



Investment Trust Directors Survey 2009

Better insight + Better process = Better results

J.P.Morgan
Asset Management

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Head of Investment Trusts at J.P. Morgan Asset Management

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Introduction: the opinions that shape our industry

The requirement for an independent board of directors is a feature that renders investment trusts unique in the UK savings market.



David Barron

Head of Investment Trusts,
J.P. Morgan Asset
Management

Today around 950 individuals in the UK, from many different professional paths, are directors of investment trusts and investment companies.¹ As the largest manager of investment trusts in the UK, J.P. Morgan Asset Management experiences at first hand the depth of insight and analytic rigour that these directors bring to their role. Their knowledge of, and engagement with, investment companies is always impressive.

Board members are thus instrumental in shaping the investment company industry. Which is why in 2004, we published the first-ever comprehensive survey of investment trust directors, assessing their collective views on the key issues facing the sector, including discount management, corporate governance, fees, distribution of share ownership and investment performance.

Five years on, we want to see if and how those views have changed and what are now considered to be the key factors that will shape the investment companies sector and drive its success.

2004 and 2009 are interesting years to compare. Both follow in the wake of corrections from sustained bull markets. In 2004, the investment trust industry was reassessing its own governance and future direction in the wake of a series of split-capital trust insolvencies. In 2009, the UK savings market is negotiating a raft of challenges including global recession, banking consolidation and the Retail Distribution Review - potentially, the biggest reorganisation in UK retail financial distribution for 20 years. Subsequent to carrying out this research, the European Commission has put forward proposals for regulation of alternative investment funds, including hedge funds, private equity funds and other closed-end investment companies.

This new report therefore aims to offer an overview of what investment companies directors are thinking about their industry at a time of great change both for the UK investment market and the wider financial sector. Alongside directors of conventional investment trusts, we also invited opinion from board members of offshore investment companies and venture capital trusts. So we continue to call this the Investment Trust Directors Survey but recognise the changing base of vehicles. To secure impartial opinion, our 2009 survey was conducted without attribution to J.P. Morgan Asset Management. We have also provided our own commentary on key findings.

We thank every director who took the time to complete this survey. In return, we hope these collected findings are of interest - and of real value in assessing the investment company industry's next steps in assuring its future.

¹ Source: Association of Investment Companies; not including venture capital trusts

J.P. Morgan Asset Management, part of J.P. Morgan Chase & Co., is a global investment manager, with over £787 billion in assets under management for investors across 20 countries worldwide, and one of the 10 largest asset managers in the UK (source: IMA, June 2009).

We are the largest manager of investment trusts in the UK, responsible for assets of more than £5 billion across 21 investment companies, spanning both core and highly-specialist asset classes.

In 2008, J.P. Morgan Asset Management was named Investment Trust Group of the Year by Investment Week, What Investment, Professional Adviser and Investment Trusts magazine.

All figures above as at 30 September 2009 unless stated.

Background to the research

The 2009 survey was conducted among an invite list of 1,000 investment trust directors during 2009. The findings are based on 148 completed interviews.

Survey highlights

2004 Survey headlines

- Nearly **80%** of investment trust directors expect some degree of **formal regulation** to be introduced into the governance of investment trusts
- **46%** of directors believe that **share buybacks** are an effective way of managing discounts/premium to net asset value
- **Almost half** of directors believe that **consolidation** is a key to improving liquidity in the investment trust sector
- On average, directors expect the **360-strong investment trust sector** to reduce to around **250 trusts** over the next ten years
- Most (65%) directors believe the **level of gearing** in the sector to be about right but one in four believe it is too low
- **62% believe management fees** for investment trusts are fair but 57% believe they should be calculated on net assets rather than gross assets
- More than **two-thirds** of directors (68%) support the idea of lower management fees in return for **performance-related charges**
- Almost **three out of four** directors (71%) do not believe that expenses should be increased for marketing to promote awareness of investment trusts

2009 Survey headlines

- Some **50%** of investment company directors consider that investment companies **should be regulated** in some form
- **60%** of directors now believe that a **share buyback** programme with a discount target is the most acceptable means among shareholders to manage discounts
- **Consolidation** of investment trusts is perceived to improve liquidity across the sector for **84%** of respondents
- By 2018, directors anticipate that the number of **UK-listed investment trusts** will stand at **250**
- Around two thirds believe the **level of gearing** in the industry is about right, while only 15% of directors believe it to be too low
- **64% of directors** favour using net assets as the basis of calculation for management fees
- Just **under half** (49%) of directors believe performance-based fees should be employed even more extensively by **investment trusts**
- The proportion of directors who feel that total expense ratios should increase to allow for greater marketing spend to aid awareness is **30%** – but only **15%** believe shareholders would support the idea of raising marketing spend

Additional 2009 headlines

- Fewer than half (43%) believe that absolute returns are the most important measure of performance
- 94% of directors believe that a large retail shareholder base has an impact on liquidity, suggesting that greater mainstream retail distribution is seen as critical to the survival of investment trusts
- One in four directors believe treasury shares have no positive effect on liquidity at all, while the majority view is that any positive effect on liquidity is limited
- The majority, at 88%, believe regulation has increased a director's responsibilities – with 12% believing responsibilities have been increased to a very large extent
- Nearly half (45%) of directors believe lack of interest among intermediaries is the single biggest threat to survival of investment companies

The 2009 Findings

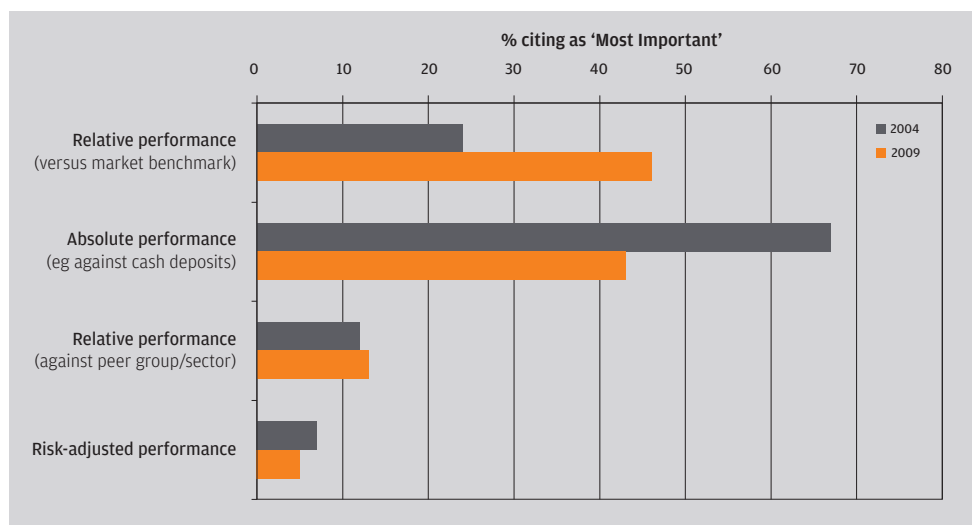
i. PERFORMANCE & GEARING:

Focus turns to longer-term relative performance

As in 2004, investment trust directors still believe strongly that investment performance is a key driver of demand for investment trusts, with 55% believing performance is instrumental in driving the level of discount on an investment trust

But there has been a significant shift in how directors believe that performance should be measured. In 2004, two-thirds (66%) of directors believed that absolute returns - e.g. the return against a consistently positive benchmark such as cash deposits - were the most important measure of performance. Today that proportion has dropped to 43%, while the percentage of directors now prioritising relative performance against a stock market index has almost doubled from 24% to 46%.

