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Introduction

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1.1 AIMS OF THE BOOK

The crisis surrounding the UK split capital investment trust sector broke in late 2001. It led to a major Financial Services Authority (FSA) investigation and a House of Commons Treasury Select Committee enquiry that called as witnesses a number of well-known personalities from the investment trust industry. Some of these Treasury Select Committee hearings produced moments of great theatre that were widely reported in the mainstream press.

This book aims to provide an in-depth and authoritative analysis of the crisis. Although it is generally regarded as a difficult subject even for investment professionals, most chapters are suitable for the interested lay reader. An unusual feature of the book is the large number of contributors, each with expert knowledge of his chosen topic. This inevitably means that varying views are expressed but this I consider to be a strength of the book. It is important that different sides of the story are told if the reader is to obtain a balanced view of what happened.

The FSA investigation and the large number of interested parties with legal representation have made editing a book of this kind a considerable challenge. Some people have suggested that it is too early for a book on the splits saga. However, the alternative is to wait until the court battles are over, which could be years away. By then, many of the details of the crisis will have faded from memory. But there was more to this saga than a simple admonition that it represented "the unacceptable face of capitalism". While memories are fresh, it is useful to look beyond the casual soundbite and analyse the causes and effects of this serious crisis. There may be lessons to learn.

1.2 THE INVESTMENT TRUST INDUSTRY

An investment company invests in a portfolio of shares or other securities for the benefit of its own shareholders. It enables investors to purchase an interest in a professionally managed fund.

An investment trust company (also sometimes referred to as an "investment trust" or just "trust") is a UK investment company whose ordinary shares must be listed on the London Stock Exchange.[1] It is subject to the regulation of the Companies Act and the

[1] An investment company can become an investment trust company by complying with the requirements of Section 842 of the Income and Corporation Taxes Act 1988. One requirement is that the company must be listed on the London Stock Exchange. An investment trust company is exempt from tax on capital gains realised within its portfolio.

UK Listing Rules. It is not a product regulated directly by the FSA unlike a unit trust or an open-ended investment company (OEIC).

Ultimate responsibility for running the affairs of an investment trust lies with the board of directors, but day-to-day investment management and administration is normally delegated to a fund management firm.[2] This firm may also manage other investment trusts together with other types of fund, such as pension funds or unit trusts. The conduct of the fund manager in managing the portfolio of the investment trust is regulated by the FSA, as is its marketing activities.

In common with any other company, an investment trust has a fixed number of issued shares. To liquidate their holdings, investors must normally sell their shares to other investors.[3] An advantage of this "closed-end" structure is that the fund managers can invest for the best long-term interests of the trust shareholders without having to worry about a possible reduction in the underlying portfolio of assets in adverse market conditions. Such a problem can arise in the case of unit trusts or OEICs[4] because investors buy or redeem their investments directly with the managers, and if there are a significant number of redemptions the managers will be forced to sell assets in the underlying portfolio.

Again, in common with any other company, an investment trust can borrow money and thereby obtain the benefits and risks of "gearing". This can be done by issuing listed or unlisted loan capital or simply by borrowing from a bank. Ignoring the cost of borrowing, if the value of the underlying portfolio of the investment trust rises (or falls) by a certain percentage, the residual assets attributable to shareholders will rise (or fall) by a greater percentage. So, gearing exaggerates movements in the value of underlying assets from the investment trust shareholders' viewpoint.

Conventional trusts (i.e., trusts with only one class of share) generally invest almost entirely in equities, often with a heavy overseas exposure. "Generalist" investment trusts combine investment flexibility with the opportunity to diversify by spreading investments over several markets and sectors. "Specialist" investment trusts provide a vehicle for investment in some specialist area, such as a particular geographical region or a specific industry sector.

Split capital closed-end funds ("splits") may be defined as investment companies[5] or investment trust companies with more than one main class of share capital, offering different rights to income and capital.[6] They aim to match simultaneously the risk, income and tax preferences of different types of potential investor. Splits are usually designed to be wound up at some future date, with most splits having an original term of seven to ten years.[7] If the company is wound up, its assets are sold and the proceeds

[2] There are, however, a number of well-respected self-managed trusts.

[3] However, a number of trusts have a limited life. There may be a fixed redemption date but very often there are a number of optional wind-up dates. Furthermore, "buy-backs" in which a company buys its own shares and cancels them have been popular since 1999.

[4] Unit trusts and OEICs are "open ended" so that if a sufficient number of unit holders wish to sell their units it may be necessary to sell assets in the underlying portfolio to generate sufficient cash to meet the demand.

[5] Split capital investment companies may be domiciled offshore (e.g., in the Channel Islands). This can enable them to have certain advantages in respect of their tax and accountancy treatment.

[6] In everyday usage, the term "split" is often taken to include conventional trusts with high levels of bank debt. These we refer to here as pseudo-splits.

