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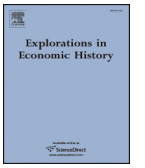

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The first global emerging markets investor: Foreign & Colonial Investment Trust 1880–1913

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Abstract

The Foreign and Colonial Investment Trust is the oldest surviving closed end fund, having been established in 1868. Its early success and emulation were related to its identification of a missing market – the provision of a wholesale diversified vehicle for the investing public. This paper is a micro-study of this leading investment trust during the First Era of financial globalisation. The history of this flagship fund over more than three decades provides an insight into the relative success of this financial innovation as well as into the risk and returns of investing in emerging markets over a century ago.

JEL classifications: F21; F65; G23; N23
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1. Introduction

The Foreign and Colonial Investment Trust (FCIT) is the oldest surviving closed end fund in the world today. Improving upon an idea first adopted by the Dutch in the 18th century (Rouwenhorst, 2005), the trust started in 1868 fully half a century before such funds first appeared in the US. Established as the Foreign and Colonial Government Trust, it was substantially reorganised a decade later. Our analysis of the annual portfolios from 1879, when its shares first became listed on the London Stock Exchange (LSE), until 1913 provides an insight into how one sophisticated investor approached the rapidly expanding world of international investment during the First Era of Globalisation (O'Rourke and Williamson, 1999; Obstfeld and Taylor, 2004). This paper is therefore a micro-study of one of the pioneering investment institutions that opened up the way to investment in emerging markets in the three decades up to World War I.

Compared with the very extensive literature on technological innovation, financial innovation is still a field with many unanswered questions. Most innovations in the financial sector are similar to general purpose technologies that generate benefits for the immediate adopters, but can also have widespread impacts on the whole economy. Some of the latter take the form of externalities, often negative, which in turn invites discussion as to the net social benefits of the financial sector (Levine, 2005; Litan, 2010). Among the criticisms

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levelled at financial innovations is their potential to create 'systemic risk', harm consumers and waste resources due to rent-seeking behaviour by the innovators themselves. Recent reviews of the finance literature therefore make a plea for more study of the costs and benefits of financial innovation, its diffusion process and, especially, its origins (Frame and White, 2004; Lerner and Tufano, 2011). Financial history is an obvious means to address this gap. In this spirit, our paper provides the first quantitative account of the origins of the investment trust industry. And, based on primary sources, seeks to answer several of the questions about the origin, diffusion and benefits of this mutualised form of investment.

The contribution of this study is fourfold. First, the FCIT successfully identified a missing market – that for wholesale investment in diversified portfolios by the general public – at a time when domestic securities were yielding historically low returns. Over the period 1880 to 1913, FCIT delivered attractive risk-adjusted returns to the investing public at very modest cost. The fund's investments averaged a total return of 5.3% per annum, well in excess of the 2.2% return on British Consols with a better risk-return trade-off. Furthermore, in only two years did FCIT record a negative return and the maximum drawdown was only 8% in 1890. The investment trust model gained in popularity over the period, such that by 1913 there were 61 investment trusts quoted on the Stock Exchange, with a combined market capitalization of close to £90 million. In documenting the development of the investment trust sector, the important distinction needs to be drawn between the original "average trusts," pioneered by FCIT and focused on delivering long returns with low leverage, and the speculative fringe of "financial trusts" which emerged in the 1880s and quickly failed during the Baring crisis. US investors in investment trusts went through a similar costly experience in the late 1920s and early 1930s (Delong and Shleifer, 1992). This experience resulted in their marginalization and the rise of the open end mutual fund (Fink, 2008). Britain ultimately followed where the US led over the rest of the twentieth century. In this paper, we argue that the history of mutual funds post-1929 has overshadowed some of the more desirable features of the original closed end fund innovation as represented by FCIT.

Second, FCIT maintained its investment focus on emerging markets throughout the period. From its beginnings as a portfolio of "well-selected Government Stocks" it added colonial government securities and then US railroad stocks. After 1890 the fund moved to a 90% exposure to the New World outside Europe. A similar model of institutional investment had been pioneered in the Netherlands in the late eighteenth century (Rouwenhorst, 2005). However, whilst Dutch mutual funds substantially concentrated their investments in the US during the eighteenth century, FCIT took full advantage of the broader range of investment opportunities available by the late nineteenth century to construct a globally diversified portfolio. Hence, a study of FCIT provides new insights into the risks and opportunities confronting international investors over a period of 33 years by a rapidly expanding developing world and invites comparison with recent emerging market investment since its re-emergence in the early 1990s.

Third, we provide early evidence on the existence of a closed end fund discount which has in the later twentieth century been considered a "puzzle" (Lee et al., 1991) given that a well-capitalized investor might be expected to exploit the law of one price, acquire such a fund and liquidate its investments. To the best of our knowledge, the only prior historical study of the closed end fund discount was undertaken by DeLong and Shleifer (1992). The authors found that the highly-leveraged US funds traded at a premium up to 1929, before suffering heavy losses and trading at substantial discounts in the 1930s. By tracing how FCIT's deferred shares traded relative to the net asset value (NAV) of the underlying investments, we estimate a level of discount for the FCIT which is not out of line with investor experience later in the twentieth a century. One explanation for this discount is, similar to today, the exposure to illiquid securities. In addition, fluctuations in the discount around the time of the 1890 Baring crisis appear to reflect the ebb and flow of investor sentiment, also in keeping with experience later in the 20th century.

Last, from its inception FCIT pursued a patient buy-and-hold investment approach rather than a high frequency trading approach seeking to exploit short-term mispricing of securities. This is most apparent in the very low turnover of its portfolio compared to that of modern institutional investors. That FCIT was able to adopt this approach is due at least in part to its choice of the closed-end fund structure. Unlike open-end mutual funds which emerged on both sides of the Atlantic in the 1930s and offered shareholders the facility to redeem units on a daily basis, this structure diverted the pressure of shareholders withdrawing their funds into the secondary trading of its shares on the LSE and left the managers free to hold onto their investment positions, particularly during financial crises. Our analysis of FCIT's security trading during the two most significant crises of this era, 1890–93 and 1907, suggests that the managers displayed no evidence of contributing to any emerging market contagion. Such evidence is pertinent to the evaluation of the social welfare benefits of the investment trust industry,

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