Investment Trust
NEWSLETTER

OCTOBER 2002

Investment trusts are cheap. This is not us calling the bottom of the market – we'll leave that to others – but simply noting how the average discount to net assets has widened out to around 15%, which is wide in historic terms. There are bargains about.

It should go without saying that you need to tread very carefully. Trusts investing in UK smaller companies and in the technology sector continued to suffer last month, with more significant falls belying the additional protection and comfort which is meant to come from diversified portfolios. **3i European Technology, Edinburgh Small Companies, AIM Trust, Eaglet, Merrill Lynch New Energy, Finsbury Technology, Henderson Strata,** and **Polar Capital Technology** were amongst the worst declines over the month, all dropping by more than 20%. In most cases we believe values will recover, but in the meantime there is no doubting the unease which will be felt by many holders who have seen prices falling steadily. Our advice at this point is quite simple. It's too late to panic, and on most measures, stock markets now offer good value which will be recognised at some point. If your age and circumstances allow you to take a long-term perspective, this looks like a bad time to sell (and possibly a good time to buy).

Again this month we have tried to cast the net widely in search of ideas and suggestions in the hunt for the best value. Emerging markets have been performing relatively well of late, so we were pleased to meet the doyen of the sector, Dr Mark Mobius, for an update. As usual, we provide a round-up of stockbrokers' research and of trust news – of which there is plenty.

EMERGING MARKETS AND ASIA

Average prospective P/E ratios for companies in emerging markets are around nine times, compared with around 16 for Europe and the US. This really explains why investors should like emerging markets, according to Dr Mark Mobius, the manager of Templeton Emerging Markets Investment Trust. They combine higher growth rates with lower valuations. We met Dr Mobius at a recent AITC lunch, where he examined the prospects for emerging markets in considerable detail.

Starting with economic growth, Dr Mobius explained that emerging markets "have consistently outgrown developed markets", even though the gap narrowed during the Asian crisis in 1998. Now they are growing much faster, at an average rate of around 4.25% against 1.75% for developed markets. There are laggards of course, and these countries tend to receive the most publicity. Venezuela, and most notably Argentina, are suffering badly from recession at present. At the other end of the scale, China, India, Korea, Malaysia, the Philippines, and Russia are all seeing annual GDP growth of 4% or more, in spite of the considerable drag of the US economy. China is remarkable, with GDP growth running at 7.6% and new spending power starting to flex its muscles in the domestic economy. Dr Mobius gave the example of the high fashion Prada store in Shanghai which has recently trebled its floor space.

In part the growth in emerging markets has been export-led, and there has been a good pick-up in exports from Eastern Europe, where the year-on-year growth rate is now around 5%, and from Asia, where the growth rate is even better, at 7%. Many Asian economies are, ironically enough, reaping some benefits from the currency crisis of 1998 when their currencies were devalued. That has made their exports cheap. This same phenomenon has more recently given South Africa's exports a kick. For the year to July 2002, South African export growth was a remarkable 28%.

The reason why export growth is generally less exciting than this, however, is that the US remains the prime market. And its engine is on idle. The US is the market for just over 20% of all exports from Asia, although dependence on it is lessening. China is steadily growing as a destination for goods, up to nearly 8% of the total (it has overtaken Japan in the process).

If the US economy starts to grow again, this would undoubtedly be good for Asia and for emerging markets in general, and in the meantime there

Valuations sink as markets fall again; lunch meeting with Dr Mark Mobius, manager of Templeton Emerging Markets; good results from Aberdeen Asian Smaller Companies; wide discounts provide some opportunities; 3i Group rated a buy by three stockbrokers; Old Mutual like Rights & Issues; HSBC watching City Merchants High Yield; UBS Warburg guide to Japanese trusts; Williams de Broe update their lists of favoured trusts; fund manager changes at 3i European Technology, Edinburgh Dragon, and Henderson Smaller Companies; director buying accelerates; Aberdeen Preferred Income goes into administration; news of several reconstructions; poor results from TR European Growth.

are some leading indicators which suggest better times ahead. Emerging markets money supply, which is strongly correlated with market performance, has been rising, and Dr Mobius says he "expects further strengthening." These figures look especially promising for markets such as South Africa, China, and Korea, where money supply is growing roughly twice as fast as in the UK and US. OECD leading indicators have also turned up from their worst levels, although they have been consolidating again of late. Finally, the yield differential between emerging markets bond yields and US Treasury bonds has been narrowing, indicating that investors are starting to perceive emerging markets as less risky – comparatively speaking. The strength of some emerging markets is often under-rated. In terms of currency reserves, for example, China, Taiwan, and Korea have reserves way in excess of the US.

