Dunedin Income Growth

DIG offers a high yield backed by large revenue reserves...

Summary

Update
01 March 2021

Dunedin Income Growth Investment Trust (DIG) aims to grow capital and income primarily from investments in UK equities, aiming to outperform the benchmark FTSE All-Share Index. In recent years DIG's investment strategy has shifted towards a greater focus on dividend growth at the expense of some initial yield.

This has proven useful in recent months given the parlous backdrop for UK equity income generation. As discussed under **Dividend**, the strong emphasis placed upon financial strength in stock analysis has meant that, even when holdings were suffering operational headwinds, underlying management teams have often been able to maintain payouts. We understand that DIG's revenue generation has therefore suffered milder impairments than the market, though it has also been supported by the writing of covered call options (as discussed under **Portfolio**).

The strategy shift has also ensured that the managers have not had to focus solely on identifying companies where dividends are high or growing but have also been able to introduce companies where they believe there to be attractive long-term total return characteristics. As discussed under **Performance**, over the previous five years DIG has delivered the second strongest share price returns in its peer group.

DIG has a historic yield of c. 4.3% (as at 15/02/2021) and seems to us likely to at least maintain dividends this financial year, with healthy reserves to draw on if needed. Despite this, the trust trades at a **Discount** of c. 4.3%, wider than the sector average.

ESG is embedded into the investment process, and as an output the trust scores well on quantitative measures of ESG compliance.

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Analyst's View

DIG's managers view it as a core UK equity income product, and we think many of the characteristics displayed lend themselves favourably to such a designation. An attractive historic yield reflects a level of dividends that look to us like they can at the very least be maintained in the near term, with resilient portfolio income and ample revenue reserve cover. The shift in strategy looks to have further supported the long-term sustainability of a progressive dividend policy, whilst affording the managers greater opportunity to incorporate their 'best ideas' for total returns, even when these do not necessarily offer any immediate dividend yield.

The managers use risk analytics to try and ensure that stock-specific factors remain the dominant driver of active risk, as opposed to style or market cap factors, which we think will be welcomed by many investors in this market environment, and we think likely accounts for the lack of strong 'personality' in DIG's relative returns. There has been no set market or macroeconomic backdrop that we think has demonstrated outsized influence on relative returns. Going forward, investors can perhaps therefore focus more on DIG's own characteristics than concerning themselves with the potential impact of events outwith the managers' control.

BULL
Managers have flexibility to focus on their 'best ideas'
Returns have been very strong in recent years
Substantial revenue reserves in place to support the dividend

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 on the DIG, as with many Aberdeen Standard Investment (ASI) products the approach is highly collegiate. The managers aim to generate capital growth and increasing dividends above those of the FTSE All-Share from a portfolio which has historically held between c. 30 to 60 stocks. Currently the portfolio holds 44 positions (as at 31/01/2021). This is down from 50 holdings when we last updated on DIG in July 2020 and represents a conscious decision by the managers to try and focus on the team's 'best ideas'.

This increasing portfolio concentration is a continuation of the evolution in investment strategy seen in recent years after the trust's objectives and processes were subject to a strategic review in 2016. Where previously the trust was positioned with the aim of generating a premium level of income to the wider equity market, the portfolio has been migrated to balance growth in both capital and income. The board, having initiated and supported this shift in strategy, has worked to support it subsequently with the use of revenue reserves to ensure that shareholders have continued to benefit from a progressive dividend policy even as the underlying income generated by DIG was subject to a process of readjustment.

The team have also increasingly looked to integrate ESG considerations and analysis into their investment process in recent years, with the aim of being an 'ESG leader' within the sector. This includes the utilisation of separate ESG analysis of constituent companies within the investment universe by in-house ESG specialists. Although predominantly a UK focused trust DIG will also incorporate some exposure to European shares when the managers deem the stock opportunity to be notably attractive, with Ben serving as ASI's Head of European equities and DIG having recourse to the ASI's European team's research.

As a result of this change in strategy, DIG's portfolio has been increasingly invested with a view to ensuring the dividend streams received were growing as opposed to focusing merely on the level of distribution likely to be received in the immediate term, and to afford the management team greater flexibility to focus on the total return profile of both the portfolio and individual positions.

As we discuss under **Dividend**, we think that this shift in strategy has proven fairly prescient. Elevated payout ratios in the UK market ultimately saw a raft of dividend cuts amidst operational impairments caused by the lockdown policy response to the COVID-19 pandemic. In total across the UK market, the Link Dividend Report estimates that dividends fell by c. 44% over 2020. By contrast, Ben and Georgina estimate that DIG's income stream appears to have been far less impaired (though not immune given the seismic depth and width of the economic impact). Whilst final figures will be confirmed in the coming weeks with the release of the final results to 31/01/2021, the managers feel like a fall of around 10% seems likely.

