We Need to Talk About Investment Trusts

HAWKSMOOR
FUND MANAGERS

In July and August of 2023, we wrote a series of blogs (‘Funds Crescendo’) highlighting the issues facing the investment trust sector and offered some recommendations about how these might be resolved. In this document we bring these articles together.

Introduction

This is the introductory Crescendo of our forthcoming six-part series on what to do about the current malaise impacting a sector we have always been huge supporters of. This may be a difficult read for some and may come across critically. We want to reassure everyone that our intentions are good: We care deeply about the Investment Trust sector, it has given our investors access to world class managers and asset classes that would ordinarily only be available to the wealthiest part of society via Private Funds. This exposure has been a huge contributor to our three Funds’ strong long-term performance.

It is our belief that too few stakeholders are aware of how bad the situation has become, and we are concerned that stakeholders with the wherewithal to impact the sector positively are either too complacent, unaware of the unintended consequences of their actions or simply unaware of how serious the current situation is. At the heart of the problem is the increasing evidence that discounts are becoming entrenched. The purpose of this six-part series is to try to come up with some recommendations for how the situation could be improved. The end-goal MUST be to create an environment where investment companies and trusts can trade on premia for long periods.

We have certain core beliefs, and these will form the pillars on which we build our arguments in the forthcoming series:

The purpose of an Investment Company / Trust being listed is threefold:
- to access growth capital
- to provide access to world class managers and asset classes that investors would not otherwise be able to invest in
- exploiting the closed-ended structure to deliver superior performance.

Investment Trusts are not “Funds” in the same way open-ended Funds are “Funds”. There is a share price and a Net Asset Value. The stock market provides a mechanism that intrinsically discounts any costs associated with maintaining and growing the NAV. The Investment Trust is thus not a substitute or rival to the open-ended Fund. It is a fundamentally different and complementary construct.

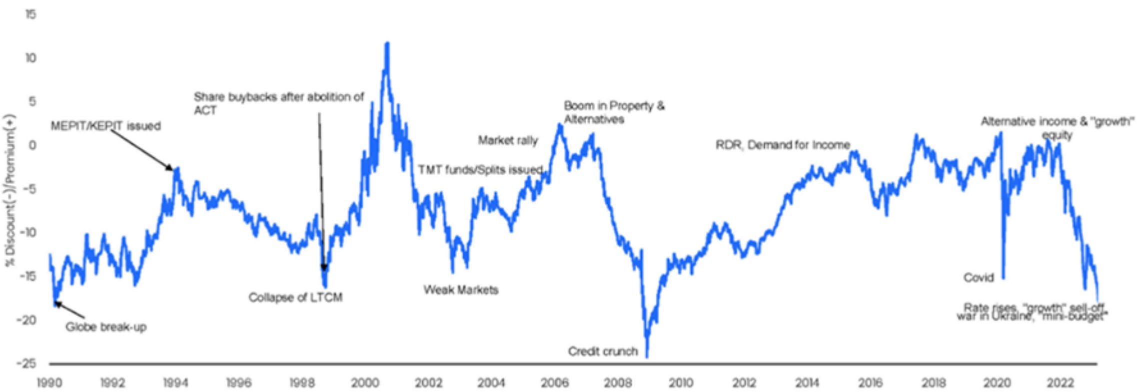
Our series of Crescendos over the coming weeks will be in five further parts under the following headings:
- Why are discounts currently so wide and why does it matter?
- The IPO process
- Alignment of interests and structure
- Capital Allocation and Corporate Activity
- Relevance and communication

We end with a Crescendo outlining our recommendations. We think it is important to not just point out flaws but suggest ways forward. In doing so, we recognise that we do not have a monopoly on wisdom. We are certain we have either missed something or that others will disagree.

Part 1 –Why are Discounts Currently Wide and Why Does it Matter?

Addressing persistent investment trust discounts is vital not just for the health of the sector, but also for the whole UK economy, with responsibility falling on all stakeholders; investment company directors, investment advisors, brokers and all shareholders, both institutional and retail.
When discussing discounts, a clear differentiation needs to be made between investment trusts that own liquid assets, i.e. equities, and compete with open-ended funds and those that own fewer liquid assets i.e. smaller company equities, loans, alternative assets etc. With the former group, we believe the discount is a choice. It is clearly in the power of boards to undertake some form of corporate event which might include liquidating part or all of the portfolio to buy back shares or to return cash to shareholders. Shareholders and boards simply should not tolerate persistent discounts in those trusts. On the latter group, the discount is a reflection of multifarious factors that may be outside the board's control. In any case, across all trusts where a discount is persistent, potential solutions are not possible without the board's recognition.