The strength of some emerging market currencies might lead to pressure for some currency revaluations soon – a reversal of what happened during the Asian crisis – and in due course this might make it more difficult for some economies to rely on export growth to drive their economies. As Dr Mobius explains, "they may need to look beyond their mercantilistic approach" to develop their domestic markets. This would in effect be a shift to Phase II of emerging markets growth.

Turning to the performance of stockmarkets, emerging markets have outperformed developed markets over the last year, meaning that they have fallen less. That said, they remain a long way down from their peaks of 1996 or 1997, with plenty of scope for recovery. The Korean market, for example, would need to rise by 64% to recover its peak levels, Chinese 'H' shares by 254%, Taiwan by 89%, Thailand by 382%, South Africa by 59%, Turkey by 493%, and Russia by 69%. For comparison, the same calculations for the US and UK produce figures of 66% and 71%. Whilst there is no guarantee at all that previous peaks will be scaled and conquered, these are interesting figures which give some idea of the potential for very significant rebounds.

Forecasts for earnings growth over the next twelve months certainly look attractive, especially for Asia where they are expected to leap ahead by around 30%. The figure of 20% for Latin America is also high. Eastern Europe, at 5%, is dragged down by Poland, where the outlook is not good. Overall the data for emerging markets averages out at around a 26% forecast growth rate, compared with 23% for Europe and 18% for the US. And of course emerging markets companies are rated far more cheaply. Prospective P/E ratios of 19.5 for the UK and 16.5 for the US are much less attractive than 9.9 for Thailand, 7.8 for South Africa, 7.2 for Russia – where Dr Mobius adds some companies are trading on just three times earnings – 7.1 for Korea, and 6.7 for Turkey. Other indicators such as price to book value tell the same story.

So why are these markets so cheap? Risk is the answer. The perceived risks are high – critics will point to the monetary mess in Argentina, to political scandals and uncertainties, and to weak corporate governance. These are all fair points, but it is also fair to point to Mr Bush's aggressive position on Iraq, and accounting scandals at Enron and WorldCom. Perhaps there is a case to be made for a reduction in the 'risk premium' which investors need to consider investing in emerging markets.

Since inception in 1989, Templeton Emerging Markets has produced annualised total returns of 10.5%, comfortably outperforming both the MSCI emerging markets index and developed markets, including the FTSE 100 Index. The trust's value approach to investment has undoubtedly helped. Value investing is back in fashion now that the technology bust has injected a new note of realism, and Templeton is a well-known exponent. The trust refused to get sucked into highly-priced growth stocks even at the height of the technology boom, and this natural conservatism has served it well. It can be seen in the portfolio now. The average P/E ratio for the 102 stocks in the trust's portfolio is 11.8 times against 15.1 for the MSCI emerging markets index; the average price to book value in the portfolio is 1.3 times against 1.5 for the index. The portfolio yield is 3.2% against 2.4% for the index.

Whilst the value approach is an imperative, it is more difficult to say whether the trust is a top-down or bottom-up investor. Rather, the trust's management approach is an amalgam, overlaying careful macroeconomic and political analysis, and then having a hands-on local approach to selecting the best companies in each country. "It really helps to have people on the ground" Dr Mobius says, "not so much for picking winners, but in keeping us out of trouble." The investment approach could become even more hands-on if Dr Mobius gets his way. He believes the trust should start to seek board positions with its investee companies.

Favoured countries in the portfolio are China, Thailand, Turkey, and Indonesia. The trust is underweight in Taiwan and Korea, where technology plays are important. By industry, three significant overweight positions are interesting. The first is in telecoms, in many ways a scourge of the developed markets, but actually very attractive and successful in emerging markets. The trust holds companies such as China Mobile and Telmex. Second is beverages. Beer and soft drinks are key products for domestic spending in emerging markets. Third is electric utilities. The demand for electricity is increasing rapidly in many countries as these economies grow and as services like internet usage grow in popularity. The top ten holdings are SAB Miller (South Africa), Sinopec (Chinese 'H' share), Telekomikasi (Indonesia), Siam Commercial Bank (Thailand), Cemex (Mexico), Akbank (Turkey), Korea Electric (Korea), Tupras Petroleum (Turkey), Gedeon Richter (Hungary), and KT Corporation (Korea).

We asked Dr Mobius, who has a very strong personal reputation, whether his recent step down from the board of the trust

held any implications for his ongoing management. He said not. He was replaced on the board by an independent director – and it was this quest for greater independence on the board which triggered the change.

Overall, we think the prospects going forward look reasonable for the trust, and as part of a diversified portfolio we can certainly see that the shares, trading on a discount of 19.3%, make a sensible enough holding. In addition to topping the sector performance tables over five years, Templeton Emerging shares are easily the most liquid in the sector. They are trading on a dealing spread of 86p-87p.

