

Treasury Shares

A REVIEW OF MARKET EXPERIENCE AND PERSPECTIVES ON
TREASURY SHARES IN THE INVESTMENT COMPANY MARKET



DIANE WILDE JULY 2006

Contents

Foreword

Executive summary

A review of treasury shares

- What are treasury shares?
- The current status of treasury share activity
- Market context
- Perspectives on the treasury shares debate
- The process of securing treasury share powers
- Boundaries to a treasury share programme involving the sale of treasury shares at a discount
- Communication with shareholders
- Dealing Issues
- Acknowledgements

Appendix 1: empirical case studies

Foreword

The AITC battled long and hard to ensure that investment companies would share the ability to hold in treasury shares that have been repurchased in a buyback. It is our view that, whilst use of this facility will not be appropriate for every investment company, there can be circumstances in which treasury shares can help to add value for shareholders.

The market has a mixed view on the potential contribution that treasury shares can make to the fortunes of the investment company sector – in particular where the shares may be re-issued at a discount to NAV. The AITC has been concerned that the debate has not always been as fully informed by the lessons learnt from market experience as might be possible. We therefore commissioned this report to examine the ways in which treasury shares have been used to date and the arguments surrounding their deployment.

The AITC Board has concluded that whilst taking treasury share powers and selling shares from treasury may not be suitable for every investment company, the evidence confirms that there are circumstances where holding shares in treasury and re-selling them at a later date (even at a discount) can provide a useful tool for boards to narrow discounts, reduce volatility, improve liquidity and provide a Net Asset Value uplift for shareholders.

Of course, different shareholders will have differing views on the desirability of using treasury shares and under what conditions. The AITC is keen that all shareholders consider proposals to take and use treasury share powers on their objective merits.

One important lesson drawn from the research that went into this exercise has been that boards have to consider very carefully the likely perspectives of their shareholders and, if they want to secure permission to hold and resell treasury shares, they must do their best to explain why, according to the circumstances of their particular company, this would be advantageous. Shareholders have every right to expect this. Having done this, shareholders (or their representatives) should in their turn be expected to judge the case made on its individual merits, and not according to dogmatic rule.

Daniel Godfrey

On behalf of the AITC Board – July 2006

Executive summary

For the purposes of this paper, taking 'treasury share powers' involves repurchasing shares to hold in treasury for a potential subsequent re-sale at a later date.

Many industry stakeholders are positive about the potential for taking treasury share powers to help add value for shareholders. One use, for example, involves investment companies repurchasing shares then re-selling them from treasury to manage a shift in their shareholder register away from large holdings by institutions towards an expanded retail base without incurring discount problems or increasing the relative cost of running the company. This process may well require shares to be traded in volumes that cannot easily be provided by the secondary market alone. The process can therefore be assisted by the use of buy-backs and the re-sale of treasury shares. Despite benefits such as these, it is undeniable that the re-sale of treasury shares, particularly at a discount to net asset value (NAV), remains contentious for many.

The main philosophical argument surrounding the re-selling of shares from treasury at a discount to NAV involves the notion of the 'round-trip'. Supporters view the process of repurchasing, holding and re-selling shares as one exercise and consider its overall impact on NAV and other issues (such as liquidity). They take a wider view of the overall benefits than simply the level of the NAV enhancement which would arise if repurchased shares were cancelled. The significance of the 'round trip' is the single major difference of opinion in this debate.

It is clear that, if a board believes taking treasury share powers can provide benefits for shareholders, they will have to consider carefully :

- The merits of a treasury shares programme, and whether the benefits perceived are reasonably likely to truly outweigh any costs involved
- The 'boundaries' of the process (to deal with concerns of more sceptical shareholders); and
- How they will communicate their case to shareholders (which could involve compiling views from brokers and market makers, targeting specific shareholder groups and proactively addressing concerns etc).

The AITC hopes that greater engagement from both sides of the debate will help practice to evolve for the benefit of shareholders.

A review of treasury shares

What are treasury shares?

