View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Edinburgh Research Archive

ORDINARY SHARE PRICE BEHAVIOUR AROUND "C" SHARE ISSUES BY INVESTMENT TRUSTS.

by

Andrew Adams and Michael Szakacs

ABSTRACT

This paper examines the abnormal returns and discount/premium to net asset value behaviour of the ordinary shares both before and after the announcement of "C" share issues. The research was conducted using event study methodology and an innovative approach to the analysis of discount/premium movements. The results show that the ordinary shares tended to outperform the FT-SE Actuaries Investment Trust Index over the six months following a "C" share issue announcement, despite a reduction in the premium to net asset value rating of the shares over the same period.

ACKNOWLEDGMENTS

We wish to thank David Warnock and Gordon Young of Aberforth Partners for sharing their knowledge of "C" share issues with us.

1. INTRODUCTION

The “C” share issue is an innovation which was developed in 1991 by Aberforth Partners, an Edinburgh-based fund management firm. It is designed to be a risk-free and equitable way of increasing the capital base of an investment trust. Many of the problems with rights issues are avoided.

In a “C” share issue, the new money raised is kept separate from the investment trust’s existing funds until a large percentage of the new money has been invested. The required percentage is normally specified in the offer document, and is usually around 75% to 90%. When the required percentage of the new money has been invested, the new pool of money ceases to run independently and its shares (the “C” shares) are converted into ordinary shares.[1] This process involves more than just the winding up of the new pool of money and enlargement of the existing pool. Both pools are valued precisely so that when the “C” shares are converted, neither the existing shareholders nor the “C” shareholders are disadvantaged. Holders of “C” shares receive the number of new ordinary shares that results from applying the “conversion ratio”, which is the net asset value (NAV) attributable to each “C” share divided by the undiluted NAV attributable to each existing ordinary share. If the “C” shares have an NAV of 100p and the ordinary shares have an NAV of 200p, the conversion ratio is ½ and therefore two “C” shares will convert into one ordinary share. After conversion takes place, the weighting of the investments in the portfolio of the investment trust is broadly as it

[1] A variant of the “C” share issue, pioneered by Scottish Value Trust, is where the new shares instantly convert and there is never a second portfolio.

was before the "C" share issue, but the merging of the two funds has enlarged the size of the investment trust.

A "C" share issue is normally only feasible if the ordinary shares are trading at a premium to NAV. This makes subscribing for the "C" shares more attractive to investors than buying ordinary shares in the market. If the ordinary shares are trading at a discount, there is little chance of a successful issue since there would be no incentive for investors to subscribe.

Most "C" share issues are pre-placed so there will be quite wide knowledge of the issue before the official Stock Exchange announcement. The broker involved as sponsor will try to take out any loose holders at this stage, but other loose holders may emerge at a later stage from other brokers who are not involved in the transaction.

In the case of trusts with warrants, there is the problem of how to calculate the number of warrants to issue. Warrants could be attached to the converted shares in the same ratio as had applied to the original ordinary shares. Thus, the converted shares would be identical in every way to an original ordinary share. It may be considered necessary, however, to issue a new series of warrants on conversion as the original exercise price might be considered too far away from the current NAV of the ordinary shares.

Rights issues still occur in the investment trust industry, but are now much less common. In 1994, for example, 7 rights issues took place compared with 17 "C" share issues. In Section 2, we set out the advantages and disadvantages of "C" share issues compared with rights issues.

2. ADVANTAGES AND DISADVANTAGES OF "C" SHARE ISSUES

2.1 Advantages of the "C" share issue.

The many advantages of a "C" share issue compared with a rights issue are outlined below.

a) The "C" shares bear all the costs of the issue. This is an equitable system because only those investors purchasing shares pay the fees involved. In a rights issue, the administrative costs of the issue are reflected in the value of all shareholdings, whether or not an existing shareholder wishes to subscribe for the issue.

b) In a rights issue, the subscription price is set at a discount to the share price at the time of the announcement. Should the stock market fall sufficiently for the shares to drop below the subscription price, shareholders would not take up their rights. The issue would normally be underwritten, of course, but this incurs underwriting fees. In a "C" share issue, investors subscribe "up front" and the ratio of ordinary shares to "C" shares is calculated later, at the time of conversion. This eliminates much of the risk of the share price falling.

c) The costs associated with a "C" share issue are lower than those for a rights issue. Rights issues now only tend to occur when the amount of capital being raised is relatively small compared with the market capitalisation of the investment trust in question. The existing shareholders do not object in this case to paying what are relatively low fees for the rights issue.

