Edinburgh Investment Trust

EDIN has delivered strong outperformance in its first three years under a new manager...

Update
25 October 2023

Overview

For more than three years, James de Uphaugh and Chris Field have managed Edinburgh Investment Trust (EDIN). They've delivered strong results with a strategy of balancing stocks with above-average earnings potential with latent recovery stocks, all in order to deliver income and capital growth. They both recently announced their retirement and will hand the reins over to Imran Sattar in February 2024 (see **Management section**). The message behind the change is one of continuity, with Imran having worked with James and Chris for a number of years and taking a similar approach to management.

Over the last three years, James has invested predominantly in UK companies, with a small allocation to overseas businesses, to deliver long-term capital and income growth. He's run a concentrated portfolio of 40-50 holdings, blending both income and growth opportunities, as well as targeting businesses with multiple drivers of returns over a cycle.

This strategy, which Imran intends to continue, has led to impressive results. EDIN's NAV total returns have been ahead of the sector and index since March 2020 (see **Performance section**), driven largely by the manager's astute stock selection. Imran believes there are some brilliant opportunities in the UK market currently and potentially amplified given some are sitting at more appealing valuations versus history.

EDIN yields 4.1% at the time of writing, and the managers report good growth prospects for the portfolio income in the medium term.

The trust has long-term, cheap structural debt, the board having refinanced it prior to last year's rate hikes. Net gearing (with debt at fair value) was 4.2% as of the end of September 2023, and at the time of writing, EDIN's discount is 9.7%, which is above the sector average.

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Analyst's View

In our view, EDIN's flexible investment approach positions it well as a core holding for investors and should provide them with exposure to high-quality companies with good earnings growth that should deliver both capital and income returns. We think James and Chris have done an excellent job since taking over, so seeing the retirement of such seasoned management is disappointing. However, we are encouraged that their colleague Imran Sattar, another seasoned investor, will take over. Imran intends to stick to the same basic principles and is experienced in running money with a similar approach. The traits he seeks in each company are also similar to those preferred by James and Chris but given his investing track record, he may tilt slightly more— 'tilt' being the operative word—to growthier companies versus his predecessors (see **Portfolio section**).

While EDIN's yield is not among the highest in the sector, we'd argue the prospects for income growth are favourable and should appeal to investors with a long-term time horizon. It's possible that the yield being below the peer group average is responsible for the **Discount** being wider than the sector average. Therefore, we view the discount as highly attractive as a long-term entry point. Over time, we would expect sentiment towards UK equities to improve, while interest rates are cut and the yield on offer in safe assets falls. We think EDIN's offer of income growth will seem more attractive over time, while the current portfolio has lots of growth potential too, particularly when the UK's low valuations start to mean revert.

BULL
Managers apply a total return ethos, balancing income and capital growth
Low OCF offers investors low-cost access to UK equities
No dogmatic style bias could mean the trust won't be as impacted in periods of sharp style rotations

BEAR
Structural gearing can magnify losses in a falling market, as well as gains in rising ones
EDIN's dividend is lower than the sector average
The UK market offers little exposure to certain high-growth sectors, like technology

Portfolio

James de Uphaugh and Chris Field revamped Edinburgh Investment Trust's (EDIN) portfolio when they took over management in March 2020, leading to impressive results so far (see **Performance section**). The goal remains the same though – long-term growth ahead of the FTSE All-Share and dividend growth ahead of UK inflation. Having spoken to Imran, we understand he intends to continue with the key tenets of their approach when he takes over in February 2024.

To achieve these objectives, James places a particular emphasis on total return, meaning he invests in companies offering both a growing dividend over time and some capital growth. He doesn't want to prioritise one over the other or get stuck chasing a higher yield. He also doesn't want to be wedded to one single investment style. Instead, he prefers a balance of stocks that offer above-average earnings potential as well as some latent recovery. This underpins the total return approach and helps target stocks with multiple drivers of returns over a cycle.

The total return ethos is echoed by Imran, given that's the way he's invested over his entire career, and he intends to continue this focus. Just as the current managers do, Imran intends to continue looking at the macro picture to help identify structural or emerging trends but will spend most of his time focusing on the bottom-up, stock-driven, fundamental analysis. This, alongside ESG integration, is crucial to help better understand companies' business models.