Illustrated by the below chart from Numis, the investment companies' sector is trading at close to the widest discount in history.



Source: Numis 30/04/2023.

Historically, investment trust discounts have broadly correlated with stock markets with discounts widening in 'risk-off' periods. However, the current historically wide discount is at odds with that past-experience for a number of reasons, some of which are laid out below:

1.The great re-pricing of fixed income and debt.

The composition of the investment trust sector has changed markedly with new issuance over the past decade dominated by alternative asset classes, that represent around 50% of the sector, many of which have income focussed return targets. In a world of rock-bottom risk-free rates, the relative yield attractions of alternative income trusts saw many trade on persistent premia. The 2022 step change in the returns available from vanilla fixed income has, however, seen these premiums turn into discounts as investors move to price these alternative income trusts on a yield basis relative to competing assets. With many alternative investment trusts applying leverage, higher interest rates also impact via the channel of higher debt costs whilst forward NAV expectations are also susceptible given the opaque discounted cash flow valuation methodology employed by many. With that 50% of the sector represented by alternatives, their NAVs are calculated using a variety of methodologies, usually by an independent valuer and report to the market on a quarterly or six-monthly basis. There will therefore be occasions when discounts are still reflecting the old NAV and effectively pricing in future changes in the valuation.

2. Negative sentiment towards particular asset classes.

For example, sentiment towards 'growth capital' trusts has reversed with these former darlings of the sector now deeply unloved today. The largest investment company, Scottish Mortgage has been at the epicentre of this shift moving from a premium in November 2021 to a 20% discount today as a result of the changing macro and interest rate environment.

3. An over-supply of trusts in particular sectors.

There are simply too many trusts doing the same thing. For example, one large asset manager has four Asia Pacific trusts, with each of them trading on double-digit discounts. While they each have an independent board of directors and will have slightly different objectives, this neatly illustrates the over-supply issue. Too much supply combined with often poor liquidity means too many trusts lack relevance, particularly in the context of vanilla equity trusts where many closed-ended mandates could just as easily be managed within a daily dealing open-ended fund. In addition, the externally managed structure can be a barrier to consolidation (with some boards perhaps not wishing to lose their jobs, or the management contract putting off potential acquirers).

4. Structural headwinds around fees.

The Investment Association's recent guidance for all funds in the IA sectors, to disclose investment companies' 'costs' within their own OCFs has, despite good intentions, provided a disincentive to invest in them. That compounds the wealth management community's aversion to the sector partly because of the requirement to disclose these costs since MIFID. There can be no doubt that a significant portion of the UK's investor base now no longer invests in the sector or is currently actively disinvesting.

5. Wealth management consolidation.

Ever larger wealth and asset managers demand scale and liquidity meaning their market cap threshold for investing in investment trusts has got higher and higher over the years, thus reducing the number of eligible trusts in their universe.

6. Weak corporate governance and shareholder inertia.

A long-argued advantage investment trusts have over their open-ended equivalents is the presence of an independent board of directors whose job it is to prioritise the interests of shareholders over the interests of the investment advisor. There is plenty of anecdotal evidence where those priorities have been the wrong way round, but the presence of these persistent discounts is, in our opinion, hard evidence of sub-standard corporate governance within the sector over recent years. The inability or unwillingness of all shareholders to engage and hold Directors' feet to the fire has compounded the issue.

Why discounts matter?

In the past, wide discounts have, to a degree, been self-correcting with the powerful combination of a rising NAV and narrowing discount attracting new buyers. Confidence in this dynamic playing out going forward is however, undermined for all of the reasons outlined above with important implications for the sector, investors and broader economy alike:

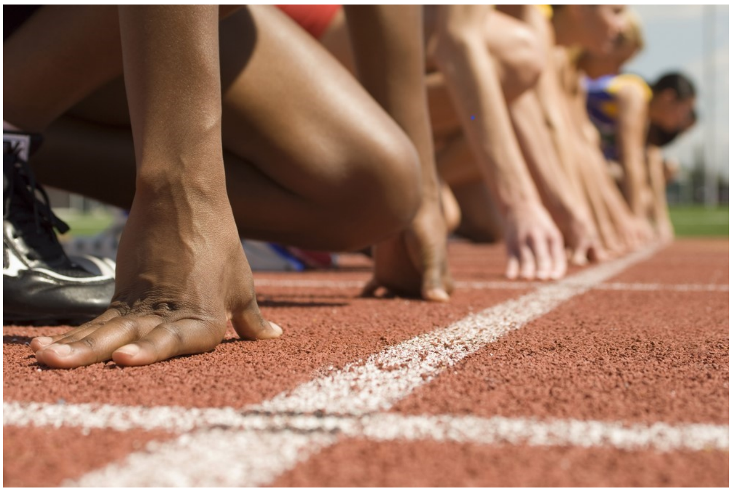
1. The long-standing accepted process of investment trust IPOs is that shareholders pay a 2% premium on day one, reflecting the costs involved in setting it up. We will talk about the IPO process later in this series and how it needs to change, but that derating from a premium to discount is painful and off-putting for day-one investors.
2. Discount volatility is often cited as a reason to not invest in investment trusts. Investors in trusts, particularly those alternative asset classes that promote an uncorrelated return to equities and bonds, need comfort that the shareholder total return will closely track that of the net asset value.

3. A key attraction of being a listed company, rather than a private fund, is access to growth capital. As all equity issuances should be done at a premium, investment trusts trading on a discount cannot raise capital. The window for IPOs and secondary raises also closes when the whole sector or peer group is trading on a discount.
4. Renewable energy and infrastructure trusts comprise a material part of the sector and, beyond their importance to the UK stock market, they are also important for the UK economy. The example we often give on this subject is the battery energy storage trusts which own approximately 40% of all energy storage projects in the UK today. Without these investment companies launching over recent years and raising significant amounts of money in subsequent secondary placings, the renewable infrastructure industry would be constrained in meeting the UK's energy transition targets.

The difficulty in assessing why discounts are currently so wide is the inability to scientifically disaggregate the various causative factors. We believe there is a real danger of complacency. Many boards are too reliant on sentiment or cyclical factors to explain away the discount on their trusts. Some of the factors we point out above are new and structural in nature. It is time to face up to these issues and do something about them.

Part 2 – The IPO Process

On the 27th April 2023, we demonstrated why we thought the IPO process for investment trusts was close to absurd. Rather than repeat those arguments, we would urge you have a quick read (see here). It is our strong belief that the following issues need to be addressed:



Day 1 investors should receive £1 of assets for their £1. Any costs should be borne by the chief day 1 beneficiaries of the launch: the investment adviser. If the investment adviser does not have the capital to pay these costs, it is not hard to think of arrangements whereby they can finance it: either through borrowing the money with the debt secured against the fees as stated in the investment management contract, or by deferring the consideration due to the broker.

In general, day 1 investors should be rewarded not penalised – as happens with normal equity IPOs or even with open-ended funds (with founder share classes). Investors could be involved in the valuation and purchase of the day 1 portfolio (if it involves the purchase of a ready-made portfolio of assets). Subscription shares should be considered. A special class of share held only by day 1 investors could be considered. Too often, investment advisers benefit to a much greater degree than shareholders. Many asset management businesses have been launched / created / had their growth accelerated on the back of investment trust IPOs, and then sold for huge sums. Day 1 investors should share in these gains, with perhaps a revenue share on the fees earnt by the management company or a share class with a stake in the investment adviser.

IPOs of investment trusts should ideally not be cash shells. In some cases, transactions costs to acquire the seed portfolio can exceed 7% (e.g. property). Cash shells also mean execution risks, which are borne by the investor, making day 1 economics even more absurd. As a minimum, no fees should be earned on uninvested cash, and there should be penalties (on the investment adviser) if cash is not deployed within a certain time frame (e.g. a backstop wind-up provision).

There is an asymmetry of information at most investment trust IPOs that needs to be reflected in pricing. A new asset class comes to market (e.g. song royalties) and inevitably the investors know less than every other stakeholder and the due diligence process can't cover the information gap. This is arguably true of all IPOs, but it is only with investment trusts that this risk isn't rewarded adequately. Transparency and disclosure need to be enhanced for these asset classes.

All too often we find that the investment advisers are new to the investment trust world. For example, they may underestimate the risks of not trading at a premium (constraining growth) or the role of the Board. This can manifest itself in poor governance post-IPO (e.g. influencing the Board to issue shares at a discount) or treating shareholders with disdain.

