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In Changing of the Seasons We (Investment) Trust...

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It is the time of year when we, in the northern hemisphere, emerge from winter, welcome new life, and even start a new UK tax year. Our gardens sprout new growth and rediscover colourful displays, it is in many ways an optimistic time of year. Investors might be tempted to have similar feelings towards the investment trust market.

To recap, recent years have seen what feels like an unprecedented period of "issuance" where new investment trusts were formed to invest in a variety of assets such as property, infrastructure and even esoteric things such as music royalties, that have typically been out of reach of many investors. The shares of such vehicles typically traded at premiums to Net Asset Value (NAV) which afforded them to issue further equity and expand their portfolios of assets. With the odd exception, returns were good, dividend income was earned, investors diversified their portfolios beyond simply holding equities and bonds, and UK plc benefitted from a new source of financial capital to help address the almost overwhelming need for investment in its physical capital. All was going well and then the season changed...

It started with the Autumn "fiscal event" which set bond yields reaching for the stars, with a resultant negative impact on NAVs which take some of their reference point from the plunging value of "risk free" government debt. Even though some normality returned to gilts under Jeremy Hunt, the damage was done; it has been an embarrassing lesson for enthusiasts of backward looking "risk" models.

The situation was made worse by what can only be assumed were unintended consequences of the application of cost disclosure regulation for investors in Europe. The problems raised by these rules are too expansive to cover here but have been commented elsewhere in the investment press. However, in simple terms they have created an uneven playing field that has unfairly penalised holders of these specialist investment trusts versus ordinary equities. By making funds that hold investment trusts such as Greencoat UK Wind optically (but crucially not economically) more expensive than other investors that hold listed equities such as SSE plc, the rules on cost disclosure have removed a key "marginal buyer" of investment trusts.

The price of anything that is traded is set by the marginal buyer and marginal seller, that is where the last available seller will supply an asset and the last available buyer is prepared to buy an asset at a given price. Once you remove one of those market participants, the price resets to find the next marginal buyer/seller. The motivation to buy or sell is driven by a multitude of factors, only one of which is the price.

In the case of investment trusts, investors who were buying in the years leading up to mid-2022 will have been drawn to income paying credentials, diversification benefits, ESG attractions, their own investment inflows and outflows to name a few; the premiums to NAV implied there was more buying demand than any need to sell investment trusts. However, in the last six to nine months those marginal buyers have either walked away or even become sellers; possibly spooked by falling NAVs, needing to finance outflows from their own investor base, or reluctant to have to report their optically (but not economically) higher cost of holding investment trusts.

The result of this descent into winter has resulted in discounts to NAV opening up of 10-20% in some infrastructure names; up to 30% in property REITs (despite solid evidence of rental growth in many sectors), whilst private equity is suffering discounts of over 50% in some names.

It is true that the sector has not helped itself with scandals such as HOME REIT shaking investor confidence, and private equity allowing itself to get carried away with some deals in the period of low interest rates. Greed also resulted in an excessive number of trusts being launched that has resulted in too many being sub-scale. Self-help is required with Boards instigating consolidation; yes, an ironic test for a quality Board is its preparedness to put itself out of a job.

With valuations being where they are, it is hard to believe that marginal buyers will not return, particularly if catalysts for value discovery occur. Furthermore, common sense could be restored as a result of the packaged retail investment and insurance products and UK Retail Disclosure consultation papers from the Government and Financial Conduct Authority in March. Selling investment trusts at this time does not feel economically rational.

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