Alliance Trust

ATST's diverse core equity offering has outperformed its peers in today's bear market...

Update

08 September 2022

Overview

Alliance Trust (ATST), under the management of the global investment consultancy Willis Towers Watson (WTW), brings together a group of sophisticated investment managers from across the world into a single highly diversified global portfolio. ATST's portfolio has been constructed with the intention of creating a 'core' equity offering, where thanks to WTW's process, the trust demonstrates no material stylistic overweights relative to its benchmark the MSCI ACWI, while still retaining the stock-picking skill of its eight delegated managers. We describe the allocation process of WTW, as well as the company's current market views, in our **Portfolio section**. While ATST has yet to remove a manager based on performance concerns, they have removed them due to changes in corporate ownership.

While ATST's diversification in a concentrated market has historically hindered its relative **Performance**, thanks to the substantial increase in market risks over 2022 it has instead become a major tailwind. ATST has been able to substantially outperform its peers year to date while still keeping pace with wider equity markets, having weathered the sell-off in mega-cap growth stocks better than its peers. ATST has also commanded a more resilient **Discount** than its peers have, having not seen the same year-to-date widening that its global peers have. ATST currently trades on a 7.9% discount, compared to the 10.1% of its peers.

A major change to ATST over the last year has been a significant increase in its **Dividend**. The board has elected to increase the overall payment by 32.5% over the prior year's, capitalising on the flexibility afforded by its substantial reserves. ATST currently has a yield of 2.3%.

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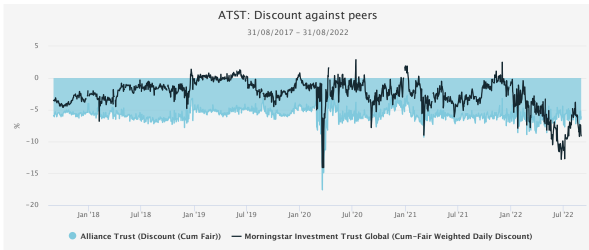
Key Information:

Price (p)	947
Discount (%)	-7.9
OCF (%)	0.61
Gearing (%)	5
Yield (%)	2.1
Ticker	ATST
Market cap (£)	2,807,870,152



Kepler View

We believe that ATST reflects a true 'fire and forget' equity portfolio, one which is best placed as a 'core' exposure in a portfolio. Ideally, this would be used by investors looking to increase their overall equity exposure without having to choose which specific style, region or sector to overweight. We believe ATST may be particularly attractive to long-term, low-turnover investors, as the responsibility for manager selection is effectively delegated to WTW, thus simultaneously removing any concerns about 'style drift' within the portfolio given WTW's historical success in ensuring the trust has no style biases relative to benchmark.

We are also encouraged by the board's own efforts in ensuring that ATST remains aligned to shareholder needs, further reinforcing the idea of its being a 'core' allocation. This has been shown through both the board's continuing commitment to improving ATST's ESG integration and the recent increases in the trust's dividend profile.

We think that the major attraction of ATST is its ability to offer what WTW believes are amongst the best stock-pickers available to it. The current market environment has brought an end to the dominance of growth stocks, with WTW's views on the dangers of market concentration being vindicated as a result. If this is the start of an unwinding of the historical headwinds that WTW's style of investing has faced, then ATST may have the catalyst it needs to continue its outperformance. Once dominant style factors dissipate, this may give a chance for effective stock-picking to become the major driver of ATST's portfolio returns.

BULL
Relative performance has improved year to date, despite the market downturn
Dividend profile has improved
Offers a compelling choice as a 'core' equity allocation

BEAR
Can underperform during stylistically driven markets
Gearing can enhance losses on the downside
'Core' investing styles can lack diversification relative to other equity strategies

Portfolio

Alliance Trust (ATST) gives investors access to a range of sophisticated investment managers from across the world, each with a different style, brought together in a well-diversified investment strategy which has been intentionally designed to function as a 'core' equity holding. Crucially, ATST does not overly expose its shareholders to any one investment bias. ATST's capacity to be used as a 'core' holding is only enhanced by the actions of its board, which continues to ensure the trust remains aligned to shareholder interests, be that through ESG integration or a recently improved **Dividend** profile.

