INVESTMENT TRUST

What is it?

Investment trusts are a type of collective investment. They are structured as companies and exist purely to invest in a portfolio of shares and securities in other companies to make money for their own shareholders. They pool investors' money and employ a professional fund manager to invest in the shares of a wider range of companies than most people could practically invest in themselves. This way even people with small amounts of money can gain exposure to a diversified and professionally run portfolio of shares, spreading the risk of stock market investment.

Closed ended

Investment trusts are what is known as closed ended funds. This means that the amount of money which the trust raises to invest is fixed at the start by issuing a set number of shares to investing shareholders. Every selling shareholder must first be matched to a potential buyer via the stock market before a transaction can take place. Having a fixed pool of money enables the fund manager to plan ahead.

Specialising in particular sectors

Trusts often specialise in particular sectors and types of company. Some might specialise, for example, in communications companies, or alternative energy producers. Others specialise in companies from different parts of the world.

Trusts also specialise in what they aim to give their shareholders. Some try and maximise income. Others aim exclusively for capital growth over the long term. Some trusts aim to provide a combination of income and capital growth. All trusts have investment objectives that will be clearly stated in their literature.

Gearing

Investment trusts can borrow to purchase additional investments. This is called 'financial gearing'. It allows investment trusts to take advantage of a favourable situation or a particularly attractive stock without having to sell existing investments.

The idea is to make enough of a return on the investment to be able to pay the interest on the loan, repay it and then make a profit on top of that. Obviously, the more a trust borrows, the higher risk it's taking - but the greater the potential returns.

Financial gearing works by magnifying the investment trust's performance. If a trust 'gears up' and then markets rise and the returns outstrip the costs of borrowing, the return to the investor will be even greater. But there is a downside to gearing too. If markets fall and performance of the assets in the portfolio is poor, then losses suffered by the investor will be increased due to the costs of borrowing.

Although the term 'gearing' when applied to investment trusts usually describes the effect on the asset value, it also affects a trust's revenue and dividend potential.

When investment trusts gear up, they can usually borrow at much lower rates of interest than individuals or other kinds of companies. This is because the borrowings are secured on the trust's portfolio, making the trust a good credit risk.

Not all investment trusts use financial gearing and many of those that do, use it to very modest levels. Whether or not to use gearing is a decision taken by the fund manager and the board of directors.

Different share classes

Certain types of investment trust can issue different classes of shares to meet different investors' needs.

Some shares aim to pay regular dividends for investors who want an income. Others aim to pay out only a capital amount at the end of the trust's life. The different share class priorities and entitlements can provide a type of gearing with varying risk levels called 'structural gearing'.

Investment trusts that issue different kinds of shares are called split capital investment trusts. The different classes of share have varying risk levels.

Buying at a discount

The price of shares in an investment trust is established by the stock market. Sometimes demand for a trust's shares is low and as a result the price can fall. When the price of the shares is such that the value of the share is less than the value of the trust's assets attributable to that share, this is called 'trading at a discount'.

This may represent a good buying opportunity. If the discount narrows, there is the potential for enhanced returns.

The prices of OEICs and unit trusts (which are alternative types of collective investments) are calculated depending on the value of their assets, so you can never buy them at a discount.

Eligibility

To be eligible to invest in an investment trust, an individual investor must be 18 years of age or over. An investment can also be made by a company or trustee(s).

Contribution limits

The minimum monthly contribution is normally £100 and the minimum lump sum £500-£1,000. There is no maximum limit.

Taxation

Income (the yield, or dividend) from Investment Trusts can be distributed or accumulated within the fund. You'll pay tax on any dividends you receive over £500 at the following rates:

- 75% on dividend income within the basic rate band
- 75% on dividend income within the higher rate band
- 35% on dividend income within the additional rate band

When the holding is sold, if there is a gain, this is subject to capital gains tax. However, each individual has the benefit of an annual allowance (currently £3,000) and as long as the gain together with any other gains you may have in the same tax year is less than the allowance, there is no tax to pay. Any gain in excess of the annual allowance will be taxed at a single rate of 10% if, after adding the net taxable gain to your taxable income in the relevant tax year, the total falls within the basic rate income tax band. A tax rate of 20% applies to gains or parts of gains which exceed the upper limit of the basic rate income tax band.

Many investment trusts can be held in an ISA, this means your income and capital gains will be tax free.

All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.

Withdrawals

Most investment trusts allow shares to be sold at any time.

You can make partial withdrawals or encash your full investment. The tax treatment is described above.

Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- Governments can and do change the rules on tax in respect of investments such as investment trusts
- Income generated from investments held in investment trusts is variable and is not guaranteed
- Stock market fluctuations will generally mean than an investment trust's share price is not the same as its net asset value
- Past performance is no guarantee of future returns
- The price of shares and the income from them can fall as well as rise
- If growth is low, charges may eat into the capital invested
- The value of this investment is not guaranteed and on encashment you may not get back the full amount invested
- If upon realisation, your total gains (from all sources) less any allowable losses are greater than your annual Capital Gains Tax allowance, there will be tax to pay at either 10% (basic rate band), 20% (higher / additional rate band) or a mixture of both rates depending which tax band(s) the gain falls into after adding to total taxable income for the tax year
- Investment trusts which are focused are more volatile than mainstream funds
- Highly geared investment trusts are more risky than those that are not geared

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