Investment Trust
NEWSLETTER

FEBRUARY 2007

The times are changing, and for investment trusts they are changing rapidly. Every month we have news of reconstructions and corporate activity, and we also have news of investment trusts specialising in previously untapped realms. In this issue, for example, we cover trusts investing in hospitals and schools, in new surgeries for doctors, in US railways, in wind power, in Croatian property, and in US pharmaceutical stocks. Gone are the days when Brazil and Russia seemed unspeakably exotic – now closed-end funds are being used as vehicles for many more distinctive activities requiring expert knowledge. The managers may have this expertise, but whether potential investors have sufficient wisdom to select well from these new-style trusts is another matter. We think the nature of analysis is changing in this market – our job in the newsletter is certainly different from when we started in 1996. Nowadays, finding large discounts with the scope to narrow is much more difficult, and more value is to be had from trying to find the trusts likely to deliver strong (risk-adjusted) returns from niche markets. We think that many of these trusts may be overlooked in future, particularly if stockmarkets in general suffer a downturn, and at that point we may well see many striking valuation anomalies which generate good opportunities for profit. For this reason we think it is well worth becoming familiar with some of the ‘backwater’ specialist trusts, even if you are not intending to invest now on premium ratings. If Merrill Lynch New Energy Technology can move from a 37% discount to a 4% premium in under five years, we certainly think that some trusts can move the other way as well.

We think the investment trust market is going to have a very interesting 2007 with new trusts delivering returns from new areas, and we also foresee plenty of profit to come from well-informed analysis in the future.

NEW ISSUE

3i Infrastructure Limited

3i Infrastructure, a newly-established, Jersey-incorporated, public closed-ended investment company, has announced its intention to float on the London Stock Exchange. This new trust intends to build a diversified portfolio of equity (or equivalent) investments in entities owning infrastructure businesses and assets. Its initial focus will be on Europe, North America and Asia. It intends to invest the initial net proceeds over the two-year period following the listing. As the name suggests, 3i will manage the trust, and will also be a substantial investor in it. 3i intends to invest £325m, so there will be no doubt about the community of interest between the manager and other investors.

This will be a major launch: the trust plans to raise between £700m and £1.3bn through the issue of shares with warrants attached on 1-for-10 basis. Each warrant will entitle the holder to subscribe for one additional share at the offer price from six months after listing to five years after listing.

3i Infrastructure will acquire an initial portfolio of UK infrastructure investments from 3i Group, comprising interests in substantially all of 3i Group’s unrealised infrastructure investments. These include an investment in AWG. Anglian Water, AWG’s principal business, is the fourth largest

Warning. **Investment Trusts** may use or propose to use the borrowing of money to increase holdings of investments or invest in other securities with a similar strategy and as a result movements in the price of the securities may be more volatile than the movements in the price of underlying investments. Your investment may be subject to sudden and large falls in value and you may get back nothing at all. You should not buy shares or warrants with money you cannot afford to lose. You run an extra risk of losing money when you buy shares in certain smaller companies including ‘penny shares’. There is a big difference between the buying price and the selling price of these shares. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, it may go down as well as up, and you may not get back the full amount invested. Changes in rates of exchange may have an adverse effect on the value or price of the investment in sterling terms. As with other investments, transactions in investment trust securities may also have tax consequences and on these you should consult your tax adviser. **Options and other derivatives, warrants, and margined transactions.** This warning notice draws your attention to some of the high risks associated with warrants. The risks attaching to instruments and transactions of this kind are usually different from, and can be much greater than, those attached to securities such as shares, loan stock and bonds, such transactions often having the characteristics of speculation as opposed to investment. Warrants may involve a high degree of ‘gearing’ or ‘leverage’. This means that a small movement in the price of the underlying asset may have a disproportionately dramatic effect on your investment. A relatively small adverse movement in the price of the underlying asset can result in the loss of the whole of your original investment. Moreover, because of the limited life of warrants, they may expire worthless. A warrant is a right to subscribe for shares, debentures, loan stock or government securities, usually exercisable against the original issuer of the securities. Because of the high degree of gearing which they may involve, the prices of warrants can be volatile. Accordingly, you should not buy warrants with money you cannot afford to lose. In certain circumstances it may be difficult to sell or realise the investment. Because of the volatile nature of the investment, a fall in its value could result in your recovering nothing at all. We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material respects. Figures for net asset values and historical track records supplied by Thomson Financial, Fundamental Data, the AIC, Cazenove, or by the trusts themselves. Investors should seek appropriate professional advice if any points are unclear. This newsletter is intended to give general advice only, and the investments mentioned are not necessarily suitable for any individual. The publisher’s associate may have an interest in some of the shares mentioned in this newsletter. It is possible that the McHattie Warrants Alert Fund or officers of the McHattie Group may have a beneficial holding in any of the shares or warrants mentioned in this newsletter. Published by The McHattie Group, St Brandon’s House, 29 Great George Street, Bristol, BS1 5QT. Tel: 01179 200 070. Fax: 01179 200 071. E-Mail: enquiries@mchattie.co.uk. Web Site: http://www.tipsheets.co.uk. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means, electronic, mechanical, photographic, or otherwise without the prior permission of the copyright holder. Authorised and regulated by the Financial Services Authority.

