Henderson Opportunities Trust

Unconstrained UK portfolio with small-cap spice

Investment trusts
All-cap UK equities

Henderson Opportunities Trust (HOT) invests in UK stocks across the market cap spectrum. Managed by James Henderson and Laura Foll (who also co-manage Lowland Investment Company and the Law Debenture Corporation), HOT has an unconstrained portfolio that differs markedly from peers and the team's other funds, with c 70% invested outside the UK large and mid-cap index, and c 55% in AIM stocks. HOT seeks capital growth but also offers a growing dividend (current yield of 2.4%), paid quarterly from FY20. The managers see the trust as one that will sit beside a mainstream fund in a portfolio and bring diversity to the combined list of holdings, not for the sake of it but for real capital appreciation. While HOT's long-term performance record is strong, its returns in FY19 suffered as lowly valued UK small-caps (particularly those listed on AIM) have been out of favour.

Video: Unloved and undervalued? Yes please!

Source: Janus Henderson Investors

The market opportunity

UK equities remain relatively out of favour with global investors, even as the bellwether US stock market continues to test all-time highs. The broad UK market is trading at a forward P/E multiple c 17% lower than the world index, which could prove an attractive entry point if ongoing Brexit talks provide a positive resolution.

Why consider investing in HOT?

- Unconstrained mandate, blending investment in exciting, fast-growing UK smaller companies (c 70%) with more established large and mid caps.
- Small-cap stocks are currently at a wide P/E discount to larger companies.
- HOT's long-term performance record is strong, and it has significant recovery potential on the back of further reversal of Brexit-driven negative sentiment.
- Dividends paid quarterly from FY20; 2.4% yield and multi-year dividend growth.
- Double-digit discount could narrow substantially should sentiment improve.

Wider-than-average discount reflects fear factor

At 6 February 2020, HOT's shares traded at a 17.1% discount to cum-income NAV. While narrower than the 12-month high of 22.6% seen in August, the wide discount reflects a lack of appetite for UK small caps and perceptions of illiquidity, particularly in AIM stocks. It thus has scope to narrow with a pick-up in sentiment.

7 February 2020

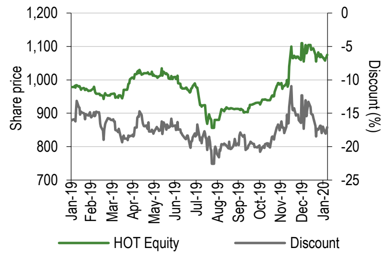
Price	**1,075.0p**
Market cap	**£84.9m**
AUM	**£114.8m**

NAV*	1,267.8p
Discount to NAV	15.2%
NAV**	1,296.6p
Discount to NAV	17.1%

*Excluding income. **Including income. As at 5 February 2020.

Yield	2.4%
Ordinary shares in issue	7.9m
Code	HOT
Primary exchange	LSE
AIC sector	UK All Companies

Share price/discount performance



Three-year performance vs index

52-week high/low	1,111.0p	856.0p
NAV* high/low	1,311.7p	1,084.8p

*Including income.

Gearing

Gross*	11.0%
Net*	11.0%

*As at 31 December 2019.

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Henderson Opportunities Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

Henderson Opportunities Trust aims to achieve capital growth in excess of the broad UK stock market from a portfolio of UK investments. Stock selection is not constrained by the benchmark and there are no limits by sector or market capitalisation; therefore, the portfolio will differ materially from the index.

Recent developments

- 7 February 2020: Results for the year ended 31 October 2019. NAV TR +0.2% and share price TR -3.7%, versus +6.8% for the broad UK stock market. Final dividend of 19p brings the total for the year to 26.0p (+23.8% on FY18). Dividends to be paid quarterly from FY20.
- 20 December 2019: HOT director Wendy Colquhoun appointed to the board of Schroder UK Mid Cap Fund.

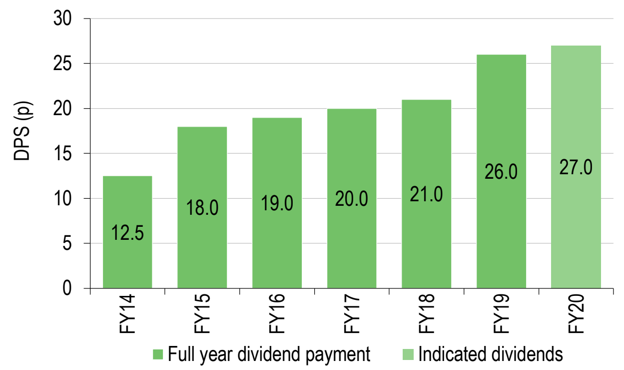
Forthcoming		Capital structure		Fund details	
AGM	March 2020	Ongoing charges	0.91%	Group	Janus Henderson Investors
Interim results	June 2020	Net gearing	11.0%	Managers	James Henderson, Laura Foll
Year end	31 October	Annual mgmt fee	0.55%	Address	201 Bishopsgate,
Dividend paid	September, March	Performance fee	Yes (see page 10)		London, EC2M 3AE
Launch date	2007	Trust life	Indefinite, subject to vote	Phone	+44 (0) 20 7818 1818
Continuation vote	Three-yearly, next 2020	Loan facilities	£20m	Website	www.hendersonopportunitiestrust.com

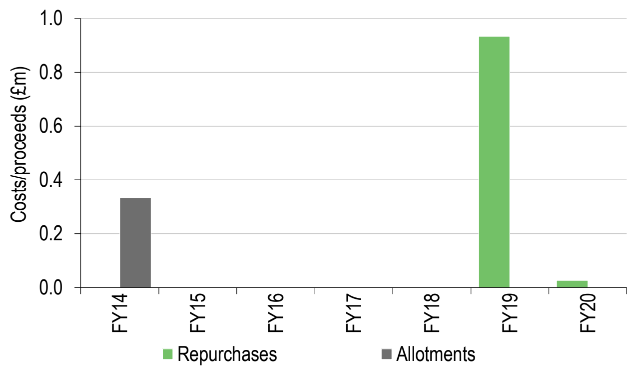
Dividend policy and history (financial years)

Two dividends have historically been paid each year, in September and March. From FY20, dividends will be paid quarterly. While income growth is a secondary objective to capital appreciation, HOT does seek dividend growth over time.

