

Investment trusts: the case for consideration

An intermediary's guide to investment trusts, their
unique benefits and their role in client portfolios

Spring 2011

FOR INDEPENDENT FINANCIAL ADVISERS ONLY - NOT FOR RETAIL CONSUMERS

J.P.Morgan
Asset Management

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Acknowledgments

J.P. Morgan Asset Management would like to thank the following organisations for their generous assistance in compiling this report:

Association of Investment Companies (AIC)

Lipper, a Thomson Reuters company

Numis Securities

Winterflood Securities

Foreword

Investment trusts represent the most enduring structure for pooled investment in the UK with a track record spanning 140 years. But with over 2,500 other retail UK based funds to choose from¹, why should an adviser consider investment trusts as well?

It is an important question – especially as the FSA has stipulated in its Retail Distribution Review (RDR) that investment trusts should be included in the spectrum of retail investment products considered by independent advisers from 2013².

At J.P. Morgan Asset Management, we provide investment solutions that span many types of fund structure, from OEICs to investment trusts to SICAVs. As the UK's largest manager of investment trusts³, we are inevitably a staunch supporter of these closed-end investment vehicles – and we are not alone.


Over £92 billion of assets are held in investment trusts⁴. The number of investment companies listed on the London Stock Exchange has seen net growth over the past six years. In 2010, 10 fund launches raise £1.16 billion, indicating that, even given a choice of other vehicles, the investment trust structure is still considered ideal for certain investment mandates.

Investment trusts may be a substitute for other types of investment vehicle but can also be an important complement to them, capable of serving many different clients. As we hope to show in this paper, low costs, a strong performance record and an RDR-ready charging structure should increase their appeal to any advisory firm looking to adjust their business to forthcoming regulatory demands.

This paper aims to be a practical resource for intermediaries who want to know how investment trusts work, the unique combination of benefits they offer and what specific roles they can fulfil in a client's portfolio.

We also recognise that investment trusts have not always been readily accessible to the wider adviser community. We, therefore, present our views on what we think needs to happen within key distribution channels to enable advisers to access investment trusts on a level footing with other products.

We hope this paper will inspire more intermediaries to consider investment trusts for their clients. As always, we value your feedback. If you have any thoughts about the paper or want to learn more about investment trusts, please email us at investment.trusts.guide@jpmorgan.com.



David Barron
Head of Investment Trusts
J.P. Morgan Asset Management,
Spring 2011

¹ Source: Investment Management Association – total number of unit trusts and OEICs.

² The FSA has specifically included both investment trust securities and savings schemes within its definition of a retail investment product. From 2013, 'independent' advisory firms will be required to base client recommendations on a comprehensive and fair assessment of the 'relevant market', which should include all retail investment products unless a firm specialises in a particular market (Source: FSA Policy Statement 10/6: Distribution of retail investments).

³ Source: Association of Investment Companies (AIC), by total market capitalisation and number of trusts as at 31 January 2011.

⁴ Source: AIC as at 30 September 2010.

Investment trusts – some facts

30% of investment trusts have a total expense ratio of less than 1% a year

Source: Association of Investment Companies (AIC)/Lipper – a Thomson Reuters company, July 2010.

Over 10 years, the average investment trust has turned £100 into £164.60

Source: AIC, based on conventional member companies using member data, assumes any income was reinvested, September 2010.

12 investment trusts now have assets of more than £1 billion each

Source: Numis Securities, excluding property and private equity, October 2010.

10 investment trusts have increased their dividend every year for more than 30 years

Source: AIC, September 2010.

Glossary of investment terms

In this report, the term ‘investment trust’ is used to refer to closed-end investment companies listed on the London Stock Exchange.

This can include conventional trusts that issue one share class and invest primarily in publicly-listed securities, split-capital investment trusts with multiple share classes, private equity trusts, property investment companies (including real estate investment trusts—REITs), venture capital trusts and listed hedge funds. It may also include offshore companies that are domiciled in an offshore centre such as Jersey and have an LSE listing.

A full explanation of how investment trusts work is given in Appendix i of this paper.

Glossary of investment trust terms

Capital share

A share in a split-capital investment trust that is entitled to all surplus assets on wind-up after other prior charges are met.

Closed-ended

Refers to investment funds such as investment trusts that have a fixed number of shares so the share price is driven by demand. See ‘Open-ended’.

Conventional trust

Investment trusts that invest primarily in listed securities and only issue one type of share.

Crest

Electronic system used to settle share transactions in the UK and Ireland.

Discount

Where an investment trust share price is lower than the net asset value per share. See also ‘Premium’.

Dividend yield

The annual dividend paid out by an investment trust expressed as a percentage of its current share price. A 10p dividend on a share trading at 250p would be a dividend yield of 4%.

Gearing

The practice of borrowing additional capital to invest to increase potential returns for shareholders. Also known as ‘leverage’.

Generalist

Name given to large investment trusts that invest across global markets.

Income share

A share in a split-capital investment trust entitled to income generated by the trust and in some cases, to capital when the trust winds up.

Investment company

Another name for any closed-ended fund that trades its shares on the stock market.

Investment trust

A closed-end investment company whose shares trade on the stock market. Must meet Section 1158 requirements of the Income and Corporation Taxes Act so gains within its asset portfolio are exempt from capital gains tax.

Leverage

Another term for ‘gearing’.

Net asset value

Broadly, the value of all of the assets and cash holdings within an investment trust, minus any debt or other liabilities.

Net asset value per share

The total value of a trust’s net assets divided by the number of shares in issue. A trust with total net assets of £80 million and 10 million shares in issue would have a NAV per share of 800p.

Open-ended

Refers to investment funds such as unit trusts and OEICs where the number of shares/units changes as investors move in and out of the fund and the share/unit price tracks its net asset value.

Premium

Where an investment trust share price is higher than the net asset value per share. See also ‘Discount’.

Real Estate Investment Trust

A listed investment company that invests directly in property, with beneficial tax treatment of income and gains.

Rights issue

An offer made by a company to its shareholders to buy further shares in the company, often at a discount to the current market price.

Share buy back

Where an investment trust offers to buy back a proportion of shares in issue. Used as a means to return cash to shareholders and to narrow discounts to Net Asset Value by reducing the number of shares available. See also ‘Tender offer’.

Split-capital trust

An investment trust that issues a number of share classes, each with differing entitlements to income and/or capital from its assets. Often has a fixed-term life.

Tender offer

An offer made by a company to shareholders to repurchase a proportion of its shares – usually at a narrower discount than the prevailing price.

Treasury shares

Share capital that is repurchased by an investment trust then held in treasury with the potential to be reissued at a future date. Used as a means to manage discounts.

Warrant/subsorption shares

Securities issued along with shares that give the right to buy more shares in the company at a specific price on a future date. Warrants can be traded independently.

Wind-up

The date when a fixed life trust distributes its assets to shareholders.

Zero-dividend preference share

A share in a split-capital investment trust that receives no income but instead gets a pre-defined capital gain on wind-up, provided assets in the trust have grown sufficiently.

Introduction – Why consider investment trusts for your clients?

The case for investment trusts is strong – and getting stronger

When it comes to collective investment funds, advisers and their clients are not short of choice. In the UK alone, there are over 2,500 unit trusts and OEICs⁵, with many more funds listed offshore in centres such as Luxembourg and Dublin. So why should advisers take notice of the 400-strong investment trust universe as well?

Quite simply, investment trusts offer a unique combination of attributes that may help meet both the long-term objectives of clients and the increasingly stringent demands of the financial regulator.

Key benefits of investment trusts include:

RDR-ready structure – Under RDR proposals, commission on investment products is set to be banned from 2013. Instead, advisers must agree the cost of their advice directly with their clients. Investment trusts have commonly operated on a fee basis rather than commission structure for years and so offer advisers and their clients an RDR-ready investment solution⁶.

Low-cost active management – With the advent of the adviser charging regime, more scrutiny than ever is going to be placed on investment charges by both advisers and their clients. This could create greater demand for low-cost passive investments such as index trackers and ETFs. But for those advisers and clients who want active investment, very few other retail investment vehicles have been able to offer professional portfolio management at lower overall cost than an investment trust.

Proven performance record – Many investment trusts have delivered strong long-term performance. As we hope to explain in this paper, this is the result of a low-cost structure, the ability to use leverage and partly because investment trusts are free to focus on their investment strategy rather than managing investor inflows and outflows.

Also, boards are required to justify the retention of the fund manager to shareholders each year and can replace poor-performing managers.

Board/shareholder control – As listed companies, investment trusts are controlled by their boards and managed in the interests of their shareholders. The board and shareholders determine how a trust invests – its use of gearing, whether to invest in both listed and unlisted shares and how aggressive their strategy should be. The focus is on optimising the agreed outcome for shareholders, pure and simple.

Income record – Many investment trusts have a consistent record of increasing their dividend year after year, often over many decades. This is partially the result of the less-fettered investment trust structure that allows trusts to retain income in good years to pay dividends in poorer years. On a long-term compounded basis, this has enabled some trusts to deliver strong after-inflation total returns.

Choice – As we will show in Part One, investment trusts span a broad spectrum of investment choice from generalist trusts providing a broadly-diversified portfolio to highly specialist trusts that can be used to target very specific areas of investment.

The closed-end structure of investment trusts lends itself especially well to less liquid stock markets or asset classes that may not be widely represented among open-ended funds. But equally, the sector has a reputation for creating world-class, globally-invested funds delivering steady, solid performance.

⁵ Source: IMA – Annual Survey, July 2010.

⁶ A few investment trusts do build commission into their charging structure; many investment trust savings schemes (share plans, ISAs, pensions, etc) have an option for investors to agree for commission to be deducted from their investment to pay their adviser.

Comment: Factors to be aware of

In the interests of balance, it is important to acknowledge some of the factors that have deterred investors from using investment trusts in the past.

Complexity – The structure of an investment trust whose share price is driven by market demand, rather than the value of its portfolio, does take a little more time to grasp. However any investor who understands how an ordinary share works should quickly understand the mechanics of a listed investment company.

Volatility – As a company trading on the stock exchange, the shares of an investment trust will generally tend to be more volatile than that of a comparable open-ended fund whose share price simply reflects its underlying portfolio. Investment trusts should always be viewed as a long-term commitment so that short-term share price fluctuations can be overcome.

Discounts – Investors can be deterred by the fact that investment trust shares can trade below the value of their investment portfolio (trading at a discount). Many trusts have measures in place to manage discounts. Plus as commentators in this paper observe, discounts can be used to the advantage of investors, enabling them to take advantage of investor sentiment to buy assets at a price below their fair value.

The Splits Crisis – One of the biggest deterrents for many advisers will be memories of the ‘splits crisis’ when a number of split-capital trusts with high gearing and cross-holdings collapsed in value. We would argue that most constituents of the investment trust sector are very different investments from these types of vehicles.

