Dunedin Income Growth

DIG's shareholders recently voted to incorporate ESG into the trust's investment objectives...

Update
17 August 2021

Summary

Dunedin Income Growth Investment Trust (DIG) recently continued its strategic evolution after shareholders voted to formally incorporate ESG principles into the trust's investment objectives. This follows an evolution in recent years towards a greater focus on dividend growth at the expense of initial yield. DIG remains invested primarily in UK equities, looking for dividend and capital growth.

Supported by substantial revenue reserves, the managers have migrated DIG's portfolio to a greater emphasis on income growth, as discussed under **Dividend**. DIG currently yields c. 4.1% and has now grown its dividend in 37 of the last 41 financial years (and has maintained it in the other four years). Driven in part by the strong emphasis on quality characteristics and financial strength in the stock selection process, DIG's revenue generation proved significantly more resilient than the wider market to the challenges posed by the economic environment in 2020.

The resilience of many of the underlying companies to the wider macroeconomic environment in 2020 helped DIG to outperform over the calendar year. This followed a trend of strong relative returns in recent years, though the post-vaccine outperformance of value and cyclical stocks posed some headwinds to relative performance at the start of 2021, as discussed under **Performance**.

Whilst ESG factors had historically been incorporated into the stock analysis process as part of the team's assessment of quality (see **Portfolio**), at the most recent AGM it was agreed to formally incorporate ESG policies into the investment objectives. As we discuss under **ESG**, this has seen the application of several rules around portfolio construction going forward, and has also seen the team exit certain positions to meet the new criteria.

DIG's **discount** has narrowed notably in recent months to its current level of 1.5%.

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Analyst's View

DIG is positioned and managed with a view to offering 'core' UK equity income exposure, and we would suggest that the portfolio output matches these criteria. Income investors will doubtless find the consistent track record of dividend growth and ability to support future dividends from revenue reserves reassuring, and we think that an ongoing recovery in market-wide dividends is likely to be reflected in DIG's revenue account. The benefit of hindsight proves the shift away from an absolute focus on maximising yields to have been prescient, as elevated payout ratios in many FTSE 100 companies could not be sustained in 2020 whilst DIG's revenue generation remained reasonably robust.

Some investors will find the incorporation of ESG into DIG's investment objectives attractive, and this could potentially serve to widen the shareholder base and help maintain the newly narrower discount level. It is worth noting that many of the areas from which DIG is now excluded or to which it only has restricted exposure are typically high distributing, as seen by the disproportionate impact on revenues from the stocks exited (16% of income from 8% of the portfolio). However, the managers are confident that they can reinvest this capital while maintaining the yield. In our view the re-rating higher in many of these stocks would likely have seen the trust's value-aware managers reduce these positions in any event.

BULL
Returns have been strong in recent years
Substantial revenue reserves in place to support the dividend
Structural incorporation of ESG will appeal to some investors

BEAR
Writing of call options could prove a relative headwind if UK market moves rapidly higher
Gearing can exacerbate downside, as well as amplify upside
Rate of dividend growth, as with the market, likely to be muted in the near term

Portfolio

Dunedin Income Growth Investment Trust (DIG) is managed by Ben Ritchie and Georgina Cooper, with Georgina having been named co-manager in September 2020. Whilst Ben and Georgina are named managers, the team operates with a highly collegiate approach. The managers are able to draw on a deep analytical resource pool, with Aberdeen Standard Investments' UK equity team currently comprising a total of 15 analysts and managers. Analysts tend to be sector specialists, and thus are expected to be aware of industry-level developments and their potential impact on various companies. All companies within the FTSE 350 continue to be reviewed on an ongoing basis, with research updates reviewed by the wider team and widely available on a company-wide database.

The managers aim to generate capital and dividend growth rates above those of its benchmark the FTSE All-Share from a portfolio which has historically held between c. 30 and 60 stocks. As part of a broader strategic shift in recent years, the team have looked to gradually concentrate DIG into a smaller number of higher-conviction positions, with the current total of 45 holdings down from 50 holdings in July 2020.