In general, things are expected to continue as normal, but naturally each portfolio manager does things slightly differently, so we'd expect there to be some small changes made over time. For example, Imran noted that he sometimes favours the growthier companies more so than James and Chris do, so the portfolio may seem marginally more growth-tilted at times. The emphasis here is on the word 'tilted' though, as the potential changes are expected to be very slight in his eyes.

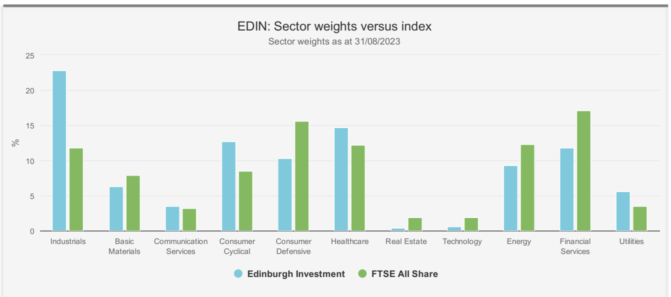
Another area of potential change is the allocation to overseas companies. James utilises the freedom he has to invest in overseas companies, with around 9% of the portfolio invested in international companies, which compares to roughly a 14% average in the sector. The belief is that investing in companies like Novartis, a Swiss healthcare business, and Thales, a French company providing solutions in the security, defence, and aerospace industry, can help diversify the underlying income streams and drivers of capital growth, thus, reducing the reliance on one economy doing well.

Imran echoes this belief but says that it's likely he'll increase the overall exposure to overseas businesses over time while keeping it well within the allotted limits. He thinks that while there are some brilliant opportunities in the UK at huge valuation discounts, there are some missing parts. For example, in his eyes, UK companies in the technology, data, and healthcare sectors are underrepresented, so delving into the pockets of the US and Europe could provide diverse opportunities the UK simply can't match.

Given James' focus, the portfolio is concentrated, roughly 40-50 stocks, highlighting the level of conviction in each investment. Companies are selected based on their own fundamentals, but James identifies a number of other categories that have emerged too: Corporate Darwinism is one, referring to the identification of winners through a tough economic period, with Whitbread and Serco being examples in the current portfolio. ESG rehabilitation is another, with James finding opportunities in defence companies in the aftermath of the Russian invasion of Ukraine and heightened awareness of the importance of defence, owning BAE Systems and Thales. The Revenge of the Incumbent is another theme, referring to established businesses having turned around operations and using their strong market position better. A stand-out example here would be Marks & Spencer, which has seen its shares more than double over the past 12 months as management have finally succeeded in bringing success to the clothing side of the business as well as food.

James' approach is highly active, something else Imran intends to continue. Despite investing mostly in the FTSE 100 and FTSE 250, and despite the income remit, which is a factor influencing stock selection, the active share was 64.5% as of the end of June. The chart below shows some considerable active sector positions. The largest overweight is industrials and tend to be companies that play a crucial role in the economy, by supporting other industries. We think this could offer the potential for multiple drivers of returns through a cycle. James also invests more in the consumer cyclical and healthcare sectors, compared to the index.

Fig.1: Sector Allocations Vs Index



Source: Morningstar

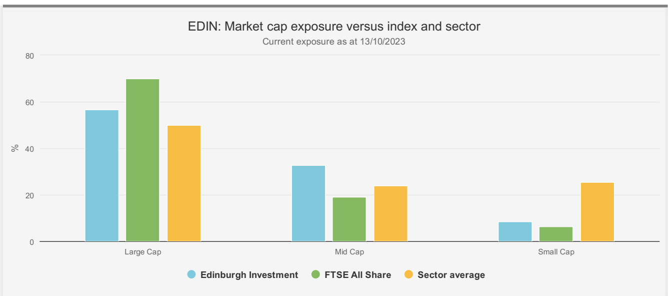
Across other sectors, there have been a number of changes so far this year. One of the biggest changes was the decision to purchase BP. James liked the fact the group has increased its investment plans in energy transition growth engines and high-return upstream assets, as he believes it could help the business achieve greater energy security, post-war in the Ukraine. Total Energies was sold to fund this purchase, and the managers slightly reduced their position in Shell as well. The exposure to oil & gas and utilities has remained fairly consistent, c. 10%, since the managers took over in March 2020, which is broadly in line with the average of peers.