Board selection is often opaque. The pool of non-executive directors is not as broad or deep as it should be. The Board is chosen after the investment adviser and broker have been appointed. Too often this results in a Board being too close to the investment adviser.

Post-IPO market dynamics are often far too unhealthy. Every penny is taken at IPO leaving a weak secondary market. If day 1 pricing were to be more in investors' favour, perhaps books would be more often over-subscribed, and the probability of post-IPO premium ratings would be higher.

All IPOs should be accompanied with rock-solid longer-term protections – either in the form of continuation votes after a certain period of time (e.g. after the end of the term of the first management contract) or better, return of capital provisions if certain conditions are not met.

We have been encouraged that more brokers are engaging with us on this issue. We welcome the informal forums that we have participated in and would like to see more of them. We believe brokers have a crucial role in improving the economics and dynamics around the IPO process. Until the situation improves, we will continue to avoid the vast majority of IPOs.

Part 3: Alignment and Structure

We believe there needs to be significantly better alignment in the investment trust universe between Boards of Directors, Investment Managers, and brokers with shareholder interests. This requirement becomes increasingly obvious when discounts to net asset values (NAVs) are persistent as there is no motivation to do something about it due to poor incentive structures.

Board of Directors

The job of the Board of Directors is to ensure that shareholder interests are always looked after. This is a wide-ranging remit including making sure the investment advisor is managing the vehicle to the best of their abilities and in line with the objectives of the trust, to ensuring that the trust structure is relevant, and shareholder returns are closely aligned with NAV returns. One of the big positives of the investment trust structure for investors is the additional layer of scrutiny on the investment manager that having an independent board brings. Although sometimes the external managed structure of an investment management agreement can make it hard to effect changes.

Whilst there are some good Boards in place today, there are far too many examples of poor governance from Boards of Directors across the investment trust universe, with many of the issues stemming from poor alignment of interests between Boards and the shareholders they are employed to represent.

This lack of alignment is particularly noticeable when it comes to addressing investment trust discounts. Remuneration in general is poorly structured and does not incentivise Boards to do all they can to close the discount, especially the option of winding-up trusts that persistently trade on discounts. Today, most directors are paid a fixed fee each year regardless of the shareholder experience or manager's performance.

The investment companies' team at the broker Investec publish an excellent annual "Skin in the Game" report, which shows the annual fees for the directors of all investment trusts compared to the amount they have invested in the trust. What always stands out is that the annual fees that most directors receive from their role on the board is higher than the amount they have invested in the vehicle. This immediately creates a conflict of interest with shareholders: boards are more incentivised to keep the vehicle running and collect their annual fees than drive a good return on their shareholding and are especially disincentivised to wind up a trust even if it would result in the best outcome for shareholders. Turkeys don't vote for Christmas.

Ultimately, shareholders have the power to remove directors if they are not acting in the shareholders' best wishes – but this can be a complicated, long, and messy affair: many investors do not have the time or resources to pursue this. Therefore, we believe a better alignment from the start for all directors will have hugely positive repercussions for the whole sector.

Investment Managers

The job of investment managers is to achieve the investment objectives of the trust, and successfully market the vehicle to help keep demand for shares elevated and help with the trust's rating relative to the NAV. Very rarely do we see investment management fee structures that ensure close alignment with shareholders.

Today, only around 10% of investment trusts have fee structures that see the investment manager paid on the lower of net asset value or market capitalisation. Most investment management agreements have fee structures that are paid on NAV. We believe this results in poor alignment with shareholders:

1. If the shares trade at a discount to NAV, the investment manager does not experience the same pain as shareholders as their fees continue to be paid on NAV. This is especially the case if there are also performance fees based on NAV.
2. Investment managers can be overpaid based on stale NAVs. Many investment trusts only publish NAVs on a quarterly or semi-annual basis. As a result, NAVs are often stale and not reflecting current market conditions. In the event market conditions deteriorate and a discount opens, investment management fees do not reflect that until the NAV is lower, potentially a full 6 months later. We do accept this works both ways with a rising NAV, which would result in higher fees for the investment manager, also coming with a lag.

Brokers

When it comes to investment trusts, the job of brokers is varied from launching new vehicles, including appointing the initial board members, providing ongoing advice to the board, and market making.

