue just the one.

A normal investment trust will have equal ranking shares which enjoy the same entitlement to capital growth (or loss) plus any dividends along the way. A split-capital trust tended to have three types of share: Zeros, Income and Capital (the last two no longer exist). These different shares enjoyed different pre-determined entitlements to the capital and income returns of the portfolio. At least one component usually had a fixed wind-up date.