

**Annex:** Information published in the specialist press and the general press about the risk levels potentially associated with zeros, and about the risk factors that a firm might need to take into account in assessing the suitability of a particular zero as an investment.

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**1975: “The Great Crash 1929: book by J K Galbraith**

This book was probably aimed at the general public rather than the investment industry as a whole, and it was published over 20 years before the current problems in the split capital investment sector. However, it shows that it was widely known, and foreseeable, that high gearing and/or cross holdings introduced extra risks in respect of investment trust investments.

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**1992 (October): “Noddy Buys a Zero: Zero coupon preference shares – understanding risks as well as rewards”; Report by Smith New Court UK (now Merrill Lynch), stockbrokers**

The theme of the report was that the stock market did not properly understand zero dividend preference shares and that the market in this type of share was inefficient.

It questioned the validity of relying on “static” measures of risk such as asset cover and hurdle rate. It argued that *“insufficient attention is given to portfolio yield on the underlying assets. In addition, the market does not seem to have priced into the valuation of many shares the substantial risk that zeros will not be repaid in full”*.

It queried the method of accounting for zeros in a company balance sheet, because companies stepped up the value by predetermined amounts rather than recording the full cost of the liability. It went on to say –

*“This allows people to make all kinds of statements about the various classes of paper, which often do not bear especially close examination. Such phrases as “zero geared capital share X is on a discount to Y” is almost never well founded. All this makes the capital shares difficult to value. This sometimes proves to be a useful marketing property.”*

The report acknowledges that zeros, unlike all interest bearing securities, have no reinvestment risk<sup>1</sup>. But it also concluded that they are *“the most volatile debt instrument in the market”* and that investment trusts shares geared with zeros may prove to be a wasting asset. It described zeros as *“an aggressive play on interest rate movements”* with no certainty of short-term return and emphasised that they were more volatile than coupon-bearing instruments. It concluded:

- The key to understanding zeros was to have a proper assessment of the risk that the stock will not receive all of its predetermined final repayment.
- Static measures such as cover, hurdle rate and total return to cover were insufficient measures of risk in themselves.
- It was important to guard against the “free yield” fallacy [that additional yield generated by borrowing is ‘free’].
- There was a need to take into account total return and the yield of underlying stocks in the portfolio.
- There may be “sectoral risk”. Yield funds concentrate on certain sectors and higher yield requirements reduces sector diversity.

The Report commented – *“We have little doubt that the market does not give enough weight to the implications of portfolio yield for the zero coupon market, nor that it gives much weight to the element of equity-like risk which almost all of these stocks bear.”*

It also stated that zeros, however well covered, should trade on a higher gross redemption yield than a comparable dated government stock, as there is “no risk whatsoever” in a dated government stock. The final conclusion of the report was that a well-covered zero ought to trade on a gross redemption yield which made them very cheap gearing. *“This, though, necessitates some restraint on those issuing zeros; this restraint has not been over forthcoming in the past. We hope that it will become so in the future.”*<sup>2</sup>

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<sup>1</sup> Comment: If interest rates fall, the cost of fixed-interest rate investments is likely to rise. Typically, interest-bearing securities will repay at par (which may be more or less than the amount invested) and, if interest rates have fallen, it may not be possible to reinvest to produce the same level of income. Zeros are expected to repay at a target value, which will include the return on the investment – and is likely to be more than the amount invested. So there is an increased amount of capital to reinvest.

<sup>2</sup> Comment: As long ago as October 1992, and before the increase in bank-debt gearing, this report drew attention to the “substantial” risk that zeros would not be repaid in full – a risk which would have been increased by the effects of bank-debt gearing and cross holdings.

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### 1996 (1 June): “How splits began to crack”: Financial Times

This article began with the statement – “*This year a well-oiled piece of financial engineering started to corrode. Gillian O’Connor explains what went wrong.*”

The report drew a comparison between the poor performance over the year by investment trusts with a worse one from split capital investment trusts. This was taken as symptomatic of splits beginning to unravel. It stated that the financial engineering mechanism on which they were based started to creak in the harsher financial climate. It felt that many splits could only produce good results, at least for riskier types of shares, if 1980’s style stock market growth rates continued. The market had a good year in 1995 but the kind of shares splits bought, according to the article, did much worse than average.

Splits generally held shares yielding roughly twice as much as the market and such shares had recently been out of favour. The report felt the claims of the zero holders would take most of the capital growth achieved and stated “*The only shareholders who are set to do as well as they are expected are long term holders of zeros, who will enjoy 1980’s style returns until the trusts wind themselves up.*”

The report then went on to comment about the trend towards rolling over trusts into new splits vehicles and the competition between fund managers and alternative products producing high incomes. The fact that some fund managers ran splits investing in other splits was commented on as “*All such trusts are playing with levers.*” It later went on – “*The snag with gearing is always the same. Though it accelerates returns against a favourable background, it rapidly eliminates them when the background deteriorates. Investment trust analysts have a pleasing statistic called ‘Wipe out’. They look at a portfolio of a trust and work out what rate of growth is necessary to ensure at least some return for owners of the capital shares. Or more often, how much assets can fall each year before there is nothing left for owners of the capital shares. Most trusts now have a comfortable safety margin.*”

The article concluded – “*When even specialists are having second thoughts about the merits of the split capital concept, it is time for the layman to tread very carefully.*”<sup>3</sup>

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### 1998 (17 April): “Split Decisions”: Investors Chronicle<sup>4</sup>

The complexity of splits is acknowledged and the article advised that they “*can pay off handsomely for anyone who is able to pin down their financial objectives and their attitude to risk, though you do need professional advice.*”

The article was largely supportive of splits and there was no real discussion of risk but under “*Pay-out order*” it made the comment – “*But no return is guaranteed – even predetermined entitlements depend on the fund manager achieving certain levels of performance.*”<sup>5</sup>

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### 1998 (4 September): “Magic circle at work”: - Investors Chronicle

The article drew attention to cross-holdings under the heading “*Magic circle at work*”. It noted that “*A Magic circle [was] raising the bulk of money needed for new funds by investing in each other’s funds, say leading investment trust analysts.*”

Specific trusts mentioned were Abtrust High Income, Dartmoor, Geared Income and Exeter Preferred. “*This so-called dirty income – which depends on dividends from other ‘income’ shares – has plagued the splits market for a number of years, say the analysts. But they refuse to be quoted by name.*” It reported that Aberdeen Preferred Income had announced a 150% increase in size, £214,000,000, in the last week and that raising so much had been no mean feat in an out of fashion industry. Almost £80,000,000 came from a rollover from Scottish National Trust, £87,000,000 came from a placing with shareholders and a further £51,000,000 came from bank loans.

Piers Currie, Aberdeen Investment Trust Marketing Director, dismissed the Magic Circle theory as – “*Oh, that old chestnut*” and argued that money was coming from private investors after high-yielding securities. Brewin Dolphin Bell Lawrie, who had researched sources of income for split capital investment trusts in June 1997, following similar criticism, also rejected the idea. The article said of Brewin Dolphin Bell Lawrie’s research – “*Its conclusion*

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It also pointed out that the element of equity-like risk, which almost all zeros bore, was not sufficiently taken into account. It could be difficult to justify classifying an investment described as “*an aggressive play on interest rate movements*” as low risk.

There was some concern that the method of accounting for zeros in a company balance sheet could allow inaccurate statements to be made about the investment trust and that the capital shares could become difficult to value.

Not all zeros carried the same level of risk. Two zeros with identical yields could have significantly different risk profiles. Most zeros bear an element of equity (ordinary share) risk.

<sup>3</sup> Comment: Some concern was expressed about the poor quality of underlying portfolios, the structural gearing of splits and the further gearing brought about by cross holdings. There was no mention of financial gearing and most of the concern appeared to be reserved for shareholders lower down the pecking order rather than for zero shareholders.

<sup>4</sup> Comment: Investors Chronicle is a weekly magazine read widely throughout the investment industry and, being available at newsagents, by a large number of serious private investors. It is owned by the same company as the Financial Times.

<sup>5</sup> Comment: This indicated that even zeros are dependent on the quality of the underlying portfolio to reach their target value.

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contradicts the claims being made by the analysts that we spoke to: 'We could find no case where dependency on the second-hand income was a serious concern anywhere in the sector' Brewin Dolphin says."

The article concluded – "Overall there is a need for greater clarity. On the surface there seems to be little new money coming into the split capital sector, which makes up 8 per cent of the investment trust industry. One analyst says 'There is a certain amount of internal money, but it's hard to tell how much because there's a lot of cross-investment.' The fear is that, in more volatile markets, if shares in one highly geared split-capital trust go down, cross-investment may mean they all fall steeply."<sup>6</sup>

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#### **1998 (10 September): Investors Chronicle.**

This edition contained a survey entitled "*Investment Trusts: Doing the splits – Sector restructuring and the arrival of external gearing may have breathed new life into the split cap sector but investment remains a careful balancing act.*" The survey reported – "As one might expect of any geared play on the UK market, split capital investment trusts have had a good run for their money in the past two years." It goes on to warn – "Gearing will cut both ways, of course, but for the moment, splits are holding their own."

The problems of winding up and rolling over funds was explained and attention was drawn to the new issue market in splits being "far from easy" and gave various problems which could be encountered. It commented – "Re-structuring is also leading to more imaginative and sophisticated ways of gearing. The drawback of structural gearing is its inflexibility – when performance falters, a manager can be left trying to satisfy various shareholder classes with potentially opposing aims." It then reported a trend towards gearing via external sources, such as bank debt, rather than structural gearing through zeros.

The complexity of this type of investment was summed up as follows – "Getting to grips with such conceptual intricacies can be hard work for the private investor. Direct investing in splits is therefore likely to remain the domain of the determined hobbyist, although there are a number of closed-end and open-ended fund of funds available which sub-contract stock selection." Further sources of help for the private investor to assist in investing in splits were given before the article concluded – "... so the opportunity is there for the brave if they can grapple with the complexities of risk and gearing in this sector."<sup>7</sup>

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#### **1998 (20 November): "The incestuous world of split-capital trusts": Investors Chronicle**

The article started with two questions – the first in answered immediately, and following the second the theme was expanded upon.

It began by asking if splits were artificially inflating their share prices by buying into each other and answered – "In general, no – but appearances can be deceptive." It then asked – "Is there a magic circle operating in the arcane world of split capital investment trusts?" The report commented that at first sight it looked like splits ostensibly competing to produce better performance were actually propping each other up through a complicated series of cross-holdings. It reported that at least five had more than one third of their portfolios invested in income shares of other splits and in some cases each other.

The author commented that these shareholdings were potentially troublesome for investors in splits because of the danger of a pyramid effect as each trust depended on others for capital growth and the maintenance of high dividend payments. It said that if one trust suffered and cut its dividend so would the others in an ever-downward spiral.

The article then asked if investors should worry about these holdings and drew on comments by an analyst at Brewin Dolphin Bell Lawrie who said no since high income had to be financed somewhere and as there were just 40 splits it was not surprising that individual trusts had concentrated holdings in trusts that also had holdings in them. The analyst also pointed out that in terms of market capitalisation of the splits sector cross shareholdings were actually small. The analyst accepted that if more private investors put money into the sector there would be greater liquidity and the relatively low level of cross-holdings would be further diluted; but until there was greater liquidity many investors were put off. And "magic circle accusations don't help."

The report went on – "That's a shame because, complexity aside, split-capital trusts have a lot to offer more sophisticated investors. But, for now the sector is largely dominated by institutions, despite a concerted effort this year by the Association of Investment Trust Companies to promote the sector to the public."

There followed a description of share types in which zeros were described as "for the risk averse investor" but it was qualified by "this payment is pre-specified and guaranteed unless the fund has insufficient assets to pay up – unlikely because zeros are first in line for repayment on wind-up." Features of Income shares and capital shares

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<sup>6</sup> Comment: It appears that it was commonly known among analysts that the practice of cross-holding shares in other split capital investment trusts was widespread. It seems this knowledge, if not actively suppressed, was dismissed out of hand by the providers of the split capital investment trusts.

It is interesting that the article mentions gearing in its final conclusions, an element, which had not formed any part of the article before that point. The fears expressed in the last sentence would seem to be prophetic of what later came to pass and the article itself should have served as a warning, not only to analysts and the investment trust industry but also to the wider public. Certainly, it goes some way to counter the argument that the problems encountered later were unforeseeable.

<sup>7</sup> Comment: Some of the internal stresses and strains inherent within split capital investment trusts were brought to light in this survey. The survey appeared to acknowledge substantial risks involved with investment in split capital investment trusts and again drew attention to gearing; the problems it creates within a trust, its benefits and also its detrimental effect if markets fell. This shows therefore that the risk of gearing was well, and widely, known.

were also described and it was thought that that cuts in dividend shares were unlikely. Income shares and capital shares carry the warning *“But remember that these shares are more risky than others: if there aren't enough assets on wind-up to pay other shareholders, you'll get nothing.”*

The report concluded – *“Most importantly with splits, look for underlying asset quality – what the trust is actually invested in.”* It quoted another analyst – *“Go for less geared trusts initially with a lower risk profile, and aim for the longer end of the market, as this gives you more time for your call on the market to be right.”*<sup>8</sup>

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#### **1998 (28 November): “Split Capital Investment Trusts: Just too close for comfort?”: Financial Times**

This article stated – *“It is an image transformation of which any spin doctor would be proud. Split capital investment trusts, once an obscure and sleepy backwater of the trust sector, are now portrayed as a sought-after investment that could point the way to the sector's survival. But critics claim this renaissance is at least in part illusory. They believe that some private investors may be hurt as a result. Splits are on a money-raising roll, mainly because there are few other sources of high yields for income-seeking investors. Their structure means investors can get shares that offer either a very high income or a potentially high capital return (see ‘Split cap formula’ this page).*

*“The falling rates on gilts, bonds and deposits have increased the attraction of the pre-tax yields of 10 per cent or more paid by some splits' income shares (see ‘Split cap performance’). ‘You name it, the sources of income that used to be relied upon have dried up’ says Chris Whittingslow at Exeter Investment Management, one of the big split cap managers. ‘You are left with splits and quasi-splits as the only place where you can easily find high income.’ Split cap managers appear confident that this influx of money will continue.*

*“Chris Fishwick, at Aberdeen Asset Management, says ‘I predict the sector (which contains about Pounds 5.8 billion of assets) will double in size in the next three years.’ But critics question whether the growth of the sector is being inflated artificially – and if private investors really understand what they are taking on.*