In the banking sector, James has reduced exposure to two UK banks, NatWest Group and Standard Chartered. While they do operate globally, James believes the companies aren't as robust as Lloyds Banking Group, so prefers it as an investment. Investing in companies that have a global presence adds an additional element of diversification to a portfolio.

Another notable purchase is LondonMetric, the property company. In James' view, the company has a good management team and valuations are attractive, as the property has been under pressure for some time. The stock yielded around 5.5% on purchase, and James thinks a recovery will be felt in the share price too over the coming years.

EDIN stands out versus the index and a lot of its peers in the UK Equity Income sector based on its exposure to mid-cap companies. While these companies offer more sensitivity to the market versus their larger counterparts, they tend to have better growth prospects, which lends itself to the managers' total return ethos and explains the overweight position versus the sector and index. We show the current allocation below, with around a third of the portfolio in mid-caps. The allocation has been roughly similar since the end of 2020.

Fig.2: Market Cap Exposure Versus Index And Sector



Source: Morningstar

While there remains an element of caution for UK equity markets, James thinks there is a lot to be excited about. He believes recent increases in returns could be a signal for the early stages of recovery and could be rooted in the undervaluation of UK equities. James also thinks that some of the headwinds that have plagued UK markets could also be waning, so is more optimistic now. Having spoken with Imran recently, it's clear he shares this view. He also tells us he is very proud to be taking the reins and believes both James and Chris have done a brilliant job over the last three years, putting the trust in a very strong position. We think EDIN could provide investors with exposure to good quality companies, across a diverse range of sectors with the potential for earnings growth which should feed into rising dividends.

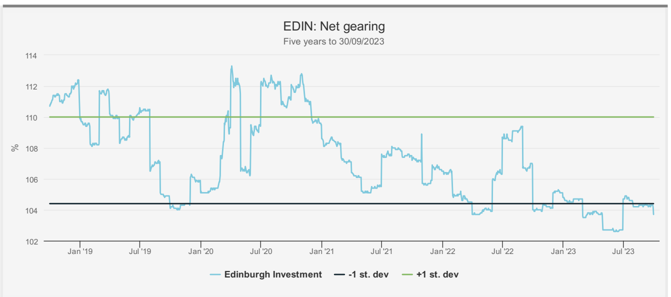
Gearing

EDIN has long-term, structural gearing of £120m, or c. 10% of NAV at the time of writing. This debt was arranged in September 2021 and locks in a low rate of 2.44% maturing in tranches between 2037 and 2057, which is highly attractive in comparison to current market rates. The board believes that gearing should enhance returns over the long run, although it does bring sensitivity to falling markets, and has a stated policy to prevent gearing from exceeding 25% of NAV.

As highlighted in the below graph, James has reduced the trust's gearing down towards the lower end of its range over the last year, partly by allowing cash to build up, and partly through the fall in the fair value of the debt as market yields have risen. EDIN has a net gearing of 4.2% NAV, as of 30/09/2023.

Historically, EDIN was hampered by expensive long-term debt taken out before the financial crisis when rates were much higher. The trust had a debenture costing 7.75% per annum. This matured in September 2022, but a year prior to its maturity, the management team locked in replacement debt, at a much lower rate. We think this rate is very attractive in the current interest rate environment and puts the trust in a much better position versus its history, and in a strong position to benefit from gearing over the long run as markets rise.

Fig.3: Gearing



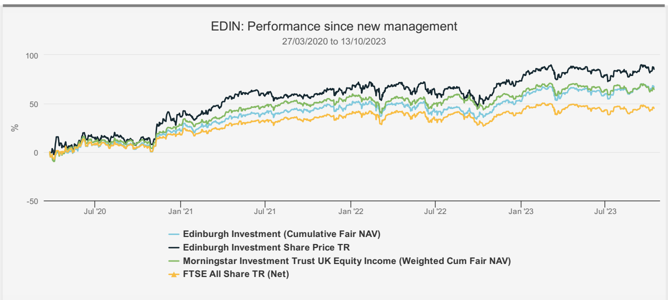
Source: Morningstar

Performance

As we note in the **Management section**, James and Chris took over management of the portfolio in March 2020 and the strategy they have employed since has led to impressive results. Over this period, to 13/10/2023, NAV total returns were 66.8%, ahead of the sector's gain of 64.5% and FTSE All-Share's increase of 45.9%.

