EDISON

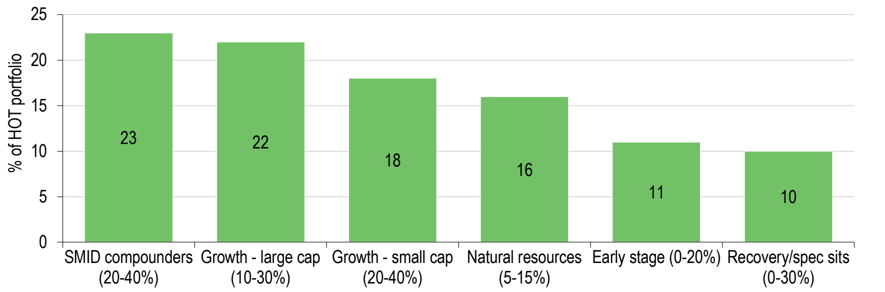
Henderson Opportunities Trust

Riding the next wave with stabilisers

Investment trusts
UK multi-cap equities

Henderson Opportunities Trust (HOT) is unusual in that its unconstrained mandate means it can buy into very small companies and hold them no matter how large they get. Managers James Henderson and Laura Foll explain that the investment trust structure enables them to own micro-caps (sub-£50m), which can be very illiquid and therefore unsuitable for an open-ended fund. For example, AIM-listed Serica Energy (the top holding at c 3.6% of the portfolio) now has a market cap of c £700m but it was only c £48m when HOT first invested in late 2013. Meanwhile, the trust's all-cap nature means that, unlike a dedicated smaller companies fund, it can also own mega-caps such as Shell (£176bn) and HSBC (£106bn). HOT has underperformed the broad UK stock market in recent months after a very strong FY21, but has a compelling longer-term track record, ranking highly in the AIC UK All Companies sector over one, three, five and 10 years.

Buckets of opportunity: HOT's portfolio breakdown by category



Source: Henderson Opportunities Trust, Edison Investment Research, at 30 April 2022.

Why consider UK equities now?

UK equities have been out of favour with international investors since the vote to leave the EU in 2016 and, with Brexit worries continuing over the Northern Ireland protocol, the market remains at a substantial P/E discount to the world and other developed regions. But despite the uncertain inflation backdrop and cost-of-living squeeze, the UK market continues to offer both world-class companies and niche domestic leaders. Indeed, while most eyes are focused on the US and China, the UK equity market has outperformed all major regional indices ytd in 2022 (to end-April). Investors may wish to consider whether its mix of more defensive qualities with pockets of higher growth could represent an attractive contrarian opportunity.

The analyst's view

HOT's small size and eclectic portfolio – with c 50% in AIM stocks – may not make it a 'core' holding for many, but it offers a truly diversified portfolio of UK companies from across the market cap spectrum, with a blend of growth drivers and end-markets, designed to offer good long-term returns. The managers continue to work on articulating the investment proposition and, in our view, a better understanding among investors of the trust's mix of 'tomorrow's leaders' and near-term 'stabilisers' could help to narrow a discount that we feel is persistently and unwarrantedly wide for a trust that is a strong performer in its sector over one, three, five and 10 years.

NOT INTENDED FOR PERSONS IN THE EEA

26 May 2022

Price	**1,217p**
Market cap	**£97m**
AUM	**£131m**
NAV*	1,409.2p
Discount to NAV	13.6%

*Including income. At 13 May 2022.

Yield	2.3%
Shares in issue	7.9m
Code/ISIN	HOT/GB0008536574
Primary exchange	LSE
AIC sector	UK All Companies

52-week high/low	1,570.0p	1,100.0p
NAV* high/low	1,676.3p	1,359.6p

*Including income.

Gearing

Gross gearing*	16%
Net gearing*	15%

*As at 30 April 2022

Fund objective

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.

Bull points

- HOT is arguably the only 'UK All Companies' fund that is truly an all-cap UK portfolio.
- The breadth of the opportunity set and the clear portfolio construction parameters should allow the managers to continue to meet the brief.
- Significant recovery potential in growth small-caps could help drive a re-rating from the current wide discount.

Bear points

- Fears over a UK and global recession could set back the timing of a small/micro-cap recovery.
- Strong commodity prices – a key support of recent performance – may not persist.
- Earlier-stage companies inherently have a higher risk of failure.