*“The concern centres on a small “magic circle” of split cap managers who hold stakes in each other's apparently rival funds. The biggest three split cap managers – Aberdeen, Exeter and BFS Investments – are at the centre of the circle. The diagram shows the position for just two of these managers, but the web of cross-holdings stretches across the sector. Each member appears keen to help the other. Indeed, just under half the Pounds 40 million raised recently by Exeter for its Enhanced trust came from the other two groups. Even so, the managers stress that there is no collusion. ‘We don't get involved in the area of “You have a few of these, we have a few of those” ... it would be unduly jaundiced to say there's a gang of three in charge,’ says Whittingslow. ‘I don't think it's entirely surprising the large players turn to one another as sources of the very high yield that clients are clamouring for.’ But the technique used to generate that income, known to insiders as ‘pig on pork’, remains highly controversial. Some splits operate as a type of fund of funds, building at least part of their portfolio by using shares in other splits.*

*“This has raised fears of a ‘pack of cards’ effect. The easiest way to understand this is to look at a couple of typical trusts. Aberdeen High Income (AHI) owns 10 per cent of the ordinary shares of Dartmoor (one of Exeter's trusts) which, in turn, owns 7 per cent of the ordinary shares of AHI. Suppose Dartmoor hit an extremely bad investment patch and its ordinary share price fell significantly. The fall in the value of the Dartmoor shares held by AHI might affect the price of its own ordinary shares. This could, in turn, hit Dartmoor, setting off a domino effect. Splits' defenders scoff at such concerns. ‘On the surface, it's very easy to say “shock scandal”. But it's scare mongering and drivel,’ says Rolly Crawford, an analyst at ABN Amro Hoare Govett. He argues that most of the fund-of-fund style splits are buying into other trusts to get income, rather than heavily geared capital growth, and should prove relatively resilient to stock market movements as a result. He also makes the point, echoed by the fund managers, that most of the big splits have very diversified portfolios, which reduces their dependence on other managers. For instance, the holdings of the five Aberdeen trusts in BFS Income and Growth, shown in the diagram, account for less than 2 per cent of each trust's market capitalisation. This argument is backed by an analysis of the four trusts with the highest degree of income share overlap, carried out last year by stockbroker Brewin Dolphin Bell Lawrie. It suggested that only about 13 per cent of their combined gross income was re-circulated – and so at risk – if the chain between them collapsed.*

*“But not everyone is entirely convinced. ‘Quite clearly, the private clients holding these pieces of paper don't understand the underlying risks,’ says one analyst. ‘True, most have come via (independent financial advisers), but how many of those IFAs understand either?’”*<sup>9</sup>

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<sup>8</sup> Comment: There was obviously some concern about the potentially negative effects of cross holdings at this stage, although concern appears more to do with maintenance of the level of dividend or the effect on capital shares than any structural problem affecting zeros.

The necessity of looking at the quality of the underlying portfolio and considering gearing is acknowledged at the end of the article and the advice to go for trusts with a lower risk profile shows that not all splits were regarded to be of equal risk. However, again this advice looks to be aimed more at income or capital shares than at zeros.

<sup>9</sup> Comment: Clearly there was concern about the extent of cross holdings and there was, in some quarters at least, the fear of a ‘house of cards’ type collapse. There was also an apparent lack of confidence by analysts that IFAs understood the risks associated with split capital investment trusts.

**1998 (28 November): “Split Capital Investment Trusts: A trade-off between risk and reward: Split cap performance”: Financial Times**

This article stated – “*Split capital trusts have had a good run recently – and, it seems, the higher the risk, the better the results, writes Jean Eaglesham. The figures for some trusts appear at first glance to defy the investment truism that you can have either a high income or a decent capital return, but not both. Aberdeen Preferred’s shares, for example, which have a pre-tax yield of more than 12 per cent, increased their capital value by 48 per cent in the year to 31 October. Dartmoor achieved a similar feat: the shares yield over 9 per cent, yet increased in capital value by more than 40 per cent. Split caps which have conventional portfolios, rather than investing at least some of their assets in other split caps, suffered by comparison. The ordinary income shares of Second Scottish National, which yield more than 10 per cent, fell slightly in value over the year. Conventional trusts also lagged, as the chart shows.*

“*Stockbroker Brewin Dolphin, which sponsored the launch of Aberdeen Preferred and so has a vested interest in its success, maintains in a research note published this week that the figures demonstrate the virtues of high yields and high gearing. ‘The use of gearing as high as 50 to 60 per cent is to be encouraged, rather than the reverse, particularly as the cost of borrowing money is decreasing,’ it says. Brewin Dolphin contrasts the ‘high returns’ from the likes of Aberdeen Preferred with the ‘woeful performance of large, under-g geared and low-yielding (conventional trusts), which we liken to beached whales’. The broker also points out that split caps appear to have a clear edge over their conventional cousins in terms of drumming up demand from both private and institutional investors.*

“*The key indicator of demand – the average discount between trusts’ share prices and the value of their underlying net assets – is only about 3 per cent for splits, compared with 13 per cent for conventional trusts. Brewin Dolphin concludes: ‘The trust industry may be adept at identifying its apparent problems but it is obviously unwilling to recognise a solution (high-yielding, highly geared splits) even when one is staring it in the face.’ Investors, however, should take these arguments with a hefty pinch of salt. According to Michael Wrobel at Gartmore, which managed Second Scottish National, comparing the performance of trusts that invest in other trusts with that of normal splits, let alone conventional trusts, is ‘comparing apples and pears ... Aberdeen Preferred is a very unusual animal with very high gearing’. Anyone who is impressed with the recent out performance of the specialised splits should bear in mind that gearing can have a dramatic effect when markets are going down as well as up. ‘It’s a risk/reward trade-off,’ says Simon Moore, at Williams de Broe.*

“*This broker’s figures show that the ordinary shares of Aberdeen Preferred, for example, will rise – or fall – by 10.3 per cent in value for every 5 per cent movement in the stock market. The effect is even more marked for Geared Income trust, where every 5 per cent market movement produces a 13.1 per cent change in the shares.*”<sup>10</sup>

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**1999 (19 February): “Absolute Beginners”: Investors Chronicle**

The complexities of splits were acknowledged. Although zeros were described as “*the least risky type of split-capital share*” the report warned – “*These pay-outs aren’t guaranteed – the trust must have sufficient assets – but zero shareholders are usually first in line for payment at wind-up. Look out for gross redemption yields, asset cover and hurdle rates.*”

Under useful tips it concluded – “*Check the order of capital repayment*” and “*remember that no two split-capital trusts are the same*” and “*Gearing is also important in assessing the value of split capital trust shares, particularly of income and residual capital and capital shares. Gearing is the level of borrowing the trust has – more gearing enables trusts to increase their returns but also exposes investors to more risk. If necessary take professional advice before investing in split-capital investment trusts. The Association of Investment Trust Companies (AITC) publishes a free guide to splits.*”<sup>11</sup>

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**1999 (4 May): “Zero dividend preference shares”: Warburg Dillon Reed <sup>12</sup>**

The firm noted in this report – “*If zeros are analysed on a fair value basis we calculate that many actually offer better value now than in September. Covers have increased but the ‘insurance cost’ on many zeros has not declined significantly.*” ‘Insurance cost’ is defined as the difference between the price of a zero (which has the risk of being unable to meet its redemption) and the valuation of a gilt with a similar life”. It also commented – “*Zeros have become better covered and offer a lower risk profile. The vast majority can weather another substantial market setback without falling short of their promised redemption values.*”<sup>13</sup>

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<sup>10</sup> Comment: Although highly geared splits with substantial cross holdings were enjoying some success there was an undercurrent of concern about the effects of gearing when markets turn downward. There was also some concern that the high returns could come with a higher risk attached.

<sup>11</sup> Comment: The importance of gearing as a risk factor was recognised and checking the order of capital repayment should uncover any prior charges, through borrowing or debt instruments, to capital ahead of the zero. Potential zero investors were advised to check gross redemption yields, asset cover and hurdle rates.

<sup>12</sup> Comment: This firm is the investment banking division of UBS AG and the firm is generally supportive of zero dividend preference shares as a low risk investment.

<sup>13</sup> Comment: The possibility of zeros not meeting their redemption value was being factored into their price and it seemed that there was concern that some, if not the “*vast majority*”, could experience difficulties on a substantial market setback. It would seem therefore that it was accepted that not all zeros had the same risk profile.

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### 1999 (13 May): “Ask The Experts”: This Is Money

A reader of this publication – who was not well off, was a non-taxpayer and had no other substantial assets except a house – asked for advice about a holding of shares they had in a large well-known company. The reader was concerned about the narrow spread of risk and was considering switching to a share based ISA or diversifying into other equities.

The advice given was not to retain the shares in case the stock market fell considerably just before it became necessary to sell and not to invest in further shares. A building society or bank account was suggested with zero dividend preference shares as an alternative. It was pointed out that the returns on zero dividend preference shares were not guaranteed but the article stated that “*the risk that they will not meet their targeted returns is very low*” and recommended that further details can be obtained by contacting the Association of Investment Trusts.<sup>14</sup>

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### 1999 (August): “Zero Dividend Preference Shares – What are they worth?”: Merrill Lynch, stockbrokers

This report said that the 1992 report from Smith New Court (referred to above) had not markedly affected the valuation of zeros.

The report noted that, by August 1999, zeros had been issued relatively heavily – and expressed Merrill Lynch’s belief “*that the ZDP market currently operates using some archaic methods of valuation*”. Although these “*archaic methods of valuation*” were not defined, later comments suggest they are referring to a combination of asset cover and gross redemption yield.

It noted that zeros had some exposure on the downside and a fixed upside and raised the questions “*Is it a bond?*” and “*Is it an option?*” The answer it reached in both cases was “yes”, but Merrill Lynch expressed a preference for the option approach.

They suggested that the easiest way to grasp the concept was to regard a zero as a combination of a short call<sup>15</sup> and a long stock position.<sup>16</sup>

Merrill Lynch expressed the view that, because of their tax treatment, zeros were extremely well suited to private investors. They believed that in most cases investors should adopt a “*buy and hold*” strategy, picking relatively safe zeros and holding them to maturity. The report considered that zeros should always trade at a premium to gilts, to take into account the default risk associated with zeros – the possibility that the zero will not meet its target value on maturity.

Some of the stocks they regarded as attractive at the time were listed but with the caveat – “*In some cases, however, the underlying portfolios are not mainstream, and investors are right to demand some compensation for this.*” In other words, zeros relying on non-mainstream portfolios carried, or should have carried, a premium return to compensate for the extra risk involved.

The report noted that the contemporary approach of looking at cover coupled with gross redemption yield captured only part of the risk/valuation picture and expressed the belief that a more accurate measure would be obtained from a combination of credit spread analysis and option technology.

It felt little had changed in assessing value and risk since the 1992 report by Smith New Court. The 1998 report warned against relying on “*static*” risk measures such as asset cover and cautioned against looking solely at yields without assessing the associated risks. The report compared gearing through zero dividend preference shares to gearing through bank debt. It said –

*“Because they are preference shares, they tend to fall relatively low down the pecking order in terms of claims on assets, and to be somewhat bereft of rights. Some trusts have taken to using relatively high levels of bank debt as an alternative to ZDPs, and in many cases this is sensible, but banks do have an uncomfortable habit of wanting their money back.”*

*“Typically, a bank will be able to force some sort of repayment if various levels of capital covenants are breached, whereas a ZDP holder has no such ability. The only option available to ZDP holders is to keep their fingers crossed. This undoubtedly adds to ZDPs’ attractiveness to issuers. In other words, ZDPs carry a degree of equity risk. Assessing this risk is a key part of assessing ZDPs overall.”*

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<sup>14</sup> Comment: Although the risk of zero dividend preference shares not being able to meet their target is regarded as low the article nevertheless acknowledged that this was a possibility and pointed out that the return was not guaranteed.

<sup>15</sup> Comment: A ‘call’ is a contract that gives the holder the right to buy a certain quantity (usually 100 shares) of an underlying security from the writer of the option, at a specified price (the strike price) up to a specified date. [Source: trading-glossary.com]

<sup>16</sup> Comment: Merrill Lynch appear to be saying that, should equity markets rise by a small amount, there will be an increase in the value attributable to the holder but this increase is capped at a value which is known.

Thus, a substantial rise will be of no benefit to the holder. Conversely, should equity markets fall by a only a small amount, a holder should not suffer because the value of the call money taken plus the now reduced value of his holding might still exceed the sale proceeds of the stock which he might have achieved had he sold it outright rather than selling the call.

However, this protection is limited on the downside. In a major market slide, the money taken by selling a call short is dwarfed by the size of the loss on the underlying security, which is still held.

The report described the standard approach to valuing zeros by considering gross redemption yield and asset cover as an extreme oversimplification. It acknowledged that, up to then, no zeros have ever finished their lives uncovered. But, it said *"Equally, it is true that the last ten years have seen bull markets for most equity markets – there is a logical case for a split capital Japanese trust, but it is one which the market has, luckily, ignored - and this has helped cover a multitude of sins"*.

It expressed the belief that the market did not price in default risk, and that what tended to happen was that stocks were divided into those that were 'safe' (had adequate cover) and those that were not. Using Corporate Bond's as a comparison the report reaches the view that the market tends to under price the risk in zeros.

It accepted that there was a case for zeros to be owned by retail investors, but it recognised the limitations of demand from this sector and concluded that zeros would continue to be priced with the institutional investor in mind.

It said that the various risk assessment/valuation methods assumed there was nothing to choose between the various asset pools of the investment trust and that this too was an oversimplification. It recommended in depth investigations into the underlying portfolio management of each stock, risk control, tracking error, management resources etc.

The report recognised the risks posed by extensive cross holdings in other split capital investment trust companies, stating –

*"One issue which exercises people is that of holdings in other split capital trusts. There has been a vogue recently for trusts to allocate a relatively small portion of assets to what is termed a 'high yield' UK portfolio. This tends to be a portfolio of income or highly geared ordinary shares ... We would also tend to look for some modest added pricing advantage in their ZDP's, to compensate for what must be regarded as a raised risk profile, where this form of investment is material".*

Merrill Lynch explained that in looking for 'quality' in a stock they looked for high cover, a mainstream portfolio and little prior gearing. They then make certain recommendations of what they considered to be attractive stocks.

A subsequent note warned that this analysis was aimed at institutional investors who should be prepared to invest in zeros with significant equity risk. They provided a list of what they considered safe reasonably priced zeros, avoiding significant equity risk even if offering good value, assuming private clients held them to maturity.<sup>17</sup>

In their conclusion Merrill Lynch express the belief that zero dividend preference shares were interesting and potentially attractive stocks to retail investors but that they were not as simple as some commentators supposed, at the time.