d) The additional capital inflow from a rights issue inevitably leaves the investment trust holding cash until such time as the additional funds have been invested. This

potentially distorts the investment return for existing shareholders. This is not the case with a "C" share issue. The additional capital raised by the issue of "C" shares will be accounted for as a separate pool of assets within the investment trust until conversion takes place. The NAV of the existing ordinary shares will thus be unaffected by the introduction of the additional capital, and the "C" shares will have an attributable net asset value based solely on the investment performance of the new capital raised by their issue.

e) The fund managers need not rush into the investment of new money raised by a "C" share issue because the two pools of assets are kept separate from each other. This is particularly important in the case of smaller company or emerging market funds for which it may take time to invest the money. The fund manager does not need to explain the delay, it has effectively been agreed upon in advance by the new shareholders.

2.2 Disadvantages of the "C" share issue

Disadvantages of the "C" share issues are concerned more with administrative complexity. Running what are effectively two investment trusts side by side requires a more advanced accounting system than for a single investment trust. Until conversion, the investment trust must be operated so that the assets attributable to the "C" shareholders can, at all times, be separately identified. In particular, separate cash accounts, broker settlement accounts and investment ledger accounts must be created and maintained for the assets attributable to the "C" shareholders. Furthermore, separate earnings and dividend accounts are required and, until conversion, the investment trust must allocate a fair proportion of every expense or

liability of the company to the “C” shareholders. Accounting procedures are particularly complicated if the life of the “C” shares extends over an accounting year end.

3. EVENT STUDY

The purpose of the event study in this paper is to examine the weekly "abnormal" or "excess" returns earned by the ordinary shareholders, not only for the week of the "C" share issue announcement itself but also for the weeks leading up to and after the "C" share issue announcement. We chose an event period consisting of 61 weeks, from 30 weeks before to 30 weeks after the week of the "C" share issue announcement (week zero).

3.1 Sample size

Between the first "C" share issue in the autumn of 1991 and the end of 1994, 37 "C" share issues were made in the investment trust industry. This is a relatively small sample size and unfortunately it had to be reduced further. The two split-capital investment trusts (Finsbury Smaller Companies and Aberforth Split Level) were eliminated due to the ambiguity of the different classes of shares, and Ptarmigan International Capital was eliminated due to lack of data. Finsbury Smaller Companies, one of the above splits, has had two "C" share issues, so the final sample size was 33, down 4 from the original sample size. (See Appendix 1).

3.2 Characteristics of the sample data

Descriptive data for the sample are given in the appendices indicated below.

1. Distribution of announcement dates[2] - Appendix 1.
2. Distribution across AITC sub-sector - Appendix 2.
3. Distribution of trust market capitalisation - Appendix 3.
4. Distribution of issue size in relation to trust size - Appendix 4.

---

[2] The "C" share issues tended to be bunched together, with three active periods: February 1993; October 1993 to November 1993; and January 1994 to March 1994.

3.3 Choice of index for expected returns

Abnormal return is the difference between the actual (total) return observed and the expected (total) return. Three possibilities were considered for the determination of expected returns.

The event study could be carried out using a trust's own benchmark index to determine expected returns. The benchmark adopted by a fund against which to measure its performance should be that which corresponds as exactly as possible to the investment task which the trust is setting out to achieve. Many investment trusts state a single benchmark index in their annual report.

A second alternative was to use the Association of Investment Trust Companies (AITC) sub-sector averages such as Smaller Companies, Emerging Markets, Continental Europe, etc. (see Appendix 2). One weakness of the AITC averages concerns single-country investment trusts. The single country investment trusts are grouped together as Far East Single Country or Europe Single Country. The problem is that countries as diverse as Korea and Australia, or Spain and Ireland, end up being averaged together.

A third alternative was to use a single all-encompassing index, such as the Financial Times-Stock Exchange Actuaries All Share Index or the Financial Times - Stock Exchange Actuaries Investment Trust (FT-SE A IT) Index. The latter is preferable because all the sample came from the investment trust sector. Even so, it provides a rather crude assessment of expected returns, given that investment trusts in the sample tend to be specialists, with over half the sample from two sub-sectors - smaller companies and emerging markets.

