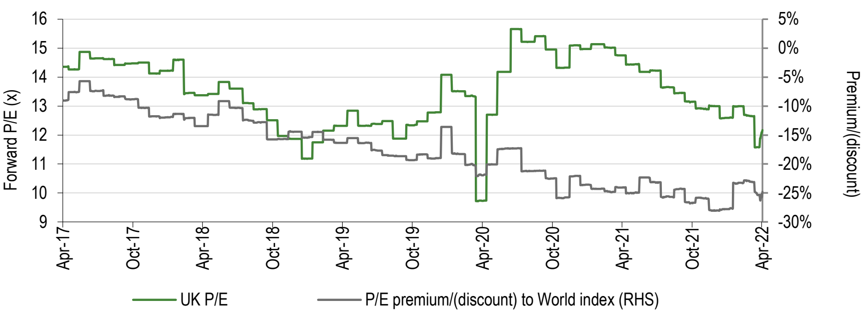
# Lowland Investment Company

## Patient, diversified and ripe for consideration

Investment trusts
UK income & growth

**Lowland Investment Company's (LWI's) managers, James Henderson and Laura Foll, run this UK equity income portfolio with a 'growth first' mentality, believing that companies with strong market positions and pricing power are best placed to grow their earnings, and consequently their dividends, over time. They cast their net across the market cap spectrum, aiming to own a diversified set of attractively valued – mainly UK – stocks spread across six 'buckets', from small-cap income to large-cap growth. Currently, the portfolio is tilted towards financial and industrial stocks, so the recent performance has somewhat lagged a volatile market where gains have been driven in large part by commodity producers. However, the managers are confident in the longer-term prospects of the 100+ companies they own, and with a c 4.8% dividend yield, investors in LWI are arguably being 'paid to wait' for value to be realised.**

**UK remains at wide P/E discount to rest of the world (Datastream indices)**




Source: Refinitiv, Edison Investment Research. Note: Total returns in sterling.

## Why invest in the UK now?

Although UK stocks have largely recovered from a sell-off in early March following the Russian invasion of Ukraine, the market remains at a significant valuation discount to the rest of the world, despite featuring many world-class companies as well as smaller stocks with leading niche positions. The well-established dividend culture provides investors with income as well as growth and revaluation potential.

## The analyst's view

LWI is one of Janus Henderson's flagship UK equity income trusts, yet it may be overlooked by investors in favour of the higher-profile City of London IT (CTY) or Henderson and Foll's other portfolios, The Law Debenture Corporation (LWDB) and Henderson Opportunities Trust (HOT). We believe LWI deserves closer attention. It combines some of the multi-cap growth attributes of HOT and the core income characteristics of CTY and LWDB, with a lower P/E and a higher yield, and is currently trading at a wider discount to NAV than its UK Equity Income peer group. Although the trust's performance since the Brexit vote in 2016 has been somewhat patchy, LWI's managers are patient investors – average portfolio turnover suggests a holding period of six to seven years – and we would argue that investors with a similar mindset could be well rewarded in both capital and income growth terms.

**NOT INTENDED FOR PERSONS IN THE EEA**

**7 April 2022**

| | | |
|---|---|---|
| **Price** | | **126.5p** |
| **Market cap** | | **£342m** |
| **AUM** | | **£422m** |
| NAV* | | 138.5p |
| Discount to NAV | | 8.7% |

*Including income. As at 6 April 2022. NAV is ex-dividend.

| | | |
|---|---|---|
| Yield | | 4.8% |
| Ordinary shares in issue | | 270.2m |
| Code/ISIN | | LWI/GB00BNXGHS27 |
| Primary exchange | | LSE |
| AIC sector | | UK Equity Income |
| 52-week high/low | 144.5p | 114.5p |
| NAV* high/low | 150.1p | 126.1p |

*Including income

| | |
|---|---|
| Gross gearing* | 15.0% |
| Net gearing* | 14.0% |

*As at 28 February 2022

### Fund objective

Lowland Investment Company (LWI) aims to give investors a higher-than-average return with growth in both capital and income over the medium to long term by investing in a broad spread of predominantly UK companies. LWI measures its performance against the total return of the broad UK stock market, although its portfolio make-up is markedly different from that of its benchmark index.

### Bull points

- Valuation discipline means portfolio companies could be more resilient in a prolonged period of market volatility.
- Multi-cap, multi-sector approach gives investors exposure to a variety of return drivers.
- UK income recovery means dividends should move back to full cover in the next few years.

### Bear points

- High inflation environment – while it can favour equity investment – could push the UK economy into recession, with wide-ranging ramifications.
- Value style tends to perform better in recovery phases.
- Gearing (currently 14%) can be a drag on returns in a falling market environment.