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Edison profile page

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The managers' view: Strength in diversity

To help investors make sense of the trust's broadly diversified, all-cap portfolio, HOT's managers have moved past the basic distinctions of small-, mid- and large-cap, instead classifying their holdings into one of six 'buckets': early stage, small-cap growth, small- and mid-cap compounders, large-cap growth, recovery/special situations and natural resources (see chart on page 1 for weightings). To clarify the process even further, Henderson and Foll now group the buckets under two broad headings: 'tomorrow's leaders' (the three small/mid-cap buckets and recovery/special situations) and 'stabilisers' (large-caps and, currently, natural resources). Each bucket has an indicative weighting range and, while HOT may choose to have no exposure to early-stage or recovery situations, it is a feature of the trust that natural resources must always be represented. Henderson and Foll argue that this is an important discipline, since the highly cyclical nature of energy and materials stocks means it is not always immediately clear when the 'wrong' time to own them becomes the 'right' time, adding that in the current environment of high commodity prices, it is essential to be exposed to the producers, and not just the consumers, of such resources.

Looking at HOT's top 10 holdings (Exhibit 1), natural resources companies (currently marginally over the 5–15% indicative range) are well represented, with large-cap mining stocks Anglo American and Rio Tinto (share prices each up c 10% so far in 2022) playing second fiddle to AIM-listed oil and gas operator Serica Energy (up c 36% year to date), currently the largest position. Despite the strong gains in Serica's share price between December and mid-April (it has recently fallen back somewhat), it remains on a very low forward P/E of 2.0x, because the high price of gas in particular means its earnings per share are forecast to be very high, at c 166p on a share price of c 330p. Henderson explains that, counter to the general view that a low P/E = good value, with resources companies, the time to buy is usually when the P/E is high, because the cyclical nature of the business means that earnings are due to recover from a low base.

Exhibit 1: Top 10 holdings (as at 30 April 2022)

Company	Index	Sector	Portfolio weight % 30 April 2022	Portfolio weight % 30 April 2021
Serica Energy	AIM	Oil & gas producers	3.6	2.2
Springfield Properties	AIM	Household goods & home construction	3.5	3.1
Next Fifteen Communications	AIM	Media	3.2	2.7
Tracsis	AIM	Software & computer services	2.9	2.4
Barclays	Large-cap	Banks	2.7	2.9
Anglo American	Large-cap	Mining	2.6	2.0
HSBC	Large-cap	Banks	2.4	1.2
Vertu Motors	AIM	Automotive retail	2.1	2.2
Rio Tinto	Large-cap	Mining	2.1	2.1
Jersey Oil & Gas	AIM	Oil & gas producers	2.1	1.2
Top 10 (% of holdings)			**27.3**	**26.2**

Source: Henderson Opportunities Trust, Edison Investment Research

HOT is more than just a natural resources play, of course; indeed, more than 85% of its portfolio is invested elsewhere, with the three largest sector exposures at 30 April 2022 being in industrials, financials and consumer discretionary (Exhibit 2). Many of the financials holdings also come under the 'stabilisers' umbrella, including the three high street banks in or near the top 10 (Barclays, HSBC and NatWest). While these were an important contributor to HOT's strong performance in FY21 (to 31 October), they have done less well recently (HSBC excepted), as soaring inflation and the war in Ukraine have dampened hopes for continued global economic recovery.

The core of the portfolio, however, is in 'tomorrow's leaders', which currently make up around two-thirds of the total, although this could go as high as 85%. Henderson and Foll currently see fewer attractive opportunities in the growth small-cap area (which is at the bottom of its allocation range), given valuations are somewhat stretched, and they have reduced some long-standing positions in companies such as mobile payments specialist Boku and railway software firm Tracsis, although both remain in or close to the top 10 holdings. Of the allocation ranges, Foll comments: 'The indicative ranges are meant to challenge us to think "is there a good reason we are lower or higher?". We will of course continue to look for attractive small-cap growth companies, but we are not forced to.' While growth small-cap valuations are on the high side, the managers comment that small and mid-cap compounders have derated significantly year to date, with translation specialist RWS Holdings down c 44% (hindered by fruitless bid speculation) and corporate advisory group K3 Capital off by c 34%. Early-stage companies have also had a rough ride, including in the fuel cell space, with the share prices of Ceres Power and AFC Energy – two of HOT's top performers in FY20 – having declined by c 33% and c 45% respectively so far in calendar 2022. 'We might have trimmed some of these positions, but we ask ourselves are valuations at a point where we would want to add back to them', says Foll.