[7] They normally have a fixed wind-up date but for some splits there may be a range of wind-up dates and the life of others may be extended if a continuation resolution is passed. A number of "undated splits" were created in the splits boom in which the ordinary shares were undated. This was made possible by issuing zero-dividend preference shares (see Section 1.3) via a subsidiary company. It is the subsidiary which winds up, to be replaced by a follow-on subsidiary if the split structure is to be maintained.

Table 1.1 Size of the conventional trust and splits sectors

	End-1997 (£bn)	End-2000 (£bn)	End-2003 (£bn)
Conventional trusts	46.2	67.1	48.2
Splits	7.4	14.7	7.9
Total	*53.6*	*81.8*	*56.1*

Source: Cazenove/Fundamental Data.

are used to pay off the various classes of share capital after meeting the entitlements of holders of debt, if any. Shareholders always have the option to take cash, but in practice the directors and managers normally try to retain some of the funds under management by encouraging shareholders to roll over into an existing trust or by restructuring, rather than liquidation.

Table 1.1 shows the estimated total assets (including assets financed by borrowings) of the conventional trust and splits[8] sectors on three dates around the crisis period. It can be seen that the total assets of the splits sector doubled over the three-year period up to end-2000, but then roughly halved over the three-year period to end-2003.

1.3 TYPES OF SPLITS

There are two basic types of splits: "traditional splits" and "quasi-splits". However, many more complicated splits were launched, particularly over the period from 1999 to 2001, some of which have defied simple catagorisation.

Traditional splits

A simple "traditional split" has its ordinary share capital divided into two distinct categories: income shares and capital shares. Dualvest, the first split, launched in 1965, was of this type, as were many of the splits launched up to the late 1980s. They generally invested in a broad portfolio of UK equities with an above average yield and commonly had no borrowings.

Holders of the income shares of traditional splits are entitled to all or most of the distributed income and a predetermined capital value on liquidation. Thus, they receive a much higher income yield than that of the underlying portfolio. They are considered suitable for investors who require a high income, such as elderly people. Most income shares are entitled to a capital repayment when the trust is wound up, but some are more like annuities, with very little capital repayment.

Holders of the capital shares of traditional splits receive little or no income but are entitled to the remaining assets on liquidation after the income shares have been redeemed. So they obtain geared returns which depend on the growth of underlying assets up to the wind-up date. They are a risky type of share, which may appeal to high-rate taxpayers looking for potential strong capital gains.

[8] "Splits" in Table 1.1 means split capital and highly geared closed-end funds.

Quasi-splits

A "quasi-split"[9] always has zero-dividend preference shares (zeros) in issue but, in its most straightforward form, there is only one class of ordinary share capital, namely ordinary income shares (also known as income & residual capital shares). This type of structure was common from 1988, shortly after the first zero was invented, through to the late 1990s. Again, such splits generally adhered to prudent investment principles, holding a broad portfolio of UK or international equities, and did not incorporate additional complexities, such as bank borrowings.

Zeros are designed to pay a predetermined capital sum when the trust is wound up before any distribution can be made to ordinary income shareholders. They have no entitlement to income so that, importantly, there is no liability to income tax. Provided the underlying portfolio is widely spread and does not have overly demanding yield requirements, and there are no prior ranking charges (e.g. bank debt), the zeros in these simple structures are generally low risk. Such zeros are attractive to private investors who need a fixed sum at a future point in time and are able to use their annual exemption allowance to avoid paying capital gains tax. If sums of money are required at different points in time, an appropriate portfolio of zeros can be created. The zeros in these simple structures are suitable for such things as school fees planning and retirement planning.

Ordinary income shares offer high income plus all the remaining assets of a quasi-split trust at the wind-up date, after the zeros have received their capital entitlement. They are analogous to holding an equity portfolio partly financed through a prior claim (the zeros) repayable at wind-up.

More aggressively structured splits

A common variation of the above theme was to combine the traditional split and quasi-split concepts. In other words there could be three classes of shares: zeros, income shares and capital shares. When such a trust is wound up, zeros are (in the absence of borrowings) repaid first. So, other things being equal, the risk/return profile of the zeros is no different from that of zeros in a simple quasi-split. But, the income shares are likely to be more risky than in a simple traditional split because they rank after the zeros for capital repayment. The capital shares would have the lowest priority for repayment in either case.

In the buoyant markets of the late 1990s, it became fashionable to launch splits that used complicated capital structures, often with significant levels of bank debt and other devices, to make the shares appear attractive to investors. Some of them had a narrow thematic investment policy or invested in the high-yielding shares of other splits (hence "cross-holdings"). Their complexity made it almost impossible to "stress-test" the products adequately before launch. As always, one of the main driving forces behind the creation of these vehicles was the pursuit of fees by fund management firms and their broker/advisers. Some sections of the firms involved became highly profitable.