Any public limited company has been able to repurchase its shares and hold them 'in treasury' since December 1st 2003. This means that repurchased shares are not cancelled but are held by the company itself. These shares can then be sold at a later date to meet increased or new demand in the company's stock. This process allows a company to manage its share structure without the cost and administrative complexity of cancelling and issuing new shares.

While shares are held in treasury they carry no voting rights or rights to dividends. They also have no entitlement to capital in the event that a company winds up. Company law allows up to 10% of a company's issued share capital to be held in treasury. These shares may be:

- Held indefinitely
- Cancelled at a later date; or
- Sold for cash at a price no more than 10% below the mid-market price at the time of sale.

However, the scope allowed to a company to repurchase shares and hold them in treasury for re-sale is dictated by shareholders. Shares held in treasury continue to carry pre-emption rights. Therefore their re-sale into the market has to be approved by shareholders via a special resolution i.e. a 75% vote in favour of allowing shares to be released into the market. Further information on relevant technical issues can be found in "*Treasury Shares, a guide to the Commercial and Technical Issues*" which is available at:

www.aitc.co.uk/files/technical/TreasurySharesGuide.pdf

The current status of treasury share activity

The use of treasury shares within the investment company sector is evolving swiftly. By the end of 2005, 66 investment companies (just over 20% of the sector¹) had announced that they wanted to use treasury share powers. This is a significant increase from 2004 where the total was just 34.

Of the 66 companies, 27 said that they may seek to resell shares at a discount to NAV. 24 have made it clear that they will only resell shares at a premium to NAV. The remaining 15 have not expressed a view on the price at which they would intend to resell shares.

During 2005, 19 investment companies bought shares into treasury. This takes to 28 the total number of investment companies which have actually repurchased shares and held them in treasury since this option became possible at the end of 2003. Since the powers to hold treasury shares were granted, 11 investment companies have subsequently re-sold them from treasury. 5 companies re-sold them at a discount to their NAV. 6 sold them at a premium.

The situation is developing rapidly and it is anticipated that, over the course of 2006, a significant number of investment companies will develop policies on treasury shares and seek relevant permissions from their shareholders.

Market context

Market developments have increased the attention which investment company boards are paying to the potential of treasury shares. One factor, which is critical for some investment companies, is an imbalance between the supply and demand for the shares. This can arise where previously long-term institutional shareholders are seeking to reduce their interest in a particular investment company's stock and replacement demand from other sources cannot be immediately secured.

¹ UK investment companies excluding VCTs. Source: AITC

One option for a board facing such circumstances is to repurchase shares for cancellation. However, this may not always be considered the best long-term solution for remaining shareholders; as such actions reduce the capital base permanently and can lead to reduced liquidity and persistently higher expense ratios. Where these issues are a concern for boards, they may wish to hold shares in treasury to provide them with the option of reselling them to meet increased (or new) demand at a later date. In effect, by using treasury share powers the board can address timing differences between supply and demand and enhance liquidity – benefiting all shareholders.

Another factor has been the involvement in the sector of shareholders seeking to secure investment returns by buying investment company shares on large discounts and exiting when they have been reduced. Reducing discounts, viewed in isolation, cannot be viewed as anything but a good thing for all shareholders. However, concerns are raised when responses to activist shareholders involve buying them out at a narrower discount and permanently reducing the capital base or size of the company. This in turn increases costs and undermines the ability of the company to achieve its long-term investment objectives. This would be unwelcome for shareholders focussed on the long-term performance of the mandate and the manager.

One response to this scenario has been boards introducing discount control mechanisms. These seek to either stabilise or reduce discounts (or a combination of the two). Along with tender offers, redemption offers and buying back shares for cancellation, there is a clear view that holding shares in treasury for re-sale can play a useful part in developing discount control mechanisms. The issues are complex and it is difficult to produce empirical evidence of the impact of holding shares in treasury for later resale on discounts. However, it has been observed that investment companies with share-buy back policies in place have tended to enjoy narrower discounts.

It is anticipated that the ability for a board to manage liquidity in times of high demand (reselling shares from treasury) as well as when there is low demand (buying in shares) should help reduce discount volatility. This will help focus the market's attention on the performance of the underlying assets of the investment company in relation to its investment objectives – which should be to the benefit of all shareholders. (It is worth noting that discounts across much

of the investment company sector are lower now than has been seen since the early 1990's.)