Exhibit 2: Portfolio breakdown by sector

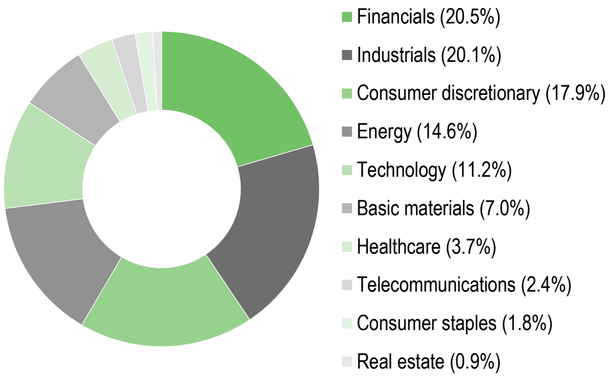
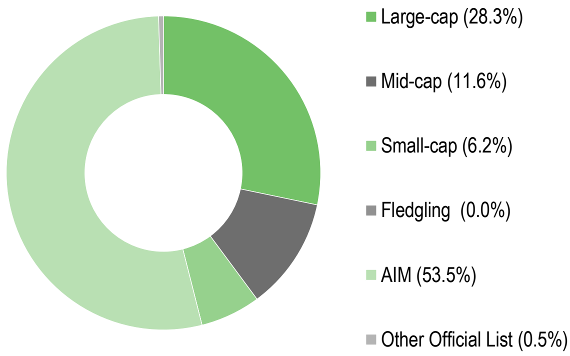


Exhibit 3: Portfolio breakdown by index



Source: Henderson Opportunities Trust, Edison Investment Research. Note: Sectors and index data at 30 April 2022.

Indeed, the managers have added to the holding in AFC Energy in recent months, along with acetylated wood producer Accsys Technologies (growth small-cap), Scottish housebuilder Springfield Properties (compounders), defence company Babcock (recovery), Direct Line Insurance (growth large-cap) and Shell (natural resources). This serves to illustrate the breadth of the portfolio, with individual opportunities existing in each of the buckets even where some categories may look unattractive at the aggregate level.

'We are looking for good strong companies on a longer view, and the diversity is important', says Henderson. 'The UK market is still relatively cheap and we believe earnings growth will surprise on the upside. We are trying to use the volatility and buy on the "red" days. The market is adjusting to a move up in bond yields and a change in interest rate expectations; we might have expected there to be more weakness, but so far it has mainly been in the areas that have been really strong and are highly valued.'

Longer-term performance remains compelling

Exhibit 4: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	CBOE UK All Cos (%)	Numis Smlr Cos + AIM ex-ICs (%)	CBOE UK 250 (%)
30/04/18	9.4	12.0	8.1	7.9	6.9
30/04/19	(0.4)	0.7	2.5	(5.0)	(3.5)
30/04/20	(24.7)	(23.6)	(17.2)	(16.5)	(19.7)
30/04/21	121.1	80.4	25.3	60.3	64.1
30/04/22	(20.6)	(8.9)	9.1	(9.1)	5.9

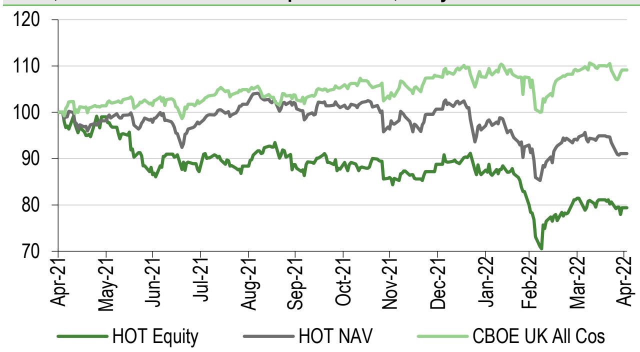
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

After a stellar year in the 12 months ended 30 April 2021 (NAV and share price total returns of 80.4% and 121.1% respectively), HOT has had a tougher time in the following period, posting absolute declines in both NAV and share price terms (Exhibit 4). Taking the two years together, the trust's NAV and share price (total returns of 75.6% and 65.3% respectively) have still outperformed both the broad UK market (+36.7%) and the Numis Smaller Companies + AIM index (+44.1%), while narrowly beating the mid-cap index (+73.8%) in share price total return terms but slightly lagging it on an NAV basis.