The shares in these aggressive structures often did not have the same well-known

[9] Some commentators use the term "quasi-split" to mean a conventional trust with high levels of bank debt. To avoid confusion, these highly geared conventional trusts will be called "pseudo-splits" (see Footnote 6).

characteristics as shares with the same title (e.g., zeros) issued by earlier simple splits. It was often very difficult to understand the investment attributes of the different shares, not least because sufficient information was not readily available to outsiders. Traditional risk statistics used to assess the risk of shares in a split often became dangerously misleading for the new splits. As a result, there was a general lack of understanding of the true risks involved. The obvious risk created by geared trusts investing in other geared trusts was generally missed by private investors and their advisers.

1.4 THE CRISIS AND ITS SIGNIFICANCE

Many analysts with specialist knowledge of splits felt that there was "an accident waiting to happen" by the end of 2000. But, it took a severe bear market to drive home the dangers of bank debt and cross-holdings to the majority of investors and their advisers. The impact of falling markets accompanied by equity dividend cuts led to collapsing market prices and dividend cuts for the income-bearing shares of many splits. The substantial cross-holdings then caused dividend cuts to compound themselves across a section of the splits sector, and share prices fell yet further. Even the market prices of a number of zeros fell sharply, a type of share which until then had generally been regarded as low risk. By the end of 2001, desperate measures were being taken by fund management firms and their broker/advisers to save many of the new splits, and the FSA started to take a much keener interest. Confidence in splits then collapsed. But the splits crisis will be remembered most for the Treasury Select Committee hearings in the second half of 2002 and for the financial losses suffered by private investors, some of whom are suffering real financial hardship as a result.

According to the Association of Investment Trust Companies (AITC), retail investors have lost over £700m[10] across all share classes in splits[11] that have gone bust. Of course, there are other shares in splits that are unlikely to recover their full launch value, but according to the AITC retail losses here stood at less than £500m[12] based on end-February 2004 share prices.

The crisis itself may arguably be over, allowing this book to be written, but it will be a long time before every compensation decision has been taken and we learn what disciplinary action, if any, the FSA has imposed on the firms and individuals it is currently investigating. While the principle of "caveat emptor" should never be forgotten, it is clear that both the Treasury Select Committee and the FSA believe that there has been some serious wrongdoing.

One obvious consequence of the crisis will be to reduce the complexity of future splits. But, as we will see in this book, the splits crisis will have a permanent effect on the whole investment trust industry in such areas as corporate governance, disclosure of information and the freedom of trusts to invest in other trusts. For better or worse, there is now a stricter regulatory environment for investment trusts.

[10] This figure is based on launch values and may underestimate the amount lost by retail investors as they could have bought their shares in the aftermarket at higher prices than launch value.
[11] The term "splits" here includes not only closed-end funds with more than one class of share capital and those with high levels of bank debt, but also closed-end funds investing in such funds ("funds of funds").
[12] Again, this figure is based on launch values and may underestimate the amount lost by retail investors as they could have bought their shares in the aftermarket at higher prices than launch value.

I should stress that most investment trusts are not splits, not all splits were a problem and the splits crisis was wildly out of character for the traditionally cautious investment trust industry. It is most unfortunate that the splits crisis has adversely affected the image of the investment trust industry as a whole, an industry which has served investors well for over 130 years. In my view, investment trusts remain an excellent vehicle for long-term investors.

The publicity surrounding the splits crisis has not helped the reputation of the savings industry. Along with other financial disasters, such as Equitable Life, endowment policy shortfalls, pensions mis-selling and precipice bonds, the splits crisis has discouraged people from saving sufficiently for their future. Given the urgent need for a rise in the UK savings ratio, so that people will be better able to provide for themselves when growing old, this could in the end prove to be the most significant aspect of the splits crisis.

1.5 OVERVIEW OF THE FIVE PARTS OF THE BOOK

This book is divided into five parts, each dealing with a different aspect of the crisis.

Part One (*The Crisis*) gives a historical background to the crisis, including the lessons from past booms and busts in the investment trust sector, and describes the main milestones in the evolution of the splits industry. The boom years of the late 1990s, the unfolding crisis and the underlying reasons for the crisis are also discussed.

Part Two (*Risk and Valuation Models*) is the most technical part of the book. It outlines theoretical models for the risk assessment and valuation of shares in splits, which will help in understanding their behaviour during the crisis. Less technically minded readers may find Part Two difficult whereas trust specialists may find it the most immediately useful part of the book.

Part Three (*Response to the Crisis*) discusses the media, regulatory and political response to the crisis. John McFall MP expresses some strongly held views formed from the Treasury Select Committee (of which he is chairman) enquiry in discussing the political response.

Part Four (*Management Issues*) tackles three key management issues which have been widely discussed in relation to the splits crisis. The contributors to this part of the book view the crisis from very different perspectives.

Part Five (*Looking Forward*) concentrates on the main lessons and implications of the crisis for the fund management industry, especially in the area of product innovation and marketing. The final chapter discusses the lessons for corporate governance of investment trusts, the Association of Investment Trust Companies, financial advisers, financial education, the financial press and the regulators.