OUR EXPECTATIONS FOR INVESTMENT TRUST BOARDS

PHASE ONE - EQUITY INVESTMENT TRUSTS
JULY 2023

QUILTER CHEVIOT
INVESTMENT MANAGEMENT

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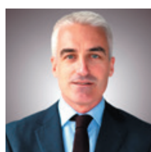

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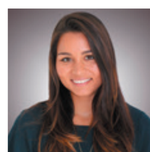

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INTRODUCTION

Investment trusts have been in existence for over 150 years, delivering strong long-term performance for their shareholders. They have continued to innovate and adapt to meet investors' needs and invest in a range of assets, from equities to renewable infrastructure, from property to private equity.

The investment trust industry's assets have grown by over 140% over the last decade to £267bn. There is an increased awareness of investment trusts and their many advantages which include their income returns and suitability for illiquid assets.

Investment trusts' independent boards of directors are another key benefit for shareholders. Boards have been particularly proactive this year in their pursuit of shareholder value, proposing mergers, reducing fees and even proposing the winding-up of companies.

Shareholder engagement is a critical component of good governance. We welcome Quilter Cheviot's thorough engagement programme which explains their views, the rationale behind them and their recommendations. This is a valuable contribution from a leading wealth manager that is clearly committed to the investment trust sector. We look forward to Quilter Cheviot's future engagement with the industry.

Richard Stone, Chief Executive of the Association of Investment Companies (AIC)

Executive summary

In May 2022 we launched an engagement focused on our centrally monitored investment trust holdings. During this first phase we have focused on equity investment trusts that we invest in on behalf of our clients to evaluate and set expectations with each board for the future against three factors:

- board composition
- board effectiveness
- responsible investment disclosures.

This is a long-term engagement, and this paper represents the outcome of this first formal evaluation focused on investment trusts investing in equities; the second phase will focus on alternatives. We have valued our discussions and certainly learned along the way. The investment trust sector is far from homogenous, and this is reflected in the evaluations we have conducted. There is in our view, room for improvement for most trusts, however we are also mindful that the regulatory landscape and shareholder expectations are also changing and what looked good a couple of years ago has now perhaps lost some of its shine. Ultimately, we want to work in partnership with the trusts where we are shareholders on behalf of our clients, in order to ensure that the sector keeps pace with expectations and regulations.

An investment trust[1] is an investment fund which is listed as a public limited company and the shares can be bought and sold on the stock exchange. One of the key differences of investment trusts versus open-ended funds is that they have an independent board of directors whose job is to work in the best interest of the shareholders. Investment trusts are permanent capital therefore they can be well suited to investing in more illiquid assets.

As at 30/04/2023 there were 378 listed investment trusts representing £266bn, of which £112bn are invested in equites[2].

1 Investment trusts are a type of investment company which has a UK tax base (unlike non-UK investment companies or VCTs), but for this report, we are using the term interchangeably.

2 Association of Investment Companies (AIC)

Whilst the actions of boards are instrumental in achieving change, the role of shareholders is also important, and we believe that there is room for improvement. Shareholders are not exercising the levels of stewardship (active ownership) that we would expect to see from investment firms. For example, firms do not always (and sometimes rarely or never) accept the board's offer of a meeting. We appreciate that meeting a board annually when there is little to discuss, is not an effective use of time for any party involved, however we would expect that firms investing on behalf of their clients would seek some engagement with boards.

Managing succession planning and ensuring that tenure remains appropriate (we support the nine-year rule) are key ingredients in effective governance. We appreciate that boards might need to add an extra non-executive director (NED) to the board in the short-term to manage succession and we will support this. We are less supportive of the notion that the nine-year term resets when a NED is appointed to the chair position.

Whilst statistically board diversity metrics have improved significantly over the last decade, this remains problematic in parts. Whilst we do not invest in any trusts where there is no female representation, a few boards have work to do on this, and ethnic diversity remains an issue that a number of boards have not addressed sufficiently. To foster a more diverse NED population we believe that personal wealth should not be a barrier to becoming a non-executive director (NED); however, that is not an issue for most NEDs and therefore we will question where NEDs do not hold shares in the trust.

Judging whether a NED is 'over-boarded' and is unable to devote sufficient time to the role is not as easy as simply counting the number of NED, executive and chair positions and awarding points, as not all roles are created equal. This is true not just for investment trusts, but for all listed companies. Therefore, whilst the points system is a helpful starting point, a more qualitative analysis is required.

As at 30/04/2023 Quilter Cheviot[3] owned 41 investment trusts that we have classified as investing in equities with a combined value of £1.4 billion.

Turning to responsible investment disclosures consideration must be given to local expectations and future regulatory standards. The disclosures should be about the trust's holdings and its approach – not about the firm – we want to see the manager's work in regard to voting and engagement, as well as how environmental, social and governance factors are integrated within the investment process. We are not advocating a specific responsible investment committee however the board should have the appropriate expertise to challenge the manager as required on what is an ever-evolving subject.

Finally (and this is solely in reference to the 41 trusts that we engaged with) we found that large is not better and that developed markets do not lead the way. Trusts with a market cap over £2 billion tended to score worse for board composition and effectiveness whilst trusts investing in emerging markets and Asia have outperformed in all the three areas of board composition, board effectiveness and responsible investment disclosures.

3 This represents the Quilter Cheviot centrally monitored universe

Overview

Introduction and scope

In May 2022, Quilter Cheviot initiated an engagement focused on investment trusts. On behalf of our clients, we have significant exposure to the investment trust market. There are fundamental differences between an investment trust and an open-ended fund. When we invest in an investment trust, we become the shareholders of the company and, as such, our expectations for the governance of that company are much higher than they would be for an open-ended fund. An investment trust is a listed company, and like other listed companies, it has a board of non-executive directors (NEDs) whose job is to ensure that the investment advisor (manager) is acting in the best interest of the shareholders. The manager is appointed by the board to run the day-to-day operations of the investment trust.

