Aberdeen Standard Equity Income

ASEI targets above-average income and capital growth with an index-agnostic approach...

Summary

Update
05 November 2020

Aberdeen Standard Equity Income Trust (ASEI) aims to provide shareholders with an above-average income and real (inflation-adjusted) growth in capital and income, through investment in a diversified portfolio of predominantly UK equities. ASEI is managed by Thomas Moore, who also manages the open-ended ASI UK Income Unconstrained Equity Fund and co-manages the ASI Income Focus Fund. The manager seeks to identify companies where change is not yet accurately reflected in the valuation.

ASEI is an all-cap portfolio, with a majority of the portfolio invested out with the FTSE 100. The closed-ended nature of ASEI affords Thomas a greater degree of flexibility to take and hold positions in less liquid (often smaller) companies, and by extension to deviate from the benchmark FTSE All-Share index without constraint.

As discussed under **Dividend**, ASEI has now raised its dividend every year for the previous 19 financial years, and appears likely to do so again when the board declares the final dividend for the financial year 2020. Having accrued substantial revenue reserves of 1.03x the current dividend, the board has significant flexibility to support further dividend growth going forward – even as index level dividends are likely to see significant impairments. The historic dividend yield is presently very high, at c. 7.8% (as at 09/10/2020).

The historic yield is further boosted by a **Discount** that has widened to c. 12.3%. This figure is noticeably wider than that seen in the wider peer group, but is likely in part a reflection of challenging conditions for performance in recent years. As discussed under **Performance**, we believe stylistic factors (specifically a value tilt) have proven a sharp headwind to relative returns.

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Analyst's View

Conditions have undoubtedly proven challenging for ASEI in recent years. Sharp dispersions in market pricing of solvency risks have driven even wider what the manager had already previously identified as near-unprecedentedly high valuation spreads between lowly and highly-valued market constituents. Reversion of this, and with it the likely relative fortunes of ASEI, continues to hinge on the shape of the economic recovery. A more rapid economic recovery than is currently anticipated could see insolvency concerns fall for many companies, and prove a tailwind to value stocks. However, a continuation of low-interest rate regimes (with the BoE reputedly considering negative interest rates) could feasibly extend value's travails, particularly if the market belief shifts towards an assumption that the authorities are willing to hold 'real' rates negative for a protracted period.

Perhaps this explains why a shift higher in inflation expectations has not yet catalysed a significant value recovery? Yet 'later' does not equate to 'never', and the degree of value dispersion within the UK market highlighted by the manager remains compelling. If there is a rebound for value, then ASEI should be a beneficiary. In the near future the dividend is unlikely to be covered by income within ASEI, but there are substantial revenue reserves available to support the dividend which, yielding c. 7.8%, is very compelling. With a 19 year track record of dividend increases at stake, we expect the board's dividend policy to remain supportive for the near term.

BULL
Strong track record of dividend growth, backed by revenue reserves
Likely to perform strongly in a value recovery, and positioned for easing macro concerns
Discount is wide relative to peer group and ASEI's own history

BEAR
Performance has remained challenging from a macro and stylistic perspective
Gearing can exacerbate downside, as well as amplify upside
Whilst discount is relatively wide there is little sign of narrowing as yet despite buybacks

Portfolio

Aberdeen Standard Equity Income (ASEI) aims to generate an above-average income to shareholders whilst growing both capital and income. Managed by Thomas Moore, the trust invests predominantly in UK equities within the FTSE 350 index, but the manager has an unconstrained mandate and focuses primarily on stock specifics as opposed to benchmark weightings. The management team seek to identify companies where the changing operational situation is not yet accurately reflected in market pricing of the stock.

The manager, in charge of a trust with an explicit income mandate, considers income characteristics of the constituent companies closely. This is particularly the case at the present time given the extremely challenging operational conditions that the current macroeconomic backdrop presents to companies, and the associated challenges to income generation and dividend distributions. Indeed Thomas notes that the team's base expectation from aggregated bottom-up data is for dividend cuts of between 40-50% in 2020 from the FTSE All-Share. Against such a backdrop, the team has been placing an emphasis on resilience or resumption of dividend streams amongst many companies at the current time.

Nonetheless, portfolio construction seeks to strike a balance between attractive dividend streams and opportunities for capital and dividend growth. Positions are, accordingly, typically sized upon stock-level conviction, but with Thomas maintaining an eye at a portfolio level to maintain a balance between growth and income opportunities.