water supply and sewerage company in England and Wales, measured by regulatory capital value, with approximately 4.2m water and 5.9m sewerage customers. Other interests include Norfolk and Norwich Hospital, Alpha Schools Scotland, and an interest in Infrastructure Investments LP, one of the largest UK equity funds investing in secondary PFI projects. Let's take a closer look at each of these in turn. Starting with Octagon Healthcare, this company undertook a £229m project to design, build and maintain a new hospital in Norwich. Under a 35-year private finance initiative (PFI) contract, Octagon maintains the hospital. The NHS Trust is committed to make RPI-linked payments to cover the use and maintenance of the buildings and is responsible for the provision of all clinical services. As you may recall from earlier coverage of HSBC Infrastructure, one of the impressive elements of PFI projects is that they tend to be well managed, delivered on time and within budget. The Norwich hospital was completed in September 2001, 20 weeks early and £10m under budget. Turning to Alpha Schools (Highland), this is a £176m project to build 10 new schools in Scotland under a 30 year PFI contract and in which 3i has committed to invest around £7m. Construction has started and the target date for completion of all schools is 2010. Finally, Infrastructure Investors LP is a fund which makes and manages investments in secondary market public and private infrastructure projects in the UK and Europe. 3i has committed £150m alongside Barclays Private Equity and Societe Generale with a total committed fund size of approximately £478m. It is one of the largest equity funds in the UK investing in secondary PFI projects with assets including the DLR Lewisham extension, HM Treasury and HMRC offices, and HPC Kings College Hospital.

3i says its team covers the full range of infrastructure assets, but with particular focus on three asset classes: (i) transport infrastructure - toll roads, bridges, tunnels and road maintenance, ports, airports and air traffic control, rail, bus and light rail, and ferries; (ii) utilities – oil and gas distribution and storage, electricity distribution, power generation, water treatment and distribution, and waste processing; and (iii) social infrastructure – primary and secondary PFI, healthcare and education facilities, government accommodation, and defence support facilities. In general, the managers look for investments with a significant underlying asset base either through ownership or concession-based right, relatively predictable, income-oriented cash returns, and the potential for capital growth including returns from refinancings. As with other infrastructure trusts, we think that 3i Infrastructure can make a solid long-term investment for investors seeking reasonable returns without taking too much market risk. The trust is aiming for a total return of around 12% per annum, with an annual distribution yield of 5% taken from this.

These are the only details we have at present – we expect the full prospectus to be available later in the month. The offering is scheduled to close during the first half of March 2007. Michael Queen, managing partner and head of infrastructure at 3i Investments, commented "the launch of a dedicated infrastructure investment company is a natural progression for 3i which has been investing in infrastructure for the past 20 years. We believe infrastructure is an attractive asset class with the potential for long-term predictable returns. 3i Infrastructure will give investors access to 3i Group's existing high quality infrastructure assets, as well as the benefit of our 20 year track record in infrastructure investing, backed by 3i Group's powerful brand and market presence." Michael's own experience, from his work as head of the NHS private finance unit, to group finance controller of 3i Group, clearly illustrates the depth of expertise which 3i can bring to this sector.

We note that this trust's most obvious competitors – Babcock & Brown Public Partnerships and HSBC Infrastructure – are both trading on significant premia to net asset value (4% and 9.2% respectively), and think there is a good chance this new trust will as well. With the warrants available as a bonus at launch, we can see a good argument for applying for shares in the offer. Certainly this sector is highly sought after at present. In addition to this new trust, General Electric of the US is planning to buy a French water purification company, and an increasing number of financial bidders and private equity firms are investing in the traditionally low-growth utility and infrastructure sectors as they seek stable cash flows they can securitise to pay off interest on bonds. We have seen it reported that investment banks including Merrill Lynch and Goldman Sachs are also setting up infrastructure funds. The demand for infrastructure investments look set to roll on for a while, which augurs well for this launch.