Within this first phase we have focused on the equity sector; of which Quilter Cheviot owns 41 trusts within its centrally monitored universe.

Most of the meetings were in person at our offices. On most occasions we met the chair, or the chair and the SID. The meetings were performed independently from the investment adviser. However, some board members were escorted by one (or more) chaperones, usually someone on the central investment trust team or a relationship manager.

Whilst we are happy to indicate the topics that we would like to discuss with boards, in some cases we have been asked to send a comprehensive list of questions. We appreciate that this might reflect the investment adviser being overprotective and not necessarily at the board's request; we have not provided a question set in advance as we are keen to have a conversation rather than a highly scripted response. We would emphasise that as long-term investors we are seeking a partnership approach, which will at times take the form of being a critical friend.

As part of this engagement, we have also engaged with the Association of Investment Companies (AIC) and two service providers, Trust Associates and a leading reviewer of investment trust boards.

We have also spoken at various industry events including the annual AIC conference, a broker hosted NED meeting and an asset manager hosted NED meeting. Additionally, we have attended a board meeting of a trust, met with the heads of marketing and sales for one large investment trust manager, as well as meeting chairs of investment trusts who are not on our target list, but are interested in discussing the role of the board and our views.

The three factors

The objective of this engagement was to improve the corporate governance practices and responsible investment disclosure in the investment trust sectors, primarily focusing on three factors:

Factor	Detail
Board composition	We expect a board to be independent, diverse and have the right skillset. In regards to independence there are two areas of primary focus: firstly, we do not believe it is acceptable for an investment trust to have a board member that has been appointed or is employed by the investment advisor. Secondly, we believe that tenure does impede independence and expect boards to adhere to the nine-year rule unless there are mitigating circumstances. We expect boards to be diverse and to meet the FTSE Women Leaders and Parker Review targets. The board's skillset should be appropriate to challenge and support the investment adviser as well as representing shareholders.
Board effectiveness	The board function is to represent the shareholders and act in their best interest. Therefore, we expect boards to have the ability and willingness to challenge the investment adviser when necessary. Additionally, boards should be accessible and prepared to meet with shareholders and open to considering their feedback.
Disclosures	We want to see responsible investment disclosures that are pertinent to the investment trust and its holdings. This will vary depending on the asset class that the trust invests in. For equities at minimum, we want the trust to disclose how it has voted on its holdings (when applicable) and the rationale behind some of the most significant votes. Examples of how the manager has engaged with the holdings as well as clear examples of ESG integration are encouraged for all asset classes. It is also good practice to report on the board's role in managing these ESG risks.

The first phase of the overall engagement is to evaluate each investment trust against these three factors and to set expectations with each board for the future.

Initial assessment and escalation

For each of the meetings we have RAG rated the three factors and for all the trusts we have set expectations for the future, obviously these will vary depending on the RAG rating. Quilter Cheviot will always advise the board of its voting intentions. This will be an ongoing engagement programme and we have established our own specific escalation plans including (depending on the issue):

- Voting against the chair or other NEDs
- Voting against adviser representatives.

We have decided to anonymise investment trusts within this engagement framework as our intention is to work with the investment trusts to engender better governance and disclosure and we feel that disclosing names would not necessarily help with this.

Board composition

The investment trust landscape is a mixed bag when it comes to governance standards. The sector is generally less understood by investors, proxy advisers and ESG data providers which can lead to corporate governance standards not being as high as one would expect.

We believe that there are several factors that are critical to an effective board which has proper oversight on behalf of shareholders.

Skills and independence

As obvious as it is, the basis of a well-run board is having the right people at the table. Having a mix of skill sets and independence is critical to this.

For example, having some NEDs with investment trust experience is helpful and allows the board to deal with the intricacies of the vehicle, however, in our view the law of diminishing returns applies and not all NEDs need an investment trust background. As this engagement progresses, we will place more scrutiny on boards where there is a plethora of NEDs with multiple investment trust appointments as we wonder whether this leads to an echo chamber effect. Within the board it is important is to have experience in the investment strategy of the trust, for example if the trust invests in private equity, we expect to see NEDs that have experience in the subject. Furthermore, the more enlightened boards seek complementary skills such as marketing.

We believe NEDs:

- should not be appointed by the investment adviser
- be employed by or connected to the investment adviser
- should be independent of the underlying holdings.

Where a board includes employees of the investment adviser, we will challenge this as we do not believe that this is necessary and can lead to potential conflicts of interest which are not always manageable or obvious. Within the equity investment trusts there are two which have a manager representative as well as a further two who are in effect representatives of the founding family. It does not help that proxy voting advisers fail to make this distinction as their focus is on the percentage of independent NEDs on the board. Manager representatives will obviously be present at board meeting but that does not mean that they need to be a NED. One chair suggested that not having the manager representative on the board could lead to a 'shadow director' position. We do not believe that this has veracity given that the vast majority of boards do not have a manager representative.

Grudgingly, we will make an exception for the handful of investment trusts that have significant family ownership. However, we will do so only in the knowledge that the board has significant independent representation and strong leadership from the chair.

One area that we will explore further over time, is the appointment of NEDs at the time of an IPO (Initial Public Offering). From our brief discussions about this, it is common that the manager sources and appoints the NEDs at IPO; external executive search firms are not always (commonly?) used. We appreciate that the IPO market has been relatively quiet (indeed asleep until recently) however this still is a potential issue, and this has been validated by some of the conversations we have had where the NED has been appointed since IPO and sees their role as being at the manager's discretion.