Thomas is able to lean on the research conducted by the wider Aberdeen Standard Investments research team, who typically conduct over 3,000 company meetings a year. Analysts tend to be sector specialists who seek to understand the operational dynamics within a company undergoing changes from both an absolute basis and in the context of the company's industry peers. This stock analysis process also looks to judge the quality of company management teams, and their ability to allocate capital effectively and efficiently and thus execute business strategies. The analysts seek to combine this with an understanding of how the fundamental operational performance of the company will be impacted by the business strategy, and how the relative prospects for the company will look if this is executed successfully.

As the team is seeking to identify companies where the market has not correctly understood the changing dynamics of a business, valuation is considered an important indication of market expectations within the investment process. Valuation assessments seek to identify companies where Thomas expects a re-rating higher over the medium term as a tailwind to stock returns, combined with improving company fundamentals. These valuations are considered relative to both the company's history and to the industry peer group. We have discussed how the team differentiates different opportunities in **our previous research note**.

From an income perspective, the portfolio can be categorised into three categories: resilient income, interrupted income and resumed income.

The core of around 65% of the portfolio is exposed to 'resilient income' stocks, an area that Thomas and the team had increased exposure to slightly earlier in 2020 as the COVID-19 pandemic spread. These companies are typically those that the team believes are likely to experience limited impact on operations or profits from the COVID-19 pandemic and related economic shutdown; indeed, some are even likely to find the crisis providing opportunities. In these companies, Thomas believes that the market is underestimating the resilience and robustness of their income streams, offering the potential for a positive valuation re-rating to drive stock returns. At the very minimum he believes there is support for current valuation multiples as a consequence of the scarcity of income in the broader market and the company's ability to supply it.

Companies meeting these criteria can vary and are often in areas which might be typically assumed to be more vulnerable to an economic downturn. For example, ASEI has top ten positions in both Rio Tinto and BHP, two of the world's largest mining companies. Although commodity prices have remained highly volatile in 2020, reflecting massive uncertainty over economic conditions and likely outcomes, Thomas notes that both company managements have exercised significant cost and supply discipline over recent years, and retain highly resilient balance sheets.

Top Ten Holdings

HOLDING	%
CMC Markets	4.4
GlaxoSmithKline	4.3
British American Tobacco	3.7
BHP	3.6
Rio Tinto	3.2
Close Brothers	3.1
National Grid	2.9
Diversified Gas & Oil	2.8
SSE	2.6
BAE Systems	2.6
TOTAL	**33.2**

Source: Aberdeen Standard Investments, as at 30/09/2020

Thomas believes that both companies should be able to profitably maintain production levels and demonstrate operational resilience in all but the most severe and protracted of downturns. Conversely, a more rapid economic recovery potentially offers increased profitability and upside for both companies over the medium term. Both companies have shifted to a payout-based dividend policy, rather than a progressive dividend policy, which should, in his view, serve to better guide market expectations of dividend levels.

A second category of stocks - 'interrupted income' – are companies that have been in the short term been affected by COVID-19, but whose longer-term prospects Thomas believes are attractive and are not priced into their valuations. The ASEI team are looking to understand normalised operating environments, normalised earnings and, subsequently, what a normalised yield is likely to be on many companies, looking at what they deem likely operational performance in from mid-2021 onwards. In many instances they believe that there is the potential to access substantial dividend streams at compelling valuations, precisely because, in its current mindset, the stock market is focused on the here and now. Such, they believe, is the case with sofa retailer DFS, whose market share has increased through the pandemic, with some of their largest competitors have gone into administration. Thomas anticipates that, in the absence of spending on social spending (such as eating out and holidays) consumers are set to re-divert their spending to home improvements, including replacing sofas. He notes that DFS's latest trading updates have indicated that trading is significantly ahead of expectations.

The final income category is 'resumed income', where robust fundamentals have allowed management teams to reintroduce the dividend after a short break. Since the onset of the pandemic Thomas has sought to identify stocks that have the greatest potential to resume their dividend. For example, Thomas bought a holding in Persimmon well before they announced that they would be resuming their dividend (the first housebuilder to do so). Thomas notes that the company has not only remained financially resilient (with no need to access the UK Government furlough scheme) but has in fact seen its order book and revenues increase. The team believes that the market's negativity towards the stock is linked to macroeconomic concerns, despite substantial evidence of strong company-specific prospects. Similarly, another ASEI holding, Close Brothers, has become the first UK lender to announce a dividend, to the managers underlining the robustness of the business model even during an unprecedented economic recession. This holding is also an example of ASEI's index-agnostic approach, as the portfolio holds no mainstream banks whatsoever. As the list of 'resumed income' stocks grows Thomas expects ASEI to benefit, both in terms of income and capital growth.

