Aberdeen Smaller Companies Income

Update
01 February 2019

Summary

Aberdeen Smaller Companies Income aims to generate an income and capital growth from investing predominantly in UK smaller company equities. The trust currently yields 3%, with a fully covered dividend.

As well as an income, the trust's portfolio offers high exposure to quality growth characteristics in pursuit of its capital growth objective.

Since September the trust has been run by Abby Glennie, one of the two UK small cap managers in the Standard Life Smaller Companies team, which has an outstanding track record of generating strong total returns with a quality growth style.

The portfolio transition is almost complete, with many key holdings being retained for their quality growth characteristics. The level of portfolio transactions may remain slightly elevated in the short term as the tail of less preferred stocks are rotated into higher quality businesses.

The trust also owns a portfolio of bonds and preference shares to help boost the yield, although these only make up around nine per cent of the portfolio. We understand that this percentage is unlikely to rise in the near future given yields in those markets remain relatively low.

The trust is trading on a discount of 17%. This is a step back, as it had come in following the change of manager, before the global sell-off in Q4 last year saw it move wider again.

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Portfolio

Aberdeen Smaller Companies Income aims to generate an income and capital growth by investing predominantly in UK smaller company equities. The trust also invests in bonds and preference shares to help boost the income, but these make up only around 8% of the trust, a figure which is unlikely to grow much in the short term given the low yields available in the market.

The trust was taken over by the Standard Life Smaller Companies team in September of 2018 following the merger of Standard Life and Aberdeen in 2017. The new lead manager is Abby Glennie, who runs the trust in line with the quality growth, franchise which Standard Life have had much success with on their funds run by Harry Nimmo, including the **Standard Life UK Smaller Companies** trust.

The process leans heavily on a proprietary screening system (aka The Matrix), developed within SLI prior to the merger. The Matrix analyses the financials of all the stocks in the smaller companies universe on a number of key metrics, including EPS growth, price momentum, P/Es and yields, directors dealings and metrics measuring balance sheet quality. Key elements to the final score include earnings revision and momentum-related characteristics. Valuation metrics are given limited importance, as the team believe they do not work well in the smaller company sphere.

In the case of Aberdeen Smaller Companies Income, Abby also applies filters on the income generating characteristics of the companies. This tends to tilt the trust back towards more defensive companies as well as the larger names in the index as these have the higher yields in the small-cap universe. However, there is no yield target, and capital growth is a key objective too, so the growth and quality biases still show in the holdings.

Quality And Growth Characteristics

	ASCI	FTSE SMALL CAP
ROE (5yr)	16.7	11.1
Operating Margin	19.2	15.6
Net Margin	16.4	10.4
Debt / Equity	0.4	1.1

Source: Aberdeen Standard, as at 31.12.18

Quality is likely to be given more emphasis in 2019 due to the volatile nature of markets. Cash generation is a critical component of a quality business, in Abby's view, and in poorer markets especially this gives companies resilience, with the ability to invest in their operations while others are struggling. Higher yielding businesses also tend to be more exposed to quality than growth factors, so we expect this to be a longer-term tendency of the trust.

The team will always prefer 'low risk' smaller companies, meaning those with sustainable profits and manageable levels of debt. They have a tendency to run their winners, which means turnover should be low; the aim is for a three to five year holding period. For comparison's sake, although clearly the strategies are not identical, the turnover on the Standard Life Smaller Companies Trust has averaged 23% over the past three years. Short term, turnover is likely to be higher this year thanks to the change of management, although Abby tells us that she found most of the portfolio scored highly on the screens and many names were worth retaining. In many cases, the stocks which the previous manager held but the SLI team didn't in their other funds were ones which they had previously owned. In some cases, liquidity concerns had prevented them owning them and in other cases the team was becoming interested in buying back in anyway. As such, between August and December, two stocks were sold completely and six reduced. There were seven new holdings added and three increased significantly. The resulting portfolio has 51 total holdings.

One addition was Midwich, an audio and visual equipment distributor. This stock exemplifies well many of the characteristics that Abby prizes, in particular, the ability to expand into adjacencies, which means that a company can continue to grow faster than the market might expect on the numbers alone. In the case of Midwich, it is expansion into Europe which is delivering the growth as well as into different product lines. Midwich is also founder-owned, a quality which the manager likes as it implies management loyalty and long-term thinking.

