Digging deeper: Investment Trusts

4. Gearing

Key takeaways:

- Understand how investment trusts borrow to invest – a process known as gearing
- Learn about the limits in place (the maximum that can typically be borrowed)
- Understand the risks and benefits of gearing in an investment trust

Category:
Investment insights

Investment trusts can borrow to invest, an arrangement referred to as gearing. This often happens when the fund manager sees an opportunity to increase returns in the trust and borrows money to pursue it. Gearing means that investment trusts can have more money to invest on behalf of their shareholders.

There are downsides to gearing, however – namely, the interest and ultimate repayment of the loan. High levels of gearing in a trust can also skew its risk-return profile, as higher debt represents more risk.

How much gearing is allowed?

The level of gearing is decided by the board of directors and portfolio manager and is limited by company objectives. Investment trusts place strict limits on how much gearing their fund managers can use – a maximum of 25–30% is common.

The Association of Investment Companies (AIC) indicates that the average gearing across all investment trusts (not including Venture Capital Trusts (VCTs)) is approximately 8%, however in certain sectors this might be higher.

An example

Let's consider an example of gearing in practice. Here, we assume the trust raises £100 million from investors and borrows £10 million from a bank. It therefore has a total of £110 million working for shareholders.

If £1,000 is invested in the trust, the borrowing means the trust's fund manager is deploying £1,100 into the stock market. Therefore, the trust is 10% geared, as the £10 million loan is 10% of the £100 million the trust has in shareholder capital.

Assuming the fund manager earns an investment return on the borrowed money that is more than the interest the trust pays on its loan, then the gearing should be good for shareholders in the trust.

Also, if the fund manager earns a yield on the borrowed money that is more than the interest the trust pays on its loan, then the gearing should be good for the trust's revenue yield.

These are important differentiators from open-ended funds (OEICS), which do not typically allow for the fund manager to borrow.

There is always the possibility, however, that the fund manager may pay more interest on the borrowed money than the return earned from investing it, which will negatively impact returns for shareholders.

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