The board should be focused on strategy and constructive challenge to the manager; this is not about second-guessing investment decisions (if they are in line with the mandate).

One interesting (and so far, unique?) example of a board's independence is a trust holding a beauty parade to ensure that the current manager was still appropriate. The chair explained that he believes this is best practice and that it is common in the charity sector. An added advantage is that undertaking this when there are no specific issues ensures that you understand the marketplace if in the future a manager change is required.

Succession planning

Succession planning should be managed on an ongoing basis – we regard an inability to do so as a governance failure.

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The AIC's corporate governance code provides more flexibility than the UK corporate governance code when it comes to the tenure of NEDs. However, it is our view that a nine-year tenure is best practice.

We know that there are situations outside of the board's control where longer tenures are required, however, even in those cases there should be succession plans in place and there should not be unlimited term extensions. It is the chair's responsibility to ensure that there is a solid succession plan in place that is taking experience and diversity of NEDs into account. We do not mind temporary increases in board size to smooth out succession, but directors should be aware of tenure "cliffs" where multiple NEDs should leave the board at the same time.

Finally, in instances where the chair successor's is already a director, boards should be mindful that the nine-year rule applies from the moment a director joins the board and not when they become chair.

Diversity

We expect boards to be diverse and by this we have considered the FTSE Women Leaders[4] and Parker Review targets[5] as well as the FCA's diversity targets[6].

The FCA diversity targets do not differentiate between investment and operational companies in its expectations. We are sympathetic to the view that given the smaller size of investment trust boards it may be harder for them to meet the full FCA targets. Therefore, our current expectation is that the board should have 40% female representation as well as meeting the Parker Review ethnic minority target as appropriate. Additionally, we encourage boards think about how their recruitment processes and whether they are accessing a wide pool of candidates.

During our conversation we have seen a range of approaches on this issue. The boards we have engaged with use executive search firms as part of the recruitment process and therefore diversity is included within many of the search parameters. It is notable that some executive search firms are gaining a reputation as providing more diverse shortlists.

Anecdotally a few directors have mentioned that they are able to reach a more diverse pool of candidates by using personal networks. We are not against this, however, there must be a thorough process managed by the executive search firm to ensure these candidates are properly vetted and not just get a free ride because they know the right person.

For trusts listed in the Channel Islands there are requirements to have a NED (or more) based there. Given the size and demographics of the population this can lead to a shallower and less diverse candidate pool which trusts need to take into consideration when constructing a board.

Talking about cognitive diversity being important and that the focus should be on appointing the right person is becoming very tired.

4 The target is to achieve 40% women representation in FTSE 350 leadership teams before 2025

5 Parker review target UK100 companies of representation of at least one member from a minority ethnic background on their boards by 2021 and UK250 by 2024.

6 FCA target: (1) 40% of the board should be women (2) At least one of the senior board positions (Chair, (CEO), (CFO) or Director (SID) should be a woman (3) one member of the board should be from an ethnic minority background – reporting from Q2 2023

Recruitment

The manager should not be involved in the recruitment process, the only aspect that seems reasonable is to provide a shortlist of names to the manager to sense check any potential issues. On the whole trusts do seem to follow this approach however there are some instances where the manager is heavily involved.

The Association of Investment Companies' Code of Corporate Governance states that: *If an external search consultancy is engaged it should be identified in the annual report alongside a statement about any other connection it has with the company or individual directors.* However, we have found examples where the name of the executive search firm has not been disclosed in the annual report.

In our conversation a total of eleven different executive search firms have been employed recently. What is interesting is that boards tend to switch between firms more frequently than one might expect – this seems to be driven by the recruitment firms' speciality.

One area we are keen to explore further in the future is whether sufficient opportunity is given to candidates who do not have existing investment trust experience. We have heard of at least one trust which is running "NED apprenticeships" where a person without previous director experience will attend board meetings as a way of gaining board experience.

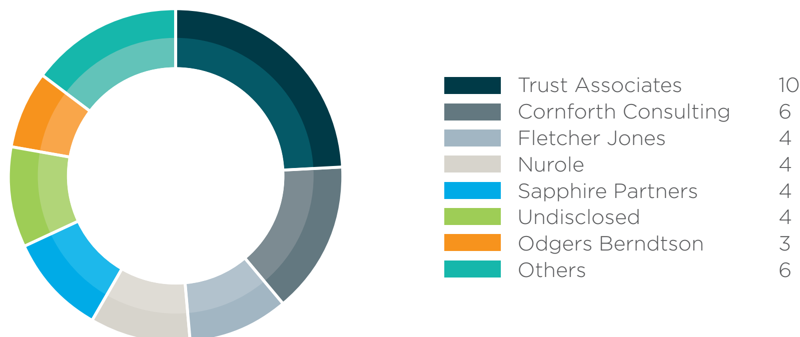
Case study

As part of the engagement, we spoke with Trust Associates, which is a board advisory firm specialising in succession planning. It was the most used external executive search firm by the trusts within this engagement. The purpose of engaging with Trust Associates was to understand how investment trusts boards are evolving over time, specifically in regards recruitment preferences and succession planning.

Perhaps unsurprisingly, diversity has become a more important factor within the succession planning process; boards are seeking a more diverse shortlist of candidates as pressure mounts to meet regulatory targets. In some cases, boards are looking to hire NEDs with no board or investment experience to broaden their potential universe of candidates. In these cases, boards are looking for experience like marketing or responsible investment.

Some trusts are expanding the boards to meet diversity targets. This is not our preferred approach, especially for boards that are already looking overcrowded. Board diversity expectations have been flagged for some time and careful succession planning should yield balanced boards.

