Capturing the Market:
The investment trust opportunity in a post-RDR world
Summer 2014
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Foreword

The investment trust industry has for a long time considered greater take-up of their offering among the IFA community as a potentially powerful solution to perennial issues such as persistent discounts and illiquidity. Measures imposed at the start of 2013 by the Retail Distribution Review (RDR) would appear to present an opportunity for the investment trust industry to attract a more mainstream following.

For example, the RDR has specifically included investment trusts in the range of products that independent advisers must now consider. The abolition of commission and the growing adoption of clean share classes have put fund types on a more equal footing as far as remuneration is concerned. Plus, with all advisers now required to study to a minimum of QCF Level 4, a higher level of professionalism may foster more confidence to consider a more diverse range of investment vehicles.

On paper, these look like very positive drivers for the 300-strong UK investment trust sector. But how realistic is it that these changes will translate into higher levels of investment among advised clients? In this latest paper from J.P. Morgan Asset Management, we wanted to answer three questions:

■ Has interest in investment trusts among the IFA community genuinely increased in the run-up to and the immediate aftermath of the RDR?

■ To what extent is the more supportive regulatory environment being matched by fair access to investment trusts through investment platforms and other key forms of distribution?

■ What does the investment trust industry now need to do to fully reap the post-RDR opportunity?

At the end of 2013 – a year on from the launch of RDR – 89% of the advisers we researched had chosen to adopt an independent/whole-of-market business model, which means they must have sufficient knowledge to include investment trusts in the products they consider for their clients.

The opportunity for the investment trust sector is compelling. We hope this research paper goes some way to identifying how its potential can be fully realised.

Simon Crinage
Managing Director, Head of Investment Trusts
J.P. Morgan Asset Management
Executive summary

This paper assesses the potential for greater use of investment trusts among retail advisers following the implementation of the Retail Distribution Review in January 2013, and what measures the investment trust sector now needs to take to maximise the post-RDR opportunity.

Use of investment trusts among traditional independent financial advisers (IFAs) has historically been low. IFAs account for less than 5% of shareholdings among investment trusts managed by J.P. Morgan Asset Management, for example. But attracting greater take-up within the advised retail market has long been seen as a solution to persistent investment trust challenges such as discount volatility and lack of liquidity in the sector.

Adviser interest to triple

Requirements put in place by the Retail Distribution Review (RDR) have created an unprecedented foundation for greater interest in investment trusts within the intermediary community:

- the inclusion of investment trusts among the retail investment products that independent advisers must consider and have access to,
- greater coverage of investment trusts in professional qualifications plus
- the abolition of commission, which has put investment trusts on a level footing with other collective investments.

Research conducted just prior to the launch of RDR\(^1\) indicated the percentage of IFAs recommending investment trusts to their clients had the potential to triple from 20% to 58% following the RDR, with a notable increase among firms with £1 million+ in client assets.

Strong platform access

However, to transform these intentions into action, advisers will need the same level of access to and information about investment trusts that they enjoy with open-ended funds.

Critical in terms of access is the inclusion of investment trusts on investment platforms, which our research suggests are now used by 94% of IFAs\(^2\) to administer client assets. One of the biggest perceived obstacles to greater take-up of investment trusts among IFAs has been their absence on the three dominant ‘fund supermarkets’ - Cofunds, Fidelity FundsNetwork and Skandia. Yet our research shows that, outside of these three platforms, access to investment trusts is good, with 12 B2B platforms hosting 300+ investment trusts\(^3\). Moreover, our research indicates that advisers are comfortable with using multiple platforms. There is a risk, in our view, therefore, that platforms that don’t host the full range of retail investment products will see asset outflows as advisers move to those venues that can accommodate their independent status.

The DFM challenge

More problematic for the investment trust sector in terms of distribution is the mixed attitudes towards investment trusts among discretionary fund managers (DFMs) - the third-party investment specialists that an estimated 50%\(^4\) of IFAs are turning to in order to outsource client portfolio management. While some discretionary managers favour investment trusts as a means to access illiquid markets or strategies that are ‘doing something different’ from the open-ended fund world, we have found that many more are

\(^1\) Source: J.P. Morgan Asset Management/Opinium Research, November 2012
\(^2\) Source: ibid, December 2013
\(^3\) Source: Fundscape, May 2013
\(^4\) See sources cited on page 23
deterred by perceived liquidity risks, discount volatility and even the ‘Treating Customers Fairly’ implications of trading for clients at varying discounts or premiums. Perhaps most significant in terms of attracting generalist IFAs, investment trusts appear almost completely absent from the risk-rated model portfolios that DFMs offer via investment platforms, which account for 17% of platform assets\(^5\).

**Deciding the future focus**

We conclude that reasonable foundations are now in place to encourage greater interest and take-up of investment trusts among the wider adviser community. These are already translating into greater adviser engagement, which should accelerate as more highly-qualified advisers enter the market. However, the investment trust industry still has plenty to do to ensure that widespread concerns (real or perceived) over discounts, liquidity, portfolio disclosure, costs and the effectiveness of boards are addressed.

The investment trust industry also needs to decide if there is value in encouraging inclusion of investment trusts in commoditised platform-based products such as model portfolios or whether its focus should remain on more niche and bespoke investment services. Partly, in light of their absence on fund supermarkets and model portfolios, we envisage that investment trusts will not see significant increase in uptake among generalist advisers focused on packaged and outsourced solutions. But we do see great potential among an emergent sector of financial planners who are more confident about using exchange-traded securities and managing client portfolios themselves. This is where we believe the most exciting opportunities for the investment trust industry lie.

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6 Source: Fundscape, May 2013
About the research

**Intermediaries**
Research into IFAs and their attitudes towards investment trusts was conducted by Opinium Research first in November 2012 and again in December 2013. Opinium canvassed 206 advisory firms across the UK for the 2012 research and 205 for the 2013 analysis. Ten questions were asked in each survey and the findings analysed in aggregate and by size of firm (as measured by size of client book).