FINSBURY WORLDWIDE PHARMACEUTICAL TRUST PLC (491p)

Sam Isaly, the manager of Finsbury Worldwide Pharmaceutical Trust, provided a shareholder update by telephone conference on January 30th. We listened in. Sam identified three major trends in the sector which are important for the trust. First, in early 2006, pharmaceutical products became a covered benefit under Medicare law for people outside of hospital. This means that over-65s, for example, can now obtain pharmaceuticals free of charge, which was not the case before unless they were in hospital. This has "worked fairly well", Sam says, although there has been some controversy. When the amendment was drafted, it included a non-interference clause which stated that the US government must not use its buying power to drive the prices of pharmaceuticals lower. This is obviously good for the drug companies. The Democrats have been unhappy with

this, and have been trying to pass a bill saying that the government should do all it can to lower prices. Sam says that even if the Bill passes Congress though, President Bush will veto it, so no change is imminent. "That veto will not be overridden" he explains confidently. Sam reckons this controversy may run and run, and return in the Presidential election campaign in 2008, but for now it is not too hot an issue for the sector. "It has had some impact on sentiment, but not a major amount", Sam says.

The second important piece of news from the US pharmaceutical industry is that the regulatory body – the FDA – has a new commissioner (the head). Sam says "we believe he will carry forward the progressive policies of his predecessor. Progressive in the sense of co-operating with the industry to get more drugs approved." Sam notes that about half of the drugs being approved now are from smaller biotech companies rather than the large pharmas. The third and final trend which Sam spoke about was mergers and acquisition (M&A) activity. He says this has reached a new high in the sector, both in terms of value and also in terms of the size of premiums being paid. The trust has benefited from several of its holdings receiving attractive bids. "We expect this very much to continue", Sam says. In addition to these prime trends, all of which are positive for the sector, Sam says that "valuations remain quite modest." In the calendar year 2006, he admits that biotechs and pharmas were not a very good place to be invested – the sector rose by only a couple of percentage points over the year, well behind the rest of the market. He finds this surprising though in view of good earnings growth which was delivered as expected. In 2006 the trust went after this earnings growth with an overweight position in big biotechs, but this strategic position did not pay off. There has been some recovery in the big biotechs in the first few weeks of 2007, but it is too early to call this a new trend.

Looking forward, Sam says that "in general, valuations are very, very low. We have not seen valuations as attractive as they are today" in either absolute or relative P/E terms, he explains. "This looks very good to us moving forward" Sam says. The trust has fallen to a discount (currently 6.5%, close to its widest level for the last year), and Sam is keen to point out that the board can buy back shares when the discount exceeds 6%, and that it has been using this facility. In other words, he thinks the sector is set fair, that valuations are cheap, and that the trust's own valuation is well supported at this level. Sam doesn't mince his words, and he backs them with action too: "I personally think it's a good opportunity. I bought 100,000 shares myself. I look forward to an NAV advance which I am confident will be quite attractive over the course of 2007." Should we be buying the shares? Possibly, yes. If you believe the foregoing, and it all sounds quite sensible and persuasive, we think, then the shares offer reasonable value. As a CYCLICAL BUY we think the shares could be a useful addition to your portfolio if you do not already have exposure to pharmaceuticals or biotechnology.

INDEPENDENT INVESTMENT TRUST PLC (317p)

Subscribers will know that we like this trust, which is managed by Max Ward. Not only has the trust delivered exceptional returns to shareholders, heading the global growth sector, but it is also run in an exemplary manner, we think. On 26th January the trust released its final results for the year to 30th November 2006, during which the trust lifted its net asset value by 34.2%. The chairman notes modestly that this was "some way ahead" of the 13.8% increase in the FTSE All-Share Index over the same period. Some advantage was gained through gearing, held steady at 15% during the year, but much more of the excess gain came from good stock selection by the manager. The trust fared well from its housebuilders, plus retailers, and both Michael Page and Robert Walters in the recruitment sector.

Over the year, the trust sold down some of its holdings in housebuilding, miscellaneous financials, pharmaceuticals (GlaxoSmithKline) and banking. These sales were made to fund a big increase in the trust's exposure to energy, and the trust also built up a significant exposure to a variety of continental European property markets. The exposure to energy companies, which pay little or no dividends, does mean that the trust's income may drop next year. For this reason the increase in the dividend this time around was a relatively muted 5.9% to take the total payout to 4.5p for the year. The chairman, Douglas McDougall, explained "given that our appetite for energy companies is not yet sated, we think it right to hold to a level of annual dividend that we have a good chance of maintaining even if the switch to lower yielders continues."