Diagram 1: Most important factor when measuring performance



Source: J.P. Morgan Asset Management/TNS

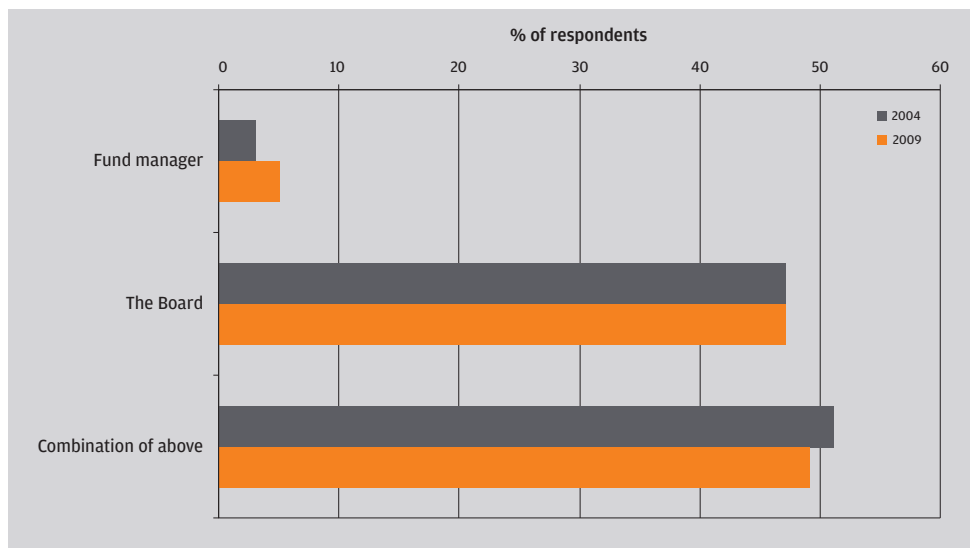
Directors are also taking a longer-term view of performance. In 2004, 63% of directors believed that investment performance could be meaningfully measured over one to three years. In 2009, this group has dropped to 38%. Instead, 60% of directors believe performance should be measured over three to five years.

There is strong interest in linking fees to performance: 49% of investment trust directors believe performance-based fees should be employed more extensively by the industry - although only 4% would like performance to be used as the primary basis for fee calculation.

Gearing

When it comes to deciding the level of borrowing an investment company should adopt 47% of board directors still believe the decision should be taken solely by the board. As in 2004, only a small proportion (5%) believes it should be the decision of the fund manager alone. The majority favour a decision by both board and managers.

Diagram 2: Who should decide the level of gearing in an investment company



Source: J.P. Morgan Asset Management/TNS

Directors appear to have become more risk-averse about leverage over the past five years. In 2004, one in four directors believed gearing in the sector was too low - this proportion has now dropped to 15%. However, as in 2004, around two-thirds of directors believe the level of gearing in the industry is about right and largely believe trusts should be employing a combination of long and short-term gearing.

A third believes recent market volatility will have had an impact on institutional investors' decision whether to invest in geared or non-geared vehicles. But only 11% believe market volatility will have influenced private investors in their decision to use geared or non-geared investments.

Comment

Given that relative-return strategies dominate the investment company sector, the strength of support for absolute-return investing among directors in our 2004 survey was surprising.

Our 2009 findings suggest that emphasis on absolute-return performance is now more proportionate to the relatively small number of investment trusts that have adopted this approach. It may also suggest boards have become more circumspect about absolute-return investing in the wake of some funds' failure to deliver their target returns in the face of severe market conditions.

Nonetheless, absolute-return strategies can play a valuable role in reducing volatility and stock market correlation. To manage risk properly, investors should continue to be offered a wide choice of relative and absolute-return approaches.

The fact that the majority of directors are looking to appraise investment trust performance over three to five years is a sensible shift in outlook. This longer timeframe is essential in enabling appointed asset managers to take a long-term investment view on behalf of shareholders, particularly in very extreme markets.

Some might be surprised, however, that a large proportion of board directors still feel that deciding whether a trust should gear up or not is their sole responsibility. Intelligent use of gearing is a key element of performance and is linked to other investment decisions. We believe gearing can be best employed successfully where the board and fund manager work closely to gear a portfolio.

ii. DISTRIBUTION: Platforms and IFAs are key to the future

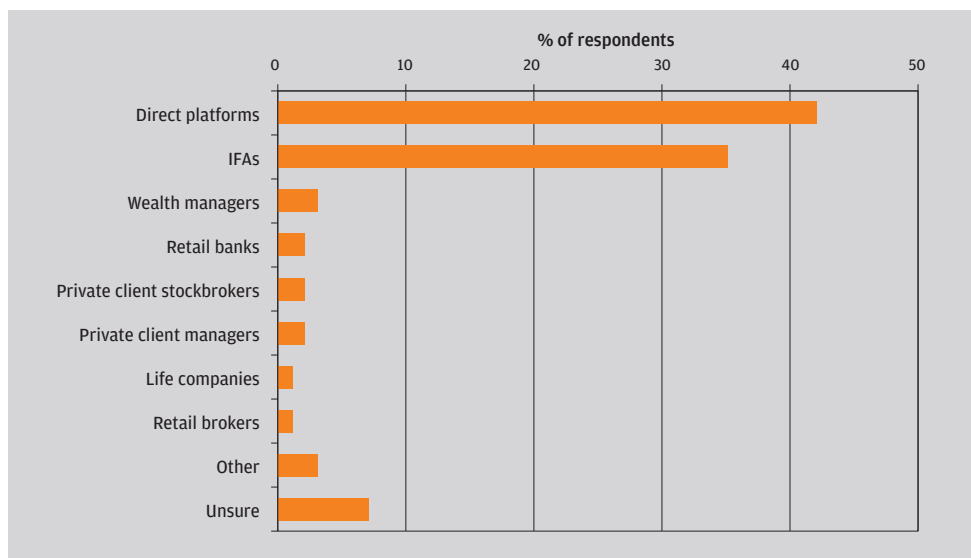
In 2004, directors believed that 65% of shares in generalist trusts should be owned by retail investors – for example, private clients – rather than institutional investors such as life companies and pension funds. In 2004, 40% of investment trust shares were in retail hands; in 2009, that proportion is 50% (source: AIC).

Greater mainstream retail distribution is still seen as critical to the survival of investment trusts. For example, in 2004, more than three-quarters (76%) of directors agreed that a large retail shareholder base improves liquidity. In 2009, that conviction has risen to 94%.

For this reason direct platforms – online portals that enable retail investors to purchase investment products directly – are seen as the single-most important channel for selling investment trusts in the future. Independent Financial Advisers (IFAs) come a close second.

