Standard Life UK Smaller Companies

Update
19 February 2020

Currently trading at a discount to peers, SLS has an impressive long-term track record...

Summary

Kepler GROWTH RATING

This trust is rated by Kepler Trust Intelligence as an outstanding option for investors seeking capital growth...
Find out more

Standard Life UK Smaller Companies offers investors an actively managed, concentrated portfolio of high-quality growth stocks, with the aim of delivering long-term capital growth.

The manager, Harry Nimmo, looks to achieve this goal through a combination of quantitative and qualitative research; incorporating a proprietary scoring system called ‘the matrix’. The matrix assesses numerous metrics, narrowing down the number of companies which Harry will meet and enabling him to interrogate management and investigate the strength of the company’s business model. The end-result of Harry’s efforts is a portfolio of between 50 and 60 stocks, currently 54. The trust has a bias towards the upper end of the small-to-medium market cap range of companies, principally due to Harry’s preference for well established companies and his propensity to run his winners.

Over the long run, Harry’s track record is excellent. The past ten years has seen SLS outperform the benchmark in eight, including in both rising and falling markets. This strong performance has continued into recent times, and over the past 12 months the trust’s NAV has comfortably outperformed the sector and index. Over this period SLS also saw considerable levels of volatility, however; H219 was the strongest six months in NAV total return terms since the manager was appointed in 2003, while H119 was the worst since 2008.

SLS has seen a complete turnaround in sentiment over the past six months. Starting Q3 of 2019 on a discount of nearly 10%, the trust narrowed relentlessly to a premium by the year-end. This has since slipped and currently the trust is trading on a discount of 5.2%.

Key Information:

As at	13/02/2020
Price (p)	604
Discount (%)	-5.2
OCF (%)	0.90
Turnover Ratio	32.9
Yield (%)	1.2
Gearing (%)	4
Ticker	SLS
Shares (£)	100,099,771
Market cap (£)	604,602,617

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Analyst’s View

SLS has an exceptional track record of delivering returns for investors. Harry’s unique, quant-based approach to investing means that he is able to remain objective, without biases or external influences impacting his investment decisions too much. This, coupled with the trust’s concentrated nature, makes for a unique portfolio with the potential for strong and differentiated returns compared to that of the benchmark and peers.

Although Harry has a strong track record, investors should recognise that in the short term SLS can be a white-knuckle ride at times. This was seen in 2019 when

SLS outperformed in all but one peer in the 25-strong AIC sector, but this was achieved with high levels of volatility. This result reflects characteristics one might expect from a manager who holds a concentrated portfolio and is willing to back his bets with conviction.

The trust's outperformance, coupled with an already wide discount, helped SLS come back into favour, and the discount narrowed significantly in the latter half of 2019. In 2020 the discount has started to widen in absolute terms and relative to the peer group.

Analyst's View

BULL	BEAR
Highly experienced manager with a long-term track record of outperformance	Concentrated approach increases the volatility of the trust
A unique combining strong quant screening coupled with a highly experienced manager	The charges are above average in the peer group
Slipped to a discount in recent times despite strong performance and improved sentiment towards the sector	

Portfolio

The focus of Standard Life UK Smaller Companies (SLS) is to achieve long-term capital growth through UK-based smaller companies.

The portfolio, managed by Harry Nimmo, is run based on a 'focus on change' philosophy. This viewpoint assumes that, although fundamentals drive the share price over the long term, there are often short-term inefficiencies in the market which lead to mispricing opportunities.

Harry's process is designed to limit reliance on the fallibilities of human fund managers, with an emphasis on the initial quant screening done by the matrix. This is a screening system which reflects quality, growth and momentum-based factor analysis; incorporating the quality of a company's financials. Metrics include EPS growth, price momentum, P/Es and yields, directors' dealings and metrics measuring balance sheet quality. Around 40% of the final score is attributable to earnings revision and momentum-related characteristics. Valuation metrics are given limited importance, as Harry believes they do not work in the smaller company sphere. Alongside quantitative screening, a high level of importance is placed on face-to-face meetings with the senior management of potential investments. This disciplined process has been embedded for many years and has delivered strong returns throughout economic and market cycles, **as shown in the performance tab**.

The end-result is a portfolio of 50-60 stocks, currently 54. This compares to a sector-wide average of 56, once we have accounted for some of the more unusual trusts. Harry is very much a small and medium market cap company investor. However his preference for companies with proven business models and recurring revenues – coupled with his desire to run winners – means that the average market cap of a company within the portfolio sits at £1.3bn, in comparison to £876m from the rest of the sector (Morningstar).

