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Activists Assemble: Recent Trends in Activist Campaigns Targeting UK Investment Trusts

The United Kingdom has long been a target destination for activist investors. It is the venue for nearly half of all of recent activist campaigns in Europe. In previous articles, we have discussed how informed boards should stay alert to the possibility of an activist campaign, and the basic steps they can take to prevent them.

The economic and structural features of UK investment trusts make them, in the words of one activist investor, "incredibly compelling" targets, and recent campaigns involving investment trusts have received press attention. In this newsletter, we explain what investment trusts are, and what renders them exposed to activist campaigns. We also explore the common strategies pursued by activists and potential counter-measures for investment trust boards.

What is an investment trust and why do they exist?

Investment trusts are a long-established form of investment vehicle. They initially emerged in the UK in the 19th century as a means for investment into foreign government bonds and debt securities issued by US railroads, often with the use of leverage. Many of the stock market-listed investment trusts that exist today can trace back their origin to that time, including Foreign & Colonial Government Trust and Scottish American Trust. The promoter of the former, Philip Rose, is said to be the father of investment management. The promoter of the latter, Robert Fleming, is said to have channelled the equivalent of $1 trillion (in today's money) into US infrastructure (principally railroads) through structures such as this. Today, investment trusts still bear hallmarks of their origins, although they hold a much wider range of investments.

Despite their name, "investment trusts" are not actually trusts. They are closed-ended investment funds, structured as public limited companies and traded on a stock exchange. This form allows them to invest in a broad range of assets including securities such as equities, bonds and those issued by other investment funds, as well as physical and intangible assets. Management of investment trusts is the responsibility of the board of directors, although investment and other key decision-making authority is frequently delegated to an investment management company, which may or may not be affiliated to the trust.

A company that is approved by HM Revenue & Customs (HMRC) as an investment trust will be exempt from UK tax on any capital gains it realises. The favourable tax treatment is a key advantage of investment trusts, but not the only one. Other advantages include the high liquidity of investments in these trusts because they are listed; the benefit of a professional investment manager; and the fact that they are closed-ended, and can thus hold investments in more illiquid assets, such as infrastructure.

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In order for a company to be approved by HMRC, it must meet the eligibility conditions and satisfy the ongoing requirements set out in the Corporation Tax Act 2010 (CTA). The act requires that: the company's business consist of investing its funds in shares, land or other assets with the aim of spreading investment risk and managing its members' funds; the company's shares be traded on a regulated market; and the company is not a venture capital trust or a UK real estate investment trust (REIT).

The ongoing requirements are that: the company is not a "close company" as defined in the CTA, meaning it cannot be controlled by five or fewer persons; it must not retain more than 15% of its income for any accounting period; and, it notifies HMRC of any changes to its investment policy or breaches of the regime.

Why are they a target for activists?

Two main factors make UK investment trusts particularly exposed to activist investors. The first is the high discounts at which many trusts' shares trade compared to their net asset value (NAV). Currently, the average discount is around 17%, though some trusts are trading at discounts exceeding 30%. Such high discounts have not been seen since the global financial crisis of 2007-2009.

Wide discounts are expected during times of economic downturns and uncertainty, so the current levels are partly driven by the geopolitical uncertainty and the general economic outlook for the UK economy. In addition, higher interest rates have created attractive alternative yields for investors (for example, through investment in government bonds), driving down demand for trust shares. Higher rates have also raised the cost of borrowing for, and lowered the value, of underlying assets. In some cases, the impact on underlying assets is exaggerated by leverage within the trusts themselves. Moreover, higher interest rates affect the calculation of the present value of future cash flows, which has an adverse impact on valuations.

The cumulative impact of these factors are historically wide gaps between the share value and the investment trusts' NAVs.

Some observers attribute investment trust valuations in part to UK's reporting rules. They point out that the way in which investment trusts are required to report their ongoing charges means that those costs often get duplicated. This can distort results, creating the misleading impression that investments in investment trust shares are more costly than investing in other types of investment funds. That further dampens demand and drives discounts higher.

High discounts mean that the potential entry for activist investors is relatively cheap, and there is a good chance of a relatively quick payout, as discounts narrow. Activist also push for other liquidity events that enable them to cash out at, or close to, NAV, including the nuclear option of seeking a winding up of the trust.

The second main factor contributing to investment trusts' vulnerability is structural. UK rules allow a shareholder who holds a relatively low percentage of the issued share capital to require a general meeting be called, to circulate a members' statement, or to table a resolution (for example, to remove a director) before the meeting.

Moreover, many UK investment trusts have a clause in their articles requiring a periodic continuation vote (a vote of shareholders to continue the business of the investment trust), which gives the activists an automatic option to challenge the board.

What tactics do activists typically employ?

Winning the support of long-term investors for a campaign against an investment trust may be expensive. However, some activists campaigns in the US have been built on the support of a few institutional investors. Applying the same tactics in the UK where the shareholder body may not all be engaged may reduce the costs. Where this approach doesn't work, sophisticated activist investors may use derivatives and leverage to acquire voting rights in a company more economically. The activist can then cast those votes via the investment banks who are counterparties to those derivatives and who own physical stock to back their derivative exposure.