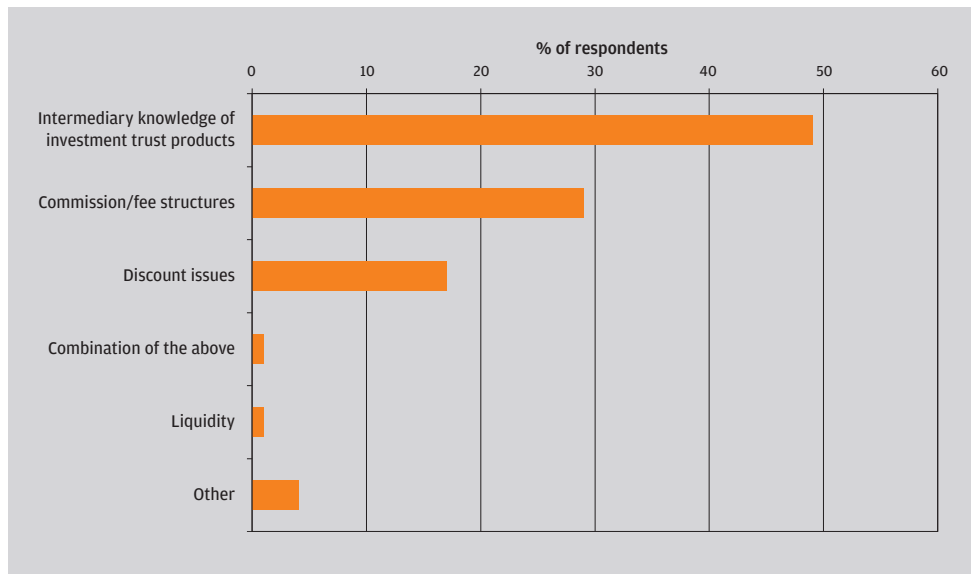
Conversely, wealth managers, private client stockbrokers and private client managers – arguably the traditional means of distribution for investment trusts – are viewed as a key future distribution channel by 3% or fewer of our respondents.

Diagram 3: Key channel for selling investment trusts in the future



Source: J.P. Morgan Asset Management/TNS

Given the perceived importance of IFAs as a future distribution channel, it is understandable that directors therefore view the lack of knowledge among intermediaries as the biggest hurdle to increasing investor uptake of investment trusts.

Diagram 4: Biggest hurdle in increasing uptake of investment trusts among investors

Source: J.P. Morgan Asset Management/TNS

Perceptions of IFA understanding of investment trusts is very low - for example, only 38% of directors believe that more than half of mainstream IFAs have a clear understanding of the relationship between a trust's share price and its net asset value.

Increasing intermediary interest

But there appears to be little agreement how greater understanding of, and greater interest in, investment trusts can be achieved among IFAs. The proportion of directors who feel that total expense ratios (TERs) should increase to allow for greater marketing spend to aid awareness has doubled over the last five years from 16% to 30%. But even if a third of directors are in support of the idea, only 15% believe shareholders would support the idea of raising marketing spend.

In addition, only 27% of directors support the idea of incorporating adviser commission into investment trusts to increase uptake.

Comment

Our latest survey findings suggest board directors believe a significant shift in investment trust retail distribution – moving away from the sector's traditional base of wealth managers and private client stockbrokers and focusing instead on mainstream IFAs and online channels such as wraps and fund supermarkets will be key to finding new buyers.

Achieving such a shift presents a real challenge – both in terms of building demand from a new segment of investors and intermediaries and guaranteeing that investment trusts can offer the liquidity and ease of trading that retail investors have come to expect from other savings vehicles.

It must be acknowledged that previous large-scale attempts to introduce investment trusts into the retail mainstream, for example through generic advertising campaigns, have met with limited success. Investment companies must use every tactic at their disposal if they believe that broader retail distribution is the key to their future survival – this process must include marketing, education and liquidity/discount management.

At J.P. Morgan Asset Management we have taken a number of initiatives to build understanding of, and access to, investment trusts and other closed-end vehicles. These include the inclusion of investment trust modules on **Academy**, our investment training and insight programme for financial advisers.

We have also taken an active role in the Association of Investment Companies' Online Project to introduce relevant investment companies centres to leading online research and broking sites.

We are also looking to achieve greater platform presence for investment trusts – both through partnerships with existing investment platforms and with the development of our own online wealth manager service, **J.P. Morgan WealthManager+**

The industry must also be ready to seize opportunities created by new regulation. For example, the Retail Distribution Review (RDR) has proposed including investment trusts in the universe of retail investment products that advisers must consider in order to call themselves independent. As a result, demand for education about investment trusts may be about to increase.

Also, given that the RDR has called for adviser remuneration to be decided by adviser and client, not by product providers, there is a major opportunity for investment trusts to promote themselves as lower-cost vehicles that clearly separate the cost of fund management from the cost of advice.

As more distribution channels and intermediaries look to adopt fee-based remuneration in a post-RDR environment, investment trusts may find greater traction in this key channel.

iii. DISCOUNTS: Buybacks still the most acceptable solution

Investment trust shares that trade below their underlying net asset value (NAV) are a perennial issue for boards, shareholders and managers, but new methods to tackle discounts have met with muted support by directors.

Discounts & performance

As mentioned in the first section of our findings, investment performance is considered a key determinant of a trust's discount, with 55% of directors saying performance drives the discount to a large or very large extent. But fewer than 10% of directors believe focusing on performance is seen as the most effective means of narrowing discounts by shareholders - see Diagram 5 below. So which tactics are preferred?

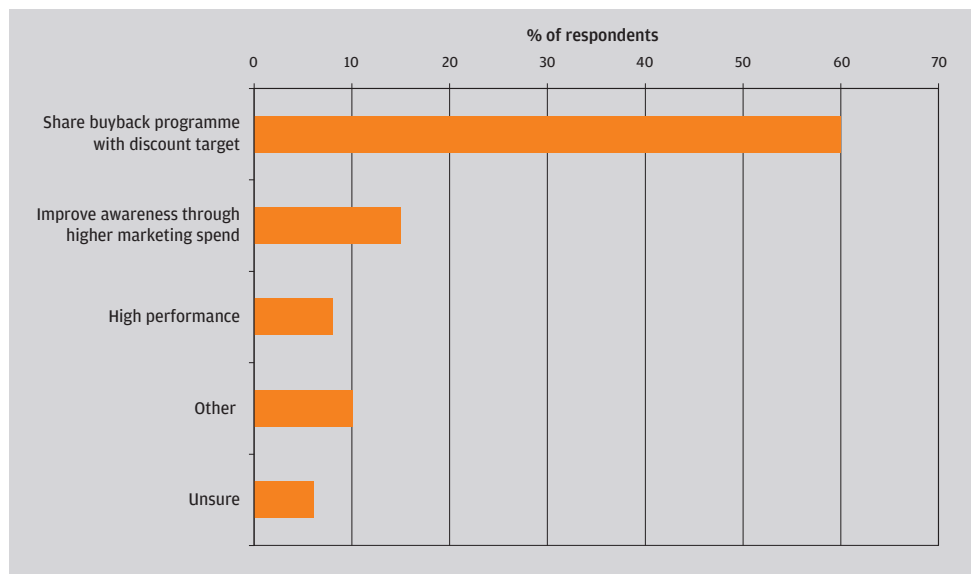
Share buybacks

The practice of buying back and cancelling investment trust shares has become one of the most widely-used means of tackling discounts.

In 2004, directors were ambivalent about the effectiveness of share buybacks: only 46% said buybacks were an effective means of managing discounts and only a third of directors believed they have a long-term impact.

Even so, 60% of directors now believe that a share buyback programme with a discount target (e.g. the buyback programme is activated if the discount hits a certain level) is the most acceptable means among shareholders to manage discounts - more so than increasing marketing spend or trying to improve performance to boost demand for shares.