**Platforms**
The research into platforms and their inclusion of investment trusts was conducted by Fundscape in April/May 2013 through a combination of online survey and one-to-one telephone interviews. Twenty-two platforms were surveyed. Collectively, these platforms represented over £244 billion in assets or 95% of total assets on platforms in the UK. Fundscape figures referring to total assets on platforms and asset flows are generally as at end-March 2014 unless otherwise indicated.

**Discretionary fund managers**
Eight discretionary fund managers were interviewed by telephone by J.P. Morgan Asset Management in March-April 2014. These firms were selected on the basis of their popularity with advisers according to a regional analysis by Citywire in February 2013.
Part One: Investment trusts and the RDR effect

How new regulation is influencing adviser attitudes to investment trusts

The challenge of attracting IFAs

Investment trust penetration within the mainstream financial advisory market has historically been low. Our own experience as the largest investment trust group in the UK indicates that less than 5% of the capitalisation of investment trusts managed by J.P. Morgan Asset Management is held by independent financial advisers (as shown by Combined D2C/adviser platforms and Adviser-only platforms in Diagram A). The most active advisory intermediaries in the investment trust market have been wealth managers and private banks, who account for 33% of shareholder volume among the trusts that we manage.

Diagram A: Shareholder composition (%) of investment trusts managed by J.P. Morgan Asset Management

![Diagram A: Shareholder composition (%) of investment trusts managed by J.P. Morgan Asset Management](image)

Source: J.P. Morgan Asset Management as at 31 December 2013

Based on percentage of market capitalisation of JPMAM-managed investment trusts held. ‘Institutions’ includes pension funds, life assurance funds, index trackers, funds of funds and multi-managers. D2C-only platforms are online platforms used directly by private investors. Adviser-only platforms are intermediated. Combined D2C/adviser platforms are used both by advisers and end-investors.

In a previous J.P. Morgan Asset Management report we asked IFAs why investment trusts were less favoured than open-ended collective investments like OEICs among the intermediary community. The main reasons cited were:

- Low understanding of investment trusts
- Absence of commission in the investment trust structure
- Lack of access to investment trusts on leading online investment platforms.

Assuming these three reasons still hold true, then the implementation of the RDR should lead to a major boost for the investment trust industry. In seeking to raise professional standards and reduce advisory bias, the RDR has directly addressed the first two of the three obstacles to greater investment trust uptake:

i Inclusion of investment trusts among regulated retail investment products

The RDR rules stipulate that to have ‘independent’ status, financial advisers must be willing and able to advise on all retail investment products (RIPs) and the list of RIPs they must know about now includes investment trusts, exchange traded funds (ETFs) and structured products.

In addition, qualifying advisers are now required to be tested on 100% of the required FCA syllabus. The FCA has drawn up a master syllabus on which all approved professional bodies must base their qualifications. The Association of Investment Companies helped to draft the investment trust content for this, which has ensured that all newly-qualified advisers – even those attaining the minimum QCF 4 level qualification – are fully tested on investment trusts.

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6 Source: AIC as at 31/05/2014 in terms of number of investment companies and AUM
7 Investment Trusts: The Case for Consideration (2012)
Definition of a retail investment product

(a) a life policy; or

(b) a unit; or

(c) a stakeholder pension scheme (including a group stakeholder pension scheme); or

(d) a personal pension scheme (including a group personal pension scheme); or

(e) an interest in an investment trust savings scheme; or

(f) a security in an investment trust; or

(g) any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset; or

(h) a structured capital-at-risk product;

whether or not any of (a) to (h) are held within an Individual Savings Account or a Child Trust Fund.

Source: FCA Handbook – Glossary, June 2014

First-hand: Investment trust education

Jacqueline Lockie – Head of Training at the Association of Investment Companies (AIC):

“Prior to the Retail Distribution Review, testing of an adviser’s investment trust knowledge equated to just a few marks in exam papers. Now all professional bodies must test on 100% of the FCA’s master syllabus, which the AIC helped to create. So we know for certain there is now much more even coverage of open-ended and closed-end funds. The investment trust knowledge of newly-qualifying advisers will be substantially higher than it was in the past.

Over 2012 and 2013 we have trained over 2,200 intermediaries at investment trust workshops. Many advisers came to our workshops initially to be able to write off investment trusts from their list of recommended products but once they understood how they work, many recognise the role they can play in a client portfolio – particularly for property, infrastructure and other illiquid asset classes. Lots of advisers we’ve trained say they want to use investment trusts more.

We’ve also found it is fruitful to hold combined workshops covering both investment trusts and exchange-traded funds (ETFs). Of the wider range of retail investment products they now need to know about, lots of advisers want primarily to learn about ETFs. But once they are more comfortable with the concept of exchange-traded products, then investment trusts become a logical progression.”
ii Abolition of commission on advised business

In the past, one of the defining features of investment trusts compared to open-ended funds and life assurance products was the absence of initial and/or ongoing ‘trail’ commission in their structure. Any adviser who wanted to be remunerated for recommending an investment trust could therefore generally only do so by charging their clients a fee.

Advisers need to have a fee mechanism in place whatever products they recommend. The absence of commission is no longer a reason for not recommending investment trusts.

Post-RDR, commission has been banned on all new retail investment advice, to be replaced by adviser charges (fees) agreed between adviser and client. (Until April 2016, ‘undisturbed’ pre-2013 business can continue to pay trail commission unless a disturbance event takes place.)

In other words, advisers now need to have a fee mechanism in place whatever products they recommend or advice they give, which puts investment trusts on a more level playing field with all other retail investment products. The absence of commission is no longer a reason for not recommending investment trusts.

Impact of RDR measures on adviser attitudes

So, are these changes having any effect on take-up of investment trusts among advisers? To find out, we conducted adviser research in November 2012 just before the RDR launched and again in December 2013, a year after the legislation came into effect.

i. Pre-RDR attitudes

Our research indicates the RDR was already influencing attitudes to investment trusts even before it was launched.