ATST is managed by a team of seasoned investment professionals at Willis Towers Watson (WTW), one of the world's leading consultancy firms. ATST's portfolio is the ultimate responsibility of three managers: Craig Baker, Stuart Gray and Mark Davis. The managers are able to leverage WTW's considerable roster of investment analysts, who have been able to scour the world's leading investment managers to create a shortlist which they believe represents the best stock-pickers available in the market today. The reach of WTW is key in this regard and one of the distinguishing features of ATST for retail investors, as some of these managers are not available to UK retail investors, making the trust the only way that they can benefit from their stock-picking skills. Thanks to the reach of WTW and the team's approach to portfolio construction, the team believe that ATST's portfolio is effectively impossible to recreate without the aid of WTW.

WTW's approach to manager selection is based on a philosophy of identifying a variety of managers of different styles which are not only the best stock-pickers amongst their peers, but are also aligned with the interests of their shareholders. This means that WTW will assess factors like team dynamics and behavioural characteristics. This type of analysis sits alongside more conventional analysis, such as ensuring the managers remain scalable, that they have a well-structured team and succession plan in place, and that they have demonstrated a long history of generating outperformance within their chosen investment styles. The culmination of WTW's due diligence is the construction of a 20-manager buy list for ATST, made up of managers WTW believes are not only amongst the best at what they do, but can also be relied upon to sustain their advantage into the future. Since taking over the mandate, WTW has so far made no changes to its chosen managers on performance concerns. There has, however, been one major change to ATST's portfolio recently, that being the loss of the River and Mercantile (R&M) team. Their removal was the result of the change in R&M's corporate structure brought about by its new owner AssetCo, which WTW believed was no longer conducive to shareholder alignment.

When it comes to selecting the managers which make up ATST's final portfolio, the WTW team comment that there is no magic number for the roster, and rather that the number should reflect a sufficiently diversified range of styles so as to allow for appropriate diversification and to capture the major market drivers in a given cycle. Currently the team have allocated across eight managers and nine distinct styles:

Delegated Managers

MANAGEMENT COMPANY	STYLE	CURRENT WEIGHT
GQG Global	Looks for high-quality and sustainable businesses whose strengths should outweigh the macro environment.	21%
GQG EM		
VERITAS	Thematic investing to identify companies and industries that are well positioned to benefit from medium-term growth.	14%
BLACK CREEK	Value-orientated buyer of leading businesses. Long-term contrarian approach.	13%
JUPITER	Seeks out-of-favour and undervalued businesses with prominent franchises and sound balance sheets.	10%
SGA	Seeks companies that have strong pricing power, recurring revenue generation and long runways of growth.	11%
METROPOLIS	Focusses on businesses undervalued by the market. Returns come from a combination of the closing of the 'value gap' and increases in the intrinsic value of the businesses.	10%
VULCAN	Focusses on finding quality businesses that have the ability to compound in value over the long term.	8%
LYRICAL	Focusses on businesses with attractive capital returns and the flexibility to react to all phases of the business cycle.	7%
SANDS	Follows a purely growth-orientated philosophy with a focus on finding high-quality, wealth-creating businesses using a fundamental, bottom-up research approach.	6%