The professionals’ chosen investment

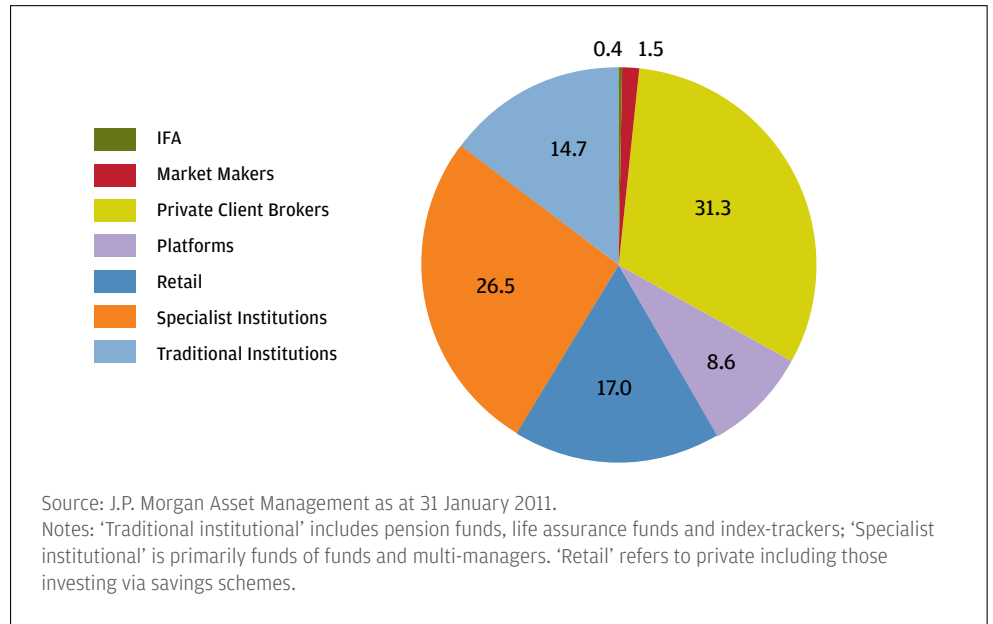
For intermediaries or investors who remain unconvinced of the benefits of investment trusts, it is worth examining who chooses to invest in investment trusts.

Data suggests that leading investment professionals and board members of investment trusts choose to maintain significant holdings in investment trusts. In the most recent Investment Trust Directors Survey 2009 conducted by J.P. Morgan Asset Management, for example:

- 70% of directors had increased their level of investment trust shareholdings over the past year
- 70% of directors claimed to favour investment trusts over other investment vehicles.

Meanwhile, a breakdown of the share register of the 21 investment trusts managed by J.P. Morgan Asset Management shows that the most dominant group of shareholders are the client nominee accounts of private asset managers and specialist institutional investors – see Diagram 1.

Diagram 1: Breakdown of shareholders of investment trusts managed by J.P. Morgan Asset Management



In other words, investment trusts are repeatedly the chosen investment vehicle of highly-experienced financial professionals. On the following pages we hope to show exactly why many investors favour investment trusts, whether for their own investment portfolios or those of their clients.

First-hand: Why we use investment trusts

Tom Hartley is Divisional Director at Brewin Dolphin

"We use investment trusts extensively for our discretionary clients. For clients with portfolios below £200,000 we use collectives such as investment trusts exclusively; for larger portfolios we hold individual UK equities and then use investment trusts to gain exposure to overseas markets and specialist asset classes like mining and healthcare.

One of the prime reasons for using investment trusts is cost. I levy an annual fee for my services so I want an investment vehicle that can help keep additional costs for my clients as low as possible.

I also like investment trusts from a gearing perspective. Being able to gear into a market recovery is an advantage and can make a significant difference to the returns you achieve for clients. Also I simply feel I can get under the bonnet of an investment trust. You get a lot of information and management teams tend to be very stable, in my experience.

I look for trusts that are trading at a discount but equally I expect an effective mechanism to limit discounts from widening too much. Explaining discounts to clients can be a challenge – and having to explain that a discount has widened dramatically isn't easy.

I think more intermediaries will start to consider investment trusts because as a low-cost, high-performing vehicle they are hard to beat. There will be prejudices to overcome and some trusts need to address liquidity issues and the bid-offer spreads that can arise when people are not buying.

Looking at the long-term numbers over 10 years plus, many investment trusts have outperformed. That's what advisers and their clients should be focusing on."

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Comment: Explaining the low take-up

There's no denying that investment trusts have experienced less take-up than other types of investment fund among the adviser community. As our own data shows, IFAs account for less than 1% of the shareholder base of investment trusts managed by J.P. Morgan Asset Management (see Diagram 1).

In April 2010, we asked IFAs why they think investment trusts are less favoured by the intermediary community. The main cited reasons were as follows:

Knowledge needs refreshing (cited by 28% of IFAs) – Many intermediaries say they aren't as familiar with investment trusts as open-ended funds and therefore feel less confident advising on them. From 2013 under Retail Distribution Review (RDR) proposals, any adviser calling themselves independent will be expected to assess investment trusts. The new qualification standards proposed under the RDR will involve more testing on investment trust knowledge. (All exams will have to cover 100% of the published FSA syllabus, which will mean compulsory coverage of investment companies and markets). As the UK's leading investment trust manager, J.P. Morgan Asset Management hopes to be instrumental in supporting advisers in improving their familiarity and understanding of investment trusts.

Low availability on platforms (cited by 26% of IFAs) – A number of leading investment platforms still don't include investment trusts. This makes it harder for intermediaries who use these online venues to administer investment trusts as part of a client's overall portfolio. As we discuss in Part Five of this paper, platform availability is now crucial to the future success of investment trusts. However, we anticipate that it will become easier for platforms to include investment trusts as adviser remuneration moves from commission to fee-based models.

No commission or trail fees (cited by 23% of IFAs) – As investment trusts do not automatically incorporate commission, it has been harder for intermediaries who operate on a mainly commission structure to accommodate them in their business model. If the RDR proposals do go ahead and intermediaries are required to operate on a fee basis, the investment trust structure should lend itself well to helping advisers make this transition.

IFA research conducted on J.P. Morgan Asset Management's Fantasy Fund Manager in April 2010.

Part One – A rich and diverse market

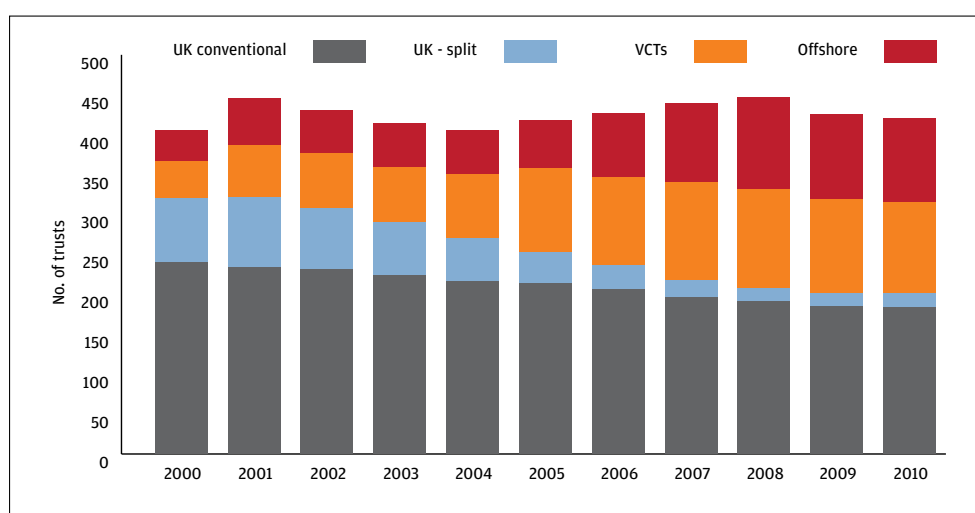
A sector of just over 400 trusts offers a wealth of investment opportunity.

The investment trust market is around a sixth of the size of the unit trust/OEIC market in terms of numbers of trusts and a fifth of the size in terms of assets under management⁷, yet it still offers a highly diverse range of investment opportunities covering all global markets and a wide variety of asset classes.

The sector has experienced both contraction and growth over the past 10 years. UK-listed investment trusts have fallen in number from over 300 to around 200. This is primarily due to contraction in the split-capital sector, whose numbers have fallen from 80 in 2000 to just 17 today, following the collapse of highly-geared income trusts in 2002.

However, this contraction has been countered by growth in venture capital trusts and in investment companies domiciled offshore to take advantage of lower rates of corporate tax. Today the investment trust sector comprises 421 investment companies – see Diagram 2.

Diagram 2: The changing structure of the investment trust market



Source: AIC figures to end-September 2010.

Comment: A sector with survivor bias

The fact that the investment trust sector has stayed constant at around 400 constituents is sometimes considered indicative of a sector struggling to achieve real growth.

Sector growth has been impacted by the fall-out from the split-capital sector early in the last decade. However, we would also suggest that the more modest size of the sector is proof of a healthy stock market discipline that naturally excludes weak performers or short-term opportunistic fund launches.

Survivor bias – The listed structure of investment trusts mean that, like any public company, only the strong survive long-term. The last 10 years have seen significant consolidation among UK investment companies as poor performers or trusts trading at wide discounts have been liquidated or taken over. This rationalisation should give investors greater confidence that those trusts that remain – or new ones that are launched – are well-managed and have a strong investment story.

High barriers to entry – Launching a publicly-listed company requires scale and resources. Today, investment trusts are only launched where there is high conviction in the investment proposition and a trust's ability to attract capital. Winterflood Securities, the investment trust analysts, point out that new launches below £40 million are now very rare as a trust would be very illiquid in the secondary market and the costs involved would render the fund unviable.

⁷Investment trust sector as measured by AIC – 421 companies with total assets of £92.1 billion as at 30 September 2010; OEIC/unit trust sector using IMA data – 2401 funds with total assets of £542.6 billion as at 30 September 2010.

Investment trust sectors

Like open-ended funds, investment trusts are grouped into investment sectors for performance and analysis purposes. These sectors are overseen by the AIC. Investment sectors can be broadly divided into the following categories:

Core equity

These are conventional structured trusts investing primarily in publicly-listed shares on recognised stock exchanges.

As well as trusts investing in individual markets and regions, the sector includes a number of so-called 'generalists' trusts that offer broad global exposure. Generalists like Alliance, Foreign & Colonial Trust and Witan, rank among the biggest, best-known trusts in the industry, benefitting from economies of scale and low total expense ratios.

Global and UK sectors are divided into those trusts aiming for growth, income or a combination of the two.

Sector and country specialist

The investment trust structure is used extensively to invest in less liquid asset classes and markets. As well as covering specialist geographic markets, trusts are available investing in diverse areas such as biotechnology, natural resources and forestry.

Property

Investment trusts are used as an easily tradable means of investing in property. In 2007, legislation was enacted in the UK enabling the introduction of real estate investment trusts (REITs) – listed property funds with beneficial tax treatment in that gains and income are taxed only on the investor, not at the corporate level. REITs invest directly in property; property investment trusts that invest in the shares of property-related companies are also available.

Venture capital trusts

Venture capital trusts (VCTS) offer a means to invest in private, unlisted companies. To encourage investment in enterprise, VCTS have tax breaks including capital gains tax deferral and no personal income tax on dividends. VCTS have been one of the biggest growth areas of the investment company sector, increasing in number from 47 in 2000 to 114 in 2010 (source: AIC).