In November 2012, 20% of IFAs researched on our behalf said they already recommended investment trusts to clients where appropriate, with the greatest penetration among IFAs with a client book of £5 million or more. An additional 38% said they would be likely to recommend investment trusts following the introduction of the RDR, with a noticeable increase among firms with £1 million+ in client assets:

Diagram B: Advisers’ pre-RDR investment trust intentions

Base: All respondents – 206.
Source: J.P. Morgan Asset Management/Opinium Research, November 2012
Diagram C: Advisers’ pre-RDR investment trust intentions – by size of client book

Just over a quarter (28%) of IFAs said they were unlikely to recommend investment trusts, even after the RDR requirements were introduced. Such IFAs tended to be firms with client books of £1 million or less and primarily felt that open-ended funds met all their client needs.

In short, these figures suggested that 58% of the IFA sector were amenable to recommending investment trusts for their clients following the Retail Distribution Review – potentially almost tripling adviser participation in the investment trust market.

In 2012, 58% of the IFA sector said they were likely to recommend investment trusts following the RDR – potentially almost tripling adviser participation in the market.

Independence & product recommendations

Under the Retail Distribution Review, advisers who wish to retain independent status must now include exchange-traded funds (ETFs), structured investment products and investment trusts in their review of the market. The FCA has stipulated that a relevant market should comprise all retail investment products that are capable of meeting the investment needs and objectives of a retail client.

But how rigorous will independent advisers be in assessing the full spectrum of retail investment products? In our research, 81% of advisers surveyed prior to the introduction of the RDR regime intended to retain their independent status (and this percentage had risen to 89% by end-2013). However, only 58% of advisers prior to RDR thought they were likely to recommend investment trusts for their clients.

This suggests that almost of quarter (23%) of advisers wishing to be independent had already discounted investment trusts as an appropriate solution for any of their clients. The question now for such firms is how they will justify a blanket dismissal of a product to the regulator – and how stringent will the FCA be in asking firms to explain their choices?

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http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/firm-guides/financial-advisers/rdr-advice-service

FCA Handbook – Conduct of Business – Section 6.2A – see Appendix.
ii. Post-RDR attitudes

While pre-RDR intentions looked promising, a year on from the introduction of RDR and there appears to be little movement in investment trust take-up. Just 5% of advisers say they have made more investment trust recommendations since the start of the new regime, while 48% say their level of investment trust recommendation has stayed the same.

Diagram D: Recommendation of investment trusts post-RDR

![Bar chart showing recommendation of investment trusts post-RDR]

- 5% have increased level of recommendation
- 48% neither increased nor decreased level of recommendation
- 33% have not recommended investment trusts at all since start of RDR
- 13% recommended investment trusts prior to RDR and this hasn’t changed
- 3% unsure

Base: All respondents - 205
Source: J.P. Morgan Asset Management/Opinium Research, December 2013

However, amenability to investment trusts remains strong. Forty percent of advisers say they are interested in using investment trusts broadly across all asset classes, with a much smaller proportion of advisers viewing them purely as a specialist vehicle for areas such as property or private equity. Moreover, only 11% of advisers dismiss investment trusts completely – suggesting that the recognition of the value of investment trusts is widespread.

Diagram E: Areas in which advisers would consider using investment trusts

![Bar chart showing areas in which advisers would consider using investment trusts]

- 40% in any sector or asset class
- 18% to access property and infrastructure
- 18% only in areas where there isn’t an open-ended equivalent
- 15% to access less liquid assets such as private equity or smaller companies
- 9% to access alternative fixed income - eg loans and ABS
- 11% would not use investment trusts in any situation

Base: All respondents - 205
Source: J.P. Morgan Asset Management/Opinium Research, December 2013
iii. Encouraging investment trust recommendation

So how can the intentions of advisers prior to the RDR to use investment trusts more be translated into action? We asked advisers what measures would encourage them to recommend investment trusts - see Diagram F.

Distribution is by far the most important driver, with over half of advisers claiming that better access to investment trusts on investment platforms would encourage them to invest. But equally, advisers want more information on investment trusts – including the ability to make direct comparisons in terms of performance and portfolio breakdown with open-ended funds. Just under a third of advisers also admit that inclusion of investment trusts in ‘model portfolios’ run by third-party discretionary managers is also likely to improve uptake.

In the next two sections of this report, we therefore assess levels of inclusion of investment trusts in what have become two key forms of investment distribution among financial advisers: investment platforms and third-party discretionary fund managers.

Diagram F: What would encourage advisers to recommend investment trusts?

![Diagram F: What would encourage advisers to recommend investment trusts?](image)

Base: All respondents - 205

Source: J.P. Morgan Asset Management/Opinium Research, December 2013

Comment: Turning interest into uptake

The willingness of 58% of advisers in the run-up to RDR to include investment trusts within their client recommendations is a huge opportunity for the investment trust sector. Plus, as newly qualified advisers with a greater knowledge of investment trusts enter the market, this level of adviser interest should grow.

But as advisers themselves make clear, intentions to consider investment trusts are only likely to translate into client recommendations if they can be as easily accessed and researched as their open-ended counterparts. Now that the regulator has done its part to encourage greater inclusion of investment trusts in the product mix, it’s up to providers and distributors to follow through in terms of delivering information and availability.
Part Two: Putting investment trusts on platforms

**Plotting platform dominance**

Investment platforms are secure online venues that allow collective funds and other investments to be bought, sold, researched and reported on in one place. As well as simplifying the administration of client holdings, platforms may offer research tools, model portfolios and panels to assist with fund selection.

First established in the UK at the start of the millennium, platform use – both among advisers and directly by private investors – has grown rapidly. As end-March 2014, there were more than 30 investment platforms operating in the UK, administering assets of over £303 billion according to Fundscape.