### Analysts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Edison profile page


***Lowland Investment Company is a research client of Edison Investment Research Limited***

# The fund managers: James Henderson and Laura Foll

## The managers' view: Unloved UK stocks offer great potential

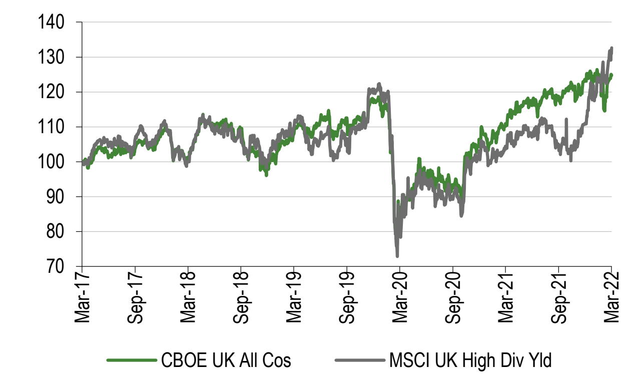
Henderson and Foll point to the significant value on offer in UK equities, which continue to trade at a wide P/E discount to the rest of the world (c 40%, close to a 30-year high, based on MSCI index data). As shown in Exhibit 1 (right hand side), the forward P/E for the Datastream UK Index is also at a c 9% discount to its own 10-year average, and a c 22% discount to its 10-year high point of 15.7x. Furthermore, the LWI portfolio is itself at a discount to the broader UK market, with a forward P/E of c 11x, partly as a result of its greater exposure to domestic rather than overseas earnings.

The managers explain that value and income investing has been out of favour, as investors have favoured growth stocks in an environment of low bond yields and muted inflation. However, higher inflation decreases the attraction of 'jam tomorrow', and as seen in Exhibit 1 (left hand side), in the very recent period, higher-yielding stocks have outstripped the broad UK market return. While this is partly due to technical factors in the make-up of the MSCI UK High Dividend Yield Index, which has a significant bias towards commodity stocks, it may also point to a broader reassessment of the benefits of dividend income in more volatile and potentially recessionary periods.

However, it is important to note that even though LWI sits in the UK Equity Income sector and pays a healthy dividend (current yield of 4.8%), its managers see growth potential as the most important driver of future income, and therefore prefer companies that can genuinely grow in the medium term, rather than the more traditional 'income' areas such as tobacco stocks.

**Exhibit 1: Performance and valuation of UK equities**

**Total return performance of UK equities over five years (£)**




**Valuation metrics of Datastream UK Index (at 6 April 2022)**

| | Last | High | Low | 10-year average | Last as % of average |
|---|---|---|---|---|---|
| P/E 12 months forward (x) | 12.2 | 15.7 | 9.4 | 13.4 | 91 |
| Price to book (x) | 1.0 | 1.9 | 0.7 | 1.2 | 84 |
| Dividend yield (%) | 3.5 | 6.4 | 2.7 | 3.5 | 98 |
| Return on equity (%) | 12.2 | 14.7 | 0.8 | 8.9 | 136 |

Source: Refinitiv, Edison Investment Research

Looking ahead, Henderson and Foll acknowledge the headwinds of higher inflation on both companies and consumers, so are continuing to focus on attractively valued businesses with strong market niches and pricing power. While the COVID-19 pandemic had a significant detrimental effect on UK dividends in 2020 and into 2021, Foll expects continued income recovery in 2022, with dividends returning in areas such as hospitality, travel and leisure, which were hardest hit by lockdown restrictions. In terms of opportunities, the managers are focusing attention on the small-cap income bucket, a largely ignored area of the market that features some well-managed, cash-generative companies such as Epwin, which supplies functional low-maintenance exterior building products such as door frames and gutters, and supermarket cake maker Finsbury Foods. 'The companies may not be exciting but they are good compounders for LWI,' says Foll. 'In five years' time, we think they can be solid performers in the vein of Redde Northgate (12 month share price return +24.5% and a 4.4% dividend yield).'

# Asset allocation

## Current portfolio positioning

LWI has a broadly diversified portfolio, with over 100 stocks held at 28 February 2022. While the multi-cap approach means a neutral allocation is seen as roughly one-third each in large, mid and small caps, the portfolio is currently somewhat overweight larger companies (a little over 40%), with Alternative Investment Market (AIM) stocks making up c 17% and the rest split across mid-caps and smaller companies listed on the main market of the London Stock Exchange. Currently, the top 10 holdings (Exhibit 2) are all large-caps (Direct Line Insurance is just outside the 100 largest UK stocks), although this is by no means always the case – 12 months ago, for example, AIM-listed battery firm Ilika (current market cap c £190m) was the fourth largest position.

**Exhibit 2: Top 10 holdings (as at 28 February 2022)**

| Company | Country | Sector | Portfolio weight % | |
|---|---|---|---|---|
| | | | 28 February 2022 | 28 February 2021* |
| Shell | UK | Oil & gas | 3.2 | 2.5 |
| GlaxoSmithKline | UK | Pharma & biotech | 2.6 | 2.5 |
| Anglo American | UK | Mining | 2.4 | N/A |
| Severn Trent | UK | Utilities | 2.2 | 2.1 |
| National Grid | UK | Utilities | 2.2 | N/A |
| Direct Line Insurance | UK | Non-life insurance | 2.1 | N/A |
| BP | UK | Oil & gas | 2.1 | N/A |
| Vodafone | UK | Telecoms | 2.1 | N/A |
| Phoenix Group | UK | Life insurance | 2.1 | 3.0 |
| HSBC | UK | Banks | 2.0 | 2.1 |
| **Top 10 (% of holdings)** | | | **22.9** | **22.7** |

Source: Lowland Investment Company, Edison Investment Research. Note: *N/A where not in end-February 2021 top 10.