Split-capital trusts

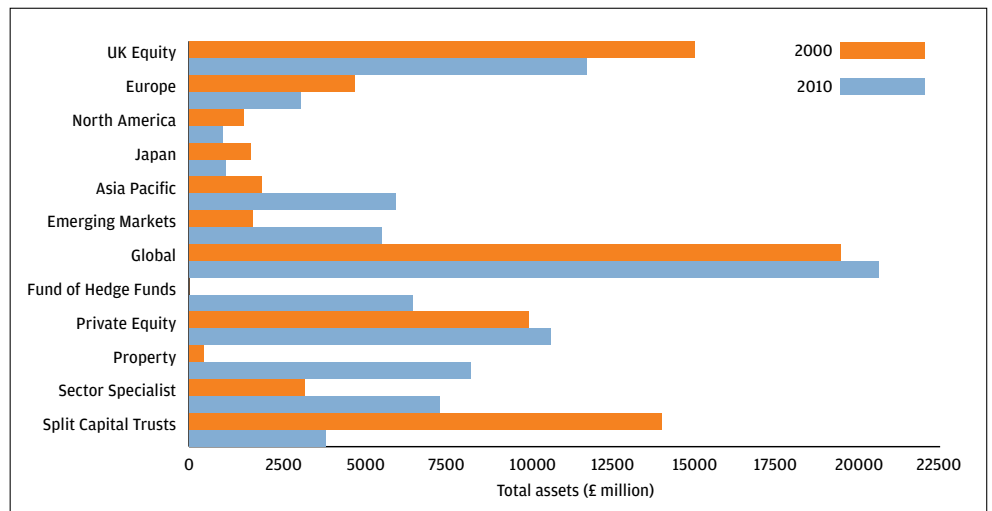
These trusts issue a number of share classes to meet the needs of different investors – for example income shares to receive all the income, capital shares that receive only capital growth, plus zero-dividend shares that have a pre-set capital gain. Split-capital trusts may have a fixed life, at the end of which assets may be shared out among the different shareholders in line with their entitlement, or assets are rolled over into a new trust.

The high-profile collapse at the early part of the last decade of highly-g geared, income-generating splits has impacted their reputation. However, there are signs of a gradual return of interest in split-capital structures.

Evolution of the sector

If we look at the industry by sector – see Diagram 3 on page 10 – we see a clear shift in focus over the past decade:

- generalist mandates investing in global and UK equity still dominate in terms of assets under management – although UK equity has declined;
- sectors focused on developed regions (US, Europe and Japan) have all seen contraction;
- specialist asset classes such as emerging markets, Asia Pacific, property and fund of hedge funds have all seen significant growth;
- split-capital trusts have seen total assets drop by almost three-quarters in 10 years.

Diagram 3: Distribution of total assets in investment trust sector 2000 vs 2010

Source: AIC figures to end-September 2010.

We believe this reflects a key future function of the investment trust sector within the savings market: to enable investors to access less liquid and more volatile markets and asset classes. Consequently we expect to see more growth in specialist asset classes.

Glossary: Open-ended vs closed-ended

Investment trusts are often differentiated by being referred to as closed-ended rather than open-ended. Closed-ended simply means they have a fixed number of shares (they are 'closed' after the initial share issue). Conversely, open-ended funds including unit trusts and OEICs can continuously create and cancel shares in line with investor demand.

Although they are closed-ended, investment trusts can take steps to increase or reduce the number of shares in circulation, including open offers, tenders and share buybacks, subject to shareholder approval.

Comment: Investment trust vs Exchange Traded Fund

Some advisers may question the value of investment trusts now that investors have access to another type of low-cost listed investment fund, the Exchange Traded Fund (ETF).

ETFs have seen major growth since 2005 when UCITS III regulation allowed greater use of derivatives in retail funds. Today there are 268 ETFs listed in the UK.⁸ Like investment trusts, ETFs are tradable on the stock market with a price that fluctuates throughout the trading day. Unlike investment trusts, ETFs are open-ended and should track the value of their underlying assets (although tracking errors can vary).

ETFs have been promoted as very low cost, with total expense ratios (TERs) typically of 0.2% - 0.75%pa. This reflects the fact that they are passive investments that simply track the value of a market index, an asset class or group of shares. There is no portfolio management team to select investments. Unlike investment trusts, ETFs cannot take steps to mitigate market falls or strategically gear up to enhance returns in rising markets. Nor is there an independent board to safeguard shareholder interests.

As such ETFs are only appropriate for investors who want pure market exposure - and a return in line with their underlying market or sector.

In short, ETFs have a valuable role to play but one that is very different from investment trusts, which can offer the benefits of active management for just 40 or 50 bps more than their ETF equivalents (see page 15 for more on investment trust TERs).

⁸ Source: London Stock Exchange - September 2010; excludes ETCs and ETNs.

Part Two – Benefits of investment trusts

A company structure provides investment trusts with many advantages.

As public limited companies, investment trusts are able to manage money in a way that's different from other retail funds. In this section we want to outline the key features that are so compelling for investors. In Part Three, we then assess what these advantages have meant in terms of performance.

1. Fixed pool of assets

A 'closed-end' investment trust issues a fixed number of shares. This means the portfolio managers always know how much capital they have to manage and do not need to worry about immediate liquidity in the fund in order to meet investor redemptions.

This lack of liquidity constraints has three benefits:

- the fund can hold illiquid investments such as real assets, emerging market securities or smaller company stocks;
- the manager can take a very long-term view on their investment strategy and only needs to buy/sell investments when the time is right;
- there is no need to hold excess cash in the portfolio to meet investor redemptions.

The closed-end structure also means that investor panic cannot force a fund to sell high-quality assets simply to meet investor demands for their cash. During periods of market panic, investment trusts can trade at high discounts but cannot be crippled by high investor outflows.

First-hand: The specialist manager

Richard Titherington is Chief Investment Officer and Head of Emerging Markets Equity at J.P. Morgan Asset Management

"In emerging markets, the benefits of a closed-end fund can be extensive. For a start, emerging markets are a very cyclical asset class: money flows in from investors when markets are rising and flows out very quickly when markets fall.

An investment trust manager, however, can be contra-cyclical if he or she wishes - selling when the market is rising and buying when it's falling. That can have a huge impact on performance and proved very beneficial to our performance in 2008/2009.

Being closed-end also gives you flexibility over what you invest in. For example, we spend a lot of time looking for promising small-cap stocks in markets like Russia and Hong Kong – but these are often highly illiquid holdings that you couldn't hold extensively in an open-ended fund. In the JPMorgan Emerging Market Investment Trust, small-caps have been able to account for 10% of our portfolio and have delivered 15% of our gains – and there are many more of these smaller stocks that we want to invest in.

Finally, the fundamental point of investing in emerging markets is long-term compound growth. With minimal inflows and outflows, we can take an extremely long-term view on our holdings. Over time the benefit of that to investors is very evident."

2. Investment freedom

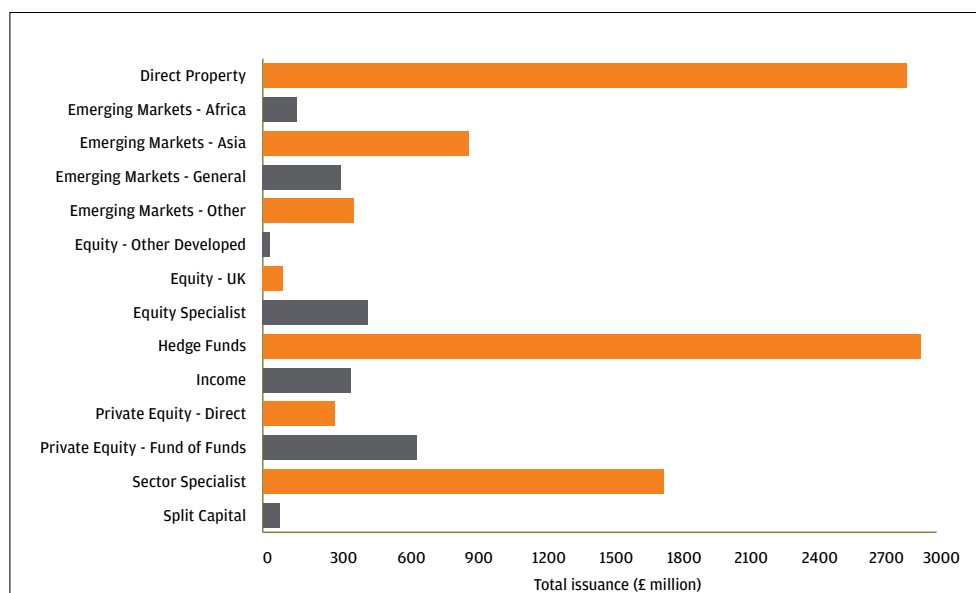
The investment strategy of an investment trust is determined by its board and shareholders. This is set out in a published investment objective that can only be altered with the consent of shareholders.

An investment trust can invest in an almost unlimited range of investments, provided they fall within its Articles of Association and meet board approval. This gives investment trusts extensive scope to invest in areas such as private equity, other unlisted investments and unapproved stock exchanges (although, in practice, the majority of investment trusts focus on more liquid securities listed on recognised stock exchanges).

This freedom can result in highly dynamic strategies – and the opportunity for private individuals who are willing to accept higher levels of risk to access highly-specialist areas of investment that might otherwise only be available to professional investors.

Diagram 4 below, detailing all investment trust issuance over 2005–2010, shows how the sector is attracting launches in highly-specialist areas of investment, while launch activity in traditional sectors such as the UK and other developed equity markets is very low.

Diagram 4: Investment company issuance by sector 2005–2010 YTD £ million



Source: Winterflood Securities, Morningstar, data to end-August 2010.

3. Gearing

Compared to other types of fund, investment trusts also have far greater freedom to 'gear up' – in other words, to borrow money to invest in order to enhance shareholder returns.

Under UCITS/FSA regulations, authorised open-ended funds can maintain gearing of up to a maximum level of 10% of assets. If the fund has EU UCITS authorisation, leverage must only be used temporarily. Investment trust boards, with approval from shareholders, can set their own limits and trusts can be geared indefinitely.

Being able to borrow capital to invest can have a significant impact on performance. Diagram 5 below shows how different levels of gearing can potentially enhance returns in a rising market. Over 20 years for example, modest leverage of 5% has increased the total return on the FTSE All-Share Index from 195.8% to 215%, while 20% leverage has increased it to 235%.

However, gearing can also amplify potential losses. As Diagram 5 also shows, higher gearing correlates to greater volatility. In our example, 20% gearing has caused volatility on the FTSE All-Share to rise from 15.6% to 20%.