Mandates by executive search firm for most recent NED recruitment



Source: Annual reports for the companies as well as through our engagements for the 41 investment trusts. Others include: Ridgeway Partners (2), Tyzack Partners (2), Russell Reynolds Associates (1), Spencer Stuart (1)

The name of the executive search firm should be disclosed in the annual report.

Over-boarding

The question of ensuring NEDs have enough time to carry out their role is an important one. However too often blunt tools are used to assess this. For example, usually only positions in publicly listed companies count towards the points system that proxy advisers and investors use. As an example, this is how one proxy voting service provider assesses the workload:

Example of a proxy voting service provider points allocation:

Holding more than five positions at listed companies will be classified as over-boarded.

NED position = 1 point
Non-executive chair = 2 points
Executive position = 3 points
Executive position + non-executive chair at another company = over-boarded

The policy states that consideration is given to the complexity of the company as well as the number of positions where the person chairs key committees. Additionally positions on investment trusts may be viewed more leniently.

However, there are several issues with this:

- this can result in chairs of investment trusts having the same points awarded as chairs of operational companies
- the workload of a chair or NED of an equity investment trust looks very different to that of the same positions on an infrastructure trust as an example
- holding a main board position on a large bank is very different to other companies and should probably be awarded 3 points
- private company, pension fund trusteeships and not for profit positions are ignored – however these could all have significant time requirements and responsibilities.

The points system is a helpful starting point and a foundation to build upon. However, to help shareholders undertake more informed evaluations (and therefore voting decisions) a qualitative assessment is a useful addition. Consideration needs to be given to the positions and more disclosure on positions outside of the listed company space would be helpful – many boards do so already. As one chair pointed out – the fees that are paid are far more indicative of the amount of work than any points system.

Board effectiveness

Communication

During our engagement it emerged that some boards are rarely troubled by shareholders asking for a meeting. One chair said he had not met a shareholder in seven years. There are several reasons behind this – and both boards and shareholders have some work to do.

An example is chairs referring to 'letters' sent to shareholders annually inviting them to meet, yet there is little or no take up. We would question how effective this communication method is as we have not received some of these 'letters'.

Equally, how proactive and interested are shareholders?

We are not sure that annual meetings with the chair are required; however, it seems that the industry needs to work on its communication methods.

Board responsiveness

'He is a non-executive director[7]'

As mentioned before when we invest in an investment trust, we become the owners (shareholders) of the trust. Therefore, one of the metrics that we are using to judge the outcome of these engagements is the "responsiveness" of the board, which is a broad metric that we use to measure how willing the board is to engage and campaign on behalf of shareholders.

Sometimes responsiveness is measured by the board's willingness to influence the manager, which can be particularly difficult with "star fund managers". For example, not wanting to discuss fees with the manager because the chair "already knows" the manager will not like that, or the manager pre-selects NEDs for appointment.

On some occasions is the investment adviser hindering access, by delaying the communication between shareholders and the board. The worst example (so far) was following a request to meet the trust's chair, one of the manager's employees contacted us to understand whether this was important as the chair is a very busy person and a non-executive director. Thankfully this response is an outlier and we have met the chair; but why a NED whom the shareholders are paying for is unable to meet them is frankly astonishing.

This can be summarised on one point; the manager works for the board and the board works for the shareholders. At the boards of all trusts there should be absolute clarity over what decisions are the remit of the board.

7 Manager representative in response to our request for a meeting with the chair of the trust

Skin in the game

Alan Brierley of Investec's "Skin in the Game" report has been frequently referenced in our discussions regarding NED shareholdings. Our thinking has evolved over time, previously we would expect a chair to hold shares in the trust equivalent to two-times annual fees, and NEDs to hold one-times annual fees. However, we acknowledge that having this as a requirement may exclude some individuals from joining the board; and that would be contrary to our philosophy of looking for diverse and skilled candidates for the job and not the person that is able to afford it. Equally we appreciate that these holdings become in effect illiquid for the NEDs as any sales would be viewed as potentially troubling.

Notably very few trusts have hard and fast rules about ownership, however chairs 'encourage' NEDs to own shares. Of the chairs we have met over the last seven years[8] we have met two chairs who believe it is a conflict of interest for NEDs to own shares. We disagree; we believe that NEDs owning shares in the trust is good practice. Whilst assessing this we are mindful of ensuring that hurdles to becoming a NED are considered however most investment trust NEDs have a background and longevity that would not preclude them from owning shares in a trust where they sit on the board. We also appreciate that in some instances there may be regulatory barriers to owning shares.

Personal wealth should not be a barrier to becoming a NED, however that is not an issue for most NEDs.

Therefore, we will continue to raise zero or low NED shareholdings with the chair.

Board evaluations

"The evaluation providers are being paid by the board therefore they are unlikely to bite the hand that feeds them, or they will very soon run out of clients[9]".

Board evaluations of UK350 companies should be externally facilitated at least every three years[10] (on a comply-or-explain basis). The AIC states that the external provider should be identified in the annual report and any connections between the investment trust and the third-party should be disclosed.

In theory, an external board evaluation is meant to provide an objective view of the board's effectiveness assessing among other things, skills, experience, independence knowledge and diversity. External board evaluations are there to complement internal evaluations which should be led annually by the chair and the Senior Independent Director in conjunction with the other NEDs.

8 We began our formal engagement programme with investment trusts in 2016; this includes meetings outside the collaborative engagement we are currently undertaking

9 Chair of an investment trust

10 UK Corporate Governance Code 2018 and the AIC Code of Corporate Governance

External evaluations get mixed reviews: several chairs felt that this adds very little value or that it is not in the interests of the provider to undertake a warts and all review. Even though this does not represent the majority view, only a handful of chairs have admitted that the evaluation provided useful insights and a to do list. No board is perfect therefore one would expect there to always be room for improvement.