Diagram 5: Shareholders' likely preference to narrow discounts



Source: J.P. Morgan Asset Management/TNS

Treasury shares

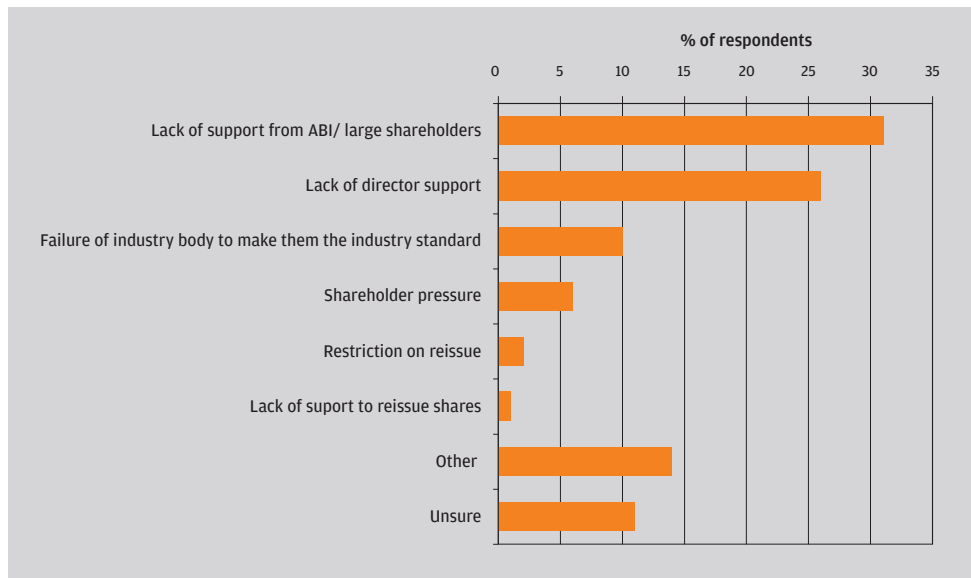
‘Treasury shares’ extend the concept of share buybacks. They enable a trust to buy back its shares but then hold them in treasury with the option to reissue them at a future date, subject to shareholder approval. Introduced at the end of 2003, it was hoped that treasury shares could give trusts greater control over both discounts and liquidity.

Five years on from their introduction, over half of directors believe treasury shares can be partially effective in managing discounts/premiums but only 4% of directors believe they are highly effective - and almost a third - 29% - believe they are ineffective.

In 2004 almost half (49%) of directors believed the ability to hold shares in treasury would improve liquidity for investment companies. Today, the majority view is that any positive effect on liquidity is limited and one in four directors believes treasury shares have no positive effect on liquidity at all.

Around one in three directors attributes this lack of success primarily to lack of support for the concept among institutional shareholders and leading institutional trade bodies, some of whom have voiced concerns that treasury shares create a share overhang, dilute the value of existing share holdings and/or are likely to be reissued at a discount.

Diagram 6: Reason for low usage of ‘treasury shares’



Source: J.P. Morgan Asset Management/TNS

One in four directors also cite lack of support for treasury shares among board directors themselves, while 10% cite the failure of the industry to make treasury shares an industry standard as a contributing factor to the lack of uptake.

The significance of discounts

But it seems that directors increasingly accept discounts as a fact of life. The percentage of directors that believes discounts are the biggest threat to the survival of investment trusts within the UK investment market has dropped substantially since 2004, from 28% to 10%. Plus, only 17% of directors believe discount issues are a major hurdle in increasing investor uptake.

Compared to 2004, marginally more directors (46%) believe volatility in the discount, rather than its absolute level (36%) is the biggest issue for investors.

Comment

While discounts are a continuing concern for investment trusts, directors appear more ready to accept them as a fact of life for closed-end funds. Provided the level of discount is kept reasonably constant, they are not viewed as a major deterrent to investment.

Share buybacks are seen as the most acceptable strategy to manage discounts. However, it is clear that a significant change is required for treasury shares to achieve a similar level of support - especially among the institutional investor community.

It is worth noting that, since 2004, 29 investment trusts have exercised the right to reissue shares from treasury, of which 15 companies reissued at a premium (source: AIC; June 2009). This may help to allay institutional concerns that treasury shares inevitably means re-issuing shares onto the market at a discount.

Overall, directors do not expect to eradicate discounts completely - nor do they appear to believe discounts outweigh the other extensive benefits of closed-end investment vehicles. However, in our view, discounts and wide dealing spreads are a deterrent to investment and investment companies need to continue to support simple, transparent solutions to improve the relationship between share price and net asset value - including broadening distribution, improving marketing and making judicious use of buybacks and treasury shares where appropriate as well as other means to offer an exit at NAV.

As an investment trust manager, we would like to reach a situation where trading at or very close to asset value is the norm for all listed investment vehicles and the key driver of a buying decision is the nature of investment returns. We believe it is a sensible strategy to spend a modest amount on marketing and awareness to improve liquidity.

iv. LIQUIDITY:

Broker proactivity and wider retail share ownership most likely to improve market flow

As closed-end vehicles with a fixed number of shares in issue, investment trusts have to be careful to maintain sufficient liquidity to ensure daily trading for investors and to manage the spread on buying and selling prices.

Role of brokers

Many board directors would like to see brokers play an active role in improving liquidity in the market. Two-thirds of directors (65%) believe that transactional flow in the market can be improved if brokers engage in more proactive communication with major shareholders. One in four directors would like to see brokers injecting more capital into the market to improve liquidity.

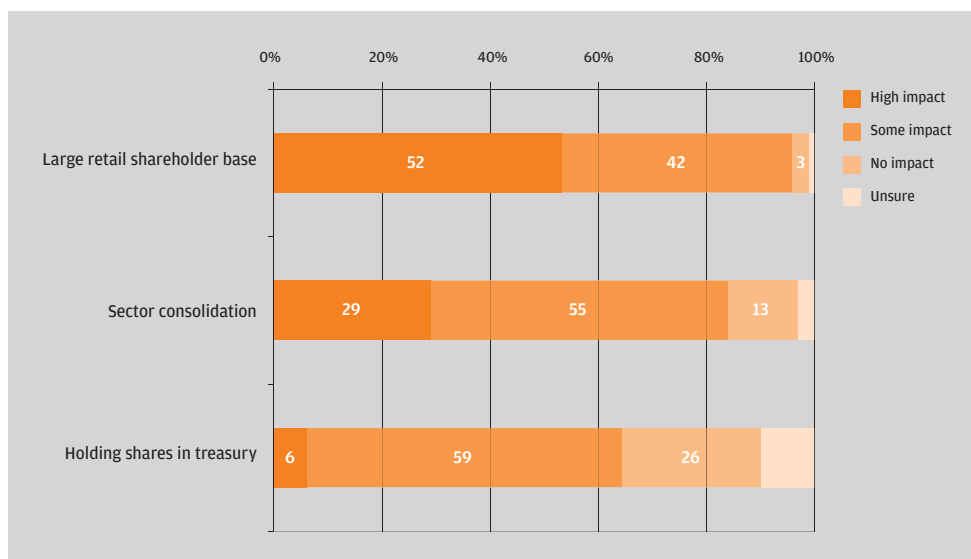
But other tactics also need to be explored, directors believe. The proportion of directors that believe that a large and growing retail shareholder base can improve liquidity in an investment trust or investment sector has risen from 75% in 2004 to 94% in 2009.

Likewise, the proportion that believes consolidation of trusts will improve liquidity across the sector has risen from 48% to 84% - see Diagram 7 below.

Liquidity v discounts

But the need to improve liquidity has to be balanced against the need to manage discounts: 87% of directors believe share buybacks reduce long-term liquidity although only 23% believe this impact is significant. Alternatively, holding shares in treasury - a strategy intended to reduce discounts without damaging liquidity - is only considered to have a significant positive impact on liquidity by 6% of directors.