Source: Alliance Trust

Other than offering a selection of best-in-class managers, ATST is also defined by its on-benchmark risk exposures, whereby the WTW team will aim to weight their delegated managers in such a way as to minimise the factor biases of the trust relative to its benchmark the MSCI ACWI. Such factors include momentum, valuation, growth, quality and market cap. This process of diversification is more of an art than a science, however, and WTW ultimately wants to ensure that the portfolio is an honest reflection of the fundamental strength demonstrated by the underlying companies selected by the chosen managers. This means that despite the lack of stylistic bias, ATST is still an actively managed portfolio, as demonstrated by its 78% active share. One of the few current overweights within the portfolio is the 12% allocation to the UK, an 8% active position. This overweight partially reflects the valuation opportunity many of the delegated managers believe is presented by UK stocks, which were previously unloved due to perceived Brexit risks. ATST's large allocation to the UK is also a result of the trust's allocation to Jupiter Asset Management, whose dedicated UK equity portfolio has come back into favour recently. WTW comments that elsewhere a small subset of its managers have begun to make substantial adjustments to their stock selection in the light of a rapidly changing market environment. For example, GQG has rotated out of high-growth stocks and into the energy sector, with a c. 40% turnover over the last 12 months.

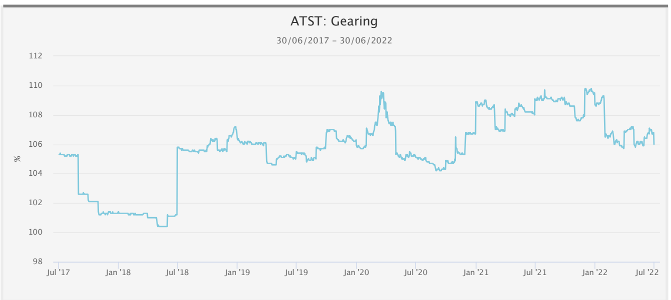
While the combination of active management and on-benchmark risks is key in making ATST a 'core' equity offering, at its essence it is a story of fundamentals rather than factor bets, with the WTW team's confidence being driven more by the reported earnings of their underlying holdings than by macro sentiment. To that end they have highlighted in recent conversations that they are pleased with the underlying growth of their companies' fundamentals, with the improving quality of their holdings being a ubiquitous feature across all managers. Given the focus on fundamentals, the WTW team's views around the current market are more centred around how companies are reacting to the current major macroeconomic forces than around the source of these forces themselves.

One of the defining features of ATST has long been its underweight to mega-cap stocks, which has previously held the trust back. WTW's team believe the current market may give way to an environment which is more suited to stock-picking than it has been for a while. In the medium term this leaves the playing field open for active managers to further outperform. However, in the near term the WTW team are more sanguine around the direction of equity markets, believing it is still too early to call the bottom.

Gearing

ATST utilises a combination of long- and short-term gearing, with the overall effective level being set by the board. The board has brought down ATST's gearing over 2022, reflecting the increased risks surrounding global equity markets. ATST currently has net gearing of 6.2%, which is unlikely to be increased until the board is more confident about the prevailing market environment. While this figure is marginally higher than the trust's five-year average net gearing of 5.7%, it is still within two standard deviations of the average. Given that ATST has £160m in fixed rate loans outstanding, which mature on a range of dates between 2029 and 2053, there is effectively a minimum 5% level of gross gearing.

Fig.1: Five-Year Gearing



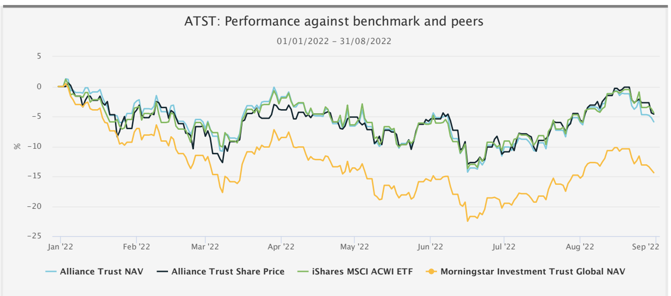
Source: Alliance Trust

Performance

2022 has seen global markets witness a significant bear market, and while ATST has not been able to entirely avoid the sell-off, its balanced approach has been a relative tailwind for the strategy, enabling the trust to start to reverse its previous underperformance. 2022's bear market has been the result of powerful inflationary pressures, as well as specific geopolitical issues like the war in Ukraine and the further outbreak of COVID-19 in China. These have fulfilled WTW's long-held prophecy about the pitfalls of the increasing dominance of a narrow group of large-cap growth stocks. The rise in global inflation, and by extension the rise in interest rate expectations, has disproportionately impacted high-growth stocks, which most mega-cap stocks are counted as.