Thomas recognises that the investment process requires the team to assess new information affecting a company's prospects. On this basis the team have looked to exit positions which they believe will be structurally challenged by the change in operating environment caused by COVID-19. This led them to take decisive action as soon as the pandemic struck, selling their holdings in Saga, TUI and Cineworld, as the route to recovery for these companies was deemed to be too long to justify retaining a holding.

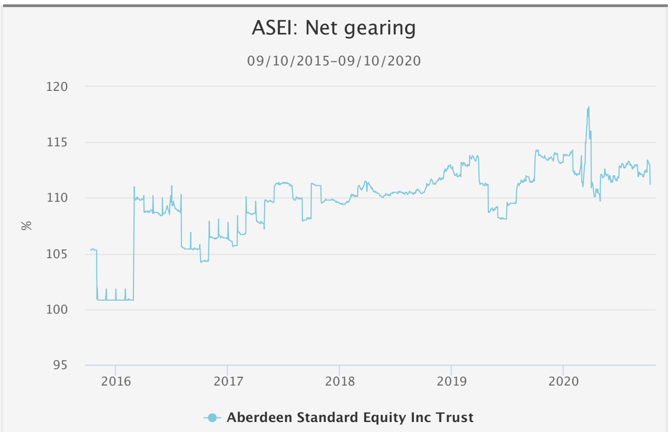
ASEI remains tilted stylistically towards value, as we discuss under **Performance**. This is an output, as opposed to a target, of the investment process. Thomas highlights wide valuation dispersions between 'value' and 'growth' stocks; these have been in place for some time, but have only widened in recent months. Whilst this has hit performance, Thomas sees it as providing the scope for a very sharp recovery in performance should conditions change. An economic recovery, potentially (in the team's view) linked to the announcement of a vaccine, could prove a tailwind to a recovery in many of ASEI's holdings.

Gearing

ASEI currently has net gearing of c. 11.2% (as of 09/10/2020). Gearing will ordinarily operate in a range between a position of 5% net cash and 15% net geared, with the board setting the overall parameters and the manager having discretion on the level within this range. Currently ASEI has a £20m revolving credit facility at a rate of LIBOR +1.3%, available until December 2023. As of 09/10/2020 the £20m facility represents c. 13.8% of ASEI's net assets, and thus the trust is presently near to its maximum level of possible gearing.

Deployment of gearing is undertaken flexibly and will primarily reflect the degree and depth of stock-level opportunities that Thomas and the team are identifying at a given time, as opposed to being representative of the team's view on the broader market prospects.

Fig.1: Net Gearing



Source: Morningstar

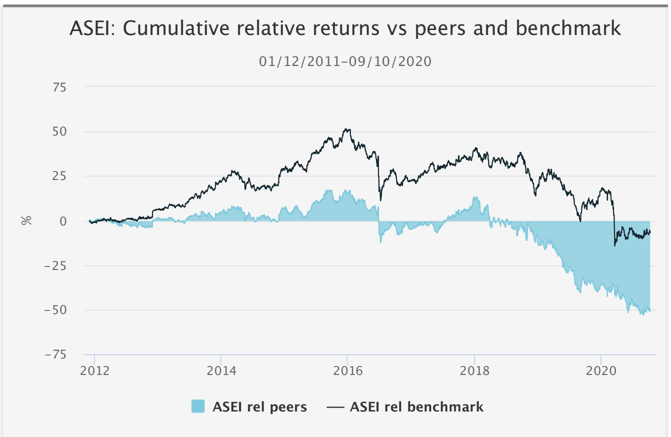
As can be seen in the graph below, the current position of c. 11.2% gearing is broadly in line with that seen in the previous two years, with gearing levels having trended higher over the past five years. We understand that this has been reflective of the broader stock-level opportunities that the team have identified in the UK market.

Performance

Thomas Moore took over management of ASEI in November 2011. ASEI has delivered NAV and share price returns of c. 53.1% and c. 45.8% respectively over the period 01/12/2011-09/10/2020. This represents underperformance of the wider Morningstar UK Equity Income peer group, which has delivered unweighted average NAV and share price returns of c. 104.1% and c. 84.5% over the same period. It also represents underperformance of the benchmark FTSE All-Share index as represented by a passive investment vehicle (the Xtrackers FTSE All-Share ETF), which delivered returns of c. 59.5% over the same period.