While the trust does have the flexibility to invest a portion of its assets overseas, the holdings are currently overwhelmingly UK listed (Exhibit 3), with the 3% exposure to Ireland largely accounted for by Dublin-listed companies that have significant UK operations. The proportions are unchanged over the past 12 months, with ferry operator Irish Continental Group remaining the largest non-UK holding.

**Exhibit 3: Portfolio geographic exposure (% unless stated)**

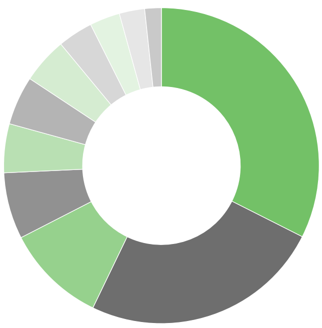
| | Portfolio end-February 2022 | Portfolio end-February 2021 | Change (pp) |
|---|---|---|---|
| UK | 97.0 | 97.0 | 0.0 |
| Ireland | 3.0 | 3.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 |
| | **100.0** | **100.0** | |

Source: Lowland Investment Company, Edison Investment Research

Although financials and industrials (Exhibits 4 and 5) remain the core of the portfolio, Henderson and Foll's recent purchases have had more of a consumer tilt. The managers have built a c 1% holding in Anglo-French DIY retailer Kingfisher, whose brands include B&Q and Screwfix. The stock is a slightly contrarian choice given analysts' consensus forecasts point to declining sales as COVID-19 benefits fall away. However, the managers believe that householders who learned DIY skills during the lockdowns will keep at it, and Foll also points to significant growth potential for the more trade-focused Screwfix format, particularly if it establishes a physical presence in France, where it currently only operates online.

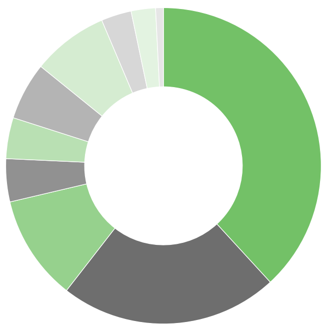
Consumer products company Reckitt Benckiser is another recent addition. While staples have not historically been a big area for LWI, Foll says that they are starting to see evidence that the company's reinvestment is feeding into a pick-up in organic growth, 'and in those situations, with some operating leverage, valuations can become quite high,' she explains. While consumer stocks have been under pressure so far this year as fears rise over the effect of higher living costs on discretionary spending (Marks & Spencer and Halfords were among the worst performers in the portfolio in February), the managers have been topping up the Reckitt Benckiser position, although it remains quite small at under 1% of the portfolio. LWI also held a small position (c 0.4%) in Studio Retail Group, which went into administration during February and was subsequently bought for £1 by Mike Ashley's Frasers Group. The positions in Phoenix Group, HSBC and Hiscox (which is now outside the top 10 holdings) were reduced during February for portfolio balance reasons.

**Exhibit 4: Sector exposure at 28 Feb 2022 (new ICB)**[1]




Source: Lowland Investment Company, Edison Investment Research

**Exhibit 5: Sector exposure at 28 Feb 2021 (old ICB)**




Source: Lowland Investment Company, Edison Investment Research

## Performance: Pause for breath after very strong FY21

**Exhibit 6: Five-year discrete performance data**

| 12 months ending | Share price (%) | NAV (%) | CBOE UK All Cos (%) | MSCI UK High Div Yld (%) | CBOE UK 250 (%) | CBOE UK Small Cos (%) |
|---|---|---|---|---|---|---|
| 31/03/18 | 6.2 | 2.6 | 1.2 | 0.0 | 5.6 | 7.0 |
| 31/03/19 | (6.3) | (4.7) | 6.2 | 9.1 | (0.9) | (3.1) |
| 31/03/20 | (29.8) | (29.5) | (19.1) | (22.7) | (21.7) | (25.3) |
| 31/03/21 | 45.9 | 47.0 | 26.6 | 23.4 | 50.7 | 75.0 |
| 31/03/22 | 14.1 | 9.9 | 13.2 | 25.8 | (1.2) | 13.0 |

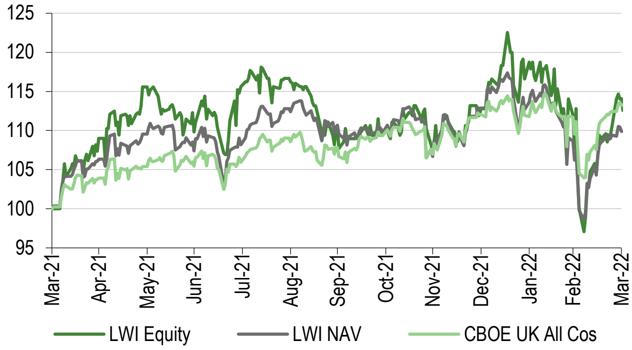
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