**Diagram G: Growth in use of platforms in the UK**

A decade on from their introduction, the dominance of platforms as a means of fund distribution is clear. By March 2014, the percentage of open-ended collective fund assets administered on platforms in the UK stood at 41% and had grown at a compound rate of 26% a year since 2006 – see *Diagram G*.

**Adviser use of platforms**

The high use of platforms in the intermediated market is clear, with 94% of IFAs in our research saying they use investment platforms to administer client investments. But the common perception of advisers putting all clients onto a single platform appears overplayed.

Eighty-four percent of advisers that we surveyed post-RDR use two or more platforms – and there appears to be a clear correlation between level of assets under advice and the use of multiple platforms as *Diagram H* shows. In part, this may be because advisers wish to access a variety of products and services. Also, where a firm takes over a client book from another advisory firm, it may choose to keep those assets on their existing platform to avoid a disturbance event, which – under RDR rules – will switch off trail commission.
What’s more, the small proportion of advisers that don’t use platforms tend to be the very smallest firms, suggesting the dominance of platforms as a form of investment distribution is only likely to grow.

**Influence of platforms on product selection**

Platforms appear to influence which products advisers consider. As Diagram I shows, two-thirds (63%) of advisers indicate that greater availability of investment trusts on platforms would increase their likeliness of recommending them.

A quarter of advisers say this is because a platform presence would facilitate their ability to assess all retail investment products and thereby demonstrate their independence. Sixteen percent of advisers claim a platform presence is essential because they conduct all their investment business on platforms and are unlikely to recommend products not available on a platform.

So while, investment trusts can be purchased directly from investment groups, through brokerage services and using CREST accounts, their inclusion on platforms now appears key to greater adviser uptake.

Two-thirds of advisers surveyed indicated a greater availability of investment trusts on platforms would increase their likeliness of recommending them.
Diagram I: Impact of greater access to investment trusts on platforms

Q: What effect does the availability of investment trusts on platform have on your likeliness to recommend investment trusts to clients?

- If my chosen platform did not include investment trusts, I would be less likely to recommend them. (10%)
- If my chosen platform did not include investment trusts, I would be likely to use a different platform. (4%)
- If my chosen platform included investment trusts as it would support my independent status. (26%)
- If my chosen platform included investment trusts, I would be more likely to recommend them as I conduct all my business on platforms. (16%)
- If my chosen platform included investment trusts, I would be more likely to recommend them for other reasons. (7%)
- It would have no effect as investment trusts are already easily accessible without platforms. (14%)
- It would have no effect as I don’t use platforms. (2%)
- It would have no effect for other reasons. (15%)
- Unsure/don’t know. (6%)

Base: All respondents – 205
Source: J.P. Morgan Asset Management/Opinium Research, December 2013

Platforms and whole-of-market access

Our research shows that the bulk of advisers tend to use two or three platforms. Only 10% rely on just one platform. The pressure on platforms from advisers to be a one-stop shop is therefore not overwhelming.

However, the FCA Conduct of Business rules say that a firm that holds itself out to a retail client as acting independently – and relies upon a single platform service to facilitate the majority of its personal recommendations in relation to retail investment products – must take reasonable steps to ensure that, as appropriate, the platform service provider bases its selection of retail investment products on a comprehensive, fair and unbiased analysis of the relevant market.

In other words, advisory firms that wish to maintain independent status need to be mindful that their chosen platform, or platforms, can host all investments that they are required by regulation to consider, or that they need to use more than one platform.
Impact of RDR on platform charging structures

The Retail Distribution Review (RDR) has been supportive of inclusion of investment trusts on platforms. Prior to the RDR, platforms fell into two broad categories:

- **Fund supermarkets** - These are platforms where remuneration - both to the platform and adviser - was traditionally paid out of the initial and annual fees on funds. There was no mechanism to accommodate products that did not integrate commission. Fund supermarkets historically therefore have not hosted investment trusts (or hosted only a handful of them), nor any other exchange-listed security. This was the model originally adopted by the UK’s three largest B2B platforms – Fidelity FundsNetwork, Cofunds, and Skandia.

- **Wraps** - On these platforms, remuneration to the adviser and the platform has primarily been paid out of fees levied directly on the end-client. To avoid double-charging, commission and fees paid out of fund charges could be rebated. These platforms could therefore host both commission- and non-commission-bearing investments, including investment trusts and other exchange-traded securities.

The RDR’s ban on commission means that the remuneration structure of fund supermarkets has fallen closer into line with wraps. Payments both for advice and for platform services must now be paid by the end-investor – whether as a fee, by redeeming investment units or from monies accumulated in a cash account. So from a remuneration point of view – if not from an operational point of view – this means that both types of platform should now be able to host investment trusts.

Investment trusts on platforms

Research from Fundscape indicates that £6.9 billion in investment trust assets were held on platforms at end-2013, with Direct to Consumer (D2C) platforms accounting for the lion’s share of assets. This represented just under 8% of the total £89.5bn market capitalisation of the investment trust market at the time - a fifth of the 41% of open-ended mutual fund assets currently held on platforms (see Diagram G at the start of Part Two).

But while the absolute level of investment trust capitalisation held on platforms looks small, access to investment trusts looks reasonable. In Fundscape’s analysis of 21 platforms, 18 hosted investment trusts and 11 of these claimed to offer them on a whole-of-market basis - see Diagram J. Fifteen platforms (68%) said that demand from advisers for investment trusts had increased following the RDR. More than half of platforms intended to increase the number of trusts they offer over the next three years, and none expected to decrease investment trust availability.