In the early stages of this research, it was thought that a trust's own benchmark index should be used to determine expected returns. This would not only be an unusual approach, however, as far as event studies are concerned, but also cumbersome. In the end, a single index, the FT-SE A IT Index, was chosen for the determination of expected returns for all the investment trusts in the sample. This allowed standard event study methodology to be employed.

3.4 Average abnormal returns

The abnormal return for share i in week t is defined as the return on share i in week t less the return on the FT-SE A IT Index in week t. To assess the average performance of ordinary shares over the event period, the average abnormal retrun (AAR) of all shares in the sample, for each week in the event period, was then computed.

The average abnormal return for each week in the event period is illustrated in Figure 1. The most interesting feature of Figure 1 is the sudden change in trend just before week zero, with small and mainly negative AARs experienced around week zero. This follows a sustained period of more than half a year of continuously positive AARs.

INSERT FIGURE 1

3.5 Cumulative average abnormal returns

Figure 2 shows the cumulation of the weekly average abnormal returns starting at week -30. The Cumulative average abnormal return *(CAR)* is seen to increase steadily up to week -2. A slight fall is then witnessed between weeks -1 and +5. The *CAR* then carries on upward,

albeit at a slower pace, and with occasional fluctuations, for the remainder of the event period.

INSERT FIGURE 2

4. MOVEMENTS IN AVERAGE (RELATIVE) DISCOUNT/PREMIUM TO NAV

Weekly movements in discounts were studied for the period starting 52 weeks before the "C" share issue announcement date and ending 52 weeks after the "C" share issue announcement date. AITC sub-sector average discounts were used to assess the relevance of movements in an individual investment trust's discount. Each investment trust's discount less its sub-sector average discount[3] was calculated for each week. An arithmetic average of this number over all the trusts in the sample was then calculated, to give the average relative discount for a particular week.

The results are given in Figure 3. All figures are negative reflecting the fact that trusts announcing a "C" share issue tended to stand on a lower discount (or, more usually, a higher premium) than that of their subsector average.[4]

INSERT FIGURE 3

On average, there was a slight increase in the relative premium rating over the year leading up to a "C" share issue announcement. After the announcement, there was on average a definite slide in the relative premium for up to nine months but this had stabilised within one year of the announcement. Note that on average the trusts in the sample still stood on a clear relative premium one year after the announcement.

[3] The relevant sub-sectors were Smaller Companies, Emerging Markets and Continental Europe (see Appendix 2). The single country and other miscellaneous trust discounts were analysed with reference to a general investment trust index discount.
[4] Strictly speaking, for trusts with warrants, the premium should be calculated on a package basis (ordinary and warrants combined) which will give a higher premium.

5. CONCLUSION

We have examined the abnormal returns and discount/premium to NAV behaviour of the ordinary shares, both before and after the announcement of "C" share issues in the investment trust sector.

There was generally positive abnormal performance of the shares ahead of a "C" share issue announcement. This was only to be expected as trusts tend to announce a "C" share issue after a period of outperformance. The reaction to the announcements tended to be negative but this was not statistically significant. More interestingly, there was a tendency for the ordinary shares to outperform the FT-SE A IT Index on a six month view after the announcement of a "C" share issue, despite a reduction in the premium to NAV rating of the shares over the same period.

Assessing the reasons behind the results of a study of this kind can be no more than informed conjecture. However, we set out below a number of possible reasons for the results.

A) As the new money for a "C" share issue is invested in many of the same shares as are held by the existing fund (which are often relatively unmarketable), there may have been a tendency for the underlying NAV of the ordinary shares to be pushed up. If this were partially but not entirely recognised by the market, there would be a tendency for the ordinary shares to outperform for a period, despite a reduction in the premium to NAV rating.

B) The issues were made in areas which were fashionable at the time, and if the underlying asset classes (in particular smaller companies and emerging markets) generally continued to show strong positive performance over the months following the issues, this

could explain the outperformance of the trusts in the sample over the same period. A good way of testing this hypothesis would be to carry out an event study with expected returns determined by the trusts' own benchmarks or by the AITC sub-sector averages.

C) A "C" share issue will absorb market demand for the trust, hence the gradual reduction in relative premium rating over the months following the issue. Furthermore, a recent article in the Financial Mail on Sunday (5 November 1995) suggested that "backscratching" can sometimes occur with share issues in the investment trust sector. This is where fund managers reciprocate by subscribing for each others' new issues, a practice which would tend to occur in difficult market conditions and which is to be frowned upon. The fund managers should be taking decisions on the basis of investment criteria rather than to save face. Firms which subscribe as a "favour" are weak holders of the new shares, and are likely to sell within months.. This "rotation back into the market" will exaggerate the reduction in relative premium rating.