We think it is particularly impressive given how difficult markets have been over this time, reflecting the success of the new management style, and changes made so far. One of the primary contributors to the performance is strong stock selection. Since taking over management, a number of very different stocks in the portfolio have performed well.

Fig.4: Performance Since Management Took Over

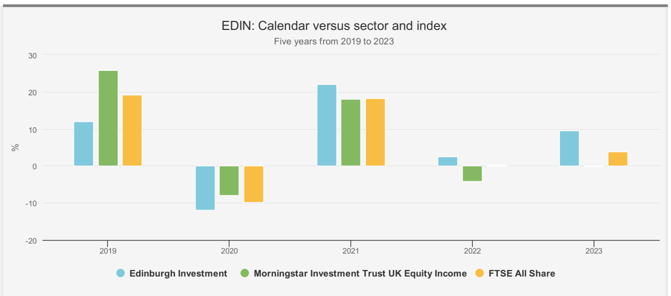


Source: Morningstar
Past performance is not a reliable indicator of future results.

The most notable performers were Ashtead, which focuses on industrial equipment, Centrica, a utility company and NatWest, a UK bank, formally known as RBS Group. It's a mix of cyclical companies that have benefited from a variety of different market events, including a bounce back in the UK economy following the trough of the pandemic and rising levels of inflation and interest rates. This reflects the managers' stock-driven approach to investments but also the flexibility they have when it comes to balancing investment styles.

The refinancing of debt has impacted performance as well. As we noted in the **Gearing section**, the replacement debt, which was secured at a much lower rate, has put the trust in a much better position versus its history, and in a strong position to benefit from gearing over the long run as markets rise. It also led to a significant gain on the fair value of debt in the 2023 financial year.

Fig.5: Calendar Returns Vs Sector And Index



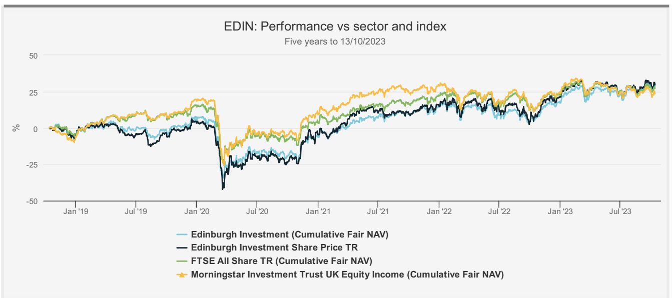
Source: Morningstar
Past performance is not a reliable indicator of future results.

James doesn't want to be wedded to one single investment style, instead preferring to focus on a total return approach, targeting stocks with multiple drivers of returns, something Imran is expected to continue doing when he takes over management as well. He wants to balance stocks he thinks offer above-average earnings potential as well as those with latent recovery. We would argue that this focus has helped reduce the trust's volatility, as well as reduce the impact of sharp style rotations.

The stability comes through when you look at discrete performance. EDIN was ahead of the sector and benchmark over 2021 and 2022, despite the chops and changes between growth and value investment styles. As Imran has invested in a similar way over his career, we'd expect this to continue.

For the sake of roundedness, we've also looked at EDIN's NAV performance over five years. As the graph below shows, NAV total return increased by 28.4%, which puts EDIN ahead of both the sector and FTSE All-Share. Though this period of performance does reflect two different managers.

Fig.6: Five-Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Dividend

At the time of writing, EDIN has a historical dividend yield of around 4.1%, which is marginally behind the AIC UK Equity Income sector average of 4.5%, as of 20/10/2023. The focus on achieving total return, means the managers invest in companies that can offer both a growing dividend over time, as well as capital growth. They don't want to prioritise one over the other.

One of the goals is to grow dividends ahead of UK inflation, but in environments like now where it's unusually high, it's a tall ask. Over the course of a market cycle though, the managers believe they should be able to deliver on that objective. While dividend growth is behind UK inflation over the latest financial year to March 2023, we've seen a positive increase in the dividend compared to last year, with the overall dividend payment reaching 26.2p, an increase of 5.6%.

The revenue return per share also increased, rising by 15.6% compared to the year prior. One of the reasons behind this jump is down to EDIN's new borrowing arrangements (see **Gearing section**). The sizeable fall in interest expenses buoyed revenue.