For investors looking for an alternative, or just another trust to consider, **Genesis Emerging Markets** has posted a good performance in its sector, just behind the market leader Templeton over five years, and well ahead over three years. Cazenove met manager Richard Carss and his team at a recent analysts presentation. The managers explained that as the trust is not managed alongside any specific index, the international asset allocation is down to investment style. In 2002, the trust has invested in Malaysia and South Korea. Overall, 41.2% of assets are in Asia, with 24.1% in Latin America, 13.9% in Africa and the Middle East, and 13.7% in Europe. Generally the managers are positive on the prospects for emerging markets. They say that companies made improvements to their infrastructure following the crisis in 1997, which led to cost-cutting and a better allocation of capital, resulting in a higher return on equity for investors now. Valuations are currently attractive, the managers argue, especially as emerging markets have de-coupled to some degree from the US. They note that the MSCI Emerging Markets Index has grown by 2.5% in the last 12 months compared with the S&P 500 Index down by 19.2%. Cazenove say that "currently trading on a discount of 18.4% compared to the sector weighted average of 17.7% it looks reasonably priced given the recent good performance. We would recommend the stock as a long-term buy."

It is notable that Asia is the preferred region for most emerging markets specialists, and this seems to be where the real growth is coming from. There are a number of trusts worth considering in Asia, and it is nice to be able to write about a success story for a change. **Aberdeen Asian Smaller Companies** announced its final results on October 3rd for the year to 31st July, and they confirmed just what an excellent job Hugh Young and his team have been doing. Over the year, net asset value rose by 19.3% compared to a fall of 3.5% in the MSCI AC Asia Pacific ex-Japan Index. That's a huge outperformance. The 'value' discipline of the trust has helped, and is reflected in the composition of the portfolio. The average P/E ratio of the stocks in the portfolio, based on 2002 estimated earnings, is 11.6. The average price to book value of the stocks in the portfolio is 2.1 with a return on equity of 15.9% and a dividend yield of 5%. The manager says he "continues to identify companies with solid earnings and strong balance sheets" and that "valuations remain very attractive in the region, highlighted by the presence of numerous good-quality and well-run companies that work to create value for shareholders, offer good dividend yields, and are not highly leveraged."

Looking in more detail at why Asia has been performing better than developed markets, the managers explain that the reasons are two-fold - one economic and the other to do with valuations. On the economic front, they say, "Asia's bubble burst some five years ago. Since then, its governments, corporates and individuals have been busy rebuilding. Reforms have been put in place, companies have restructured and balance sheets are now extremely healthy. When this backdrop is allied to low stock valuations, the potential for profitable investment is high - and that is what transpired over the past year." Demand from the US could be a drag in the immediate future, but the managers still expect corporate restructuring to "drive stock prices higher."

A strong domestic demand story in Asia, coupled with rising capital inflows, has helped the region's markets de-couple from the sell-off in the US. Economic growth throughout the region has broadened out, reflecting encouraging trends in both domestic consumption and traditional exports. "Even more encouragingly", the managers conclude, "the health of the corporate sector has improved dramatically due to effective cost cutting and more efficient use of capital resources."

The trust's biggest positions relative to the size of the respective markets are in Indonesia, Malaysia, Thailand, Singapore and India, while its lightest exposures are in Australia and Taiwan. By sector, preferred areas are in consumer staples like food, beverage and tobacco, while its most significant underweightings are in banks and electronics. "Simply put we like the visible cheap steady stocks like Unilever, Heineken and BAT (affiliates of all of which we own), whilst being wary of cyclical electronic manufacturers, particularly when it comes to small companies, and of smaller financial institutions without the necessary muscle." Following the previously announced board decision to raise the trust's initial market capitalisation limit to US$600m from US$250m the manager was allowed to introduce positions in Marco Polo, a Singapore real estate company trading at a steep discount to net value, Hong Leong Singapore Finance, to all intents and purposes a bank, in Singapore, cement company Grasim Industries in India and Carlsberg Brewery in Malaysia.

The trust is a star. Over the last twelve months, assets are ahead by more than 25%. Not surprisingly, the trust is ranked first out of 15 peer group trusts over the last year, and it is first out of 12 trusts over five years. Yet at 105.5p (dealing spread 105p-106p), Aberdeen Asian shares trade on a discount of 14.1% - barely narrower than their average for the last twelve months, and provide a gross yield of 2.8% into the bargain. We rate the shares a buy – and we'll just note too that there are some long-dated warrants for the brave.