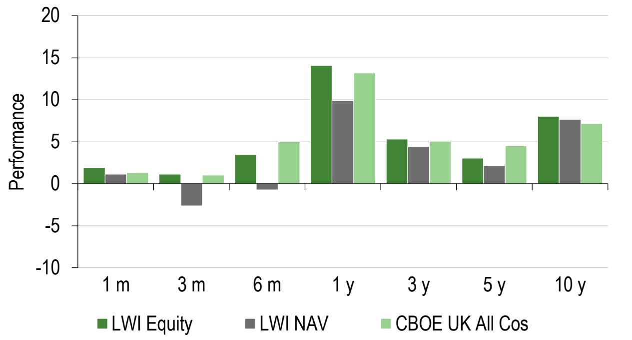
As discussed in our last note, LWI performed very strongly in FY21 (to 30 September), helped by positive news on COVID-19 vaccinations and a strong economic recovery, with an NAV total return of 51.0% compared with a 27.9% rise in its UK all-cap benchmark index. However, with the bulk of the good news having come in the early part of the financial year, the past 12 months have been more challenging versus the index, with LWI's NAV total return lagging the CBOE UK All Companies Index (a reasonable proxy for LWI's benchmark) by 3.3pp and the MSCI UK High Dividend Yield Index by 15.9pp (Exhibit 6, figures to 31 March 2022). In share price total return terms, however, LWI is ahead of the benchmark over the past 12 months. Looking specifically at H122 (1 October 2021 to 31 March 2022), LWI's NAV total return is slightly negative (-0.7%) while its share price total return is positive (+3.5%). Over the same period, the CBOE UK All Companies Index has put on 5.0% while the MSCI UK High Dividend Yield Index has surged by 25.0%, a result likely attributable to its c 40% weighting in materials stocks and tiny (sub-3%) exposure to financials, effectively the diametric opposite of LWI (32.4% financials and 5.0% materials). While financials (particularly banks and other financials, rather than insurers) were a good source of return for LWI in FY21, they have been more volatile in the wake of the Russian invasion of Ukraine, which, in addition to its heavy human cost, has caused turbulence across financial markets. Meanwhile, materials and energy stocks have surged as sanctions and supply issues have pushed up already high commodity prices.

[1] The Industry Classification Benchmark (ICB) sectors were reorganised during 2021, meaning a direct comparison is not possible between the periods in Exhibits 4 and 5.

**Exhibit 7: Investment trust performance to 31 March 2022**

| 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.

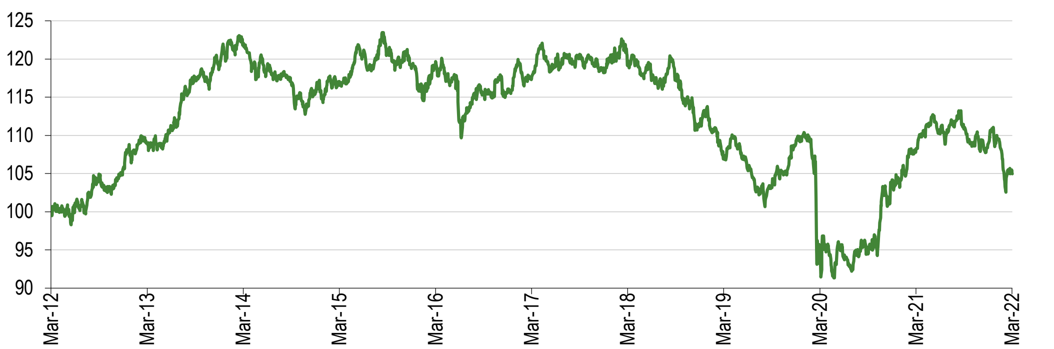
LWI has outperformed mid-cap stocks in the last 12 months (Exhibit 8), in both share price and NAV total return terms, while its NAV has underperformed more large-cap focused indices over this timescale. However, over the long term (10 years) the position is reversed, with the trust outstripping its benchmark (and our proxy for it), as well as the MSCI high-yield index.

**Exhibit 8: 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 CBOE UK All Cos | 0.6 | 0.1 | (1.4) | 0.8 | 0.7 | (6.8) | 8.7 |
| NAV relative to CBOE UK All Cos | (0.2) | (3.6) | (5.4) | (2.9) | (1.8) | (10.7) | 5.0 |
| Price relative to MSCI UK High Div Yld | (1.9) | (14.5) | (17.2) | (9.3) | (2.7) | (11.4) | 3.5 |
| NAV relative to MSCI UK High Div Yld | (2.6) | (17.7) | (20.5) | (12.6) | (5.1) | (15.0) | 0.1 |
| Price relative to CBOE UK 250 | 2.3 | 13.1 | 15.1 | 15.5 | 0.2 | (4.8) | (10.5) |
| NAV relative to CBOE UK 250 | 1.5 | 8.9 | 10.4 | 11.3 | (2.2) | (8.8) | (13.5) |
| Price relative to CBOE UK Small Cos | (1.9) | 0.1 | 4.3 | 1.0 | (21.0) | (24.2) | (30.9) |
| NAV relative to CBOE UK Small Cos | (2.6) | (3.7) | 0.1 | (2.7) | (22.9) | (27.4) | (33.2) |

Source: Refinitiv, Edison Investment Research. Note: Data to end-March 2022. Geometric calculation.

**Exhibit 9: NAV performance versus CBOE UK All Companies Index over 10 years**




Source: Refinitiv, Edison Investment Research

For FY21, the top contributors to performance relative to the benchmark were K3 Capital, which provides services to small- and mid-sized UK companies such as M&A and tax advisory and restructuring services, engineering firm Senior, vehicle hire specialist Redde Northgate, concrete screeding firm Somero Enterprises and specialist lender International Personal Finance, all of which saw their share prices more than double. The biggest detractors were insurers Phoenix Group (life) and Hiscox (non-life), water utilities Severn Trent and Pennon, and 4D Pharma. Of these, only Hiscox (-5%) and 4D Pharma (-61%) saw negative total returns.