This means that over this year to 31/08/2022, ATST has generated a year-to-date NAV total return of -5.9% and a share price return of -4.6%. While this is slightly behind the -4.4% return of its benchmark, the MSCI ACWI (proxied by an ETF here), it is far ahead of the -14.4% simple average NAV return of ATST's AIC Global peers. We note that ATST's ability to keep up with its benchmark over 2022 is made all

Fig.2: Year-To-Date Performance



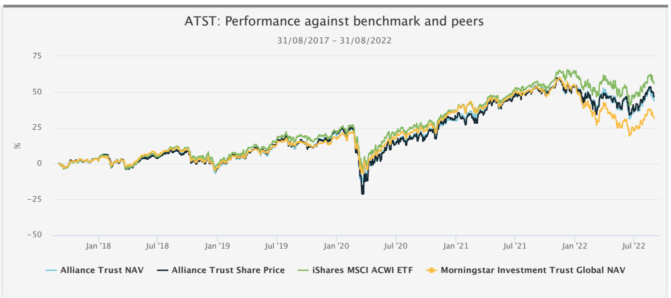
Source: Morningstar

Past performance is not a reliable indicator of future results.

the more impressive by the underlying managers' typical aversion to low-quality equities, a style of investing which has been one of the few ways to generate positive returns year to date.

Over the last five years ATST has underperformed its index. ATST has generated an NAV total return of 43.9% over this period and a share price return of 46.6%, below the 55.8% return of its benchmark. As we mentioned previously, this underperformance is in part due to the dominance of a select group of mega-cap stocks, but also due to the disposal of a number of legacy assets held by the previous manager of the trust, which has been a net drag on performance. However, ATST has outperformed its peer group, which generated a simple average NAV total return of 31.7% over five years. This outperformance by ATST highlights the benefits of a disciplined approach to diversification, as much of the performance gap has been the result of the trust's concentrated growth-focussed peers having fallen substantially during 2022, undoing the past outperformance the average peer had generated against ATST.

Fig.3: Five-Year Performance



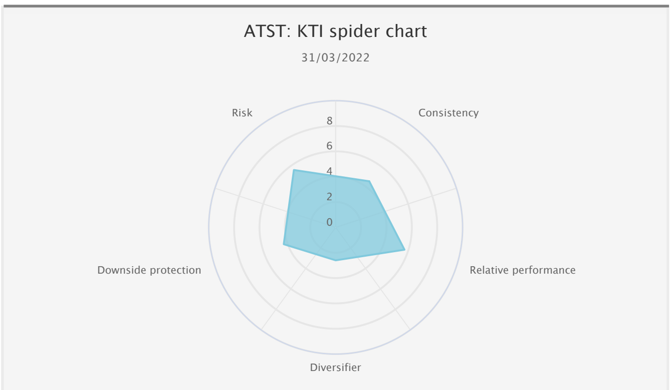
Source: Morningstar

Past performance is not a reliable indicator of future results.

The 'core' nature of ATST's approach is captured by the below KTI Spider Chart. This chart shows how ATST has performed versus an expanded peer group of the AIC Global, AIC Global Equity Income and AIC Global Smaller Companies sectors over the past five years in some key categories. Each category is scored out of ten based on returns over the five years to 31 March 2022. Scores are normalised to the peer group, with higher scores indicating superior performance.

As can be seen, ATST has been able to generate above-average relative performance and risk metrics, indicating a superior risk–return profile than that of its average global peer and exemplifying the benefits of a diversified global equity portfolio while justifying its use as a 'core' equity exposure. The major downside of ATST has been its lack of diversification versus its benchmark. However, this is effectively by design, as any major stylistic deviation has been diversified away from its portfolio, giving it characteristics similar to the MSCI ACWI.