DISCOUNTS

We have said in this newsletter many times that it can be unwise to make investment decisions on the basis of the discount (or premium) alone. Do not forget that seemingly anomalous positions can be corrected in three ways – by the shares moving, by the assets moving, or by the goalposts moving. With that caveat in mind though, there are a few examples now of trusts which we have mentioned in these pages before, which do seem to be trading on very attractive discounts indeed. How about Gervais Williams' **Gartmore Growth Opportunities** smaller UK companies trust on a 25.1% discount? Or **Framlington Innovative Growth** on a 24.9% discount? Or **North Atlantic Smaller Companies** on a 31.0% discount? Or **Capital Opportunities Trust** on a 35.4% discount? If you believe this is the right time to invest you can certainly get a lot for your money at the moment. And one thing you can be sure of: as soon as markets rally convincingly, these discounts will snap shut.

NEW ISSUES

New issues are comparatively thin on the ground at present for obvious reasons, but we do have some advance information on at least two offerings which are planned for the period between now and Christmas. A new fund management company called Iimia plans to launch a £30m investment trust of investment trusts, to be managed by trust expert Nick Greenwood, formerly with Christows. The trust will target absolute returns and will be benchmarked against cash. Mr Greenwood notes that there are some wide discounts at present, of a size which occurs only once every few years. We also know of a property trust which is on the blocks and which promises to be major launch: we hope to reveal further details next month.

STOCKBROKERS' RESEARCH

At an analysts briefing before it entered its pre-results close period, **3i Group** confirmed that its net asset value should be between 540p and 570p. Credit Lyonnais had estimated 550p earlier in the month, which was obviously accurate, although the brokers noted there should be a number of revaluations or devaluations before the end of the financial year (30th September) figure is calculated. "Until then", Credit Lyonnais conclude, "3i remains attractive given its double-digit discount to net asset value, even without accounting for any value attributable to the 3i business." They sound a note of caution on the company's high correlation with the market, but otherwise feel comfortable reiterating their buy stance. Their price target is 625p. Merrill Lynch published an in-depth report on 3i Group on 18th September, and another flash note on 24th September. Their 12-month price objective is 700p, which they say represents the company's prospective book value including the third party asset management. They go on to say "we would stress that at this level, 3i would in our view still be very seriously undervalued. Risks include economic weakness, and further market falls." UBS Warburg also rate the shares a buy, saying that the share price has already discounted a substantial amount of bad news going forward, and calculating a fair valuation of 558p-568p. The shares are currently 407.5p.

Old Mutual Securities point to an opportunity for brave investors – a capital share. **Aberforth Split Level** capital shares were trading on a discount of 13% (now 10.6%) at the time of the suggestion on September 26th. The brokers said "this looks attractive given that a cash exit is promised in two years at close to NAV. Over and above the cash potential, Aberforth have the best small cap team in the country and we anticipate continued outperformance of the benchmark going forwards. How many trusts have posted 9% NAV growth over the last 12 months?"

Old Mutual have also praised, at some length, **Rights & Issues Investment Trust.** Since Simon Knott became manager of the trust 18 years ago, the brokers say "he has outperformed the FTSE All Share by 7% per annum and consistently increased dividends on the income shares. This has been achieved with minimal use of gearing. The strategy is essentially based on the avoidance of error, the need to understand every business in which he invests, and a focus on companies with high turnover relative to market cap, alongside superior margins relative to sector." He would rather invest in a £10m market cap company with good management, they explain, than a £200m company with average management. There are no size restrictions imposed on the manager and he prefers to invest in companies that he can hold for five years at least without need to monitor them constantly.

Any restrictions on where or in what he invests are self imposed, though he does seek board approval to make unquoted investments (which are minimal). There are no overseas stocks, no "fashion" stocks, and very few FTSE100 stocks. Old Mutual say "his strategy is clearly one that works and the manager made clear that he has absolutely no intention of changing it." They conclude that "Knott thrives on having complete flexibility of investment style and time management. We expect the trust to continue posting strong performance." It is also worth noting, in terms of motivation, that the Knott family has much of its wealth tied up in the trust. At the time of the note on 24th September, the *Funddata* income share net asset value estimate suggested a 10% premium at 470p. This is hard to swallow at this time, but Old Mutual argue that "given the high yield on the shares, the quality of the portfolio, track record of the manager and scope for capital growth, [the premium] seems like a small price to pay for such a high quality income stream." If this trust takes your fancy, we would suggest sending off for the Annual Report for more information.