Finally, in the Technical Appendix, Merrill Lynch commented on borrowings – *"Clearly, the existence of any bank debt before zeros has to be allowed for. This will alter the cover figure, and also the risk properties of the zero ... we do know that if you assume a constant growth rate, you are overestimating the overall return, because in the real world returns are volatile, and this reduces the end result."*

Although Merrill Lynch suggested zeros were appropriate for private clients (retail investors) they felt investors should adopt a 'buy and hold' strategy, picking relatively safe zeros and holding them to maturity. They acknowledged that zeros had default risk and they clearly drew a distinction between 'safe' and 'unsafe' zeros indicating that not all zeros were low risk.<sup>18</sup>

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<sup>17</sup> Comment: In this context, 'safe' did not necessarily mean "low risk", because the list of *"safe zeros suitable for private clients"* included:

- Aberdeen Preferred, which the note had earlier described as *"a riskier than usual UK equity income portfolio"* and about which it said - *"There has to be an element of 'caveat emptor' about this stock. The underlying assets – a mixture of other split capital shares and higher yielding UK bonds and preference shares – strikes us as riskier than the usual UK equity income portfolio and there are significant prior charges ahead of the zero"*.
- Geared Income, about which the note said - *"... there is some kind of systemic risk with such structures."*
- Murray Global Return, which was described as *"a rather more speculative stock."*

<sup>18</sup> Comment: Although the zero market was over 12 years old, and zeros were being heavily issued at this time, the best methods of valuing zeros, and assessing the risks involved, were still in doubt and being actively debated.

The report expressed concern that the risk associated with zeros, particularly default risk, might be being ignored with only the yield being considered – and that what risk measurement existed was inadequate.

It recognised that zeros have an element of equity risk and holders have few rights compared with the providers of bank debt if things go wrong. The often-quoted defence of zeros, that none had failed to mature at full value, was challenged. The general sense was that this lack of any previous default might only have been because of the extended run of a bull market and that this might not hold true in less benign market conditions.

It also recognised the risks posed by extensive cross holdings in other split capital investment trust companies – and that some investigations into the underlying portfolio management of each stock should also be considered when assessing the value and risk profile of zeros.

The term 'safe' did not necessarily equate to 'low risk' – in the way that a portfolio of high quality bank shares might be regarded as 'safe' but the risk profile would generally be considered as 'medium'.

It was known that bank debt altered the cover figures and the risk properties of zeros, and that assuming a constant growth rate lead to overestimating the overall return – because actual returns are volatile, and this reduced the end result.

### 1999 (18 September): The Herald, Glasgow

An article in this newspaper reported – “Gartmore, a wholly-owned subsidiary of the NatWest Group, announced yesterday the formation of a new split-capital fund that will invest mainly in the shares of other trusts”. This was the Gartmore Split Capital Opportunities Trust (GSCOT). Then – “The creation of the fund will put Gartmore into what is known as the “magic circle” of split capital funds. These trusts, which are mainly composed of cash from large institutional investors, all support one another by investing in each other’s shares. While this produces a high yield during a market boom – GSCOT has forecast an initial annual net yield of 10.5% - putting cash in a “trust of trusts” produces a highly geared investment. For that reason, many analysts advise that this area is too risky for private investors.”<sup>19</sup>

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### 1999 (November): “Using split capital investment trusts in financial planning”: Bloomberg Money Guide<sup>20</sup>

The first article, “Finding the split cap that fits”, maintained that investors could, through splits, “buy shares which offer relatively risk-free predetermined growth, higher-risk capital growth or high income”. It explained that in the early 1990s the range of splits was limited with the underlying portfolios being made up of shares in UK companies and shares from other splits. This was seen as a problem since “The focus was on a magic circle of trusts from Aberdeen, BFS and Exeter. The worry was that problems which may have been experienced by one trust could be passed on to the others.” It was intimated that this potential problem may have been relieved by the larger number of split capital trusts available.

In the article “Building blocks in financial planning” the publication gave the following advice, “despite the increased sophistication of investors, they are advised to not only carefully plough through the information, reading all the small print, but consult a financial adviser as well before plunging in.” It is acknowledged that bank debt, debenture holders and holders of unsecured loan stock all have a prior call on assets on the winding up of the trust. Further advice is given by a contributor who suggests investors should “not only evaluate the type of split they are investing in but the underlying assets. ‘At one time, many split capital trusts were exposed to mainly UK companies’ shares, particularly in the FTSE 350, but there has been a real broadening out of the market and we are seeing greater exposure to Europe as well as technology stocks”. It goes on “Again, it depends on the investor’s appetite for risk. Naturally, blue chips are the safest.....technology is also for those who like to live on the edge.” Finally it counselled that investors should tread carefully and be aware of different asset classes and attributes as well as their shortcomings.

Although zeros were classified as “low risk” in the following article they were described as “the least risky type” of split and “not entirely risk free”. It was also pointed out that payouts were not guaranteed and when compared with gilts that zeros were not backed by the government. Gilts and gilt income funds were quoted as comparable investments. Stepped Preference shares were described as a “relatively low risk investment” and income shares as having a “medium” risk profile. Income shares of different trusts could vary greatly and potential investors were recommended to comb through their different risk and reward profiles before making their investment. Comparable investments were quoted as equity income funds and high interest bank accounts. However, one financial adviser said of income shares, “They are one of the riskier share classes, however, and I’d only recommend them to people with a substantial portfolio of other investments to produce capital growth as there’s the possibility of capital erosion.” Income and residual capital shares were described as riskier than their counterparts whilst capital shares were described as having a “high risk” profile. The effects of gearing on the price of capital shares was explained.<sup>21</sup>

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### 1999 (12 November): Investors Chronicle

This edition contained a survey entitled “Investment Trusts: Turning somersaults – The split capital trust sector has come full circle again and is now enjoying an extremely high profile. But there are still some participants who are worried by the thought of cross holdings.”

The article reported the yields of the FTSE All-Share Index and the FTSE 350 Index as “less than 2.5%” and “less than 3.5%” respectively and compared this with income from the highly geared ordinary shares of split capital investment trusts which were offering yields of between 8 and 10.5%, the latter being attributable to the then recently issued Gartmore Split Capital Opportunities Trust (GSCOT).

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<sup>19</sup> Comment: Clearly analysts were aware of the extra risks involved with cross-holdings and gearing in split capital investment trusts at the time of this article. The ‘magic circle’ also appeared to be more in the public domain. Although this article proved that such concerns were in the public domain the local nature of the publication restricted the audience of who could, or should, have been aware of the article.

<sup>20</sup> Comment: Bloomberg Money Guide was generally supportive of the investment trust industry being sponsored by a number of fund management groups servicing the investment trust sector.

<sup>21</sup> Comment: There appeared to be some awareness that the cross holding of other splits may cause structural weakness. There was also the use of the term “magic circle” which may have been obtained from previous articles critical of cross holdings in splits.

Some warning was given about prior charges on the winding up of splits and potential investors were advised to consider carefully all available information, take independent advice and look at the underlying assets before making an investment.

Zero dividend preference shares continued to be regarded as “low risk”, capital shares as “high risk” and income shares as either, depending on the type. The effects of gearing were only explained in regard to capital shares.

The ability of GSCOT to provide such a high return was explained by the trust investing primarily in the income shares of other split capital investment trusts, with between 20% and 30% in the income oriented shares of splits that invest in other splits. The article pointed out that this was a departure from Gartmore's previous strategy of avoiding investment in other splits which played on fears that "cross holdings could encourage rapid 'contamination' if one of the trusts concerned 'got into trouble'." The report continued – "The scaremongers pointed out that the trusts managed by leading specialists such as Aberdeen Asset Managers, Exeter Fund Managers and BFS Investments tended to have large cross holdings and suggested that this was intrinsically dangerous. Just as an enhanced rating, a much increased dividend, or an investment coup could ripple round in a virtuous circle, so a fall from favour, a dividend cut or an investment disaster, could prove equally contagious and self feeding, argued the cynics."

To balance the argument the article reported that the managers and designers of splits with substantial cross holdings regarded such fears as being "over-blown". The leader of Gartmore's split capital team was quoted as saying that the most important price determinant for these trusts was a secure dividend stream and that the most obvious source of trouble would be "a huge pile of dividend cuts" similar to that which "decimated" split capital investment trusts in 1992. Given the then level of dividend cover this was not seen as a significant threat.

This was supported by a paper by a leading architect of split capital investment trusts at Brewin Dolphin Securities entitled "On Magic Circles and Innuendo". This paper largely dismissed any fears, considering any risk reasonably limited and concluded – "There is no 'house of cards', because the trust sector diversifies its risk very widely. As equity dividends can be expected to grow each year, this income can be regarded as assured. The dividends are unlikely to suffer any interruption."

Further support came from the head of investment trust activities at CGU who believed that investing in a split capital investment trust with an ultra high yielding direct equity portfolio could be as risky as investing in a well managed split capital fund of funds. He added that the dangers of cross holding had been considerably diluted by the diverse nature of split capital, investment trust newcomers.

The report concluded that this type of investment would be vulnerable, despite their professional managers, if world stock markets took a protected downturn. It warned "anyone investing in geared shares, be they in a conventional trust, a split or a split capital fund of funds, must understand that they will be badly hit by a sustained bear market. Investors should only be tempted by the high yields if they believe in a strong medium term equity market."<sup>22</sup>

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#### **1999 (13 November): "Ask The Experts": This Is Money**

A reader of this publication asked for help in finding some zeros with a yield as close to 10% per year as possible with negative hurdle rates due to wind up in 2 to 5 years.

Most of the response, from an IFA with Chartwell Investment Management, comprised background information about zeros but two zeros were quoted. For further information about zeros readers were referred to the Association of Investment Trusts website.

The response finished as follows, "When investing in zero, do your homework: you must consider the underlying philosophy and shareholdings of the investment trust offering the zeros."<sup>23</sup>

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#### **1999 (22 November): "Advisers hit out at Jupiter failure to highlight risks": Daily Telegraph**

This report related to the launch of Jupiter Dividend & Growth Trust which projected a 9% pa return for ordinary shareholders but the article commented "financial advisers fear investors may not be aware that they might not get their capital back if the fund does not achieve 5.5 pc annual growth. Indeed, if the market falls and the fund experiences zero growth, investors can only expect to see the return of 16 pc of their capital. Advisers are complaining that this information is buried in the small print of Jupiter application process."

Given their track record Jupiter did not feel a hurdle rate of 5.5% a year over 6 years was unreasonable. The advert for the fund did contain a warning; according to the report "buried in a Jupiter advert for the fund is a statement that investors can only expect back 16pc of the capital they invested if the fund experiences 0pc

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<sup>22</sup> Comment: In the light of some of the points in this article it would be difficult to argue that the detrimental effects of gearing and cross holdings in a sustained falling stock market, or in a market which fell drastically in a short time-span, were unforeseeable. It would seem some managers and designers of these trusts were advised of the possible detrimental effects but chose to ignore them and to treat them as "over blown". The possibilities of a drastic fall in the stock market or of a sustained falling stock market are ever present and again a claim that any such fall was unforeseeable does not hold up.

This article appeared in a widely read periodical so some of the risks, particularly to the income or capital shares in a split capital investment trust, had been brought into the public domain. Given the reassurances in the article it is difficult to conclude that private investors or IFAs gave it much weight in reaching investment decisions. However, it should have alerted them to possible future problems.

<sup>23</sup> Comment: The final sentence suggests the writer was aware that not all zeros carried the same degree of risk. In this instance the writer appears concerned that some zeros relied on investment trusts with inferior underlying portfolio quality than others, although his "philosophy" comment could also include attitude to gearing and cross holdings.

The important thing is that this IFA was aware that the quality, and therefore the inherent risk, of zeros varied and that it was prudent to "do your homework" when considering a zero investment. If he had that knowledge so should other IFAs and it makes it difficult for them to rely on the generalisations that all zeros "are safe" and "no zero has failed to repay at its target price on winding up" in recommending a zero without undertaking further research.

growth; 51 pc at 2.5 pc growth and 90.7 pc at 5 pc growth.” There was also some comment about the level of the fees and the drag this would have on the return for ordinary shareholders.<sup>24</sup>

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### 1999 (3 December): “Beware of doing the splits”: Investors Chronicle

The article starts with the warning from Best Investment Brokers “*Don’t be lured by the high-sounding yields of investment trust income shares unless you realise the risks*” following the successful launch of Jupiter’s Dividend & Growth fund. It goes on to compare the return, 9%, with deposit rates which were substantially lower concluding that a higher return than the deposit rates will almost certainly carry risk. The broker was concerned that investors did not appreciate the risks involved with split capital investment trust income shares.

The report states – “*It’s easy to forget, in the welter of figures, ratios and projections, that any entitlement depends ultimately on the success or otherwise of the investments held in the fund. The Jupiter Dividend & Growth ordinary income shares will need the trust’s investments to grow by 5.5% a year over the next 6 years for the investors just to get back their original investment. Should the assets show no growth, investors will lose 84% of their capital – because the holders of zero shares will have first call on the trust’s capital assets at the end of its life. ‘We are concerned about the over issuance of split-capital trusts’, says Mr Hollands [of Best Investment Brokers]. He believes the current high-profile Its campaign represents the last chance for the investment trust sector. Run by the Association of Investment Trust Companies, it is designed to save a sector that has lost investors’ confidence as a result of too many new launches of both conventional and split-capital trusts. Many trusts failed to live up to the hype of the launch.*”<sup>25</sup>

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### 2000 (January): Investment Trusts: Bloomberg Money Guide

This issue contained, amongst others, an article on “*discount*” risk explaining plans attempting to reduce or avoid it, an article about “*High earners*” and an editorial comment entitled “*Trusts must not yield to temptation*”.

In “*High earners*” the concept of “*gearing up*” to achieve a “*free*” extra return was explained but several warnings were given. The article explained the need to look at gross redemption yield rather than running yield to judge the attraction, or otherwise, of the overall return (a high running (income) yield may be eroded by capital depreciation) and warned that gross redemption yield figures for ordinary shares in split capital investment trusts could only ever be estimates because no one could be certain about future growth of dividends or capital.

It went on to say that “*it must be stressed that if the assets do not grow by the projected growth rate then the ordinary shareholders may not receive a full return of the capital they have invested. This is the risk that an investor takes in order to receive a higher income than the building society going rate. With any investment, the higher the reward, the higher the potential risk. The reward is ‘payment’ for the risk. An investment manager setting out to produce a higher return than the going rate will have to take some risk with the capital they are using to generate the return.*” It then advised that risk could be reduced by choosing a trust with a good track record and one which does not require an unrealistic growth rate to achieve a full return of capital.

Thumbnail comments were given on four trusts, three giving running yields of between 6% and 7.64% each, two would give capital growth if the capital value of the portfolio increased by 2.5% per year, the other would give a full return of capital. The remaining trust offered a running yield of 11.1% but capital and income growth of 2.5% or less would result in a capital reduction on maturity.