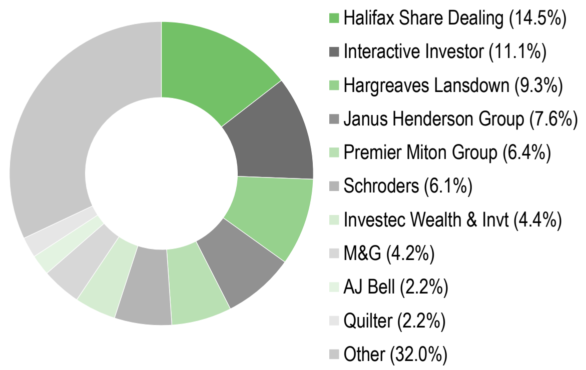
Share buyback policy and history (financial years)

Renewed annually, the board has authority to buy back up to 14.99% of shares in issue. Buybacks are primarily undertaken with the aim of enhancing the NAV for shareholders, rather than limiting the discount to a specific level.

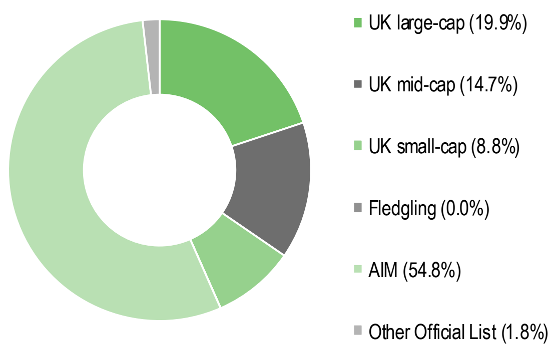




Shareholder base (at 7 November 2019)



Portfolio exposure by index (at 30 November 2019)



Top 10 holdings (at 31 December 2019)

Company	Index	Sector	Portfolio weight %	
			31 December 2019	31 December 2018*
RWS	AIM	Support services	3.6	4.6
Tracsis	AIM	Software & computer services	3.1	3.1
Learning Technologies Group	AIM	Software & computer services	3.1	N/A
Springfield Properties	AIM	Household goods & home construction	3.0	N/A
Blue Prism Group	AIM	Software & computer services	2.8	3.3
Serica Energy	AIM	Oil & gas producers	2.8	5.2
SigmaRoc	AIM	Construction & materials	2.6	N/A
Oxford Instruments	UK mid-cap	Electronic & electrical equipment	2.5	N/A
Cohort	AIM	Aerospace & defence	2.3	N/A
HSBC	UK large-cap	Banks	2.2	2.7
Top 10 (% of holdings)			**28.0**	**30.5**

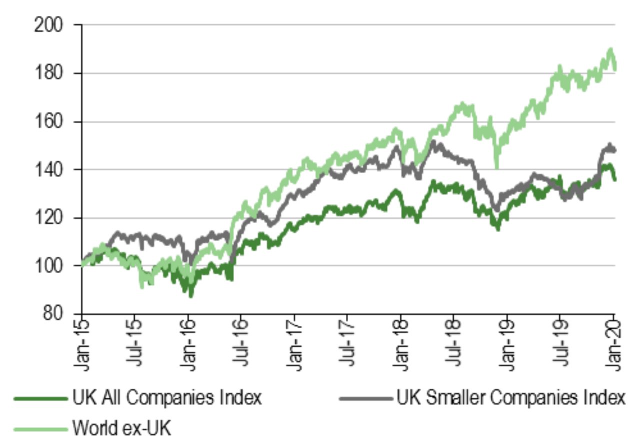
Source: Henderson Opportunities Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-December 2018 top 10.

Market outlook: UK small caps remain out of favour

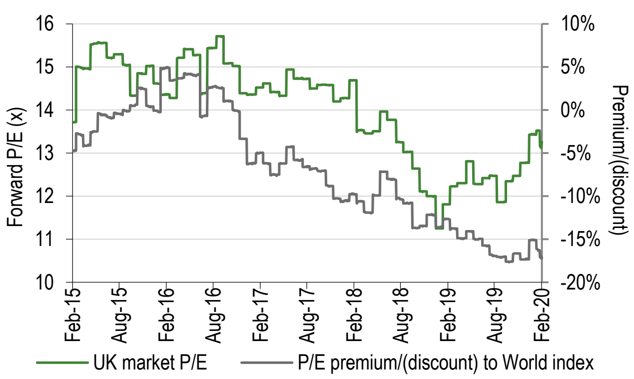
In spite of declining global economic activity and a slew of geopolitical risk factors, the global stock market, led by the US, continued to test all-time highs until the recent period of coronavirus-induced volatility. With the equity bull market now having endured for more than a decade since the global financial crisis, more sceptical investors may be questioning the role of central banks in keeping the good times rolling when company fundamentals seem to point more to fear than greed. However, against this backdrop, the UK equity market looks comparatively good value. As shown in Exhibit 2 (left-hand chart), the rest of the world has markedly outperformed the UK in sterling terms over the past five years. While some of this can be attributed to the weakness of the pound since the June 2016 Brexit referendum, the continued uncertainty over the terms of the UK's withdrawal from the EU has also kept investors (both at home and internationally) on the sidelines. This was particularly true with regard to UK smaller companies in the run-up to December's general election: while over five years the UK all companies and UK smaller companies indices had delivered broadly the same return, over the 12 months to end-November 2019, the broad index saw a total return of 11.1% while the small-cap index rose by 5.2%. The AIM all companies index lagged even more, with a total return of just 0.7% over the year. The clarity provided by the 'market-friendly' election outcome (albeit there is still much work to do on negotiating the post-Brexit relationship with the EU) has seen this reverse somewhat, and the small-cap index is now ahead of the All-Share over 12 months to 31 January, with a total return of 13.4% versus 10.7% for the broad index. However, the UK's current c 17% forward P/E discount to the world index (right-hand chart) could still prove an attractive entry point for investors in companies of all sizes.