HSBC have identified **City Merchants High Yield** as a 'stock to watch'. A note published on 8th October said "recent weeks have seen a fairly notable weakening of this trust's premium status, with the trust currently trading virtually at par (+0.2%) with its NAV. This comes despite the still relatively hefty premium enjoyed by Glasgow Income Trust (even allowing for last week's issuance of stock) and, more crucially, similar values on offer within a weaker performing UK Income Growth sector." This is in spite of lower yields from other trusts, and inferior capital performance. Indeed, aided by its strong cash bias (45% at end-September, with some cash having been reinvested over the course of the previous month), City Merchants High Yield has delivered a drop in NAV of just 8% over the last quarter (and a positive return over the first half of 2002). This contrasts with a comparatively hefty (market capitalisation weighted) loss of 21% delivered by the UK Income Growth sector. HSBC's argument is that the slippage in City Merchants' premium rating over recent weeks has been "unjustified on both a relative and absolute basis. Market participants continue to cry out for high-yield, lower-risk products at a time of continued insecurity. This heightened level of uncertainty has also created investment opportunities for City Merchants in the high yield sector with yields on specific companies (with weaker prospects but at no risk of default) also climbing, creating the capacity for opportunistic investment as cash is gradually reinvested by the trust."

In the UK growth sector, HSBC rate **Liontrust Winners** as a buy. The trust is ranked sixth out of 28 trusts over the last year in the sector. The trust has an active, highly concentrated stock selection process based on upward market expectations and/or profit growth levels in relation to specific stocks. It seems to work, and over the last quarter, HSBC say the trust has lost less than half of its peer group average net asset value. On a discount of 13.4% the shares do not look expensive.

UBS Warburg have produced a guide to trusts investing in Japan. The brokers say "there has been increasing investor interest in Japanese investment trusts", adding that their own strategists are bullish. Their forecast is for the Nikkei 225 Index to rise to 11,000 by the end of this year, from the current level of 8700, and for a further rise to 12,000 by the end of 2003. The report does not recommend specific trusts outright, but its analysis points investors with certain requirements in the right direction. **Atlantis Japan Growth** is highlighted for its adaptable management style, producing consistently strong performance from a highly diversified portfolio of companies. **Baillie Gifford Shin Nippon** is favoured in the smaller company realm because of its consistently strong relative performance which has come from good stock selection. **Fidelity Japanese Values** is for those seeking high gearing – actual gearing is typically maintained at between 125% and 130%. **Fleming Japanese,** the largest and most liquid trust, is UBS Warburg's highlighted trust for larger company exposure. **Schroder Japan Growth** is also mentioned as having a strong relative performance, derived from a diversified portfolio of stocks in terms of market capitalisation.

UBS Warburg continue to rate **Candover** a buy following its interim results to 30th June. The venture capital trust's net asset value came in at 1072p, which was slightly below forecasts of 1095p. This figure was based, however, on PE multiples up to 19th August, so it was based perhaps on a lower multiple that would have been the case earlier. Net assets fell by 4.9% over the six months, during which the trust realised five investments. Looking forward, the managers expect few realisations to the end of 2002, but they are preparing a number of possible IPOs or other sales for the first half of 2003. UBS Warburg reduced their fair valuation for Candover after the results from 1250p to 1200p, but continued to rate the shares a buy.

European Growth & Income is a very small trust now that it has repaid its outstanding bank debt of £13.07m. The debt-free trust has been left with assets of just £7.4m, around £5.2m of which is invested in European equities, £1.3m in an split-capital investment trust portfolio, and £0.9m in bonds. Cazenove say the bombed-out zeros are "worth a look." At the time of their comment on 17th September the zeros at 6.5p were trading on a discount of 56% to the assets of 15p per share even if the split holdings are written down to zero. "This is clearly excessive", Cazenove said, pointing out that if the assets did not change for the next four years, the zeros would boast a gross redemption yield (GRY) of 25%. Assets could fall by 19% per year before zero holders would lose money, and even accounting for the costs of running a small trust eroding the asset base, Cazenove rated the zeros a buy. The zeros have since moved up to 8.25p and the assets (including the splits) down to 14.26p, so the case is less convincing now, but an interesting one to follow nevertheless. You can check the latest figures on www.splitsonline.co.uk.

Williams de Broe have produced an update on their favoured trusts in three risk categories. Two changes have been made to the low-risk funds list. The first is the replacement of **JPMorgan Fleming American** with **North Atlantic Smaller Companies.** "Both are good funds", the report says, "but North Atlantic, run by Christopher Mills, has not only performed somewhat better, but now stands at a discount to NAV of approximately 28%, as opposed to around 9% for the Fleming fund." The second change is the addition of **Schroder Japan Growth.** Analyst John Newlands says that "investors in Japan have suffered grievously for over a decade now, and we believe that, at long last, selective good valuations are to be had. We have chosen the Schroder fund not just because of its consistent upper-quartile performance, but also because its manager, Denis Clough, adopts a considered stock-picking approach based upon two decades of investing in the region." **Fidelity European Values** is removed to make room for this inclusion.