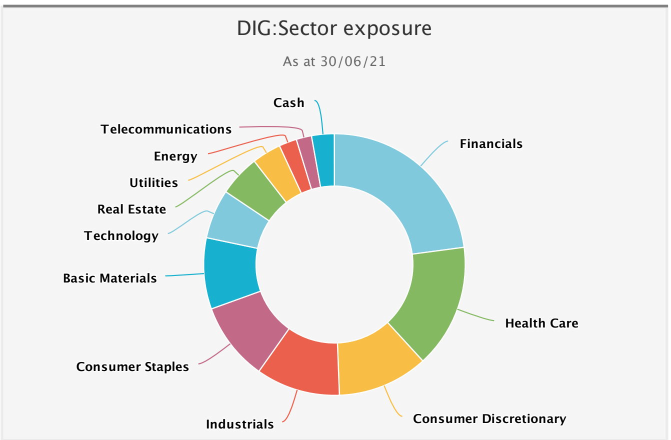
This broader strategic shift has been part of a gradual evolution in the investment strategy following on from a strategic review of DIG's objectives and processes in 2016. Following this review, the managers and board have sought to place a greater emphasis on both dividend and capital growth, where previously there had been more focus on trying to generate a premium level of income relative to the wider UK equity market.

Following the most recent AGM, DIG's investment objectives were further amended to make formal and specific reference to "the Company's Sustainable and Responsible investing criteria as set by the board". The board has noted its belief that incorporating this formally should serve to further differentiate the trust from peers and potentially widen its appeal to investors.

In practice, the managers note that they do not anticipate that this will significantly impact their day-to-day approach to investment analysis, ESG considerations having been incorporated into their assessment of a company's quality for some time. Having already exited certain positions to meet these new rules, there has been little substantive change to sector allocations, which had historically tended to be underweight to many areas which are more likely to be impacted. The managers note that the new rules had excluded c. 8% of their portfolio (accounting for c. 16% of the income generated), and they do not anticipate any substantial change to the long-term dividend outlook as a result of these rule changes.

The investment philosophy remains unchanged, focussing on identifying high-quality companies to build a portfolio which balances both capital and income growth, and the board does not intend to alter its dividend policy. However, it will formalise certain rules regarding ESG for future portfolio construction, incorporating both quantitative and qualitative considerations. We have discussed these new rules in further detail under **ESG**.

Fig.1: Sector Allocation



Source: ASI

Qualitative ESG scores will continue to be integrated into the investment process, with separate ESG analysis of constituent companies within the investment universe undertaken by in-house ESG specialists. Companies scoring a '4' or '5' in ESG will not be eligible for inclusion going forward (though Ben and Georgina note that such companies would likely generate too low a quality score overall in any event). ESG scores feed into the overall 'Q score' that the team assign companies within the investment universe, in which '1' represents what they deem to be the highest-quality companies and '5' the lowest quality.

As we have **previously discussed**, the managers seek to avoid holding any companies with a Q score of more than 3. Severely negative ESG scoring would likely drag many potential holdings below this level. Whilst this focus on quality characteristics within the portfolio typically sees the portfolio exhibit a slightly greater tilt towards 'quality' factors than growth or value, the managers remain keen to ensure that stock-specific factors remain the key drivers of 'active risk' (i.e. performance deviation from the benchmark).

In part the team have looked to ensure this remains the case by exiting lower-conviction positions and concentrating the portfolio more into their 'best ideas' in recent years as part of the strategic shift in portfolio construction. The strategic review had also highlighted the team and board's concern over the long-term sustainability of dividends in the UK market given it had, at the time, a very high payout ratio. Reflecting this concern, the team have in recent years increased their exposure to small- and mid-cap companies within DIG, where growth run rates (and thus the potential for sustainable income growth) are often greater. This has seen the active share of the portfolio increase in recent years, and it now stands at c. 73.5% (as at 30/06/2021). Whilst the active share of the portfolio has generally been rising, these ideas have generally been more equitably spread across the portfolio, with lower concentrations in the top ten positions; we observed this in our previous note, and this trend has further continued.

