Guide to investment trust pricing

Investment trusts are collective investments. Collective investments offer a spread of investments where your holding is directly related to the net asset value of the investment fund. Let's say for example the total net value of a collective is £1 million. If your holding is 1% of the total issued, it is worth 1% of £1 million = £10,000.

This is an over-simplification – there are many factors which affect the value of collective investment funds – but it is the basic principle. Most other collective investments are either:

- unit trusts
- open-ended investment companies (OEICs); or
- offshore funds (SICAVs)

An investment trust is rather different. This is a company which trades in shares, as opposed to pharmaceuticals, clothes etc but it is just as much a company as Glaxo and M&S are companies.

When you invest in an investment trust, you are a shareholder in a single company – the investment trust. The value of the shares in that trust can fluctuate independently of movements in the value of the underlying assets (the net asset value).

For this reason, shares in investment trusts can trade at a discount or premium to the net asset value.

Say an investment trust holds similar shares to a unit trust - £1 million worth - and you have 1% of the shares in issue. On the face of it your shares should be worth £10,000 but this would only be the case if the shares were trading "at par" – ie with no premium and no discount.

In reality there is nearly always a discount, or a premium. Discounts can vary widely, ranging to over 30%, although most investment trusts tend to trade with a discount of between 5 - 15%.

In the case of our example investment trust, if the fund were trading with a 10% discount then your shares would be worth only £9,000, because of the discount of 10% on the net asset value of £10,000.

One reason discounts exist is that an investment trust can borrow money, whereas a unit trust cannot, but another reason is market sentiment which affects supply and demand.

An easier way to understand it is to pretend the assets are gold ingots. Taking the above values, both £1 million, we still have the case that a unit trust investor with 1% of the units has a £10,000 investment. Sentiment affects the investment trust when traders expect the value of gold to fall. Then, the shares will start trading at a discount (or a wider discount) because the market believes they will be worth less in the future than they are today.

During adverse market conditions, investment trusts often trade at much wider discounts to their net asset values than they do when markets are optimistic. If you felt the markets had become overly depressed, and are likely to recover, buying an investment trust with a wide discount can prove very rewarding. This is because, if the market does recover, the discount on an investment trust might well narrow. In this case, you can benefit not only from the rise in the underlying asset values but also the narrowing discounts.

If, for example, shares rose by 10% and discounts reduced by 10%, the holder of an investment trust will have made a 20% gain compared with a similar unit trust investor’s gain of just 10%.

On the other hand, if discounts widen (increase) by 10% and the market falls by 10%, the investment trust shareholder will suffer a drop of 20% while the unit trust investor only suffers a drop of 10%

There are other factors affecting discounts and premiums. Some investment trusts are so specialist that there might not be a comparable unit trust available. If this happens in a sector that has become very popular, the fund might trade at a premium simply because there is so much demand for the fund.

To explain this, an investment trust is a close-ended fund. This means when you buys shares in an investment trust, you are buying them from someone who has sold them – you are not buying newly-created shares. The number of shares in issue and the amount of money being managed by the fund remains the same. This is the reason the price is affected by supply and demand.

In comparison, if you buy units or shares in an open-ended unit trust, OEIC or other similar fund, the new money goes to the fund manager and new units or shares are created. When you sell your unit trust holdings your units are cancelled. In this situation, the price of units is less affected by supply and demand.

When discounts for investment trusts are low (narrow) by historical standards, it may not be worth taking the risk that they will widen. This is particularly true if there are similar unit trusts available, which eliminate this risk.

On the other hand, when discounts are wide, it can prove to be an excellent strategy to buy investment trusts.

As mentioned above, there are other factors at play, and we take all of these into account when we give you advice. 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.

Please note

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, a unit trust manager will adjust the price of units 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.

Important note

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.

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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