Diagram 7: Measures to improve liquidity and their perceived impact



Source: J.P. Morgan Asset Management/TNS

Comment

Maintaining high levels of liquidity in investment company shares is key if closed-end investment companies are to compete successfully with other savings vehicles where the ability to buy and sell shares freely is not an issue. Board directors say they would like to see wider interest in investment trusts among mainstream intermediaries but this is unlikely to happen unless advisers can be assured their clients can buy and redeem their investment at any time - and at a reasonable bid/offer spread.

Although the broker community may have been instrumental in driving liquidity levels in the past, it is important to appreciate how the market has changed as investment in investment trusts has moved away from the institutional market.

Rather than looking to brokerage houses to ensure liquidity, we believe - as many board directors clearly do - that liquidity is primarily improved by having a diverse shareholder base spanning both retail and institutional investors and this is where we believe the industry now needs to focus its efforts.

In our view, patchy liquidity and erratic spreads between the bid and offer price for investment trusts can undermine the positive appeal of investment trusts.

² Based on total market capitalisation value of £37.6 bn for UK conventional investment companies (source: AIC) and total UK stock market value (main market and AIM) of £1,505bn (source: London Stock Exchange) as at July 2009.

V. GOVERNANCE & REGULATION: Increased support for code driven regulation and diversified boards

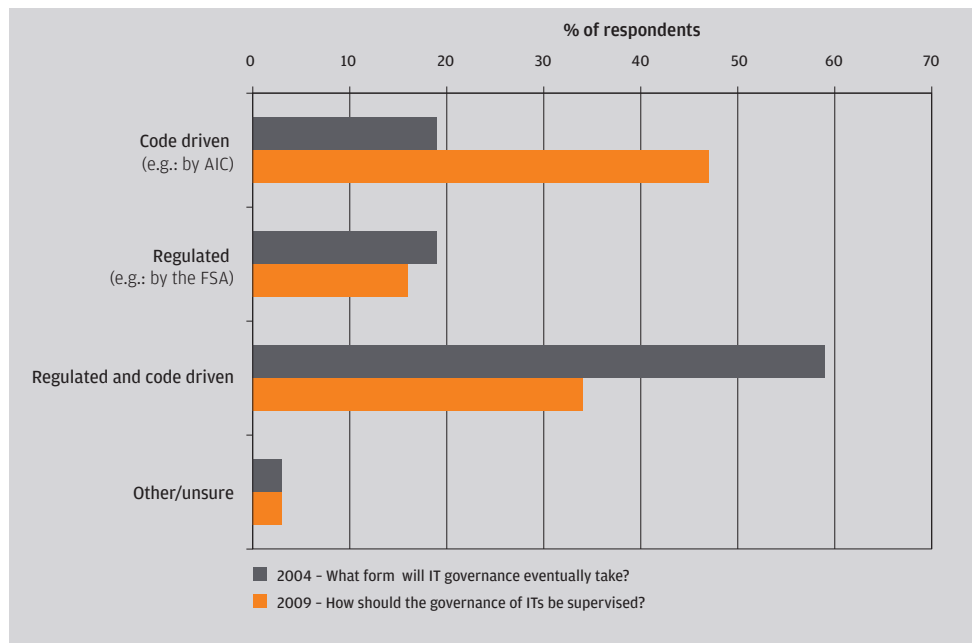
Five years ago, the investment trust industry was responding to calls for better governance in the wake of the split-capital trust crisis. Since researching this report investment trusts have been particularly caught within the EU Directive calling for greater regulation of non-UCITS funds.

Regulation

Directors generally are wary of over-regulation. Five years ago, half of directors believed that increased regulation was making the role of the non-executive director too onerous. Five years on, this proportion has increased to 88% - although only 37% believe regulation has increased a director's responsibilities excessively.

In 2004, 59% of directors predicted investment trusts would eventually governed by both regulation and an industry code. Five years on, 47% of directors would prefer investment trusts to be governed solely by an industry code.

Diagram 8: Expectations for investment trust regulation



Source: J.P. Morgan Asset Management/TNS

Recruiting directors

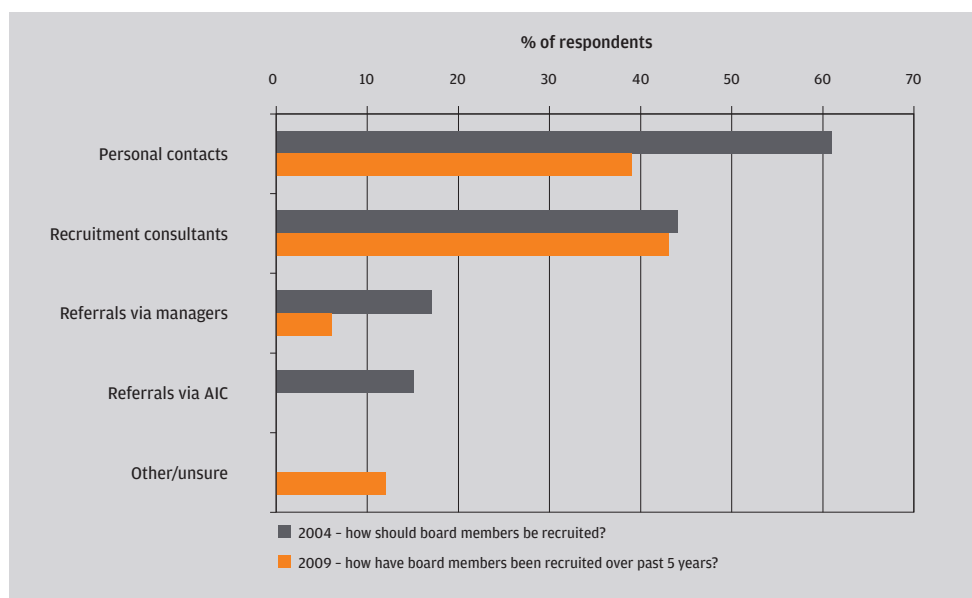
The investment trust industry has taken measures to safeguard the independence and diversity of boards – for example through the AIC Code – and these steps appear to have had an impact.

In 2004, for example, 61% of directors believed that personal contacts should be the key means of recruiting board directors. However, only 39% of directors now say that personal contacts have been the key means of recruiting over the past five years, while 43% say they have primarily used recruitment consultants.

Other ‘intra-industry’ methods of recruitment – i.e. via fund managers and the Association of Investment Companies (AIC) – have also been used far less than directors anticipated five years ago – see Diagram 9.

This growing preference for using external consultants may be leading to more diversified board composition: 63% of directors agree that using recruitment consultants has led to candidates that the boards would not typically have considered.

Diagram 9: Principal method of recruiting new board members



Note: Respondents allowed to select multiple options in 2004 survey.

Source: J.P. Morgan Asset Management/TNS

Stakeholder relationships

As well as more diversified boards, directors also seem in favour of a more fluid relationship between stakeholders in a trust.

Sixty-eight percent of directors believe that professional shareholders are often reluctant to meet with directors because their key relationship is with the fund manager.

Eighty-two percent of directors therefore favour a tri-partite relationship where each party (board, manager and shareholders) have a relationship with the other two. Only 15% of directors favour a more linear approach where boards hire investment managers, who are then responsible for liaising with shareholders.

Director conviction

Investment trust directors continue to back their conviction in the sector with investment. The proportion that claims to have increased their investment in investment trusts has risen from 60 to 70%. Likewise, the proportion favouring investment trusts over open-ended investment vehicles has risen slightly from 66 to 70%.

Comment

That almost half of directors now believe investment trusts should be regulated solely by an industry code is somewhat at odds with the prevailing climate for increased financial product regulation.