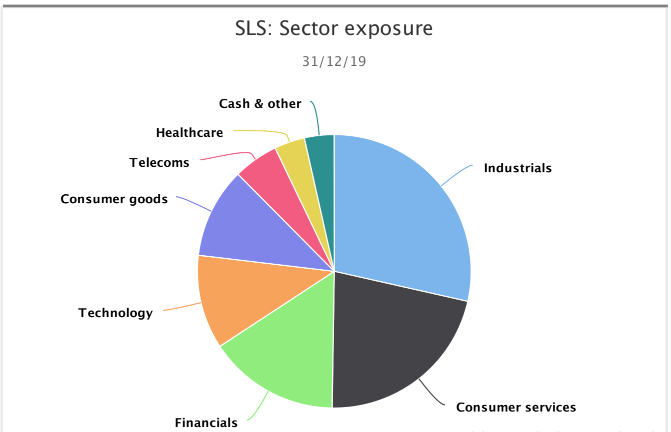
Top Ten Holdings

COMPANY	HOLDING SIZE (%)
Gamma communications	3.6
Dart	3.6
Marshalls	3.6
Intermediate Capital Group	3.3
Future	3.2
Diploma	3.1
JD Sports Fashion	3.0
Kainos	2.9
RWS	2.9
Games Workshop	2.8
TOTAL	**32.0**

Source: Aberdeen Standard Investments (31/12/19)

Harry has sector preferences, and his largest sector allocations come from industrials (28.5%), consumer services (21.7%) and financials (15.5%). On the other hand Harry will normally avoid oil and gas stocks, even if they are attractive based on information provided by the matrix. This is down to the risky nature of the companies, mainly their dependence on a single site or single country's political or economic situation. Similarly Harry avoids 'blue sky' companies, which are those which have yet to record a profit. Only 5% of the portfolio is allowed to be allocated to these types of companies.

Fig.1: Sector Allocation

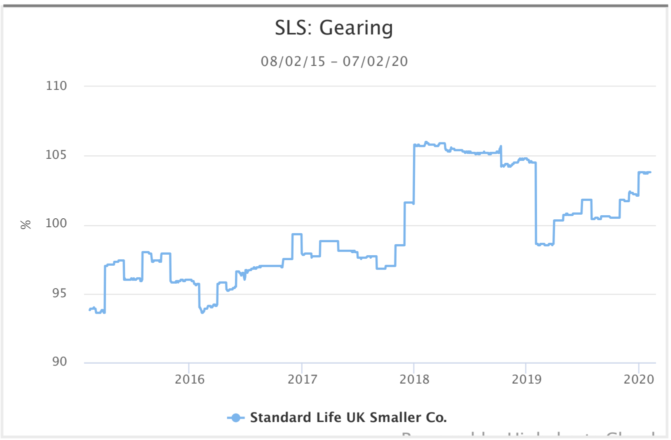


Source: Aberdeen Standard Investments

Gearing

Despite having the capacity to gear up to 25% of NAV, SLS's gearing levels are usually significantly lower than this. The manager has both structural and flexible gearing in place, allowing him to vary the exposure to equities relatively frequently. The trust started 2019 with net cash; however gearing has gradually increased over the year to the current level of c.4%. This is significantly higher than the five year average of 0.5% net cash, but lower than the average gearing of 6% in the AIC UK Smaller Companies sector.

Fig.2: Gearing

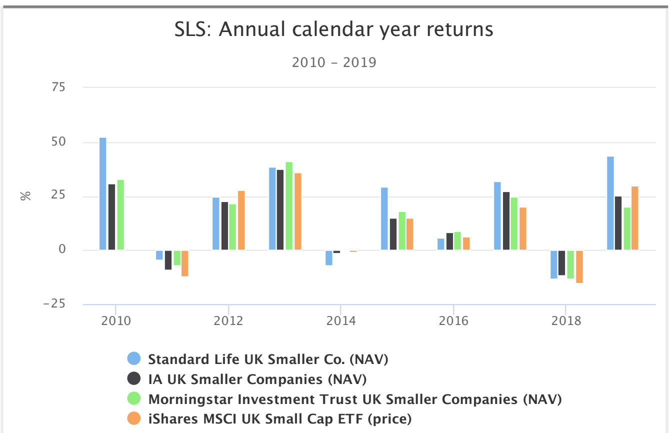


Source: Morningstar

Performance

Over the long run Harry's track record with this trust is excellent. The past decade, ending 10 February 2020, has seen the trust has deliver 439.3% in NAV total return terms. This eclipses the benchmark Numis Smaller Companies plus AIM ex Investment Trusts return of 163.2%, as well as both the IA and AIC UK Smaller Companies peer groups, which have returned 251.5% and 258.3% respectively. This outperformance has been relatively consistent on an annual calendar year basis, with SLS beating the