Exhibit 2: Market performance and valuation

Sterling performance of UK and world-ex-UK indices (rebased to 100)



Valuation of Datastream UK versus Datastream World indices



Source: Refinitiv, Edison Investment Research. Note: Valuation data as at 6 February 2020.

Fund profile: A 'good mixer' for a diversified portfolio

HOT began life in 1988 as Henderson Strata, originally a global smaller companies investment trust, but later a UK-focused micro-cap fund with a smaller company index benchmark. In 2007 it was reconstituted in its current form, with a mandate to invest across the UK equity market with a bias to smaller companies and a value-orientated investment style. It was renamed Henderson Opportunities Trust, changed its benchmark to a broad UK stock market index, and James Henderson was appointed as manager alongside Colin Hughes, who had run the portfolio in its previous incarnation. Henderson and Hughes co-managed the fund until Hughes's retirement in 2018, at which point Laura Foll (already co-manager with Henderson on other mandates including

Lowland Investment Company [LWI] and The Law Debenture Corporation [LWDB]) was appointed co-manager.

While HOT is heavily biased to the smaller end of the UK market (almost two-thirds of the portfolio is currently invested outside the UK large and mid-cap indices, with c 55% in AIM-listed stocks), its 'go anywhere' mandate means it can provide investors with small-cap exposure without some of the volatility that can bring, owing to its c 20% exposure to more stable large-cap stocks. However, returns are likely to differ markedly from those of the benchmark index, c 80% of which is accounted for by large-cap companies. The trust is a constituent of the Association of Investment Companies' UK All Companies sector, although again it is significantly differentiated from many peers, which may have more of a large- or mid-cap focus. The managers describe HOT as 'a good mixer', which could sit alongside a more mainstream UK fund in an investor's portfolio and bring diversification as well as the possibility of significant capital appreciation from its smaller company and early-stage holdings. However, this does come with the potential for higher volatility of returns. While smaller stocks may be illiquid, the permanent capital nature of an investment trust makes this structure more suitable than an open-ended fund for holding less liquid assets.

HOT has the ability to invest up to 30% of its assets in fixed income securities and cash, but in practice it has not done so. Henderson says the current investment policy was designed in 2007 'with a blank sheet of paper', and the ability to hold bonds was included as a contingency, rather than as a core part of the strategy. Portfolio construction is unconstrained apart from the stipulation that HOT must hold 70–100 companies, with no more than 10% of gross assets (at the time of investment) in unlisted securities. Henderson and Foll may invest up to 15% of gross assets in investment companies (including other investment trusts), but do not normally do so.

Gearing of up to 25% of net assets is permitted (up to 15% without prior board approval), and the managers tend to use it to a larger extent than many peers, believing a geared approach is accretive to long-term investment returns. The end-December 2019 figure of 11.0% is somewhat lower than the 12-month average of 13.2%, but well above the average gearing for the UK All Companies peer group, which was 5.0% at end-December 2019.

The fund managers: James Henderson and Laura Foll

The managers' view: UK offers huge valuation opportunities

Henderson argues that HOT offers a truly differentiated investment proposition, with a diversified stock list giving access to multiple end markets. 'Although we have more in UK domestic companies than the general market, we are seeing a lot of different end users, and some are really unaffected by Brexit,' he says. HOT also has a very high active share versus its benchmark (this is a measure of how much a portfolio differs from an index). 'Our job is to participate in the strong times for the UK and not give up too much in the bad times,' the manager explains, acknowledging that in the past, the trust has had a tendency to underperform in unfavourable market conditions. 'It has been very good when things were good and bad when things were bad, so we have tried to make it smoother,' he adds.

Foll says that the breadth of HOT's mandate means it can be flexible in its aim of delivering capital growth while limiting volatility and retaining its focus on value. 'At times, people get overexcited about smaller companies, and then you need an unconstrained mandate with the flexibility to go up into mid- and large-cap,' she explains. 'At the moment, we are c 55% AIM, which is higher than historically, partly for structural reasons – there are effectively no operating companies left in the Fledgling index, which is largely made up of investment companies, including HOT itself – and also because there are genuine opportunities on AIM.' She adds that while the junior market may not always have had the best reputation, 'there are some really excellent companies that could easily be Main Market listed'.

As well as being diversified by company size, HOT's seven portfolio construction 'sleeves' (see Investment process) also help it to perform in different market conditions. Foll explains: 'Last year was really difficult on AIM but we did well out of natural resources stocks, such as Serica Energy, or Faroe Petroleum, which was acquired at a good premium. It is a nice demonstration that the sleeves are working and add genuine diversification – growth small-cap has been under real valuation pressure, but the allocation to natural resources meant our returns were more stable.'