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31 Although it must be noted that in the case of investment trusts managed by J.P. Morgan Asset Management, case, 29% of shares are held via platforms - see Diagram A on page 7. But in line with Fundscape’s findings, direct-to-consumer platforms, rather than advised platforms, account for the vast majority of these assets.
Diagram J: Availability of investment trusts on the major investment platforms

<table>
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<tr>
<th>Platform</th>
<th>Type</th>
<th>No of ITs</th>
<th>Intend to increase ITs on platforms?</th>
<th>Basis of IT inclusion</th>
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<tr>
<td>Aegon Retirement Choices</td>
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<td>■</td>
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</table>

UR = under review. ITs managed by JPMAM and FTSE All-Share constituents. Source: Fundscape/J.P. Morgan Asset Management, April 2013

However, the three largest B2B platforms in the UK, which account for almost half (48%) of total platform assets - Cofunds, Skandia and FundsNetwork – either don’t currently host investment trusts or in FundsNetwork’s case, only offer Fidelity-managed trusts. Cofunds and FundsNetwork confirmed in March 2014 that they hope to host more investment trusts in the future but have no firm schedule to do so. Skandia says it has no plans to host investment trusts.

The current lack of investment trusts on these major platforms is often seen as the main stumbling block to greater uptake among traditional IFAs. However, Diagram J shows there are 11 other B2B platforms that host in excess of 300 investment trusts (a reasonable proxy for the whole of the UK-listed investment trust market).
Collectively, these B2B venues administered an estimated £101 billion in (primarily) advised assets as at end-March 2014. That’s a third of the £303 billion platform market – and exceeds the total market capitalisation of the whole investment trust sector.\(^{11}\) Even if no other platform were to introduce investment trusts, simply encouraging advisers on these platforms to increase their allocation could create major inflows for the investment trust industry.

Comment: Non-availability on fund supermarkets not the issue

So long as advisers are comfortable with wrap-style platforms, access to investment trusts on platforms for intermediaries is already reasonable. Investment trust groups should be buoyed by the fact that their funds are now available on online venues administering around a third of all platform-based advised assets.

We have already seen that over three-quarters of advisers (78%) are comfortable using multiple platforms. Therefore, the non-availability of investment trusts on the big three fund supermarkets should not be the obstacle to investment trust take-up that is often assumed.

In fact, platforms that don’t offer investment trusts should be more concerned that not offering the full range of retail investment products may lead to fund outflows as advisers seek to broaden their investment choice and/or demonstrate to the regulator that they do offer whole-of-market access.

Researching investment trusts on platforms

Of course, having access to investment trusts on platforms is only part of the story. Advisers – particularly those new to exchange-traded securities – often also want to be able to research and appraise investment trusts easily on platform too – and ideally on an equal footing with open-ended funds.

Where a platform simply bundles investment trusts with other listed shares, this may be hard to do. However the majority of platforms do appear to give investment trusts their own categorisation instead of – or as well as – including them with all listed securities – see Diagram K.

As we saw earlier in our report, 29% of advisers said that being able to make like-for-like comparisons with open-ended funds would make them more likely to recommend investment trusts to clients. Fundscape research indicates that seven B2B platforms allow investment trusts to be compared on-screen with other types of investment fund. Five platforms, however, only allow exchange-traded products to be searched within their own separate category or with other exchange-traded securities which potentially makes it harder for advisers to make fair comparisons with open-ended funds. This may also discourage advisers from viewing investment trusts as a mainstream fund type.

Aegon (which hosted 20 investment trusts as at April 2013) is the only platform that claims to have the functionality to allow searches to include fund types both together and separately - a feature that needs to become more widespread if advisers are to be able to make meaningful comparisons across all retail investment products.

\(^{11}\) Total market capitalisation of investment companies including UK, offshore and VCTs as at end-March 2014 was £96.5bn. Source: Association of Investment Companies.
Model portfolios

As we will see in the next section an increasingly important platform feature for advisers is access to model portfolios (commodified portfolios constructed to meet different investor risk profiles). Our research suggests that investment trusts have no or very little presence in these vehicles – which has significant implications for uptake among advisers seeking to outsource investment management.

Diagram K: Categorisation of investment trusts on B2B platforms

<table>
<thead>
<tr>
<th>Platform</th>
<th>Listed securities</th>
<th>Investment trusts</th>
<th>Search functionality for investments</th>
<th>Exchange-traded products shown separately</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aegon Retirement Choices</td>
<td>□</td>
<td>□</td>
<td></td>
<td></td>
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<tr>
<td>AJ Bell</td>
<td>□</td>
<td>□</td>
<td></td>
<td></td>
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<tr>
<td>Alliance Trust</td>
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<tr>
<td>Ascentric</td>
<td>□</td>
<td>□</td>
<td></td>
<td>Note 1</td>
</tr>
<tr>
<td>Axa Elevate</td>
<td>□</td>
<td>□</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FundsNetwork (Fidelity)</td>
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<td>□</td>
<td></td>
<td></td>
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<tr>
<td>James Brearley</td>
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<td></td>
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<tr>
<td>James Hay Investment Centre</td>
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<tr>
<td>Novia</td>
<td>□</td>
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<tr>
<td>Nucleus</td>
<td>□</td>
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<tr>
<td>Praemium</td>
<td>□</td>
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<tr>
<td>Raymond James</td>
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<tr>
<td>Transact</td>
<td>□</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

1 - Non-funds must be searched  
Source: Fundscape/J.P. Morgan Asset Management, April 2013

Comment: Comparing like with like

Access to investment trusts on platforms appears reasonable. But greater uptake among advisers may only happen if investment trusts are presented on platforms as funds first and foremost, rather than simply grouped with all listed securities.

Ideally, advisers should be able to research and compare investment trusts on a like-for-like basis with other fund types. This raises questions as to whether performance should be shown on a share price or net asset value (NAV) basis. There’s also the issue of the different sector categorisations used for OEICs and investment trusts, and whether these should be fully harmonised. Neither of these issues is insurmountable, however, and addressing them is absolutely necessary to enable advisers to assess closed and open-ended funds on an equal footing.
DFMs – a core advisory tool

While use of investment platforms among advisers has grown rapidly over the past decade, another key distribution trend has been the use of third-party discretionary fund managers (DFMs) to manage client investment portfolios.