## Peer group comparison

The AIC's UK Equity Income sector, of which LWI is a member, is one of the largest AIC peer groups and encompasses funds with a wide range of investment approaches within the overall remit of providing income and capital growth from a portfolio at least 80% made up of UK equities.

LWI is one of the more value-orientated funds in the peer group, which has affected returns over the three- and five-year periods shown below, as while UK equities as a whole have been largely out of favour since the referendum on EU membership in 2016, 'value' has also markedly underperformed 'growth' for the majority of this period. However, the recent market rotation in favour of value stocks has boosted returns for LWI, which now ranks ninth of 17 funds shown over 12 months (we have excluded five trusts with a market cap below £100m), with its 9.5% NAV total return broadly in line with the average for the selected peer group (10.1%) and ahead of the whole sector average (7.6%). Compared with its Janus Henderson stablemates, CTY and LWDB, LWI has a more multi-cap approach (arguably most similar to sector peers Aberdeen Standard Equity Income and The Diverse Income Trust). It also has more of an income tilt than LWDB (also managed by Henderson and Foll), as the other trust's professional services division supplies c 30% of total income, allowing the managers the freedom to invest in lower-yielding stocks. While LWDB has performed better recently, LWI's significant exposure to smaller companies gives it a differentiated source of potential return (in both capital and income growth terms) compared with many sector peers.

In a sector that is very competitive on cost, LWI's 0.60% ongoing charge, coupled with the recent removal of its performance fee, stacks up well versus a peer group average of 0.68% and a whole sector average of 1.25%. Net gearing of 14% is higher than the peer group average but comparable with the managers' other portfolios. LWI's 7.5% discount to NAV at 4 April is wider than the sector average, and nearly 9pp wider than LWDB, which has recently been trading at a small premium. Its 4.7% dividend yield is above average for the peer group, ranking joint second of 17 trusts.

**Exhibit 10: Selected peer group as at 5 April 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 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Lowland** | **347.9** | **9.5** | **13.2** | **11.3** | **109.6** | **0.6** | **No** | **(7.5)** | **114** | **4.7** |
| Aberdeen Standard Equity Income | 176.0 | 11.5 | 2.1 | 8.8 | 92.7 | 0.9 | No | (4.6) | 114 | 5.9 |
| BMO Capital & Income | 346.1 | 7.5 | 14.0 | 27.0 | 112.3 | 0.6 | No | (0.1) | 107 | 3.6 |
| BMO UK High Income Units | 109.9 | 1.7 | 10.3 | 11.5 | 81.4 | 1.0 | No | (11.7) | 101 | 4.6 |
| City of London | 1,887.1 | 16.6 | 17.4 | 26.1 | 124.3 | 0.4 | No | 1.7 | 110 | 4.6 |
| Diverse Income Trust (The) | 392.7 | 0.7 | 30.5 | 36.8 | 202.0 | 1.1 | No | (1.8) | 100 | 3.5 |
| Dunedin Income Growth | 443.3 | 3.1 | 20.6 | 31.6 | 103.4 | 0.6 | No | (1.2) | 107 | 4.3 |
| Edinburgh Investment Trust | 1,096.6 | 13.4 | 13.3 | 10.1 | 114.7 | 0.4 | No | (7.1) | 104 | 3.7 |
| Finsbury Growth & Income | 1,862.2 | 5.0 | 14.5 | 41.9 | 212.8 | 0.6 | No | (6.3) | 101 | 2.1 |
| Invesco Select UK Equity | 136.4 | 17.3 | 28.8 | 30.1 | 175.0 | 0.9 | No | (7.9) | 109 | 3.6 |
| JPMorgan Claverhouse | 425.7 | 9.5 | 15.4 | 24.9 | 130.7 | 0.7 | No | (3.7) | 114 | 4.3 |
| Law Debenture Corporation | 1,007.7 | 15.4 | 41.2 | 55.7 | 170.5 | 0.5 | No | 1.4 | 113 | 3.6 |
| Merchants Trust | 748.7 | 20.0 | 38.7 | 49.6 | 154.0 | 0.6 | No | 1.3 | 112 | 4.7 |
| Murray Income Trust | 1,037.4 | 11.4 | 24.7 | 35.7 | 119.3 | 0.5 | No | (5.9) | 110 | 3.9 |
| Schroder Income Growth | 212.6 | 13.6 | 20.1 | 27.2 | 131.3 | 0.8 | No | (4.5) | 112 | 4.2 |
| Temple Bar | 757.0 | 6.6 | 0.4 | 10.3 | 89.5 | 0.5 | No | (4.0) | 107 | 3.4 |
| Troy Income & Growth | 232.2 | 8.9 | 8.9 | 16.4 | 102.1 | 0.9 | No | (1.6) | 100 | 2.6 |
| **Simple average (17 funds)** | **660.0** | **10.1** | **18.5** | **26.8** | **130.9** | **0.68** | | **(3.7)** | **108** | **4.0** |
| **LWI rank in peer group** | **11** | **9** | **13** | **14** | **12** | **12** | | **15** | **1=** | **2=** |

Source: Morningstar, Edison Investment Research. Note: *Performance as at 1 April 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).