Whilst clearly cumulative returns have been disappointing over this whole period, it is notable that the track record is skewed negatively by a period of underperformance which largely started at the beginning of 2018 (though relative returns peaked in December 2015). Consistently high levels of gearing since the start of 2018 have negatively impacted returns, with the benchmark index declining by c. 11.9%.

Fig.2: Cumulative Returns Relative To Peers And Benchmark

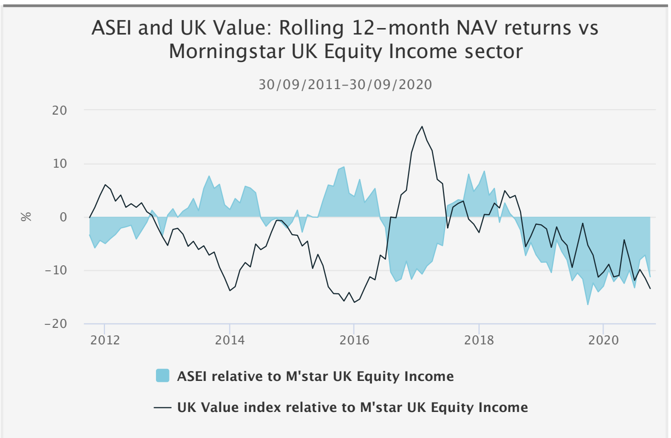


Source: Morningstar

Whilst gearing has been a contributor to the underperformance relative to the benchmark, the greater emphasis that the manager has in recent years placed upon value characteristics within the portfolio has also hurt returns relative to the wider Morningstar UK Equity Income peer group. In the graph below we can see the relative returns of ASEI's NAV to the peer group on a rolling 12-month period. We can also see the relative returns of a UK Value index to the peer group over this same period.

Where previously there was broadly an inverse relationship between the relative fortunes of ASEI and value factor indices to the peer group, this relationship has become much closer in recent years and now appears positively correlated. (Whilst we have not included this below, the same pattern is true of ASEI relative to the benchmark index). In addition, the R2 of ASEI to the same UK Value index over the previous 12 months to the start of October has been c. 0.86, against a 10-year average of c. 0.55; the change in behaviour below seems to be reflective of ASEI-specific factors, as opposed to a change in the behaviour of the wider peer group.

Fig.3: Rolling 12-Month NAV Returns Vs Morningstar UK Equity Income Sector



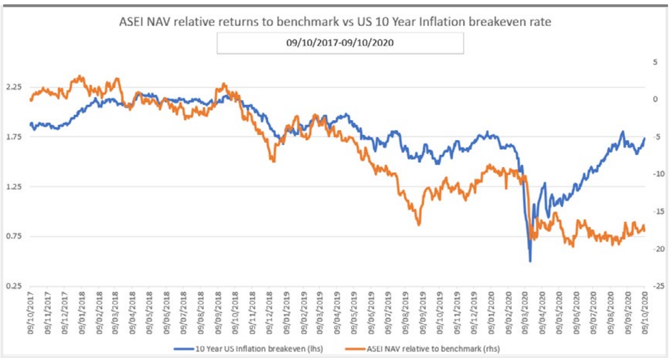
Source: Morningstar

The shift has reflected the manager's observations on the increasing valuation disparity between broader 'growth' and 'value' factor stocks, including an extremely disparate gap in dividend yields, as we discuss under Portfolio. In the longer-term Thomas believes this gap to be anomalous rather than structural, and expects mean reversion towards more normal levels of value dispersion, which would likely serve as a tailwind to ASEI.

As we highlighted in our previous research note, this tilt towards value also resulted in a greater tilt towards economic cyclicality with associated downside risks from any economic slowdown. This trend proved to be a very significant headwind in the extreme acute economic contraction seen earlier in 2020. Accordingly, 12-month returns to 09/10/2020 have remained highly challenging. Over this period ASEI has generated returns of c. -19.3% and c. -22.7% on a NAV and share price basis respectively. This again represents significant underperformance relative to the peer group, which saw average NAV and share price returns of c. -8.5% and c. -12.7% respectively, and the benchmark index, which saw returns of c. -11.5%. Over this same period the above UK value index has returned c. -23.6%, against a growth factor index of c. 2.2%.