Top Ten Holdings

AS AT 31/01/2021	%	AS AT 30/06/2021	%
AstraZeneca	5.0	AstraZeneca	5.5
GlaxoSmithKline	4.1	Diageo	4.2
Diageo	3.8	Rio Tinto	3.6
BHP	3.6	Prudential	3.5
Rio Tinto	3.6	Coca-Cola	3.3
Assura	3.4	BHP	3.1
Aveva	3.4	Intermediate Capital Group	3.1
National Grid	3.4	RELX	3.0
Prudential	3.1	SSE	2.9
RELX	3.0	Direct Line	2.8
TOTAL	**36.4**	**TOTAL**	**35.0**

Source: ASI, as at 31/01/2021 & 30/06/2021

As we discuss under **Gearing**, Ben and Georgina remain positive on the UK market, and this is reflected in the continued deployment of gearing within the portfolio. Nonetheless, they retain the ability to allocate up to 20% of the portfolio overseas and continue to do so when they identify superior or differentiated opportunities. This ability to allocate into European stocks has allowed them to include positions such as French oil & gas company Total, which generates over 40% of its revenues from renewables. Thus the team can retain exposure to the oil & gas sector whilst complying with the new ESG criteria which was set out.

More generally, Ben and Georgina have been increasing exposure to high-quality names with exposure to the domestic UK economy, adding to their exposure in housebuilders such as Persimmon. They note that Persimmon has a very strong balance sheet and land bank, supporting a dividend that they believe will prove extremely resilient to any variations in the macroeconomic cycle. The Persimmon position has been increased at the expense of the non-dividend-paying Countryside. Whilst constructive on the outlook for many companies, the managers wish to retain a focus on companies such as Persimmon which are in a strong position to pass on any input price inflation. They think that H2 2021 and H1 2022 could prove more challenging for profit margin expansion across the market as a whole, based on observations around increasing pricing pressures from factors such as logistics and wages.

The managers generate additional income for the trust through the writing of covered call options on stocks held within DIG. Typically, they aim to generate a relatively fixed amount each year, and note that the higher premiums available as a result of the elevated volatility seen in 2020 have meant they have been able to generate a similar level of income whilst writing options on a smaller percentage of their total portfolio. Although the aim is ordinarily to limit the proportion of underlying income generated through this process to c. 10% of total income, this was relaxed in 2020 given the exceptional circumstances at the time, and we note that this has likely mitigated the income pressures seen in income generation. Whilst this activity generates additional income for the trust, it also potentially inhibits the upside capture of DIG should the market move sharply higher and one or more stocks on which calls are written end up ‘in the money’. However, the managers report that there have been limited occurrences of this (see **Performance**).

Gearing

DIG presently has net gearing of c. 7% (as at 29/07/2021). The gearing ratio has gradually fallen in recent months; however, we note that this has been a result of a static usage of debt facilities falling proportionally relative to a rising NAV.

Gearing comprises a mixture of structural gearing and a flexible revolving credit facility. The former is undertaken through c. £30m in loan notes (c. 6.2% of current net assets), maturing in 2045 and bearing interest of 3.99% per annum. The flexible revolving credit facility gives the manager access to a further £30m of gearing, with the option of increasing this to a total of £40m with the lender’s consent. This gives a total gearing capacity from existing facilities of c. 12.4%, potentially rising to c. 14.5% of current net assets.

This is in keeping with the managers’ focus of seeking to ensure that the trust remains appropriate as a ‘core’ UK equity income strategy, and limited utilisation of tactical gearing is also in keeping with the general focus on returns being derived more from alpha as opposed to beta. Nonetheless, the sell-off in early 2020 provided the team with the opportunity to utilise the gearing facility to average down on existing or new positions in high-quality names that they deemed to have been unfairly sold off in the indiscriminate nature of the market sell-off at that time.

Fig.2: Gearing

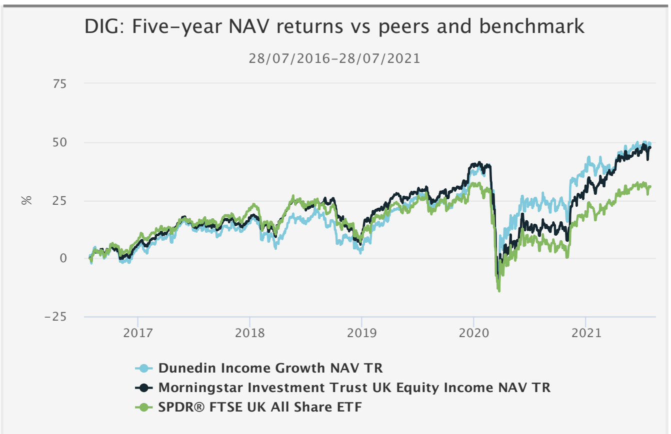
Source: Morningstar

Performance

Over the five years to 28/07/2021, DIG has delivered strong relative returns. NAV and share price total returns have been c. 49.4% and c. 62.5% respectively, with the significant share price outperformance driven by discount narrowing over this period. We note that this is the second-strongest share price performance over this period within the sector.

