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INVESTORS

WHITE PAPER

INVESTMENT TRUSTS FOR RETIREMENT PLANNING

INVESTMENT TRUSTS FOR RETIREMENT PLANNING - EMERGING FROM THE SHADOWS

It's an accurate, albeit somewhat depressing, truism: we either die too soon or live too long. Whilst the issues presented by the former are fairly self-evident, those relating to the latter are a little more nuanced. Indeed, a great many of us may well be in a state of denial about our financial futures and the inherent financial implications.

At just over £9,000 a year, the UK's current Basic State Pension is designed, at best, to provide a token level of income for retirees. The vast majority of us are reliant on other arrangements when looking to maintain any semblance of our pre-retirement standard of living when we eventually leave work behind us. However, as we've suggested, any 'pot' of money we might build up for retirement may well have to last a considerable time. Medical advances, a better general understanding of what constitutes 'good health' and a growing focus on diet and exercise – at least in the developed world – have all contributed to markedly extended lifespans.

We have come to realise that longevity is malleable; if it were not, the UK would not display the range of age expectancies it does. Walk more and use the car less, do some regular exercise, give up smoking, watch your weight, fast occasionally, be sure to get a good night's sleep and stick close to your family and you could make it well into your 90s or early 100s. You might also do so in good health. According to the Office for National Statistics, a UK male aged 65 has an average life expectancy of 20 years, and a one in 10 chance of reaching 96. For females, the issue is even more acute: if you're aged 65, you will on average live to be 87, with a one in 10 chance of reaching 98.

With this being the case, those wanting to retire in comfort have been compelled to rely on other arrangements in order to supplement the government's meagre offering: either occupational – ie workplace – pensions, or privately funded arrangements, such as a Personal Pension, a Self-Invested Personal Pension (SIPP), or a Small Self-Administered Scheme (SSAS). Space doesn't allow us the latitude to delve into the idiosyncrasies of these various retirement saving vehicles here, but suffice it to say that they all have the intrinsic appeal of tax-efficiency on their side: contributions (within certain limits) enjoy relief from income tax, the underlying investment assets grow within an environment that's free of income or capital gains tax and, at age 55, a proportion (typically 25%) of the accumulated fund can be extracted tax-free.

However, it's important to bear in mind that, irrespective of the particular type, a pension plan is merely a holding device – a 'wrapper' that entitles the holder to a number of attractive tax benefits. Of fundamental importance is the investments one chooses to place within it, since that will be the key determinant of the returns you subsequently enjoy (unless of course, you're lucky enough to be in a 'defined benefit' scheme, where the pension will be a guaranteed percentage of your final salary based on length of service).

The income you have to live on in retirement will be dictated by the success of your investment strategy, and therefore by the assets you choose. There is no universal panacea when it comes to selecting investments for retirement – or for any other financial need for that matter

– but investment trusts are particularly well-suited to long-term retirement savings for a number of compelling reasons. In this article, we set out to explain some of those key reasons.

INVESTMENT TRUSTS HAVE STAYING POWER

Investment trusts have been around for some time. The first – the Foreign & Colonial Government Trust (now known as the Foreign & Colonial Investment Trust) – was established in 1868, the same year as the discovery of Helium and the last public execution in Britain. The late 1800s saw the launch of two investment trusts now managed by Janus Henderson: The Bankers Investment Trust in 1888 and City Of London Investment Trust in 1891. Both trusts have formidable long-term records, of which more later.

By the outbreak of the First World War in 1914, 90 investment trusts had been established. Of those, 26 are still in existence today, having survived everything that the ups and downs of world markets could throw at them for over a century: the financial crash of 2008 driven by the collapse of the US housing market; Zimbabwe's hyperinflation – the worst case in the 21st century with a peak rate of 80 billion percent; the dot-com bubble of 2001; and the failure of previously successful hedge fund Long-Term Capital Management, driven into the ground in 1998 as a result of the ripple effect caused by Russia defaulting on its government debt. These examples are testament indeed to the extraordinary resilience of investment trusts.