Fig.3: Returns

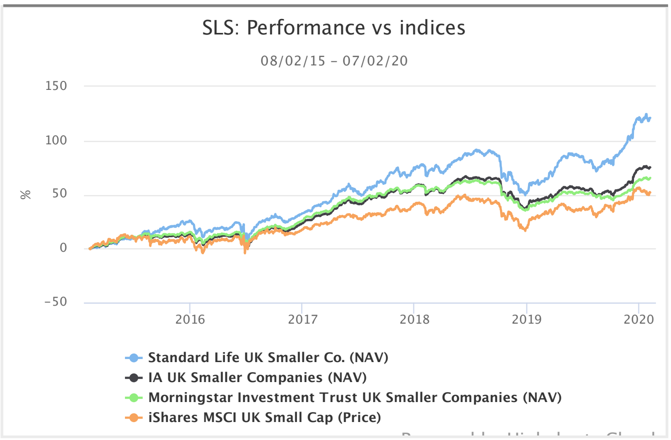


Source: Morningstar

benchmark in eight of the past ten years, including in both rising and falling markets. It is worth noting that in June 2018 the trust changed its benchmark from the Numis Smaller Companies (excluding AIM) Index, in response to the increasing importance of AIM stocks. AIM companies, however, still make up just 2% of the portfolio.

Over the past five years, ending 7 February 2020, SLS's NAV returns are equally impressive. The trust has delivered NAV total returns of 120.8%, compared to 47.3% from the benchmark over that period. The AIC peer group average generated NAV total returns of 65.5%, whereas the IA peer group delivered returns of 75.2%. Over the same period the manager has generated an alpha of 7.8% per annum, the third highest in the AIC sector. While achieving these strong returns, the SLS standard deviation of 14.1% was quite significantly above the benchmark (11.5%), and the trust's beta was 1.07. Given the concentrated nature of the portfolio, however, volatility and deviations from the benchmark – as indicated by the beta – should be expected.

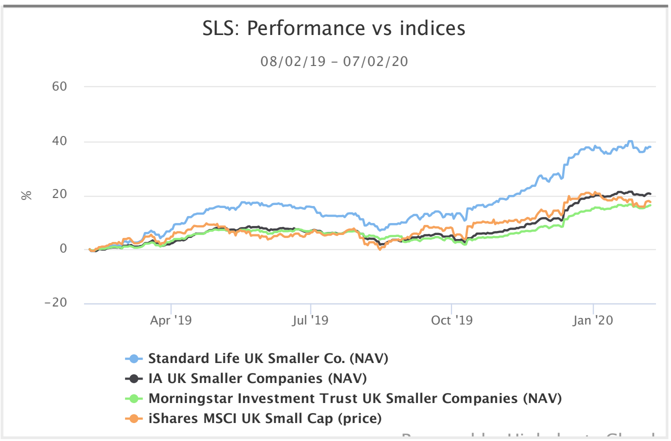
Fig.4: Five-Year Performance



Source: Morningstar

In the recent past SLS's NAV has comfortably outperformed the sector and index. Over the last 12 months it has delivered NAV total returns of 38.0%, the second strongest return of any in the 25-strong sector. In comparison the NAV total returns from the benchmark, AIC peer group and IA peer group were 14.2%, 16.3% and 20.5% respectively. However, the year has not been without its ups and downs. The second half of 2019 was the strongest since the manager was appointed in 2003, while the first half was the worst since the six months ending 31 December 2008. The top contributors to performance over the 12 month period included Marshalls (paving company), Gamma Communications (network operator) and Kainos Group (data services).

Fig.5: One-Year Performance



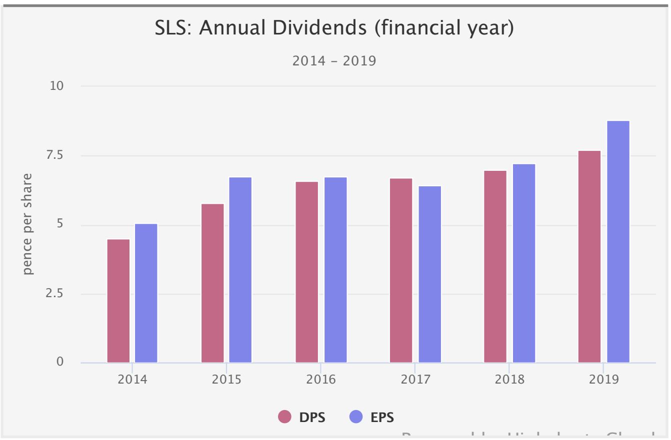
Source: Morningstar

Dividend

Harry does not target a dividend per se, but the trust's yield is 1.2% despite its small cap focus. Harry is typically attracted to stocks with strong earnings growth, which means the trust has delivered strong dividend growth. Over the five years to 7 February 2020, dividends have grown at 11.3% per annum.