Diagram 5: Impact of leverage on performance

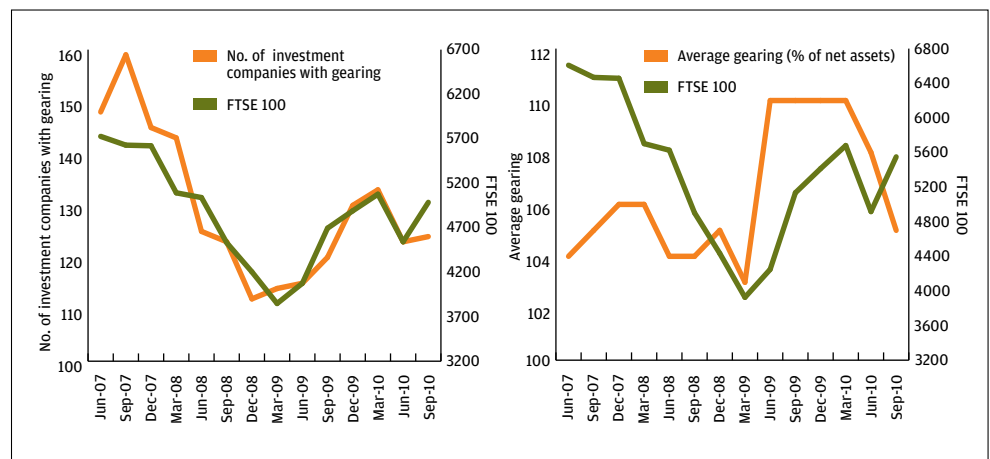
FTSE All-Share	1 year	5 years	10 years	20 years	Volatility
- no leverage	13.6%	10.2%	-4.6%	195.8%	15.6%
- with 5% leverage	14.3%	10.7%	-4.8%	205.6%	16.7%
- with 10% leverage	15.0%	11.2%	-5.1%	215.4%	17.7%
- with 20% leverage	16.3%	12.2%	-5.5%	234.9%	20.0%

Source: J.P. Morgan Asset Management. Figures to end-October 2010.

Oversight by the board is required to ensure that a trust is not inappropriately geared. Trusts must explicitly state their maximum potential gearing and this will indicate to investors what level of volatility they can expect.

Overall levels of gearing among investment trusts tend to rise and fall throughout the market cycle. Diagram 6 shows how the number of trusts using gearing, and the average level of gearing per trust, tends to rise and fall in tandem with markets. As at late-2010 we are seeing a pick-up in gearing, although the number of geared trusts is still below pre-credit crisis levels.

Diagram 6: How leverage levels have changed throughout the market cycle



Source: Winterflood Securities, Morningstar, data to end-August 2010.

First hand: Using leverage

Stephen Macklow-Smith, a European investment manager at J.P. Morgan Asset Management, gives a personal view on gearing.

“Gearing is a very powerful tool for a fund manager, but in recent years it has had to be actively managed through the market cycle in order to add maximum value for shareholders.

We use gearing partly to enhance our views on individual stocks. At a market level we take a contrarian approach, typically increasing leverage when markets are unloved and undervalued and reducing it when markets look overloved and overbought.

To take one example, maximum gearing for one of our European investment trusts is 20%. We reached this level in 2000 but rapidly moved to a net cash position in 2002 as markets started to overheat. We then redeployed gearing between 2003 and 2007. One misstep was increasing gearing in July 2008 when markets were looking oversold. However, since early-2009 the decision to remain moderately geared has served us well. In the financial year to March 2010, the trust outperformed its benchmark by 6.3% on a NAV basis, of which 4.3% was attributable to gearing.

As European markets continue to move sideways, skilful use of gearing will be key to delivering returns. The long-term performance of investment trusts is indicative of the value that gearing can offer.”

4. Income control

The corporate structure of an investment trust gives it the ability to manage its income very skillfully. Whereas authorised open-ended investment vehicles are obliged to distribute all of their income, an investment trust can retain up to 15% of its annual income as reserves. This can potentially be used to supplement dividends in future years, helping to ensure a steady income is paid to shareholders whatever the business environment.

Because of this structure, a number of global and UK investment trusts have built a reputation as very reliable income funds, increasing their dividend every year for a period of decades – see Diagram 7.

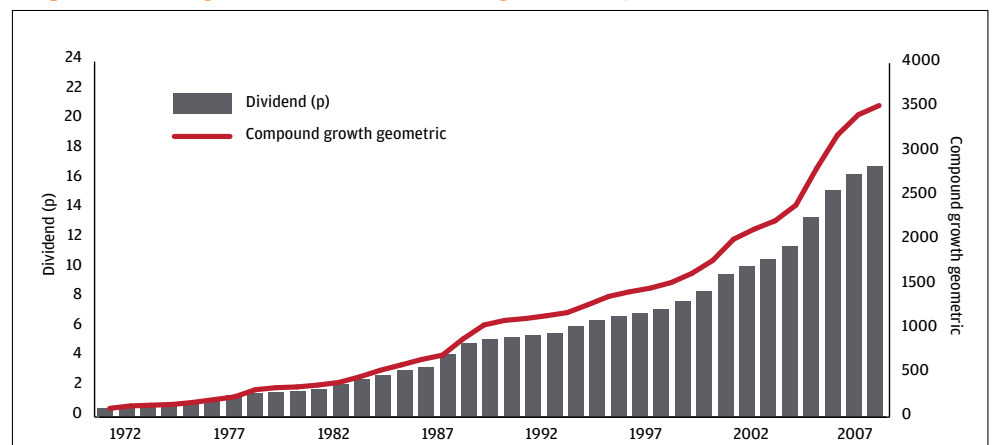
Diagram 7: Long-term dividend increasers

Companies	Manager	Sector	Number of consecutive years of dividend increase
City of London Investment Trust	Henderson	UK Growth & Income	44
Alliance Trust	Self managed	Global Growth	43
Bankers Investment Trust	Henderson	Global Growth	43
Caledonia Investments	Self managed	Global Growth	43
Albany Investment Trust	Rathbone	UK Growth	41
F&C Global Smaller Companies	F&C	Global Growth	40
Foreign & Colonial Investment Trust	F&C	Global Growth	40
Brunner Investment Trust	Allianz Global Investors (RCM)	Global Growth	38
JPMorgan Claverhouse Investment Trust	J.P. Morgan Asset Management	UK Growth	37
Witan Investment Trust	Self managed	Global Growth	34
Scottish Mortgage Investment Trust	Baillie Gifford	Global Growth	28
Merchants Trust	Allianz Global Investors (RCM)	UK Growth & Income	28
Murray Income	Aberdeen	UK Growth & Income	27
Scottish Investment Trust	Self managed	Global Growth	26
Temple Bar	Investec	UK Growth & Income	26

Source: AIC, September 2010.

The ability to increase dividends continuously year on year can offer a safeguard against inflation – particularly when combined with share price growth. Diagram 8 below shows share price and dividend growth from J.P. Morgan Claverhouse Investment Trust, a UK growth strategy that has increased its dividend every year since 1972.

Diagram 8: JPMorgan Claverhouse – Dividend growth compared with UK Retail Price Index



Source: J.P. Morgan Asset Management figures to 2010.

The majority of investment trusts generate income from mainstream equities. The sector also offers diversification into more specialist sources of income including emerging markets and high-yielding real assets such as property and infrastructure. Thanks to recent tax changes, investment trusts also have more scope to invest in fixed-interest securities, but investor interest in a bond-focused investment trust has so far proven low.

5. Competitive costs

Investment trusts have long been promoted as low-cost investments. While this is true, we would acknowledge that the claim is not completely clear-cut.

The trail issue

On a simple comparison basis, investment trusts on average have lower total expenses than unit trusts and OEICs. On a UK-invested investment trust, the average annual total expense ratio (TER), including any performance fee, is 1.29% compared to 1.63% for an open-ended fund, according to data from Lipper. For a global trust, the average TER for an investment trust is 1.14% but 1.66% for an open-ended fund – see Diagram 9i.

But it is often pointed out that the cost differential between closed and open-ended funds can be largely accounted for by trail commission. Once a nominal 0.5% trail is stripped out from an open-ended fund's TER – as it may well be from 2013 – the cost of an investment trust and an open-ended fund is broadly the same.

Diagram 9: How TERs on investment trusts compare with unit trusts/OEICs

i Total Expense Ratios – simple average		
	Investment trusts	Unit trusts & OEICs
Total universe	1.56%	1.68%
Global	1.14%	1.66%
UK	1.29%	1.63%
Asia Pacific	1.34%	1.71%

Source: Lipper – a Thomson Reuters company, as at August 2010.

TERs take account of performance fees. Unit trust data includes actively-managed funds and excludes institutional funds and other additional share classes. VCTs have not been included in the investment trust data.

ii Total Expense Ratios – asset-weighted average		
	Investment trusts	Unit trusts & OEICs
Total universe	1.20%	1.65%
Global	0.89%	1.67%
UK	0.94%	1.61%
Asia Pacific	1.28%	1.68%

Source: Lipper – a Thomson Reuters company, as at August 2010.

TERs take account of performance fees. Unit trust data includes actively-managed funds and excludes institutional funds and other additional share classes. VCTs have not been included in the investment trust data.

The size effect

However, the tendency for many investment trusts to reduce their management charges as they grow, along with other factors such as fixed administration charges, means that TERs often drop significantly the larger an investment trust becomes – and to a much greater degree than on other types of investment fund where board pressure does not exist.

Diagram 9ii, above, shows the table of average TERs again but this time with averages weighted by the size of assets within each trust in the universe. The TERs on unit trusts and OEICs have dropped only by a couple of basis points. However average TERs for investment trusts have dropped significantly - indicating that TERs on larger investment trusts are well below average.

This is further illustrated by Diagram 10 detailing the 10 largest investment trusts by assets under management. Seven of the growth trusts have TERs below 1% and four have a total expense ratio below 0.7%. Even the two highly specialist trusts investing in emerging markets and natural resources have TERs that are highly competitive for their particular asset class (including performance fees).

Diagram 10: 10 largest investment trusts by assets and their TERs

Company	Manager	Sector	Gross Assets (GBP m)	TER (%) inc perf fee if applicable
Alliance Trust	Self managed	Global Growth	£3,077m	0.70%
Scottish Mortgage	Baillie Gifford	Global Growth	£2,291m	0.56%
Foreign & Colonial	F&C	Global Growth	£2,248m	0.51%
Templeton Emerging Markets	Templeton	Global Emerging Markets	£2,254m	1.28%
RIT Capital Partners	Self managed	Global Growth	£2,022m	1.88%
BlackRock World Mining	BlackRock	Commodities & Natural Resources	£1,443m	1.47%
Mercantile	J.P. Morgan Asset Management	UK Growth	£1,305m	0.54%
Caledonia	Self managed	Global Growth	£1,255m	1.17%
Witan	Self managed	Global Growth	£1,189m	0.90%
Monks	Baillie Gifford	Global Growth	£1,122m	0.64%

Source: Morningstar TER figures as at 2010; Gross Assets as at October 2010.

TER trends

There are signs that average TERs on investment trusts have crept up, having declined steadily between 2005 and 2008. This reflects the fact that a growing proportion of the sector is focused on specialist mandates investing in areas such as property, emerging markets and hedge funds. However the AIC has identified that 30% of investment trusts still have TERs below 1% and 58% have TERs below 1.5%¹⁰.