For example, the FSA has proposed raising the level of product knowledge for advisers to be considered independent to include investment trusts under its definition of retail funds.

We welcome any well-thought out measures that can increase investor confidence and engagement in the savings market without stifling innovation. For example, bringing investment trusts within the definition of retail investment products in the UK means that all advisers would need to have a knowledge of investment trusts to be able to call themselves independent. This can only be good for the industry.

However, we do have concerns about the EU's AIFM directive published more recently. While there are welcome proposals such as a Europe-wide passport for alternative investment funds, there are recommendations which could prove particularly difficult for UK-listed investment trusts and other closed-end funds. Attempts to ring-fence fund distribution and management within the EU will impose further costly change.

Overall, we recognise that the trend is now for greater regulation, rather than less - and investment companies that want to achieve wider retail share ownership will need to be alert to the trade-off involved with this.

But, it should be recognised that extensive measures have already been taken over the last five years to improve the corporate governance of investment trusts including the Association of Investment Companies' Code of Corporate Governance (the 'AIC Code'), which has been approved by the Financial Reporting Council as an acceptable interpretation for investment companies of the Combined Code and the Listing Rules.

The preference among board directors for code-driven regulation is not simply reflective of a desire for less onerous regulation. It is also a tribute to the AIC's success in developing a flexible, workable but comprehensive set of principles for investment companies to follow - and one which fits well with the FSA's own stated preference for principles-based rather than rules-based regulation.

vi. FEES:

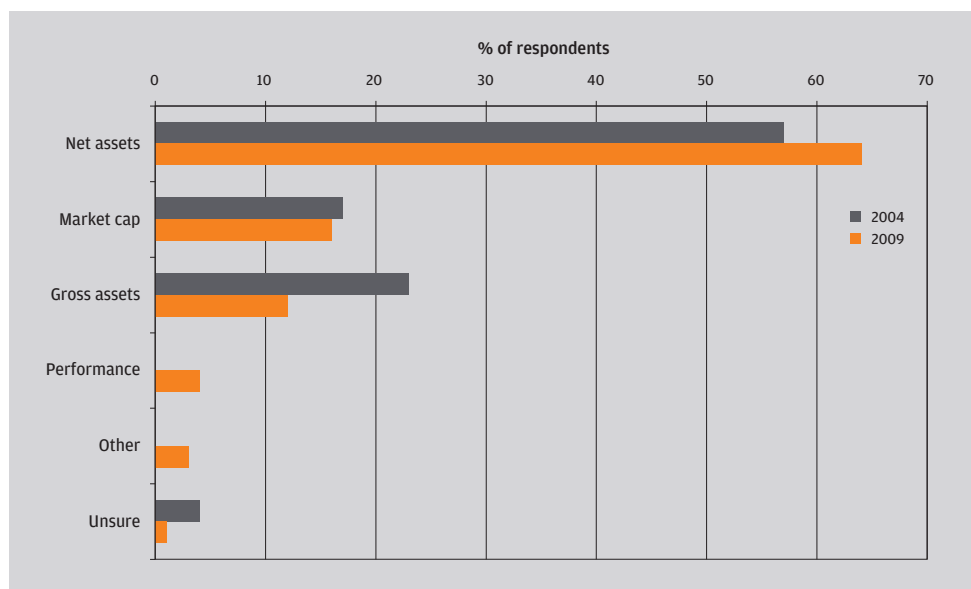
Low costs remain a powerful differentiator

Investment trusts have built a reputation for having lower costs than other comparable investment vehicles and directors appear keen to protect this status.

Sixty-one percent of directors are against increasing total expense ratios to allow greater marketing spend to increase awareness of investment trusts. Likewise, only 27% believe investment trusts should pay commission to IFAs to increase their uptake.

In terms of calculating management fees, the majority of directors (64%) still favour using net assets as the basis of calculation. The proportion in favour of calculating fees on gross assets (i.e. assets plus debt) has halved to 12% over the past five years. In fact, market capitalisation is now a more popular basis for fee calculation than gross assets – even though the fund manager has no direct control over the market value of a trust's shares.

Diagram 10: Preferred basis for management fee calculation



Source: J.P. Morgan Asset Management/TNS

Performance-related fees

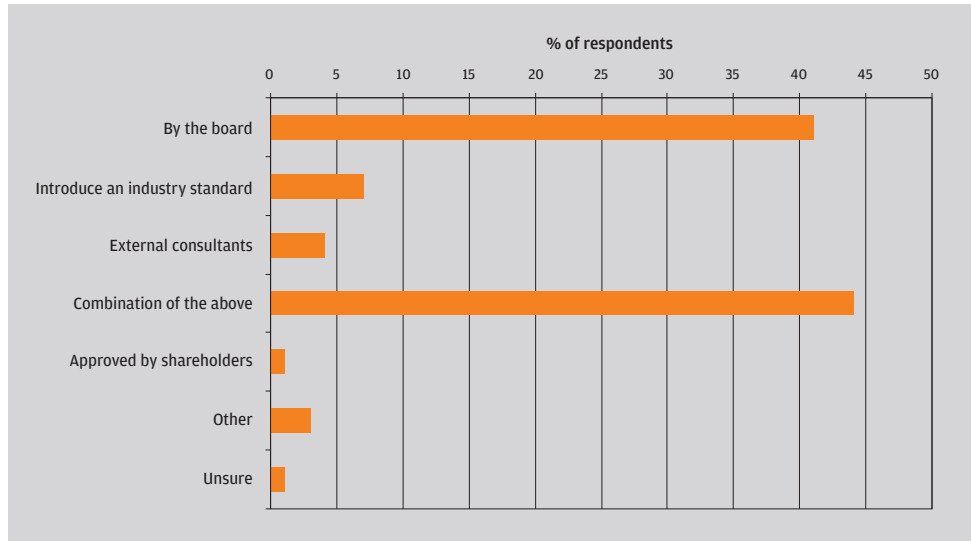
In 2004, two-thirds of directors agreed that lower management fees in return for performance fees would be a positive development for the investment trust industry and believed this could align interests of managers and shareholders. Since then, the number of investment trusts employing some form of performance-related fee has increased steadily. As at August 2009, 130 conventional investment companies incorporate a performance-related fee (source: AIC/Lipper).

Although performance-linked fees have been widely adopted, 49% of directors believe performance-based fees should be employed even more extensively by investment trusts, marginally outstripping the 43% who disagree.

Director's fees

As to their own fees, 41% of directors believe their remuneration should be set solely by the board. However over half (51%) of directors believe a combination of influences, including an industry standard and external consultants, should be involved in determining director fee levels.

Diagram 11: How should directors fee increases be set



Source: J.P. Morgan Asset Management/TNS

Comment

Lower total expense ratios (TERs) are one of the great strengths of investment trusts and should be carefully protected. In volatile markets - where investors become more sensitive to cost - lower TERs become proportionately more attractive.

Communicating this cost benefit more forcefully may be one way to improve the retail uptake that directors believe to be so critical to survival of the investment trust sector. As we have suggested elsewhere, the fact that investment trusts do not incorporate commission may also be increasingly viewed as a benefit by intermediaries and other distribution channels, given the proposals in the FSA's Retail Distribution Review to separate the cost of advice from the cost of product manufacture.

However, investment trusts shouldn't be complacent about their reputation for low expenses. The fact that 40% of directors believe they alone should set their own fees sits uncomfortably with current calls for wider control over public company pay.

vii. FUTURE TRENDS:

Consolidation expected but some sectors still on course for strong growth

Directors are expecting significant challenges for the investment company industry both in terms of competition within the UK savings market and pressure for consolidation among small and struggling investment trusts. But there is still potential for expansion in some areas.