Dividends are paid semi-annually and the most recent full year dividend (2019) was 7.7p, up from 7.0p in 2018. The dividend was fully covered by earnings. The trust had revenue reserves worth 1.5x last year's dividend at the end of the last financial year in June.

Fig.5: Dividends



Source: Aberdeen Standard Investments

Management

Harry Nimmo has managed the trust since SLS took over in 2003, having run this strategy since 1997 on the open-ended sister fund. Harry joined SLS in 1985 just after university, and has worked on UK equities since then, taking over responsibility for small-cap equities in 1993.

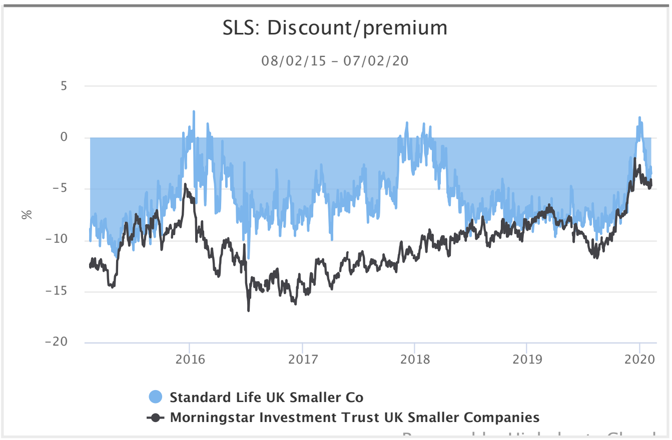
This means he has a huge amount of experience in the market, having worked through a number of market cycles and numerous fads and trends. With the absorption of Dunedin Smaller Companies into this trust, alongside his open-ended fund, Harry now runs over £2bn with this mandate.

Discount

Over the past five years SLS has spent most of its time trading at a mid-digit discount, although there have been short periods where the trust has narrowed to a premium. Over the past five years, ending 7 February 2020, the shares have traded at an average discount of 6% in comparison to a sector-wide average discount of 10.4%.

The trust has seen a complete turnaround in sentiment over the past six months. SLS started Q3 2019 on a discount of nearly 10%, before narrowing to a premium by the year-end. This has since slipped and currently the trust is trading on a discount of 5.2%. The narrowing of the discount, followed by a marginal slip, has also been reflected across the wider sector, as can be seen below; although the weighted average of the constituents sits marginally narrower at a discount of 3.6%.

Fig.6: Discount



Source: Morningstar

The board has a discount control policy in place, aiming to maintain a discount level of less than 8% in normal market conditions. The trust does, however, occasionally slip wider than the target level (as can be seen in the five year graph). Over the course of 2019, more than half a million shares were purchased back to treasury, representing around 0.05% of the total number of shares in issue.

The trust also has a tender offer mechanism in place. This is used on a discretionary basis when the board believes that share buybacks are not sufficient to maintain the discount at an appropriate level; although it expects that buybacks should be the primary mechanism for managing the discount. The last time the tender offer facility was used was in July 2015.

Charges

The OCF for SLS is 0.90% compared to a sector weighted average of 0.78%, according to JPMorgan Cazenove. There is no performance fee, however, as there is on a number of other trusts in the sector (performance fees are excluded from OCFs). The management fee is tiered, with 0.85% payable on the first £250m of net assets, 0.65% on the next £300m and 0.55% thereafter. With total assets currently sitting at £679m, we calculate that the effective management fee is 0.70%.

The KID RIY for the trust is 1.13, in comparison to a sector-wide weighted average of 0.77. However, calculation methodologies can vary among companies.

ESG

According to Aberdeen Standard Investments, environmental, social and governance (ESG) considerations underpin the investment activities of all their managed funds. For SLS this means trying to make a difference for their clients, society and the wider world while aiming to meet long-term financial goals.

SLS aims to specifically make a difference through Harry constructively engaging with investee companies on issues of social, community and environmental responsibility. The aim is to positively influence developments in these areas. He also believes that companies that demonstrate a commitment to environmental and social responsibility are likely to have distinct advantages in the long run compared to those that don't.

Disclaimer

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that Independent financial advice should be taken before entering into any financial transaction.

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