Why you should encourage share buybacks by investment trusts

by Mohammed Amin

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There is a great deal of misunderstanding regarding the effects of listed companies repurchasing their shares. The issues are quite different for investment trusts and for trading companies.

This article considers only investment trusts. My views about trading companies repurchasing their shares are very different and will be the subject of a separate article in the next edition of the Private Investor.

Investment trusts generally

These are one type of closed ended investment fund. The investment trust company has a fixed number of shares which are listed on the stock exchange. The company's assets consist of investments, normally quoted investments but sometimes also unquoted investments.

There is no reason why the total market value of the investment trust (shares in issue x price per share) should equal the net asset value (the total market value of the investments held by the company after deducting any liabilities.)

When an investment trust is very popular, investor demand to purchase its shares on the stock exchange may well mean that the market price per share exceeds the net asset value per share. In this situation the shares are said to stand at a "premium."

A more common situation is for somewhat limited investor demand for the shares of the investment trust causing the share price to fall below the net asset value per share. In this situation, the shares are said to stand at a "discount."
For example, the investment trust may own investments which in aggregate are worth £20 million. If it has 1 million shares in issue, the net asset value per share is £20. However, the quoted market price on the stock exchange may only be, say, £18 per share. In this situation, one would say that the shares stand at a

10% discount to net asset value.

(£20-£18) / £20 = 10%.

Impact of a share buyback

For illustration, assume that the company offers in the market to buy back up to 100,000 shares at a price of £18.50 per share, an aggregate cost of £1,850,000.

Selling shareholders

They should be happy. Before the investment trust commenced they buyback, they could only sell at the market price of £18.00 per share. Instead they have been able to sell their shares at £18.50 each.

Continuing shareholders

They should also be happy as well. The long term objective of shareholders in an investment trust is to have the management grow the net assets per share at a favourable rate without taking on excessive risks. That applies irrespective of the path of the quoted share price, since if desired the value represented by the net assets can be realised by the investment trust selling all of its investments and being liquidated.

The own-share buyback will increase the net assets per share, since both the net assets and the number of shares in issue have increased. Before the buyback, net assets per share were £20.00 each (£20 million net assets / 1 million shares in issue.)

Now the net assets per share are:

(£20 m - £1.85 m) / (1,000,000 – 100,000) = £18.15 m / 900,000 = £20.17

Even if the buyback fails to reduce the previous 20% discount, or if the share price remains unchanged at £18.00 per share, thereby widening the discount, the continuing shareholders are still better off than they were, since the key ratio of net assets per share has increased.

However, in practice, the activity of the investment trust in repurchasing and cancelling shares often causes the market price of the shares to increase. Apart from anything else, the company represents an additional buyer beyond those buyers already active in the stock market. Indeed, the expectation that the company will buy back its shares may itself cause the discount to narrow.

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Arguments against investment trust own-share purchases

Investment-trust managements are sometimes reluctant to make share
repurchases because, as can be seen from the above example, it reduces the absolute size of the investment trust.

It is normal for external investment trust managers to be paid a fee which is set as a percentage of the total assets under management, so reducing the size of the investment trust reduces the fee that the external managers will earn. Also, if an investment trust becomes too small, its overhead costs will become a more significant burden on the shareholders since they do not normally reduce in proportion as the investment trust shrinks.

However, for large investment trusts overhead costs should not be a material factor in deciding whether to repurchase shares at a price below net asset value.

As a general principle, I would always support investment trusts repurchasing their shares at prices below net asset value.

As I mentioned at the start, my views about trading companies buying back their own shares are very different. I believe that in the vast majority of cases share buybacks by trading companies are hard to justify in terms of the benefits they achieve for the shareholders. I shall explore the issues surrounding trading companies and share buybacks in the next issue of The Private Investor.

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