A typical activist campaign will often revolve around some combination of the following demands:

- Changing the investment manager or the investment strategy.
- Structural changes, such as moving away from a self-managed structure to appoint an independent investment manager.
- Changing members of the board of directors or other governance changes.
- Advocating for an acquisition or a merger (*e.g.*, with another, larger trust to improve liquidity), or opposing a proposed acquisition or a merger.
- Changing capital allocation (*e.g.*, to increase dividends), the fund structure or other strategic alternatives.
- Pushing for changes around environmental and social concerns.

For example, the chair of the world's largest closed-ended fund, Scottish Mortgage Investment Trust (a prolific investor in technology stocks), was forced to step down after 14 years in the role, following a public campaign by a non-executive director.

Activists may also push to exit an underperforming investment or offload poorly performing assets to fund share buybacks, or attempt to force a vote on winding up the investment trust or cancelling the investment management or advisory agreement. In the case of investment trusts, the activist may use a fund's continuation vote as a means to achieve theses aims.

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Investment trusts are closed-ended funds, meaning they have a fixed pool of capital and do not have to concern themselves with investors redeeming or withdrawing their funds. To give a measure of accountability to shareholders, therefore, some investment trusts provide for periodic continuation votes in their articles of association, which require a majority of the shareholders to vote to continue the fund. If an investment trust's board fails to secure a majority in favour of continuation, management may be required to completely reorganise the investment fund, or even wind it down.

These votes are a powerful lever for activist investors to exploit. For example, activist investors in Hipgnosis Songs Fund, a UK-listed investment trust that specialises in buying the rights to music royalties, called for shareholders to vote against the continuation of the fund for another five years. This campaign followed a plummeting share price, a widening gap between the share price and the stated NAV (reaching over 50%), and the board's decision to axe the interim dividend. Predictably, the activist investors also called for the removal of the chair and other senior executives from the board, two of whom have already announced their resignations.

At the subsequent continuation vote, more than 83% of the votes were cast against the continuation of the fund. The investors also overwhelmingly opposed the board's proposed asset sale and the re-election of fund's chair, despite the fact that he previously announced his resignation. This outcome not only means that half the board will be replaced — a key victory for the activist investors — but also that the new board will have six months to decide whether to wind down the trust or attempt to reconstruct it with the shareholders' assent.

The threat of such a vote may compel the board of directors of an investment trust to explore different ways of returning capital to investors, whether through share buybacks, dividends or otherwise to shore up investor support for a continuation vote.

Case study: European Opportunities Trust

To illustrate the broader trend we described above, we can look at the example of European Opportunities Trust (EOT). The fund had struggled to perform, hit by losses on its long position in Wirecard, the German payment processor and financial services firm that collapsed after accounting irregularities were unearthed. EOT was trading at an average NAV discount of 13%. EOT's management had taken some early steps to address shareholder discontent, such as deploying capital reserves to hike dividends by 40% and actively buying back shares to lower the discount to NAV. Earlier in the year, the board announced an offer to shareholders to tender up to 25% of their interests if the fund's NAV does not grow at an equal or greater rate than the benchmark index over the next three years.

Despite these efforts, a series of investors who take advantage of discounts moved to increase their holdings. Saba Capital, an activist hedge fund led by Boaz Weinstein, increased its stake in EOT to 5%.

In response to the increasing pressure, the fund's investment manager agreed to lower its annual fees. Not satisfied, Boaz Weinstein released a public letter declaring Saba's intention to vote against the board at the upcoming continuation vote. Moreover, the activist began galvanising support against the board's buyback offer, contending that the fund has underperformed the relevant benchmark by 40% over the last five years.

The continuation vote is scheduled to take place on 15 November. The key demand is for the board to provide an exit at NAV to all shareholders. EOT rejected Saba's demand for an improved tender offer on 7 November 2023.

While EOT was particularly vulnerable to such a campaign, it is not an isolated example. Saba has also taken a 10% stake in Edinburgh Worldwide, another investment trust, and smaller interests in a number of others. Going further, Saba have announced that it is raising a $500 million fund to target opportunities in UK investment trusts.

Conclusion

Activist campaigns against UK investment trusts are becoming more common. While activists' most common techniques are known, the example of EOT demonstrates that even an alert board deploying early counter-measures is not immune from an activist campaign.

As the discount rates for UK investment trusts widen, the intensity of activists' interests may increase, putting even more pressure on fund managers and boards, just as they are squeezed by adverse macro-economic conditions. Activist investors are evidently ready to strike.

Although sponsors of investment trusts may be unable to shift macro-economic conditions, they should carefully consider what defensive steps they can take. That may just be a matter of increased engagement with existing shareholders, but other steps such as reviewing disclosure practices, reconsidering the investment policy and investment manager, instituting a discount/premium control mechanism and investing in greater marketing efforts may be worthwhile.