Assessing what proportion of advised assets are outsourced to third-party DFMs is challenging. However, recent research suggests the figure could range from 23% to more than 50% of advisory firms. Usage is assumed to have increased in light of the RDR as advisory firms seek to de-risk their business and free up more of their own resources to focus their core business of financial planning.

In addition, firms appear comfortable with using multiple DFMs. In a 2012-13 survey of adviser firms that outsource investment management, financial analysts Matrix Solutions found that 60% use two or more third-party firms.

Diagram L: Number of DFMs used by advisory firms that outsource investment management

DFM solutions are also becoming more prevalent on platforms. According to Fundscape, 29.6% of assets on platforms were held in model portfolios, shortlists or bespoke discretionary portfolios as at the end of 2012. In terms of net flows for 2012, 32% of assets went into these forms of guided architecture – suggesting their growing importance to advisers who use platforms.

Model portfolios – which typically offer a choice of strategies across a spectrum of risk profiles to which clients can be matched – are the most popular outsourced product on platforms. According to Fundscape, 17% of platform assets – or approximately £41 billion – were held in model portfolios at the end of 2012.

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12 The Defaqto Platform Service Satisfaction survey 2013 (452 respondents) found that 45% of advisers were outsourcing their investment propositions. Of that 45%, more than half (51%) were doing so via discretionary management services. Research on behalf of Investec published in June 2014 indicates that 54% of advisers outsource their clients’ investments to a DFM.
Use of investment trusts by DFMs

For investment trust groups that wish to penetrate the advised and platform market, therefore, it may becoming increasingly important to have a presence on the recommended lists of discretionary fund managers. Our research across a selection of major DFMs, however, indicates that use of investment trusts is very mixed. In particular:

- **Platform products** - No DFMs use investment trusts directly in the commodified products they offer on investment platforms, such as risk-rated model portfolios. This is partly a liquidity issue. However, a greater deterrent is that the individual platform will be managing all trades so the DFM has no control over the price or time of day at which dealing takes place, which can have an impact on performance.  

- **Funds of funds usage** - Where investment trusts are offered in platform-based products, some DFMs are choosing to do so indirectly through proprietary fund-of-fund structures, which overcome dealing problems and also the ‘Treating Customers Fairly’ implications of dealing for clients at different prices or discounts to net asset value (NAV).

- **Bespoke discretionary** - Use of investment trusts is most prevalent among bespoke discretionary portfolios – primarily to access illiquid markets and asset classes – or, more rarely, specifically to exploit discounts to net asset value. While our sample of DFMs is small, there are signs of a correlation between use of investment trusts and assets under management, with smaller DFMs the most enthusiastic users. One notable exception is Investec – by far the largest DFM in the UK and an extensive user of investment trusts.

Attitudes of DFMs to investment trusts

According to our research, many DFMs agreed that closed-end funds have their role in accessing illiquid asset classes – particularly private equity, property, infrastructure and developing markets. But there are also reservations about the sector. Here were some of the most common areas of discussion in our interviews with DFMs:

- **Boards** - One DFM specifically mentioned the presence of an independent board as a major benefit of an investment trust, as it provides a mechanism to address poor investment performance that open-ended funds simply don’t have. But other firms were critical of some boards as being too cosy, sometimes too large, or demonstrating insufficient value for the fees incurred.

- **Fees & dealing costs** - Investment trusts have historically been viewed as broadly lower cost than open-ended funds. But the removal of commission from annual management fees mean that OEICs are now catching up and – say some DFMs – there is greater competition in the open-ended fund space to keep driving down investment management costs. This, together with the fact that investment trusts incur dealing costs on each sale or purchase, can make it harder to justify use of some investment trusts over their open-ended equivalents.

- **Discounts** - Some DFMs view trusts trading at a discount to NAV as a buying opportunity. But there is wide concern about discount volatility – and in particular, the ‘Treating Customers Fairly’ implications of buying into a trust for different clients at different discounts. Many DFMs want to see discount management mechanisms in place – for example, if not a zero-discount policy, then a commitment to keep the share price within a -2/+2% range of NAV.

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13 This is less of an issue for model portfolios using open-ended funds, which are only priced once a day.
- **Portfolio disclosure** - The limited disclosure of portfolio holdings by investment trusts has also been a deterrent to investing, given the need among both DFMs and advisers to perform portfolio look-through. Compared to their open-ended peers, only a minority of investment trusts have been willing to publish all holdings on a frequent basis—although DFMs recognise the situation is changing (see Conclusion).

The fact that the largest DFM in the UK, Investec, say it uses investment trusts widely across most asset classes suggests the issue of liquidity may mostly be problem of perception.

- **Liquidity** – Limited liquidity was often cited by DFMs that don’t use investment trusts as a reason for not investing. However, most DFMs who do use investment trusts say liquidity isn’t a problem provided they are able to control dealing themselves to avoid moving the market. In other words, liquidity is more of a challenge for where dealing is delegated (for example, to a platform). Very few DFMs specify a minimum liquidity requirement.

One firm did say that growth and consolidation in the DFM market is likely to make liquidity a growing issue. However, the fact that the largest DFM in the UK, Investec, say it uses investment trusts widely across most asset classes suggests the issue of liquidity may mostly be a problem of perception.

**Comment: Guided investments – in or out?**

For some discretionary fund managers, investment trusts play an important role in accessing those asset classes that don’t easily lend themselves to investment via open-ended funds. Other DFMs invest in investment trusts simply because they like the manager’s approach or specifically wish to exploit discounts to net asset value. At JPMorgan, we have also noticed that local offices may often use investment trusts and exchange traded funds to differentiate their portfolio services from what other mainstream advisers may typically offer.

But for most DFMs serving the adviser community, investment trusts generally appear to be a niche product and appear out of bounds for products offered on third-party platforms.