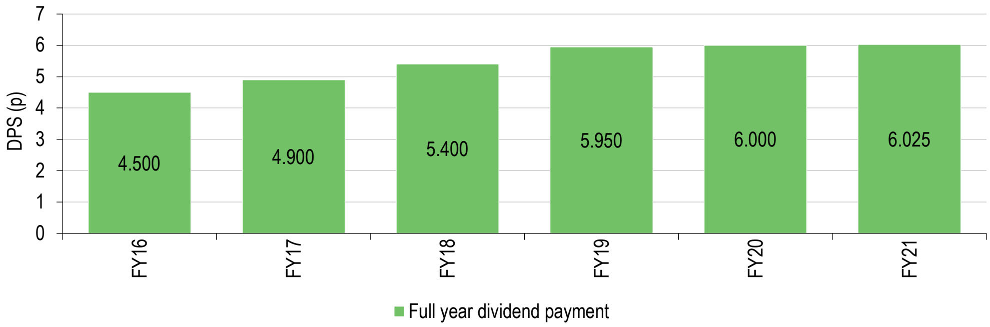
## Dividends

LWI pays dividends quarterly (in April, July, October and January) and has a 46-year record of maintaining or growing its annual payout, with 2008 the only year in which dividends were held at the previous year's level rather than increased. Dividends have grown at a compound 6.0% over the past five financial years, although the rate in recent years has slowed substantially, reflecting the impact of COVID-19 on UK corporate dividends, particularly in 2020 (effectively spanning LWI's H220 and Q121). The trust's net revenue per share in FY20 was down by just over 50% compared with the previous year, a slightly worse outcome than the 44% fall in UK dividends as a whole in calendar 2020 (source: Link Dividend Monitor). In FY21, earnings per share rebounded by 26.0% to 42.7p (FY20: 33.8p), although this remains 37% below the FY19 level of 68.0p. As more and more UK companies reinstate, and in some cases increase, their dividends, we would expect continued recovery in LWI's revenues in H122.

A slight 0.25p rise in LWI's fourth and final dividend (to 15.25p) in FY21 brought total dividends for the year to 60.25p, a 0.4% increase on FY20's 60.0p. Having built its revenue reserves over many years (the last time the dividend was not fully covered by income was in 2010), LWI used these reserves to help fund the FY20 and FY21 dividends, and a small contribution (£1.5m or 5.5p per share) from capital reserves was necessary to cover the final dividend in FY21.

Following the 10-for-one share split in February 2022 (see Capital structure section), dividends per share have reduced by a factor of 10. A first quarterly dividend for FY22 of 1.525p per share (the same as the adjusted Q421 dividend) was announced on 23 March 2022. Based on the current share price and the last four dividends (adjusted for the share split), LWI has a yield of 4.8%.

**Exhibit 11: Dividend history since FY16 (adjusted for share split)**



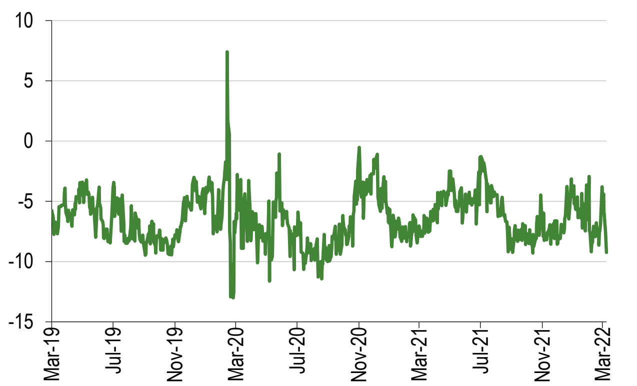

Source: Bloomberg, Edison Investment Research

## Discount: Broadly stable in mid-single digit range

At 6 April 2022, LWI's shares traded at an 8.7% discount to cum-income NAV. This is a little wider than short- and medium-term averages (6.1%, 6.4% and 6.3% respectively over one, three and five years), reflecting very recent share price weakness (-4.9% from 31 March to 6 April) versus the NAV (-0.5%). However, it is within the medium-term range of 0–10% (see Exhibit 12), disregarding the brief period of extreme market dislocation in March 2020 as COVID-19 took hold.

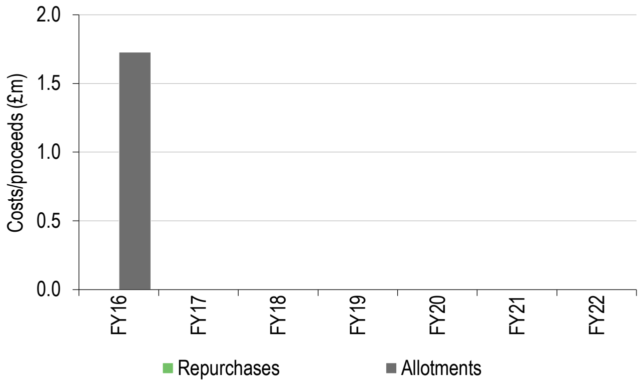
LWI's board does not favour the use of share buybacks as a means of discount control, seeing these as negating some of the benefits of the closed-end structure, as well as potentially shrinking the size of the trust, reducing the audience of potential investors, increasing the ongoing charges ratio and reducing liquidity in the shares. No shares have been repurchased in any of the last seven financial years (Exhibit 13), although the board may allot shares when the trust's shares are trading at a premium to NAV, as seen during FY16. The relative stability of LWI's discount to NAV in the mid-single digits suggests the market is comfortable with the board's position.