Brokers are well incentivised to launch new vehicles and over the past decade have taken advantage of buoyant markets to help raise billions of pounds for new investment trust IPOs. When it comes to advising on M&A and wind ups however, brokers are not nearly as well incentivised. Once they have made a large one-off sum from launching a new vehicle, they are quickly onto the next thing. As we covered last week in the IPO process, this fee structure for the IPO process could be staggered over the first few years post launch and even linked to the rating of the trust during that period to ensure better alignment with shareholders.

Brokers should speak the truth to Boards and provide sound advice. However, this can be clouded by the fact that brokers want to retain their brokership and as a result there is a danger of telling the board what they want to hear rather than what they need to hear.

It is common that the investment manager is involved in the selection of the independent board during the IPO process. This should not happen and brings into question the independence of some Boards, with the risk they are more aligned with the investment manager than shareholders.

Shareholders

Shareholders have their part to play too. Too many owners of investment trusts are not engaged enough with the sector and do not speak to the Boards that represent them. This amplifies the alignment issues that comes from poor structures because it makes it difficult to effect change. If shareholders don't talk to their Boards, their Boards cannot know what is in their best interests and so the easy default position is stick with the status quo and continue to collect their annual fees and brush issues under the carpet, including persistent discounts. For a healthy, thriving investment trust sector we need engaged participation from all shareholders. Afterall, most institutional investors boast of their ESG credentials yet fail to deliver on the 'G'. We worry that the trend of industry consolidation, creating ever larger wealth managers with centralised buy lists run by analysts lacking the time, resources or skillset to effectively engage with Boards is at the heart of this lack of shareholder activism.

Investment trust structure

We recognise that when it comes to addressing discounts on investment trusts that hold illiquid assets, there are often limited options in the short term. It can take some time to sell assets to gain the liquidity required to help manage a discount either through returns of capital at close to NAV or through accretive share buyback programs (buying shares at a discount increases NAV per share). Within private equity, there is often ongoing funding requirements for companies, which at times will need to come before discount control mechanisms as failing to provide additional capital could result in material NAV falls. Many trusts employ gearing, and in more difficult times when discounts widen and as NAVs come down gearing increases and needs to be addressed ahead of issues like discounts to NAV.

Ultimately, we need to recognise that while the investment trust is a fantastic vehicle to access less liquid assets, it is not perfect. This imperfection is amplified by poor incentive structures. A discount can become entrenched for many reasons, so incentive structures need to exist to protect shareholders. Boards, brokers and investment advisers must always remember the day one shareholder who paid a 2% premium. That shareholder MUST be protected with corrective mechanisms in place to realise value, triggered by stakeholders who are incentivised to do so.

The limitations of the structure need to be addressed as part of the IPO process as outlined in "Part 2: The IPO Process", but also through reviews of existing investment trust structures.

Part 4 – Capital Allocation and Corporate Activity

The de-rating of the investment trust sector and the fact that many now trade on wide and entrenched discounts poses important questions of Boards regarding capital allocation and strategy.

All too often when questioned about wide discounts Boards and management teams shrug their shoulders and say there's not a lot they can do about the share price and that measures like buying back shares does little to drive a re-rating. This is perhaps true but that doesn't negate the importance of share buy-backs as a tool in the armoury of all trusts trading below net asset value (NAV). Buying back shares on a wide discount can be highly accretive and should be regarded as a capital allocation decision to be considered alongside reinvestment, debt reduction and other forms of returning capital to shareholders when looking to deploy cash. Buying one's existing portfolio at a discount should also be a lower risk, better informed investment than making a brand-new acquisition which on a risk-adjusted basis suggests a higher hurdle rate for the latter. From an IRR perspective the correct decision only becomes apparent after the event of course, but it would still be nice to see more boards and advisors giving greater thought to the capital allocation decision and perhaps even providing ex-post analysis of the outcome. Ultimately the burden of proof should be on the Board to outline why buy backs are NOT happening.

As previously discussed, we believe certain investment trusts in the alternative real assets space trade on wide discounts because investors don't have faith in the stated valuation of the underlying assets. NAVs for assets like infrastructure, renewables and royalties are inherently opaque with lots of moving parts and assumptions around revenue forecasts, inflation and discount rates to name but a few. With this in mind, we believe judicious recycling of capital is key. Asset disposals provide investors with transactional evidence helping to validate NAVs with the amount a third party is willing to pay the ultimate arbiter of value. Prevailing discounts also mean real asset investment trusts can no longer pursue the old strategy of buying assets with debt and then raising fresh equity to pay down their revolving credit facilities. In this new world, selling steady state projects or investments where asset management has already borne fruit provides capital to be deployed into new investments with potentially higher return prospects. Selling assets can also free up capital for accretive buybacks and whilst we accept prescriptive discount control policies are less appropriate for trusts investing in less liquid assets, we still believe buy-backs should be a permanent consideration. There are plenty of examples of alternative trusts buying back shares and we think its important more follow suit, particularly in the context of the pre-2022 rush to issue fresh equity at often debatable premiums to live NAVs. Doing something to try and address the divergence between relatively stable NAVs and prevailing elevated share price volatility is particularly important in this space given the embedded diversification qualities of the underlying assets (low economic sensitivity, defined cash flows etc.).