As such this unsurprisingly represents an outperformance of the peer group (the Morningstar Investment Trust UK Equity Income sector), which has seen NAV and share price returns of c. 47.7% and 41.8% respectively, whilst the benchmark FTSE All-Share Index (as represented by the passive SPDR FTSE UK All-Share ETF) has returned c. 30.9% over the same period. DIG, as might be expected by its investment approach, has tended to outperform its peers in more challenging periods for the wider market whilst lagging slightly in rallies led by more cyclical parts of the market. We note, however, that as the focus has shifted

Fig.3: Five-Year Nav Total Returns Versus Peers And Benchmark



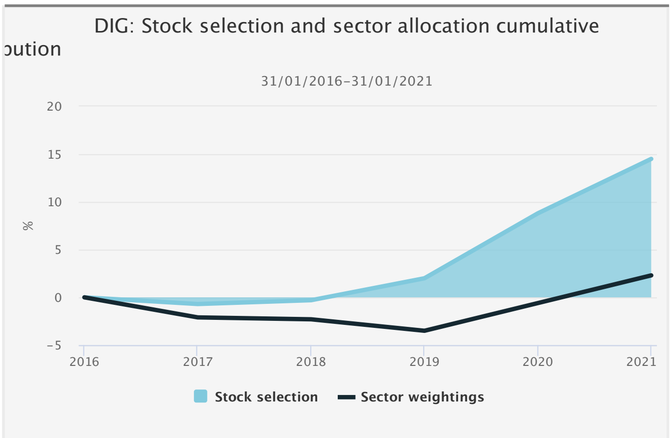
Source: Morningstar

Past performance is not a reliable guide of future returns

to total return in recent years DIG has displayed improved upside capture relative to the wider peer group.

Stock selection has been a significant contributor to active returns relative to the benchmark in recent years; whilst gearing has also benefitted relative returns, this has been more muted. Below can be seen the cumulative impact of active stock selection and sector allocations where DIG has deviated from the benchmark (encompassing the period from 31/01/2016 to 31/01/2021).

Fig.4: Cumulative Contribution Of Stock And Sector Allocations



Source: Dunedin Income Growth, Kepler calculations - FY 2017–2021

Past performance is not a reliable guide of future returns

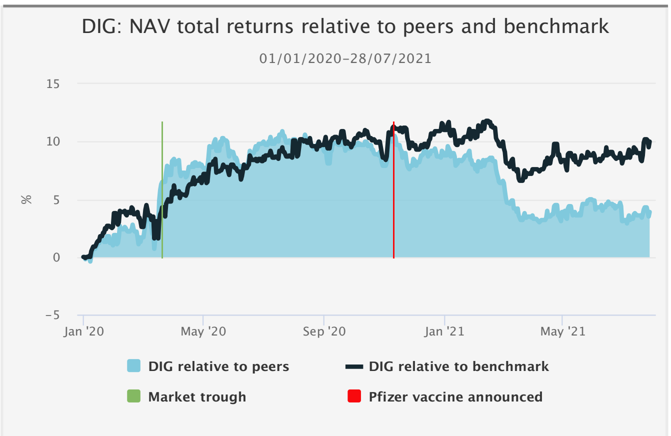
From the start of 2020 to 28/07/2021 – encompassing the drawdown of Q1 2020 and subsequent market recovery – DIG has generated NAV and share price total returns of c. 10% and c. 15.2% respectively. This represents outperformance of both the unweighted average of the Morningstar UK Equity Income peer group, which saw NAV and share price total returns of c. 6.1% and c. 7.6% respectively, and the benchmark FTSE All-Share, which generated total returns of c. 0.1%.