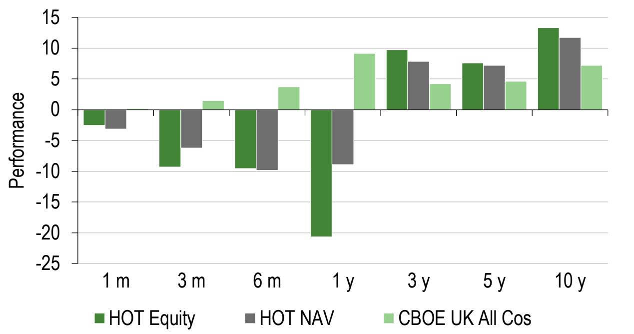
30 April is HOT's half-year end and, in the past six months, the effects of higher inflation and commodity prices, the spectre of recession and the war in Ukraine have all had an effect – for good or ill – on the share prices of UK companies. Bigger companies have performed better than small and mid-caps over this period, with the CBOE UK All Companies Index (c 80% large-cap) gaining 3.7% but the mid-cap CBOE UK 250 and Numis Smaller Companies + AIM indices declining by 10.9% and 11.2% respectively. HOT outperformed both these indices, albeit with negative NAV and share price total returns of -9.8% and -9.5% respectively. Given the magnitude of the share price falls in some of the trust's major holdings (see previous section), the relatively muted decline illustrates the benefit of HOT's allocation to 'stabilisers' in the form of larger companies and, particularly beneficial in recent times, natural resources stocks.

Exhibit 5: Investment trust performance to 30 April 2022

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



Price, NAV and index total return performance (%)



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

As shown in Exhibit 5 (right hand chart), despite the recent reversals, HOT has a solid longer-term record of outperformance versus the broad UK stock market, with annualised share price and NAV total returns of c 8–13% over three, five and 10 years, compared with c 4–7% pa for the CBOE UK All Companies Index over the same periods. The trust also has a good longer-term track record versus its peers in the AIC UK All Companies sector (Exhibit 6), being at, or near the top over three, five and 10 years and still ahead of the average over one year, a period in which eight of the nine funds have seen negative total returns. HOT also has an above-average dividend yield in the sector, yet persistently trades on one of the widest discounts to NAV.

Given there are separate sectors for UK Equity Income and UK Smaller Companies, the UK All Companies sector in reality is home to UK equity funds that do not have a specific income or small-cap mandate. Looking at the constituents in greater detail, JPMorgan Mid Cap and Schroder UK Mid Cap, as their names suggest, are mid-cap specialists, while Mercantile invests in small and mid-caps. Aurora and Baillie Gifford UK Growth both have a mid-cap bias (c 50% or over), while Artemis Alpha and Fidelity Special Values both have significant (c 20%) non-UK holdings. Independent Investment Trust, while broadly spread by size, has c 6% ex-UK and c 17% in cash (all data from AIC/Morningstar). This leaves HOT as the only trust in the sector that is truly UK (over 98%) and truly all-cap (see Exhibit 3, noting the large percentage in AIM stocks, which come in a variety of sizes), perhaps suggesting that it should be a more obvious choice for investors seeking a 'good mixer' to sit alongside more pedestrian UK or global holdings.

Exhibit 6: UK All Companies peer group as at 25 May 2022*

% 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 Ord	96.2	-9.3	22.1	35.0	217.3	0.9	Yes	-13.6	116	2.3
Artemis Alpha Trust Ord	108.9	-27.5	3.0	1.8	28.8	0.9	No	-8.2	113	1.6
Aurora Ord	165.5	-5.6	20.3	20.4	45.0	0.5	Yes	-6.7	98	0.9
Baillie Gifford UK Growth Trust Ord	246.5	-20.8	-4.2	-0.6	84.9	0.7	No	-15.4	101	1.5
Fidelity Special Values Ord	909.1	3.6	24.5	27.8	221.9	0.8	No	-6.2	106	2.4
Independent Ord	230.5	-17.1	-5.5	4.7	174.9	0.2	No	-16.0	83	1.8
JPMorgan Mid Cap Ord	222.9	-25.3	-1.8	2.0	204.8	0.8	No	-13.1	111	3.0
Mercantile Ord	1,590.8	-21.5	5.9	15.9	176.2	0.5	No	-14.8	109	3.4
Schroder UK Mid Cap Ord	195.7	-12.7	14.5	19.1	184.4	0.9	No	-16.5	110	2.6
Average	418.4	-15.1	8.8	14.0	148.7	0.7		-12.3	105	2.2
HOT rank in sector	9	3	2	1	2	4		5	1	5

Source: Morningstar, Edison Investment Research. Note: *Performance to 25 May 2022 based on cum-fair NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

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