Standard Life UK Smaller Companies

Update
02 January 2019

Summary

Standard Life UK Smaller Companies is a relatively concentrated portfolio of quality growth stocks held for the long run, with a long-term track record of outperformance.

The manager, Harry Nimmo, has run the strategy since 1997 for the trust's sister open-ended fund and since 2003 for the trust itself. Historically, much of his outperformance has come in falling or flat markets.

Stock selection leans heavily on quantitative screens, with Harry analysing the output of a proprietary scoring system, called the Matrix, which assesses numerous metrics, and then meeting company management and investigating the strength of the company's business model.

The last 12 months have seen the trust outperform in NAV total return terms, despite the sell-off in the autumn hurting some of the trust's largest positions disproportionately.

At 8%, the discount is tighter than the sector average, as has been the norm, although it is wide compared to its own recent history. The board targets 8% as a lower limit and has been active with buybacks when it has gaped wider.

The yield is 1.7%, but dividend growth has been strong over ten years, and the manager aims to continue to grow it year on year.

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Portfolio

The trust typically owns a concentrated portfolio of 50 to 60 stocks that are selected mainly for quality, growth and momentum characteristics. Harry aims to buy tomorrow's larger companies when they are small, looking for stocks with proven business models and recurring revenues and aiming to hold for an average of six to seven years.

In October 2018 the trust merged with Dunedin Smaller Companies Trust PLC, a smaller companies trust run by Aberdeen prior to the merger with SLI in 2017. The trust thereby gained c.£147m in additional capital. After the merger had been agreed but prior to completion, the Dunedin portfolio was refashioned as Harry wanted it, which meant that the costs of the merger were borne by Dunedin shareholders, whose trust was trading on a far wider discount. As a result of the process, the number of stocks has ticked up to 58, with Harry retaining nine new holdings from the Dunedin portfolio. These were companies which Harry had owned previously in the past and knew well but had not owned on valuation or size grounds in recent years.

Harry's process is designed to limit the reliance on the fallibilities of human fund managers, with an emphasis on the quant screening done by "the Matrix". This is a screening system that analyses and weighs many factors in 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.

Harry looks at the output of the screens and then looks to test the results, meeting with company management, analysing the business model and looking at the strength or otherwise of the company's position in its industry. He normally avoids oil and gas stocks, even when they are sometimes flagged up by the screens, as he believes they tend to be too risky and often too dependent on a single site or single country's political or economic situation.

Harry believes in running his winners and a number of the most successful stocks in the portfolio have been there for many years. For example, Abcam has been held since 2007, and Fevertree was bought at IPO in 2014. He does not rush to exit his stocks when they grow out of his universe, but sells down slowly, avoiding being seen as a forced seller by the market and taken advantage of.

The merger with Dunedin allowed Harry to dilute his position in some of his largest stocks quickly and efficiently – large holdings NMC Health, Fevertree, First Derivatives and Dechra Pharmaceuticals were not added to in the Dunedin portfolio. He has also allowed cash to build up a little.

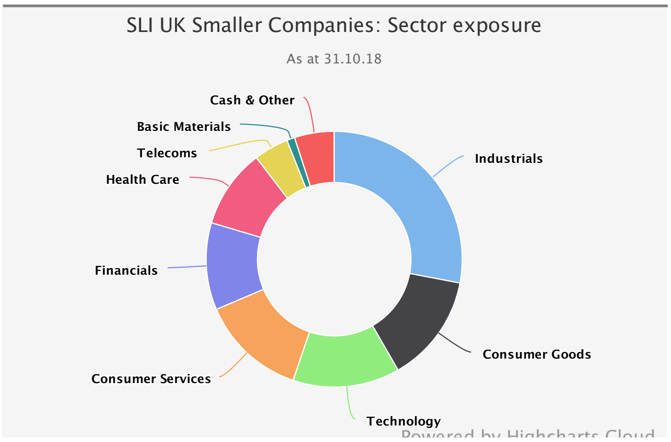
Harry believes that low risk leads to higher returns in smaller companies, and this is borne out in the volatility of NAV, which is in the lowest quartile of a combined closed-ended and open-ended peer group. In keeping with the low-risk approach, he steers clear of "blue sky" companies, which are those which have yet to record a profit, allocating a maximum of 5% to companies yet to prove their business model can be profitable.

