CORPORATE GOVERNANCE AND THE SPLIT CAPITAL INVESTMENT TRUST CRISIS

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Abstract

The aggressive pursuit of fees by certain fund management companies and broker/advisers drove them to launch new split capital investment trusts (“splits”) that exploited the retail demand for high yield in the environment of falling interest rates of the late 1990s. This led in many cases to substantial bank debt financing, high charges to the capital account and investment in the income shares of other splits, to generate the required initial yield and meet demand for new splits issues as interest rates fell. Thus, the need for ever-more demanding starting yields for income shares and gross redemption yields for zero dividend preference shares (“zeros”) caused the promoters of splits to devise increasingly aggressively structured funds that did not fully take account of possible stock market conditions.

The impact of falling markets from 2000 accompanied by equity dividend cuts led to collapsing market prices and dividend cuts for the income shares of many splits. The substantial cross-holdings then caused dividend cuts to compound themselves across a section of the splits sector, and share prices fell yet further. Even the market prices of a number of zeros fell sharply, a type of share that had generally been sold as low risk. By the end of 2001, desperate measures were being taken to save many of the new splits and the FSA started to take a much keener interest. Confidence in splits then collapsed and many private investors incurred significant financial losses.

The boom and bust within the UK split capital investment trust sector was, in the true sense of the word, extraordinary. It tested investment trust directors in a way unknown for at least a generation and brought into focus a number of corporate governance issues. We discuss the lessons to be learned from the crisis and the implications for investment trust corporate governance of the regulatory response to date. We believe that a fundamental change in the regulation of investment trusts is unnecessary and could be delivered only at a considerable cost.