Fig.4: KTI Spider Chart



Source: Morningstar, Kepler calculations

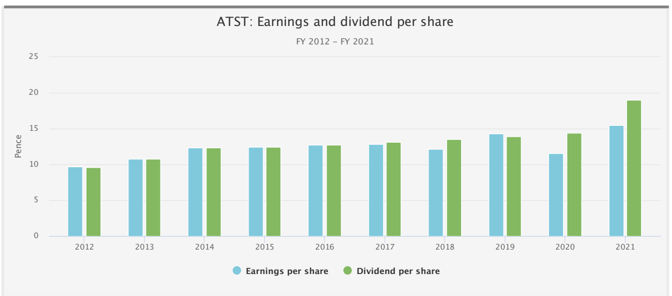
Past performance is not a reliable indicator of future results.

Dividend

As a truly core equity holding, part of ATST's offering to investors has been the provision of a progressive dividend, with the trust having a dual mandate of income and capital growth. While WTW does not manage the portfolio with an explicit income target in mind, and does not utilise dedicated equity income managers within the selection process, the board has nonetheless been successful in its endeavour to provide an income. ATST holds one of the longest track records of consecutive dividend increases of any trust, with 55 years of consecutive increases, ranking it as joint second within the AIC's 'dividend heroes' rankings, a collection of trusts which have managed to grow their dividend for at least 20 consecutive years.

ATST's most recent full-year dividend of 19.05p per share marks a significant 32.5% increase in its dividend versus the prior year's. This increase in dividend was the result of the board making greater use of ATST's substantial £3bn distributable reserve, which was enhanced over its 2021 financial year by the successful conversion of its merger reserve into a distributable reserve. As a result of the increase in the payout, ATST's 2021 dividend was not fully covered by revenues and required the use of £10.5m to fund. We note that prior to the outbreak of COVID-19, ATST had historically paid out a dividend which was largely in line with the revenues generated by the trust. ATST

Fig.5: Revenue And Dividend Per Share



Source: Alliance Trust

currently yields 2.5%, which is slightly above the 2.1% simple average yield of the AIC Global sector. While a consistent source of income is an attractive feature of any trust, ATST's yield may be insufficient for dedicated income investors, given the 3.6% average yield of the global equity income sector.

Management

The board delegated the management of ATST to Willis Towers Watson (WTW) in April 2017. WTW is a global provider of investment management advice and solutions tailored to the specific needs of clients, with $168bn of assets under management and $3.4tn under advice. WTW's services are typically reserved for professional clients such as pension funds, insurance companies or sovereign wealth funds. This makes ATST one of the few ways retail investors can access WTW's investment expertise.

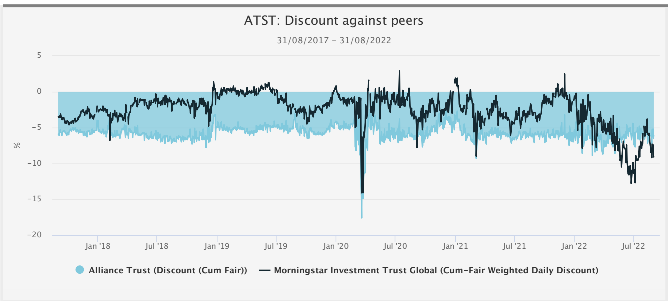
ATST is currently managed by three members of WTW: Craig Baker, Stuart Gray and Mark Davis. The trio form ATST's investment committee and determine manager selection and asset allocation, as well as providing the ongoing monitoring of the delegated managers. This committee selects the managers, then monitors and oversees their performance. It also reviews portfolio blending and risk controls, implementing any gearing and hedging requirements. Craig Baker, WTW's global chief investment officer, chairs the investment committee and has over 25 years of investment experience. Stuart is a member of the equity portfolio management group at WTW and a member of the investment committee for the group's equity funds. Mark has more than 20 years' investment experience and runs WTW's portfolio management team in Europe, the Middle East and Africa.