The theme of risk/reward is continued in “*Trusts must not yield to temptation*”, observing “*Advisers know just how easy it is to sell yield-based products at the moment*” and queries “*but are they making sure that investors are really aware of the risks involved?*” In response to its own question it concludes – “*Unfortunately I suspect not, given the extent to which such new issues are being promoted purely on the basis of blunt mail shots rather than on the basis of knowledge of an individual’s personal circumstances and attitude towards risk.*”

It was pointed out that income shares carry a considerable risk to capital which is exacerbated if the trust also has Zero Dividend Preference Shares. A trust may also have prior bank debt (i.e. they may be geared investments). An example was given of a share requiring a growth rate in the underlying portfolio of 5.5% over 6 years to ensure income holders get back their original investment. It was estimated that with no growth the value of these shares would fall by 84%. No estimate of the value of the shares if the underlying portfolio depreciated over the 6 year period was given but the article commented – “*While it is highly unlikely that a trust operated by a respected manager would fail to achieve an annualised return of 5.5%, the effect of magnifying any downside in the event that the market falls or moves sideways should not be ignored ... The golden rule should be to treat very high levels of yield with suspicion. Any investment offering considerably higher yields than prevailing rates is likely to be carrying above average levels of risk ... it would be inappropriate to compare such products with a deposit*

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<sup>24</sup> Comment: The main criticism was the high hurdle rate for the ordinary shares and that the risk of capital depreciation was hidden away in advertising literature. The possibility of a fall in the stockmarket appeared to be being ignored, or given insufficient weight, by the trust designers. No calculation was made of a possible fall in market but if ordinary shareholders would only get back 16% of their investment at 0% growth the capital of holders of zero dividend preference shares could be at risk on a stockmarket fall.

<sup>25</sup> The article expresses some disillusion with the investment trust sector and highlights that the ultimate return of share classes within a trust are dependent on the performance of the underlying portfolio. The relationship between risk and the reward offered by income shares is commented upon and it is easy to see that if the risk of the Income shareholders not receiving their capital entitlement, or anything at all, is high the risk to the capital shareholder is even higher.

account.” It concluded – “Our concern is not with the competency or integrity of the team at ... it is that some investors do not understand the risks of income shares and that other groups will start flooding the market with new issues.”

A glossary of buzzwords was included in the publication and the entry under “gearing” was – “Investment trusts differ from unit trusts in that they are allowed to borrow money to invest. This means the fund can potentially gain much higher returns if they spot a good investment. Unfortunately, it means they can lose more too, if the bet goes against them. Gearing, or borrowing, is usually quite cheap and each trust has its official limits.”<sup>26</sup>

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## 2000 (May): “Find your way through the split cap maze”: Bloomberg Money Guide

This issue recorded the boom in the split capital investment trust sector with funds under management increasing by £3bn from £6bn to £9bn, a 50% increase, in 1999. There were 26 new issues in the year raising £2.9bn of new money.

A decision tree was included to help readers decide which type of shares of split capital investment trusts might be appropriate to meet their needs. Following affirmative answers to the questions “Do you require a definite sum for a future commitment such as paying school fees?” and “Is it important that your investment is low risk?” the reader was led to “Zero dividend preference shares should fit the bill” but where higher returns were required in the decision tree, following a negative response to the question “Are you willing to accept higher risk if it means a potentially higher return?” the reader was led to “The higher returns you require, the higher the risk you typically have to take. Perhaps you should reconsider how much risk you are prepared to trade for returns and go back to the beginning.”

Under a separate branch of the decision tree, more concerned with income production, for investors requiring income in excess of 10%, it concluded “The higher the rate of income the fund is offering, the higher the risk it is likely to be taking to try and achieve such an attractive yield.”

There was a subsequent article on Zeros, which drew no distinction between individual zeros. The article regarded this type of investment as low risk although it allowed that they were not guaranteed, that the return could be predicted “with reasonable accuracy” and that “you can be reasonably sure of what you will get back on a certain date.” Dependency on stock market performance, whilst acknowledged, was discounted with a comparison with gilts (although it was pointed out that gilts are backed by the government and zeros are not) and a reassurance that it would only be in extreme stock market conditions that a zero would not pay back in full and that none had defaulted in over 30 years.

Following the zero article was one on split capital income shares recommending them, with typical yields of 10%, as an alternative to deposit accounts. With traditional income shares it stated at “the end of its life you will normally get back most of your original capital” whereas it was explained that for annuity income shares all but a nominal amount of capital would be lost. Reading of the small print was regarded as essential before investing in income shares and the importance of cover rate, hurdle rate and gross redemption yield in assessing suitability was mentioned. A strategy of coupling income shares with residual capital shares was discussed but highly geared ordinary shares were described as riskier than their counterparts. However, it concluded – “But their risky nature can be tempered by mixing them with income shares or zeros.” This theme is continued in the next item on split capital ‘capital’ shares which concluded – “Capital shares are highly geared which means they amplify the stock market’s movements in both directions. If the portfolio’s underlying investments fall, they do exceptionally badly. But if the assets go up over the life of the trust they do exceptionally well. Mixed with zeros, though, which provide a low-risk return and are an ideal tool to protect the capital value of your portfolio, capital shares may provide potentially higher capital returns with reduced risk.”

An article then followed about what to consider when choosing a split capital investment trust investment. It began by stating that split capital investment trusts were “under-used and misunderstood”. It was pointed out that splits were complex structures, that portfolios vary considerably from one trust to another and that comparisons were difficult. Potential investors were recommended to seek specialist advice. Again the low risk nature of zeros is emphasised and it was suggested that comparison can be made with building societies and gilts. It commented that returns of between 7% and 9% on zeros “compare very favourably with gilt yields.” It went on – “Following healthy market performances over recent years, many zeros are well covered and, hence, fairly secure.” An example was given then – “Investors prepared to accept a higher level of risk for potentially higher capital returns should consider less well covered zeros or capital shares.”

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<sup>26</sup> Comment: The publication expressed concern that not enough attention was being paid to the possibility of shares depreciating and about the level of growth rates over an extended period which were required to meet target values. Although these concerns were primarily aimed at income and capital split capital investment trust shares there would be some knock on effect for zero dividend preference shares. There were also misgivings that the concept of a higher reward requiring a higher risk was being overlooked – again, as all classes of share relied on the same underlying portfolio, zero dividend preference shares could be affected.

The comments about new issues being promoted by mail shots and the concern expressed about quality of advice in regard to income shares could also be extrapolated to zero dividend preference shares. The disadvantages of gearing in a falling market was acknowledged and, on the whole, the articles “High earners” and “Trusts must not yield to temptation” give the impression that in selling shares in split capital investment trusts it was being assumed that stock markets would continue to rise in a more or less linear manner over any extended period of time. Insufficient attention appeared to have been given to the possibility of a drastic fall, an extensive fall over a period of time, or a lengthy stagnation, in the stock market.

The article then went on to consider capital shares, income shares, Income & residual capital shares and package units. It described capital shares with prior entitlements (bank debt, zeros, etc.) as a “geared play” and commented “Higher gearing means potentially higher returns, but also increases volatility and risk”. On capital shares it concluded – “Capital shares need analysing carefully and, in many cases, are not appropriate for low risk investors.” With income shares it cautioned – “But once again, risk and likely returns vary enormously and thorough analysis is important” and “assessment of the likelihood of full repayment (of capital) is essential.”

Whilst some risk was admitted to for income shares there was the comment that many issues were low risk and could prove an attractive alternative to zeros on a gross redemption yield basis. Income & residual capital shares were referred to as having income yields, gearing levels and risk, which varied enormously, and that they could be high risk. Since packaged units were merely various classes of split capital investment trust shares bundled together here was little extra comment.

The next item in the guide was about fund of funds investment trusts investing in splits. It commented – “Putting your money into one investment trust is relatively risky. A wider spread of holdings reduces the risks associated with any one of them hitting hard times.” It was estimated that about 35 splits would be held in a fund of funds, which could be an investment trust or unit trust. Whilst unit trust fund of fund investment sidestepped the problem of, potentially, having a double discount to asset value an investment trust fund of funds could also be a split and seek to improve performance by gearing.

At the time of writing there were nearly 80 split capital investment trusts on the market and having a portfolio of them actively managed by a professional fund manager within a fund of funds wrapper was seen as an advantage. Different types of fund of funds investment trusts were discussed including some where it was acknowledged investors may not get back any of their capital if things went badly wrong. BFS Income and Growth was, according to the article, “both higher-yield and more risk-orientated ... But the danger is that ordinary shareholders could lose the entire value of their initial capital if performance went totally pear-shaped.”

The difference in charges between unit trust fund of funds and investment trust fund of funds was discussed and it was mentioned that investment trust investors could incur second layer management charges on top of dealing costs of the underlying splits. It was felt that obtaining advice would be easier in respect of unit trusts because commission based independent financial advisers were happy to sell them and that guidance on investment trust options would be better obtained from a fee charging independent financial adviser or a stockbroker. The article concluded that most investors should get independent professional help in selecting an investment of this type.

Finally, under “Sourcing Information” the point was made that “A split cap is no different to any other investment trust, unit trust or Oeic and you should be comfortable with the companies a split holds.”<sup>27</sup>

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#### **2000 (4 July): “Sit back and watch the zero”: Mail on Sunday**

The article was supportive of zero dividend preference shares as a “safe” investment and recommended them as an appropriate investment vehicle for saving over the long term for future expenses such as school fees. The article said – “Their attraction is that they offer a relatively safe way to gain from stock market growth.”<sup>28</sup>

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#### **2000 (16 October): “Aberdeen Trust to raise cash”: - IBL (InterNet Bankruptcy Library)**

This said: “The troubled European Technology & Income trust has announced plans to raise more money to stave off the recall of some or all of a 172 million pounds loan from Bank of Scotland, Citywire reported earlier this week. The split capital trust, which raised 200 million pounds in February and arranged a 200 million pounds credit facility, was forced to pay back 25 million pounds of the loan in July to avoid breaching its credit agreement

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<sup>27</sup> Comment: Although it was acknowledged in the decision tree that the degree of return was linked to the risks involved in an investment this link appears to have been overlooked or ignored when it comes to zero dividend preference shares. The return on zero dividend preference shares became very attractive at a time when interest rates even on premium savings accounts was low but zero dividend preference shares continued to be regarded as universally low risk. The amplification of price movements caused by gearing was referred to but only in respect of the ordinary shares.

Whilst continuing to classify all zeros as low risk there is nevertheless an indication, with the suggestion that “Investors prepared to accept a higher level of risk for potentially higher capital returns should consider less well covered zeros”, of an awareness that some zeros carried a higher degree of risk than others. The comment “many zeros are well covered and, hence, fairly secure” after a “healthy market performances over recent years” hardly inspires confidence in a low risk investment. If zeros returns are only “fairly secure” after a good stock market performance the question could be asked about the effect of a stock market fall.

The perceived “advantage” of a fund of funds investment trust having a professional investment manager may be more apparent than real if the professional investment manager fails to fulfil the role satisfactorily. This Bloomberg Guide explored the effect of the performance of the BFS Income and Growth portfolio going totally pear-shaped and concluded that ordinary shareholders could lose the entire value of their initial capital. They did not mention if they went further to see if holders of the BFS Income and Growth Zero Dividend Preference shares could be similarly affected. Since BFS, themselves, said “The Income and Growth fund would suit someone game for risk” it may be fair to assume zero dividend preference shares would be similarly affected, or that the risk profile for this particular zero was higher than the low risk profile accepted for zeros in general.

With the comment “A split cap is no different to any other investment trust, unit trust or Oeic and you should be comfortable with the companies a split holds” there is an intimation that the risk profile of split capital investments could vary with the quality of the underlying portfolios.

<sup>28</sup> Comment: The use of the word “relatively” indicates that they are not risk free and investors were urged to look at both the redemption yield and hurdle rate when picking a zero. There was also an indication that zeros had a risk that the yield may not fully meet their target yield and that the risk of this in one zero may be greater, or less, than another.

with the bank. The agreement required the trust's assets to be worth 165 percent of the loan's value, but the crash in technology stocks in March hit the fund's assets and threatened a breach of the covenant. Bank of Scotland is entitled to recall the loan if the covenant is breached.

"The 275 million pounds trust, which is managed by Aberdeen Asset Management, has therefore announced a placing of 25 million income shares, 25 million capital shares and 25 million zeros, a share class the trust previously did not offer, to raise the trust's total assets to 322 million pounds. The trust's assets following the placing will be worth 187 percent of the loan. Aberdeen said Bank of Scotland had 'agreed to waive its right to request the repayment of the loan subject to the completion of the placing on or before 9 November'. If the placing does not go ahead the trust would have to sell some of its holdings to repay some or all of the loan. In its statement Aberdeen said in such circumstances 'the reduced gearing of the [trust] would materially reduce the potential returns to both income and capital shareholders.'<sup>29</sup>

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#### **2000 (29 November): "Aberdeen fund ready for rescue shake-up": Daily Telegraph**

The report began – "European Technology & Income, the biggest investment trust launch this year, is poised to announce drastic salvation measures to prevent it from breaking banking covenants." It explained that Aberdeen Asset Management raised £400 million in March 2000, at the height of the technology bonanza but had been devastated by the subsequent fall in technology stocks. The shares had fallen from 108p in March 2000 to 43p after the previous days 5% fall in the FTSE techMARK index.

The report explained that the Board were expected to announce a shake-up which was thought to include the sale of assets to repay part of the bank loans (£200 million at issue - taken out to increase gearing and chase better returns) and to move into cash. The company admitted to being very close to breaching its banking covenants. According to the article the trust had already been forced to repay £25 million of its borrowings and to raise more cash from investors.

The article went on – "Split-capital investment trusts such as this one sometimes attract criticism because of the tendency of the same circle of investors to buy into each others funds. One analyst, who asked not to be named, said 'All the people who have suffered want to keep it under wraps because they are part of the magic-circle in split-level trusts. They don't have any way of rebalancing if the market is bombed-out'."

Another fund suffering problems was reported to be New Energy Technology Trust. Merrill Lynch raised £200 million at launch in October 2000 and the shares, after initially climbing from 100p to 110p subsequently dropped to 90.5p with a net asset value even lower at 78.3p. The report finished by referring to a Merrill Lynch report about the increase in the introduction by investment trusts of performance related fees.<sup>30</sup>

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#### **2000 (9 December): Personal Finance: Financial Times**

The report confirmed that, in addition to repaying £25 million earlier in the year, European Technology & Income Trust had, in the last week, been forced to repay a further £40 million of bank debt to avoid breaching banking covenants. Comment was made that this should be of concern to investors in general since such circumstances can force trusts to sell shares at inopportune times. Further comment noted that whilst there may be heavy gearing as net asset values fall by reducing the bank loan there was not so much gearing when net asset values rise. With much lower weightings in technology it concluded that European Technology & Income Trust may not make up recent losses if technology stocks rebounded.