Max Ward explains in more detail why he has increased exposure to the energy sector. He says that "for years we have been worried about the availability, price and security of energy supplies to the western world, but have ducked out of doing much about it in recognition of our complete inability to forecast energy prices over sensible investment time frames. However, our background reading over the last year has left us especially worried about the long term outlook for oil supply and the implications that has for all energy prices." Max says the stark fact is that for a decade or more much less oil has been discovered than has been produced (the IEA puts the proportion at about a half), with the result that the world has become increasingly dependent on ageing fields whose useful lives are subject to dispute, but clearly not infinite. He concludes "unless the record on discoveries improves dramatically within a fairly short period of time (no more than ten years, we guess) the risk of supply disruptions will rise significantly. Meanwhile, the IEA has predicted that non OPEC production

will peak within the next five to seven years, leaving the western world at the mercy of producers whose historical interest has been in maximizing price."

In investment terms, this line of reasoning has led the trust to two different categories of investment: (i) exploration and production companies that have a good chance of achieving strong production growth in an environment of high energy prices (tar sands companies and Canadian gas exploration companies); and (ii) companies that will benefit from greatly increased expenditure on exploration (offshore drillers).

We mentioned that the trust is well run. The chairman seems upset to report an increase of costs of 13% over the year, but he does take comfort from the news that as the rate of increase in costs was less than the rate of increase in net asset value, Independent's Total Expense Ratio (TER) declined from 0.32% to 0.26%. Mr McDougall notes "we are pleased that on this measure we are among the cheapest of all investment trusts." The same cannot be said of the trust's rating against its net asset value – Independent is trading on a 5.9% premium to net assets, which is close to its average for the year. It occasionally moves on to a discount, and as the managers themselves note, they are bound to run into a bad patch of performance at some stage. When they do, we would try to buy the shares at asset value or cheaper.

STOCKBROKERS' RESEARCH

Cazenove have met the new co-manager of **JPMorgan Fleming Asian Investment Trust,** Joshua Tay. The brokers explain that he was appointed in an attempt to improve performance and has a proven record managing the JF Singapore Fund and their Thailand Fund. He is a stock-picker, with a self confessed preference for spotting management talent rather than having any particular ability to model companies' financials better than anyone else. Joshua manages the portfolio's stock picking whilst Michael Koh (the existing manager) manages the top down asset allocation. Since being appointed, Joshua has been working to reduce the number of companies in the portfolio in an attempt to provide a more focused and highly concentrated portfolio of 'best idea' stocks. Michael analyses each stock and invests accordingly from a pool of high conviction ideas provided by the JF network of managers who run a stable of country funds. Cazenove understand that the JF stable has an impressive long term track record, whilst this trust has had a variable performance history, and it has been middle of the pack in terms of peers over most time periods. It trades on a wider than average discount.

Cazenove note that performance has been improving since Joshua arrived. He has cut exposure to technology companies which he believes import US-centric risks, which dilutes one of the key themes of emerging markets currently – that of these economies decoupling from western economic cycles. Additionally the number of stocks has been cut to 62 (from above 70). Joshua aims to invest a minimum of 1.5% in any idea and tries to include as many companies that are below the radar of many of the more international investors. In this way shareholders are gaining most from what Joshua believes is JF's core competitive advantage – that of the network of 'on the ground' fund managers who are able to delve far deeper into each market to find interesting stocks. As a result, the portfolio tends to be centred around mid and small caps.

Joshua sees several themes emerging in Asia which he hopes to exploit. These include Chinese and Indian domestic demand, with changing lifestyles bringing a raft of opportunities to incumbents with management talent. He believes for instance that companies with good distribution networks will increasingly be seen as having a highly valuable asset. Infrastructure is also another large growth area, as is the increasing financial sophistication of the banking network in Asia. Joshua believes that personal and corporate lending is set to increase dramatically.

Cazenove conclude "we believe that the managers' approach, combined with the depth of talent at JF from which the co-managers can draw, should deliver good returns over the longer term. The trust stands on a discount to peers (7.8% relative to a weighted average of 5.6%). We believe that there is potential for this to narrow should the managers' performance relative to peers continue to improve. This is the classic "double-whammy" that we look for after a change in manager and is the reason that we rate the trust as outperform."

On 2nd February UBS highlighted **RIT Capital** shares at 966p, saying that the shares offered good value following a de-rating. Back in November the broker had suggested the shares were expensive on a premium of 9%, and they were right. Since then the shares have dropped from 1025p to 966p, a fall of 6%, while Thomson Financial estimate the net asset value has risen by around 6% over the period. The note from UBS concluded "we now think the shares are attractive in valuation terms and there is an opportunity to get into a well managed fund on a discount."

Panmure Gordon have made some changes to their model investment trust portfolio. In its latest quarterly guide, Panmure decided to sell out of **Candover Investments** and to reduce the position in **Baillie Gifford Japan.** To replace these holdings, Panmure advised buying into **Prospect Epicure J-REIT Value Fund, Alliance Trust,** and **MedicX Fund.** Assuming you are familiar with most of these, we thought it might be most interesting to focus on the broker's analysis of the MedicX Fund. Panmure Gordon initiated coverage of the trust last month, with a buy rating and a price target of

120p. The current share price is 108p, and Panmure believes the trust could generate "excellent long-term returns."