Discount

ATST currently trades on a 7.9% discount, which is narrower than the 10.1% simple average of its peer group. This may be a reflection of the perceived benefit of ATST's core style of investing, considering that many of its peers carry substantial growth stock biases, and so have suffered in 2022 as a result. ATST's relative resilience may shine a light on its appeal and, if the trend of outperformance continues, may be the catalyst for the trust's discount to narrow.

ATST's shareholders have undoubtedly benefitted from the board's discount control mechanism. While there is no explicit discount level that will trigger a buyback, the board does monitor the stability of the discount and will take advantage of any significant widening to use buybacks to generate additional returns for shareholders. The board has been very active over the last 12 months, repurchasing 6% of the shares in issue over this period.

Fig.6: Five-Year Discount



Source: Morningstar

Charges

ATST has a current OCF of 0.6%, below its peer group's simple average OCF of 0.63%. ATST's OCF includes all investment management expenses incurred by the trust (£14.1m over the 2021 financial year). WTW is entitled to a £1.5m fee per annum (equivalent to c. 0.05% of net assets), increasing in line with the UK Consumer Prices Index (CPI), plus 0.055% per annum of the market capitalisation of ATST after deduction of the value of both non-core assets and subsidiaries. Each of the underlying managers is entitled to an ad valorem management fee, generally based on a percentage of the value of assets under management for the trust. No performance fees are payable, and fees are generally taken 25% from revenue and 75% from capital profits.

ATST currently has a KID RIY of 0.94% compared to the 1.74% simple average of its peers, although calculation methodologies can vary between trusts.

ESG

The board views the integration of ESG as a key component of a 'core' equity offering, and as such WTW ensures that at both a manager and aggregate portfolio level, the tenets of good ESG analysis are integrated. Part of the rationale for the selection of managers is that not only must the managers be able to evidence strong ESG integration practices through their own investment processes, but they also must be able to meet WTW's own ESG criteria. WTW's insistence on ESG integration does not come from an ethical standpoint, as the company will not compromise ATST's return potential to fulfil ESG or ethical objectives, but rather to ensure that the managers account for the ESG risks that WTW has identified. For example, when assessing climate risks WTW uses an internal metric of Climate Transition Value at Risk – CTVaR – which analyses some 450 scenarios that could potentially need to occur if we are to succeed in meeting the 2°C global warming target set by the Paris Accords, as well as what would need to happen to various industries in order to hit that target.

The board's ESG initiatives stretch far beyond the integration of ESG within WTW's investment philosophy, for the board has set explicit ESG restrictions and targets which WTW must ensure are met. The most ambitious of these is the objective of achieving a net-zero portfolio by 2050, in line with the Paris Accords. This is more onerous than it may initially seem, as carbon neutrality must be achieved effectively across the board but ATST's diverse range of holdings means there are unlikely to be large single positions in low-emission companies which can offset the portfolio. The board has also implemented an exclusionary policy, whereby companies associated with thermal coal, tar sands or controversial weapons cannot be purchased by any manager. The board has also been continually improving the level of disclosures that it is making in regards to ESG, by not only improving the detail in the trust's annual report but also producing regular reports on engagement activities, which can be **read here**.

Although each of the managers actively engage with the stocks that they own and retain voting rights, the board has delegated the additional responsibility for supplementing engagement activities with ATST's underlying holdings to EOS at Federated Hermes. EOS is a service which collates the assets of various professional investment managers so as to ensure its voice has a greater weight with the companies it engages with, be that via proactive voting at AGMs or by directly addressing ESG issues with management. EOS currently represents $1.6tn in assets.

Morningstar currently rates ATST's sustainability as 'below average' relative to its wider global equity peer group (of open- and closed-ended funds). This rating is likely the result of the wide range of holdings in ATST, as well as its underweight to conventional mega caps. This has led ATST to be underweight to many of the tech giants whose naturally lower ESG risks help to raise the ESG scores of the benchmark and other less diversified strategies. We believe that the board has been successful in ensuring that ATST meets the required level of ESG integration needed to be considered a 'core' strategy.

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