The report noted that Technology & Income, another split capital investment trust in the Aberdeen Asset Management stable, would probably be forced to repay debt to avoid breaching banking covenants if there were a further fall of 7% in the trust's assets. It was noted that both European Technology & Income Trust and Technology & Income Trust were 'barbell' trusts and that these performed well in strong markets but poorly in modestly rising, static or falling markets.

Finally there was some optimism about the yields available on geared ordinary units but there was a warning that they would perform badly in flat markets and disastrously when markets are falling.<sup>31</sup>

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<sup>29</sup> Comment: This report would not itself have been widely available; but the Citywire report to which it refers would have been. The fact that the trust was having to raise cash in distressed circumstances would also have been commonly known. No warnings are given about sector risk, cross-holdings or gearing but the fact that a split-capital investment trust was having to restructure to avoid breaching banking covenants should have caused greater vigilance to be applied by advisers when recommending investment in this type of investment vehicle. For the first time zeros were to be issued in European Technology & Income Trust.

<sup>30</sup> Comment: Although there were no explanations or warnings about the adverse effects of gearing, cross-holdings or sector specific risks, all three appear to be contributory factors to the problems of this trust. The rescue package reported in October 2000 would appear to have failed.

It could be argued, particularly as the other trust suffering problems was also primarily aimed at investing in the technology sector, that these were technology sector specific problems. However, there were other sector specific trusts in other sectors and a similar weakness in their sectors could have had a similar effect on them. Furthermore, a general weakness over all stock market sectors could have similarly affected diversified trusts.

Together with previous available warnings about gearing, cross-holdings and portfolio quality the fact that two split capital trusts were suffering very real problems should have alerted financial advisers to be more vigilant in their analysis of trusts prior to making a recommendation to invest in them.

<sup>31</sup> Comment: The fact that European Technology & Income Trust had to repay bank debt indicates that its emergency reconstruction announced in October had failed. This report together with the Daily Telegraph article of the 29 November 2000 showed three trusts with major problems: European Technology & Income Trust, Technology & Income Trust and New Energy Technology Trust.

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## 2001 (10 January): Annual review: Cazenove & Co

The report recorded that 2000 was a relatively good year for Investment Trust Companies and that Cazenove was broadly optimistic about equity markets for 2001.

In 2000 Investment Trust net asset value (NAV) fell by 5.3% but on average Investment Trust share prices only fell by 2.3%, indicating a reduction of the discount between net asset values and share prices. Cazenove suggested that the reasons for the narrowing discounts, while difficult to pin down, could have been a combination of share buy-backs, good stock selection by managers of active portfolios, the expectation of strong future performance, increased retail demand, the AITC "its" campaign, increased interest in the stock market and the willingness of the boards of Investment Trust companies to be proactive in enhancing shareholder value. It was further noted that Investment Trusts outperformed the FTSE-All Share index by 6%.

An increase in discount volatility over the preceding five years was identified, which Cazenove considered had been driven, primarily, by volatility in Net Asset Values.

The report observed that the split capital investment trust sector overall did not perform as badly as might have been expected given falling markets, although there had been some well publicised disasters from technology-related funds and those with a large, high-yield bond component.

Under the heading "*Worst NAV total returns by all investment companies during 2000*" the report stated: "*It is not surprising that in falling markets very highly geared shares performed poorly. This was also the case in 1999, but did not prevent substantial fund raising in the Split Capital sector.*" Then, under the heading "*The performance of the Highly Geared Ordinary sector*" it noted: "*2000 was an excellent year for the Split Capital sector in terms of fund raising, but there was a diverse performance from the existing issues. Generally, shares with specialist underlying portfolios performed well, while funds with very high yielding underlying portfolios and investment trust funds of funds performed poorly.*"

The report contained a discussion on discount volatility, noting that narrowing discounts were treated ambivalently but widening discounts were a cause for concern. It referred to finance theory which assumed that risk was normally distributed around a mean and that it was the range of movement around the mean, not just the downside, that was relevant in a discussion about discount volatility. Three conclusions were drawn from a chart based on available data. These were:

- Discount volatility had been on an increasing trend over the previous five years.
- Discount volatility increased with NAV volatility.
- NAV return was more volatile than the discount return and both appeared to be closely correlated.

The conclusion reached by Cazenove was that it implied investment trust share prices displayed excess volatility relative to the underlying assets and that this would not necessarily be the case if discount returns and NAV returns were negatively correlated. If discount returns and NAV returns were negatively correlated it would reduce the total risk.

Cazenove deduced that, whilst buybacks could be a powerful force to limit the downside of discounts, there was little evidence that they reduced discount volatility or that they had caused discounts to narrow. They stated that a clear reason for increasing discount volatility was increasing NAV volatility, since a more volatile NAV made it more difficult to estimate the NAV and for discount traders to take advantage of anomalies. Boards might be able to dampen share prices but to solve the problem of volatile discounts it was felt that a "low risk" stance was required of the trust investment manager, which was more difficult for geared funds to achieve. Cazenove felt that there was too much concern being given to discounts and that, in the end, the discount reflected an investment performance relative to other funds and the enthusiasm for the asset class in which the fund invested.

The section "*Industry Trends*" noted "*An increasing trend to convert conventional funds into split capital funds usually at the same time as a placing to increase the fund size*", "*The proliferation of 'barbell' portfolios*" and a move by some funds away from benchmarking and top-down risk controls towards absolute returns.

The following section entitled "*The split capital sector*" began with the statement "*The European Technology and Income 'default' in October clearly demonstrated the risks of high levels of bank debt in a split capital structure - if there had been some zeros the bank would have had a greater cushion. It has been tempting for splits to use larger amounts of bank debt due to its lower cost - the quid pro quo is that in return for the higher security the covenants are more onerous, which places a constraint on the fund.*"

An implication of the European Technology and Income 'default' was forecast to be an increase in risk capital with a reduction in bank debt within split capital structures. This should then lead to increasing yields from increasingly aggressive structures.

Cazenove referred to their nervousness about barbell trusts and the underlying portfolios of some split capital trusts. They believed the growth element was often highly volatile and that the income element had more capital

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Although these trusts were all associated with the technology sector the importance of considering sector risk and the effect of bank debt gearing, with the associated dangers if covenants are breached, in all cases is apparent. All share classes are ultimately dependent on the performance of one portfolio within a split-capital trust hence these matters should be considered when assessing risk levels for purchase recommendations of any share class in a split capital investment trust.

risk than many investors thought. They warned: “Not only could the proportion invested in other splits fall sharply if the underlying hurdle rates are not met, but the high yielding bonds that are popular in some structures are quasi equity. The worst-case scenario for investors is therefore a growth portfolio that does not grow and an income portfolio that suffers defaults and capital loss. In this instance, high headline yields do little to mitigate the overall losses that will be suffered. This becomes a real problem when covenants are breached - this could mean a fire sale of part of the portfolio when in normal circumstances the manager would not be a seller. This latter point has always been one of the great advantages of the closed end fund structure – but not where gearing is excessive and the bank wants its money back.”

The report then discussed systemic risk and whether the poor performance of some recently launched funds contributed to this for the whole split capital sector. Cazenove suggested that hurdle rates which had previously looked difficult appeared, at the time of the report, very challenging.

Whilst acknowledging some splits were useful and had an important role in providing a high level of income, Cazenove regarded some splits with “a healthy scepticism”. Its main difficulties were:

- Managers often had a conflict of interest between pursuing growth or income.
- Many income shares required asset growth of over 4% per year to maintain capital; a figure regarded as optimistic. High yielding split vehicles were not usually appropriate for investors requiring capital growth and in many cases investors in these shares should be prepared for potentially substantial capital losses. In many cases the growth rate required to avoid total capital loss was quite high.
- Companies were increasingly using share buybacks instead of paying dividends – making it harder for fund managers to find reliable and high quality sources of income.
- Prior charges, particularly zeros, used to gear split structures were often relatively expensive – due to a higher risk of default.
- Geared trusts that invested in other splits could be very high risk in terms of NAV and were not very transparent. Investors were unsure of the downside in the NAV in the event of a fall in the underlying portfolio.
- There was a suspicion in the industry that the real demand for these vehicles came from those already within the sector. Cross holdings created a complex web of ownership, and resulted in trusts effectively owning their own shares.
- They believed sophisticated investors knew that splits created a high income through the use of “smoke and mirrors” and high charges to the capital account. They suspected that most private clients and IFAs did not. They felt an institution could create its own ‘DIY’ split at less cost than purchasing an onshore split with inherent management fees.
- While the average split traded on a 1% premium, investors would be less inclined to pay such high ratings if they realised the high income they received meant that capital growth was more difficult to achieve. The high ratings could also be damaged by oversupply, caused by new issues or conventional investment trusts deciding to convert into splits.

Cazenove concluded that too many convoluted structures were created that looked good but did not work as originally intended. They acknowledged a “split solution” could be appropriate in certain circumstances but suspected investors were confused by the complexity of many splits and this might have prevented investors from valuing them rationally. They promised to look at these issues later in the year (which they did in their report “*Barbells unbalanced*” in July 2001).

Cazenove expressed their confidence in conventional investment trusts (not splits) but encouraged them to gear in order to differentiate themselves from open ended funds (unit trusts & OEICs) - but not to the same extent as a typical split.

The section on gearing noted that the split capital sector used gearing to the full during 2000, with most new issues employing substantial amounts of relatively short-term bank debt. They felt the problems at European Technology and Income highlighted the pitfalls of high gearing against a volatile portfolio. The conventional investment trusts employing gearing during the year opted for longer term debt via debentures. Cazenove found that gearing increased the volatility of NAV returns and resulted in higher risk-adjusted returns.

Cazenove acknowledged the near record amounts raised for investment in the investment trust sector during 2000 but commented: “However, we have established that much of the new money has been raised in the splits sector, in a way that we do not view as being entirely healthy.” All of the 2001 recommendations appear to be conventional investment trusts.<sup>32</sup>

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<sup>32</sup> Comment: According to Cazenove:

- The added risk of “discount volatility” was identified and linked to volatility in NAV. Discount volatility had been increasing for five years together with NAV volatility. This implied that investment trust share prices displayed excess volatility relative to the underlying assets. The correlation of discount volatility with NAV volatility made it more difficult to value NAV correctly, thus increasing risk.
- Share buybacks could limit downside discounts but there was no evidence they reduced discount volatility or caused discounts to narrow. To solve the problem of volatile discounts a “low risk” stance by the fund manager was required, but such a stance was more difficult to achieve for geared funds. It was acknowledged that geared shares performed poorly in falling markets. Geared Split Capital funds, funds of funds and investment trusts with very high yielding underlying portfolios performed poorly in the year 2000.

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## 2001 (March): Regulatory Update 85: Personal Investment Authority

This update would have had limited circulation, probably restricted to those of the following who were regulated by the Personal Investment Authority (PIA): split capital investment trust providers, portfolio managers, fund managers and independent financial advisors.

The update was issued because of concern about the way the risk of income shares of split capital investment trusts was being described in marketing literature. The PIA felt the risk of total or partial capital loss might have been greater than for many alternative income-generating investments.

Paragraph 4 stated – *“Income shareholders must be aware that if the trust does not have enough assets to repay the higher-ranking shares, then they will not receive any capital back at the winding up date. And depending on the performance of the trust, there is also a risk that they will receive less than their original capital.”*

Paragraph 7 allowed trusts to be launched with hurdle rates, for zero capital return, of between –5%pa and –1%pa and, for full capital return, of between 3%pa and 5%pa. It was thought that although the risk of total capital loss was low it was perceptible and that there was a real possibility of capital shortfall.

It was considered that any factors affecting the capital return and the risk of partial or full loss of capital should be included in any leaflet or brochure accompanying the prospectus for any split capital investment trust, to give a fair and balanced picture of the investment. Similarly such risks should be stated, clearly and prominently, if the shares were offered as an option in an investment trust savings scheme.

In addition to the risk sections of the prospectus or mini-prospectus and supporting brochures leaflets etc. the PIA considered that press advertisements for such offerings should clearly alert investors to the risk of potential loss of capital. Such statement should be in the main body of the advertisement and should have the same prominence and tone as the information about the level of income available. The same principles should apply to covering letters issued with direct offer advertisements.

Independent financial advisers were reminded of the need to assess the product’s risk profile to ensure it is appropriate for the customer and of the need for the nature of the product and its risks to be properly explained to the investor. It was emphasised that these obligations become increasingly important if the investor is unfamiliar with the type of product being sold. The investor’s background and degree of financial knowledge should be assessed, and particular account taken of the nature and risk/reward profiles of other investments held. The update goes on – *“The advice process needs to at least reflect the explanation of risk given in marketing literature and key features documents: it should not dilute it. The extent to which these products fit into the consumer’s overall risk profile should feature in the records made of the consumer’s attitude to risk and conveyed back through discussion and more formally in reason why letters. In order to fulfil these obligations it is imperative that the adviser is fully conversant with the type of product and the precise details of the contact on offer.”*<sup>33</sup>

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- The European Technology default highlighted the risks of high levels of bank debt and sounded an alarm about later problems with other Split Capital Investment Trusts with ‘aggressive’ structures.
- The volatility of the growth element of barbell trusts, and the fact that the income element had more capital risk than was widely known, was making some split capital experts nervous about barbells. There was also concern that the high proportion invested in other splits could fall drastically if hurdle rates were not met and that some high-yielding bonds, a popular constituent, were quasi equity. The possibility of “fire sale” disposals was seriously considered in portfolios that were highly geared through bank debt, where the covenants were breached and banks wanted their money back.
- There was a systemic risk in the split capital investment trust sector, with factors such as: fund managers’ conflict of interest between income and capital growth; high year-on-year growth requirements of 4% plus to maintain capital; increasing share buybacks in place of dividends; extensive use of gearing creating prior charges; and cross holdings in other splits. There was unease at the lack of clarity, a suspicion that the real demand for split capital investment trusts was from those already in the industry and that the prevalence and complexity of cross holdings could result in trusts effectively owning their own shares.
- Sophisticated investors knew that splits created a high income through the use of “smoke and mirrors” and high charges to the capital account which was probably not known by most private clients and IFAs.
- Some of the Split Capital structures were over-complex and failed to work as intended. This complexity might have contributed to the difficulty in valuing them rationally. Splits were being regarded as somewhat over-gearred through bank debt and there was doubt about the health of some funds raising new money for investment.

<sup>33</sup> Comment: Although this update was concerned with income shares of split capital investment trusts some of its concerns and recommendations could equally be applied to zero dividend preference shares. Particularly in paragraph 4 if “prior charges” were substituted for “higher-ranking shares” it could be as valid for zeros as for income shares.