These trends have been critical in increasing boards' focus on the potential benefits of holding and re-selling treasury shares. To secure a more in-depth view of market perspectives on these issues a variety of industry stakeholders and practitioners were canvassed in the preparation of this report. They included:

- Fund management groups
- Stockbrokers/market-makers
- Investment company non-executive directors; and
- Institutional and retail shareholders.

Perspectives on the treasury shares debate

Perspectives on the use of treasury share powers differ according to a number of factors. One critical element is the price at which treasury shares are re-sold. In ordinary trading companies the key factor is the difference between the prevailing share price and the price the treasury shares are sold to the market. Where the shares are sold at a discount to the share price investors may have concerns about dilution. These types of issues are well understood and account for the existence of pre-emption rights in company law.

For an investment company, shares sold from treasury would normally be at the prevailing share price (or very close). The critical issue, in terms of shareholders being prepared to waive their pre-emption rights, is less to do with shares being sold at a discount to the share price than at a possible discount to NAV.

NAV enhancement: One market view is that any re-sale of shares at a discount to NAV inevitably erodes value for existing shareholders. It maintains that repurchased shares should always be cancelled following a repurchase as this provides the greatest possible uplift of NAV per share. The contrasting view focuses on the 'round-trip'. This identifies the whole process of repurchasing, holding and re-selling shares as one exercise and considers its overall impact on NAV and other issues (such as liquidity).

The 'round-trip' perspective takes a more holistic view of the operation. It recognises that there is an 'opportunity cost' in selling the re-issued shares at a discount, but that this should be weighed against potential other benefits.

For example, discretionary managers often complain that they find it impossible to deal in large lines of investment company shares and that they therefore use open-ended funds by default. But an investment company with an appropriate performance record, mandate and shareholder base could provide an attractive exit to institutional holders and improve liquidity for discretionary managers by repurchasing the shares from the institutions in a buyback and then, over time, re-issuing them to the discretionary managers at the market price. Some NAV uplift will have been given up, but uplift will nonetheless have been achieved and liquidity improved.

Critics find it unacceptable that any possible NAV enhancement should be forgone. For some, this is such an article of faith, that they would not support sales at a discount, even if the uplift lost were 'de minimis'. Some treasury share sales have resulted in a loss of NAV enhancement so small that it can only be measured in fractions of a basis point on the prevailing NAV. At the same time the re-sale has contributed far greater benefits in relation to reducing the total expense ratio. Despite this, critics have remained unmoved over the principle of accepting any loss of NAV enhancement.

Liquidity issues: An important issue for supporters of the round trip approach is the impact that cancellation of shares potentially has on future liquidity. A number of industry stakeholders have been concerned about a withdrawal of stockbrokers and capital from the investment company market which has reduced liquidity in the sector. This has been a result of long-term institutional selling of investment company shares and increasing competition for capital from other asset classes.

One stockbroker commented, "reduced capital at risk (from the market makers) has encouraged the practice of putting stock back on companies for cancellation (share buybacks), or selling to activist shareholders." This view was widely endorsed. Supporters of the round trip approach felt the sector would be better served if, instead

of immediate cancellation, shares could be held with a view to re-selling them to satisfy emerging demand from new retail investors. This would be invaluable where boards and managers were trying to stimulate demand from new sources, for example, private client managers or IFAs, to develop their shareholder base. Where there was potential demand from intermediaries, treasury shares could be used to sell blocks of shares in larger amounts than could often be afforded by the market. (See the case of Montanaro UK Smaller Companies).

A supportive private client shareholder described the use of treasury shares as “a facility to take away the debate about liquidity and to take away the debate about the discount” and focus on “is the manager performing or not”? This is a critical consideration in the debate on treasury shares. It reflects the difference between investors focussed on immediate issues related to the discount and those seeking optimal performance going forward. While providing an immediate exit for shareholders via a buy-back programme can clearly be important, it does not eliminate the value to remaining shareholders of addressing ongoing liquidity problems and reducing, or keeping as low as possible, ongoing costs.