Whilst a significantly elevated volatility environment increased the potential for options written by DIG to end up 'in the money', we estimate that reported losses from such situations amounted to c. 0.2% of DIG's average net assets over FY 2021 (ending 31/01/2021).

As we can see in the graph below, DIG outperformed the benchmark during the turbulent market conditions of Q1 2020. The focus on quality and balance sheet strength in underlying companies will have benefitted performance in this period, due to the economic uncertainty of the time mitigating market drawdowns. Yet many of these companies exhibited strong rebounds in the initial recovery as the time frame for a 'normalisation' of economic activity remained uncertain and the market sought out companies perceived to have better control of their own destiny.

DIG continued to outperform for much of the initial recovery rally in 2020 relative to both peers and the benchmark, but relative returns slipped slightly after the announcements around the successful development of COVID-19 vaccines, which catalysed a sharp period of outperformance from value stocks and many 'old economy' companies and sectors. Significant positions in cyclicals such as BHP and Rio Tinto will have offset this effect somewhat, but a sharp value rally was unsurprisingly something of a relative headwind to DIG (given the investment approach adopted). However, in recent weeks and months relative returns have picked up again as the outperformance of cyclicals has faded and stock performance seems to have become more driven by operational updates (as opposed to perceived stylistic alignment).

Fig.5: Nav Total Returns Relative To Peer Group And Benchmark

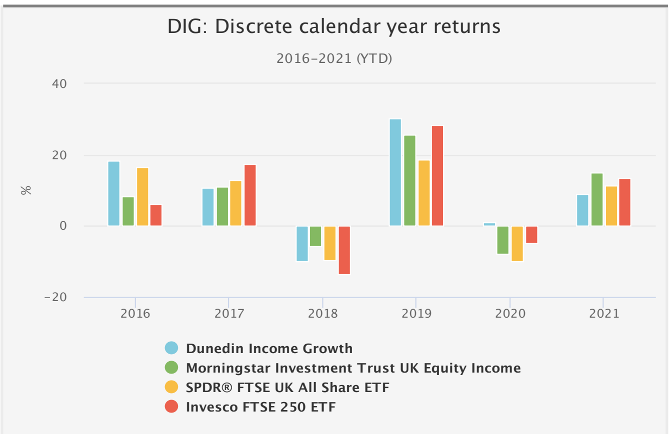


Source: Morningstar, Kepler calculations

Past performance is not a reliable guide of future returns

Relative returns have improved in recent years as the portfolio has increasingly diverged from the benchmark. The increasing exposure to mid-caps has seemingly had

Fig.6: Discrete Calendar-Year Returns Relative To Ftse All-Share



Source: Morningstar

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an impact, and we can see in the chart below the discrete calendar-year NAV total returns for DIG, the peer group and the FTSE 250 relative to the All-Share (i.e. how much they out- or underperformed the FTSE All-Share over each year). Whereas previously DIG's relative fortunes tended to be somewhat weaker in periods of strong mid-cap outperformance, this has reversed in the last two calendar years, concurrent with DIG's relative returns profile improving.

Dividend

DIG currently yields c. 4.1% (as at 29/07/2021) on a historical basis, in line with the unweighted sector average (Source: JPMorgan Cazenove). DIG has now increased its dividend in 37 of the last 41 financial years, and has maintained dividend levels in the other four financial years. Over the last ten financial years DIG has generated dividend per share growth of c. 2.2% per annum; this has accelerated slightly in the past five years to a growth rate of c. 2.3% per annum, despite the challenges that 2020 posed.

As discussed under **Portfolio**, DIG has undertaken a strategic realignment in recent years. This followed the conclusion of both the board and management team that UK market-wide payout ratios were unsustainably high, and this saw DIG move away from seeking to maximise income distribution levels towards a greater focus on ensuring the portfolio exhibits sustainable dividend growth.

Despite this realignment, revenues had continued to cover dividends until financial year (FY) 2020 (ending 31/01/2020), as can be seen in the chart below. Subsequently the board made use of revenue reserves accrued in previous years to support the dividend going forward. The intention to do this had been part of the strategic planning around the shift in the trust's strategy, but the COVID-19 pandemic made the need to utilise these reserves to support the dividend plain.

