Atkins Bland

Investments • Pensions • Financial Planning

Guide to: Investment Trust Pricing

Investment Trust Pricing

Investment trusts are collective investments, which means they are pooled funds invested on behalf of their shareholders, normally in equities (shares), bonds or real estate.

However, they differ from other collective investments, such as Unit Trusts or Open Ended Investment Companies (OEICs) in several ways, but especially in the way the shares are priced.

The reason is that Investment Trusts are “closed ended” funds, with their shares traded on the stock exchange, whereas Unit Trusts and OEICs are “open ended”, so shares are bought from, or sold back to, the management company.

The “closed ended” and “open ended” terminology refers to whether money moves in and out of the fund when investors buy or sell. With closed ended funds it doesn’t, but with open ended funds it does.

With either, the assets of the fund are beneficially owned by the shareholders. That means, with a fund worth £10 million and with 10 million shares issued, the value of each share should be £1, which is the “Net Asset Value” (NAV) of each share.

However, while that will always be reflected in the share price for an open ended fund, with the price very close to the NAV and moving in line with it, other than within modest parameters (see later), the share price of a closed ended fund can move a long way apart from the NAV.

This is because the price will reflect supply and demand in the market, just as applies with the shares of trading companies quoted on the stock exchange.

The result is shares in investment trusts can trade at a discount or premium to their NAV, and these can sometimes be very significant. Discounts occasionally exceed 50%, although most investment trusts tend to trade between a premium of about 10% and a discount of about 20%.

In the case of our example earlier, if the shares were trading at 88p instead of £1, they would be at a discount of 12%. If buying, you get £10,000 worth of assets for £8,800. However, if selling, you only get £8,800 even though the underlying value of the assets is £10,000.

One reason discounts exist is that an investment trust can borrow money, and if this is at a high level, so adds considerable risk, or loans that are due for renewal and less favorable interest rate terms are expected, that can make investors shy away .

However, the main reason is simply market sentiment and the way it impacts on supply and demand for the shares.

A closed ended fund investing in a sector that goes out of favour will likely see more people wanting to sell than buy, and that will depress the share price, creating or widening a discount.

In contrast, one investing in a popular sector may see more people wanting to buy than sell, pushing up the price and creating or widening a premium

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While sentiment towards particular sectors can be a core driver of discounts or premiums, the global market mood will also play a part. At times of general investor optimism, discounts are likely to reduce and premiums increase. During adverse market conditions, the reverse is often the case, with premiums falling back and shares trading at a discount seeing that widen.

This can create some excellent opportunities for those buying at a wide discount and waiting for sentiment to improve, as they might gain from both the recovering market and the narrowing discount, so enjoy a classic "double whammy".

It can also create larger falls though, especially for those not mindful of how the share price compares with the NAV and buying at a big premium. In many cases, a trust at a premium is invested in a popular sector which has already risen significantly, so carries increased risk of a set-back. If that gets combined with the premium reducing, or turning into a discount, it's a double whammy of a much less pleasant nature.

There are other factors affecting discounts and premiums, but the purpose of this guide is to look at the pricing mechanism, not discuss all the factors and issues that can impact the desirability, and hence demand for a share. However, Atkins Bland will take other factors into account before making a recommendation.

Indeed, while we gravitate towards investment trusts trading at a discount, since that fits in well with our general philosophy towards investing, if an investment trust has particular merits which are hard to find elsewhere, we might recommend it even if the discount is narrow or the shares trade at a premium.

Finally, it is important to emphasise that this guide is intended as a brief explanation of some key points. It does not cover all the details of the structure and pricing mechanisms of different types of collective funds. For instance, an open ended fund manager will adjust the price of shares within narrow ranges to reflect demand. Details of how this applies can be found in our Guide to investment vehicles, available on request.

We want to emphasise this guide is intended as a supplement to individual advice, not as a replacement for it. Any advice we give you will be specific to your own circumstances and objectives.

Other Atkins Bland guides you may wish to read and which are available on request:

- Guide to Investment Vehicles
- Guide to Our Investment Principles and Philosophy
- Guide to Fund Selection and Portfolio Construction

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced or generated, an investor, therefore, may get back less than invested,

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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