Over recent years a growing proportion of the fund has been invested in AIM-listed businesses; it is currently just over 40%. Harry has found more opportunities there as the market, which used to be dominated by oil and mining companies and fads, has matured.

Since the 2016 EU referendum, Harry has shifted the portfolio towards companies with overseas earnings; currently 55% of the sales of the stocks in the portfolio are from overseas. This helped the portfolio through 2017 as the weak pound meant that foreign earnings were worth more translated back into sterling. This move was prompted by the signals from the Matrix flagging up these stocks rather than an "override" from the manager. Harry says that there has been a levelling out of this trend and the overseas earnings share is no longer growing, although not falling.

Sector allocations are an output of stock selection. The latter has led the portfolio to be most exposed to industrials and consumer services.

Fig.1: Sector Allocation



Source: Aberdeen Standard Investments

Important sectors to the portfolio include software companies, healthcare and food and drink. Within food and drink Harry notes that the trends towards premiumisation and knowledge of provenance have been beneficial to the trust. For example, Cranswick and Hilton Foods have both benefitted from the extra attention paid to the source of supermarket meat since the horse meat scandal, while Hotel Chocolat and Fever-Tree are benefitting from the premiumisation trend. Within healthcare, pet healthcare is a winning theme: CVS provides veterinary services, while Dechra and Eckoh Animal Health both operate within animal pharmacology.

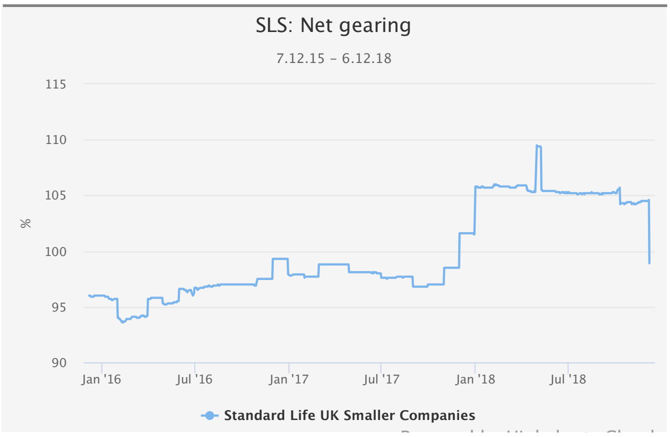
There has been higher turnover in holdings in 2018 than in previous years, thanks to the merger with Dunedin Smaller Companies and also Harry's trimming of some of the larger positions to reinvest in newer ideas. From Dunedin, Harry inherited Victrex, a manufacturer of high-performance polymers which has a stable niche market seeing strong growth and reported good results in Q3. This has done little for the share price, however, which has been under pressure in a falling market. Similarly, Robert Walters, the recruitment business, generates 15% to 20% of its revenues from Japan which is fast becoming a good market for recruitment due to their labour shortage, has reported excellent numbers this year, but the shares haven't responded as market sentiment has dominated stock-specific fundamentals.

The SLI team run a large amount of money in small caps, the result of many years of outstanding performance.

Gearing

Harry does not anticipate using significant levels of gearing unless or until the market cycle turns and recovers, and presently the portfolio is net cash. This is partly due to Harry's caution about the current market and partly to support the discount to NAV, which has opened up in recent months. However, he has facilities on hand to be used when opportunities arise.

Fig.2: Gearing



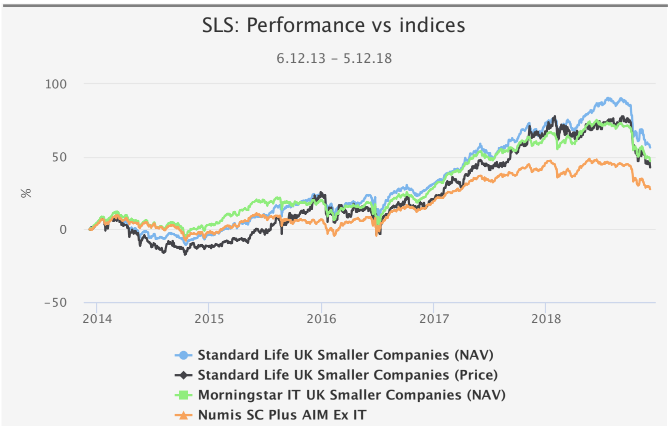
Source: Morningstar

The board has arranged £45m worth of borrowing facilities until October 2022. Of this £25m is in long-term debt fixed at a lower cost of 2.35%. This is drawn down but currently uninvested. The remainder is a revolving facility to be employed tactically and currently not drawn down at all.