The clear conclusion of market participants was that holding shares in treasury for re-sale does offer boards the potential to address liquidity issues by tackling timing differences between demand and supply, particularly from intermediaries (See Finsbury Growth and Income case study).

TER implications: As noted above, supporters of the round trip felt that share buy-backs for cancellation alone will also tend to increase the TER for remaining shareholders. This would be felt particularly strongly in smaller companies. On the other hand, holding shares in treasury for possible re-sale offers greater flexibility to increase the size of the available share capital at some point in the future, so reversing the adverse effects of cancellation. It was suggested that being prepared to keep this option open shows that the board is confident that the fund manager, portfolio performance and investment mandate of the company is capable of stimulating demand from potential shareholders in the future.

Discount control: As noted above, the debate over the use of treasury share powers has also been coloured by an increased focus on the discount. Supporters of the round trip saw value in maximising the ability of boards to resell shares from treasury to help deliver a discount management strategy which could enable them to put, in effect, a ceiling on the discount.

Short vs long term: The relative attractions of immediate cancellation vs the round trip often depends on shareholders' view of securing certain quantifiable benefits immediately in comparison with less explicit benefits in the future. Those shareholders focussed on the short-term and those who have a philosophical bias against the round trip view argue that the certainty of the uplift given by immediate cancellation outweighs any potential longer-term gain from narrowing discounts and enhancing liquidity. Those with more immediate time horizons often felt that providing a route for shareholders to exit the register immediately was the most important consideration in relation to liquidity. They were less concerned about the future liquidity of the fund.

Advisory services: Some key voices in support of immediate cancellation have been voting advisory services. Their advice has consistently warned against the waiving of pre-emption rights on shares that can be resold at a discount to NAV. They remain adamant that there is no potential for the round trip to provide additional benefits for shareholders which outweigh the cost of any sacrifice of NAV enhancement, however small that cost may be. The impact of warnings such as these has been very influential. Some supporters of the round trip believe that this type of opposition has less to do with the merits of the case than a lack of recognition for the less quantifiable, but important, benefits which cannot be readily identified by a formulaic assessment.

The process of securing treasury share powers

The substance of the issues raised by taking treasury share powers will depend on the particular circumstances of the company considering seeking them. However, it is clear that all boards seeking to secure shareholder approval for a treasury share programme will face communications issues. These will relate to both explaining the potential benefits of a treasury share programme to shareholders and in convincing shareholders to vote to enable relevant resolutions to be passed.

Many boards considering their treasury share options believe that a clear majority of shareholders support the proposals, including in circumstances when the re-sale of shares at a discount to NAV is proposed. However, a number of these have failed to secure the 75% majority required to pass the special resolution at the AGM. This reflects the fact that the proportion of shareholders voting were skewed towards institutional shareholders sceptical of the round trip view themselves or advised against supporting sales of treasury shares at a discount to NAV.

This problem was experienced, for example, by JPMorgan Fleming Claverhouse. It is 86% owned by retail investors, who are likely to benefit in the long-term from a liquid and active market in the shares (which the board believed would be delivered by a treasury shares programme which facilitated sales of stock at a discount from NAV). However, the special resolution on this issue was not put forward because the view of institutional investors was negative. The board felt that the motion was bound to fail because the vast majority of retail investors were unlikely to vote. The same problem arose with JPMorgan Fleming Emerging Markets.

Another company, Murray Income, only narrowly secured such powers with a 75.5% majority. To put this in context, however, only 5.9% of the issued shares were voted against the special resolution, but secured 24.5% of the share of the vote. Of course, this means that only 18% of the shareholders voted in favour and highlights the problems of low turnouts.

This suggests that working to secure a positive vote on re-selling shares from treasury is a very important element in developing a

successful programme. This will particularly be the case where the programme envisages selling them at a discount to NAV and institutional investors and their advisory bodies are sceptical about the round trip argument.

Boundaries to a treasury shares programme involving the sale of treasury shares at a discount

Where Boards are committed to only re-selling treasury shares at a premium to NAV, such proposals are likely to be routinely supported by shareholders.