In the medium-risk selection, Williams de Broe have added three new investment trusts: **Aberforth Smaller Companies, City Merchants High Yield** and **Schroder Japan Growth** again. Aberforth's solid record is reason enough for its inclusion, and City Merchants High Yield is called a "rare animal" for meeting its dual objectives of generating both high income and capital growth. "Even over 2002 to date, during which the FTSE All-Share Index, yielding less than 4%, has fallen by more than 25%, the trust's managers have succeeded in increasing NAV total return marginally (+1.2%). This was achieved while maintaining a dividend yield in excess of 8% at the current share price. The trust's long-term record is similarly impressive", the note explains. To make way for these new selections, **TR European Growth, Invesco English & International,** and **TR Property** have been taken out of the broker's medium-risk funds list. The first two have underperformed, and the third is going because the brokers are "concerned about the prospects for property in the event of an economic slowdown."

In the high-risk portfolio, Williams de Broe have replaced **Atlantis Japan Growth,** which is benchmarked to the TSE Second Section Index, with **Schroder Japan Growth,** which is benchmarked to the more broadly-based TSE First Section Index. The only other change in the high-risk portfolio is the removal of **TR European Growth,** which has continued to disappoint, and the addition of **Merrill Lynch World Mining.** Merrill Lynch World Mining's portfolio is invested mainly in gold (30.5%), base metals (18.7%) and platinum (11.8%) as well as having smaller holdings in silver, diamonds and industrial minerals. The brokers say that "defensive exposure to commodities and energy is no bad thing given current world uncertainties."

FUND MANAGER CHANGES

3i European Technology has announced the appointment of Pierre-Andre Boutin as manager to replace Mike Prentis. Mike took over in a temporary capacity when Henrietta Marsh left. The new man has joined from Close Finsbury, where he was joint manager of the Close Finsbury EuroTech Trust. Prior to this he was at Schroder Investment Management and Banque Nationale de Paris.

There is to be a change of fund manager at **Edinburgh Dragon Trust.** The manager since late 1999, Alastair Thompson, is leaving Edinburgh to join First State Investments, which is the latest of a series of blows for Edinburgh. We understand that his deputy, Jeremy Whitley, will take over. He has worked on Edinburgh's Pacific desk for seven years, assisting both the departing Thompson and his predecessor Richard Muckart. The investment trust team at HSBC have commented on the change. They rated Thompson very highly, but the appointment of Whitley is seen as a sign of continuity. There is unlikely to be a change in emphasis or approach, which has historically been based on stock selection rather than the macro asset allocation, or index tracking adopted by many of trust's peers. Edinburgh Dragon has a reputation for benchmark beating performance and so the emphasis will be on maintaining its status in the sector. Whitley will be assisted by Richard Keery in the interim, but is looking to add one or two members to his team in the medium-term. In the meantime, Whitley has reduced the trust's exposure to Hong Kong, resulting in a reduction in gearing to around 95%. He is awaiting what he describes as an 'inflection' point in key markets, with specific stocks in Korea of particular interest to him, with the aim of increasing exposure and gearing. With the trust on a 21.5% discount to net asset value, some observers, including *The Scotsman* newspaper, have suggested that Edinburgh might have trouble hanging on to the investment management mandate. One way or another we think there is a decent chance that the discount will narrow.

John Alexander is to step down as manager of **Henderson Smaller Companies** after 15 years. Neil Hermon from Morley Fund Management will take over the responsibility. The trust is the worst performer in its sector, out of 26 trusts, over five years, so perhaps a change was due. In the short-term, some shuffling of the portfolio might bring more in the way of costs and disruption rather than enhanced returns, but existing holders might like to give Mr Hermon a chance. He describes his investment approach as being bottom-up with a growth bias. The trust has been aggressively growth oriented under Mr Alexander, which is why its recent performance has been so poor.

DIRECTORS' DEALINGS

There has been a notable acceleration in the amount of director buying over recent weeks. The list below details some of the most significant transactions announced over the last month. **3PC Investment Trust** director JB Holford acquired 10,000 shares at 60p each on 23rd September to lift his total holding to 35,000 shares. **Aberdeen Development Capital** director Charles Scott has doubled his shareholding to 30,000 shares after the purchase of 15,000 shares at 49.5p each on 3rd October. **AIM Trust** director Audrey Baxter bought 20,000 shares at 58p each on 26th September to lift her holding to 25,000 shares. Blue Planet Investments, a company owned by Ken Murray, a director of **Blue Planet European Financials,** bought 30,000 shares at 39p each on 27th September. Mr Murray is beneficially interested in 676,500 ordinary shares. **Edinburgh Income and Value** director Frank Malcolm acquired 9000 shares for himself and the same number for his wife, at 78.5p per share, on 3rd October. **Framlington Innovative Growth** director SJP Reed bought 2000 shares at 144.9p each on 8th October to take his total holding to 5000 shares. Fellow director RJ Frost bought 5000 shares at 172p on 12th September. **Henderson High Income Trust** director Christopher Dunkerley purchased 41,500 shares at