Returns

Over the long run Harry's track record with this company is excellent. Over the past decade the trust has returned an average 18.9% a year in NAV total return terms, compared to an average of 16.8% for the closed-ended peer group and 16.6% for the open-ended sector. However, a poor 2014 means the five-year numbers show relatively limited outperformance. In 2014, the trust was hit by outflows from FTSE 250 trackers, as many of its holdings were in the FTSE 250, as well as by some stock-specific disappointments such as ASOS.

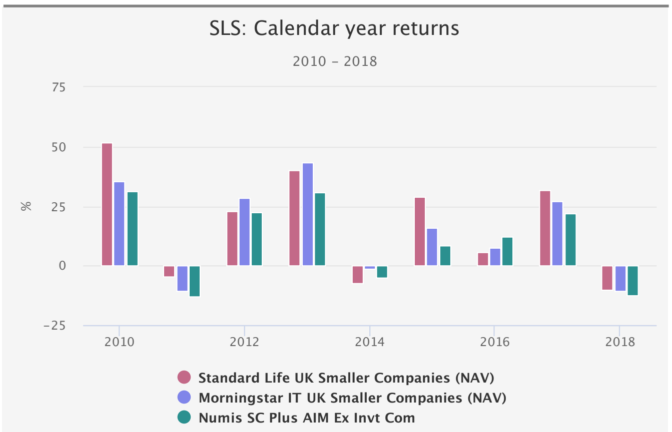
Fig.3: Five-Year Performance



Source: Morningstar

In the even longer term, the trust has tended to outperform in flat or falling markets and lag in the strongest rallying markets such as 2004, 2009 and 2013 due to its focus on quality stocks. It lost considerably less than the index in 2008 and fell half as far as the wider market in 2011 when the European sovereign debt crisis intensified.

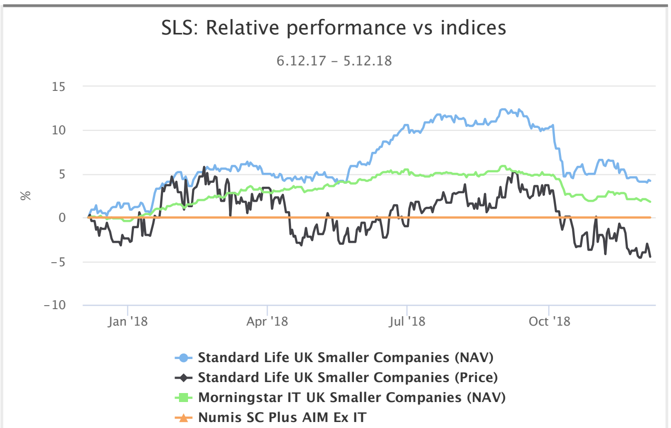
Fig.4: Annual Returns



Source: Morningstar

The trust's NAV has outperformed the sector and index over the last 12 months despite underperforming in the sell-off in September and October. In the below graph a rising line denotes outperformance and a falling one underperformance. In those months some of the largest contributors became detractors as the market leaders sold off disproportionately. Fevertree, First Derivatives and NMC Health were all top contributors in the year to the end of June but underperformed the market significantly in the autumn sell-off. These stocks were all being sold down prior to the slump in the market and continue to be sold on size and cost grounds.

Fig.5: One-Year Relative Performance



Source: Morningstar

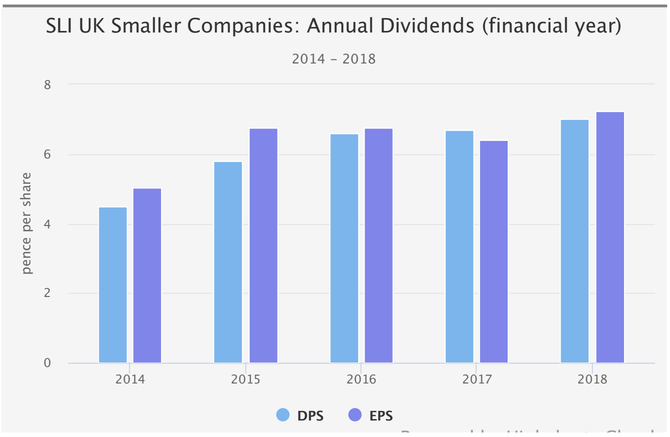
Not all of the stocks that have underperformed are those that Harry wants out of. In general, the price momentum factor which his style makes use of has gone into reverse and hurt the portfolio in the recent sell-off. However, given his momentum style, he does not look to "buy the dip", but will rather wait for the stocks to rebound before building back up the position. This helps explain the build-up of cash, which will be put to use once an upward trend in the stocks reoccurs.