Another addition was recruiting business FDM Group, which had been owned since IPO in the SLI funds. FDM trains job-seekers in specialist technology roles and places them with industry on short-term contracts. The highly successful business is growing well internationally, including in Asia and the US.

The trust can also invest up to 10% outside the UK, which Abby uses to boost the yield when she finds appropriate opportunities. There are three team members dedicated to global small caps and two to European small caps who provide the ideas. The same quant screens are applied to ex UK stocks too. Some non dividend-payers are held if the manager believes a dividend is likely in the future. There are currently two, including Irish property company Cairn Homes which Abby expects to pay a dividend in 2021.

Holding the higher-yielding preference shares ensures stocks like this don't bring the portfolio yield down too much. There are currently two bonds in the portfolio, which yield 4.1% in aggregate on a running yield basis, and four preference shares yielding 7.3%.

Fixed Income Portfolio

	# OF INVESTMENTS	% OF PORTFOLIO	RUNNING YIELD (%)
Bonds	2	1.5	4.1
Pref shares	4	6.2	7.4

Source: Aberdeen Standard, as at 31.12.18

The portfolio derives two thirds of its income from twenty names, including three preference shares, illustrating that there is a good blend of quality, growth and income characteristics across the holdings.

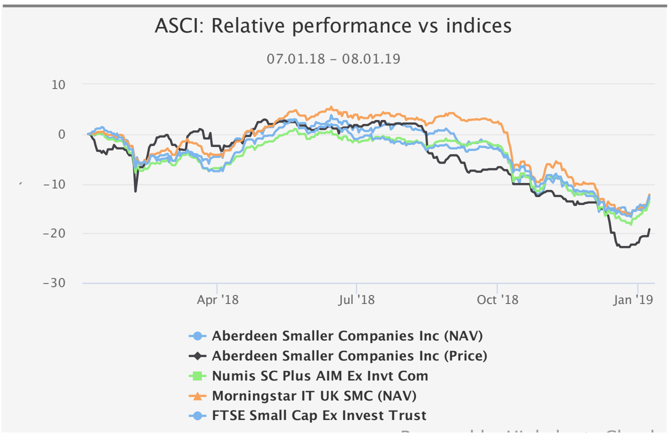
Gearing

On a gross basis, gearing has been held consistently at £7m, or 11% of NAV at the current time, although there have been some minor movements on a net basis thanks to changes in cash levels. The trust has a £5m five-year loan, so this much of the debt is structural. The loan was renewed in April 2018 and now matures in 2023. The remainder is drawn down from a £5m revolving credit facility which could be paid off at any time. Historically, the gearing has been invested in the fixed income and preference shares, although the size of that portfolio has been falling in recent months, to 7% of NAV, as the new manager believes the yields are currently relatively unattractive and as such, the trust has a small geared exposure to equities.

Returns

Over the past year the trust has performed significantly better than the sector average. This is largely due to the trust falling less than its peer group in December and bouncing higher in January. Contributors here included top ten holdings Burford Capital, which bounced 9.4% in December, Telecom Plus up 4.8%, and DiscoverIE, up 2.3%. The trust has returned slightly less than its FTSE Small Cap ex IT benchmark over the period, -13% to the -12.5% of the benchmark. However, it has slightly outperformed the Numis Smaller Companies plus AIM index, which returned -13.6%.

Fig.1: One-Year Performance



Source: Morningstar

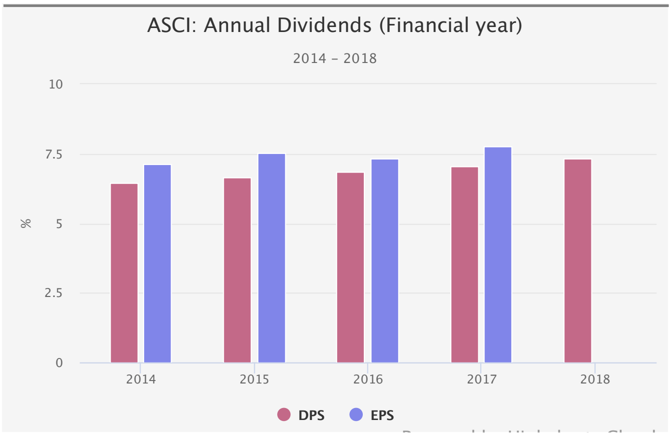
The Numis index has become a fairer representation of the trust's opportunity set over time in our view (there was only 24% exposure to the FTSE Small Cap as of 31 October 2018), although there has been little difference in returns over this rough period for small caps.