However, even if Boards are convinced of the merits of a treasury share programme, which include the sale of treasury shares at a discount to NAV, experience to date suggests that setting some parameters on how and when treasury shares can be sold may provide more sceptical shareholders with comfort and increase their willingness to support such proposals.

Such boundaries may include:

1. Only re-selling treasury shares at a narrower discount than that prevailing at the time of repurchase. This will provide comfort that the operation of the treasury shares programme as a whole is NAV enhancing, as the 'dilution' which occurs when treasury shares are sold at a discount is more than outweighed by the enhancement on the buy-back.
2. Setting a maximum limit on the dilution (compared to an immediate cancellation) of all treasury sales in any one year (e.g. to 0.5% of asset value). This helps to give a context to the cost/benefit arguments being put forward by the board.
3. Setting a maximum number of treasury shares that may be re-sold in any one year.
4. Setting a maximum absolute discount at which treasury shares may be re-sold.
5. Limiting the life span of stock held in treasury.

It has been suggested that treasury shares sales could also be usefully limited to times when, in addition to the shares being at a lower discount to that at the time of repurchase, they are also standing at a higher absolute price. Though this may seem an instinctively comfortable position to present to shareholders, the general view of commentators to the sector, and the view of the AITC, remains that such a boundary is likely to be of only of cosmetic benefit. For a further discussion of this issue, see page 35 of *“Treasury Shares, a guide to the Commercial and Technical Issues”*.

When considering such boundaries, Boards should consider not only their impact in normal or benign market conditions, but also in times of sudden market corrections. Boards may wish to allow themselves some flexibility to deal with sudden changes in the market conditions, though this may in turn increase the concerns of sceptical shareholders who may prefer to see absolute boundaries.

Communication with shareholders

If Boards are seeking powers that they know may be considered by some shareholders as being controversial, then it is important that they demonstrate a willingness to be as clear as possible about their reasons for seeking such powers and about how they will be used in practice. Failing to provide such information creates uncertainty, and thereby gives weight to the argument that a blanket opposition to sales of treasury shares at a discount to NAV is more appropriate than a qualitative assessment of what is being proposed.

Information that Boards should consider providing might include:

1. Why the Board considers that the use of treasury shares will be beneficial to the longer-term interests of shareholders.
2. Why they consider that re-selling shares at a discount (if this is to be permitted) should be a part of this overall strategy.
3. What other options they considered to deal with the issues that it is hoped treasury shares will address and why they considered the treasury shares route to be preferable.
4. How the Board intends to use treasury shares in practice and what boundaries (if any) they intend to set on their use.

5. How they will assess the results, and judge the success, of the use of treasury shares and how they will communicate these to shareholders.

Boards should not be intimidated by the pre-emption guidelines nor the reaction of institutional investors to date. The withdrawn notice of AGM for JPMorgan Asian Company PLC 2005 stated:

“The Board believes that the use of treasury shares assists the Company in managing both the absolute level and volatility of the discount to net asset value at which the shares trade, for the benefit of shareholders. Reissues of treasury shares assist in maintaining the Company’s current levels of share capital, enhancing its secondary market liquidity and facilitating an orderly market.”

Providing boards are convinced that the use of treasury shares is in the interests of the majority of shareholders, they should be prepared to seek such powers from their shareholders at the companies AGM and continue to seek them even if resolutions do not gain sufficient shareholder support initially due to the failure of significant groups of shareholders to vote.

The more contact a board has with its shareholders, and the more information on the use of its treasury share powers it is willing to provide, the more likely it is to be able to persuade them of the case. Boards need to be as close to their shareholders as possible. This will allow them to provide them with information and answer queries in a timely manner.

Dealing Issues

The Board may wish to set up a dealing structure in treasury shares to provide clear accountability to shareholders. Managers may have extensive in-house facilities; however, the corporate broker may well provide the most effective audit trail for best execution. And brokers will deal within the guidelines as set by Boards. Boards may wish to consult with both the manager and their broker upon this.