D) There may be a tendency for directors to "clean up" the underlying portfolio before a "C" share issue, which might involve selling small illiquid "failure" stocks and revaluing other unlisted securities conservatively so that existing shareholders are not disadvantaged. This would be consistent with the negative average abnormal returns observed around the time of the issues.

A detailed account of this research is available from Ingrid Yeats, The Centre for Financial Markets Research, Department of Business Studies, The University of Edinburgh.

Appendix 1

Investment Trusts in the Sample Studied with Corresponding "C" Share Issue Announcement Date

Investment Trust - (33)	Announcement Date
Aberforth Smaller Companies	18 October 1991
Templeton Emerging Markets	20 January 1992
Scottish Value	26 August 1992
Beta Global Emerging Markets	10 September 1992
US Smaller Companies	22 December 1992
Fleming Emerging Markets	17 February 1993
Moorgate Smaller Companies Income	23 February 1993
Templeton Emerging Markets	23 February 1993
Fleming Claverhouse	11 May 1993
City Merchants High Yield	25 June 1993
Smaller Companies	28 September 1993
Foreign & Colonial Smaller Companies	18 October 1993
Pilot	26 October 1993
Morgan Grenfell Equity Income	3 November 1993
Amicable Smaller Enterprises	4 November 1993
Govett Emerging Markets	8 November 1993
Fleming Japanese	13 January 1994
Edinburgh Smaller Companies	25 January 1994
Emerging Markets Country	25 January 1994
Abtrust New Dawn	26 January 1994
NatWest Smaller Companies/Cty. Sm. Cos.	3 February 1994
Templeton Emerging Markets	10 February 1994
Beta Global Emerging Markets	17 February 1994
Fleming European Fledgling	21 February 1994
SHIRESCOT	21 February 1994
Hoare Govett Smaller Companies Index	28 February 1994
NM Smaller Australian Companies	28 February 1994
TR European Growth	1 March 1994
TR Property	14 March 1994
Baillie Gifford Shin Nippon	22 April 1994
INVESCO Korea	23 September 1994
Fleming & Colonial Emerging Markets	3 October 1994
Geared Income	9 December 1994

Appendix 2

Investment Trusts in the Sample Studied, Grouped by AITC Sub Sector

Smaller Companies - (10)
Aberforth Smaller Companies
Amicable Smaller Enterprises
Edinburgh Small Companies
Foreign & Colonial Smaller Companies
Hoare Govett Smaller Companies Income
Moorgate Smaller Companies Index
NatWest Smaller Companies/County Smaller Companies
Pilot
Shires High-Yielding Smaller Companies
Smaller Companies

Emerging Markets - (6)
Beta Global Emerging Markets
Emerging Markets Country
Fleming Emerging Markets
Foreign & Colonial Emerging Markets
Govett Emerging Markets
Templeton Emerging Markets

Continental Europe - (2)
Fleming European Fledgling
TR European Growth

Miscellaneous - (12)
Abtrust New Dawn - (Far East - excluding Japan)
Baillie Gifford Shin Nippon - (Japan)
City Merchants High Yield - (High Income)
Fleming Claverhouse - (UK General)
Fleming Japanese - (Japan)
Geared Income - (High Income)
INVESCO Korea - (Far East - Single Country)
Morgan Grenfell Equity Income - (Income Growth)
NM Smaller Australian Companies - (Far East - Single Country)
Scottish Value - (Closed End Funds)
TR Property - (Property)
US Smaller Companies - (North America)

Appendix 3

Investment Trusts Ranked by Market Capitalisation (at the time of their "C" Share issue)