The long-term performance track record reflects the strategy and approach of the previous management team. In 2017, good stock-picking meant the trust outperformed in a strong year for the UK small cap market, which was one of the top performing asset classes globally. The focus on growth and quality also helped in the year. Five-year returns are in line with the sector but significantly ahead of the Numis plus AIM ex IT index.

Dividend

One objective of the trust is to generate a high and growing dividend from UK small caps. The yield is currently 3% thanks to the 17% discount, but on NAV the payout would equal just 2.6%. The current discount could therefore be an opportunity for income-seekers to get a diversifying source of dividends from a smaller companies portfolio with good growth potential. The yield on the Numis plus AIM ex IT index is 3%, for comparison. We note that dividends have continually grown in recent years (3.3% per annum over the past five years) and been fully covered by income.

Fig.2: Dividends



Source: Morningstar

The 2018 dividend was 4.2% higher than the 2017 payout, but growth might be more modest in 2019. This is because the trust received substantial special dividends from Victrex and Aveva during the year which will not be repeated.

Management

The trust is now managed by Abby Glennie, who is one of two UK small cap managers on the Standard Life small cap team which took control of the portfolio in September 2018. Harry Nimmo is the other UK small cap manager. Abby previously managed large cap portfolios, having joined Standard Life from Aegon (now Kames) in 2016.

Abby works alongside Harry in the small cap team which also boasts two European focused analysts / PMs. All use their proprietary Matrix screening system which is overseen by a dedicated senior quantitative analyst. The team runs over £2bn in UK small caps, which gives Abby excellent contact with management teams both for prospective holdings and current ones (the team meets twice a year with the companies they own).

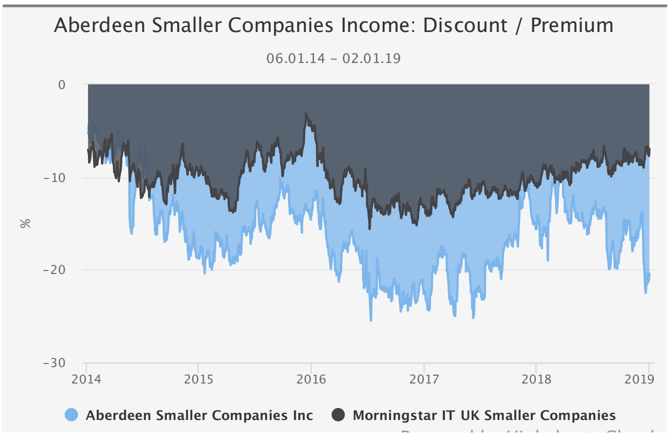
The long-term track record of Standard Life UK Smaller Companies Trust illustrates the value of the process which Abby will be using. Since taking over the trust in September 2003, the SLI team led by Harry Nimmo has generated NAV returns of 14.6% a year compared to 6.8% for the Numis Smaller Companies Plus AIM ex IT Index. The equivalent index without the AIM stocks has made 8.4% a year, with AIM having been a hindrance rather than a help in the first part of this period.

Discount

The trust is trading on an intriguing discount of c17%. This is back near where it was trading prior to the announcement of the merger between SLI and Aberdeen, which raised expectations the trust would be influenced more by the highly regarded SLI small cap team and saw the discount narrow.

Standard Life Smaller Companies trust has had an average discount over the past five years of 5.6%.

Fig.3: Discount



Source: Morningstar

Charges

The OCF of the trust is 1.35%, compared to 1.01% for the average UK smaller companies trust and 1.04% for Standard Life Smaller Companies Trust. Given the trust is quite small, fixed costs are higher as a proportion of net assets, which explains the higher charges. However, the management fee is 0.75% of gross assets, around average for the smaller companies sector. Management fees and the cost of debt are charged to capital (70%) and to revenue (30%).

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