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Dear Ms Thompson

Exposure Draft April 2004 – The Fair Value Option (Consultation)

Baillie Gifford & Co are the investment managers for several investment trusts (ITs) with total assets of £2.7billion at 30 June 2004. The primary business of ITs is to invest in financial instruments. In addition, ITs can issue a range of financial instruments such as debentures or take out fixed term bank borrowings, for instance at fixed rates of interest. IAS 39 is therefore of particular relevance to ITs.

The December version of IAS 39 allowed ITs to value both financial assets and liabilities at fair value through the profit and loss. However, under the proposed amendments only financial liabilities that contain one or more embedded derivatives may be fair valued. We believe that financial assets and all financial liabilities should be valued on the same basis – fair value through the profit and loss.

This approach avoids the anomaly whereby if one investment trust buys another's bond the two will value the instrument differently because of where it lies on the balance sheet.

The practical purpose of this is to ensure that, where the proceeds of debt instruments are invested in equivalent bonds, the value of these will rise and fall broadly in parallel leaving the net asset value (nav) neutral. This is consistent with industry best practice in our view and accounting standards should properly reflect sound balance sheet management. If, however, the debt instrument is not fair valued, a misleading nav can arise.

In order to meet this potential mis-perception, investment trusts now produce and report to the London Stock Exchange navs with debt at fair value and I attach, for your information, a short paper from Close WINS which gives the background to this. It would seem sensible that the basis of valuation of liabilities in accounts should be the same as that used in the statistical data provided to investors and on which the market bases its perception of true share value.

Yours sincerely

Lindsey M Beattie

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Head of Investment Trust Department.

Debt at Fair Value

The AITC has proposed that its members should produce a net asset value with debt valued at fair value (often called market price) and that this NAV will be used as the basis for discount calculations in the AITC's monthly statistics from 30 June. This will also affect NAVs and discounts published in the Financial Times.

The key reasons for this change are:

a) The AITC believes that institutional investors already allow for expensive debt when valuing funds. As a result, there is the potential for retail investors to be misled into believing that funds on wide discounts offer value, when the reason for this is simply the high cost of their borrowings. The AITC is keen that it should always publish the most conservative NAV.

b) Under International Accounting Standards, which are expected to be adopted by the industry for accounting periods starting from 1 January 2005, some types of debt (such as interest rate swaps) will have to be valued at market price.

Valuing liabilities at market price makes sense

We support the move to NAVs with debt valued at market price. After all, it makes sense to value assets and liabilities on the same basis. Most investment trust brokers already publish discounts adjusted for debt and funds with expensive debt tend to trade at a wider discount than their peers. In addition, we believe most investors, at least those who understand the issue, would welcome a move to using NAVs with debt at market value. Adjusting for debt at market price effectively allows for the net present value of the additional interest payments over equivalent debt issued today.

Some fund managers are also in favour as it will put funds with expensive debt on a more equal footing in the secondary market and should lead to tighter discounts – investors will no longer need to discriminate against funds with expensive debt (although the break-up value may still be significantly higher due to the premium to repay debt early).

How Do You Value Debt at Fair Value?

A theoretical value often has to be calculated

Many debentures are quoted, but the secondary market is very illiquid and these stocks rarely trade. As a result, for most funds you have to calculate what the theoretical market value of the debt would be. We do this by valuing the debt on the basis of a spread over gilts with a similar maturity. We estimate that the spread is currently 140-150bp for most funds and the size of the issue rather than credit quality tends to be the key factor in determining spreads. However, it gets more difficult for funds where the debt represents a high proportion of the fund's gross assets (e.g. many splits) or where the debt is less conventional (e.g. RPI linked debentures).

Companies are already required to calculate debt at fair value in the notes to their accounts. However, the methodology varies and it may be difficult to ensure that a consistent valuation approach is adopted.

Some NAVs may rise

Initially, the AITC had considered being conservative by using the lower of NAV with debt calculated at par (book) or market value. However, it will now simply focus on NAVs with debt at market value. We believe this is sensible as cheap borrowings are just as much of an advantage to an investment trust as expensive borrowings are a drag. Given the sharp fall in interest rates in recent years, this is not a significant issue at present. However, with interest rates moving up again, it could become so within the next few years.