**Exhibit 12: Discount over three years**




Source: Refinitiv, Edison Investment Research

**Exhibit 13: Buybacks and issuance**




Source: Morningstar, Edison Investment Research

## Fund profile: Fundamentally driven multi-cap approach

LWI was established in 1963 and aims to achieve capital growth and a growing income for its shareholders by investing mainly in UK companies from across the market capitalisation spectrum. It is jointly managed by James Henderson (since 1990) and Laura Foll (since 2013), who are members of the global equity income team at Janus Henderson Investors and co-manage Edison client HOT and the investment portfolio of LWDB.

LWI is a member of the Association of Investment Companies' UK Equity Income sector and benchmarks its performance against a broad UK stock market index, although this is an imperfect comparator given the fund's high weighting in mid- and small-cap companies, particularly those listed on AIM. The managers' preference for out-of-favour value and recovery situations can also mean performance diverges from that of the index, which in a rising market naturally tends to be driven by the most popular stocks.

As part of their investment strategy, Henderson and Foll actively use gearing with the aim of enhancing returns. LWI has a mix of short- and longer-term borrowings equating to maximum gearing of £90m or c 25% of net assets. Net gearing at 28 February 2022 was 14.0%.

## Investment process: Income with a growth mindset

LWI's managers invest on a bottom-up basis with a keen awareness of valuations, seeking to create a diversified, multi-cap portfolio of c 100–120 mainly UK companies. In the past couple of years, they have codified their portfolio construction parameters (see Exhibit 14) into a series of classification 'buckets' similar to those employed for another fund they manage, HOT (latest Edison research here). This does not reflect a new approach, but rather a different way of expressing the way they think about the companies they seek to own.

**Exhibit 14: Lowland's portfolio 'buckets'**

| Name | Indicative range (%) | Portfolio weighting* (%) | Stock example |
|---|---|---|---|
| Small-cap income | 5–15 | 8.0 | Redde Northgate |
| Small-cap growth | 0–10 | 4.0 | Ilika |
| Small and mid-cap compounders | 25–40 | 32.0 | Halfords |
| Large-cap income | 20–35 | 28.0 | GlaxoSmithKline |
| Large-cap compounders | 10–20 | 15.0 | Tesco |
| Recovery | 5–15 | 14.0 | Johnson Service Group |
| | | **100.0** | |

Source: Lowland Investment Company, Edison Investment Research. Note: *At 31 December 2021.

One of the key differentiators between LWI and most of its UK Equity Income peers is its high weighting in small- and mid-cap companies, which tend to average around two-thirds of the total portfolio through an investment cycle (although currently there is a slight tilt towards larger-cap companies). Across the classifications, Foll and Henderson are looking for well-managed, cash-generative, market-leading companies that are out of favour with the market. The six buckets ensure diversity in the portfolio, both in terms of company size and source of return, with some higher-growth names that can move up through the classifications over time alongside more traditional equity income stocks where most of the return may come from high and/or growing dividends.

The multi-cap nature of the portfolio, which may include a significant proportion in companies listed on AIM, means LWI's profile (and hence its performance) is likely to differ appreciably from the benchmark, where c 80% of total market capitalisation is accounted for by the largest 100 names. Running a long stock list is a good way of limiting company specific risk, particularly in smaller firms that may be at a relatively early stage of development. The trust may invest up to 20% of its assets overseas; however, non-UK holdings currently account for only c 3% of the total, focused on Irish-listed companies with significant UK operations.

Four key principles underpin the investment philosophy, which has remained largely unaltered since the trust was set up in 1963:

- The UK is home to many world-class companies with sustainable long-term growth potential.
- Mid-cap and smaller companies make better long-term investments because of their superior growth potential.
- Capital growth and dividend growth go hand in hand as drivers of investment performance.
- As long-term investment returns have tended to exceed the cost of borrowing, gearing is an appropriate way of maximising performance.

The managers use a range of valuation criteria to identify the companies in their investment universe of c 1,500 stocks that have potential to generate both capital appreciation and a growing income. They meet with hundreds of companies every year (virtually or in person), seeking businesses with real prospects of sales and earnings growth. Henderson and Foll strongly prefer to buy into companies that are trading at low valuations because their potential to recover and grow may be under-appreciated by the wider market. In addition, because they believe dividend growth is a key to long-term capital growth, the managers favour companies that pay sustainable dividends.

Positions tend to be built slowly, starting at c 0.5% of the total portfolio or less. The managers' approach is long term and portfolio turnover is low, at 15.6% in FY21 and 14.7% in FY20, implying an average holding period of six to seven years.

## Lowland's approach to ESG

Henderson and Foll see responsible investing as a long-term process that depends not just on businesses meeting current legislative standards but also operating with an understanding of changing societal attitudes towards issues such as climate change, pollution and working conditions. While ESG risks do not preclude ownership of a stock, they are a key consideration in arriving at an appropriate valuation and position size. Where evidence of poor practice emerges, the managers will engage with the company to discover how the problem is being addressed and will monitor progress to assess evidence of improvements. Specifically on governance, LWI always votes at the AGMs of investee companies, and Henderson and Foll try to work constructively with firms on appropriate executive remuneration structures to ensure the best alignment of the interests of management and shareholders.