Any investment trust savings scheme after March 2001 should give appropriate warnings about partial or total loss of capital in respect of Income Shares in Split Capital Investment Trusts. Any advertisement after March 2001 should give appropriate warnings about partial or total loss and these should have the same prominence and tone as the information about the level of income available.

Clear guidelines were given regarding the sale of income shares in split capital investment trusts by independent financial advisors. Guidelines about the risk warnings, which should be given orally, and in writing, are also given. There is a further stipulation that the adviser making the sale should be fully conversant with the type of product and the precise details of the contact on offer.

### **2001 (1 March): Money Marketing.**

An article in this issue was primarily concerned with the launch of Gartmore's Absolute Growth and Income Trust, a split capital investment trust investing in small to medium sized companies in the UK.

Commentators contributing to the article identified that the split capital market had become crowded but suggested that it could use more quality split capital investment trusts.

Contributors felt the trust was suitable for investors who had "*an appreciation of the risk factors inherent in this type of geared investment*". It was felt to be suitable for investors interested in ordinary income shares who were active high income seekers and for investors wanting a lower risk investment through the zero dividend preference shares. The return on the zeros was viewed as acceptable rather than spectacular.

The consensus was that at 9% the zeros looked attractive to lower risk investors with a hurdle rate of 2.6% but the highly geared ordinary shares were a very aggressive investment, which would appeal to the more adventurous investor.

There was some concern that the underlying portfolio could be "cannibalistic" with 40 % being earmarked for other split capital and high yielding investments. Other causes for concern were the concentration on UK stocks, investment in immature stocks (which could result in wild growth fluctuation), and high gearing.

Although earlier in the article the zeros had been recommended as appropriate for risk-averse investors one of the contributors commented, "*The Zeros can also be more risky than their perceived low-risk status.*" It was also felt, by another contributor that the structure and risk ratings of the trust were far too complex for mainstream investors and assessing their suitability would take in depth consideration.<sup>34</sup>

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### **2001 (22 March): "*Its' a knockout idea*": Money Marketing.**

An article entitled "*its' a knockout idea*" was generally supportive of investments in investment trusts. Split capital investment trusts were explained in brief and were recommended as a highly efficient way of investing for income, growth or a combination of the two.

The article included information about how IFAs could be supported in the sale of investment trusts stating: "*The 'its' campaign is raising the profile of investment trusts among your clients. IFAs are at the centre of the AITC activity and there has been a very positive response to the 'its' marketing club.*" It explained that the club provided IFAs with newsletters, training material, seminars and workshops and that the AITC hosts regular forums across the UK. Details of a share dealing service set up by the AITC with Transact were also given and details of the AITC website, containing investment trust performance statistics, news from the AITC, and news from investment trust managers were also included.<sup>35</sup>

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### **2001 (April): "*For whom the barbell tolls...*": Professional Investor**

This article argued that if some of the new barbell trusts started to unravel then confidence in the investment trust sector as a whole would be affected by averse publicity. It began with a quote from "*The Great Crash 1929*" by J K Galbraith, which it recommended as one all investment professionals should read.

Whilst the article noted that many investment trusts were models of simplicity and caution, there was concern that the public demand for investment trust stock in the UK was being partly satisfied by a riskier and more novel type of trust called "*barbell trusts*". These were designed to offer growth prospects in a fashionable sector together with a good income.

There was some debate about the definition of a barbell trust but on a strict definition 3 such trusts were issued in 1999 followed by a further 15 in 2000. It was reported that over these two years £2.7 billion was raised by these trusts but that it would be twice that amount if a looser definition of "*barbell*" were used.

The article explained that in a barbell two distinct portfolios are held: a growth portfolio and an income portfolio. An example is given of the relationship between the assets - the two portfolios - and the liabilities: bank debt, zeros and ordinary shares. The example was that of a split capital trust, but although a lot of barbells are splits, most splits are not barbells. It is the division of assets in the balance sheet into two separate portfolios, together with a high level of gearing, which makes a barbell.

An explanation of how barbells emerged from the boom in split capital investment trusts was given which included a comment on why banks were eager to fund investment trust gearing: "*The bank ranks first in order of priority and the bank checks the covenanted cover on the bank debt each month. Therefore, although bank lending*

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<sup>34</sup> Comment: There is an implication in the observation that the splits market is crowded but could do with more "*quality*" trusts that some existing trusts were not of the best quality and therefore carried higher risks. The ordinary income shares appear to have a higher risk profile owing in part to the underlying investments but also to the degree of gearing and cross holdings. Initially the zeros were referred to as "*a low risk investment*", lower risk and as suitable for risk averse investors but then, after the above risks with the ordinary income shares had been explored, this was revised to "*zeros can also be more risky than their perceived low-risk status.*" There is therefore an apparent acknowledgement that zero dividend preference shares are not automatically low risk.

<sup>35</sup> Comment: The article is aimed at IFAs. It does not contribute to the awareness of the risks of split capital investment trusts. It explains where further details about investment trusts can be obtained.

*inevitably increases the risk of capital loss to holders of lower-ranking classes of capital, the banks cannot be blamed for making large sums of money available. The Boards, not the banks, are responsible for trusts' borrowing decisions and how these affect shareholders."*

A table was given showing the number of new barbell (strict definition) trusts, with either non-UK geographical specialist portfolios or a sector specialist portfolio (those offering exposure to more volatile equities). This showed 8 conventional and 10 split trusts with a total capitalisation of £2,702.6 million.

The charging structure of barbells was examined and the conclusion was reached that initial and recurring costs to ordinary shareholders of barbells were much higher than they first appear. With other expenses charges could *"amount to an annual 3% or 4% of the assets attributable to holders of the ordinary share capital – a massive hurdle to clear before one even reaches the starting gate."* Furthermore most barbells held shares in other investment trusts resulting in multiple management expenses.

A warning was given about bank debt: *"The inclusion of bank debt in trusts' capital structures means that a major subscriber of capital to a trust now has the right to blow the whistle and demand either repayment or changes to the portfolio before the end of the game, regardless of the effect on the other subscribers of capital (the various classes of shareholder). This has already happened in the case of two barbells, European Technology & Income and Framlington NetNet Income. It could happen to others."*

The risks of narrow investment in one sector was reiterated and it was pointed out that investment in high yielding split securities and bonds could also be risky. A further note of caution was sounded: *"It is therefore important not to be misled by the illusion of conservatism offered by the two portfolios of barbell trusts – and legally, of course, there is only one portfolio anyway."*

The point was made: *"Because promoters' and investors' expectations of rates of return from equities have been shaped by the experience of the bull market of the last quarter of a century, the hurdle rates for the ordinary shares of barbells may be perceived as being less demanding than they actually are. Yes, there will have been 'wealth warnings' galore. But how many investors in the ordinary shares of barbells really expect to receive back significantly less than the capital they have subscribed?"*

Observations were then made in the article about cross-holdings and *"The Great Crash 1929"* was quoted. It was noted that cross-holdings make it difficult to establish ownership of the trust and to pin down where unit trusts, managed by fund management groups within the so-called "magic circle" hold shares in them. There are therefore problems of accountability and transparency. The article considered the risks created by geared trusts investing in other geared trusts were very real and of even greater importance. It stated: *"Substantial price declines in the ordinary shares of some individual barbell trusts might all too easily become a self-feeding downward spiral as the net asset values of the ordinary shares of other trusts that held them fell in their turn."*

Because barbells are complicated, it recommended that issuers put more emphasis on the investment characteristics and that the significant risks and expenses be spelt out clearly in prospectuses and reports and accounts. There was a worry that if barbells started to unravel then confidence in the investment trust sector as a whole would be affected by the adverse publicity.<sup>36</sup>

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## **2001 (21 April): "Can risks really be reduced to a zero?": The Times**

*"Richard Miles; Funds in Focus:*

*"With few signs of an end to the bear market, zeros have been widely promoted as a safe investment for those seeking an income of 6 per cent or more. But some independent financial advisers (IFAs) have begun to question whether all zeros are as secure as many fund managers would have us believe.*

*"Zero dividend preference shares, to give them their full name, are rather odd beasts. They are issued by a breed of investment trust known as split capital funds. Splits have at least two or more classes of share, each tailored to the risk appetite and goals of different investors. A typical combination would be income shares and zeros.*

*"Technically, zeros are equities, but they look and behave more like bonds: they have a fixed life and a fixed redemption price. They offer a specified rate of annual growth, which is rolled up until the investment trust matures. By buying a portfolio of zeros with staggered maturity dates, you can create a regular income. They make ideal investments for school fees planning.*

*"The Inland Revenue classifies the returns on zeros as capital gains rather than income, so you can use your annual CGT exemption, pegged at £7,500 this year, to shelter the gains from tax. This makes them particularly attractive to investors in the higher tax bracket, who would normally face a 40 per cent deduction on other forms of income.*

*"The reputation of zeros for safety largely stems from the status they have when a split capital investment trust is wound up, either when it reaches maturity or because the fund has run into trouble. Zeros have first call on any*

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<sup>36</sup> Comment: This highlighted the increased risks caused by gearing and sector-specific investment. It suggested that barbell trusts were probably more costly and riskier than investors, especially retail (non-institutional) investors, realised. Although barbells split the underlying portfolio into two separate sections, legally there remained only one portfolio. The risks of geared trusts investing in geared trusts was recognised as being significant.

surviving assets, ahead of income or capital shares. Only bank debt and other borrowings have a prior calculation on the investments.

*"Since their invention in 1987, not one zero has missed its target, prompting one or two commentators to describe them incorrectly as guaranteed investments. But – as the Financial Services Authority never tires of telling us – past performance is no guide to future returns, and some advisers are privately asking whether the track record of zeros can remain unblemished for ever.*

*"Certainly, some zeros are far riskier than others. As always, it pays to kick the tyres and check beneath the bonnet before buying. Sue Whitbread, investment trust expert at Chartwell Asset Management, the independent adviser, says that any assessment of a zero should begin with the underlying portfolio. 'You want a well-diversified blue chip portfolio,' she says.*

*"For such information, it is best to lay your hands on the trust's annual report. Failing that you can scrutinise a fund's top ten holdings on any number of Internet sites. One of the best is Trustnet.com which is in the midst of a revamp of its split capital funds database.*

*"Once you have established that the fund invests in a broad spread of reputable companies rather than a bunch of high-risk junk bonds, you must look at what the industry coyly calls 'the hurdle rate'. This is a measure of how much the fund's assets must grow each year for the zero holders to be paid in full at maturity.*

*"Ideally, you are looking for a large negative figure. If the hurdle rate is minus 50, then that means that you will still get your money even if the assets halve in value each year. On the other hand, a plus rate of 5 means that the zero will hit its target only if the investments grow at a rate of 5 per cent each year. The majority of zeros have negative hurdle rates.*

*"You should also get to grips with another metric: the cover rate. This is an indication of whether the current value of the trust's total assets, minus any liabilities, will meet the redemption value of the zeros. A cover rate of 1.5 means that the trust's assets could lose a third of their value and still pay out in full on its zeros. The higher the rate, the safer the zero.*

*"Unfortunately, there are no fixed rules for the calculation of cover rates, so you could end up comparing grapefruits with gooseberries. Paul Craig, a fund manager who runs £240 million in zeros on behalf of Exeter Fund managers, says that many trust managers now set their charges against capital rather than against current revenues, a ruse that can dilute a trust's cover.*

*"Few of us, however, have the patience, let alone the time, to master these complexities. The good news is that there are some clear signals of danger which do not require a detailed knowledge of the splits market. The telltale sign is a far higher yield than the norm. If the zero quotes a yield of 11 per cent against a sector average of about 7 per cent, ask yourself why.*

*"The explanation could lie in the composition of the portfolio: beware of funds that invest in other split trusts. This is piling risk upon risk, and dilutes cover. For this very reason, Ms Whitbread generally rules out the zeros that belong to many of the funds managed by Aberdeen Asset Management, the market leader, and BFS Investments, another specialist.*

*"Security of capital is paramount for buyers of zeros,' she says. 'You need to look at the underlying portfolio of the fund and its manager's strategy. In some ways, the splits market is quite incestuous, with several funds investing in the income shares of other funds. Aberdeen and BFS are the main culprits here.'*

*"At Exeter, Mr Craig also urges private investors to avoid the zeros of splits with a high level of exposure to the income shares of other splits. He cites three examples: BFS Income & Growth, Jersey Phoenix, and Leveraged Income. The last two are managed by Aberdeen. Leveraged Income has a gross redemption yield of 11.2 per cent. 'I can afford to buy them because I have so many holdings, but they are not for ordinary investors,' he says.*

*"Such has been the depth of concern about the risks associated with this crop of zeros that one fund management company recently sold off its holdings and re-invested the proceeds in an earlier generation of zeros. The company preferred a cut in yield rather than risk a dent in capital.*

*"The near collapse earlier this month of Framlington NetNet, and a handful of other technology split capital investment trusts, has done nothing to soothe fears that the web of interlocking splits could start to unravel – and set off a chain reaction throughout the £12 billion sector.*

*"Ironically, neither Framlington NetNet nor any of the Aberdeen funds which have come close to breaching their banking covenants has any zeros, relying instead on the banks for their leverage. This has not helped their plight.*

*"While zero holders have to sit tight until wind-up, bankers can demand their money back if the fund's coverage slips beyond agreed limits.*

*"A meltdown of the splits sector remains a remote possibility, and so long as investors choose wisely, zeros will continue to be a low-risk way of wringing out a better return from your money than if you put it on deposit with the building society. Nigel Sidebottom, director of BFS and an expert in zeros, points out that even the riskiest zero is less risky than a tracker fund.*

*"Buying individual zeros is straightforward: most stockbrokers will carry out the transaction for a modest fee. IFAs and asset managers such as BFS will build a tailored portfolio for you. And there are also a number of funds which invest solely in zeros. Exeter was one of the first companies in the field: the gross redemption yield on its*

*£165 million fund stands at 8.4 per cent. Investec Guinness Flight has a similar fund, while Jupiter is looking at the market too.*<sup>37</sup>

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### **2001 (May): “Split Capital Investment Trusts”: Bloomberg Money Guide**

The first article attempted to identify the success of split capital investment trusts, concluding that splits were popular because they provided an income-producing investment unavailable elsewhere. Investors wishing to replace income from maturing government securities which had offered about 10% at purchase, and investors who had seen the return from bank deposit and building society accounts fall, were attracted by the returns available on splits. It was accepted that in many cases splits did not have a simple structure and that the income part of the portfolio could be invested in bonds, corporate bonds or the shares of other split trusts. The article said: *“Therefore it is important to understand both the capital structure and the portfolio construction before investing.”*

Things could go wrong: *“The fact that these structures do contain high degrees of bank debt will cause problems when there is sustained fall in the assets of the trust.”* Framlington NetNet was quoted as an example, and the article continued: *“The precipitous drops in the value of its internet portfolio, combined with a decrease in its income portfolio (as a result of generally falling equity markets), led to the situation where it was necessary to repay all borrowings. Hopefully this will be an unusual event, but continued falls in equity markets would eventually cause problems to everyone – and not just splits.”* However, in view of the falls in stock market values which had occurred an optimistic tone was adopted, suggesting that investing in geared structures would be the way forward to enhance returns *“in the inevitable recovery”*.