Trust	Mkt. Cap. (£m)	Size of Issue (£m)	"C" share issue as a % of Mkt Cap
Templeton Emerging Markets (2/94)	**422.1**	116	27%
Fleming Japanese	**305.5**	159.3	52%
Templeton Emerging Markets (2/93)	**148.1**	83.1	56%
Foreign & Colonial - Smaller Cos.	**146.7**	24.6	17%
Foreign & Colonial - Emrg. Mkts.	**134.8**	108.5	80%
TR Property	**118.7**	79	67%
Fleming Claverhouse	**82.6**	22.8	28%
Fleming Emerging Markets	**80.4**	48.9	61%
Abtrust New Dawn	**79.2**	30.6	39%
Beta Global Emerging Markets (2/94)	**73.7**	28.6	39%
Templeton Emerging Markets (1/92)	**62.3**	27.3	44%
TR European Growth	**61.3**	36.7	60%
Moorgate Smaller Companies Inc.	**61.2**	24.3	40%
Edinburgh Small Companies	**60.0**	20.6	34%
Pilot	**59.2**	15	25%
Amicable Smaller Enterprises	**51.3**	25	49%
Fleming European Fledgling	**44.3**	14.3	32%
Hoare Govett Smaller Companies Ind.	**44.2**	24.4	55%
Aberforth Split Level	**39.6**	47.4	120%
INVESCO Korea	**37.5**	18	48%
Morgan Grenfell Equity Income	**33.4**	14.3	43%
NatWest Smaller Cos.	**32.8**	35.8	109%
NM Smaller Australian Cos.	**31.7**	26.8	85%
Govett Emerging Markets	**31.2**	16.5	53%
Emerging Markets Country	**30.5**	10	33%
Finsbury Smaller Companies (9/94)	**28.3**	10.5	37%
Baillie Gifford Shin Nippon	**28.3**	22	78%
US Smaller Companies	**27.1**	39.2	145%
Geared Income	**25.2**	14.1	56%
Smaller Companies	**21.9**	23.8	109%
Beta Global Emerging Markets (9/92)	**20.8**	28.6	138%
SHIRESCOT	**20.4**	10.4	51%
City Merchants High Yield	**19.5**	6.3	32%
Aberforth Smaller Companies	**18.6**	53.2	286%
Finsbury Smaller Companies (5/93)	**15.3**	7.1	46%
Scottish Value	**13.9**	14.2	102%
Ptarmigan International Capital	**11.0**	9	82%

Appendix 4

Investment Trusts Ranked by "C" Share Issue as a Percentage of Market Capitalisation - (at the time of their "C" Share issue)

Trust	"C" share issue as a % of Mkt Cap	Size of Issue (£m)	Mkt. Cap. (£m)
Aberforth Smaller Companies	**286%**	53.2	18.6
US Smaller Companies	**145%**	39.2	27.1
Beta Global Emerging Markets (9/92)	**138%**	28.6	20.8
Aberforth Split Level	**120%**	47.4	39.6
NatWest Smaller Companies	**109%**	35.8	32.8
Smaller Companies	**109%**	23.8	21.9
Scottish Value	**102%**	142	13.9
NM Smaller Australian Cos.	**85%**	26.8	31.7
Ptarmigan International Capital	**82%**	9.0	11.0
Foreign & Colonial - Emrg. Mkts.	**80%**	108.5	134.8
Baillie Gifford Shin Nippon	**78%**	22.0	28.3
TR Property	**67%**	79.0	118.7
Fleming Emerging Markets	**61%**	48.9	80.4
TR European Growth	**60%**	36.7	61.3
Templeton Emerging Markets (2/93)	**56%**	83.1	148.1
Geared Income	**56%**	14.1	25.2
Hoare Govett Smaller Companies Ind	**55%**	24.4	44.2
Govett Emerging Markets	**53%**	16.5	31.2
Fleming Japanese	**52%**	159.3	305.5
SHIRESCOT	**51%**	10.4	20.4
Amicable Smaller Enterprises	**49%**	25.0	51.3
INVESCO Korea	**48%**	18.0	37.5
Finsbury Smaller Companies (5/93)	**46%**	7.1	15.3
Templeton Emerging Markets (1/92)	**44%**	27.3	62.3
Morgan Grenfell Equity Income	**43%**	14.3	33.4
Moorgate Smaller Companies Inc.	**40%**	24.3	61.2
Beta Global Emerging Markets (2/94)	**39%**	28.6	73.7
Abtrust New Dawn	**39%**	30.6	79.2
Finsbury Smaller Companies (9/94)	**37%**	10.5	28.3
Edinburgh Small Companies	**34%**	20.6	60.0
Emerging Markets Country	**33%**	10.0	30.5
City Merchants High Yield	**32%**	6.3	19.5
Fleming European Fledgling	**32%**	14.3	44.3
Fleming Claverhouse	**28%**	22.8	82.6
Templeton Emerging Markets (2/94)	**27%**	116.0	422.1
Pilot	**25%**	15.0	59.2
Foreign & Colonial - Smaller Cos.	**17%**	24.6	146.7