Threats to the sector

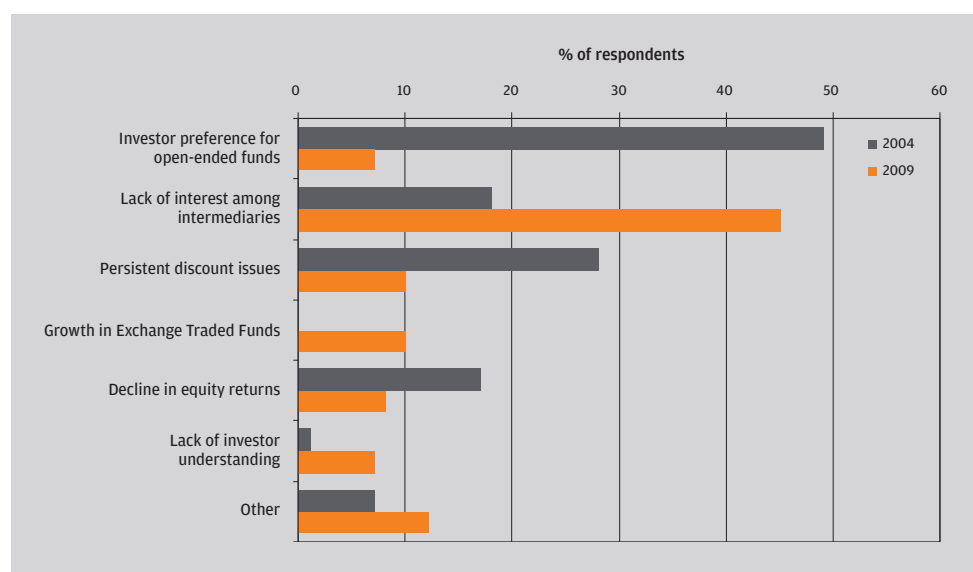
Perceptions as to the biggest threats to investment trusts within the UK savings market have altered significantly over the past five years. There is a mix of factors: some structural within investment trusts, some threats from competing products and some lack of demand which may be driven by the previous two.

In 2004, almost one in two (49%) directors believed the biggest threat was investor preference for open-ended investment vehicles. In 2009, this had dropped to just 7% of directors - see Diagram 12 below.

Only 6% of directors believe the ability of OEICs to now use gearing has had major impact on investment trusts' ability to attract investors and a third of directors believe it has had no impact at all. If anything, exchange traded funds - easily-tradeable securities that track a stock market index - are considered a bigger concern, with one in 10 directors citing ETFs as a key threat to investment trust survival.

By far the biggest single threat to the survival of investment trusts, directors believe, is lack of interest among intermediaries, cited by 45% of respondents.

Diagram 12: Biggest threat to investment trusts survival in the UK investment market



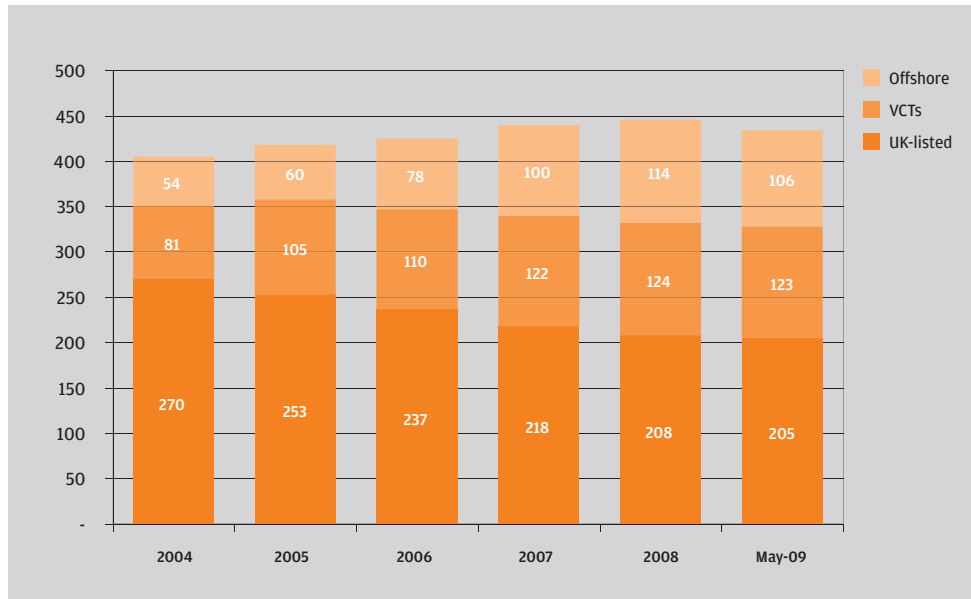
Source: J.P. Morgan Asset Management/TNS

Changing size of the sector

Eighty-four percent of directors welcome the prospect of consolidation in the investment trust sector, believing it would improve liquidity.

By 2018, directors anticipate that the number of UK-listed investment trusts will stand at a mean of 259. In fact, if we look at the numbers of UK-listed conventional and split-capital investment trusts, we see that numbers have fallen steadily over the past five years from 290 to just 205 trusts as at May 2009. However this has been countered by steady growth in the number of venture capital trusts and offshore investment companies - keeping the number of overall sector constituents to remain above 400 - see Diagram 13 below.

Diagram 13: Total number of investment trusts



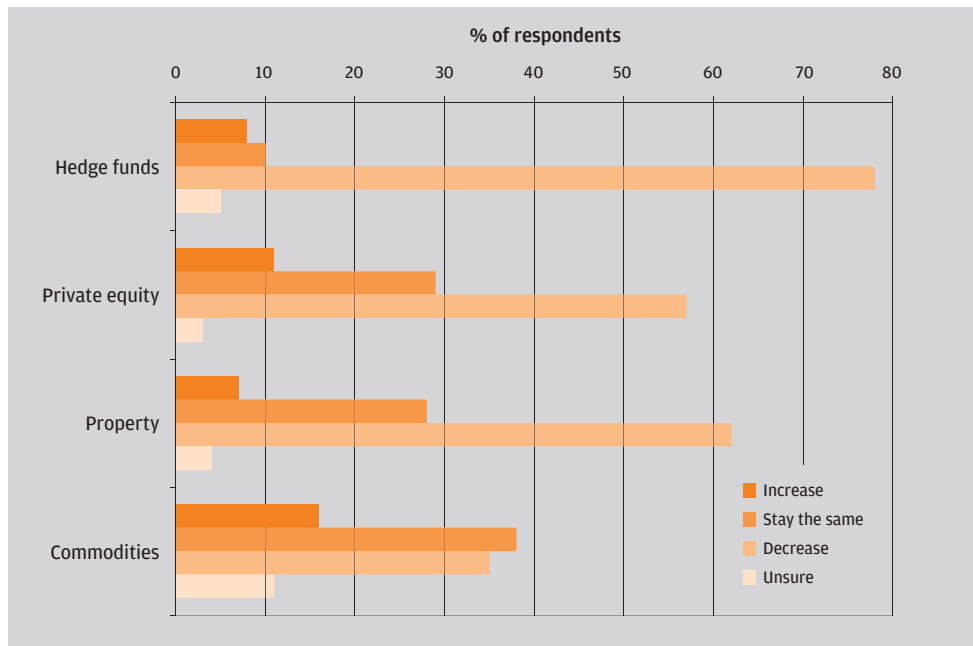
Source: Association of Investment Companies

Much of the contraction in the UK market has resulted from liquidation of trusts rather than consolidation, with the AIC reporting only nine trust mergers over the past five years. Directors believe consolidation is being held back primarily either because the process of merger is too difficult (cited by 36% of directors) or by the lack of value-creation opportunities (cited by 32%).

