How to pick an INVESTMENT COMPANY

There are only 300-odd investment companies, compared to something like 3,000 open-ended funds. But choosing between them can still be daunting.

First of all, here's how not to do it. Picking an investment company (also known as an investment trust or closed-ended fund) just because it has performed the best over the past one, three, five or ten years is a tactic that's likely to end in disappointment.

Take the AIC Global sector, which has 20 investment companies in it. The very best-performing of these companies in 2017, delivering a whopping 71% return, turned into the very worst-performing of 2018, losing 24%. Meanwhile 2017's biggest loser, which was down 6% in that year, topped the charts in 2018, returning 47%.

In fact, in the world of investment companies, there's a tendency for big winners one year to become big losers the next, and vice versa. That's because performance is driven partly by market sentiment, which affects the discount or premium to net asset value at which an investment company trades. Sharp swings in sentiment, positive or negative, are vulnerable to equally sharp corrections.

So is success in picking an investment company down to blind luck? Well, that really depends on how you define success. If your goal is to pick the top performer in the global sector over the next five years, then perhaps you should forget investing and try horse-racing instead – the odds would be similar and it might be more fun. On the other hand, if you're aiming for a return of inflation plus 2% over the next decade, you won't need Lady Luck on your side to feel happy with the outcome.

First, you need to make some basic choices. Are you looking for income, growth, or a combination of the two? Will you stick with mainstream equities (UK or global) or branch out into regions (Europe, Asia or emerging markets) or even other asset classes (property, infrastructure, private equity)? Your choices here will depend partly on your experience and confidence.

These decisions will help you zone in on one or two AIC sectors. For example, let's just imagine you want income, and you want to invest in UK equities. You'll end up in the AIC's UK Equity Income sector, which has 24 investment companies in it.

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Now it gets interesting. We've said that past performance is no guide to the future but now I'm going to row back on that a little. That's because you're looking for income, and several investment companies have track records of raising dividends going back 20 years or more (50 years, in a few cases). These are not guarantees, but a fair indication of where the priorities of the board and manager lie. Investment companies are able to achieve these long records because they don't need to pay out all their income, and can reserve some for difficult times in future. If that is important to you, it should be a selection criterion.

The level of yield is also important, to give you an idea of where you are starting from. How much income do you want? Be aware that as a rule of thumb, the higher the starting yield, the slower the income stream is likely to grow.

Now let's look at total return (that's capital growth plus reinvested dividends). Yes, we know it doesn't tell you what you'll get in future, but you wouldn't be human if you didn't want to look at it. Interpreting it, though, is tricky. Analysts will split the total return into components: how much was due to the market, any particular style bias, asset allocation or stock selection. They'll use terms like 'alpha' and 'beta'. But all these numbers are also open to interpretation. There is no magic statistic that offers a surefire method of picking a winner.

What's important is to get a sense of how the return was achieved. Compare it to the investment company's benchmark: if it's particularly good or bad, why? Read the chairman's statement in the annual report, the past two or three annual reports if you can. Look at what's been written about the investment company online. You'll start to build up a picture of the manager's style and be able to judge if it makes sense to you.

Many investment companies have been run by the same manager for a long time. In these cases, it's easier to get a sense of how they perform in different market conditions. If the manager is a more recent recruit, be aware that past performance may be telling you little.

Finally, don't forget to consider the discount or premium at which the investment company trades: high premiums mean you're paying over the odds, but very wide discounts should ring alarm bells too – why is the fund so unpopular? Gearing (or borrowing to invest) could be appealing if long-term growth is your aim, but it increases losses when markets tumble. And an investment company's fees and charges should also be carefully considered and compared to peers.

Finally, don't get obsessed with picking a winner. Investing is a learning process, and there's a lot of luck involved as well as some skill. Patience is important, too: once you've chosen an investment company, be prepared to give it a fair run. The best returns come to those who wait. ■

Top 10 dividend heroes

	Company	Consecutive years of dividend increased
1.	City of London Investment Trust	52
2.	Bankers Investment Trust	52
3.	Alliance Trust	51
4.	Caledonia Investments	51
5.	BMO Global Smaller Companies	48
6.	F&C Investment Trust	47
7.	Brunner Investment Trust	46
8.	JPMorgan Claverhouse Investment Trust	46
9.	Murray Income	45
10.	Witan Investment Trust	44

Important information: *This article can only cover some of the considerations necessary when choosing an investment company. It does not constitute investment advice or a personal recommendation, and you should seek independent financial advice as to the suitability of any investment.*

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