The manager adds that she and Henderson currently see a real value opportunity in recovery stocks. 'The market is very focused on growth, and if a company is out of favour, it can be at quite an extreme valuation', she says, giving the example of used car dealer Vertu Motors – one of the biggest holdings in HOT's recovery sleeve – which is trading below the value of its properties, yet the operating company is profitable. 'There are lots of examples like that,' says Foll. 'We would like to increase the recovery allocation on a company-by-company basis.' However, she adds that it is often in the nature of recovery stocks not to be very long-term holdings: 'If Vertu reaches its property value, we will happily move on.'

Conversely, holdings in the early-stage and university spinout sleeve are usually bought with a far longer time horizon. Foll says: 'Sentiment towards early-stage and IP [intellectual property] commercialisation stocks is so negative, but it might be that people are giving up on companies like 4D Pharma and IP Group just as they are coming to fruition.' Henderson adds that at times of poor market sentiment, people's time horizon becomes shorter and 'you get a certainty premium'. He says: 'With these stocks, you need a long horizon and an element of hope value. In 2025, 4D Pharma could be a substantial business.' The managers explain that part of the reason for having a relatively long list of stocks, with the core of the portfolio in more stable compounders such as RWS, Tracsis and Assura, is to take out some of the extreme volatility but catch the real growth potential of these earlier-stage companies.

Along with recovery stocks, the riskier early-stage area presents the clearest valuation opportunity to Henderson and Foll, although they are cognisant of the need to move slowly as there are obvious headwinds from lack of liquidity, large placings (particularly in former Woodford fund holdings, where HOT has topped up some of its positions), and very poor sentiment. Meanwhile, they have selectively been taking profits in compounders such as Assura and RWS. 'We have no fundamental concerns; it's just valuation-driven,' says Henderson.

Foll points out that the valuation of some of HOT's portfolio holdings is 'remarkably low', although the portfolio average 12-month forward P/E of c 13.3x is in line with the average for the UK market as a whole, which itself is at a substantial discount to the 16.0x average for the world market. However, she adds that investors should be aware that some of the riskier early-stage companies may be excluded from the P/E calculation because they have no earnings.

Henderson argues that there is much pent-up performance in these valuations. 'When the results come through over time, the value will be realised without needing a big change in conditions. A few factors together are suppressing share prices; I believe they will ease, and in my view it is an exciting time to buy shares, particularly at HOT's current level of discount.' He adds that the upswing is likely to start in big stocks and filter down as confidence builds, giving HOT the opportunity to benefit across its portfolio. 'The smaller end of small-cap is particularly out of favour, with people moving up liquidity thresholds because of MIFID II and coverage falling. These are opportunities to make the closed-end structure count, particularly given HOT itself is quite small, so we can trade at the small, illiquid end of the market,' concludes Henderson.

Asset allocation

Investment process: Unconstrained fund with small-cap tilt

Henderson and Foll run all their funds with a similar philosophy, based on valuation awareness, diversification, and in-depth research including many company meetings. However, HOT differs from LWI and LWDB in that it has no specific income requirement, and as such the managers are able to hold a marginally more concentrated portfolio of c 70–100 stocks, compared with c 80–120 for LWI and up to 150 for LWDB. Henderson explains that with an income fund they prefer to run a longer list to mitigate the impact of any dividend cuts, but HOT is less constrained by distributions, although it does seek to grow its dividends over time. The trust has a higher active share than the managers' other portfolios, and also a higher level of risk, owing to its tendency to hold bigger individual positions, and the larger proportion of smaller company holdings, in particular those listed on AIM.

While the managers do not use specific quant screens to filter their investment universe, their focus on buying good companies cheaply means they employ a range of valuation criteria, such as P/E ratios, price/book value and enterprise value to sales. They note that the small-cap end of the spectrum often offers superior earnings growth and a P/E discount to the wider market, albeit with the risk of lower liquidity and greater volatility of returns. Meetings with companies are a key part of the process, with the managers undertaking several hundred meetings and site visits each year. They see company management as one of the most important factors in identifying possible investments, noting that a good management team can navigate a difficult economic backdrop, while poor management can get it wrong even in the good times.

HOT's portfolio holdings are split into seven classifications, or 'sleeves', which are likely to perform better or worse at different points in the market cycle. Henderson says that while the list may look esoteric, the seven classifications (each with an indicative exposure range) are based on different ways of looking at valuation, and the diversification should reduce the overall volatility of NAV performance over time. The sleeves are as follows:

- **Small and mid-cap compounders (20–40% of the portfolio):** quality, usually well-established companies with strong management, which offer long-term compounding of returns as they grow. As of 28 November 2019, this was the largest portfolio exposure, at c 32%.
- **Growth small cap (20–40%):** these earlier-stage quality companies with correspondingly higher growth rates made up c 21% of the portfolio at 28 November 2019.
- **Large cap (10–30%):** familiar names that nevertheless offer operational quality and long-term growth potential. These increase the liquidity of the overall portfolio and may also be an important source of yield. Exposure was c 21% as at 28 November.
- **Early stage/university spinouts (0–20%):** although these may be largely unproven and can be risky, their prospects are largely uncorrelated to market moves, and they may offer significant profit potential as assets are commercialised. They made up c 7% of the portfolio as at 28 November 2019.
- **Natural resources (5–15%):** positioning will depend on the commodity cycle, but these cyclical stocks add portfolio diversification. At 28 November, exposure was c 9%.
- **Recovery (0–20%):** contrarian value opportunities made up c 9% of the portfolio at 28 November.
- **Special situations (0–10%):** distinct from recovery stocks in that they offer a specific catalyst for change, such as a restructuring, rather than simply being out of favour. These accounted for just 1% of the portfolio at 28 November 2019.