Given the increasing importance of AIM stocks to the portfolio, the trust changed its benchmark to the Numis Smaller Companies plus AIM ex IT in June 2018.

Dividend

Harry does not target a dividend per se, and the yield on the portfolio is only 1.7%. However, an outcome of his process is to lead him to stocks with strong earnings growth, which in practise frequently means strong dividend growth too. Over the five years to 30 June 2018, dividends have grown at 9% a year. The full year dividend for 2018 was 7p up from 6.7p in 2017, and the dividend was fully covered by revenue, which is reassuring after 2017's dividend was uncovered. The trust had reserves worth 39% of last year's dividend at the end of the last financial year in June.

Fig.6: Dividends



Source: Morningstar

Dividend growth has slowed over the past couple of years thanks partly to a falling number of special dividends from the portfolio companies. Harry has also been selling down some of the larger stocks in his fund as they grow too big and recycling the money into smaller companies which may be growing their dividends faster but from a lower base. He expects long-term earnings growth to be between 10% and 15% per year on his portfolio and thinks it's likely dividend growth will settle around this figure.

Management

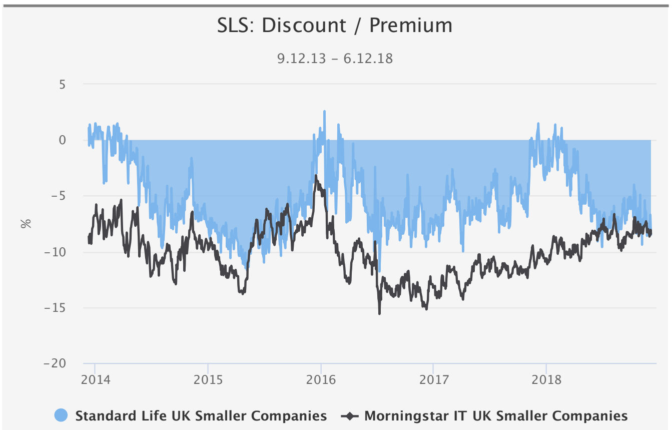
Harry Nimmo has managed the trust since SLI took over management in 2003, having run this strategy since 1997 on the open-ended sister fund. Harry joined SLI in 1985 just after university, and has worked on UK equities since then, taking over responsibility for small-cap equities in 1993. This means 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 to this trust, Harry now runs over £2bn in line with this mandate.

Discount

The trust is currently sitting on an 8% discount, the deepest discount permitted by the board. Two factors have weighed on the company's discount this year: the conversion of convertible unsecured loan stock (CULS) into common equity at the end of March and the purchase of the portfolio of Dunedin Smaller Companies which was announced in June and completed in October.

Although Dunedin Smaller Companies was an underperforming portfolio, it was brought into line with SLS before it was absorbed, and so there was no dilution of performance and none to be expected. However, we think it possible there are some shareholders of either trust which have decided to sell out and this has weighed on the share price. This coincided with a testing period of performance for the market and relative performance of the trust thanks to its style.

Fig.7: Discount



Source: Morningstar

This means the trust is trading on a wider discount than its sector, a rare occurrence. The long-term trend is for the company to trade on a tighter discount than its peers, and NAV performance this year has actually outstripped its peer group average, albeit in a falling market.

We would note that the trust traded on a premium, albeit briefly, as recently as last December, at which point the board was considering issuing equity. Since 2007 the trust has almost always traded at a tighter discount to NAV than its sector. Indeed, it has traded on a premium on a number of occasions since 2010.

Charges

The OCF is 1.04% compared to a sector weighted average of 0.73%, according to JPMorgan Cazenove . However, there is no performance fee, 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 and 0.65% on the next £300m and 0.55% thereafter, so the growth in the trust is being charged at a lower rate. The asset base has grown by 20% since the OCR was last reported.

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