ASEI experienced a similar period of underperformance over 2016, and subsequently saw a rapid recovery. It is possible that a pick-up in inflation expectations could ultimately serve as a tailwind to the trust's relative performance. When we look at the recent relationship between the relative returns of ASEI to the benchmark, and of US 10 year breakeven inflation rates (serving as a proxy for global inflationary expectations), we can see a clear influence in the recent past, but this appears to have broken down somewhat in recent months.

Fig.4: NAV Returns Relative To Benchmark Vs US 10 Year Inflation Breakeven Rate



Sources: St Louis Federal Reserve, Morningstar

As we note above and under **Portfolio**, valuation disparities between 'value' and 'growth' factor indices are very elevated at this time. Should the pick-up in inflation expectations seen in recent months prove sustained and ultimately be followed by higher bond yields, this could ultimately, in our view, prove to be a tailwind for ASEI if the market accordingly normalises. We note that ASEI's internal risk metrics suggest a stabilisation or move higher in bond yields should benefit the portfolio on a relative basis.

Dividend

ASEI presently yields c. 7.8% on a historic basis (as of 09/10/2020), paying quarterly dividends in March, June, September and December. This figure represents a substantial premium to the level of yield offered by the benchmark FTSE All-Share, and to the broader AIC UK Equity Income peer group. The latter presently has an unweighted average historic yield of c. 5.8%. In fact, ASEI offers a greater level of historic yield than all but two of its peers at the time of writing.

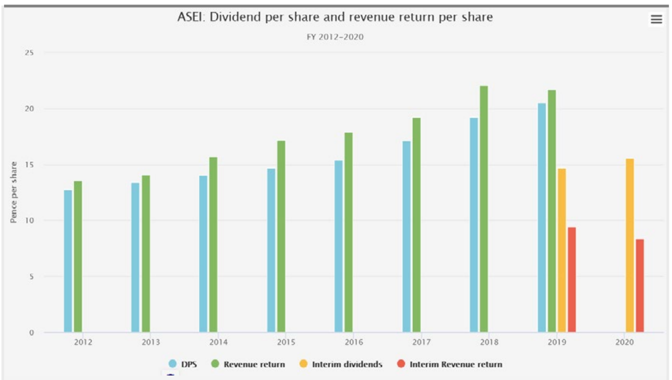
Historic yields are clearly only a reflection of the past, with very substantial cuts anticipated to dividend distributions across vast swathes of the UK market (with a July aggregate of analyst estimates from Bloomberg of 43% falls in FTSE All-Share dividends over 2020). As we have discussed under **Portfolio**, Thomas and the team are currently evaluating stocks through different prisms with regards to income, looking to balance ASEI across companies with resilient incomes, as well as in companies where they anticipate income distributions being resumed in the near future, and in companies where they accept there may be an interruption in dividend streams, but which the market is undervaluing future dividends.

Consequently, it is anticipated that there will likely be impairments to ASEI's income for the financial year ending 30/09/2020. Some of this impact has already been seen with the interim report to 31/03/2020 showing a decline in revenue returns per share of c. 11.5%, against the same period in the previous financial year.

Historically, ASEI itself has a strong track record of dividend growth, having now increased dividends every year for the previous 19 financial years (and thereby being tantalisingly close to becoming an AIC Dividend Hero, representing 20 years of continuous growth). Dividend growth over the past five years has been robust, with the dividend growing at an annualised rate of c. 7.9% over this period to the end of FY 2019, significantly in excess of the rate of growth in the CPI index. The board has yet to declare the final dividend for FY 2020, but the three interim dividend payments have seen an increase of c. 6.1% over the equivalent dividends in the previous financial year. The board has previously noted, in their interim report released in May 2020, their intention to raise the FY 2020 dividend to 20.6p per share. Whilst this is a reduction from the board's previous FY 2020 target of 21.4p per share, in recognition of the extraordinary conditions and challenges of the current market, this would nonetheless still represent an increase of c. 0.5% over the FY 2019 dividend of 20.5p per share.

With income taking a knock, dividends are likely in our view to be supported by revenue reserves. The board sought to build up revenue reserves in more favourable years, and has subsequently noted that such a challenging backdrop as we are currently experiencing equates to

Fig.5: Dividend Per Share And Revenue Return Per Share



Source: Aberdeen Standard

precisely the sort of conditions whereby they believe it is appropriate to draw on these reserves. Although revenue reserves had been drawn upon in the interim reporting period to 31/03/2020, ASEI retained revenue reserves per share of c. 1.03x the FY 2019 dividend. Accordingly, even allowing for some further reductions in the revenue reserve to meet the subsequent interim dividend (and the forthcoming final dividend), ASEI would seem to us to retain ample dividend cover to support dividend growth for the foreseeable future.