98p each on 7th October to lift his total holding to 55,000 shares. **Henderson Smaller Companies** director Peter Cadbury bought 3250 shares at 82.75p on 30th September to lift his total holding to 16,550 shares. Fellow (new) director J Nelson bought 2958 shares at 84.5p on the same day. **Herald** director DCP McDougall bought 50,000 shares at 145p apiece on 2nd October to lift his holding to 150,000 shares. **Invesco Continental Smaller Companies** director Ian Dalziel bought 6950 shares at 28p each on 27th September to take his holding up to 53,077 shares. **Invesco Geared Opportunities Trust** director Peter Clark's wife bought 50,000 shares at 23p each on 24th September, while he halved his holding of zeros with the sale of 5000 at 141p each. **JPMorgan Fleming Income & Capital** director AP Hichens made a switch on 8th October, selling 16,459 geared ordinary shares and buying 12,000 zeros. **Martin Currie Capital Return** director David Simpson sold his entire holding of 20,000 'A' ordinary shares on 8th October. **New Opportunities** director Charles Fowler bought 5000 shares at 82p each on 3rd October to lift his holding to 6000 shares. **Pavilion Geared Recovery Trust** director T Trefgarne purchased 400,000 shares at 3p each on 26th September, taking his interest to 405,000 shares. Two **Prelude Trust** directors have topped-up their already substantial stakes. Dr Robert Hook bought 35,000 shares to take his holding up to 456,961 shares, and Andrew Allars bought 19,000 shares to take his holding up to 100,224 shares. **Securities Trust of Scotland** director Andrew Irvine's wife purchased 50,000 shares at 79p each on 24th September to lift her total holding to 70,000 shares.

NEWS ROUND-UP

Aberdeen Preferred Income has been placed in administration and is now one of the highest-profile casualties of the split capital bust. This trust, with 9000 shareholders, was worth more than £240m two years ago, but became the fourth Aberdeen split capital trust to go into receivership on 25th September. Exeter's **Dartmoor Investment Trust** has also suspended its shares and looks likely to follow.

Baring Emerging Europe has succumbed to pressure from the arbitrageur Laxey Partners and has announced that it is to reconstruct. Following consultations with major shareholders, the board of the trust has proposed a voluntary liquidation and reconstruction of the trust. This will enable shareholders to take the cash or to roll over into another closed end investment company with the same investment policy and the same management team. Those who exit will bear the costs, and warrant holders will be paid off in line with the terms of the warrants. Full details are due to be sent to shareholders by mid-November. This is slightly disappointing news in some respects, as this outcome is scant reward for a trust which has increased its assets by 28% over the last year, which is top in the emerging markets sector over one year and five years, and where the manager Klaus Bockstaller who took over in difficult circumstances and survived a beauty parade for the mandate, has certainly proved his worth. The good news is that investors will be able to carry on with the same manager, which is our suggestion. Laxey Partners have turned their attention now to **LeggMason Investors Enterprise,** where they have built a 15.36% stake. You wouldn't bet against a reconstruction now. The manager John Johnston had his time in the limelight during the technology boom, but since that time the trust has struggled. Assets are down by 43.5% over the last year, and the trust is lowly-ranked. The 26.4% discount to net assets seems to leave a bit of room for margin, so watch this space.

Fleming Technology Trust, or JPMorgan Fleming Technology as it will be known for a short time, has decided to wind up, burdened not only by the continuing weak performance of the sector, but by certain requirements in its structure. In particular, the burden of the 13p annual dividend payable on the trust's preference shares became "unduly onerous" as the overall net asset value fell. It is good that the board has chosen to address the matter rather than labouring on with an inappropriate structure. At least there is some value appearing elsewhere in the sector for investors looking to maintain exposure: **Polar Capital Technology** shares, for instance, are on a 22% discount.

Investec Extra Income is to reconstruct. Ordinary shareholders are being offered a cash exit, or a choice of shares in two Investec open-ended funds. The UK Value Fund aims for a mix of income and long-term capital growth, primarily through investment in UK equities with a bias towards value stocks. There are a lot of similarities to the existing trust. The investment focus is on companies which offer fundamental value in terms of good asset backing, above average yields, and/or strong market positions. Holdings include GlaxoSmithKline, BP, HSBC, Gallaher Group, Shell, EMI, Barclays, Scottish Power, Lattice Group, and Lloyds TSB. There is no gearing, which means the yield is lower than on the existing trust. The second OEIC option is the Investec Income Share Fund which invests in split capital income shares. A conservative approach is adopted, with the manager avoiding highly geared trusts. For investors seeking some continuity, we cannot say that the Value Fund is a bad choice, but if you take the cash you can choose from a broad investment trust universe where there are some reasonable discounts, and trusts which use gearing sensibly to enhance returns.