However, whilst DIG's revenue returns per share fell by c. 9.8% in the 12 months to 31/01/2021, this was significantly better than the declines seen in the wider UK market (with the Link Dividend report estimating that total UK market dividends fell by c. 44% over the calendar year 2020).

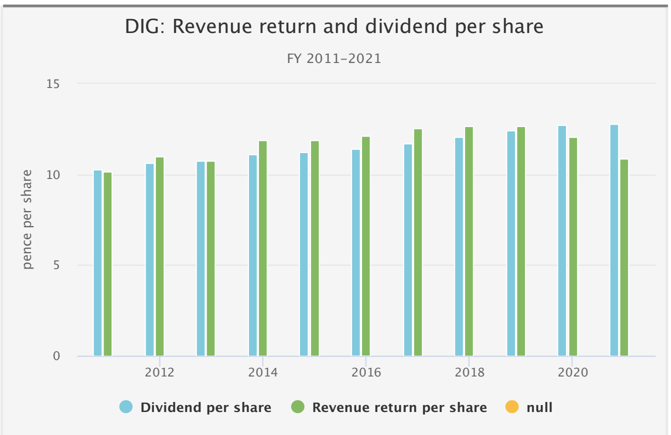
The ongoing writing of options contracts will have assisted income generation, and this activity contributed c. 9.5% of the FY 2021 income, up from c. 7.8% in FY 2020. Total income generated from this activity rose by c. 8.9% over this period. The availability of higher premiums from elevated market volatility meant that the team were able to generate this contribution.

The incorporation of the new ESG rules into portfolio construction has seen the team exit positions which they estimate generated approximately 16% of revenues; however, they report that they do not anticipate difficulties in reallocating this capital in a manner which will generate sufficient income to offset this.

Despite the strategy shift, revenue returns continued to consistently cover dividend distributions before a shortfall occurred in FY 2020 (ending 31/01/2020). Unsurprisingly, this persisted in FY 2021. However, the potential for such shortfalls as a result of the strategic shift had been anticipated by the board, with revenue reserves having been accrued in prior years with a view to facilitating the strategy shift should any shortfall occur, thus ensuring the management team had maximum flexibility to implement the new investment strategy. Revenue reserves at 31/01/2021¬ were reported as equating to c. 9.06p per share, equivalent to c. 1.24x the full FY 2020 dividend.

However, a subsequent interim dividend payment has been declared. When we account for the subsequent interim dividends, deduct the declared final dividend and then estimate retained earnings (based on the reported differences in cum-income and ex-income NAVs), we pro forma estimate that DIG retains revenue reserve cover equating to at least c. 1x the FY 2021 dividend. Given this does not account for any income that will subsequently be received, we think this likely underestimates the actual level of revenue reserve cover that will be retained.

Fig.7: Dividend And Revenue Returns Per Share



Source: ASI

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Management

DIG is managed by Ben Ritchie and Georgina Cooper. An emphasis is maintained on utilising a collective approach, in keeping with the trust's historical management by Aberdeen Asset Management (AAM), even after the merger of AAM with Standard Life Investments. This approach for example requires rigorous peer review of potential holdings by the wider team before they are bought.

As part of a turnaround plan in 2016, the management team were reorganised. The merger with Standard Life Investments in 2017 has broadened the coverage of the UK and deepened the expertise in UK small and mid caps (both in terms of personnel and quantitative resources).

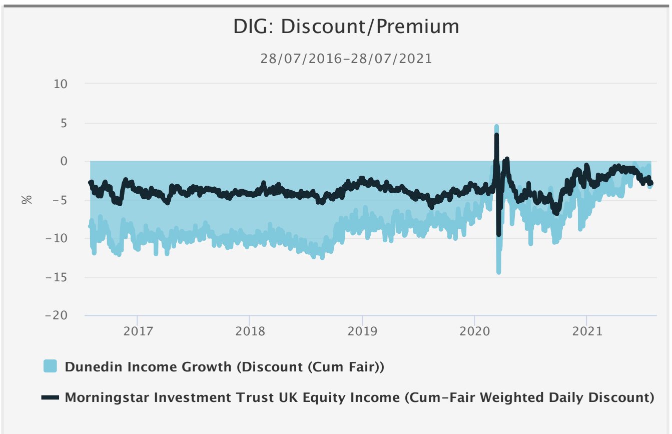
Ben and Georgina are additionally able to utilise the analytical resources of the wider ASI European equity team, and also have access to internal ESG analysts.