Other NEDs commented on the high cost associated with running this exercise and suggested that the manager or shareholders are in a better position to assess the board's effectiveness. On the latter we note that most of the chairs do not tend to meet with shareholders regularly so that might not be sufficient oversight for most boards. Also, the external evaluation provider that we engaged with noted that awareness of shareholder views is something that NEDs tend to rate as being an issue they struggle with, yet we are aware of only one investment trust within our wider universe that has engaged with shareholders as part of an external evaluation (we were part of it). It seems that this should be a stakeholder that boards are engaging with.

External evaluations come in two forms: paper-based questionnaires and interview-based assessments.

- Paper-based questionnaires: NEDs complete a questionnaire, which is then reviewed by an external firm and summarised into a report. This report may be presented at a board meeting by the evaluation firm.
- Interview-based assessments: this is more comprehensive. It includes individual interviews with directors and may involve the evaluation firm observing board meetings. The findings are summarised into a report. While interview-based assessments are more expensive (up to three times in some cases) we would argue that they offer better value for the money.

Most boards acknowledged that whilst most of the evaluations are uneventful under normal circumstances, it is a useful tool to provide an objective resolution when there are internal issues with the board dynamics.

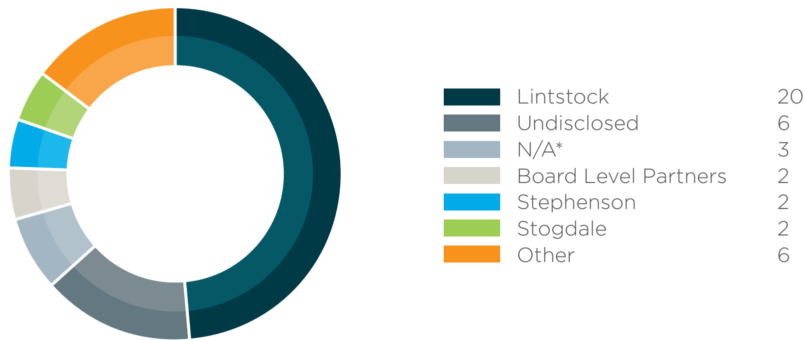
The AIC Corporate Governance Code states:

There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors. The chair should consider having a regular externally facilitated board evaluation. In FTSE 350 companies this should happen at least every three years. The external evaluator should be identified in the annual report and a statement made about any other connection it has with the company or individual directors.

Again, not all trusts disclose the external company that is employed to do this.

Boards should disclose the company undertaking external evaluations. Boards should consider who should be engaged with through the external evaluation process. We would suggest including all third-party providers as well as shareholder representatives would lead to a more complete evaluation.

External board evaluation (most recent)



Source: Annual reports for the companies as well as through our engagements for the 41 investment trusts. Others include: Aidan Lisser (1), BoardAlpha (1), Fletcher Jones (1), SCT Consultants (1), The Effective Board (1), Value Alpha (1)

**N/A – this represents trusts that have not had an external board evaluation*

Case study

Key findings from our engagement with a leading reviewer of investment trust boards:

- Investment trust boards tend to rate themselves higher than boards at operational companies
- Investment trust boards' perception of their efficacy is positively correlated to the performance of the trust's investment
- NEDs are least confident about understanding shareholder views and marketing.

Case study

Engagement with a board and so much more

We engaged with the chair and SID of the board as part of this process. Our conversation led us to being invited to the board meeting (no manager representatives were allowed) to discuss our views with the wider board. One of the key issues for us, and the board was about the marketing of the trust, and how we felt that the marketing was lack-lustre and the story behind the trust, and particularly the responsible investment disclosures could be improved.

This then led to meetings with the heads of marketing and sales for investment trusts, and then onto a session for the NEDs of all the manager's investment trusts.

This is what mean by partnership.

Responsible investment disclosures

By responsible investment disclosures we mean the following:

- The overall responsible investment approach taken by the trust
- Voting record and rationale
- Engagement with underlying holdings
- The integration of ESG (environmental, social and governance) factors within the investment process
- Metrics and data used, including any net zero alignment.

Room for improvement

It is irrelevant whether the trust has sustainable or responsible investment objectives or outcomes: all trusts should be disclosing how they act as a steward of their shareholders' assets. For example, integrating ESG factors into the investment process is a method of risk mitigation which we expect from all investment trusts.

When it comes to disclosure, on the whole investment trusts have some room for improvement. Too often there is over-reliance on the manager's reporting at a firm level whereas we are focused on reporting at the investment trust level.

Reporting should be meaningful and should not rely on the underlying holdings' own reporting but should reflect the manager's own view of the ESG risks and opportunities.

One message that we are keen to deliver is that data dumping is not of interest to us. Voting statistics without the rationale or engagement behind the voting decision is not helpful to us.

PRI signatory status

We consider whether a firm is signed up to the United Nations' backed Principles for Responsible Investment (PRI) and UK Stewardship code, where appropriate. From 1 June 2021, any new funds (including investment trusts) added to our centrally monitored investment universe are expected to have PRI signatory status through their investment manager/adviser[11].

Three of the funds within the equity investment trust universe are not signatories and we have engaged several times with them regarding this. In the case of one firm, we have declined to invest in a new fund launch on the basis that they are not a PRI signatory. One of the chairs stated

We understand that for some strategies, being a PRI signatory would not have a tangible benefit. However, for those operating in the equity space we believe it does and will continue to engage on this.