The question that the investment trust industry needs to ask itself is whether lack of inclusion in guided platform solutions such as model portfolios is a major concern. If it is, then DFM reservations, such as dealing in investment trust shares and discount volatility, need to be addressed.
Assuring liquidity in a £250m world

None of the DFMs we spoke to specified a minimum for the size of fund they can deal in. However, the Association of Investment Companies’ 2012 report on liquidity suggested that investment companies need capitalisation of £250m or more to get onto many private wealth managers’ buylists. Smaller investment trusts that wish to participate in the advised market therefore need to consider what action they can take to ensure the liquidity that the sector requires – whether that means intentionally growing their capitalisation or merging with another trust.

But it is only fair to point out that liquidity isn’t only an issue for investment trusts. If an open-ended fund encounters insufficient liquidity in one of its underlying holdings, there can be a delay in the investment of new money, which can lead to a cash drag on performance for all investors. Additionally, open-ended funds sometimes have to retain high cash positions to meet investor redemptions, which can also hold back performance.
In the introduction to this paper, we stated we wanted to answer three questions:

- Has interest in investment trusts among intermediaries genuinely increased in the run-up to and the immediate aftermath of the RDR?
- To what extent is the more supportive regulatory environment being matched by fair access to investment trusts through investment platforms and other key forms of distribution?
- What does the investment trust industry now need to do to fully reap the post-RDR opportunity?

Our findings suggest a broadly positive environment for building investment trust demand, but there is still plenty of work left to do.

### Conclusion

**Capturing the investment trust opportunity**

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- Has interest in investment trusts among intermediaries genuinely increased in the run-up to and the immediate aftermath of the RDR?
- To what extent is the more supportive regulatory environment being matched by fair access to investment trusts through investment platforms and other key forms of distribution?
- What does the investment trust industry now need to do to fully reap the post-RDR opportunity?

Our findings suggest a broadly positive environment for building investment trust demand, but there is still plenty of work left to do.

#### Diagram M: The pillars of investment trust opportunity

1. **Intermediary interest has grown – supported by a solid educational foundation**

   The inclusion of investment trusts in the range of retail investment products that independent advisers must know about and the deeper coverage of investment trusts in qualifying examinations have created good foundations for raising adviser understanding. (The Association of Investment Companies must be congratulated for lobbying to get greater investment trust coverage onto the FCA’s master syllabus.)

   Our research indicates that 40% of advisers are interested in using investment trusts broadly across all asset classes. Given that comprehensive testing of investment trust knowledge will only be required of newly-qualifying advisers, it will be some years before we can assess the impact of greater understanding investment levels. This also means that investment trust firms still need to do all they can to improve understanding and assist with qualification gap-filling among existing advisers.

2. **Access to investment trusts is good – for advisers making their own investment decisions...**

   A greater level of understanding and interest in investment trusts cannot be effective unless also accompanied by strong access. With 93% of advisers surveyed now using investment platforms to arrange and administer client assets, a presence on these online venues is now essential if interest in investment trusts is to translate into higher levels of investment. Indeed, more than half of advisers say in our research that inclusion of investment trusts on platforms is critical to recommending them.

   Our conclusion is that platform access to investment trusts is reasonable – for those advisers
willing to make their own investment selection. Much has been made of the fact that the three largest platforms in asset terms – Cofunds, Skandia and FundsNetwork – either do not host investment trusts, or in FundNetwork’s case only host a handful of trusts that Fidelity manage.

However, 11 B2B platforms host in excess of 300 investment trusts\(^\text{14}\) which, we believe is sufficient to accommodate rising adviser demand. Given that over three-quarters of advisers already use multiple platforms, non-availability on the ‘Big Three’ should not be the obstacle many assume. Indeed, the regulatory onus on advisers to demonstrate they have comprehensive access on their chosen platforms to all relevant markets could encourage flows of funds to those platforms that host the full spectrum of retail investment products. Rather than trying to get investment trusts onto fund supermarkets, the investment trust industry should perhaps focus more effort on raising adviser awareness of those platforms on which investment trusts are available.

... but almost non-existent for guided investment

Where investment trust availability on platforms does appear to fall down is in guided investment solutions. Advisers seeking to use model portfolios provided via platforms by discretionary fund managers will have almost no contact with investment trusts – except through a handful of funds of funds. As we’ve discovered this is largely due to dealing and liquidity concerns. But, even off-platform, use of investment trusts among discretionary fund managers is highly selective. If the investment trust industry believes that outsourced investment services are a key source of flows then addressing the needs of discretionary fund managers will be just as important in a post-RDR world as addressing the needs of intermediaries.

If the investment trust industry believes that outsourced investment services are a key source of flows then addressing the needs of discretionary fund managers will be just as important in a post-RDR world as addressing the needs of intermediaries.

3. There are seven actions the investment trust industry needs to take now

Capturing the opportunity to increase uptake of investment trusts among advised clients will continue to require extensive action by the investment trust industry. The Retail Distribution Review has helped substantially in terms of improving understanding of these vehicles and – by abolishing commission – enabling advisers to be agnostic in terms of the vehicles and products they recommend. But there is still plenty more the industry needs to do to help put investment trusts on a level footing with open-ended funds.

In response to our discussions with platforms and discretionary fund managers, there are seven actions we believe investment companies and the investment trust industry as a whole needs to think about:

i. **Demonstrate differentiation** - A number of discretionary fund managers specifically mentioned they use investment trusts to access strategies that are ‘doing something different’ from what’s available in the open-ended fund market. That might include taking positions in less liquid investments such as Asian small-caps or property, or using gearing to enhance income. If an identical strategy is available in the open-ended market, many firms say they find it hard to justify taking on the additional liquidity and discount risk that investment trusts involve.

\(^\text{14}\) Source: JFundscape/ J.P. Morgan Asset Management. April 2013
ii. **Provide portfolio transparency** - There is no legal requirement for a closed-end fund to disclose all of its portfolio holdings and the illiquid nature of underlying holdings can make this hard to do in any case. But with advisers, DFMs and platform tools seeking to perform comprehensive ‘portfolio look-through’, investment trusts should consider if it is practical to provide full details of portfolio holdings at least quarterly (albeit with a one to three-month lag to avoid data exploitation).