Part of the explanation for this uncommon ability to weather financial storms is that investment trusts, as closed-ended funds, are structured rather better for the longer term than their open-ended counterparts. Since they issue a fixed number of non-redeemable shares, its capital is permanent. Investors in trusts buy and sell shares by trading amongst themselves on a recognised stock exchange, in a similar way to a standard company share. With open-ended funds, however, investors buy and sell units directly from and to the fund manager, which is constantly having to issue or cancel units respectively, in line with investor demand. The manager of a closed-ended fund can, therefore, focus on what they're good at – taking a long-term approach whilst looking through short-term market volatility – without the endless distractions of managing inflows and outflows of capital. Fund managers despise admin just as much as the rest of us!

THE IMPORTANCE OF DIVERSIFICATION

In general, but particularly when investing for the long term – as is the case with retirement planning – it's important to ensure that a portfolio is well-diversified, ie it holds a broad range of asset types across a mix of geographies. Illiquid investments are typically better suited to an investment trust structure since the managers are able to take a longer-term view regarding their asset holdings, relieved of the pressure of having to dispose of assets at short notice to meet the needs of those selling shares.

As a result, investment trusts will often be seen to hold alternative assets such as unquoted shares, infrastructure, forestry, wind farms and, of course, residential and commercial property, resulting in more broadly diversified portfolios. For long-term investors saving for retirement, ready access is unlikely to be a requirement and so a lack of liquidity doesn't present any significant issues.

THE VALUE OF INDEPENDENT SUPERVISION

Since all investment trusts are established as public limited companies (PLCs), they are required to maintain an independent board of directors appointed by the shareholders. In addition, the shares of an investment trust are listed and traded on a recognised public stock market, such as the London Stock Exchange and, in common with any stock market quoted company, investment trusts are required to publish an annual report and produce audited accounts.

This level of independent, professional supervision provides important long-term safeguards for the retirement investor. As the custodians of a listed company, the board directors are obliged under section 172 of the Companies Act 2006 to have a mind to the needs of all stakeholders; however, their main priority is always going to be the longevity of the trust and the needs of its shareholders, who can and do turn up to the Annual General Meeting to voice their concerns if they aren't convinced.

The board is entirely independent of the fund manager and plays a pivotal role in terms of protecting the interests of those shareholders by monitoring charges to ensure they remain competitive, reviewing investment policy, making key strategic decisions about the trust's future direction, as well as overseeing and scrutinising the performance of the fund manager and management company, ensuring that they perform well and comply fully with the objectives of the trust.

THE POWER TO BORROW

Unlike most other types of investment fund, investment trusts are able to borrow money, which can be invested alongside the capital injected by purchasers of the trust's shares. This facility provides the trust with leverage and is known as 'gearing'. It gives the fund managers freedom to take advantage of a long-term view, or to react swiftly in terms of a favourable situation with a particular asset, without having to dispose of any existing investments to raise the necessary cash. Needless to say, the investment manager needs to be confident they can generate a higher return than the cost of borrowing the money.

Consider an example:

An investment trust with net assets of £100 million has a bank loan of £20 million, and therefore gross assets of £120 million. Assuming the fund is fully invested and the underlying value of the assets rises by 10%, the new gross asset value will be £132 million. However, given that the bank loan is unchanged, the new net asset value is £112 million whereas, without the gearing, the net asset value would only have risen to £110 million based on the same 10% market rise.

Gearing, therefore, offers the potential to enhance returns when markets are rising but, by the same token, can have a detrimental effect by exacerbating losses when the investment climate is less healthy.

THE EFFECT OF FEES

Investment trusts have a long-term record of outperforming open-ended funds, probably for the reasons cited[1], although historically lower fees have also played a part. In any longer-term investing scenario, the level of charges can have a profound impact on total returns and so it's important to consider how much you're paying for the management of assets and other related costs, particularly when investing over such a long timeframe. For example, a monthly investment of £500 for 30 years into a fund that grows at 7% pa with an annual fee of 1% would produce a return of £484,000. If the fee was 0.1%, the final figure would be £577,000.

Investors in an investment trust incur an annual management fee and other ongoing administration costs – these are normally set against the income a trust receives from its investments, with the difference being distributed to the shareholders as a dividend. Analysis has shown that the full amount of these charges, known as the Ongoing Charge, tends to be lower than for unit trusts and open-ended investment companies (OEICs), especially for the largest investment trusts (those with assets of £500m or more).