Although it is too great a generalisation to say that all investment trusts are low cost, we can conclude the following:

- Currently with all ongoing costs taken into account, investment trusts are lower-cost on average than open-ended funds across most sectors.
- This differential may potentially narrow as open-ended funds cease inclusion of trail commission in their annual management charge, in line with RDR requirements (although there is little visibility yet as to how the open-ended fund industry generally intends to adjust its charging post-2012).
- The presence of an independent board creates pressure on listed investment companies to maintain competitive costs as their assets increase so the lowest TERs tend to be found on the largest trusts.
- The recent upward trend in average total expense ratios across the investment trust sector reflects increased prevalence of highly specialist investment strategies within the sector.

As with any investment, it is important for advisers and investors to look beyond average costs and assess charges on a sector-by-sector and a fund-by-fund basis. On this basis, we would maintain that total expenses on investment trusts remain highly competitive for the type of active management being provided.

¹⁰ Source: AIC/Lipper - a Thomson Reuters company, July 2010.

Comment: A new focus on cost

With the advent of adviser charging under the RDR proposals, many advisers will be concerned how they can make the total ongoing cost of investing - both in terms of advice and investment management - acceptable to their clients.

The adviser charging regime is undoubtedly going to exert more pricing pressure both on advisers and investment managers. Some advisers may turn to low-cost passive investments in order to maintain their own margins. However, investment trusts may look increasingly attractive as a means to deliver competitively-priced active management.

We look forward to discussing with advisers how investment trusts could work within their chosen charging framework.

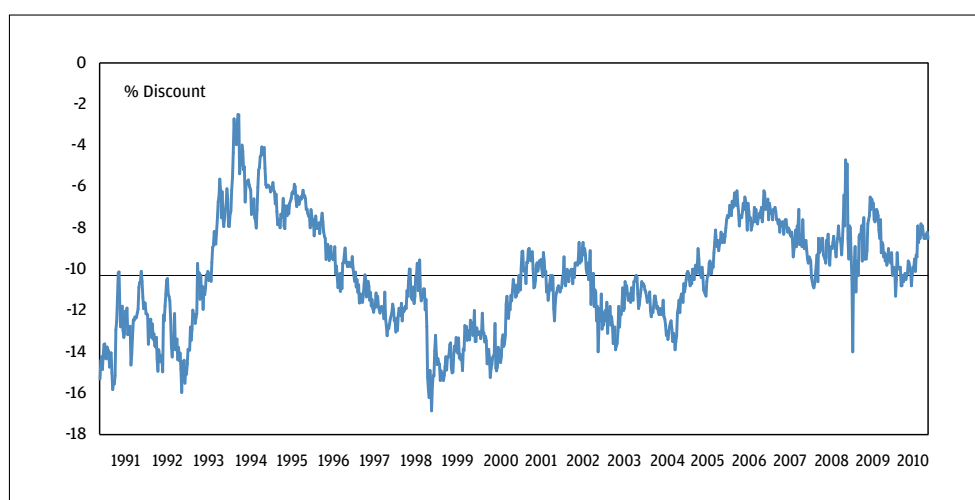
6. Discount opportunities

Because the share price and net asset value of an investment trust are not directly linked, there may be opportunities to purchase investment trust shares at a discount to net asset value (NAV). Effectively this means investors can have beneficial ownership of assets at below their market value - for example a 10% discount means a shareholder benefits from 100p of assets for a 90p share price.

This can present a compelling investment opportunity to experienced clients seeking undervalued investment opportunities if they buy before the discount closes up (see 'First hand: The Discount Seeker'). Discounts can also be beneficial to income-seekers as a discount to NAV will magnify the share price yield compared to the NAV yield.

Some investors may be deterred from investing in trusts trading at a deep discount, concerned that the discount will remain or widen. Many trusts now employ mechanisms to control the discount, such as buybacks, tenders and treasury shares, or look to reduce discounts by encouraging liquidity and a diversified shareholder base. The effectiveness of these tactics has been questioned. However, there are clear indications that discounts have narrowed over the past decade. During the global credit crisis of 2008, it was also noticeable that discounts widened only temporarily and to a lesser degree than in previous crises such as Black Wednesday in 1992 and the Asia Currency Crisis of 1998 - see Diagram 11.

Diagram 11: Historical discounts on investment trusts 1990 - 2010



Source: Winterflood Securities, Thomson Reuters to end-September 2010.

First-hand: The discount seeker

Andrew Lister is Senior Investment Manager at Advance Emerging Capital

“We have used investment trusts for 12 years as a means to access emerging markets. Apart from the benefits of a fixed capital base and low fees, investment trusts offer the advantage of frequently trading at discounts to the value of their assets. We typically look to buy on a wide discount then wait for it to narrow – or take action to encourage it to narrow. By buying at a discount we are able to access our target markets more cheaply than through open ended funds. To us, discounts offer an added margin of safety.

It’s a fallacy that only poorly-managed trusts trade at a discount. High-quality trusts can trade at a discount for numerous reasons, for example where market sentiment is generally negative or if there is a temporary overhang of shares in the fund. In 2008, for example, widening discounts among property, private equity and closed-end hedge funds weren’t symptomatic of poorly-run funds but were more a reflection of structural issues, not least who owned the funds and how distressed those specific investors were.

Among emerging market closed-end funds, discounts have narrowed noticeably over the past decade. This is partly because investors are now taking a longer-term view on these markets. Plus many less-liquid trusts or those with poor governance have been forced to exit the sector. The trusts that remain tend to be well-run and properly resourced. During previous emerging market crises we may have bought mediocre funds on a 30% discount and added value by pushing for corporate action. Today, we are more likely to adopt a buy-and-hold strategy, taking long-term positions in better managed funds, but at lower discounts.

The days of substantial and persistent discounts on emerging market funds are history in our view. The asset class is more popular and the benefits of the closed-end fund structure are more widely understood. That said, there will always be periods of irrational exuberance and pessimism and opportunities will present themselves as we pass through these periods. As long as someone is taking a shorter-term view on markets than we are, opportunities will continue to arise.”

Glossary: Premiums and discounts

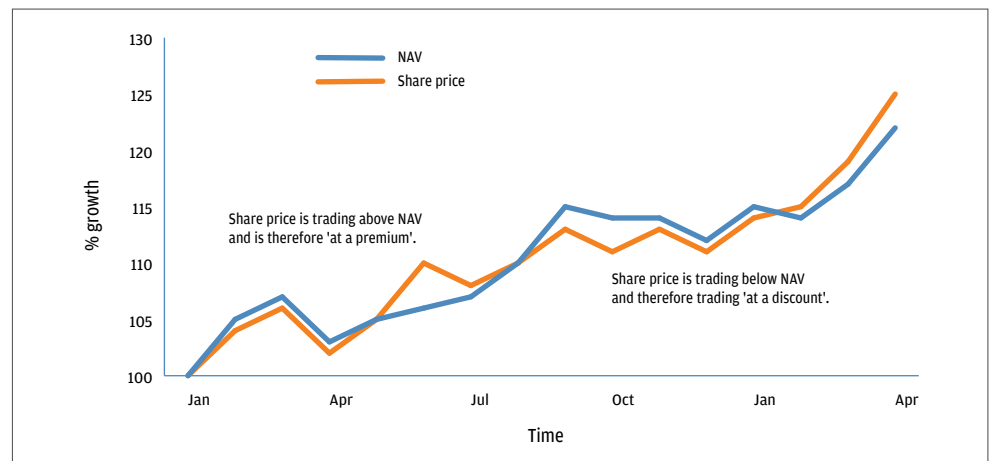
Whereas unit trusts, OEICs and SICAVS are open-ended, investment trusts are closed-end schemes and have a finite number of shares in issue.

This has important implications as it means the share price is driven by demand. So whereas open-ended funds create and redeem at net asset value (NAV), an investment trust's shares can trade above or below its NAV, depending on investor demand. When shares are in high demand and the share price is driven above NAV per share, they are said to be trading at a premium; if below NAV, they are trading at a discount - see Diagram 12.

Investment trusts tend to trade at a slight discount to NAV. Should discounts widen too far, a board can take action - for example, instigating a buy back or tender offer of shares to increase the value of those that remain in the market. For further discount control, repurchased shares can be held in treasury with the option to rerelease at a later date, subject to board/shareholder approval.

Diagram 12: Illustrative graph showing relationship between share price and NAV

For illustration only



Comment: Are boards independent?

Investment trusts have often promoted the fact that they are overseen by boards of directors that are independent of the investment manager.

The strength of board independence has frequently been called into question - particularly during the split-capital collapse of 2002. However there is plenty of evidence that boards are rigorous in ensuring trusts are run in the best interests of shareholders:

- Performance** - Boards are obliged to give reasons each financial year why the investment manager should be reappointed. They have the power to remove investment managers if they feel their performance isn't up to standard.

Between 2005 and October 2010, investment managers have been changed by the boards at 12 major investment companies (source: Numis Securities).

Equally, boards work closely with managers on an ongoing basis to see how performance can be optimised for shareholders.

- Cost** - As discussed on page 15, boards expect investment managers to keep their costs as efficient as possible. There is also more pressure for managers to take part of their fee on a performance-related basis. According to the AIC, over half of investment companies now have a performance-related fee.
- Shareholder contact** - Boards act as a vital intermediary between the investment manager and the investor, enabling the voices of even small investors to be heard. Shareholder attendance at annual general meetings underlines the value that private investors place on this dialogue.

Part Three – How performance compares

How the benefits of investment trusts translate into performance.

In the previous section we have outlined a range of benefits offered by investment trusts. However these features are only of any real value if they translate into strong performance for investors.

Advisers have to contend with an ever-increasing universe of investment options to consider for their clients. The acid test for many advisers will be how well an investment can meet clients' risk-reward expectations.

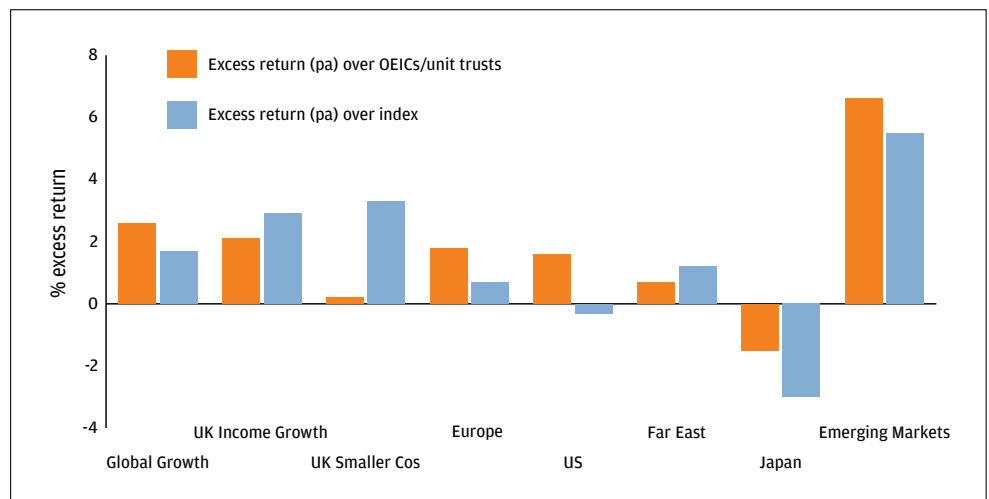
Winterflood Securities recently assessed how eight key investment trust sectors have performed against their open-ended equivalents and the market itself over 10 years. This analysis shows that investment trusts outperformed their open-ended equivalents in seven out of eight sectors and outperformed the benchmark in six out of eight sectors – see Diagrams 13 and 14. The one notable exception is Japan where investment trusts have underperformed both open-ended funds and the market index, reflecting the steep decline in demand for Japan exposure.