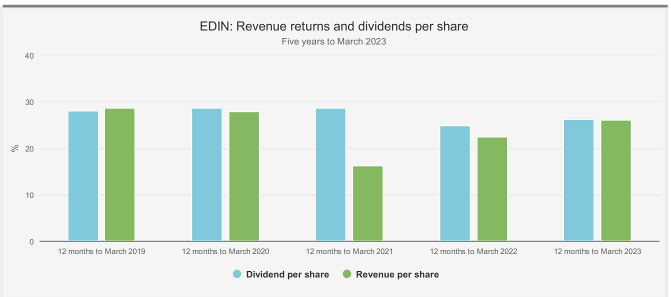
As a result of these increases, the dividend was almost entirely covered by revenue for the last financial year—26.0p of revenue per share compared with a dividend per share of 26.2p. The board can cover the dividends through the revenue reserve (1.22 times last year's dividend).

The board also noted over 40% of the portfolio has declared some form of share buybacks, over the latest financial year to March 2023, which is very supportive of its total return ethos. It's essentially another way of delivering returns to shareholders and may underpin income and capital growth over the long run.

When the managers took over the trust in March 2020 (see **Management section**), the picture was quite different to now. EDIN yielded c.6.6%, which was one of the highest in the AIC UK Equity Income sector at the time. Both the board and managers believed the dividend was unsustainable as it potentially hindered the total return objective, prioritising income over a balance between long-term dividend and capital growth. The board bit the bullet and reduced it in 2021. This is something Imran fully supports as well, so it's expected that EDIN's yield will remain at a similar level moving forward.

While EDIN's yield is now not one of the highest in the sector, we would argue it's in a more sustainable position versus history. We think there is the potential for good long-term dividend growth, which should help deliver a stronger income stream, along with capital growth.

Fig.7: EPS And DPS



Source: Edinburgh Investment Trust Annual Reports

Management

James de Uphaugh is currently the Head of the Liontrust Global Fundamental team. He has managed EDIN alongside Chris Field since March 2020 when the trust was managed by Majedie Asset Management (MAM). James and Chris joined Liontrust in April 2022 following the acquisition of MAM.

Both managers have been in the industry for decades, but unless you're Warren Buffett, you can't go on forever. At the beginning of October 2023, James and Chris announced their retirement from the industry. Chris is scheduled to retire in November 2023, and his deputy position will be taken by an experienced colleague, Imran Sattar. Imran will then work alongside James until February 2024, when he then takes full control of EDIN.

While it is disappointing to see two managers with such extensive expertise step down, we are encouraged that Imran, who brings a wealth of knowledge to the table, is taking over EDIN. Imran started as a graduate at Mercury Asset Management in 1997, which was subsequently acquired by Merrill Lynch and then BlackRock. During his time at BlackRock, Imran was Managing Director and responsible for managing assets, primarily through UK equity funds. He joined James and Chris at MAM/Liontrust in 2018 and has been managing the UK equity portfolios throughout.

Just as when James and Chris took over in 2020, Imran will retain full autonomy to run the portfolio as he sees fit. From February 2024 onwards, Imran will also become the head of Liontrust's global fundamental team. This means he can continue drawing on the large pool of resources at Liontrust to help with analysis, challenge, and debate.

As we understand it, there aren't any significant changes planned under Imran's leadership: the investment philosophy and process will remain the same. He will continue to look for good quality companies with sustainable business models, as well as quality management teams whose shares are attractively valued. He will also continue to champion the total return ethos that EDIN is now well known for (see **Portfolio section**). However, following our most recent call, Imran noted each portfolio manager does things slightly differently, so he may, in time, make some small changes. These changes may come in the form of increasing exposure to companies overseas, and, at times, the portfolio may seem slightly more titled towards growth companies than it did under the previous managers.

In summary, the overarching message is continuity under Imran's leadership. And while there may be some small adjustments to be made over time, Imran has worked closely with both managers in the past, running his own funds in a very similar way. This gives us some comfort that the change in management should not impact the investment strategy of the trust.