Indeed, the ongoing charges for some trusts are almost as cheap as passively managed funds. The City of London Investment Trust, for example, charges an ongoing 0.39% pa, Henderson Smaller Companies Investment Trust charges 0.42% pa, and The Bankers Investment Trust charges 0.52% pa.[2]

[1] Source: FT Adviser, 15/07/2019

[2] Source: Janus Henderson, 17/08/2020

TIME IN THE MARKET, NOT TIMING THE MARKET

And so, given all of the above, how well have investment trusts performed in terms of the accumulation capital? New data from the Association of Investment Companies (AIC), the trade body which represents the investment trust sector, is insightful and proves the worth of the old adage that it's time in the market, not timing the market, that counts. See the table overleaf.

£1,000 invested in the average investment trust in October 2007 – the FTSE 100 Index was then at its pre-crash peak – would have fallen to £587 by February 2009 but would be worth £2,115 today, more than double the amount invested – and this is after the market crash of last month.[3]

Let's go back further, to the bursting of the dot-com bubble in 2000. £1,000 invested in March 2000, near the height of the dot-com boom, would be worth £3,665 today, a 267% return.[3] Remarkably, this 20-year period includes the dot-com crash, the global financial crisis and, importantly, the falls of the past few weeks when markets experienced their worst quarter in more than 30 years.

Retirement savings are more likely to take the form of regular contributions as an effective way of building up a large pension pot over the years – not to mention removing the worry of timing the market – and so the AIC data also show how this would have performed. A lump sum investment outperforms drip-feeding over the long term, even if made at the worst possible time, but the performance of regular contributions is nevertheless hugely encouraging.

A monthly investment in the average investment trust from October 2007 to the end of March 2020 (£7,550 invested) would now be worth £12,319. (A lump sum of £7,550 invested over the same timeframe would be worth £15,971.) [3]

Again, going back further, investing £50 a month in the average investment trust from March 2000 to March 2020 (£12,100 invested) would have grown to £32,285 today. (A lump sum of £12,100 invested over the same timeframe would be worth £44,346.) [3]

	Dot-com crash (peak to trough)	**Dot-com crash to present**	*Global financial crisis (peak to trough)*	**Global financial crisis to present**
Performance from	*01/03/2000*	**01/03/2000**	*01/10/2007*	**01/10/2007**
Performance to	*28/02/2003*	**31/03/2020**	*28/02/2009*	**31/03/2020**
Duration	*2yr 11mo*	**20yr 1mo**	*1yr 4mo*	**12yr 6mo**
Share price total return	*-40%*	**267%**	*-41%*	**112%**
£1,000 lump sum				
Sum invested	*£1,000*	**£1,000**	*£1,000*	**£1,000**
Sum at end of period	*£598*	**£3,665**	*£587*	**£2,115**
£50 regular savings				
Sum invested	*£1,800*	**£12,100**	*£850*	**£7,550**
Sum at end of period	*£1,258*	**£32,285**	*£597*	**£12,319**
Lump-sum equivalent of £50 regular savings				
Sum invested	*£1,800*	**£12,100**	*£180*	**£7,550**
Sum at end of period	*£1,077*	**£44,346**	*£499*	**£15,971**

[3] Source: AIC/Morningstar. Performance is share price total return of the weighted average investment trust (excluding Venture Capital Trusts and 3i), based on month-end data. Italicised columns represent bear markets, columns in bold total returns from the beginning of each bear market to 31/03/20.

As can be seen, trying to time the market is something of a fool's errand. These figures clearly illustrate that the best course of action is to maintain your investment discipline and stick to your strategy, no matter how painful that might feel at times. Those investors who had the conviction to stay invested – or maintain their ongoing investments during a downturn – would have been richly rewarded for their fortitude.

ACCUMULATION TO DECUMULATION

At some point however, the retirement saver's attention turns from capital accumulation to income generation. Interestingly, investment trusts can serve investors well in both these stages of their retirement planning.

Before the introduction of pension freedoms in April 2015, most people used the money in their retirement fund to buy a fixed or inflation-linked income for the rest of their life – known as an 'annuity', offering security of income. These new-found pensions freedoms have effectively blown away the line in the sand which previously existed between the accumulation and decumulation phases of retirement planning. Low rates have put many people off the concept of annuities, which is why a growing number – roughly two-thirds of all retirees – now opt for a more flexible alternative, known as 'income drawdown'. This enables them to withdraw up to a quarter of their fund tax-free with the balance remaining fully invested, from which they then draw an income.