Rather than relying on external ratings, which may be absent in the case of smaller companies, or based on flawed, outdated or incomplete data, the managers review each new investment idea for potential ESG shortcomings. Any material issue they discover is discussed with Janus Henderson's governance and sustainable investing team and/or the company itself before an investment is made.

## Gearing: Used actively to benefit from opportunities

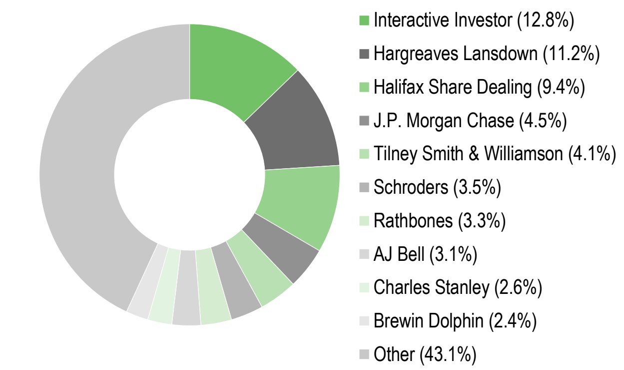
Henderson and Foll are keen to maximise the benefits of LWI's investment trust structure, one of which is the ability to use gearing. The trust has up to £90m of low-cost borrowing (c 25% of NAV) available, via a two-year bank loan of £40m (extendable to £60m) with Industrial and Commercial Bank of China at an interest rate of Libor+0.9%, and £30m of 20-year loan notes (maturing in 2037) with a fixed coupon of 3.15%. Net gearing of 14% at end-February 2022 suggests c £20m of the bank loan (on top of the £30m of loan notes) is currently drawn, and in percentage terms is in line with the average level of net gearing in the past six months. The gearing allows the managers to continue to be net investors during periods of market volatility when they may not wish to sell other holdings. They point to the continued wide valuation discount of UK equities versus the rest of the world as evidence of the attractiveness of using low-cost gearing to invest.

## Fees and charges: More competitive since revamp

LWI revamped its fee structure at the beginning of FY21, removing the performance fee and adjusting the tiers at which reducing management fees are paid to Janus Henderson Investors. The manager is paid a fee of 0.5% on the first £325m of net assets (previously the first £375m), reducing to 0.40% thereafter. Fees are split equally between the capital and revenue accounts. During FY21, the change led to a c 3% reduction in the absolute level of fees paid compared with FY20, despite average net assets being c 1% higher, and ongoing charges were 0.60% for FY21 compared with 0.66% in FY20. This is below the average (0.68%) of the peer group (see Exhibit 10), which in turn is well below the 1.08% average for the AIC investment company universe.

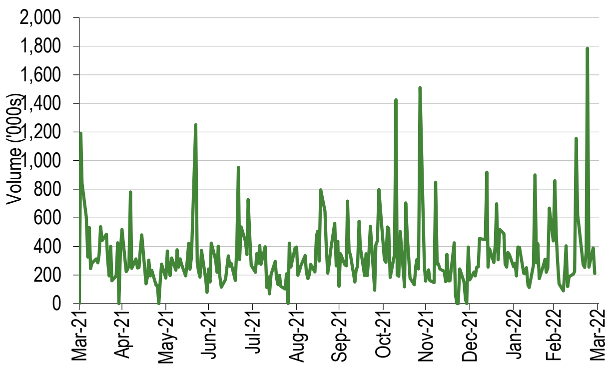
## Capital structure

**Exhibit 15: Major shareholders**




Source: Bloomberg, as at 28 February 2022

**Exhibit 16: Average daily volume (adj. for share split)**




Source: Refinitiv. Note 12 months to 1 April 2022.

LWI is a conventional investment trust with one class of share. In February 2022, the trust undertook a 10-for-one share split and has 270.2m ordinary shares in issue as at 6 April 2022. Disregarding the split, the share base (previously 27.0m) has remained unchanged since FY16, when c 130,000 new shares were allotted. As shown in Exhibit 15, LWI's shareholder register includes strong representation from retail investors, with the self-directed platforms Interactive Investor, Hargreaves Lansdown, Halifax Share Dealing and AJ Bell accounting for more than a third

(36.5%) of the share base. In terms of trading liquidity (Exhibit 16, adjusted for the share split), an average of 341,100 shares (c 0.13% of the total) changed hands each day in the 12 months to 6 April 2022.

## The board

**Exhibit 17: Lowland's board of directors**

| Board member | Year of appointment | Remuneration in FY21 | Shareholdings at end-FY21* |
|---|---|---|---|
| Robert Robertson (chairman) | 2011 (2017) | £39,000 | 59,225 |
| Gaynor Coley (audit cttee chair) | 2016 (2017) | £30,500 | 1,045 |
| Duncan Budge | 2014 | £25,500 | 9,779 |
| Tom Walker | 2019 | £25,500 | 1,600 |
| Helena Vinnicombe | 2021 (May) | £10,648** | 1,000 |

Source: Lowland Investment Company. Notes: *Shareholdings prior to share split. **£25,500 pro rata.

Karl Sternberg, a director since 2009, stepped down from the board in December 2021. Helena Vinnicombe became a director in May 2021. She is currently a trustee of a child health research charity and formerly chaired the asset allocation committee at Smith & Williamson Investment Management, where she was a senior partner.

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