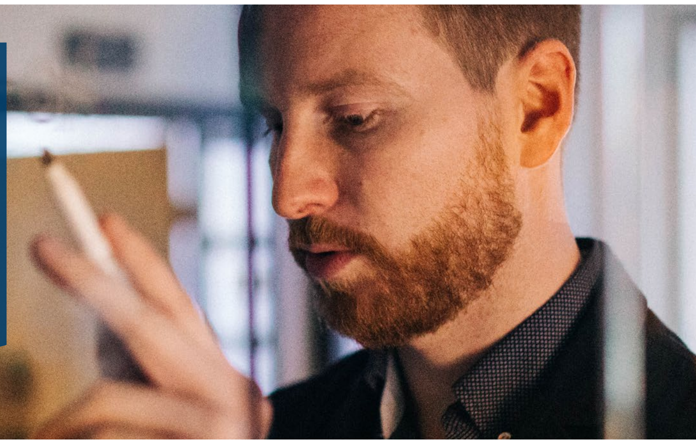
Digging deeper: Investment Trusts

3. Revenue reserves



Key takeaways:

- Understand how a trust's revenue reserve works
- Learn why this feature makes investment trusts useful for income-seeking investors
- Understand key terms relating to revenue reserves

Category:
Investment insights

Like other pooled investment funds, investment trusts earn income on most of the money they invest. This income comes from dividends paid by companies whose shares the trust holds and interest paid from loans to governments and businesses.

But an investment trust does not have to pay out all the income it receives from its investments. Instead, it can retain 15%, to be held in reserve. If the trust experiences a difficult financial period, or the economy is contracting, the trust can then choose to maintain dividend payments to its investors. Some investment trusts have used this feature to increase dividends every year for over 50 years.

Paying dividends from reserves is at the discretion the trust's board of directors and is not guaranteed, especially as it should be seen as an accounting term and not necessarily unused cash sitting on the balance sheet. However, a trust's ability to retain income to smooth dividends, both when the economy is growing and contracting, is attractive to people who are looking for regular, long-term income from their investments. Retained income can also be reinvested, which (thanks to the effect of compounding) helps to bolster long-term growth.

Thanks to their structure, investment trusts are also better suited to hold other types of assets, such as commercial property and infrastructure, which are hard for other funds to buy and sell but offer good income.

The Investment Trust (Approved Company) (Tax) Regulations 2011 (SI 2011/2999)

The income distribution requirement

19. (1) An investment trust must not retain in respect of an accounting period an amount which is greater than **15% of its income** for the accounting period.

- Therefore, not all income must be distributed in any one accounting period
- Income retained can be distributed in subsequent periods
- This provides a mechanism for the fund manager/directors to smooth income distributions over time
- Retained income is reinvested for additional growth

Key terms

Income received – income received by the trust

Distribution paid – the amount of money paid out by trust

Percentage distribution – the percentage of income distributed by the trust to investors

Retained income – the amount retained by the trust

Accumulated retained income – the value of income retained by the trust

An example

The table below shows varying examples of income received, the distribution paid and the percentage distributed.

Smoothing income distributions

Income received	Distribution paid	% distributed	Retained income	Accumulative retained income
£100	£90	90%	£10	£10
£110	£93.5	85%	£16.5	£26.5
£90	£90	100%	£0	£26.5
£100	£90	90%	£10	£36.5
£80	£90	112.5%	-£10	£26.5
£85	£90	105.89%	-£5	£21.5
£100	£90	90%	£10	£31.5
£665	**£633.5**			

Source: Columbia Threadneedle Investments, example for illustrative purposes only.

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