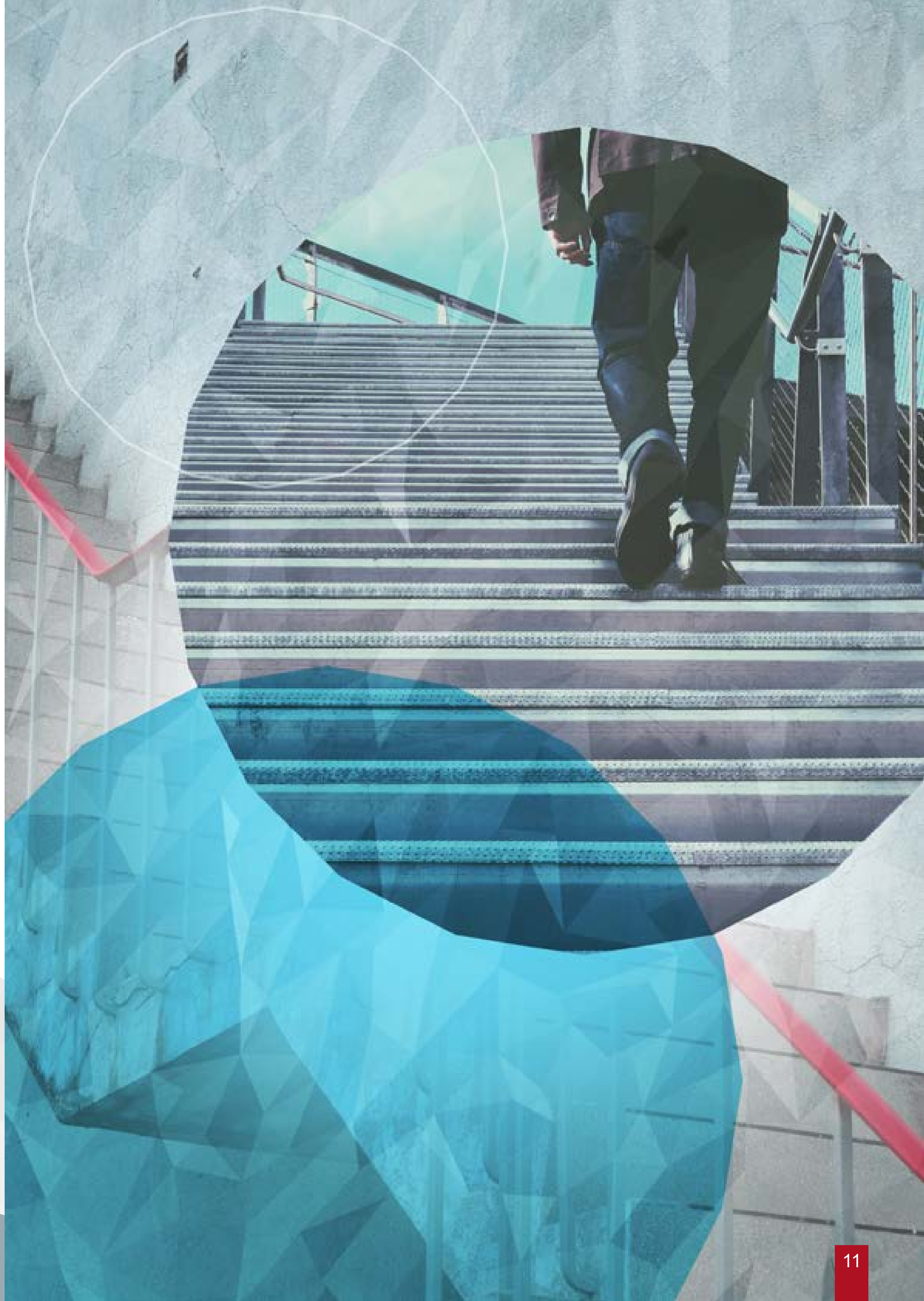
Investment vehicles that combine growth with a reliable – and ideally rising – level of income, therefore, offer a 'double whammy' for investors in both the accumulation (saving) and decumulation (drawing an income) stages. This is, in part, why investment trusts have seen a marked resurgence in their popularity. Having been the investment industry's best-kept secret for some considerable time, their total assets have increased by over £120 billion in the 10 years to the end of 2019, more than doubling the size of the sector.[4] The ability to generate a rising level of income is clearly desirable for investors in drawdown, in that they are able to take the natural yield without inflation eroding their spending power, and it's an area where investment trusts have consistently demonstrated their strength.