The broad strategic shift has been completed, with DIG now holding greater exposure to small- and mid-cap companies than the case in previous years. Ben and Georgina remain focused on ensuring that the primary differentiation of the portfolio from the broader index is driven by stock-specific factors. They have sought to ensure this is the case through an increased focus on the team's 'best ideas' across the stock universe, seeking to exit lower conviction positions and only add new ones when they believe them to exhibit significant additional potential upside compared to existing holdings. Ben and Georgina note that reducing the number of holdings has, in some ways, been a challenge as the team are presently identifying a surfeit of attractive opportunities.

DIG now has an active share of c. 70%, as at 31/01/2021. Whilst the team have sought to increase the stock-specificity of their relative return profile in recent months, this has been done through a reduction in the number of holdings and a more equitable spread in portfolio weightings, with the proportion allocated to the top-ten positions falling since we last updated on the trust in mid-2020.

DIG: TOP-TEN HOLDINGS

AS AT 31/05/2020		AS AT 31/01/2021	
AstraZeneca	5.7	AstraZeneca	50
GlaxoSmithKline	5.4	GlaxoSmithKline	4.1
Assura	4.6	Diageo	3.8
British American Tobacco	4.3	BHP	3.6
RELX	4.1	Rio Tinto	3.6
Diageo	3.9	Assura	3.4
National Grid	3.7	Aveva	3.4
Rio Tinto	3.5	National Grid	3.4
Croda	3.2	Prudential	3.1
Chesnara	3.1	RELX	3.0
TOTAL	**41.5**	**Total**	**36.4**

Source: ASI, as at 31/05/2020 and 31/01/2021

Ben and Georgina note that they now anticipate a greater rate of dividend growth going forward from their portfolio. The step away from a sole focus on income generation has also enabled them to incorporate positions which, though contributing no or very little income to the portfolio, they believe will ultimately boost the total returns profile. In recent months this has included participating in the IPO of Moonpig, a company the managers do not anticipate paying a dividend but which they believe offers strong total return potential.

Moonpig is already the UK market leader for online ordering of greetings cards and proved a beneficiary of the government-mandated shutdown of many retail shops over much of 2020. Despite this, online card retailing currently represents only c. 10% of the UK total addressable market. Ben and Georgina note that, following the appointment of a new management team in 2018, the company has increasingly been moving to attach third party gifts to their already strong card offering. The company hopes to be able to utilise their ever-growing data advantage from recurring customers and new purchases to effectively enhance this gifting proposition. Moonpig's site will serve as host to this, with attractive margins on their share of gifts sold.

This, combined with significant potential to take further market share in the UK card market, should, Ben and Georgina believe, offer the potential for rapid top-line growth in the coming years. They do not anticipate any imminent return of capital through dividends to shareholders, noting the management team are still reinvesting free cash flow into areas such as marketing with a view to increasing market share. Yet production capacity remains ample with no foreseen requirement to expand capacity, and should investment in the business roll-off in the coming years (as the managers anticipate) then any free cash flow should convert to earnings and, potentially, dividends.

Whilst Ben and Georgina are named managers on the trust, DIG operates with a highly collegiate approach. The managers are able to draw on a deep analytical resource pool, with ASI's 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.

As noted above, the managers are keen to ensure that most 'active risk' (i.e. deviation from the benchmark) is driven primarily by stock-specific factors. The stock selection process, however, is likely to have a mild tilt towards 'quality' factors, with the investment process favouring companies with strong balance sheets where they exhibit competitive advantages and high barriers to entry. Importance is placed on meetings with management teams to understand capital allocation decisions. Companies within the research universe are assigned a 'Q score' of between 1-5, with '1' representing what the team regard as the highest quality companies, and '5' the lowest.

Generally, the managers seek to avoid holding any companies with a 'Q score' of less than 2. Positions are typically introduced at c. 1%, with weightings driven primarily by stock conviction. However, regular risk analytics are also provided to ensure that the portfolio is not 'tilting' towards a particular outcome or style to too great a degree as a by-product of bottom-up stock observations. As an output, we can observe a greater tilt towards quality factors than growth or value factors on average over the previous three years, although presently ASI estimates that c. 65% of active risk is derived from stock specifics.