The managers have a long-term approach to investing, which generally results in a relatively low level of portfolio turnover, although they point out that this will naturally vary across the different sleeves. For example, while compounders (which are the core of the portfolio) are designed to be held indefinitely and tend only to be reduced on valuation grounds, growth large-cap and recovery stocks may be traded more frequently. In the first case this may be so they can be used as a source of liquidity; in the second, where the expected recovery has occurred, there may be limited further upside. Across the portfolio, turnover in FY19 was 25.1%, implying an average holding period of around four years.

Across their portfolios, Henderson and Foll tend to take a measured approach to topping up and reducing holdings. However, they are considering being more active in trimming positions that have done well, in order to lock in gains and mitigate the possibility of future losses. Back-testing has shown that capping positions at 5% would have increased historical returns and reduced volatility. HOT's largest holding, AIM-listed support services company RWS (a small- and mid-cap compounder), made up 3.6% of the total portfolio at end-December 2019.

Current portfolio positioning

At end-December 2019, there were 85 companies in HOT's portfolio, broadly unchanged on a year previously. Concentration in the top 10 holdings fell somewhat over the 12 months to 31 December, from 30.5% to 28.0% of the total. HOT is broadly diversified by market cap (Exhibit 3), with 65.1% of its holdings in sub-£1bn companies at end-November 2019. By contrast, companies bigger than £1bn made up 94.6% of the UK all companies index. As shown in Exhibit 1, more than half the portfolio (c 55%) is invested in AIM-listed stocks, with the large-caps accounting for c 20% of the total, compared with c 80% of the broad UK stock market. Henderson says that owning some of the bigger stocks ensures there is always liquidity in the portfolio, as well as boosting income, as some of the large-cap holdings are in higher-yield stocks (for example, HSBC yields c 6%). However, while the small- and mid-cap compounders might be lower-yielding, they often offer higher dividend growth.

Exhibit 3: Portfolio market cap exposure vs index (% unless stated)

	Portfolio end-November 2019	UK all companies index weight	Active weight vs index (pp)	Trust weight/index weight (x)
>£2bn	25.3	89.2	(63.9)	0.3
£1bn–2bn	9.6	5.4	4.2	1.8
£500m–1bn	14.5	2.9	11.6	5.0
£200m–500m	19.0	2.2	16.8	8.6
£100m–200m	13.6	0.4	13.2	34.0
£50m–100m	10.5	0.0	10.5	N/A
<£50m	7.5	0.0	7.5	N/A
	100.0	**100.0**		

Source: Henderson Opportunities Trust, Edison Investment Research

HOT's sector exposure (Exhibit 4) is also differentiated from that of the benchmark, with big overweights in industrials and technology (collectively 31.1pp higher than their representation in the UK all companies index), and underweight positions in all other sectors, most notably consumer goods (-9.5pp), financials (-5.2pp), and oil & gas (-4.5pp). Technology has a tiny 1.1% representation in the broad UK index, but makes up a much greater proportion of AIM stocks (c 13%), underlining the fact that innovative listed UK tech stocks do exist if investors are prepared to seek them out. Foll points out that within HOT's c 18% tech allocation (incidentally one of the largest falls in exposure over 12 months to 31 December), there are 'lots of companies doing different things', adding that while Blue Prism is 'genuinely high risk', a company like Learning Technologies, a digital learning and HR software firm with a market cap of c £1bn, is much more established. Zoo Digital, on the other hand, is very small (c £53m), but has significant growth potential from its dubbing and subtitle technology as content becomes ever more global.

Exhibit 4: Portfolio sector exposure vs index (% unless stated)

	Portfolio end-December 2019	Portfolio end-December 2018	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Industrials	25.6	23.3	2.3	11.6	14.0	2.2
Financials	21.9	15.8	6.1	27.1	(5.2)	0.8
Technology	18.2	20.8	(2.6)	1.1	17.1	16.4
Consumer services	9.7	12.2	(2.4)	12.0	(2.3)	0.8
Oil & gas	7.3	12.2	(4.9)	11.8	(4.5)	0.6
Basic materials	6.1	4.9	1.2	7.5	(1.5)	0.8
Healthcare	5.1	3.8	1.3	9.3	(4.2)	0.5
Consumer goods	4.5	3.6	0.9	14.0	(9.5)	0.3
Telecommunications	1.0	2.3	(1.3)	2.5	(1.5)	0.4
Utilities	0.6	1.2	(0.6)	3.0	(2.4)	0.2
	100.0	**100.0**		**100.0**		

Source: Henderson Opportunities Trust, Edison Investment Research

In terms of portfolio activity, the managers have recently been adding to domestic UK recovery positions, where Foll says there is a real valuation opportunity. An example is the recently initiated holding in property company Hammerson, which is doubly out of favour as it principally owns UK shopping centres. However, Foll explains, ‘they are very good assets like Bicester Village or the Bullring in Birmingham – places where people want to shop’.

Meanwhile, they have been gently reducing positions in companies on higher valuations, such as translation and intellectual property specialist RWS, which remains the largest holding, although it has fallen from 4.6% to 3.6% of the portfolio over the 12 months to 31 December 2019, despite a c 27% rise in its share price. Henderson and Foll sold HOT’s holding in Keywords Studios, which had been in the portfolio for a number of years, as they felt the company was making acquisitions that were not being fully integrated.

Gearing has historically been in the mid-teens but has been a little lower in the past year as the managers have been more cautious. Foll explains: ‘There are valuation opportunities, but there are also headwinds in terms of liquidity pressures. But we have the [gearing] firepower so we have the capacity to be net investors.’ HOT has a low-cost bank borrowing facility and no long-term debt.