Annually, in March, the AIC publishes its list of 'Dividend Heroes', featuring those investment trusts which have succeeded in increasing their dividend payouts for a consecutive period of 20 years or more. At a time when market conditions are challenging, and with interest rates sliding, the reliability of income streams is even more important. Making the AIC's hero list is no small achievement. In its latest annual analysis, published on 16th March 2020, of the 362 trusts whose dividend records were analysed, only 21 – ie circa 6% - succeeded in doing so.[5]

Four investment trusts occupy even more exalted territory – those which have increased their dividends for at least 50 years, a truly remarkable achievement given the decidedly choppy waters they will have been forced to navigate on multiple occasions over that period of time.

[4] Source: Association of Investment Companies

[5] Source: Association of Investment Companies, 16/03/2020



Of these four trusts, two are within the Janus Henderson stable: The City Of London Investment Trust (established in 1861) and The Bankers Investment Trust (established in 1888), both with 53 years of consecutive increases.[5] That's going back a bit: to place it into perspective, 1967 saw Jimi Hendrix set fire to his guitar at the Astoria in Finsbury Park, the first ATM was opened at a Barclays branch in Enfield and the average weekly wage was 21 pounds and 7 shillings.

Whilst judicious asset allocation and shrewd stock-picking will have contributed significantly to this enviable record of dependable and growing dividend performance, Job Curtis, fund manager of City of London, emphasises that it could not have achieved such a protracted period of continuous dividend growth without taking full advantage of a unique benefit applicable to the closed-ended structure: income reserving. Unlike their open-ended counterparts, investment trusts are permitted to retain up to 15% of the income they generate each year, enabling them to 'store' income in good years in order to bridge any shortfalls in more turbulent ones, a 'rainy day' facility which gives them a significant advantage when it comes to providing investors with consistent dividend growth. This is an important feature for those already drawing on their pension funds using income drawdown. If a company hits hard times and reduces or even scraps its dividend payments, individual savers relying on this income will feel the hit as their income could drop substantially.

In the 28 years that Job has been managing City of London, he has accessed the trust's revenue reserve on seven occasions – one year in four. He rightly points out that even the very largest companies can have sudden severe problems, citing BP's suspension of its dividend in the wake of the 2010 Deepwater Horizon oil disaster in the Gulf of Mexico – considered to be the largest marine oil spill in the history of the petroleum industry – as a prime example.

Job's view of the benefits of income reserving for retiree investors is shared by Alex Crooke, fund manager of Bankers Investment Trust, although Alex points out that the trust's global reach is a further advantage, offering access to more areas of growth when certain sectors or countries are stumbling. The revenue reserve built up in strong years enables the trust to cope with the fluctuations of currencies or the need to prioritise asset allocation decisions towards lower-yielding markets.

Further, since 2012, investment trust boards have in certain circumstances been able to elect to pay income out of capital. While this can erode the long-term capital returns generated, many retired shareholders who rely on the income may well be happy to prioritise these short-term income payments over and above capital value.

TIME FOR A RETHINK

Despite their many attractions, advisers and investors alike have been reticent about investing pension fund monies in investment trusts because they are seen as a relatively complicated product – suitable only for the more sophisticated investor – given the issues surrounding gearing, the potential for greater volatility, income reserving, premiums and discounts to net asset values and others.

However, buying and selling investment trusts is fundamentally no different from investing in other types of share, and is every bit as transparent, and so there is a growing view that the benefits of investment trusts far outweigh the requirement to understand one or two slightly esoteric aspects of their workings.

Like so many industry commentators, we see investment trust-based pensions finally emerging from the shadows.

DISCLAIMER

Before investing in an investment trust referred to in this document, you should satisfy yourself as to its suitability and the risks involved. You may wish to consult a financial adviser. Past performance is not a guide to future performance. The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested. Tax assumptions and reliefs depend upon an investor's particular circumstances and may change if those circumstances or the law change. Nothing in this document is intended to be, or should be construed as, advice. This document is not a recommendation to sell or purchase any investment. It does not form part of any contract for the sale or purchase of any investment. We may record telephone calls for our mutual protection, to improve customer service and for regulatory record keeping purposes.

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