There are caveats to this data. First it must be acknowledged these sectors are primarily geographical and have little overlap with the key open-ended fund sectors that advisers have recently looked to buy for their clients (eg Global Bonds, Cautious Managed, Absolute Return). But the strong performance of investment trusts across these sectors should alert advisers to their value within a client's portfolio.

Also, the open-ended fund universe is six times larger so average returns are based on a greater number of constituents. Please note, this analysis did not include any applicable initial charges on open-ended funds, nor dealing costs and stamp duty on investment trusts.

Diagram 13: Annualised excess return of investment trusts over 10 years

Based on share price total return



Source: Winterflood Securities, Morningstar Direct, Thomson Reuters/Datastream. Figures to 1 October 2010.

Diagram 14: Annualised excess return of investment trusts over 10 years

Periods where investment trusts have underperformed are shown in dark grey.

Sector	1 year (%)	3 years (% pa)	5 years (% pa)	10 years (% pa)
Global Growth				
Global Growth Relative to IMA OE	7.2	0.5	2.2	2.6
Global Growth Relative to Benchmark	5.5	-1.1	1.3	1.7
UK Income Growth				
UK Income Growth Relative to IMA OE	7.5	1.8	2.1	2.1
UK Income Growth Relative to Benchmark	4.9	0.4	0.2	2.9
UK Smaller Companies				
UK Smaller Cos Relative to IMA OE	3.2	0.1	0.0	0.2
UK Smaller Cos Relative to Benchmark	18.9	6.5	5.9	3.3
Europe				
Europe Relative to IMA OE	0.0	2.4	1.3	1.8
Europe Relative to Benchmark	0.6	1.9	0.5	0.7
US				
US Relative to IMA OE	4.8	2.9	2.5	1.6
US Relative to Benchmark	2.4	2.2	1.7	-0.3
Far East				
Far East Relative to IMA OE	6.3	2.8	2.2	0.7
Far East Relative to Benchmark	5.4	2.4	2.2	1.2
Japan				
Japan Relative to IMA OE	2.8	-5.7	-5.3	-1.5
Japan Relative to Benchmark	2.1	-6.7	-6.9	-3.0
Emerging Markets				
Emerging Markets Relative to IMA OE	14.8	4.9	5.5	6.6
Emerging Markets Relative to Benchmark	13.8	5.0	4.9	5.5

Source: Winterflood Securities, Morningstar Direct, Thomson Reuters/Datastream to end-September 2010.

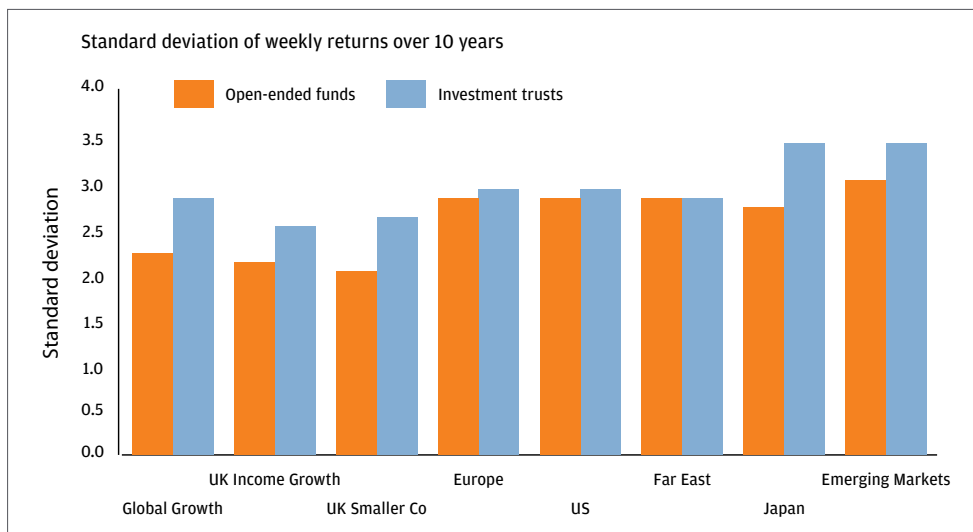
Figures to 1 October 2010. The open-ended fund data represents a weighted average of the total returns, sterling adjusted, net of management, administration and other costs but excluding upfront sales costs. Investment trust data is based on the peer groups used in the Winterflood daily datasheet using share price total return data.

Addressing volatility

Performance cannot be assessed without also addressing the issue of volatility. The share price of an investment trust share is driven primarily by investor demand/sentiment. As such, it can be more volatile than an open-ended fund whose share price is simply a function of the overall value of its underlying investments.

This greater potential for volatility is clear if we compare weekly standard deviation of the price of investment trusts with that of OEICs/unit trusts – see Diagram 15. This shows that weekly standard deviation is higher (i.e volatility is greater) among investment trusts in seven out of eight key sectors – the one exception being the Far East. (More detailed performance and volatility data is provided in the Appendices to this paper).

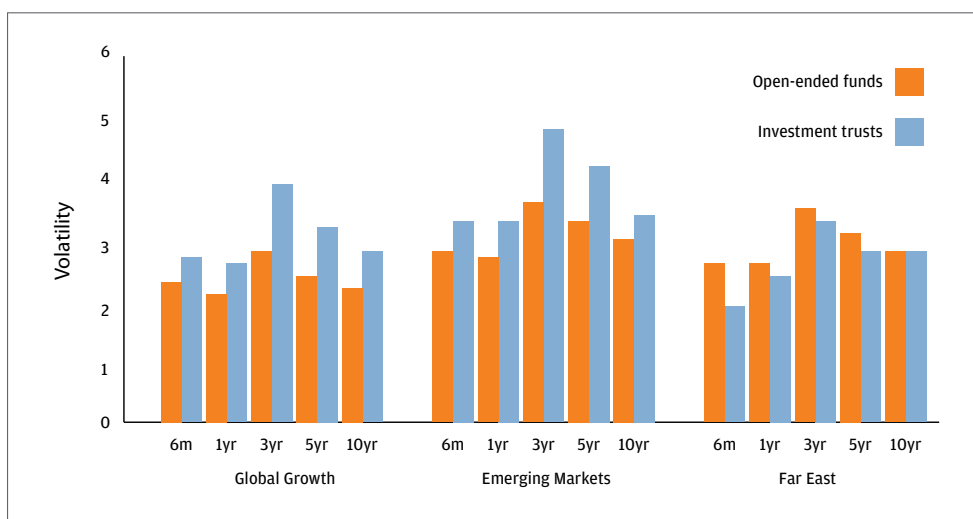
Diagram 15: Volatility of investment trusts vs open-ended funds



Source: Winterflood Securities, Morningstar Direct, Thomson Reuters. To 1 October 2010.

It is essential that advisers make this heightened volatility clear to clients alongside the potential for outperformance to ensure that the level of risk is appropriate. However it is also notable that volatility over different time periods has varied extensively - see Diagram 16. By viewing investment trusts as a long-term commitment, investors should be better placed to override short-term volatility.

Diagram 16: Volatility over 6 months to 10 years in sample sectors



Source: Winterflood Securities, Morningstar Direct, Thomson Reuters. To 1 October 2010.

Performance - some conclusions

While past performance is never a guide to the future, we would suggest the following from this data:

- investment trusts have consistently shown their ability to outperform in those markets to which a closed-end structure is best suited, particularly over longer time periods of five years or more;
- outperformance by investment trusts is evident across both core and specialist geographical markets - with the strongest outperformance by investment trusts apparent in emerging markets;
- however, outperformance is accompanied by greater volatility and this trade-off must be made clear to investors;
- the strong performance of investment trusts against market benchmarks suggests investment trusts are also capable of delivering strong relative performance against passive investment funds such as index trackers and exchange-traded funds (ETFs).

Comment: Making fair comparisons

It is clear that the long-term performance of investment trusts merits close attention by investors and their advisers.

We believe this attention is often limited because investors and their advisers lack means to make like-for-like performance comparisons between investment trusts and open-ended funds and therefore often fail to pick up on investment trusts that are delivering strong performance.

We would like to encourage more investment platforms to include tools that can facilitate fair performance analysis between different fund types.

If independent advisers are expected to assess the full spectrum of retail investment products post-2012, tools that enable fair and meaningful performance comparisons, irrespective of fund structure, will be essential.

Part Four – Using investment trusts in a portfolio

Five ways to use investment trusts to meet client objectives.

Investment trusts can fulfil a broad range of roles in a client portfolio. The rich diversity of the sector provides opportunities for both conservative and more aggressive investors. Below we outline five different ways in which investment trusts are commonly deployed.

1. The core holding

Many 'generalist' UK or Global investment trusts are highly diversified, managed very conservatively and have delivered steady dividends in a low-cost structure. All these features can make them highly appropriate as a long-term portfolio holding.

Useful for

- new investors who need a solid foundation for their portfolio
- lower-risk equity investors who take comfort from conservatively-managed investments with a long-term track record
- long-term strategies, e.g. pensions and investing for children.

2. The specialist holding

For clients who want to expand their portfolio, investment trusts offer extensive opportunities in specialist areas of investment including emerging markets or specific industry sectors such as natural resources. The closed-end structure also lends itself to asset classes such as real estate and venture capital where assets can only be valued or liquidated periodically. This specialist focus enables advisers to add a valuable extra dimension and source of diversification to a client's core portfolio.

Useful for

- experienced investors looking to target a particular specialist market
- clients who are now ready to diversify a core portfolio
- growth-focused investors looking to maximise returns.

3. The growth engine

Highly-g geared investment trusts can amplify returns from rising markets. They can therefore be useful where an adviser or their client has a high conviction that a market or sector is on a long-term rising trend. But the client must equally accept the higher risk involved in highly-g geared trusts.

Useful for

- aggressive, growth focused clients (e.g. younger and pre-retirement clients) looking to maximise returns
- strategic clients with a strong bull view on a specific market
- improving portfolio returns when general market returns are positive but sluggish.

4. The income generator

Many investment trusts have demonstrated superior income-generating capabilities, providing rising dividends over a period of decades. Such trusts should be of interest to any client looking for an income that can keep pace with inflation. In addition, investors have the potential for capital growth through a rising share price.

Useful for

- retired or partially retired clients looking to supplement pensions and other income sources
- income-drawdown clients
- other clients needing regular income - e.g. for school fees or care fees.

5. The regular-saving pool

Investment trusts have long been favoured by regular savers looking to invest their money gradually into the stock market over time. Most investment trusts offer regular savings schemes that accept monthly contributions.