Performance: Enjoying a post-election turnaround

Exhibit 5: Five-year discrete performance data

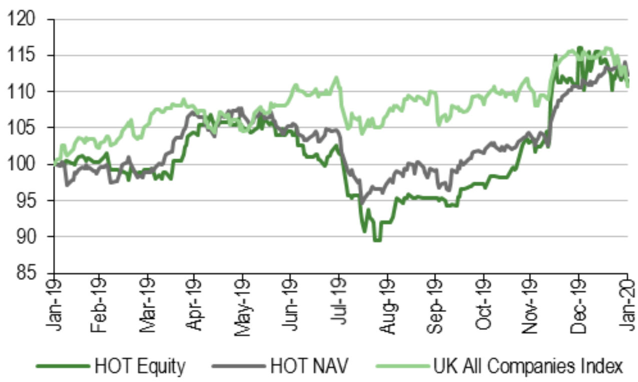
12 months ending	Share price (%)	NAV (%)	UK all companies index (%)	Numis Smaller Cos plus AIM ex-ICs (%)	UK smaller companies index (%)	UK mid-cap index (%)
31/01/16	(1.3)	(2.4)	(4.6)	3.0	5.8	3.7
31/01/17	24.0	25.6	20.1	20.9	20.8	13.2
31/01/18	16.3	17.9	11.3	17.3	13.3	14.6
31/01/19	(8.2)	(8.4)	(3.8)	(9.6)	(9.7)	(5.0)
31/01/20	11.5	12.3	10.7	13.5	13.4	16.4

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

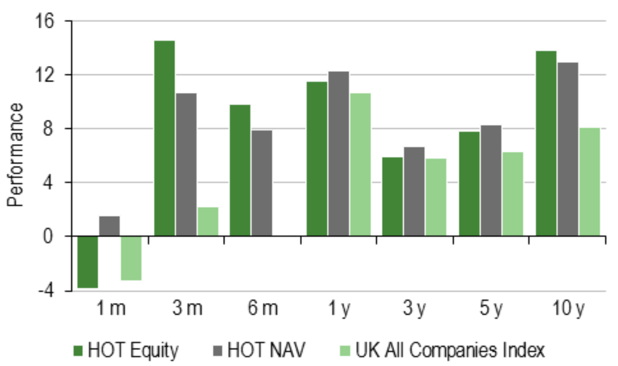
HOT has a strong long-term performance record but has suffered in the past couple of years as UK smaller companies have fallen from favour, first as a result of continued Brexit uncertainty, and later as the troubles at Woodford Investment Management led to a wave of open-ended funds selling less liquid stocks. A pick-up in sentiment following the December general election has led to better absolute and relative performance: over one year to 31 January 2020, HOT has produced a NAV total return of 12.3% and a share price total return of 11.5%, compared with a 10.7% advance in the UK all companies index. However, it is important to bear in mind that given the trust’s significant weighting in smaller companies, the broad UK stock market index (c 80% of which is accounted for by large-caps) is an imperfect benchmark, and HOT’s performance has been more in line with that of small-cap indices over the past 12 months (Exhibit 5). It is worth noting that HOT has also outperformed the AIM index, which rose by 5.0% over the 12 months to 31 January. Over three, five and 10 years, HOT's NAV total return has broadly matched or beaten the UK all companies, Numis Smaller Companies (plus AIM and excluding investment companies) and UK smaller companies indices, while its share price has also outperformed the UK all companies and UK smaller companies indices over three and 10 years (Exhibits 6 and 7). Foll points out that there has been a significant dislocation between the performance of the small-cap and mid-cap indices, as mid-caps have arguably benefited from the flight of open-ended fund capital from smaller companies as managers seek better growth opportunities than are available among the mega-cap stocks, but with greater liquidity than small-caps can offer.

Exhibit 6: Investment trust performance to 31 January 2020

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

In terms of specific drivers of recent performance, Blue Prism – an AIM-listed stock that makes robotic process automation software – has seen large share price falls in the past 12–15 months, declining by c 50% in Q418 and then by another c 40% from 31 July to mid-November 2019. However, having held the stock since its IPO in 2016, the managers had already taken profits equivalent to roughly five times the amount invested. Blue Prism sits in HOT's growth small-cap sleeve, and Foll says that while it is a good company in a very exciting space, and its share price performance had been extraordinary, it had reached a very high valuation at a time when its competitors were making greater strides. Following a positive trading update on 21 November, Blue Prism's shares jumped more than 30% in a single day. Although it was the second-biggest detractor from HOT's FY19 absolute performance, costing 2.4pp, recent returns have continued to be positive, and over 12 months to 31 January 2020, the share price is up 27.1%.

Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to UK all companies index	(0.6)	12.1	9.7	0.8	0.5	7.4	67.2
NAV relative to UK all companies index	5.0	8.3	7.8	1.5	2.5	9.7	54.5
Price relative to Numis Sml Cos + AIM ex-ICs	(1.8)	4.6	0.8	(1.7)	(1.1)	(2.9)	42.1
NAV relative to Numis Sml Cos + AIM ex-ICs	3.8	1.1	(0.9)	(1.0)	0.8	(0.8)	31.2
Price relative to UK smaller companies index	(4.0)	2.5	(2.9)	(1.7)	2.6	(1.8)	33.6
NAV relative to UK smaller companies index	1.5	(0.9)	(4.6)	(1.0)	4.6	0.3	23.4
Price relative to UK mid-cap index	(0.6)	7.9	0.7	(4.2)	(6.2)	(2.2)	21.5
NAV relative to UK mid-cap index	5.0	4.3	(1.0)	(3.5)	(4.3)	(0.1)	12.3

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2020. Geometric calculation.