We're also aware that some Boards and investment advisors are reluctant to engage in buybacks for fear of shrinking the trust and impairing liquidity. The cynics amongst you might suggest that this is particularly true of investment advisors who tend to be paid on net assets as opposed to NAV per share, but ultimately boards should be independent and embrace the fact that sometimes it's necessary to shrink to grow. Ironically, the common knowledge that a Board is committed to efficient capital allocation may prevent a discount from emerging in the first place.

Whilst buy-backs can be a useful capital allocation tool, the persistence or otherwise of a discount is largely a reflection of prevailing market sentiment which a buy-back program has only limited ability to influence. The fact that many discounts have become entrenched means that other provisions should be in place to protect shareholder interests. For more liquid investment trusts these might include features like tender offers and annual redemption facilities at NAV less costs, for less liquid ones read continuation votes and redemption pools. We believe all new trusts should include these features but also think existing trusts should embrace them as a matter of course.

There are certain instances where more drastic strategic decisions are required. Trusts trading on entrenched discounts often lack relevance, scale and liquidity and should consider returning capital to shareholders or other corporate activity to address the aforementioned issues. For investment trusts with liquid underlying portfolios, discounts are ultimately a choice with the realisation of shareholder value via an orderly liquidation a fairly straight forward and easy to execute process. Managed wind-downs are also a viable option for investment trusts investing in less liquid assets. Intransigent Boards clipping their annual salaries are an obstacle to be surmounted (turkeys don't vote for Christmas) in what would be a cathartic and cleansing process with the resulting reduced supply having benefits for the sector as a whole. Strong Boards are also required in representing shareholder interests and in making investment advisors aware there is no such thing as permanent capital. Brokers have an important role to play in this regard, offering Boards the right advice even if it's not the sort of news the respective parties want to deliver or hear. Similar principles apply to consolidation where the merging of two trusts doing similar things to one another helps boost scale and liquidity and reduce costs. Against a backdrop of centralised buy lists, wealth manager consolidation and an unrelenting focus on costs, remaining relevant is more important than ever. A weak market for corporate control and poison pills in the form of external management contracts adds further barriers but pleasingly we have started to see a pickup in consolidation and Boards embarking on strategic reviews.

Whilst this is good news, the path ahead is likely to be long and winding with a successful conclusion to the journey reliant on all stakeholders taking a more proactive stance over the key capital allocation and strategic decisions which are required to put the investment trust sector back on a firmer footing. Underlying everything must be the recognition that success (defined as an investment trust trading at a premium for at least some of the time) is only possible if Boards are willing to contemplate shrinking or even fully-liquidating. If not, the sector is in danger of becoming a place where the only stakeholders not riding the gravy train are the shareholders.

Part 5 – Relevance & Communication

In part 1 of this series, we referred to a number of reasons why we think the average discount of the investment trust sector is at a historic wide level today, and the common theme is the deteriorating relevance of investment trusts in a new paradigm for the UK wealth and fund management community. The cost disclosure regime for investment trusts (we've written enough on it so we wont repeat ourselves here), together with the new 'Fair Value Assessment' requirement, without which some wealth managers won't invest in investment trusts, means investment trusts get put on the 'too expensive' or 'why bother' pile. Why invest in 'expensive' investment trusts for private client portfolios or IA listed funds if it makes the client's or fund's overall OCF so high compared to investing in zero OCF operating companies or ultra-low OCF passive funds? It is hard for many firms to justify owning assets that make their own proposition look expensive, and therefore uncompetitive, even if they believe that investment outcomes would be better.