The MedicX Fund was launched in November of last year to capture the growing opportunity to develop and operate purpose-built primary healthcare facilities in the UK. Panmure argue this asset class shares certain characteristics with UK gilts: long leases (15-25 years) and the UK government effectively paying the rent, either directly via Primary Care Trusts, or indirectly via rebates to GPs. There is little or no history of default on loans to this sector, as evidenced by the trust's ability to borrow 30-year money at very low rates. Panmure say that even without yield compression, they believe that MedicX's greater spread over its comparable gilt compared with UK commercial property gives it greater defensive qualities in an uncertain market. The trust's long-term returns are projected to be in the order of 8%-10% annualised total return, and yet the manager has accepted a performance fee hurdle at 10%. This strongly suggests the manager believes that returns are likely to be in excess of 10%. Post-flotation acquisitions at better-than-market yields suggest that management is skilled at conducting off-market corporate activity, Panmure say, and by rapidly investing and becoming leveraged, MedicX has avoided the 'blind pool' syndrome that has dogged many new property funds. The trust has bought £70m of third party assets at a weighted average net initial yield of 5.9%. In total it has managed to invest over £116m since its IPO in November, with the balance coming from MedicX Group's own development pipeline.

This sounds fine, but what are these 'primary healthcare' facilities, and why is MedicX a suitable owner? We could do with some more explanation. By primary healthcare, MedicX is really referring to doctor's surgeries. The traditional approach to primary healthcare (GP) services in the UK has been the small partner practice, often run from a converted residential property owned by the partnership. With changes in NHS policy and also rising property prices, the model has begun to change, with the emphasis on modern, purpose-built, buildings that can facilitate a larger practice and perhaps additional services such as a pharmacy, dentist and minor treatment facilities. These types of buildings are typically not owned by the practice. Instead, barriers to successful practices expanding are being removed, allowing GP partnerships to create value as a revenue-generating business, rather than tying up capital in property – this is attractive to a younger generation of doctors who cannot necessarily afford to buy out retiring partner's share in a property. MedicX steps in to take care of the property side of matters – that's the idea. The trust is structured as a Guernsey-domiciled, London-listed, closed-end investment company, which for all practical purposes is the same as a UK REIT, but with the slight advantage that dividends are paid gross rather than net of tax. The trust is expected to pay a dividend of 5p per share for this year.

Arbuthnot analyst Chris Young upgraded **F&C Private Equity Trust** 'B' shares from 'buy' to 'strong buy' on 1st February. We wrote about the trust last month and explained that the 'B' shares are the ones for prospective new investors to consider. Arbuthnot argue the trust is underrated against its competitors, and that the manager Hamish Mair is optimistic for positive returns this year, with underlying companies continuing to make good progress and a steady flow of realisations from maturing funds. With valuations still attractive within the mid-market space, he has maintained a steady programme of new investments through primary funds, selected secondary funds and direct co-investments. Given that the underlying portfolio has generally traded strongly, Arbuthnot say it is not unreasonable to expect this to be reflected in the new NAV. "We believe F&C Private Equity 'B' offers both a highly diversified exposure to private equity funds and access to some of the most successful private equity managers operating in this space. With the shares trading at a significant discount to NAV, we upgrade our recommendation to strong buy (from buy)", Arbuthnot conclude. The 'B' shares at 164.25p now trade on a 1.3% discount to asset value, having been over 5% at the time of the note. Arbuthnot argued this was cheap against the trust's closest competitors, Standard Life European Private Equity and Pantheon International, which trade on a 24% premium and 0.1% discount, respectively. The trust has a comparatively mature vintage and, Arbuthnot say, "provides a unique opportunity to access some of the best-performing private equity investors and their proven franchises. With concerns over competitive pressures pushing up prices within the larger buyout space, we believe this fund has impressive defensive attributes, as it invests predominantly in the European mid-market space, which remains generally inefficient and continues to offer attractively valued investment opportunities. It also offers significant diversification with exposure to over 200 companies via 40 funds. While sceptics will point to the exposure to double charging, we believe that this is more than offset by the fund's diversified mix and defensive qualities. We anticipate a re-rating in the stock as newsflow improves and the strategy demonstrates a reliable track record of strong realisations and recapitalisations."