Management

Aberdeen Standard Equity Income is managed by Thomas Moore, who joined Standard Life in 2002 and has managed the open-ended ASI UK Equity Income Unconstrained Fund since 2009, as well as the ASI Income Focus Fund since December 2019. Thomas took over management of ASEI in November 2011, and works as part of a team of 16 fund managers who provide full coverage of the FTSE 350 Index.

With a deep pool of analytical resources available within Aberdeen Standard Investments, analysts contributing to the investment process of ASEI are dedicated specialists of certain sectors, seeking to build a comprehensive understanding of the performance and operations of a company relative to its peers.

As well as ASEI, Thomas also manages c. £0.9bn of assets in open-ended products utilising the same investment philosophy. The team place emphasis on the 'focus on change' investment philosophy, seeking to understand management strategies at prospective holdings and how they are likely to change the operational dynamics of the business in both a relative and absolute sense. Regular management meetings are a key input in this regard, whilst the use of sector specialists allows the team to contextualise information within industry-wide trends and the relative strengths and weaknesses of different competitors.

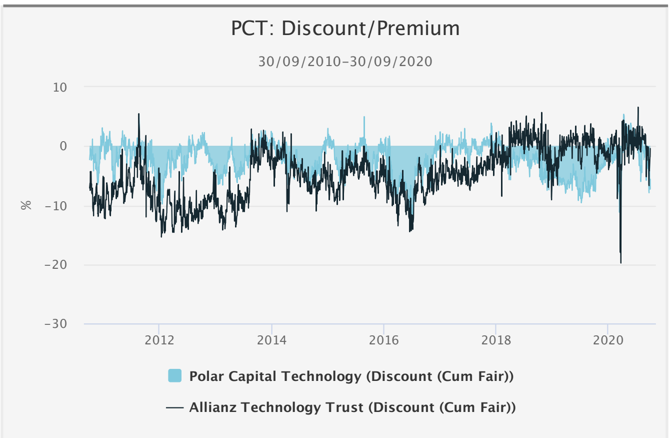
Discount

ASEI trades on a discount of c. 12.3% as at 09/10/2020. This is significantly wider than the median discount level of 4.3% seen over the previous five years, and the discount has only been wider than the current level on c. 2.9% of daily occurrences over the previous five years. The discount has continued to widen, despite the intervention of the board in buying back shares.

Whilst the broader Morningstar UK Equity Income peer group has also seen the average discount widening, this has been far more acute in ASEI and the trust remains at a substantially wider discount than the peer group average, as can be seen in the graph below. Indeed, at the time of writing there are only four trusts presently trading on a wider discount within the peer group.

The board have the authority to repurchase up to 14.99% of ASEI's shares in total. Whilst they have exercised this in part in the previous financial year, they retain significant capacity. Over the previous financial year (30/09/2019–30/09/2020) the board repurchased a total of c. 593,000 shares at a weighted average discount of c. 11.7%. Whilst they do not have an explicit buyback policy with regards the discount, as we have previously noted, the board similarly repurchased shares in mid-2019 and January 2017 when the discount had reached levels approaching roughly 10%.

Fig.6: Discount/Premium



Source: Morningstar

Charges

ASEI presently has an OCF of c. 0.91%, which is above the weighted sector average OCF of 0.62%. However, the OCF will not yet account for the reduced management fee. The tiered management fee was amended in October 2019 so that the first £175m of net assets will be charged at 0.65%, with all assets above this level charged at 0.55% p.a. With current net assets of c. £144m, as of 09/10/2020, this management fee is wholly within the first tier of 0.65%. Clearly, if the trust's assets grow, then the OCF has the potential to fall.

The latest KID RIY figure is 1.21%, which is in line with the sector average of 1.21%, although we note that calculation methodologies vary.

ESG

The investment team behind ASEI have historically taken an approach to stock analysis which tends to lends itself to certain ESG considerations. In particular, they have a strong qualitative preference for sustainable growth and superior corporate governance. In recent years this inclination has been increasingly formalised, and we understand that ESG analysis is now an embedded part of the analytical process being included in each analyst's company notes.

Dedicated ESG analysts within the ASI UK equity team also regularly meet with company managements and monitor company and industry developments, providing insight on how ESG issues are impacting upon business models. In addition to on-the-desk ESG specialists, ASI has over 50 ESG investment professionals. This team is used to better understand how the companies in which the managers have an investment perceive environmental and social risks to their business.

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