Acknowledgements

The author and the AITC are indebted to all those who took time in discussing this subject with me and were helpful in providing open and frank views on their experience and opinion of treasury shares.

Appendix 1: empirical case studies

Set out below are three cases of investment companies buying shares back into treasury and re-selling them at a discount. All support the view that liquidity has been enhanced for shareholders.

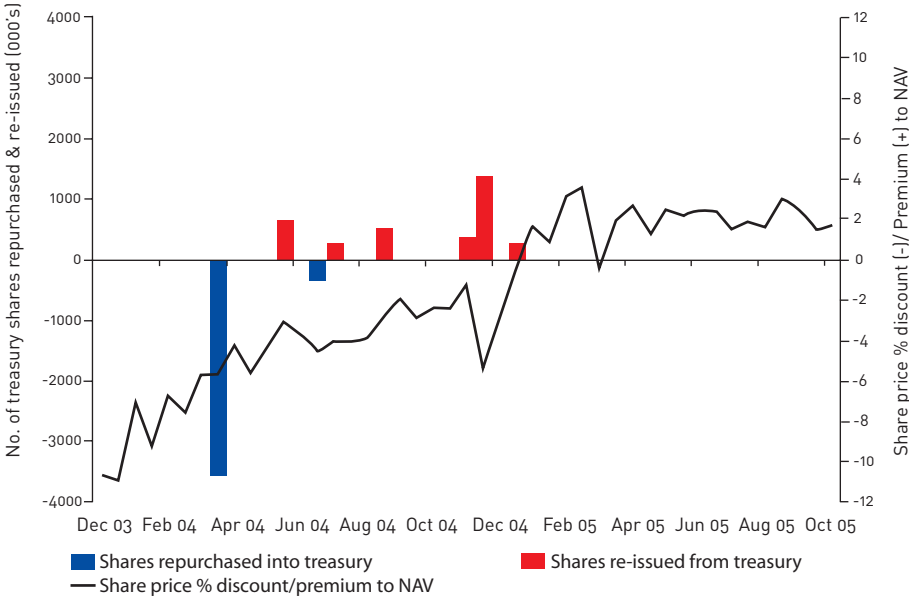
Finsbury growth and income

In April 2004, the company effected a change in investment objective and name and facilitated a significant shift in their shareholder base with the aid of treasury shares.

A large shareholder (nearly 20% of the company) looking to sell at a 5% discount for structural reasons (the fund performance had been good) caused the Board concern about the prospect of downsizing assets, given that they believed in the attractiveness of the mandate and manager, and also in treating all shareholders equitably as well as providing an exit.

Consulting with all shareholders with holdings of 1% and above, the Board committed to an active share buy-back programme at the same discount as the exit for the initial shareholder. A marketing campaign to existing and potential new shareholders in the retail sector was carried out, which resulted in some 19% of the company's equity being put through the market. The net outcome of the share transactions left 3.9m shares in treasury (due to insufficient demand) but which were subsequently placed out to private client groups at discounts of between 2-4%. The company has since issued new shares at a premium. The graph below illustrates the improvement in shareholder interests over this period.

Graph 1: Finsbury Growth & Income – Treasury share buy-backs, issuance and changes in the discount since December 2003.



Source: AITC

Points of note

- The ABI “red-topped” (informed subscribers that the Board’s application was in conflict with fundamental principles) the application for treasury share re-sale at a discount. However shareholders, happy with their Board and manager, voted through the resolutions required to progress the corporate action.
- The existence of shares in treasury was not obviously viewed as an ‘over-hang’ of stock by the market, given the reduction in the discount that took place.
- The manager of the company felt very keenly that the independent board structure of the investment company was essential to the long-term interests of the shareholder/investor and wished to avoid “morphing into an OEIC” which he believed offered less protection to shareholders. This point is often not stressed enough.

Montanaro UK Smaller Companies

The company had a concentrated institutional shareholder list (over 95%). Again, a large shareholder, following a change of owner, wished to sell their shares (approximately 7.5%).

This company had already repurchased and cancelled some 25% of its original shares over its life and was concerned that further downsizing would lead to liquidity concerns for some of its shareholders and their ability to remain invested in the company.