Discount

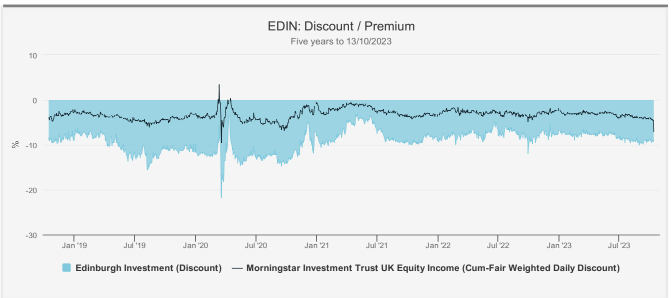
At the time of writing, EDIN trades on a discount of 9.7%, marginally wider than its five-year average. Compared to its peers in the AIC UK Equity Income sector this is one of the widest discounts, the average of which is 5.4%.

There may still be some new manager discount, even though James and Chris have delivered strong returns in their first three years. There may also be further changes to come regarding the discount, as markets digest the news of another manager change. But at the time of writing, the discount has narrowed slightly, suggesting the news has been well received thus far.

However, we think the key reason for the wider discount than the sector average is likely to be that in a higher interest rate environment, investors are favouring higher-yielding equity income trusts. EDIN is yielding around 4.1% at the time of writing, which is currently lower than some easy-access bank accounts. While there is the potential for capital growth in EDIN's shares, that is lacking with a bank account, in a difficult market environment we think some investors have been hiding in cash.

That said, you can see in the graph below that since James and Chris took over management of EDIN, the discount has narrowed from its peak in the early part of 2020 when the pandemic sent discounts wide across the board. Performance has started to pick up well (see **Performance section**) and they have focused on increasing dividends year-on-year. We think there is clear potential for the discount to narrow moving forward and when coupled with the likelihood of rates returning to normal levels in time and their focus on total return, we think EDIN could be sitting at an attractive long-term entry point.

Fig.8: Discount



Source: Morningstar

The board have noted that while the discount persists, it will continue with its policy of actively buying back shares, though there is no specific target level. Over EDIN's financial year, to the end of March 2023, 3% of shares were bought back. Since then, to 13/10/2023, a further 3.04% of shares have been re-purchased.

Charges

EDIN's latest ongoing charges figure (OCF) is 0.53%, which compares to the 0.57% weighted average of the AIC UK Equity Income sector. This includes a management fee of 0.48% on the first £500m of market capitalisation and 0.465% on the remainder. The fees are charged at 70% to capital and 30% to revenue. There is also no performance fee. We believe that management fees based on market capitalisation, rather than the NAV, incentivises the managers to reduce or narrow the discount over time.

EDIN's latest KID RIY is 1.03%. According to JPMorgan Cazenove, the sector's weighted average is 1.19%. However, we caution that calculation methodologies for the KID RIY can vary.

ESG

Liontrust Asset Management has committed to integrating sustainability across the business with the aim of bettering outcomes for investors and society. Liontrust has made an effort to enhance its capabilities in this area in recent years by bolstering how it engages and reports on companies, as well as increasing its dedicated sustainability resources.

It has also ensured that each fund management team is given full autonomy to run their portfolios according to their own preferences and allowed them the freedom to decide how best to integrate ESG factors into the investment process. Naturally, this means that the level at which each manager considers ESG differs.

The managers of EDIN have integrated ESG factors within the investment process as they believe that well-managed companies, with an emphasis on good governance, tend to make successful long-term investments. James adopts a focus on bottom-up research and company engagement, helping to identify any potential ESG issues an investment may face. Moving forward, this is something Imran is expected to continue with.

One of the most recent examples of the team's engagement was with British home furnishings retailer, Dunelm. The team spoke with management three times this year, discussing a wide array of topics, like remuneration policies, issues with supplier relationships, and how the business needs to look at its strategy and its cost-controlling methods. Engaging directly with the company helps the team build a much more rounded picture of companies in their universe, which they believes leads to more robust stock decisions and higher convictions.

There are currently no formal exclusion lists or broad restrictions on stocks the manager and his team can invest in. This means the manager, at times, may go against the typical ESG grain by investing in sectors like defence or oil and gas. James argues the Russian invasion of Ukraine has highlighted the importance of these sectors for preserving energy independence.

Morningstar scores EDIN as average for sustainability when looking across open and closed-ended funds in the UK Equity Income sector. We think that James and his team have integrated ESG well and this could appeal to many investors who value engagement and ESG inclusion in an investment process, but not for those looking for a fund with specific ESG restriction or exclusion policies.

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