On the subject of debt this article advised: *“Look at the debt as a proportion of gross assets. If the debt is covered two times or more by the gross assets, it is unlikely that market falls will be sufficient to cause the banks to call in their loans.”*

The next article dealt with split capital investment trust *capital* shares. It was acknowledged that they carry considerable risk and are a relatively complex investment. The potential rewards were described as *“staggering”* but as a general rule *“we would suggest no more than 10% of an investment portfolio be placed into this asset class.”* The article regarded them as suitable for adventurous investors who can *“stomach high levels of volatility”* and *“they are not appropriate if you can’t afford to lose any money.”*

There was a third article, on split capital investment trust *income* shares. With low interest rates and falling dividend yields this type of investment was viewed as a tempting choice for investors requiring income. Yields of 9% were quoted (although yields of 7% - 16% were mentioned as available, for non-specialist income shares, later in the publication), which were significantly higher than the best paying bank and building society accounts at the time. However, it highlighted that investors must be aware of the pitfalls and that risk and likely return varied enormously. It points out that *“the higher the income, the more risk you are taking with your capital”* and *“every time you take a step up the income ladder, you increase the risk of losing some of your capital when the trust is wound up.”* Different types of income share with varying risk profiles were discussed but only in respect of risk to capital. No attention was drawn to any income risk until the following article *“Hunting for a regular income”*. Investors were warned only to buy income shares if income was required; in other words, they were not suitable for rolling up income to provide capital growth.

Under the heading *“Safe as houses”*, various aspects of investment in zero dividend preference shares were covered. The article was supportive of zeros as a low risk investment, saying that they were for investors who *“don’t want to take big risks with their money”*, but it made it clear that the return on them is not guaranteed and depends *“on how much is left in the kitty at the end of a trust’s life.”* The article described zeros as *“almost on a par with building society accounts or UK Government Bonds”* and as an attractive alternative to endowments. It pointed out that the value was liable to price fluctuation for anyone not holding them to redemption. Assessing the relative merits of zeros is then covered, with quantitative and qualitative measures being identified. Under the latter it stated: *“Although many investors look at the zero market in conjunction with other fixed interest sectors, it is essential to understand that the assets of many trusts are actually invested in equities. Falling equity markets do have ramifications for zero dividend preference shareholders and this has been clearly seen over the last few months. Falling markets have reduced the cover on virtually every zero in the market and, to compensate for this perceived higher risk, gross redemption yields have risen – hence prices have fallen. This is simply the risk/reward relationship in action, but potential investors should note there has never been a zero that has failed to pay anything but its full redemption price.”* Average gross redemption yields for zeros at that time were reported to be 7.7%.

It was accepted that the level of cover rises and falls with equity markets and that cover may vary significantly from fund to fund. At the time, average cover was 1.35 times and the article estimated that assets would have to fall by 26% before redemption values began to erode. [It is unclear if the effect of gearing was included in this calculation.] A distinction was drawn between a zero with cover of 1.35 times with 10 years to redemption with a zero with the same level of cover with only 2 years to redemption; the former being regarded as the more risky of the two. It continued: *“Zeros are traded on the stock market and are therefore subject to external market forces. Factors, including interest rate fluctuations, supply and demand and gross redemption yield levels offered in new*

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<sup>37</sup> Comment: The article says: not all zeros are the same; it pays to look at the quality of the portfolio, asset cover and hurdle rate; the figures for asset cover are sometimes unclear, because charges are set against capital; a higher yield gives a clue that a zero is riskier; avoid splits that invest in other splits; *“A meltdown of the splits sector remains a remote possibility.”* There are passing, un-illuminating references to gearing.

issues, can all have a positive or negative impact on the price of zeros. While this might suggest that zeros are more risky than previously thought, it is worth noting that no zero has failed to pay its redemption value to date.”

It was felt the zeros' prior call on fund assets should provide a cushion against market fluctuations, but investors were advised to ensure the underlying equity portfolio was reviewed. Although many portfolios were focused on UK blue chip companies, a number invested in other funds to enhance dividend yields to ordinary and income shareholders. It was explained that the weighting in other funds was likely to have an exaggerated impact on the funds' assets, increasing volatility in fluctuating markets and increasing the risk profile.

The final article, entitled “*Devil in the detail*”, recorded that, “*split capital investment trusts have long had a reputation for being for the serious sophisticated investor,*” and, “*The unwary may become so confused by the structure and range of share classes that any associated risks may be easily overlooked.*” It surmised that this provided marketing departments with a “*heaven - sent opportunity*” and that investors for income were lured by high headline returns while dangers were in the small print. An IFA was quoted as saying that splits can be very risky with some investors comparing income shares with corporate bond funds. Other brokers were more optimistic, provided the proper research was done. Another quote recorded: “*There's a lot of fear being generated now because investors can't tell the difference between high risk, highly geared stocks and those that are not. It's a specialist job.*” This theme was taken further by another contributor who felt that the kind of detailed research required to compare trusts was only available to institutions or specialist IFAs. It was also felt that the average, general purpose IFA would not be receiving research showing the level of gearing and that valid decisions were not possible without it. Gearing was acknowledged as both a strength and a weakness of investment trusts, but it was acknowledged that finding out the level of gearing was difficult for the ordinary investor. One of the IFA contributors records: “*If a trust is highly geared, a falling market will lead to a lot of problems, but over recent years (while the market was still rising) acceptance of the risk increased and some of the gearing became heroic.*” The vogue towards more complex trusts did not help. A number of highly geared trusts with aggressive capital structures were launched at the top of the market, but to find out about the risks was viewed as a lengthy task involving several different sources, including the company and the portfolio fund manager.

There was concern that the stock market downturn would damage the whole market for splits. The need for good advice was re-emphasised and it was stated that choosing between different split products was not like choosing between Barclays or Abbey National shares. The article concluded by saying each split had to be individually evaluated. Then: “*For those with the time for analysis, splits are still a rewarding study. But you need to be a strong swimmer to cope with the hidden rip tides lurking within the sector.*”<sup>38</sup>

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#### **2001 (25 July): “*Barbells unbalanced*”: Cazenove & Co**<sup>39</sup>

The report is primarily concerned with barbell trusts. Serious structural issues were identified such as:

- Fees and financing costs, as a percentage of shareholders' equity, are magnified by high levels of debt, which is exacerbated as gearing increases in falling markets and by cross-holdings. (If bank debt is 50% of the total amount raised and the fund raises £100m issuing expenses of, say, 2%, this will amount to £2m, but it will have to be borne by the £50m of equity – effectively doubling the initial charge to shareholders to 4%. And substantial cross-holdings mean that there are ongoing management fees upon management fees.) If the value of the assets declines, bank debt remains the same, so as the total amount is charged to equity, the percentage charge will be greater.
- The provision of higher headline (income) yields, partly through charging most expenses and financing costs to capital.
- The possibility of a fund being controlled by a bank if a highly geared trust comes close to breaking, or does break, its banking covenants. Consequent rebalancing of the trust may not be to the benefit of shareholders

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<sup>38</sup> Comment: This emphasised looking at the capital structure of the split capital investment trust, and the content of the underlying portfolio, before deciding if an investment in any class of the splits shares was appropriate. There was an awareness of the risk of high gearing and that the Framlington NetNet situation could be repeated and become more common.

Capital shares were regarded as suitable for “adventurous” investors who could accept high volatility and not suitable for investors who cannot afford to lose money. The relationship between risk and reward was explained in respect of income shares but only in respect of risk to capital on winding-up. Differences in risk for different types of income share were explained but not the possibility of the risk of loss of all, or part, of the income where a split capital investment trust portfolio is highly geared and gets into trouble.

It accepted that zeros are dependent on the performance of the trust's underlying equities and that, even given their preferential status on winding-up, they are subject to the risk/reward relationship. There is also a suggestion that zeros may be more risky than previously thought, but this was qualified by the usual statement that all zeros to that date had repaid at the full redemption price. The added risk to zeros of cross-holdings in the underlying portfolio is also briefly touched upon. There is an awareness of a greater level of risk. The importance of gearing in assessing risk is recognised together with the fact that appropriate research and information was not available to the average IFA, only to institutions. and specialist IFAs. There was also an awareness that some splits carried very high levels of risk, which could become apparent in a falling market.

<sup>39</sup> Comment: This report would initially have had limited circulation, probably being restricted to split capital investment trust providers, certain analysts, brokers, portfolio managers and fund managers. It is the follow-up report to the Annual Review (10 January 2001) and refers to the April 2001 professional investor article “*For whom the barbell tolls ...*”

and sales may be poorly timed. If the trust is de-g geared it will not be so well placed to benefit from subsequent market improvements.

- In flat markets, with no dividend growth, charges to capital necessitate the sale of assets leading to a fall in the level of income. Even if dividends are maintained there is pressure on the income account. Underlying dividend cuts would exacerbate this situation and this could lead to a collapse in the share price.
- Hurdle rates can be difficult to interpret and can look deceptively easy to achieve. The basis of the calculation and an appreciation of the inflationary environment should be taken into account in assessing if they are achievable. In many instances the capital downside was identified as greater than the upside for a given percentage change in total assets. An apparently low risk income portfolio invested in splits and bonds could decline substantially in value if the amount invested in other splits failed to meet its underlying hurdle and/or where there are risky bonds that default.
- Providers of low risk capital such as zeros should have been wary about trusts backed by volatile assets. zero dividend preference shares have a limited upside but full downside.
- High profile losses could ruin the reputation of the investment trust sector. Risks should be spelt out more clearly in product documentation, particularly if it was aimed at retail investors. Reporting by trusts was not always very informative.

Systemic risk was also cause for concern: *“A systemic collapse could result from the high degree of investment by these trusts in other geared funds. A sale of these assets by trusts breaching their banking covenants could cause a collapse in market prices, and cause other funds investing in this area to breach their own covenants. If they then have to sell, it is easy to see how a downward spiral might develop, exacerbated by high gearing. Cross-holdings – which result in a trust effectively owning its own shares – add to the gearing of a geared trust but should not, in themselves, lead to a downward net asset value spiral in the event of a fall in the underlying assets.”*

The report was trying to capture key characteristics of high levels of bank debt, a high yielding income portfolio and a relatively volatile equity portfolio in the thirty-two barbells considered. Trusts with these characteristics were felt to be the most vulnerable to a downturn.

At the time of issue the average ratio of assets to bank debt was 2.53 times and most bank covenants required cover of between 1.6 and 1.7 times. (Some covenants excluded some asset classes such as other split capital holdings. Not all placing documents provided details of cover and few specified how cover was calculated or how often it was monitored.) Zeros act as a buffer between other shareholders and the bank and are important when a trust comes near to breaching its covenants. However, holders of zeros cannot wind up a trust before the end of its life, unlike the bank, and are therefore at a disadvantage. At launch, debt, including zeros, represented on average 49% of total assets.

The report felt the barbells selected provided a good test case of the robustness of highly geared capital structures in a market downturn and helped to highlight the problems in their structure. The resulting structural weaknesses and systemic risk shown above were identified. Further the article stated: *“There is a clear risk of dividend cuts in the current environment, and this could have potentially significant knock-on effects throughout the sector. Were the prop of high yields removed, there would be a collapse in capital values of these funds – European Tech and Income shares have today fallen by 44%. A new round of weakness in high yielding trusts as a result of dividend cuts could result in a systemic collapse. Whenever ultra-high yields are on offer, it is invariably in return for high levels of risk.”*

It went on that the biggest falls were suffered by barbells investing in more volatile asset classes and that the highly geared structure magnified the volatility of the asset class. It then said: *“Zero shareholders should be aware that volatile underlying assets are very bad news,”* and: *“Providers of lower risk capital, such as zeros, should be wary about financing trusts backed by volatile assets – they receive limited upside, but can suffer on the downside.”*

An example of media and Income ordinary shares was given which showed that growth of 2.5% or less per year over 6 years would result in a total loss of capital. A growth rate of nearly 7.5% per year was needed for break-even and total asset growth of above about 8% per year was required for the capital return to exceed the growth rate.

Hurdle rate was explored. Most tended to be around the 4-6% level. The authors suggested that such levels were challenging in a low inflationary environment. But the figures alter if it is assumed that a large proportion of the fund is invested in high yielding income shares, which are unlikely to provide growth. If, say, 50% is invested in this type of share, the hurdle rate for the whole portfolio is dependent on the other 50% of shares, effectively doubling the actual hurdle rate required. Considering the possibility of the assets falling in value, the original hurdle, to return to the issue price, becomes increasingly difficult to achieve as it compounds over time. If the income shares also weaken then the problem is magnified. An example was given which illustrates the problems involved and concludes that, *“In a falling market the downside is so much greater than the upside for given changes in total assets, assuming the absolute amount of debt remains unchanged.”* In the example, even if there had been no losses, the impact of charges to capital would have considerably weakened the financial structure of the fund.

The report then identified a risk the authors believed was often overlooked: that an income portfolio, dominated by investments in other highly geared funds, could decline substantially in capital value, if the underlying investments failed to meet their own hurdle rates.

There was some criticism of the level of information in initial documentation and some sponsors used different methods in calculations. The main problem, however, was identified as being that they did not show what happens under negative growth rates. The issuing documents tended to concentrate on the return while ignoring the risk, and in most cases there would be a total loss of capital with only slightly negative growth rates in total assets.

After issue, reporting by many trusts was also felt to be not very informative, and it was rare to be told how different portfolios were performing relative to any benchmarks or what the hurdle rates were or what was in the portfolio. The report reached the conclusion: *"The disclosure and quality of information supplied could be better in what is a complex area and while this is not a problem for the handful of professionals who understand these trusts, it will be of little comfort to IFAs and their clients who have invested on the expectation of high income and capital growth."*

Systemic collapse caused by gearing on gearing in a flat or falling market, resulting in forced sales and banking covenant breaches, was regarded by the authors as their greatest concern. They believed this to be related to, but distinct from, *"cross shareholding risk"*.