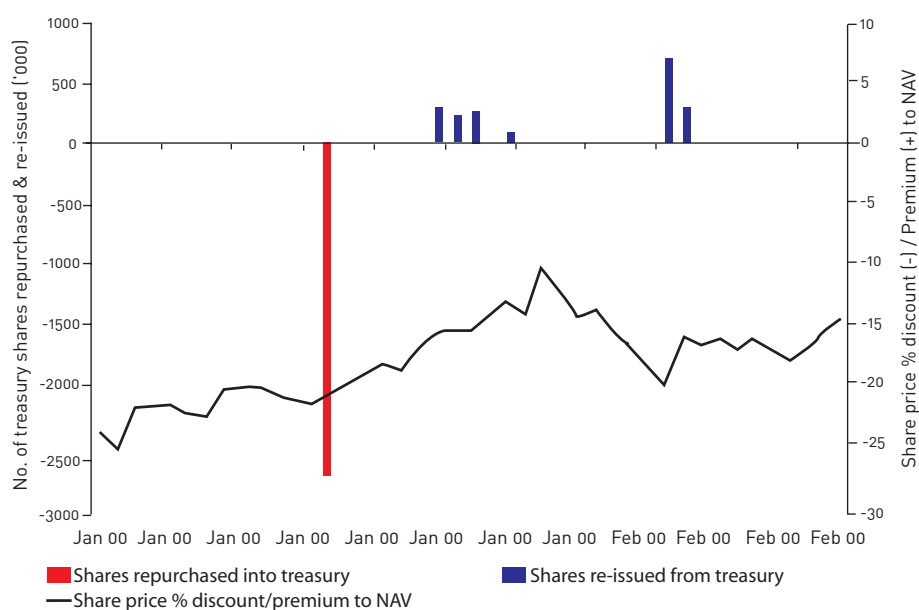
The Board, following consultation with its major shareholders, aimed to broaden the shareholder base into the retail market following a period of good NAV performance. Shares were purchased into treasury at a discount of just over 22%. At the same time it set up highly comprehensive guidelines to advise shareholders of its policy and these were published in the company's 2005 Annual Report and Accounts. Principally:

- The re-sale of treasury shares would be only at a narrower discount than that at which they were originally purchased
- Re-sale would occur only to produce an absolute price return
- Any remaining shares in treasury would be cancelled within twelve months of buy-back.

The managers undertook a marketing programme to inform investors of the company's strategy and performance and re-sold 73% of the stock to private client shareholders at discounts of between 15 and 20%. The balance of treasury shares were cancelled.

Whilst viewed as quite controversial at the time, the treasury operation served to provide liquidity to the retail market and the discount has narrowed to around 15%. NAV on the 'round-trip' was enhanced by 1.3% (Source: WINS).

Graph 2: Montanaro UK Smaller Companies - treasury share buy-backs, issuance and changes in the discount since December 2003



Source: AITC

Points of note

- No issue with the ABI. However, no more than 5% was re-sold from treasury during that period, although authority to resell from treasury up to 10% was sought.
- NAV enhancement would have been only 0.6% greater via the original buy-back (shares cancelled immediately) which interestingly corresponds to the level of “aggregate dilution” suggested acceptable for annual treasury sales by JPMorgan Fleming European Fledgeling and by Murray Income. Whilst the former received an amber top from the ABI and the latter a Red Top, both achieved the necessary majority vote for the use of treasury at their AGMs.

limiting dilution per annum from re-sales to 0.5% of NAV, and undertaking to cancel any shares not re-sold within 12 months of their purchase. Despite a clear 66.6% majority vote in favour of re-selling treasury shares at a discount to NAV, it was not enough to achieve the 75% required for the special resolution, which was withdrawn.

Each of these case studies highlights the positive use of treasury shares in balancing the timing disequilibrium of sellers and buyers of stock whilst providing liquidity (and choice) to both.



Website: www.aitc.co.uk

Registered Office: 9th Floor, 24 Chiswell Street, London EC1Y 4YY. Telephone: 020 7282 5555.
JULY 2006