Discount

DIG presently trades on a discount of 1.5% (as at 10/08/2021). In line with the Morningstar UK Equity Income sector, DIG has seen its discount narrow in recent months, though DIG's discount remains slightly wider than that of the peer group. Whilst the current discount is notably narrower than has typically been the case over the five years to 28/07/2021, where the discount has averaged out at c. 8.1%, we can see in the graph below that there has been a general trend towards a tighter discount over this period (with a three-year average discount of c. 6.7%, even allowing for the move wider which was seen in Q1 2020 in the relatively indiscriminate market sell-off). In part, we would suggest that at the wider sector level this represents improving sentiment towards the UK market as political concerns have dissipated somewhat.

The board of DIG reports that it continues to monitor the discount with a view to ensuring the strategy remains attractive to the market. We understand that the recent alterations to the investment objectives (as discussed under Portfolio) in part reflect this desire further. Whilst over FY 2021 (ending 31/01/2021) the board undertook some share buybacks to further support the share price and to seek to limit any discount widening, with the discount trending narrower over much of FY 2022 year to date, it has not deemed it necessary to do so.

Fig.8: Discount/Premium



Source: Morningstar

The board presently has the authority to repurchase a maximum of 22,213,249 of ordinary shares, equating to c. 14.99%. At present DIG holds 5,513,265 shares in treasury (c. 3.6% of the total share count), which the board may release into the market should the trust trade at a premium to NAV in the future.

Charges

DIG's OCF of 0.64% is below the 0.83% unweighted average of the AIC's UK Equity Income sector (Source: JPMorgan Cazenove). This is in part thanks to the tiered management fee, which is charged at 0.45% on the first £225m of assets, 0.35% on the next £200m and only 0.25% on anything over £425m in net assets. With net assets currently of c. £482.3m, we estimate that the management fee at present is c. 0.38%. The most recent KID RIY figure is 1.72% relative to the sector unweighted average of 1.43%, though we would caution that calculation methodologies vary.

ESG

Ben and Georgina have confirmed they are looking for DIG to be a peer group leader in ESG incorporation, and ESG considerations are considered an integral part of the stock analysis process. As we discuss under **Portfolio**, this has been formalised further at the most recent AGM with the incorporation of certain ESG 'rules' which the managers will adhere to going forward.

At a quantitative level, DIG will no longer hold tobacco companies (defined as being either a tobacco manufacturer or a company with a revenue contribution of 10% or more from tobacco). This has seen the team subsequently exit their previously long-standing holding (and UK equity income staple) British American Tobacco. Similarly, the team will exclude armaments companies and companies involved in 'controversial' weapons.

Companies involved in the extraction of thermal coal will be excluded, as will a wide range of oil & gas companies. However, up to 10% of DIG's revenues may be generated from oil & gas companies if they produce over 40% of their revenues from renewable sources; at present, this allows the team to hold some exposure to this sector via Total (with their ability to allocate up to 20% of assets overseas further facilitating this). Overall, they will target DIG's portfolio having a carbon intensity which is at least 20% lower than that of the FTSE All-Share Index.

More qualitatively, the managers will continue to lean on the stock analysis conducted by the wider team. This already sees ESG scores assigned to each company analysed as part of ongoing stock research, with independent ESG analysis also undertaken by in-house ESG specialists.

Every investment team across Aberdeen Standard Investments has dedicated ESG analysts attached to it, offering input to wider ESG considerations across industries and the market as a whole, as well as reviewing company-specific ESG issues. Regular meetings with company management teams are considered a core part of the investment process, and increasingly analysts undertaking these meetings seek to use the opportunity to further understand how environmental and social risks to each business are understood and addressed by company management. In keeping with their general preference for defensible business models with high barriers to entry, Ben and Georgina believe that the management teams best able to manage the ESG risks to their business will likely be in the best place going forward to ensure they can continue to grow the business.

As an output of these changes, DIG currently has an 'above average' score on Morningstar Sustainalytics. The core stock analysis approach used by the team inherently lends itself to certain ESG considerations, with a strong qualitative preference for sustainable growth and superior corporate governance.

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