Interestingly, Arbuthnot focus in the note on one of the trust's most exciting investments, in Dakota Minnesota & Eastern Railroad (DME). This is a regional railroad operating company in the US with just over 1100 miles of track. It traded strongly in 2006. The equity shareholders; F&C, Candover and Electra, who have all held the company for a long time have stated their intention to exit via a trade sale or IPO. Hamish Mair expects this to occur this year. While it is public knowledge that DME is still awaiting the decision on a US$3bn federal loan to fund the extension of the railway, the note says "there is every reason to remain optimistic, given President Bush's recent state of the union address and the railway's strategic importance in the transport of ethanol for alternative fuels. If the loan is granted, it is likely to enhance the returns to equity

holders." And Arbuthnot point out that DME is far more important to the 'A" shares of F&C Private Equity. At current carrying values, the holdings represent 3% of the 'B' share pool and 40% of the 'A' share pool. The equity valuation could range from US$480m-US$720m, which in Arbuthnot's view is not unrealistic given the company's strong trading last year and valuations of quoted comparables. At the opposite ends of the range, there could be an uplift of between 2.4% to 4.9% for the 'B' shares and between 36% and possibly as much as 70% for the 'A' shares. These figures suggest that perhaps the 'A' shares are worth considering too.

WINS published a note on **Merrill Lynch New Energy Technology** on 25th January. The trust is one of the broker's core long-term recommendations. At the time of the note the £117m trust stood at a 1.8% premium to its net assets, with the shares at 53p (now on a 4.4% premium at 58.25p). You will probably know that this trust, managed by Robin Batchelor and Poppy Allonby, invests purely in alternative energy companies. Of course there has been a lot of interest in this sector over recent times, fuelled by government incentives, higher oil prices and an increasing focus on the problems of climate change. WINS believe that the trust is "an attractive way to gain exposure to this specialist area."

The last few years have seen significant changes to the portfolio which at launch in 2000 was focused on fuel cell producers. Now, the largest exposure is to solar (20%), wind (25%) and ethanol/bio-fuel companies (13%). Over the last few years, the investable universe has seen significant expansion and the management team now estimates that it has grown from 350 to 950 companies, including 500 quoted companies with a combined market cap of US$500bn. The portfolio has seen a number of changes in the past year including an increase in the number of holdings from 40 to around 70 stocks. This is partially as a result of small positions taken in early stage companies, but it also reflects the expanding universe which has seen nearly 50 IPOs in the last twelve months. The managers now have more choice.

Another change is the reduced exposure to North America which eighteen months ago accounted for around two thirds of assets. Now 38% of the portfolio is in the USA with 8% in Canada, 41% in Europe, and a growing component in Asia. In terms of the underlying portfolio, two thirds of the fund's NAV is invested in companies that are net income positive and around 20% of the portfolio is invested in companies that pay dividends. Valuations within the universe vary significantly as reflected in the price earnings ratios of the top ten holdings at the end of October. All but one were profitable with price-earnings ratios ranging from 11.5x for Archer Daniels to 34.2x for REpower, with the majority in the mid-20s.

The managers say that fundamentals remain strong with wind power expected to grow by 21% in 2007 and solar power by 25%. Wind power is the most cost competitive alternative energy with traditional energy sources and consequently there has been significant growth in the sector. This is particularly true in the US where installations grew to 2,431MW in 2005, compared with 368MW in 2004, and are expected to have reached over 3,000MW in 2006. Wind companies represented the largest part of the portfolio (25% at October 2006), with holdings including Gamesa, Vestas Wind and Clipper Windpower, which has signed a $4bn agreement with BP. Solar (20% of assets) is also experiencing substantial growth, led by the US. Traditionally the solar market has been orientated around Germany, where it is subsidised, and Japan, where it is cost-competitive without subsidies due to high electricity prices. However, legislation in France, Spain, China and California has seen greater demand from these markets. The fund's key holdings include Solarworld, Renesola, SunPower and Suntech, a Chinese company in which the fund participated in the initial public offer.

Merrill Lynch New Energy is a great example of how even the best of ideas can take some time to pay off. Back in 2002 the shares had slumped to 12.5p, on a discount of no less than 37%. Times have since changed, and environmental trusts are very much in vogue. The shares have generally traded on a small premium for the last eighteen months. WINS note the changing emphasis of the trust's portfolio, which has moved with the times. Their view is that "the long-term story remains strong for alternative energy and there is substantial potential for growth over the next decade. In addition, we are encouraged by the increasing number of companies that are profitable." Within the investment trust sector, the only other funds providing significant exposure to alternative energy are Impax Environmental and Jupiter Green, although both have broader mandates that include investment in utilities. Merrill Lynch New Energy is what the brokers call a "pure play." One final note is that the trust is likely to be re-branded in the course of 2007, to reflect the merger of Merrill Lynch with BlackRock.