The table below shows the median rolling 12-month R2 (a measure of correlation) over the past three years to 31/01/2021 of DIG and the peer group to different UK factor indices. The slightly greater exposure in DIG as a whole is, in our opinion, partially a reflection of its positioning as a core UK equity income product, and also of the dampening effect that the disparity of strategies within the peer group will have on the average (with highly growth and highly value-focused trusts as constituents, for example, skewing average figures lower).

DIG And Morningstar UK Equity Income Sector: Three-Year Median NAV R2 To UK Factor Indices

	DIG	PEER GROUP
Growth	0.78	0.68
Quality	0.83	0.75
Value	0.76	0.70

Source: Morningstar

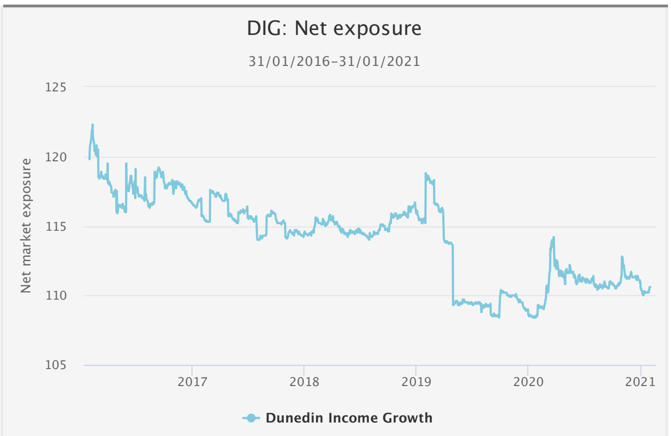
The managers generate additional income for the trust through the writing of covered call options on stocks held within DIG. Typically, they aim to generate a relatively fixed amount each year, and note that the higher premiums available as a result of the elevated volatility seen in 2020 have meant 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 and we would comment that this has likely mitigated 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.

Gearing

DIG presently has net gearing of c. 10% (as at 16/02/2021). This comprises a mixture of structural gearing and a flexible revolving credit facility. The former is undertaken through c. £30m in loan notes (c. 6.8% of current net assets), maturing in 2045 and bearing interest of 3.99% p.a. The flexible revolving credit facility gives the manager access to a further £15m of gearing, with the option of increasing this to a total of £30m with the lender's consent.

In keeping with the focus of the managers in seeking to ensure that the trust remains appropriate as a 'core' UK equity income strategy, and limited utilisation of tactical gearing is 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. Subsequently, the gearing ratio has declined slightly but we would comment this seems to be more primarily a consequence of subsequent NAV increases.

Fig.1: DIG: GEARING



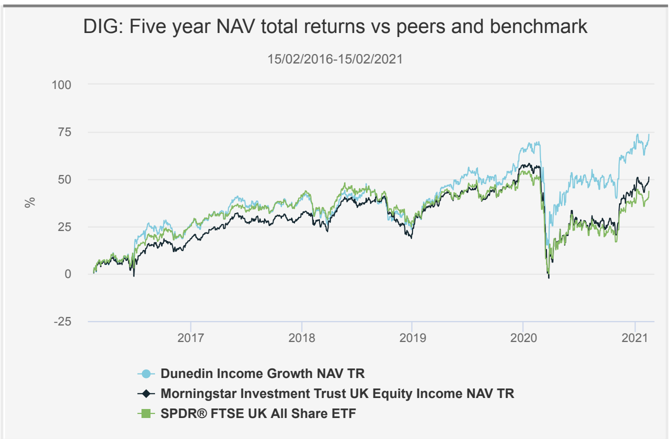
Source: Morningstar

Performance

Over the previous five years to 16/02/2021, DIG has delivered strong relative returns. NAV and share price total returns have been c. 73.7% and c. 88.1% respectively, with the significant share price outperformance driven by discount narrowing over this period. This is, we estimate, the second strongest share price returns of any trust within the sector over this period.

This represents an outperformance of the peer group (Morningstar Investment Trust UK Equity Income), which has seen NAV and share-price returns of c. 51.1% and 38.3% respectively, whilst the benchmark FTSE All-Share Index (as represented by the passive SPDR FTSE-All Share ETF) has returned c. 43.6% over the same period.

