Digging deeper: Investment Trusts

5. Issuing new shares

Key takeaways:

- Understand the circumstances in which a trust might issue new shares
- Outline the four ways in which a trust would issue shares
- Know why it makes sense for a trust to issue shares at a premium to the net asset value

Category:
Investment insights

At times when there is high demand for shares in an investment trust (indicated by the shares trading at a significant premium to the fund's net asset value (NAV)), the trust may decide to issue new shares. Doing so raises new money for the trust and can open up new investment opportunities. It also relieves pressure on the share price.

There are four ways in which a trust can issue new shares:

1. **'Tap' share issues**

   If the trust wants to raise smaller amounts of money, it might run a 'tap' issue with the approval of shareholders. Usually the amount raised is limited to 10% of the NAV.

2. **Issue 'conversion' shares (known as C-shares)**

   Here, the money raised is invested in a pool of assets that is **separate** to the rest of the trust. The costs of the share issue are paid by the new investors and funds raised sit outside of the main fund, meaning returns for existing shareholders aren't depressed. The fund manager chooses the best time to merge the two pools of assets, and the C-shares 'convert' to ordinary shares.

   But there's a downside to this mode of issuance. C-shares issues are cumbersome and often trusts prefer to simply issue more of their ordinary shares.

3. **'Placing' and an 'open offer' of new shares**

   Thirdly, a trust can issue a 'placing' aimed at new investors and an 'open offer' targeting existing shareholders. Placings and open offers can be done separately, but are often combined in a single fundraising. It's worth noting, however, that share placings are sometimes restricted to institutional or sophisticated investors, with private investors not permitted.

4. **Retail intermediaries offer**

   Lastly, new shares can be bought and sold through the stockbrokers and share dealing websites used by most private investors.

Key point: new shares are usually sold at a small premium to their NAV

This is because setting the right price for a share issue is a balance between finding a price that's attractive to new investors but fair to existing shareholders. New investors want to buy at a price that's cheaper than the trust's current shares – otherwise, what's the attraction of buying the shares? Meanwhile, existing shareholders want to see the new shares sold for slightly more than they're actually worth. That way, the costs of the share issue are paid for by the new investors.

Therefore, new share issues work best when a trust's existing shares trade above their NAV, allowing the trust to find a middle price to suit both sides.

An example

To illustrate this, here is an example of a trust selling new shares at a small premium to the NAV. Remember, the NAV is the value of all an investment trust's investments minus its debts.

- **Asset of trust** = £115m
- **Overdraft /Borrowing** = £15m
- **NAV** = £100m
- **Shares in issue** = 100m
- **NAV per share: £100m/100m shares** = £1 or 100p

If the trust is popular and doing well, the shares might be trading (as an example) at 108p, therefore an 8% premium to NAV. The premium tells us that there's good demand for the shares. The trust may take advantage and decide to issue more shares. These new shares might be issued (as an example) at 104p, therefore a 4% premium to the NAV.

- **New buyers** benefit from a 4p discount to the current share price
- **Existing shareholders** would see a lift from selling the new shares for 4p more than their NAV

However, new shares can be sold at a discount to their NAV.

If the shares aren't trading at a premium, but the fund manager sees an investment opportunity that requires more money, the trust may issue new shares at a discount below NAV. But the manager must feel that this course of action is justified. In our example, the trust may choose to issue shares at a discount below NAV – say at 98p (2% discount).

However, selling the shares for less than they're worth could prompt complaints from existing investors that their holdings have been 'diluted'.

Contact us

0207 464 5855

UK_Wholesale_Client_Services@columbiathreadneedle.com

columbiathreadneedle.co.uk/adviser-edge

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