At the same time, the consolidation of the UK wealth management industry gathers pace causing ever larger firms' buy lists to focus only on the largest and most liquid investment trusts and equities so they can be bought across as many suitable clients' portfolios as possible. The process of selling 'expensive' or small and illiquid trusts from funds and portfolios, has been exacerbated by the cyclical issue of there being plenty of attractively valued vanilla assets, such as government and corporate bonds for investors to choose instead for the first time in more than a decade. This resulting imbalance of supply and demand has pushed the discounts to the current wide level. While there is hope that the authorities will reverse their guidance on the OCF issue, we fear the wealth management consolidation trend and the consequential abandonment of large swathes of the UK equity market, of which the investment trust sector is a significant part, is here to stay. This means all investment trust stakeholders must do something about persistent discounts now, particularly the smallest trusts where the relevance problem is more acute. The Boards of all trusts have a big challenge on their hands. Questions to ask themselves, or for shareholders to ask them, include:

- Is their trust relevant today? If the discount remains wide no matter how many share buybacks or marketing efforts undertaken, that surely signals a permanent imbalance of supply and demand?
- is the mandate making the full use of the closed-ended structure investment trusts offer or can it be replicated in an open-ended fund?
- are the terms and structure of the trust relevant compared to more recently launched trusts with better discount protection measures?
- if their trust didn't exist today, would they seek to IPO it?

If the answer to any of those questions is "no", then it simply should not exist. Boards, brokers, managers and shareholders should proactively seek to merge it with a larger vehicle not necessarily one with the same asset class, change the manager or mandate to a more relevant style or asset class, aggressively seek to narrow the discount through tenders or buybacks (being prepared to shrink first in order to grow later), or just wind the trust up and give shareholders their money back. Recently the Boards of some abrdn managed trusts have clearly considered these issues and been at the forefront of the nascent consolidation trend with the merger of abrdn New Dawn and Asia Dragon trusts, the merger of abrdn Japan with Nippon Active Value, the liquidation of abrdn Latin America and the merger of abrdn UK Smaller Companies Income and Shires Income. Those directors, and abrdn, should be applauded, as they set the benchmarks for others to follow – sometimes turkeys do vote for Christmas!

If the answer to the above questions is “yes” then Boards and management teams need to consider how they are engaging and communicating with their target audience if they want to get the shares to a premium rating and be able to grow. Unfortunately, there is no silver bullet here and simply switching brokers or engaging with third party paid-for research organisations isn’t enough. Alongside those initiatives, there needs to be a determination to improve the level and consistency of disclosure and transparency of the underlying assets and valuation processes, particularly for some of the immature alternative asset classes. It is essential to ensure investment trusts are not viewed as more complicated than conventional investment options. A relentless public relations campaign with efforts to build relationships with journalists and platforms is one way of raising a trust’s profile, especially among the retail investor, whose share of the investment trust ownership is steadily rising such that they now own 67% of the conventional equity investment trusts and 25% of the alternatives (thanks Winterfloods for those stats). The retail investor is the ideal buyer of investment trusts given the origins of the sector. In 1868, the first investment trust, Foreign & Colonial Trust, was launched to provide “the investor of moderate means the same advantage as the large capitalist”, i.e. democratise illiquid asset classes that would otherwise be unavailable to most investors. All those alternative asset classes such as the various sub-sectors of property, infrastructure, song royalties, shipping and private equity provide diversification benefits beyond just mainstream equities and bonds for all investors, not just the largest and wealthiest.

In providing all investors access to asset classes and management styles that cannot or should not be replicated in open-ended form, we believe the investment trust sector as a whole is still as relevant today as it was in 1868, and even more so in light of the advent of Long-Term Asset Funds (LTAFs), the questionable invention of an open-ended fund investing in illiquid assets but with long term lock-ups and limited dealing windows. Surely investment trusts will deliver better investment outcomes than LTAFs? After all they’ve got over 150 years’ experience. Perhaps the providers of LTAFs are sensing an opportunity because of the breakdown of the relationship of NAV performance of investment trusts and shareholder experience, i.e. the widening of the discount over recent years. It may also be because the IFA community finds it easier to understand and invest in LTAFs than investment trusts where only the biggest trusts are liquid enough to be listed on the main IFA platforms. This reinforces the lack of relevancy among a huge constituency of potential trust buyers.

As we have said before, the process for investment trusts to recover and be more relevant in today’s environment is like most things in life – it can only start with an acknowledgment of the problem. We will continue to press home the message to Boards, managers and brokers but, just like the recent abrdn announcements, we need proactive measures too.