The brokers Fairfax issued a note on **Small Companies Dividend Trust** on 27th January, titled 'Star performer in a crowded sector.' At present the £62m trust, which is managed by Chelverton Asset Management, does not hit many investors' radar screens, and does not figure in comparative tables of traditional investment trusts because it has a split capital structure. Yet the trust has outperformed the FTSE Small Cap (ex Investment Trusts) Index in each of the last seven years since launch, and it has an unbroken record of dividend increases in excess of inflation. Since launch, the NAV of the ordinary shares has risen from a starting level of 96p to a high of 255.52p in early January. The forecast dividend for the current year ending 30th April 2007 is 13p, which represents a flat yield of 5.5% on the prevailing mid market price of 236.5p. The interesting point here is that the trust will convert to a conventional structure at the end of April, when it repays its zero dividend preference shares. At this point

it might attract more attention. The zeros, by the way, have always had the luxury of being well covered throughout their life and their final redemption value of 184.63p per share giving rise to a final liability of £11.54m is currently covered nearly three times, even after including the prior charge of some £9.48m of bank debt.

Fairfax point out that if this trust were treated as a conventional trust rather than a split, its shareholders' funds performance ranks it 16th out of 26 trusts over the past year, 13th out of 25 trusts over the past three years and 1st out of 22 trusts over the five year period. The brokers conclude "we therefore believe that this underlines our views that once the trust reverts to a conventional capital structure with only ordinary shares in issue, post the repayment of the ZDPs in April, the rating should improve as investors realise the strength and consistency of the shareholder returns that have been delivered." The current discount is around 9%. It is important to note that the trust has a very healthy revenue reserve, which should allow for the continuing payment of the high yield even after the gearing from the zeros is removed.

Teather & Greenwood have pointed out that **JPMorgan Fleming Russia** looks good value on a discount of 10.6%. The broker says this is "excellent value for such a vibrant vehicle." The macroeconomic picture remains strong in Russia, and the re-firming of oil prices will underpin further equity growth, Teather says. Russian equities continue to recoup the drop recorded in late 2006, and the market does not contain the bubble-like features associated with China. Despite this, and a fundamentally better performance profile, Teather conclude "it appears somewhat strange that many of the Chinese funds of this world should retain premium ratings and yet JPMorgan Fleming Russia does not."

Dresdner Kleinwort have produced their annual review of investment trusts, which is always an impressive read. In it, the brokers have addressed the changing landscape of the sector. They say that the industry has undergone a radical transformation in recent years with ongoing corporate activity and strengthened governance key drivers. "The sector has responded well to changing investor appetites", Dresdner argue, "and this has resulted in the spectacular growth of the property and fund of hedge fund sectors, with a combined market cap now comfortably in excess of £9bn, and more recently infrastructure." Dresdner expect more specialist launches moving forward, and explain that recent FSA proposals, which seek to modernise the listing regime, could result in more alternative investment funds choosing the London Stock Exchange over Euronext. We may all have our work cut out to get to grips with all the newcomers and to gain sufficient understanding to maximize the opportunities which become available.

NEWS ROUND-UP

Alliance Trust has a new chief investment officer. Katherine Garrett-Cox, apparently known in the City as 'Katherine the Great', has joined the trust to help develop its third-party fund management business. She joins from Morley Fund Management, which has £162bn of funds under management. As we have previously reported, Alliance is building its add-on businesses in an attempt to add value beyond investing its own funds, and this coup adds considerable momentum. As Katherine Garrett-Cox comments, she is joining Alliance at "a decisive moment in its development." In time we think Alliance can add extra streams of revenue to its core business, as some other trusts have. Perhaps it will be a few years before these really change the face of Alliance, but this latest appointment proves the trust is serious. On an 11.4% discount to net assets, almost in line with its 12-month average of 12%, the trust does not yet appear to be discounting any extra future value. We think the shares offer reasonable value at this level, although the underlying investment performance has been lacklustre of late.

The fund of hedge funds, **Alternative Investment Strategies,** is seeking to expand through a 'C' share offer, as are a number of other trusts. **International Biotechnology Trust, Gartmore Growth Opportunities,** and **New City High Yield** (which is also changing its domicile to Jersey) are amongst the other trusts chasing more funds. Whilst 'C' share issues used to be rare events, the increasing number of trusts trading at a premium to asset value make this a more common possibility.

The discount to net asset value on **Blue Planet Financials Growth & Income,** which we have been harping on about for some time, has narrowed significantly to 15.3%. Investors have fared very well from this trust, which has been a top-performer alongside its two sister trusts. Is it time to take a profit? We think perhaps not quite yet. A discount in excess of 15% for a trust which has delivered a rise in assets of 33% over one year and 143% over three years still looks mean. And against its sister trusts (Blue Planet European, 8.3% discount; Blue Planet Worldwide 13.4% premium), the rating just does not stack up. We would keep HOLD of the units (ticker code BPFU) at 276.5p for a while longer.