The report attempted to construct an example to show how serious the threat of these risks was. After quoting from *"The Great Crash 1929"* by J K Galbraith, the authors attempted to use a real example but *"the mathematics rapidly become complex, and few trusts disclose the detail at the portfolio level necessary to undertake the exercise properly."* A simple example of two trusts was constructed and the conclusion reached is that cross shareholdings add to effective gearing but do not, in themselves, lead to a downward spiral in net asset value. However, there was felt to be a very real systemic risk from gearing on gearing caused by cross holdings. It is pointed out that if net asset value falls below the level in the banking covenant the bank can foreclose. The trust would have to sell assets and, where there are a high proportion of splits in the portfolio, this could devastate the market, leading to further falls. The knock-on effect could reduce the asset base of other trusts, which may default and so on. The question was posed: *"Who would be a buyer in this scenario?"*

The report then went further by stating that this scenario did not require a falling market and could arise from flat or low return markets where splits fail to reach underlying hurdle rates, with resultant loss of capital which would have a knock-on impact on other trusts. It was pointed out that dividend cuts could act as a further catalyst.<sup>40</sup>

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#### **2001 (13 August): "Add a zero for low-risk reward": Mail on Sunday**

The article was a case study promotional of zeros as a low risk investment. However, it was accepted that returns were not guaranteed and that the return was dependent on the performance of the trust assets. The fact that no zero, so far, had failed to pay out the full, predicted amount at maturity was mentioned but was qualified: *"There are no guarantees that this perfect record can be maintained, and many experts predict that failures could become common, especially if stock markets under-perform."* An investment strategist for a firm of IFAs was quoted as saying: *"These trusts are attractive, but you have to be cautious and use them as part of a wider, balanced portfolio. They should not be anyone's sole investment."*<sup>41</sup>

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#### **2001 (30 August): "Split Decisions": Money Marketing**

Split capital investment trusts were put forward as an attractive investment because they offered a variety of risk-return profiles.

Zeros were described as the safest of all share classes in a split structure. At the time, income shares were offering yields of between 7% and 9% with little or no prospect of capital growth but with some measure of risk of capital depreciation. Capital shares were described as the riskiest class in a split structure and caution in selecting them is required.

The article acknowledged that if the underlying equity portfolio was invested in a high-risk area, this increased the risk across all share classes to varying degrees. The holding of income shares of other split funds, rather than

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<sup>40</sup> Comment: If high yields are on offer this is indicative of high levels of risk. Initial and annual costs can be higher than they appear and undermine performance. An apparently low risk income portfolio invested in splits and bonds could decline substantially in value if the other splits invested in failed to meet the underlying hurdle rate and/or where there were risky bonds bought that defaulted. The systemic weakness introduced by cross-holdings in other splits was explained, together with the concept of additional *"imported"* gearing. Zero dividend preference shares have a limited upside but full downside.

The risk profile of a zero in a split geared by bank debt and/or backed by volatile assets is different from one that is not. There was, at the time of the report, a deficiency in many annual reports produced by investment trust companies and offers for sale did not always fully explain the risks involved. Hurdle rates may be seriously understated when no-growth, or low-growth, elements of the underlying portfolio are discounted. They can appear deceptively easy to achieve and if assets fall in value then hurdle rates become increasingly difficult to meet. If there are cross holdings - so that there is a hurdle dependent on a hurdle - then the dependent hurdle is considerably more difficult to achieve than its headline figure.

There is a view that information provided by the trusts was not adequate and that whilst this was not a problem for the handful of professionals who understood these trusts, IFAs, their clients and ordinary investors were at a disadvantage. The conclusions of the report indicate that the main risk of cross -holdings is of possible systemic collapse, caused by "gearing on gearing", although further additional problems arise if dividends are cut or where a constituent trust fails to meet its own hurdle rate. The report concluded that even if long-term equity returns were in line with Cazenove's expectations of 8% per annum, many trusts would struggle to meet their hurdle rates.

<sup>41</sup> Comment: This indicated the risk of zeros not meeting their target value. The IFA was concerned that the zero should not be a stand-alone investment and that some caution should be exercised when buying.

corporate bonds, also introduced risk and gearing, through bank debt, if high, can introduce too much risk, particularly if coupled with a volatile underlying portfolio.<sup>42</sup>

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**2001 (6 September): “Holding out for a zero”: Money Marketing**

The article was evaluating the (then) recent issue of Gartmore Stable Growth Fund, a unit trust investing in zero dividend preference shares. Throughout, zeros were described as a “*lower risk*” investment and the suitability of zeros for cautious investors was highlighted. The article concluded with a comment by one of the contributors: “Zeros could be another source of scandal if the IFA does not have a thorough grasp of the market and its rules. Very soon, a zero will miss its target. Beware all buyers.”<sup>43</sup>

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**2001 (13 September): “Battle of the brands”: Money Marketing**

Contributors to this article discussed the possibility of seeing the first defaulting zeros and were asked if investors and IFAs had been made sufficiently aware of the risks of split capital investment trusts. It was felt by one contributor that the link between risk and reward was more visible with zeros than with other securities and by another that the main problems were with recent issues, where capital cover was the problem, and with highly geared barbell trusts. The majority of zeros were thought to be low-risk attractive investments and investors and IFAs should research the particular zeros they were using. It was accepted some IFAs might not have done sufficient research to be aware of the risks, but direct investors faced a greater problem, being unaware of the complexities involved.

The possibility of a zero failing to reach its predetermined final price was acknowledged and one contributor was of the view that some investors had not been made aware of the risks. It was further acknowledged that zeros had been sold as an alternative to building society investments, when clearly this was inappropriate. The risks were there to see, if the investor wanted to look at them properly.<sup>44</sup>

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**2001 (20 September): “Split caps in covenant risk”: Money Marketing**

Some split capital investment trusts could be in danger of breaching bank covenants if the stock market continued to fall. It was recognised that market falls increased the proportion of gearing but there was a body of opinion that banks take a lenient view in such circumstances, allowing trusts time to raise new money or sell off assets. However, one contributor commented: “There are some splits that are already quite below their banking covenants and could go bust, but there are quite a few which are still looking strong. To take a sector wide view is too generalist.”<sup>45</sup>

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**End 2001/Early 2002: “Zero Dividend Preference Shares – Structured Products – The developing marketplace – a comparative analysis”: Merrill Lynch<sup>46</sup>**

The note felt the marketplace remained uninformed of the impact on performance of cross ownership and felt that it was unclear if cross ownership was credible as an investment strategy. The article sought to illustrate the consequences of such a strategy and to explain the manufacture and inherent risks of the listed zero dividend structures. The initial conclusions drawn were:

- Cross ownership imposed through traditional split capital structures gives rise to acute gearing and increases the embedded fund expenses. Zeros issued on such portfolios are unlikely to be low risk investments. Split capital structures with high levels of cross ownership can only repay zero dividend holders when stock markets rise dramatically, despite the fact that the zeros may be covered at the outset.
- Transparency is about the delivery and correct interpretation of appropriate information. The impact of cross ownership has not been clearly understood by investors in either the primary or secondary markets.
- The risk profile of zero dividend shares issued through a derivative structure is completely transparent and, if the risk embedded in traditional split capital structures is modelled correctly, all the different types of zeros available are comparable.

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<sup>42</sup> Comment: It advanced the view that risk in the underlying portfolio of a split affects the risk profile of all the share classes of that split capital investment trust. The risks posed by cross-holdings and gearing were acknowledged, and concern about the extra risk of high gearing coupled with a volatile underlying investment portfolio was expressed.

<sup>43</sup> Comment: The zeros are described as ‘lower risk’, not ‘low risk’. There is an indication that some zeros were at risk of default. A mis-selling scandal was also being considered as a possibility.

<sup>44</sup> Comment: The article appears to give a clear acknowledgement of: there being a link between risk and reward for zeros; different zeros having different risk profiles; the possible mis-selling of zeros as a suitable alternative to building society accounts

<sup>45</sup> Comment: This article was published after the market falls experienced in the wake of the events of 11 September. There is some optimism but also an awareness that some splits were much weaker and more vulnerable to stock market falls than others.

<sup>46</sup> Comment: This report would initially have had limited circulation, probably being restricted to split capital investment trust providers, certain analysts, brokers, portfolio managers and fund managers. The report itself said in bold type: “This note is intended to be of interest to a broad spectrum of fund managers, private client stock brokers and financial advisors who use zero dividend preference shares as part of their investment portfolio.”

- Zero dividend shares issued on split capital portfolios with cross-holdings remain one of the most sophisticated and complex derivative structures available to the investor. The only way to value their worth correctly is to use complex derivative pricing techniques. This in turn requires access to a great deal of split capital investment trust company specific information.

Various tests were carried out using the FTSE All Share Oil & Gas, Pharmaceutical, Telecom/Tech, Financial and Utilities sectors in respect of a zero with initial cover of 1.25 (20%) with 7 years to run based either on a traditional split capital portfolio with cross-holdings, a zero created on an index, or a zero based on an individual sector.

It was found that cross ownership had an impact on fund performance owing to the increases in the tier of charges borne by the end investor, the effect of income or dividend payments reducing net asset value and the gearing effect. The ownership of split capital income and capital shares is likened to buying a call option and the similarities are explained.

The report then asked how the performance of the underlying fund related to the performance of the zero. In the case of the traditional zero with 30% cross holdings it was found that the market needed to rise from 100% to 116.74% for the zero to suffer no erosion of return. If the proportion of cross-holdings was increased to 70% it was estimated the market would need to rise from 100% to 242.5% for the zero to suffer no erosion of return. It cautioned against the perception that the market could fall by 20% before erosion of the maximum return occurs, since the zero is related to the performance of the split capital portfolio and not the market. The report stated that cross ownership increases the risk inherent in the underlying split portfolio compared with the market and that investors exposed to such portfolios should expect the link between fund performance and market performance to become more tenuous as cross ownership increases.

The note continued: *"Furthermore the zero dividend holder does not benefit from participating in a geared portfolio. It is irrelevant to the zero holder that the portfolio has accelerated performance beyond the point where the portfolio performance line crosses the market performance line. The zero holder is completely exposed to the under performance of the portfolio in the area below that point. Investors therefore need to look closely at the economic sense of being exposed to a portfolio that is destined to erode capital returns under typical market conditions."*

The results obtained assumed no gearing through bank debt, which would further increase the risk to the zero holders. Altogether it was felt the findings had serious implications for how zeros should be analysed by the investment industry. The typical way of looking at hurdle rates and cover to measure risk and gross redemption yield as a measure of return were described as *"hopeless in the face of sizable cross ownership"*. It was felt the industry had inadvertently created one of the most complex structured products ever seen by investors in the UK. *"The relationship between portfolio behaviour and the market it has been predicated on can only be determined by using complex analysis used in the derivatives marketplace. Many zeros have evolved into highly exotic, highly geared derivative structures and GRY only tells us where our returns are capped. It is therefore not an appropriate means of analysis and gives no insight into the 'expected' returns of a particular security."*

Further calculations were carried out for other types of zeros and the results compared with those for the traditional splits zero. The report believed it proved that zeros structured through split capital investment trusts could be validly compared with those structured using derivatives and that cross ownership should be quantified to fully interpret risks and calculate the level of reward that should compensate for that risk.

It was felt that risk-averse, capital-only return could only be accessed through zeros, but that those with cross-holdings were very complex derivative products that needed complex derivative pricing tools to value them. It concluded: *"The market to date has apparently failed to interpret cross ownership correctly and, as a consequence, the level of risk inherent in zero dividend shares extends from being low (some zeros are akin to high grade bonds) to phenomenally high (akin to highly geared plays on equity markets)."*<sup>47</sup>

### **2003 (17 April): "Data Dilemma": Investors Chronicle**

On 2 March 2003 Mr L Schneider wrote to the Financial Ombudsman Service with his analysis of the problems in the Split Capital Investment Trust sector. Mr Schneider had already discussed his analysis with the Financial Services Authority.

<sup>47</sup> Comment: It is argued that cross ownership, even without bank debt, increases gearing. Further, the duplication of management expenses has a detrimental effect on fund value. Zeros issued on portfolios with cross ownership of shares in their structure are felt unlikely to be 'low risk'. There was concern about 'transparency' through the delivery of, and correct interpretation of, appropriate information and that the impact of cross ownership was not properly understood.

The view was expressed that zero dividend shares issued on split capital portfolios with cross-holdings were sophisticated and complex derivative structures. The only way to value their worth correctly was to use complex derivative pricing techniques, which required access to a great deal of split capital investment trust-specific information that might not be available. The article said that a zero dividend preference shareholder does not benefit from participating in a geared portfolio. It is irrelevant to the zero holder that the portfolio has accelerated performance; the zero holder is completely exposed to the under performance of the portfolio.

If there is additional gearing through bank debt then their position is further undermined by the structural risks introduced by a prior charge on winding-up. Traditional methods of assessing risk - hurdle rates, asset cover and gross redemption yield - were, it said, inadequate in the light of gearing and cross ownership. It said that cross-holdings increased the risk inherent in the underlying portfolio compared with the market. The link between the portfolio and the market became more tenuous as cross-holdings increased. It was accepted by this report that the risk profile of a zero could be anything within the spectrum from "phenomenally high" to "low".

An article based on Mr Schneider's analysis appeared in the Investors Chronicle, 21 March 2003 edition, which was challenged by the Association of Investment Trust Companies (AITC). However, the report on 17 April recorded that subsequent investigations led Fundamental Data, the AITC data provider, to admit that in March 2001 the AITC calculation methodology did not accrue for interest and management charges nor did it take into account winding-up costs. These omissions were (it said) quite common and were the norm rather than the exception.

The 17 April 2003 article commented that the effect of these omissions was significant giving the following example: On 31 March 2001 the Investment Trust of Investment Trusts Zero Dividend Preference Shares were shown as having an asset cover of 1.1, whereas the zero-holders actually faced a fund deficit of £6.52m and that, *"At the time the AITC was describing zeros as low-risk investments that could be 'compared with building society accounts or gilts'. The fact that the AITC's published information does not show the gearing (debt level) for splits – even though it was shown for all other investment trusts – and fails to make clear that the redemption yields given for income shares were based on reinvesting dividends, could also be misleading."*

A quote from a Gartmore Fund Manager indicated that he was not surprised by the findings and that he had always felt the data available had been of variable quality. He had been able to exploit this by using his own calculations from his own product models. A further quote, from an IFA, complained that IFAs had to rely on external figures and that, with sources such as the AITC, IFAs would expect the data to be complete.

The article concluded by observing that the AITC is not regulated and that perhaps the FSA should consider extending its powers.<sup>48</sup>

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<sup>48</sup> Comment: This article sought to illustrate the divide between, on the one hand, split capital investment trust sponsors, fund managers and portfolio managers, who had access to, or were capable of obtaining and/or calculating, accurate data, and IFAs and ordinary investors who had to rely on external figures which might have been misleading.