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Use it or lose it

by Richard Parfect

As we bid farewell to another Rugby World Cup, I am reminded how my own rugby playing days are barely visible in the rear-view mirror. As a 'forward' I would frequently hear shouts from the referee of "Use it or lose it" if we didn't pass the ball out quick enough to the 'backs' once it had emerged from a scrum or ruck. Wasting the opportunity to use the ball, being penalised and conceding possession to the opposition is no way to win a match.

A similar call could be made regarding Investment Companies (ICs), or more commonly called Investment Trusts. Such vehicles in the UK are trading at "once in a generation" discount to their Net Asset Value (NAV). The reasons for this are numerous: rising bond yields, investor worries over the validity of reported NAVs, poor asset management performance by some (but certainly not all) management teams; and more recently the introduction of onerous regulatory guidance over the disclosure of costs of such vehicles.

This technical matter of cost disclosure has been covered in past articles, so I won't dwell on it here (**"In changing of the seasons we (Investment) Trust"** and **"I'm from the government and I'm here to help").** However, the unintended outcome of that situation is that the normal balancing forces that could come into play as a market cycle turns are unable to function. The mouth-wateringly low valuations of many investment trusts cannot be bought by many traditional UK based institutional investors for fear of such investors increasing their optical (not economic) fees. The commercial reality for such institutions is overwhelming pragmatic investment decisions.

By reducing the natural pool of investors who can buy such ICs inevitably reduces the share price. However, not all investors are inhibited by such guidelines. Private retail investors can exploit such valuation dislocation; however, it is still imperative they do their own research and avoid ending up in badly managed 'value traps'. The ICs themselves are increasingly introducing share buy-back policies (for example buying back 100p of their own capital for just 70p, which is accretive to NAV, earnings per share and dividend cover). Management teams and Board directors are buying their own shares, often in quite substantial scale.

There is another growing predator seeking to take possession of valued assets on the cheap; overseas investors and/or private capital. We have already seen well run ICs such as Industrials REIT (MLI), Ediston Property Investment Company (EPIC) and Roundhill Music Royalty (RHM) fall to opportunistic bids. More will follow.

There is of course a neat potential solution to this challenge. Back in 2013 the EU law "Alternative Investment Fund Managers Directive (AIFMD)" was introduced. Its' well-meaning objective was to protect investors in lightly regulated funds; certainly not ICs that already have to: comply with listing rules and company Acts; are managed by regulated fund managers; produce audited accounts and are overseen by directors. However, the UK regulator, decided to bring listed investment companies into scope and call them Alternative Investment Funds (AIFs). This regulation brought additional financial cost to running ICs. However, the real impact did not become apparent until the cost disclosure guidance was introduced by the Investment Association (IA) under the watch of the FCA; this guidance brought ICs caught by AIFMD into scope. There is a further insidious impact from AIFMD in 2025, which results in punitive regulatory capital requirements for market makers dealing in ICs, the impact of which would reduce their trading liquidity.

The solution, therefore, is to cease classifying ICs as AIFs and therefore remove them from the AIFMD and even capture a "Brexit" win! So, the urgent appeal to the referee is clear: give damaging AIFMD regulations the red card; this will afford the remaining players on the field the confidence to return to a successful and expansive game plan and score those tries

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