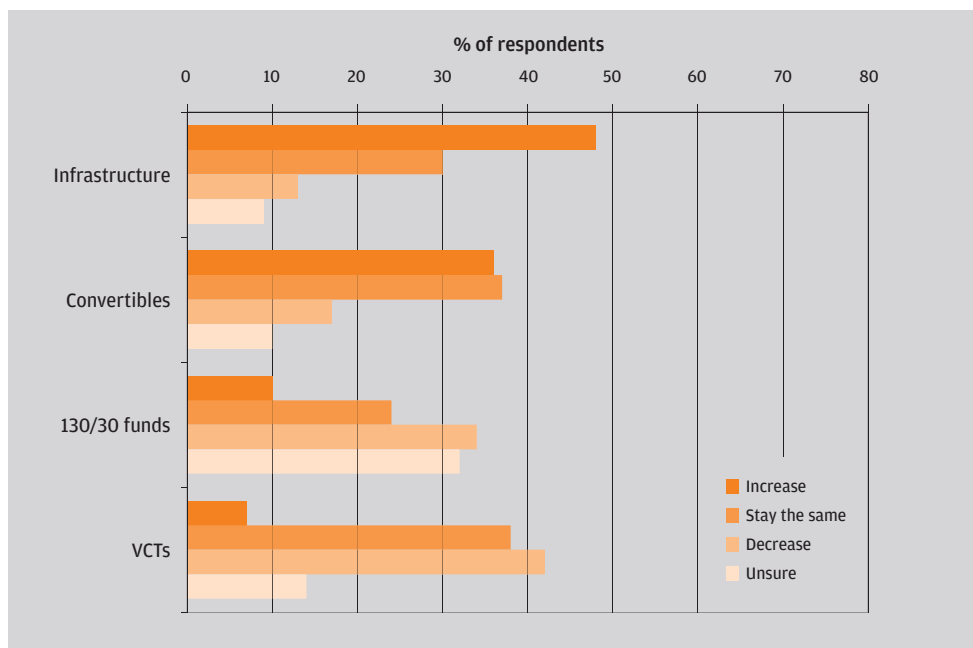
Changing composition of the sector

Directors are expecting significant contraction in some specialist areas of the market - see Diagram 14. Hedge funds, private equity and property closed-end funds are generally expected to see a reduction in numbers between 2009 and 2011. The number of commodity-based investment companies and venture capital trusts is largely expected to either decrease or remain stable over the next two years. Conversely, 78% expect the number of infrastructure closed-end funds to either remain stable or increase.

Diagram 14: Expected sector development 2009-2011



Expected sector development 2009-2011



Comment

The future of the investment trust sector has long been expected to involve substantial consolidation. But while we have seen a steady decline in the number of UK-listed investment trusts over the past five years, this has been countered by a growing number of offshore trusts and venture capital trusts.

This is testament to the fact that the closed-end structure of investment trusts uniquely lends itself to specialist asset classes as well as generalist investment strategies. Some sectors such as hedge funds and property, which have seen very rapid recent growth, are likely to see a reduction in numbers going forward. We, like the rest of the industry, would also welcome consolidation among struggling, illiquid trusts – although expectations of wide-scale trust mergers have largely been unfounded.

However, the future of the sector may be more robust than many commentators expect. The investment trust industry's inventiveness should continue to encourage the formation of new investment companies. For example, the introduction of a 50% top-rate of income tax may lead to renewed interest in zero-dividend preference shares whose returns are set against capital gains tax. More attractive tax treatment of bond income from September 2009 may lead to a wider choice of income-generating trusts, with investment trusts particularly well suited to investing in less-liquid areas of the bond market.

Quite rightly, few directors feel that open-ended funds are a key threat to investment trusts. However exchange-traded funds are considered a concern although they are not necessarily competitive on fees. With the advent of actively-managed ETFs, investment trusts do need to consider how they can match these vehicles in terms of ease of trading, performance and popularity with certain groups of investors.

Conclusion:

Retail success lies in promoting what investment companies do best

Five years on from our first Investment Trust Directors Survey, there have been some notable shifts in director perceptions.

Persistent discounts are still an issue but do not dominate director concerns. Open-ended investment company funds are no longer considered a particularly potent threat, even though they have been given greater powers to use gearing to boost performance in the same way that investment trusts can.

What has emerged as a major concern this time around is the lack of interest and understanding in investment trusts among mainstream retail channels.

Investment trusts already have a strong presence in the wealth management and private client space. But given the decline in institutional investment in investment trusts, channels such as private client stockbrokers can no longer be relied upon so heavily to achieve the take-up that investment companies require.

Securing a greater presence on investment platforms and better IFA distribution is now seen as essential to achieving that investor take-up. This in turn, many directors believe, will give investment companies the diversified and growing shareholder base they need to improve liquidity and narrow discounts.

The question now is how can that greater mainstream retail engagement be achieved?

As our findings show, board directors are largely reluctant either to increase marketing spend to raise awareness and understanding of investment trusts, or to incorporate commission into trusts to improve uptake. Quite rightly, directors recognise that one of the great strengths of investment trusts are their low expenses relative to other types of investment vehicles. However the industry now needs to consider how it can retain its reputation for cost-efficiency while continuing to invest in its future.

There are clear opportunities ahead to achieve greater retail uptake. The general refusal among investment trusts to incorporate commission into their savings schemes may prove highly advantageous in the light of the FSA's Retail Distribution Review and its drive to separate the cost of product manufacture from the cost of advice. In addition, the Retail Distribution Review has proposed that investment trusts should be included among the retail investment products that independent advisers must consider. This opens up a clear educational opportunity - and the investment companies that respond most effectively will claim a clear advantage here.

Investment trusts have a number of strong advantages - and some drawbacks - but in our view the combination of fees, governance and transparency should appeal most strongly to private investors and their advisers.

The enduring inventiveness of investment company managers and their ability to devise solutions to real investor needs and new market opportunities is another plus that must be exploited to the full. The closed-end structure has repeatedly been shown to be highly appropriate for many specialist or less liquid areas of investment - and these should continue to be an area of growth.

Moreover, as many of the directors surveyed in this report clearly believe, investment trusts should not try to position themselves as a substitute to other investment vehicles such as OEICs, but rather as a complement.

The sheer variety of investment companies means it is increasingly difficult to talk about them as a homogeneous sector, ranging as they do from conventional investment trusts to venture capital trusts to offshore investment companies.

Nonetheless, if investment trusts and other closed-end vehicles are to achieve greater retail market penetration and a more diversified shareholder base, we believe they should retain the attributes that make them so valuable to investors (competitive costs, long-term investment approach, controlled gearing) and focus on promoting these benefits aggressively. After all, it is demand for investment companies shares that will solve ancillary concerns such as discounts and liquidity - and demand will only come if the unique benefits of these investments are known and understood.

Most of all, the sector should not be deflected by current tough market conditions from focusing on what it does best. The combination of highly-respected fund managers working closely with experienced, diverse boards within a framework of pragmatic governance and cost efficiency has the potential to serve investors well for many years to come.

A handwritten signature in black ink that reads "David Barron." The signature is written in a cursive, flowing style with a period at the end.

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

October 2009