Following the reconstruction proposals from **Invesco Tokyo Trust,** 45.5% of shareholders chose the cash exit, which is no great surprise. Some holders also opted to move into an open-ended fund, so calculations suggest that **Perpetual Japanese** will probably gain around £8.3m of new assets.

The split-capital trust **Jos Holdings** is to merge with another Dresdner-managed trust (indeed with the same manager, Trevor Green), **British Portfolio.**

Jos had a planned wind-up date in January 2003: holders can choose either to roll-over or to exit. British Portfolio is a conventional trust which invests primarily in FTSE 100 companies, which makes it more mainstream than Jos. The trust does not have a long-term record, having been launched in December 2001, so it is difficult to compare it with others in the same sector. We might just make the observation that the shares look fully valued at present on a discount of just 0.7%.

The trust's portfolio is composed of the usual suspects – the largest holdings are in BP, GlaxoSmithKline, Vodafone, Royal Bank of Scotland, HSBC, Shell, Barclays, Lloyds TSB, HBOS, and Unilever. For investors seeking continuity and ease of transfer, the roll-over option looks reasonable enough, although you could take the cash and shop around for a replacement trust on a wider discount if you wish to be more pro-active.

Lindsell Train Investment Trust shares seemingly dropped by two-thirds on October 1st, and then bounced back up again the next day, but there is a ready explanation. In order to allow a buyback provision, the trust made a bonus issue and then consolidated its shares on a 3-for-1 basis the following day. This technical adjustment has left shareholders with the same number of shares as before, but with a par value of 75p rather than 25p.

Merrill Lynch Defined Returns has announced its interim results for the period to 30th June and defined the losses at that point. For the income shares, 23 of the initial 30 stocks stood below 90% of their initial value. These included Enron. Telecom stocks were also badly hit. Consequently, the unrealised loss on capital amounted to 20.4p at this time. For the zeros, 15 of the initial 30 stocks were below 80% of their starting value, making the unrealised loss on capital 18.6p. The figures will of course have worsened since. For **Merrill Lynch Defined Returns II** the story was similar. For its income shares the unrealised capital loss amounted to 17.3p; and for the zeros 20.5p.

Personal Assets Trust has published its first 25 Quarterly Reports in a very smart cloth-bound book. Its 132 pages are packed with good plain common sense and trenchant investment wisdom from Ian Rushbrook and Robin Angus. If you can beg, steal, or borrow a copy we think you'll find it a cracking and enlightening read. Personal Assets Trust is ranked, by the way, second (behind British Empire) out of 25 peer group trusts in the global growth sector over five years.

Royal London Growth & Income Trust is rejigging its portfolio and amending the target levels for equities and bonds. The amount invested in equities had already fallen from 80% at launch to 69% at the time of the interim results in June, and now the board says it will aim for 60% in UK listed equities and 40% in investment grade bonds. This change will assist the board in maintaining dividends to the geared ordinary shares and geared units in line with the level indicated at the trust's launch. The gross 9% coupon on the 2020 CULS remains unaltered.

Final results released on 24th September by **TR European Growth** were unsatisfactory in several respects. For a start, the results were poor, with a fall in net assets stated vaguely as "in excess of 30%." Diluted net asset value per share actually fell by 30.3%. Whilst the statement does not compare this with any benchmark index, we can take it as read that the trust underperformed. It is disappointing that the trust is not more open about its performance. There is not even a manager's report with the results. TR European shares, at just over 90p, have more than halved from their high over the last twelve months, and although there might be some support from the 22.9% discount to net assets, it is hard to make much of a case for the shares at present. In the European smaller companies sector, **JPMorgan European Fledgeling** has performed better and is available on a wider discount.

Warning: 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 ofthe 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 Lipper , 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 warrants mentioned in this newsletter. Published by The McHattie Group, Clifton Heights, Triangle West, Bristol, BS8 1EJ. © 2002. Tel: 0117 925 8882. Fax: 0117 925 4441. E-Mail: mchattie@trustnews.co.uk. Web Site: http://www.trustnews.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. Regulated by the Financial Services Authority.

The next issue of Investment Trust Newsletter is published on Saturday 9th November.

VALUES SURRENDER TO THE BEARS IN SEPTEMBER

The FT-Investment Trusts Index is down 454.5 points (-15.06%) to 2563.9 since the last newsletter.