Final Part - Our recommendations

Over the preceding 5 weeks we have covered the following five areas: why discounts are wide, the IPO Process, Alignment & Structure, Capital Allocation & Corporate Activity and Relevance & Communication. Here we end with our suggested recommendations to address the issues we have raised. Some of these suggestions overlap each section. Importantly, we don’t pretend to have a monopoly on wisdom, and most of all, we’d welcome extensive engagement from all stakeholders.

The IPO Process

- Investors should receive £1 of assets for a £1 investment at IPO. Brokers (plus solicitors, the LSE etc), who play an important and crucial role in the process, should have their costs (typically 2%) paid for by the investment adviser.
- Where portfolios are sold at IPO (as opposed to investment advisers being given cash shells) there should be greater involvement of investors in day 1 pricing (as there is with normal equity IPOs). I.e. the price paid for the assets at IPO should be determined by investors.
- Some consideration should be given to incentivise day 1 shareholders, such as stakes or revenue shares in the management company of the investment adviser. Greater use of subscription shares might also be appropriate.
- Sometimes cash shells are unavoidable where a pipeline of assets is ready to be acquired once the IPO

has happened, but in such instances no fees should be charged on uninvested cash. Mitigants or penalties on the investment adviser should be considered if cash is not invested in line with the execution timetable at IPO (e.g. brought-forward / contingent continuation votes).

- Board selection should ensure independence. We worry that Boards chosen after the appointment of the broker and investment adviser result in those Boards being too close to the investment adviser.
- More care needs to be taken in the book build process with greater consideration on how this might impact secondary market trading.
- All IPOs should be accompanied with rock solid longer-term protections in the form of continuation votes or return of capital provisions.

Alignment & Structure

- The investment adviser should be paid on market cap. Alternatively, lower base fees with remuneration that creates greater alignment with shareholders (e.g. reward for NAV per share accretion via LTIPs) should be considered.
- Directors' fees should have some element of shareholder alignment – e.g. 50% of fees paid in shares, and / or LTIPs for Directors based on NAV per share accretion. We also like to see Directors with 'skin in the game' and believe this should be encouraged.
- The investment trust is a fantastic vehicle to access less-liquid assets, but it is not perfect, and the IPO process must ensure that structural fallibilities are addressed.

Capital Allocation & Corporate Activity

- Best practice guidelines concerning buybacks should be formulated, placing the onus on the Board to justify why buybacks are not taking place (and, if illiquid assets are held, why they are not being sold to prove the NAV and buy back shares).
- If discounts persist for long enough, mechanisms should exist to guarantee return of capital to shareholders (redemption facilities, tenders, continuation votes, liquidation etc). Whilst all new IPOs should come with these provisions, we also think existing trusts should incorporate them as a matter of course.
- Boards and brokers should be more open to mergers and consolidation as a route to addressing persistent discounts and issues around relevance.

Relevance & Communication

- The Boards of trusts which trade on persistently wide discounts must ask themselves whether the Company remains relevant. This is particularly true of trusts that are sub-scale and have poor liquidity. Provisions like those discussed above need to be in place to guard against irrelevance.
- Transparency and disclosure need to be improved in some areas, particularly in the case of less mature, alternative assets.
- All shareholders must be motivated to engage, and for those currently at risk of being disenfranchised (e.g. retail investors) mechanisms must be sought to engage them.
- We urge brokers to enable communication among shareholders and encourage more creative destruction in their dialogues with Boards
- Finally, all stakeholders who care about the investment trust sector should engage with industry bodies and Boards on the 'OCF issue': the peculiar (in our view) requirement to disclose investment trusts' KID ongoing costs in aggregated portfolio OCFs. In short, investment companies are listed, and share prices discount fees that are levied at the NAV-level. Disclosure of fees as a percentage of NAV, when investors buy and sell at the share price, is illogical and unfair, and has created devastating unintended consequences.

These recommendations might be construed by some as being overly critical. This is not our intention. At Hawksmoor Fund Managers we care deeply about the investment trust sector. Closed-ended funds have always formed an important part of our portfolios and have been a major driver of our long-term outperformance. Whilst we accept that some of the sectors recent travails are cyclical in nature, we think there are also deeper more structural issues at play. We hope that this series of articles, alongside engagement from all other stakeholders, will contribute towards ensuring the sector can grow and flourish in the future.

Hawksmoor Fund Managers
Ben Conway, Daniel Lockyer, Ben Mackie, Dan Cartridge

August 2023