# Why you shouldn't be afraid to get into gearing

## Activist investor

Mark Atherton

Investment trusts and unit trusts may seem to be more or less the same thing. They both invest savers' money in listed companies, they are run by fund managers and they aim to deliver growth and income for investors.

There is one difference that leads investment trusts to routinely outperform their almost identical counterparts. This secret ingredient is known as gearing. It is basically borrowing money to buy extra shares to boost performance. Investment trusts are allowed to do it, but funds are not.

AJ Bell, an investment manager, recently compared unit and investment trusts in a series of head-to-head match-ups. It looked at how the same manager, from the same company, running almost identical portfolios, did when they ran an investment trust and how they performed with a fund.

It found that the investment trust outperformed the unit trust more than 75 per cent of the time.

Neil Hermon runs the Henderson Smaller Companies investment trust and the Janus Henderson UK Smaller Companies fund. While the UK Smaller Companies fund produced a very respectable return of 362 per cent over the ten years to the end of December, the investment trust version returned 620.9 per cent — a difference of 259 percentage points.

Then there is Praveen Kumar from the investment company Baillie Gifford. Nine of the top ten holdings in his Baillie Gifford Japanese Small Companies unit trust also appear in the top ten of his Baillie Gifford Shin Nippon investment trust. Yet the unit trust's return of 422 per cent is beaten by Shin Nippon's 678.4 per cent.

This is mostly down to gearing. Let's say that investors put a total of £100 million into an investment trust, which is then invested in a portfolio of shares. The managers then borrow a further £10 million, or 10 per cent of the trust's size, which also gets invested in shares.

So you now have a portfolio of £110 million, even though investors put in only £100 million. If the portfolio rises by, say, 20 per cent, the real gain for investors is 22 per cent of their original £100 million stake. The same applies if the fund falls.

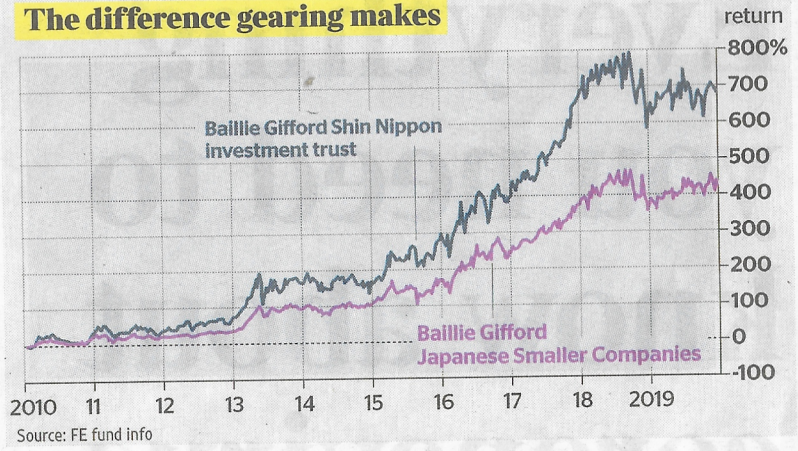
Critics of investment trusts often point to the accelerant effect of gearing as a double-edged sword and a reason why they don't tend to use them. Gearing, they would argue, makes investment trusts too risky. They often add that the term "gearing" itself is confusing and puts people off.

Another is that gearing creates greater volatility in the share prices of investment trusts when compared with non-geared unit trusts. The AJ Bell study found that nine out of ten investment trusts examined showed greater volatility than their unit trust counterparts.

I would argue that there is an antidote to volatility and it is called longevity. If you look at a graph of the total return from the FTSE all-share index over several decades it shows a clear upward path. Yes, there are some sharp and sometimes prolonged downward dips, but there is a clear direction of travel and if you are a long-term investor, then a bit of short-term volatility induced by gearing is not that much of a problem.

Although it is true that gearing accentuates share price rises and falls (the double-edged sword argument), the reality is that markets go up a lot more than they go down. The UK stock market has risen in 30 of the past 40 years, so, overall, gearing tends to work heavily in your favour if you are prepared to take a long-term view.

**The difference gearing makes**




Source: FE fund info