11 If this is a fund managed by a recently established firm, we would agree a timeline for the firm to sign up to the UN backed PRI. In exceptional circumstances, new funds may be added to our investment universe which are not, and do not have an intention to become a signatory. However, this would be extremely rare and the rationale for not being a signatory would have to be linked explicitly to the specific strategy that the fund was invested in. Any fund being added to coverage in this instance would need to be agreed by the Chief Investment Strategist. For funds within the current centrally monitored investment universe, we have identified a small proportion which are not PRI signatories. We expect a number of these will attain signatory status in the near term. For those that remain, we will continue to engage with them on this subject to continually evaluate the rationale for not becoming a signatory. We accept that for a very limited number of specific strategies, there is no tangible benefit in attaining signatory status at this stage given the nature of the underlying investments.

that the manager's responsible investment work is to a higher standard than the PRI[12]. We challenged this as the PRI does not have a standard per se – it is a mechanism for benchmarking responsible investment processes, and that we have no concrete evidence that this is the case given the lack of external disclosure on stewardship and ESG integration activity by the manager.

ESG is woke

Two of the three trusts that are not PRI signatories within the equity universe are both US based. There has been a significant backlash against 'ESG' in red states across the US. Indeed, in Florida formal measures have been taken to "protect Florida's investments from woke environmental, social, and corporate governance (ESG), ensuring that all investment decisions focus solely on maximizing the highest rate of return".[13]

If we think about why managers should be integrating ESG factors within their processes – it is firstly about risk mitigation for most investment trusts. How you can maximise the highest rate of return over the long term without understanding and managing risks such as those related to ESG factors is not clear. However, what is clear is that some US based firms are facing a very different political landscape to that in the UK. Does that mean that we let them off the hook? No. If you want to do business in the UK and manage a UK listed company then you need to do so in line with local expectations and future regulatory standards.

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Board capability

'Engagement is fatuous[14]'

Most boards are open to constructive challenge and discussion – however not all are. One chair was not receptive to the idea of disclosing information regarding the manager's engagements with the trust's underlying holdings. Obviously to be told that engagement is fatuous whilst you are in the middle of an engagement is a special experience.

We are not advocating separate committees focused on responsible investment as this should be part and parcel of the investment process. Additionally trusts run by larger investment firms perhaps have less of requirement for specific responsible investment related expertise.

12 This was prior to the new reporting system that the PRI published in late 2022 which means a manager is to see how it scores versus the median. However, without making a submission to the PRI there is no way to assess how a firm performs versus the PRI standard.

13 Governor Ron DeSantis Further Prohibits Woke ESG Considerations from State Investments (flgov.com)

14 Chair of an investment trust when asked about providing more disclosure regarding the manager's approach to engagement

The responsibility does not just lie with the board – the manager has a role to play. The responsible investment regulatory environment is constantly evolving – how well are boards being briefed on upcoming legislation such as the anti-greenwashing rule and Sustainability Disclosure Requirements?

Having responsible investment experience within the board is helpful in ensuring that the topic is understood, and the risk of greenwashing is hopefully mitigated. In the instance where the chair claimed that the manager's responsible investment work was to a higher standard than the PRI it was very clear that the chair's understanding of the PRI was very limited and was this a line fed by the manager.

Where to disclose?

We are not particularly vexed about where the disclosures should be. We absolutely have sympathy with the concern that annual reports are growing and are unwieldy. Certainly, there should be reference to responsible investment within the annual report and if the board is keen to keep the pages down then a separate report or a section on the website works equally well.

The key is that the disclosure should be about the trust's holdings and approach – not about the firm's approach - we want to see the manager's work.

RAG rating

We have RAG rated each of the 41 trusts on the three factors. We have looked at this in a number of ways including (as shown in this report) by market cap and by regional / sector focus to see whether there is any correlation between size or region / sector and the RAG outcomes. We are seeking to set higher standards therefore to achieve a green rating is the exception not the norm. Within the amber rating there is a range – some trusts need to a little bit more, whilst others have quite a bit more work to do. We have anonymised the trusts as this is a long-term engagement and we do not see any advantage in publicising the names.

Green rating:

- only three trusts have a green rating for all three factors (7% of the universe targeted here)
- The factor with the highest percentage of green rating was board effectiveness, at 70%
- 63% of the boards achieved a green rating for composition and effectiveness.

Amber rating:

- disclosure was the most frequent amber factor with 82% of trusts receiving an amber rating; this is reflective of the lack of voting rationales or engagement examples
- 15% of trusts have received an amber rating on their board composition, indicating poor succession planning. Additionally, 15% of trusts received an amber rating on their board effectiveness.

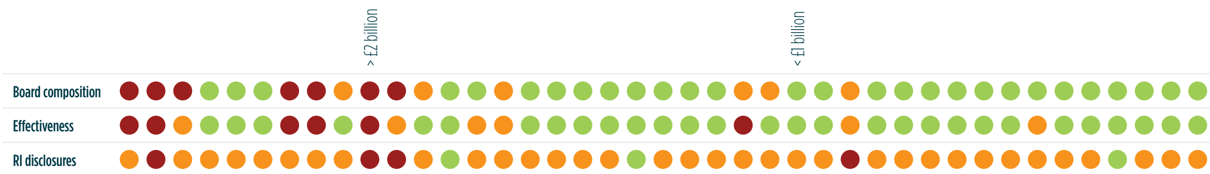
Red rating:

- two trusts received a red rating for all three factors
- board composition was the factor that had the greatest number of red ratings: seven trusts representing 17% of the trusts within this universe. The most common reasons for the red rating for board composition:
  - a board that is not meeting the UK gender targets or has non-independent directors
  - boards that have one or more directors serving over the recommended tenure of nine years with no plans to resolve this - this indicates a lack of succession planning
- those with a red rating in board composition were more likely to underperform in board effectiveness. 71% also obtained a red for board effectiveness.