Fig.2: DIG: Five-Year Nav Total Returns Vs Peers And Benchmark

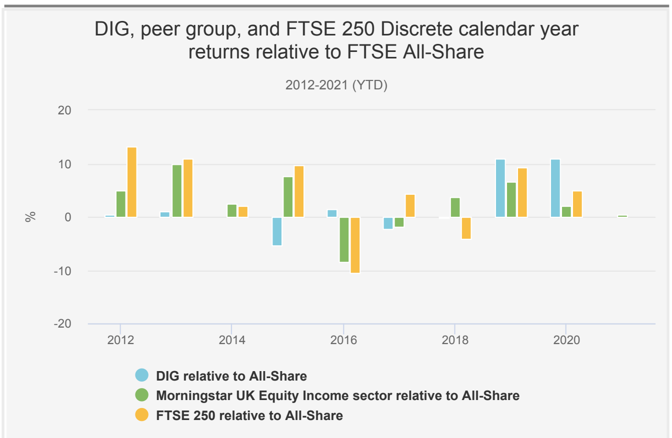


Source: Morningstar

Past performance is not a reliable indicator of future results.

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 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 that year). Where previously DIG's relative fortunes tended to be somewhat weaker in periods of strong mid-cap outperformance, this has reversed in the previous two calendar years concurrent with DIG's relative returns profile improving.

Fig.3: DIG: Peer Group And FTSE 250 Discrete Calendar Year Returns Relative To FTSE All-Share



Source: Morningstar

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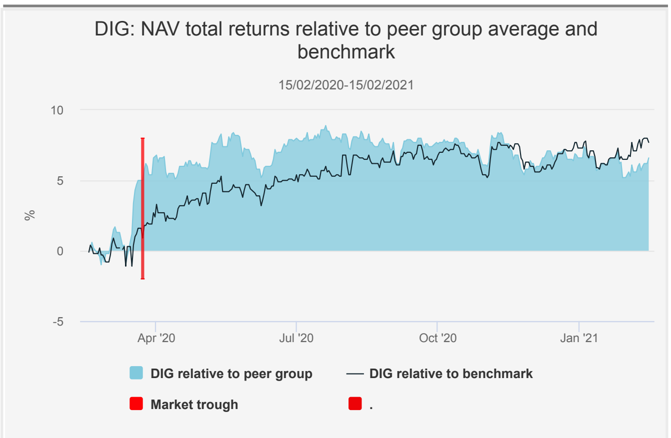
Consistent underweight exposures to large benchmark positions in areas such as energy companies and HSBC, historically large components of total market dividends, had helped relative returns over much of 2019 and 2020. The focus on 'quality' and highly defensible business models proved a tailwind to relative returns over the previous 12 months to 16/02/2021, providing some relative resilience in the initial downturn.

However, many of these companies were also perceived by the market as the corporate beneficiaries of the crisis due to their strong financial abilities and the potential opportunities arising to take market share from weaker competitors in a troubled economic backdrop. Accordingly, many of the high-quality companies which had helped DIG protect somewhat on the downside subsequently supported upside capture as markets recovered. This tailwind dissipated somewhat as the year progressed, particularly after the announcement of vaccine developments in November 2020 spurred a value rally. However, holdings in high-quality mining giants Rio Tinto and BHP, which had already been additive to returns, offset these relative headwinds somewhat, and the general backdrop was positive for absolute returns.

Over the 12 months to 16/02/2021, DIG produced NAV and share price total returns of c. 3.3% and c. 4.3% respectively, outperforming the peer group average NAV and share price returns of c. -3.3% and -3.4% respectively. This also represented outperformance of the benchmark index, which returned c. -4.4%.

Fig.4: DIG: NAV Total Returns Relative To Peer Group And Benchmark



Source: Morningstar

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Dividend

DIG currently yields c. 4.3% (as at 16/02/2021) on a historic basis, slightly under the unweighted sector average of c. 4.7% (Source: The AIC). DIG has increased its dividend in 36 of the last 40 financial years and maintained dividend levels in the other four financial years.

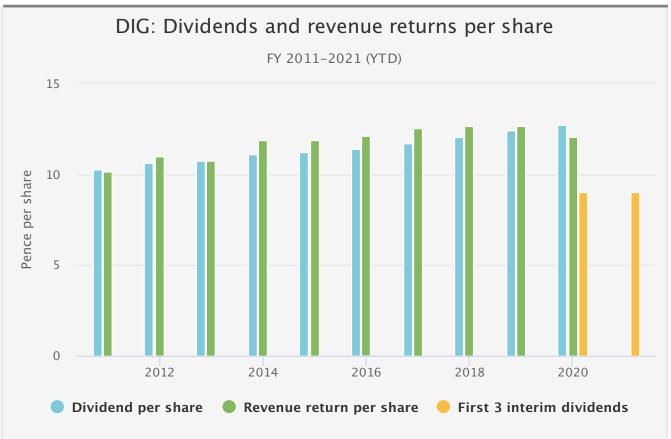
As discussed under **Portfolio**, there has been a strategic shift in recent years in the portfolio strategy. Where previously there was a focus on maximising income distributions, there is now a greater focus on ensuring the portfolio exhibits dividend growth whilst accepting that this may have sacrificed (and may sacrifice) some dividend income in the meantime. This view was founded on an acceptance amongst both the board and management team that distribution levels in the UK market were unsustainably high. With the Link Dividend Report estimating that UK market dividends fell by c. 44% over 2020 and a raft of dividend cuts amongst many significant contributors to index level yields, this view has been vindicated.