4D Pharma, a drug developer in the early-stage/university spinout category, fell in value by c 40% during HOT's FY19 and by more than 90% since its peak in March 2016, partly as a result of market frustration at its lack of clinical progress, and more recently because of its association with Woodford Investment Management, which had been its largest shareholder. Foll notes that sentiment regarding the stock had moved very quickly, in spite of very little newsflow as the share price moved from £1 to £10 and back to £1 in the space of five years. Again, HOT's managers had already taken profits in excess of the cost of their investment, and the stock is up c 12% since 31 October 2019.

More recently, conferencing software firm LoopUp has detracted, following a trading update in July in which it lowered its earnings forecasts. The share price fell precipitously and it became HOT's largest detractor in FY19, down 80.6% and with an absolute impact of -2.5pp on returns. HOT's managers say sharp moves of this nature underline the importance of holding a relatively long list of investments across a broad spread of categories, in order to smooth the trust's NAV performance.

The three biggest positive contributors in FY19 were Serica Energy, RWS Holdings and Eland Oil & Gas, collectively adding 3.2pp to NAV performance. Foll notes that stock selection was positive across all indices during the financial year, but that overwhelmingly the largest detractor in asset allocation terms was the large exposure to AIM stocks. However, over the three months since HOT's year-end (to 31 January 2020), the AIM index has produced a total return of 7.5% against the UK all companies index's 2.2%, suggesting this performance headwind could have become a tailwind in the recent period.

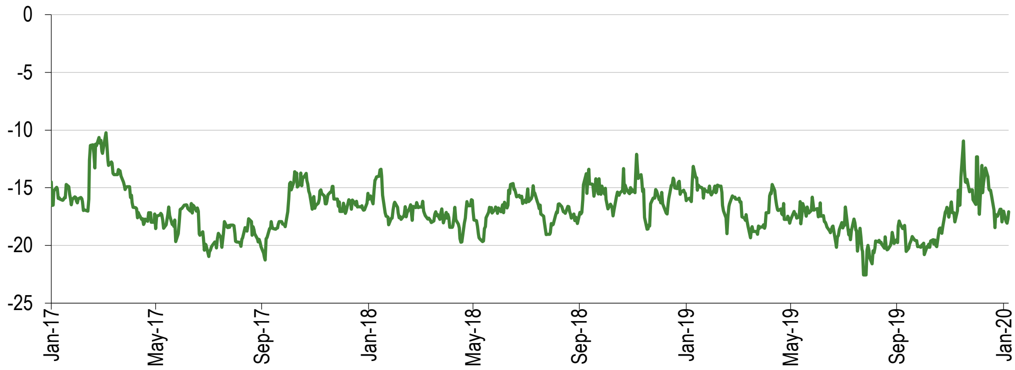
Exhibit 8: NAV total return performance relative to broad UK stock market over 10 years

Source: Refinitiv, Edison Investment Research

Discount: Wider as small caps remain out of favour

HOT's shares have traded broadly in a range of a 10–20% discount to NAV since early 2016. Prior to this the range had been larger and the discount more volatile, with the shares having reached both a c 6% premium and a c 30% discount within the past 10 years (in 2014 and 2011, respectively). At 6 February 2020, the discount to cum-income NAV was 17.1%, which was a little above the middle of the 12-month range of 10.9% to 22.6%. HOT's discount narrowed sharply following December's election result, but has since widened again; while largely in line with the average discount over one year (17.5%), it is wider than the average discounts over three, five and 10 years, respectively 16.9%, 15.5% and 16.1%. HOT's discount is also substantially wider than the 6.0% average for its peer group (Exhibit 10), in spite of its solid medium- and longer-term performance record. The trust does not have a formal discount control mechanism (DCM), having suffered as Henderson Strata following the TMT bubble of the early 2000s, when a hard DCM meant it had to buy back significant amounts of stock in a very weak demand environment, which had the effect of shrinking the trust substantially without materially closing the discount. Henderson points out that as HOT is quite a small trust with only 7.9m shares in issue (excluding treasury shares), it does not take a lot of additional demand to see the discount narrow meaningfully, as it did between October 2013 and October 2014, when the shares moved from a c 15% discount to a c 5% premium. Arguably HOT's wider discount over the past three or four years reflects Brexit uncertainty, which has negatively affected demand for the shares of smaller UK companies, especially those listed on AIM. Any clarity on Britain's future relationship with the EU that may emerge over the coming months has the potential to remove this overhang and bring investors' focus back to company fundamentals.

Exhibit 9: Share price discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

HOT is a conventional investment trust with one class of share. At 6 February 2020, there were 7.9m ordinary shares in issue, with a further 101k held in treasury. During FY19, HOT carried out its first share repurchases in eight years, buying back 99,670 shares (1.2% of the share base at end-FY18), at a cost of £0.9m, with more two small repurchases (a total of 2,813 shares) taking place in November 2019. Each year the board seeks authority to buy back up to 14.99% of shares, or allot shares up to 10% of the issued share capital. However, the primary purpose for undertaking share buybacks (which tend to take place when HOT's discount is wide and its portfolio holdings look particularly undervalued) is to enhance the NAV per share, rather than to manage a discount.

Borrowings of up to £20m are available via an unsecured loan facility. If fully drawn, this would represent net gearing of c 21.5%, versus a maximum permitted level of 25% (15% without prior board approval). At 31 December 2019, HOT's net gearing stood at 11%, having ranged between 11% and 15% over the previous 12 months.

Henderson Investment Funds (HIFL) acts as HOT's alternative investment fund manager (AIFM) under the AIFM Directive, and delegates portfolio management to Henderson Global Investors. Both are subsidiaries of Janus Henderson. HOT pays HIFL an annual management fee of 0.55% of net assets, calculated and paid quarterly. A performance fee (15% of any outperformance of the benchmark) may also be paid, subject to a cap on total management and performance fees of 1.5% of average net assets. A performance fee will not be paid if either HOT's share price or its NAV per share is lower at the end of the financial year than at the beginning, regardless of whether it has outperformed the benchmark. Any underperformance versus the index (or any unrewarded outperformance in excess of the fee cap) is carried forward and set against outperformance or underperformance in subsequent years. A performance fee was last paid in respect of FY17, and ongoing charges for FY19 (when no performance fee was paid) were 0.91%.