Does size matter?

63% of the trusts we met with had a market cap over £1 billion, with nine of the 41 trusts having a market cap over £2 billion. If we rank the trusts by market cap, the smaller market cap trusts did not seem to be negatively impacted by the RAG rating performance. In fact, trusts with a market cap over £2 billion tended to score worse for board composition and effectiveness.

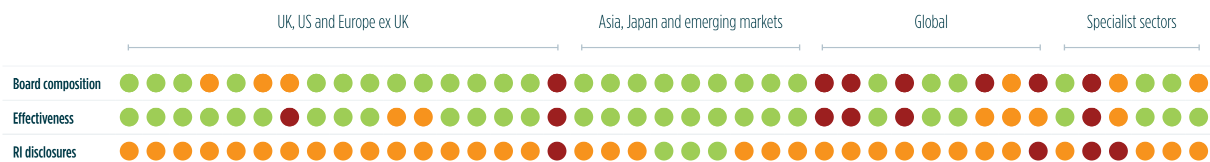
Number of trusts engaged with by market cap



Regional differences?

We have not adapted our assessment of the three factors in regards geography or sector. Our sample size may not be statistically significant, but it shows that trusts investing in emerging markets and Asia have outperformed in all three areas. This could be due to the greater severity of ESG related risks and opportunities in these regions.

Number of trusts engaged with by region or sector



At the end of the phone / email / Teams?

Within the board effectiveness rating, we also evaluated how easy it was to arrange a meeting with the chair. This may not seem to be a board related issue per se given that the adviser would usually be our contact however we felt that this reflected how accessible the board was to shareholders.

Interestingly there was little correlation to the size of our shareholding meaning that it is not dependent on how large an investor you are. Notably a number of our smaller holdings were extremely responsive – cynically, we are not sure whether this was because a meeting was seen as an intention to invest more.

This looks familiar?

We invest in a number of investment trusts which have the same investment adviser; overall there was low correlation in the scoring for board composition and effectiveness, although one investment adviser seems to be less concerned about the nine-year tenure rule than we are.

Unsurprisingly there was a higher correlation for responsible investment disclosure rating. As investment trusts managed by the same investment advisor tend to have the same reporting format, although that is not the case for all, and it was clear that some boards were far more persuasive in ensuring the reporting reflected their vision rather than the advisers.

Large is better?

On one hand, the larger investment advisors have the necessary resources to create detailed disclosures and invest in marketing programs. However, their size can also make them less agile and flexible. “It’s like steering a big tanker” was used as an analogy several times.

Other considerations

Discount: part of an investment trust's board role is to decide how the company is going to deal with its discount (and premium). Discount management can be broadly classified on two types.

1. Discount Control Mechanism (DCM) which is an automatic action will be executed when the discount/premium reaches a certain level.
2. Discount Control Policy (DCP) which indicates actions the board might take to manage the discount and but does not necessarily specify the level at which it will act.

According to the Association of Investment Companies (AIC) more than two thirds of investment companies have some type of discount management in place with a DCP being the most common practice amongst boards.[15] At the other end of the scale fewer than 5% of trusts have a zero-discount control policy which means that they will buyback or issue shares as soon as the discount moves from 0%.

The most common way to control the discount is buying back shares. Buying back shares at a discount reduces the number of shares in circulation increasing the ownership of existing shareholders. This can be an issue for institutional holders that already own a large percentage of the trust. Buybacks also carry another risk, which is that by buying back shares you are reducing the size of the trust, and this can be especially dangerous for smaller trusts as a smaller market capitalisation can create liquidity issues that might prevent institutional players from investing.

Overall, we favour a pragmatic, rather than systematic, approach to share buybacks. Our view is that investment trusts should have the ability and willingness to buy back shares. A willingness to issue new shares should be matched by a willingness to undertake share buybacks.

Gearing: We support gearing when it is used wisely as this is one of benefits that investment trusts have over other vehicles. However, we are wary of trusts that have gearing in place but do not use it, as this is another cost borne by the shareholders.

Marketing: Marketing and how to attract new (younger) shareholders has been an important part of many of our conversations. As long-term holders of trusts it is in our interest to ensure the longevity of these vehicles. We are not advocating managers taking to Tik Tok, as much could be done with some of the existing online resource.

There are some great websites which draw you in, there are others that are frankly a snooze-fest with a focus on data, which is important, but is pointless without context. Engaging with future and current shareholders needs some effort and thought into what the right medium is to connect with them. A short video providing insights into an investment is far more compelling than a written report.

Finally, broker platforms have become the primary way for retail shareholders to access the stock market. Therefore, we would really welcome more engagement between investment trusts and platforms.

15 Discount controls | The AIC

Disclosure of holdings: Equity trusts should disclose their holdings (all of them) on a regular basis. We believe that transparency is important and that there is little to support the argument that the strategy might be replicated by others. We have engaged with investment trusts on this issue in the past and we have seen a move towards far greater transparency which we appreciate.

Outcomes of our engagements to date

This is a long-term engagement and therefore we will monitor outcomes over the next three or so years as change will be incremental. Even though we are still in the early part of the engagement cycle, we have already had some positive outcomes. One of the trusts that we engaged with late last year, has confirmed that in the next annual report it has expanded the disclosure of stewardship activities, and it specifically cited this as being a result of our engagement. Equally the market is always evolving and with the advent of the Sustainability Disclosure Requirements in the UK we will see further change. Therefore, we will not be arrogant and assume that change is always a result of our actions.