As we have seen, because their price is determined by investor sentiment, investment trust shares can be more volatile than funds whose price is linked directly to their net asset value. But investors can exploit this through regular savings, which can give them the benefit of pound-cost averaging – see Glossary below.

One caveat to regular saving is the cost of dealing. Many broking services impose fixed dealing costs which can benefit larger investments but will increase proportionate costs for smaller regular savings.

Useful for

- long-term savers wanting to invest each month
- clients investing regularly on behalf of someone else - e.g. children/grandchildren
- aggressive investors looking to exploit high market volatility
- investors wanting to enter a market but believe it may fall further and so wish to feed in capital gradually.

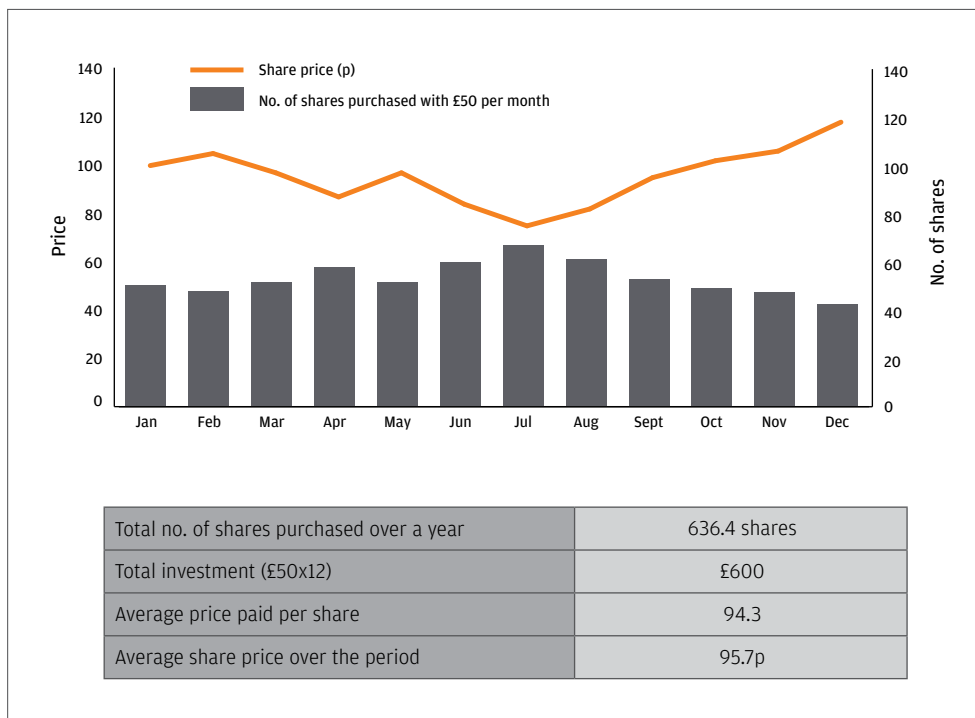
Glossary: Pound-cost averaging

Pound-cost averaging occurs when a fixed amount of money is invested in a security or fund on a regular basis. It works particularly well where the fund or share price is experiencing high volatility.

Investing a fixed amount will buy more shares when the price is low and fewer shares when the price rises. Provided the share price ultimately rises, the average price per share paid by the regular saver will be less than the average price over the period.

Diagram 17 shows the effect of pound-cost averaging on an regular investment of £50 a month approval.

Diagram 17: Effect of pound-cost averaging



Source: Hypothetical illustration created by J.P. Morgan Asset Management.

Part Five – Creating access to investment trusts

Ensuring a presence for investment trusts in an increasingly crowded marketplace.

Under RDR proposals, independent advisers will be obliged to include investment trusts in the range of retail investment products they advise on from 2013.

That should ensure a renewed focus on the sector to some extent. However, trusts, regulators and distribution providers will need to work together to ensure advisers have the access they require to make investment trusts a truly integral part of their advisory activities.

Platforms proving critical

Currently, advisers can access investment trusts for their clients through the savings schemes and product wrappers administered by a trust's investment manager. Shares can also be purchased through a normal share brokerage service.

However, access via investment platforms including fund supermarkets and wraps is likely to prove critical. A growing number of intermediaries are choosing to conduct, if not all, then the bulk of investment research and fund transactions on behalf of clients through these centralised online venues. Industry data suggests 37% of unit trust/OEIC sales are now conducted via platforms.

Unless an investment product has a presence 'on platform', it is very unlikely that advisers will include them in their assessments in any sustained way. We believe greater access to investment trusts on platform will require the following:

i. Adviser/investor demand

Access to investment trusts via platforms that incorporate a share-dealing service is reasonably comprehensive – see Diagram 18. But availability on the biggest fund-based platforms used by intermediaries, namely Skandia, Cofunds and Fidelity FundsNetwork, is currently limited. The major players in the platform market say they have plans to increase access to investment trusts. However many platforms admit that product inclusion tends to be demand-driven. Advisers need to be asking for investment trusts on platforms so they become a strategic priority for platform providers and also so the specific dealing and custody requirements of listed funds are addressed.

ii. Proper visibility

As mentioned above, many platforms do include investment trusts as part of their share-dealing service. But this can often mean investment trusts are siloed with individual shares, separate from a platform's main focus of 'funds investing'. We believe platforms must be encouraged to include investment trusts on a level footing with all retail investment products, in accordance with the goals of the Retail Distribution Review – see below. This means classifying trusts by their AIC sector or objective – not simply by an undifferentiated classification of 'investment company'.

iii. Regulatory requirements

The role of platforms in delivery of the Retail Distribution Review is being assessed by the regulator. The power that platforms now have in shaping the retail investment landscape (and what intermediaries advise on) has to be acknowledged.

As such, certain requirements should be placed on platforms. We believe these should include:

- **Inclusion** – platforms should host the widest range of investment products as possible. Just as advisers will be required under the RDR to state if they are independent or restricted, so platforms should be required to indicate which retail investment products they do or do not offer.
- **Unbundling** – platforms should offer an unbundled product neutral service, thus offering clients and advisers the opportunity to access the widest range of investments. To facilitate this, platforms should offer investors the opportunity to pay for the service they use.
- **Product-neutrality** – platform design (e.g. the homepage), research tools and guided services such as model portfolios should be structured so that all retail investment products have equal coverage – otherwise users may simply resort to products they are familiar with or those encountered most readily when logging onto a platform.

Creating a virtuous circle

Greater availability of investment trusts on platform won't happen overnight - and the sector will have to compete for advisers' attention along a wide range of other retail investment products listed under the RDR proposals.

However if the industry can establish a virtuous circle of greater adviser demand leading to greater availability and visibility then access to investment trusts on platform should gain its own momentum.

Diagram 18: Availability of investment trusts on investment platforms

Name of platform	Target distribution channel	Current investment trust availability	Future plans
Ascentric Whole of Market wrap	Intermediated	218 investment trusts from 120 managers	Will be driven by adviser demand
AXA Elevate	Intermediated	UK-listed shares available under Explicit Charging Structure option	
Cofunds	Intermediated	Not available	Not available
Fidelity FundsNetwork	Both	Currently offer Fidelity China Special Situations plc	Plan to add more investment trusts but timeframe not available
Hargreaves Lansdown	Direct	Can trade in any UK-listed security	
i.invest (provided by Alliance Trust Savings)	Direct	Offers most UK-listed investment companies	
J.P. Morgan WealthManager+	Direct	Can trade in any UK-listed security	
Novia	Intermediated	Can trade in any UK listed security through share-dealing service	
Nucleus	Intermediated	Not supplied	Not supplied
Raymond James	Intermediated	Can trade in any listed security including investment trusts, ETFs, conventional shares and bonds	
7im	Intermediated	Can trade any security listed on a major exchange globally	
Skandia Investment Solutions	Intermediated	- None on Skandia Investment Solutions - 2 on Skandia Life & Pensions	Planning to introduce investment trusts and ETFs in the future
Standard Life Wrap	Intermediated	Offers 213 investment trusts from 50 investment groups. More can be added on request if denominated in sterling and can be settled via Crest	Plan to extend investment trust range in response to market developments and client demand.
Transact	Intermediated	Can offer any investment trust from any management group	

Source: J.P. Morgan Asset Management as at October 2010.

First hand: The wrap provider

Malcolm Murray is Head of Marketing at Transact.

“We were the very first investment platform to set up in the UK in 2000 and our structure has meant we have been able to offer any type of regulated investment including investment trusts from the very beginning.

Effectively we have been an ‘RDR-ready’ platform for 10 years: the adviser agrees their initial and ongoing fees with the client. Transact then levies its own charges which are also paid directly by the client. In other words, the cost of advice and the cost of our service are fully unbundled and there is no influence from product providers.

There has never been any issue with this approach – clients recognise the value of the services we provide. Today we support over 4,400 advisers and nearly 100,000 end-clients.

Initially, advisers warmly welcomed the ability to administer investment trusts on the same venue as other collectives and securities and they accounted for around 25% of investments in our first year. The split-capital crisis set that back a bit but we have seen demand coming back recently. Advisers are being encouraged – or indeed required – to look at all the investment alternatives on the market. I think that is already resulting in greater interest in more types of investment product, including investment trusts.”

Conclusion

The forthcoming removal of product commission, the introduction of adviser charging and the wider classification of retail investment products all have the potential to create a new surge of interest in investment trusts within the intermediary market.

We hope, however, that a renewed focus on investment trusts will not be driven by regulatory or even commercial forces but rather an interest in the unique combination of benefits that investment trusts can offer.

Being able to appraise investment trusts on a level footing alongside other investment funds will, we hope, cause many advisers to wonder why they have overlooked these flexible, low-cost, high-performing vehicles for so long. In turn, acquiring a better understanding of the sheer breadth of trusts available should add a valuable dimension to client recommendations.

Investment trusts can and should increase their share of the UK funds industry. But this won't happen overnight and it will require proactivity by all interested parties including:

- **Education** - Scepticism persists regarding the 'more complex' corporate structure of investment trusts compared to other investment funds. Extensive education is required to show that the advantages of the investment trust structure significantly outweigh the potential disadvantages.
- **Reputation** - Investment trusts still carry a reputation as elitist and old-fashioned which is now completely at odds with their performance, lean cost structure and the new areas of investment they are opening up to a wide range of investors. Working within the constraints placed on the marketing of public companies, these attributes need to be communicated across all sectors of the retail investment market.
- **Access** - Equal access to investment trusts via leading wraps and fund supermarkets is now absolutely essential to the sector's penetration within the adviser market. While regulation may provide some support, the investment trust industry urgently needs to embark on lobbying activity to establish a virtuous circle of greater demand leading to greater platform presence.

As the leading manager of investment trusts in the UK¹³ J.P. Morgan Asset Management is committed to working with advisers, boards and distribution providers to enable investment trusts to be properly established as an essential element of the UK retail investment market.

To discuss our initiatives or to receive adviser education on investment trusts, please contact investment.trust.guide@jpmorgan.com

¹³ Source: AIC by total market capitalisation and number of trusts as at 31 January 2011. An investment trust is a public listed company that aims to generate profits for its shareholders by investing their capital in a portfolio of assets.