There is a continuation vote every three years, with the next due at the March 2020 AGM. At the last vote in 2017, more than 99% of votes cast were in favour of continuation.

Dividend policy and record

While HOT primarily aims to achieve capital growth, it has paid a dividend in each year of its existence, and seeks to grow the annual distribution over time. Dividends are paid twice a year, with an interim payment in September and a final dividend in March. In respect of FY19, an interim dividend of 7p per share has been paid, with a 19.0p final dividend (subject to shareholder approval) bringing the total to 26.0p, a 23.8% increase on FY18. The large increase was partly due to a significantly higher level of stock lending income, and also to a 21% year-on-year increase in investment income (including special dividends). Looking back over five years, dividends have grown at a compound annual rate of 15.8% and have been fully covered by income in all but one year (FY18, when the revenue return per share was 20.2p versus a total dividend of 21.0p). There was a significant step up in the dividend from FY14 (12.5p) to FY15 (18.0p), leading to a lower (but still double-digit) compound annual growth rate over the last three years of 11.0%. The FY19 revenue return per share was 29.9p, a 48.0% increase on 20.2p in FY18. The introduction of stock lending with effect from H218 has provided HOT with an additional revenue stream, amounting to £373,000 in FY19, or 14.9% of total income. The trust had a healthy revenue reserve of 43.4p per share at end-FY19 (24.4p if the final dividend is deducted), on which it can draw if necessary to smooth dividend payments when the trust's revenues dip.

With effect from FY20 (starting 1 November 2019), the board intends to pay dividends quarterly, in June, September, December and March. It has forecast that the three interim dividends for the year will be 6.5p per share, with a final dividend of 7.5p bringing the total for the year to 27.0p, a 3.8% increase on FY19. Based on the FY19 total dividend, HOT's shares currently yield 2.4%.

Peer group comparison

Exhibit 10: AIC UK All Companies sector as at 6 February 2020*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Henderson Opportunities Trust	**84.9**	**12.3**	**20.8**	**45.5**	**245.3**	**0.9**	**Yes**	**(17.1)**	**111**	**2.4**
Artemis Alpha Trust	133.2	19.4	25.0	32.2	83.1	1.0	No	(16.3)	100	1.5
Aurora	157.0	16.1	33.3	50.0	55.0	0.4	Yes	0.1	100	1.7
Baillie Gifford UK Growth	304.1	15.9	18.9	34.1	151.2	0.5	No	(6.2)	100	2.2
Fidelity Special Values	783.5	8.6	18.4	52.6	188.1	0.9	No	1.3	106	2.7
Independent Investment Trust	318.5	15.5	48.0	116.2	294.3	0.2	No	(7.1)	100	2.2
Invesco Perp Select UK Equity	59.7	13.4	16.5	36.2	216.9	0.9	Yes	(1.6)	106	3.6
JPMorgan Mid Cap	324.8	26.5	40.8	73.0	332.6	0.9	No	(1.8)	110	2.2
Jupiter UK Growth	46.7	11.0	4.9	9.4	93.1	1.2	Yes	(2.0)	108	2.8
Keystone	234.3	11.4	16.3	21.7	154.2	0.5	Yes	(11.0)	107	3.2
Mercantile	2,141.1	29.2	48.3	78.5	267.3	0.5	No	(0.4)	106	2.4
Schroder UK Mid Cap	229.5	21.1	36.3	60.3	283.1	0.9	No	(6.9)	105	2.9
Sector average (12 funds)	**401.4**	**16.7**	**27.3**	**50.8**	**197.0**	**0.7**		**(5.7)**	**105**	**2.5**
HOT rank in sector	**10**	**9**	**7**	**7**	**5**	**3=**		**12**	**1**	**7**

Source: Morningstar, Edison Investment Research. Note: *Performance to 5 February 2020 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

HOT is a member of the Association of Investment Companies' UK All Companies sector, a diverse peer group of 12 funds that invest primarily in UK equities, across the size spectrum, with no specific requirement to produce an income. It is one of three peers with a market capitalisation below £100m. While HOT's NAV total returns lag the sector average over one, three and five years (ranking ninth, seventh and seventh respectively), it is well ahead (c 48pp above the mean) over 10 years, ranking fifth out of the 12 funds. While many of the peers are focused on stocks outside the UK large-cap segment (particularly mid-caps), HOT's small to micro-cap bias is a differentiating factor. Ongoing charges are somewhat above average (albeit still below 1%), while HOT is one of five funds that may also pay a performance fee. In spite of its strong longer-term performance record, HOT currently trades at the widest discount to NAV. It also has the highest level of gearing. While the UK Equity Income sector is the natural home for funds that target income as well as growth, all of the UK All Companies peers currently pay a dividend, with HOT's 2.4% yield (based on FY19 dividends) broadly in line with the sector average, ranking seventh.

The board

There are currently six directors on HOT's board, all non-executive and independent of the manager. Peter Jones became a director in 2011 and was appointed chairman in 2016. Max King, the longest-serving director (appointed in 2005), will step down at the March 2020 AGM. Chris Hills has been on the board since 2010, while Frances Daley, who chairs the audit committee, was appointed in 2015. Wendy Colquhoun became a director in September 2018, and the newest board member, Davina Curling, was appointed on 1 November 2019. The directors have backgrounds in industry, law, accountancy and investment management.

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