As previously mentioned, we have set expectations for all the boards that we have spoken to within this engagement. In most cases the key areas where we would like to see improvement are responsible investment disclosure and board composition. We are not agitating for immediate change (in most cases); however, we expect to see progress and will monitor this over the next 24-month period.

For the investment trusts where red areas of concern have been identified, we will be in touch much sooner. In the most serious cases we have already escalated our engagement with a formal letter to the board indicating that unless the situation is remediated, we will be voting against management at the next shareholder meeting.

Our expectations

Investor expectations evolve over time and what was good practice a couple of years ago becomes the norm. As it stands this is what we expect.

Board composition: We expect boards to be optimised to defend the interest of shareholders and to avoid board compositions that hinder this.

- **Independence**: this is perhaps the most critical feature of a board. The board's role is to act in the interest of shareholders, having management representatives on the board is in our opinion far from optimal. We believe that having 100% independent boards is in the best interest of shareholders. We understand that manager-appointed NEDs can add valuable experience and knowledge to board's discussions, however, we argue that this experience can also be shared without being a NED. Additionally, we want boards to show independence of action; for example, we do not expect the investment adviser to be involved in the selection of NEDs bar a simple sense check.
- **Tenure**: we agree that best practice is a maximum of nine years tenure. We understand that a director will not automatically become non-independent after nine years, and in some cases a limited extension of the tenure might be a requirement to ensure appropriate succession. We expect boards to have solid succession plans in place to avoid director cliffs and excessively long tenures.
- **Over-boarding**: NEDs should dedicate sufficient time to the oversight of the investment trust, and we expect NEDs to attend to 100% of their designated board meetings unless there are mitigating circumstances. We appreciate that being a NED of an investment trust (particularly in the equity space) is very different to being on the board of an operating company; however, we monitor the number of board positions and will vote against NEDs where we believe there is an issue.
- **Board skills**: boards should have the right skills and experience be able to constructively challenge the investment adviser. An independent board without the right skills will not be able to challenge the manager and protect shareholder interests.
- **Diversity**: we expect boards to be diverse and to work towards the FCA diversity targets, (including FTSE Women Leaders and Parker Review targets). Additionally, we encourage boards reflect on recruitment processes and whether they have access to the wider pool of candidates.

Board effectiveness: this can be harder to define succinctly – as there are several qualitative elements.

- **Communication**: both boards and shareholders need to work at this – boards should be willing to engage with shareholders.
- **Board responsiveness**: a key element of it is the board's ability and willingness to interact with shareholders. An example would be a trust that we have engaged with over several years and on a variety of issues, some of which where we and the board fundamentally disagree. The point is that the chair and the SID have always been willing to engage and have the hard conversation which is the key to our goal of acting as partners not adversaries. We may not like what each other is saying, however having the conversation means that there is a relationship and an openness which

has resulted in for example, us providing very specific feedback on how the board reports the approach to responsible investment.

- **Director shareholdings**: we believe that NEDs investing in the investment trust is one of the best ways of aligning the NEDs with the shareholder experience. However, setting a strict threshold of shares might deter NEDs from different socioeconomic backgrounds from joining the board. Therefore, we encourage boards to allow flexibility in this area. We do accept that for some NEDs this is not feasible. In this instance we expect to understand why this is not possible.
- **Board evaluations**: external board evaluations should be carried out every three years; we also believe that an interview led approach is more productive. Additionally, we would like to see shareholders being a part of this evaluation.

Disclosures: When we invest in an investment trust on behalf of our clients, we become shareholders of the investment trust and not of the investment adviser. We believe investment trusts have the responsibility to disclose stewardship activities independently from those of their investment advisors. We believe that it is best practice for an investment trust to disclose voting records (where applicable) as well as examples of engagement, and ESG factor integration. This means that as shareholders we can assess and understand how responsible investment is being applied within the trust. Additionally, it is helpful to understand who is driving this – is it a centralised responsible investment team or the manager, or a hybrid? Any metrics that are used should be backed by contextual information including how these drive investment decisions, the concern is that positive metrics can be driven by happenstance rather than intentionality. Finally, talking about what you don't invest in could be seen as greenwashing as the focus is on irrelevant claims or information e.g. a healthcare focused trust stating it does not invest in fossil fuels.

- **Voting**: when applicable we expect investment trusts to use its voting rights in a manager that will benefit its shareholders. Best practice is to disclose overall voting outcomes including votes against as well as where shareholder proposals have been voted on. However, it is important to describe the voting process and how the investment advisor has come to that decision. In our view this is best achieved through providing examples of the voting rationale explaining the process and the engagements that lead to a voting decision.
- **Engagement**: investment trusts should engage with their underlying holdings and then disclose these. We do not expect a transcript of every conversation, but we want to understand the process of the engagements. Again, giving examples of significant engagements and outcomes is a good way of doing this.
- **ESG integration**: investment trusts should be specific and clear in explaining how ESG factors are integrated into the investment process. In some disclosures there can be ambiguity of how ESG data is being used.

What's next?

The next phase of this engagement will be to engage with trusts within the alternatives' classification starting with private equity trusts.

For the private equity phase the engagement framework will stay very close to the one we have used so far. Our expectations for board composition and effectiveness will be the same. Perhaps with an enhanced focus on director experience and making sure that there is relevant private equity experience on the board given the complexity of the asset class.

Where the framework will vary is in disclosure requirements as for example, proxy voting will not be applicable. However, the sentiment remains the same: we want clear and useful disclosures that will help shareholders understand how responsible investment is being applied within the trust they own.

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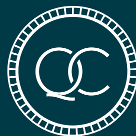

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