Appendix i: How investment trusts work

An investment trust is a public listed company that aims to generate profits for its shareholders by investing their capital in a portfolio of assets.

The term 'investment trust' includes trusts using a long-only strategy to invest in cash securities. But it can also cover investment companies investing in real estate, private equity and venture capital and also closed-end hedge funds that employ shorting and other derivative-based investment techniques.

The investment trust universe is diverse but all these vehicles have certain things in common:

- they are publicly listed companies (PLCs) and are governed by UK company law and owned by their shareholders
- have a fixed number of shares in issue (although this can be varied periodically by share buybacks, rights issues and use of treasury shares)
- have a board that is independent from the investment manager to oversee the interests of shareholders¹⁴
- investment parameters are determined by the board, subject to shareholder approval
- income and profits can be distributed as dividends to shareholders.

The structure and regulation of investment trusts

As listed companies, investment trusts have important differences from non-listed open-end investment vehicles such as OEICs, unit trusts, offshore SICAVs and ETFs, which are outlined below.

Pooled investment vehicles compared					
	Investment trust	Unit trust	OEIC	SICAV	ETF
Legal structure	Public limited company	Trust	Investment company	Investment company	Investment company
Domicile	UK onshore/Offshore	UK onshore	UK onshore	Offshore	Mostly offshore
Type of holding	Listed share	Unit	Unlisted share	Unlisted share	Listed share
Investment structure	Closed-ended - fixed number of shares in issue*	Open-ended - number of units expands and contracts with investor demand	Open-ended - number of units expands and contracts with investor demand	Open-ended - number of units expands and contracts with investor demand	Open-ended - number of shares expands and contracts with demand
Price determined by	Supply and demand (share price can be above or below Net Asset Value)	Net Asset Value	Net Asset Value	Net Asset Value	Supply and demand with open-ended structure ensuring price is close to Net Asset Value
Trades on the stock market	Yes	No	Not in practice	No	Yes
Pricing	Dealing prices subject to bid-offer spread	Usually dual bid-offer priced but some single pricing available	Usually single priced but some dual pricing available	Usually single priced	Dealing prices subject to bid-offer spread
Gearing limits	Level of gearing decided by board and portfolio manager and limited by company objectives	UCITS - 10% on a temporary basis Non-UCITS - 10% on a permanent basis	UCITS - 10% on a temporary basis Non-UCITS - 10% on a permanent basis	UCITS - 10% on a temporary basis	UCITS - limits apply but usually ungeared
Eligible investments approved by	Independent board	FSA	FSA	UCITS legislation for marketing in UK	UCITS legislation for marketing in UK
Built-in commission	Not usually - although possible on initial public offering Commission may be built into savings scheme products	Yes	Yes	Yes	No - dealing commission applies on ETF transactions

Regulation	Subject to UK listing rules and Inland Revenue approval. Registered under the Companies Act unless offshore, in which case local regulations apply. Must register for sale in the UK	Manager & trustee authorised by FSA	Authorised Corporate Director authorised by FSA Depository (for oversight) authorised by FSA	Operates under regulation of place of domicile	Operates under regulation of place of domicile
Covered by UK Financial Services Compensation Scheme	Yes if purchased through a FSA-regulated product such as an ISA, savings scheme, or pension, or through a regulated adviser	Yes	Yes	Not usually covered by FSCS. Compensation schemes may apply in offshore centre	Not usually covered by FSCS. Compensation schemes may apply in offshore centre of domicile

¹⁴Please note that a small number of trusts are self-managed and use their own in-house fund managers to manage their portfolio of assets.

*An investment trust can buy back shares and hold them in treasury with the flexibility to reissue them; additional shares can be issued subject to shareholder approval.

The most fundamental difference is the closed versus open-ended structure. Because other fund structures are open-ended and can create or cancel units in line with demand, their unit/share price can follow their net asset value (NAV). As investment trusts have a fixed number of shares, their share price will be determined by demand and can therefore be higher or lower than their NAV per share.

Regulation

As public limited companies listed on the London Stock Exchange, investment trusts are governed by UK company law and UK Listing Rules.

Because they are public companies, investment trusts are not regulated as investment products and investors don't have recourse to the Financial Services Compensation Scheme (FSCS) or the Financial Ombudsman Services (FOS) if shares are bought directly on an execution-only basis.

However any wrapper such as a savings plan, individual savings account or pension scheme provided to invest in investment trust shares must be regulated by the FSA and comes under the FSCS and FOS.

Charges on investment trusts

As public limited companies, investment trusts are subject to the usual associated costs of buying and selling listed shares:

- **Purchase costs:** Investors have to pay the costs usually associated with buying listed shares such as dealing charges and 0.5% government stamp duty. Adviser commission isn't automatically built into an initial charge but some management groups may build it into their ISA, pension or savings scheme charges.
- **Selling costs:** When an investor sells, the brokerage dealing costs of selling will be deducted from their proceeds.
- **Bid-offer spread:** Investors may be subject to a bid-offer spread on the current buying and selling price of shares. Like any share, this can widen when trading volumes fall.
- **Annual costs:** Investment trusts levy an annual management charge to cover the cost of investment management and ongoing administration costs. This is deducted directly from the trust's assets gradually over the year. So, unlike on an open-ended fund, it is not a direct cost deducted from an investor's holding. Again, adviser commission is not built into the annual costs so ongoing remuneration needs to be agreed between the client and their adviser.
Many trusts include a performance fee which is payable if the investment company outperforms its benchmark by a pre-agreed margin.
- **Wrapper charges:** Some investment trust groups make an additional cost for holding investment trusts within a savings wrapper such as an ISA; for example, a flat annual fee per trust held. As mentioned above, some commission arrangement may be incorporated into a wrapper's cost structure but this is quite unusual.

Appendix ii

Performance of investment trusts vs open-ended funds and market benchmarks

Sector	6 months (%)	1 year (%)	3 years (% pa)	5 years (% pa)	10 years (% pa)
Global Growth General Peer Group (Inv Trust)	0.3	18.3	-0.3	6.9	3.2
IMA OE Global Growth	-2.6	11.1	-0.8	4.7	0.6
FTSE World	-3.7	12.8	0.8	5.7	1.4
Global Growth Relative to IMA OE	2.9	7.2	0.5	2.2	2.6
Global Growth Relative to Benchmark	4.1	5.5	-1.1	1.3	1.7
UK Income Growth Peer Group (Inv Trust)	6.4	21.5	-1.1	5.3	5.8
IMA OE UK Equity Income	2.3	14.0	-2.9	3.2	3.7
FTSE All Share	-0.2	16.6	-1.5	5.1	2.9
UK Income Growth Relative to IMA OE	4.1	7.5	1.8	2.1	2.1
UK Income Growth Relative to Benchmark	6.5	4.9	0.4	0.2	2.9
UK Smaller Cos Peer Group (Inv Trust)	12.7	21.8	-1.8	5.0	3.0
IMA OE UK Smaller Companies	11.3	18.7	-1.9	5.0	2.8
FTSE Small Cap ex-ICs	7.1	2.9	-8.3	-1.0	-0.3
UK Smaller Cos Relative to IMA OE	1.4	3.1	0.1	0.0	0.2
UK Smaller Cos Relative to Benchmark	5.6	18.9	6.5	5.9	3.3
Europe General Peer Group (Inv Trust)	-3.4	5.1	-0.2	6.8	4.1
IMA OE Europe Excluding UK	-2.8	5.1	-2.6	5.5	2.3
FTSE Europe ex-UK	-3.7	4.6	-2.2	6.3	3.4
Europe Relative to IMA OE	-0.6	0.0	2.4	1.3	1.8
Europe Relative to Benchmark	0.3	0.6	1.9	0.5	0.7
US General Peer Group (Inv Trust)	-7.1	17.1	2.8	5.1	-1.3
IMA OE North America	-5.2	12.3	-0.1	2.6	-2.9
S&P 500	-5.0	14.7	0.6	3.5	-1.1
US Relative to IMA OE	-1.9	4.8	2.9	2.5	1.6
US Relative to Benchmark	-2.1	2.4	2.2	1.7	-0.3
Far East ex-Jap Peer Group (Inv Trust)	11.4	27.6	7.4	17.4	10.8
IMA OE Asia Pacific Excluding Japan	3.6	21.3	4.6	15.2	10.1
MSCI AC Far East (ex-Jap)	5.3	22.2	5.0	15.1	9.6
Far East Relative to IMA OE	7.8	6.3	2.8	2.2	0.7
Far East Relative to Benchmark	6.1	5.4	2.4	2.2	1.2
Japan General Peer Group (Inv Trust)	-11.4	6.2	-8.0	-7.0	-5.4
IMA OE Japan	-9.3	3.4	-2.3	-1.7	-3.9
Topix	-7.6	4.1	-1.4	-0.1	-2.4
Japan Relative to IMA OE	-2.1	2.8	-5.7	-5.3	-1.5
Japan Relative to Benchmark	-3.8	2.1	-6.7	-6.9	-3.0
Emerging Market Global Peer Group (Inv Trust)	9.5	37.5	11.4	21.1	18.3
IMA OE Global Emerging Markets	4.3	22.7	6.5	15.6	11.7
MSCI Emerging Markets Free	3.7	23.7	6.4	16.2	12.8
Emerging Markets Relative to IMA OE	5.2	14.8	4.9	5.5	6.6
Emerging Markets Relative to Benchmark	5.8	13.8	5.0	4.9	5.5

Source: Winterflood Securities, Morningstar Direct, Thomson Reuters/Datastream.

Figures to 1 October 2010. The open-ended fund data represents a weighted average of the total returns, sterling adjusted, net of management, administration and other costs but excluding upfront sales costs. Investment trust data is based on the peer groups used in the Winterflood daily datasheet, based on share price total return data.

Appendix iii

Volatility of investment trusts share price return vs open ended funds

	6 months		1 year (%)		3 years (% pa)		5 years (% pa)		10 years (% pa)	
	Open-ended	Inv Trust	Open-ended	Inv Trust	Open-ended	Inv Trust	Open-ended	Inv Trust	Open-ended	Inv Trust
Global Growth	2.3	2.7	2.1	2.6	2.8	3.9	2.4	3.2	2.2	2.8
UK Income Growth	2.4	2.4	2.0	2.3	2.8	3.2	2.4	2.7	2.1	2.5
UK Smaller Co	2.0	2.1	1.7	1.9	2.4	3.2	2.1	2.7	2.0	2.6
Europe	3.0	2.9	2.8	2.7	3.4	3.3	2.9	2.9	2.8	2.9
US	2.7	3.0	2.4	2.8	3.5	3.5	2.9	3.0	2.8	2.9
Far East	2.6	1.9	2.6	2.4	3.5	3.3	3.1	2.8	2.8	2.8
Japan	1.5	2.1	2.1	2.3	2.8	3.3	2.6	3.1	2.7	3.4
Emerging Markets	2.8	3.3	2.7	3.3	3.6	4.8	3.3	4.2	3.0	3.4

Source: Winterflood Securities, Morningstar Direct, Thomson Reuters. Figures to 1 October 2010.

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LV-JPM8818606

GB H1120 04/11