What Will the Impact Be?

Big impact for some funds

For the sector as a whole, the move to debt at market will reduce the NAV by just under 1%. Rising interest rates and higher asset values means that this is far lower than 18 months ago. However, for many funds, the impact is still significant, as highlighted in the table below. This list includes several Global Growth funds and UK Income Growth Stocks.

Prices already reflect expensive debt

We believe that prices already reflect expensive debt and so we would expect discounts to narrow once the industry moves to fair value NAVs. However, there are always likely to be anomalies and this could prevent trading opportunities.

Funds Affected Most by Valuing Debt at Fair Value

Fund	Impact of Debt at Market (% of NAV)	% Discount Debt at Book	% Discount Debt at Market	% Difference
Value and Income	11.9	-17.3	-6.2	11.1
Dunedin Income Growth	5.8	-17.5	-12.4	5.1
Edinburgh IT	5.7	-21.2	-16.5	4.7
Merchants	4.9	-11	-6.4	4.6
Anglo & Overseas	4.8	-20.5	-16.5	4.0
Brunner	4.8	-23.7	-19.9	3.8
Edinburgh Small Companies	4.9	-29.8	-26.2	3.6
Throgmorton Trust	4.5	-22.6	-19	3.6
Scottish Mortgage	4.2	-20.6	-17.1	3.5
Henderson Smaller Cos	3.8	-19.9	-16.7	3.2
Gartmore Global	3.5	-23.4	-20.6	2.8
Dunedin Smaller Cos	3.4	-25.5	-22.9	2.6
Edinburgh Dragon	3.1	-15.1	-12.5	2.6
Majedie	3.2	-18.9	-16.3	2.6
Securities Trust of Scotland	2.9	-17.2	-14.7	2.5
City of London	2.5	-12.9	-10.7	2.2
Edinburgh Worldwide	2.5	-17.3	-15.2	2.1
Keystone	2.3	-11.8	-9.7	2.1
Temple Bar	2.1	-3.4	-1.3	2.1
JPMF Continental European	2.3	-18.1	-16.2	1.9
Fidelity Asian Values	2.2	-14.3	-12.4	1.9
Invesco English & Int'l	2.6	-28.8	-27	1.8
Foreign & Colonial IT	2.1	-17.7	-15.9	1.8
Tribune Global Managed	1.9	-14.8	-13.1	1.7
TR Property	1.8	-10.9	-9.2	1.7
JPMF Mid Cap	1.8	-20	-18.5	1.5
JPMF Claverhouse	1.6	-5.3	-3.8	1.5
3i Smaller Quoted Cos	1.8	-20.8	-19.4	1.4
Scottish American	1.6	-15.6	-14.2	1.4
JPMF US Discovery	1.6	-16.2	-14.8	1.4
Monks	1.6	-18	-16.6	1.4

Source: Close WINS

Will it Affect Historic Comparisons?

Performance

Only for valuation, not performance

Significantly, debt adjusted NAVs will only be used for valuation purposes and not to measure performance. This is largely because of difficulties in obtaining comparable historic data. However, it is interesting that the Board of SAINTS has announced that performance under the new managers, Baillie Gifford, will be measured with both assets and liabilities valued at market price. We would not be surprised if more funds decide to follow this lead.

Discounts

It is not always easy to calculate historic debt at fair value NAVs as this requires adjusting for changes in spreads and yield curves as well as repayment/issuance of debt. This will cause considerable complications for many data providers.

What about Break Clauses for Early Repayment?

Cost of repaying debt will usually be higher

The cost of repaying debt early is usually higher than the cost of debt at market price. This is because most recent debt issues contain a spens clause which gives the issuer the option of redeeming the debt at the higher of par, or a price which provides a yield equivalent to gilts. This means that as well as marking the debt to market, repaying the debt entails compensation for the premium over gilts that the stock is trading on (for a long dated debenture this cost can be significant).

Important if there is corporate action

For most funds it is reasonable to assume that the debt will not be repaid early and so the relevant cost is the difference between par and market value. However, if you are focusing on corporate activity or there is a reason why the debt may need to be repaid early then it is sensible to focus on the break-up cost of debt.