All you need to know about: Discounts

Definition

Discounts are defined in our glossary as:

"*The amount by which the net asset value exceeds the share price, calculated as the share price divided by the net asset value -1 and expressed as a percentage.*"

It is all about popularity

But, in English, they are just a measure of how popular an investment company is. Unpopular companies trade at a discount to their true value. Really popular investment companies trade at a Premium – in other words the share price is higher than the net asset value.

Price determined by supply and demand

The price of shares in a company, like the price of apples or tomatoes, is determined by supply and demand. On the supply side, the number of shares available to buy in an investment company is usually fixed. If their shareholders have said it is OK, companies can issue new shares to help increase supply or buy-back shares to help reduce supply but they don't have to. On the demand side, investors' enthusiasm for shares in a company comes and goes – the demand can fluctuate quite a bit.

Big discounts are problem

Investment companies spend more time worrying about how popular they are than most companies. If an investment company trades at a big discount to the value of its assets for some time, aggressive investors could snap up the shares with the intention of winding the company up – buy at a discount, get out at asset value = nice profit! Clearly big discounts are a danger to the survival of an investment company.

So are big premiums

Big premiums are problematic too; they have a tendency of evaporating so the investment company's shares might do badly even when its assets are doing OK. This can make it look like the company is performing badly which can make it less popular and, hey presto, the investment company is trading on a discount.

So is discount volatility

Discounts that swing around too much are also bad news. You could catch the swing right – buy at a wide discount and sell at a narrow one. Unfortunately, for many people it doesn't work that way – they get sucked into buying a fund because it is popular and then get disheartened and sell when it's unpopular.

Intervention is good

This is why it is important that the investment companies intervene on the supply side of the equation by issuing and buying-back shares, reducing the absolute level of the discount and premium and the volatility.

and can be profitable

Issuing and buying back stock can help the asset value as well. Issuing stock at a premium benefits existing shareholders as new investors pay above the

odds to get into the fund. The excess they pay over asset value benefits the whole fund. Buying back stock at a discount has a similar effect. Selling shareholders give up some value every time they sell for less than asset value. The amount they give up benefits the investors who still hold the fund.

Should you ever buy at a premium?

You might ask, should I ever buy a fund trading at a premium? The answer varies on a case by case basis but, as a general rule of thumb, it is best to assume that the premium will not last forever. For most of the past few years funds with high yields have been popular because interest on bank deposits and government bonds has been low. Most of these funds trade on premiums and have done now for a while. Think about what might happen though if interest rates start to rise.

Should you always buy on a discount?

You might then ask, is it always a good idea to buy a fund trading at a big discount? The answer to that is a resounding no. Sometimes funds are unpopular for a good reason. It might be that the asset value that the discount is based on hasn't caught up with reality yet. Also the fund might hold illiquid (hard to sell) investments that would fetch less than asset value if they had to be sold in a hurry. That doesn't mean there aren't some bargains out there but always think about how liquid the underlying investments are and how up to date and real the asset value is.