Dolphin Capital Investors, the specialist European property company, has committed more funds. At the start of February the trust announced its first investment in Croatia. The company is investing EU35m in a project at the Livka Bay Resort, on the island of Solta, Croatia. Dolphin will have a 90% holding in the project, which is a 56-hectare site with a luxury hotel, a 160-berth marina and other supporting recreational, sports and retail facilities. The development is currently receiving the necessary permissions for construction, which is expected to start in the second half of 2008. Dolphin Capital Investors is pressing on with the investment of its assets at a faster pace than some other overseas property trusts, which is a good thing, and the news has been well received

by the shares. Dolphin Capital shares have risen very steadily from 85p in September to 129p now. We do wonder how much higher they can go in the short-term, but holders can ride the momentum for now.

Gartmore European, managed by Roger Guy, has for quite some time had an uncomfortably large arbitrageur holding on its share register. Now Carrousel Capital, the trust's largest shareholder, has decided to act, and has proposed the appointment of "a number of" new directors which it would nominate. The trust's AGM has been postponed to some time later this month, to allow this proposal to be considered. The ultimate plan, presumably, is for Carrousel to exit at net asset value, but there seems little to be gained from costly corporate action now. The trust's shares are trading on a discount of 2.8%, having averaged just 4% over the last year – actually a very good rating for what is at present a middling trust in performance terms. We are not sure this move has much in the way of implications for existing investors, unless you were thinking of selling (in which case you may wish to wait and see if there is an exit tender).

Henderson Opportunities Trust has completed its transformation, change of name (from Henderson Strata), and issue of subscription shares. These new securities, which are like warrants but can be put in an ISA, have started trading close to the value we expected. At present we rate them as fair value at 108.5p against the ordinary shares.

Insight Foundation Property Trust has changed its name to **Invista Foundation Property Trust.**

Warrant holders in **Merrill Lynch World Mining Trust** will have received an exercise notice recently. This relates to this year's exercise opportunity, with two more still to come. There is no need to do anything, and it would not be rational to exercise at this point. Holders should either sit tight or sell in the market at 48p. Although the 'stepped' exercise price means the shares must move higher for the warrants to have value in the future, we think we would be inclined to HOLD the warrants for now.

SVM UK Emerging has been one of the best performing trusts at the start of 2007. The shares started the year at 51p and have stepped up to 60.5p, rather surprisingly on a 3.1% premium to asset value. This is unusual for the UK smaller companies sector, but SVM Emerging is an unusual trust, with just £3.1m of assets. The obvious lack of liquidity is responsible, we think, for what appears to be a revaluation of unwarranted strength.

Templeton Emerging Markets is holdings its open meeting for shareholders just as this newsletter is written. This meeting is part of the trust's broad consultation on its future following criticism from its key shareholder City of London. The board expects to report back on its conclusions by the end of the first quarter, and we shall see what transpires. Some kind of tender opportunity to allow shareholders an exit is a possibility, as is a formal discount control mechanism. In the meantime, the discount to net asset value on the shares has narrowed to 7.5%, which we think is not a bad rating for any investors thinking of running for the doors now. You could SWITCH now into Advance Developing Markets, which has a superior track record and yet a wider discount of 8.4%.

Dr Mark Mobius, the manager of the Templeton trust, has not been able to deliver exceptional returns against the peer group, and it might be that the sheer bulk of this £1.8bn trust is a handicap against smaller and nimbler trusts. We would not take anything away though from Dr Mobius's knowledge of emerging markets, which is encyclopaedic. In a question-and-answer session with readers of the Financial Times this week, Dr Mobius said that he rates South Africa, Korea, Taiwan, China, and Turkey as emerging markets where he is able to find attractive companies. These are the markets where the fund is overweight.

More generally, Dr Mobius is quite positive on the outlook. He says expectations of a soft landing in the US economy, a pause in US interest rate rises and an improved global environment should support emerging markets. "The role of emerging markets in the global economy has grown significantly in recent years and we expect this trend to continue in the future. While companies have recorded significant price appreciation, corporate earnings have also increased allowing valuations to remain attractive," he says. "The opportunities are plentiful with strong fundamentals supporting the long-term uptrend of these markets. Moreover, many companies are experiencing strong growth and there are many upcoming IPOs in markets such as China and Russia which warrant attention." We agree that global emerging markets are still an essential component of many portfolios – but perhaps not through Templeton Emerging Markets any longer.

The next issue of Investment Trust Newsletter is published on Saturday 10th March.

START OF YEAR RALLY CONTINUES INTO FEBRUARY

The FTSE Equity Investment Instruments Index is up 177.9 points (3.13%) to 5860.7 since the last newsletter.