In our research, 44% of advisers said that better information on investment trusts would encourage them to use them more. Analysis by Morningstar suggests that trusts that provide portfolio transparency tend to trade in tighter premium/discount ranges. However, it does appear that disclosure is improving. According to the Association of Investment Companies, 155 out of 240 members were providing frequent comprehensive portfolio disclosure as at August 2013 with a further 67 in discussions to do so.

iii. **Remain competitive on fees** - Investment trusts have a reputation for being lower cost than their open-ended counterparts, with the benefit of an independent board to police investment management costs.

But now that commission is no longer included in open-ended fund charges, the cost differential is narrowing. Open-ended share classes now typically charge 75bps a year as an annual management fee. Analysis by J.P. Morgan Cazenove of 182 conventional investment trusts found that close to half had a management fee higher than 75bps and around 40% had a management fee below this.

Of course, it can be argued that simply comparing annual management fees isn’t a fair assessment of cost (investment trust managers will point out, for example, that open-ended funds have additional administration charges that typically amount to a further 18bps a year; open-ended fund managers conversely will point to the dealing charges that investment trusts incur).

However, it is widely accepted that post-RDR pressure to reduce management fees will continue across all fund types. Given that the end-investor now directly shoulders the cost of advice, platform services and investment management, advisers will be more focused than ever on seeking out cost-competitive solutions for their clients.

There are signs that investment trusts have been reducing or simplifying their fee arrangements directly in response to RDR. While not participating in a race to the bottom, investment trusts must remain highly vigilant that total ongoing charges compare favourably against open-ended funds with the same investment remit.

iv. **Assure sufficient liquidity** - While current liquidity may be sufficient for smaller discretionary managers, any investment trust seeking to court major advisory or DFM firms must be actively prepared to manage its liquidity levels. That means being willing to shrink capitalisation when demand falls or issue more shares when demand rises.

It should also be stressed that investment trusts are in a unique position in the fund world: they alone enjoy the investment control offered by a closed-ended structure, while also having the flexibility to adjust share issuance in line with market demand. Seeking to offer the best aspects of closed and open-ended structures may be a valuable strategy to gain support in the DFM/adviser community.

v. **Take action on smaller trusts** - As platforms grow, wealth managers consolidate and more intermediaries adopt centralised investment processes, it is clear that all investment vehicles need to be able to scale up with them. One DFM says that any trust with sub-£100

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16 J.P. Morgan Cazenove Investment Companies Annual Review, January 2013
17 Winterflood Investment Trusts Monthly Report, April 2013
27

million assets will need to think seriously how it can grow in size over the next three to five years – or consider merging with another vehicle to gain critical mass. We believe that trusts with a market capitalisation of less than £100 million can survive but must accept their target audience is likely to be direct investors and smaller discretionary managers only.

vi. Assess trusts in a universal context – Investment trusts tend to compare themselves only against their peers in the same investment trust sector. With the abolition of commission, advisers now have the opportunity to be ‘product agnostic’. Investment trusts therefore need to be more willing to assess themselves against their open-ended equivalents in terms both of cost and performance. This will become increasingly important as more and more online tools allow research and comparisons between different fund types.

vii. Ensure that boards add value – Many DFMs agree that active and vigilant boards can be a powerful and unique selling point for investment trusts. But large, costly or ineffective boards are a strong disincentive to invest. One DFM said they look for investment trusts where corporate governance is more than just a box-ticking exercise – and whose boards are right-sized, active and possess relevant current experience.

Capturing the market: where growth will come from

Foundations are in place for investment trusts to capture greater market share in the advised retail sector.

But the absence of investment trusts on the major ‘fund supermarket’ platforms and in platform-based model portfolios will undoubtedly have an impact on where demand comes from. Investment trusts are likely to see the strongest growth in interest among ‘financial planners’ who have the expertise and confidence to build and manage client portfolios themselves or who use off-platform DFMs – rather than ‘generalist advisers’ focused on packaged products and platform-based model portfolios (many of whom may also choose to become restricted under RDR rules). However, as more highly-qualified, fee-based advisers rise up through the industry, we anticipate that this financial planner segment will increase – providing a strong complement to the private client stockbroker community whose use of investment trusts is already high.

Diagram N: Where the investment trust opportunity lies

Source: J.P. Morgan Asset Management, May 2014
Enabling any investment vehicle to gain a deeper foothold in the intermediated retail market requires a combination of awareness, demand and access. The regulator has now done what it can to raise interest in investment trusts in terms of compulsion, training and by abolishing commission. It is now up to the investment trust sector to help support access and fuel demand by ensuring that investment trusts are seen as a viable and attractive asset class - to advisers, their clients and the third-party investment specialists who support them.

Moreover, we would hope that advisers don’t choose to consider investment trusts because they are compelled to by the regulator. Rather, we would hope that investment trusts are favoured because they are proven to be an effective and unique means of achieving clients’ aims - whether that’s accessing specialist markets, achieving a steady income yield or gaining exposure to a diversified global portfolio at low cost.
Appendix

i. Definition of independent advice
Edited from FCA Conduct of Business Sourcebook - 6.2A:

To be classified as independent post-RDR, a firm must demonstrate that its recommendations in relation to retail investment products are based on a ‘comprehensive and fair analysis of the relevant market’ and are ‘unbiased and unrestricted’.

If a firm provides independent advice in respect of a relevant market that does not include all retail investment products, a firm must disclose to clients an explanation of that market, including the types of retail investment products which constitute that market.

A relevant market should comprise all retail investment products which are capable of meeting the investment needs and objectives of a retail client. For a firm not specialising in a particular market, the FCA has said the relevant market will generally include all retail investment products.

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