Despite the strategy shift, revenue returns continued to consistently cover dividend distributions before a shortfall occurred in financial year 2020 (ending 31/01/2020). However, such an event had been anticipated by the board, with revenue reserves accrued in prior years with a view to facilitating the strategy shift should any shortfall occur and ensuring the management team had maximum flexibility to implement the new investment strategy. Revenue reserves at 31/07/2020 were reported as equating to c. 17.1p per share, equivalent to c. 1.3x the full FY 2020 dividend.

However, subsequent interim dividend payments have been made. When we account for the subsequent interim dividends and deduct the declared final dividend, and 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. 0.74x the FY 2020 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.

Although we accordingly think it is likely, given the severely adverse income backdrop in the UK market, that the revenue reserve will be utilised further in the remainder of the financial year, we note that at the interim reporting period revenue returns had proven relatively resilient. In the six months to 31/07/2020, revenue returns per share declined by just c. 8.6% compared to the same period in the previous financial year. The first three interim dividends of FY 2021 totalling 9p per share, have been declared, which is in line with FY 2020. Currently, the difference between ex and cumulative income reported NAVs indicate that DIG has accumulated c. 1.85p per share of retained income.

Fig.5: DIG: Dividend And Revenue Returns Per Share



Source: Aberdeen Standard Investments

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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 historic 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.

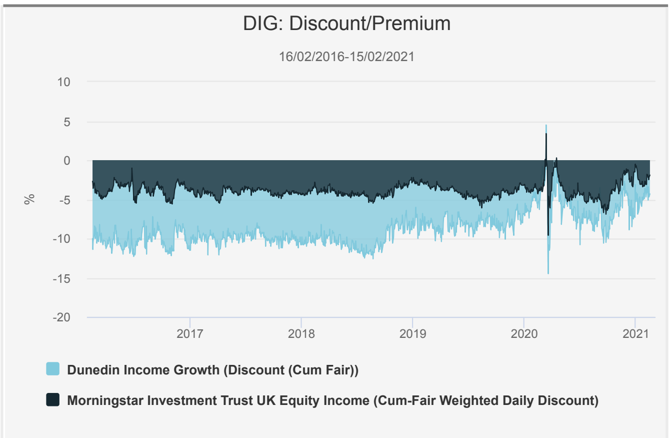
Discount

DIG presently trades on a discount of 4.3% (as at 16/02/2021). In line with the Morningstar UK Equity Income sector, DIG has seen its discount narrow in recent months. However, it remains wider than the peer group. Whilst the current discount is notably narrower than has typically been the case over the previous five years to 16/02/2021, where the discount has averaged c. 8.8%, we can see in the graph below that there has been a general trend towards a slightly tighter discount over this period (with a three-year average discount of c. 7.9%).

We understand that DIG's discount is under regular scrutiny from the board, which seeks to ensure that the strategy is attractive to the market. The board has also proven itself willing to buy back shares to limit any discount widening and support liquidity. In the current financial year to date (31/01/2021-16/02/2021), the board has not yet repurchased or issued any shares. In FY 2020, the board repurchased 22,449 shares for treasury at a discount of c. 8.2%.

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.

Fig.6: Discount



Source: Morningstar

Charges

DIG's OCF of 0.59% is slightly below the 0.81% average of the UK equity income sector (Source: JPMorgan Cazenove). This is 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 c. £441m, the management fee at present is c. 0.40%. The KID RIY figure is 1.72%, relative to the sector weighted average of 1.42%, 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 an output of this, 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. In recent years, this has been increasingly formalised as part of the portfolio construction process, and ESG considerations are now an embedded element to analytical coverage and research note production.

Every investment team across ASI 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 this opportunity to further understand how environmental and social risks to each business are understood and addressed by company management teams. In keeping with their general preference for defensible business models with high barriers to entry, Ben and Georgina believe that management teams best able to manage ESG risks to their business will likely be in the best place going forward to ensure they can continue to grow the business.

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