Alliance Trust

Update
15 January 2020

ATST offers exposure to some of the world's best fund managers via a low cost manager of managers approach...

Summary

Alliance Trust (ATST) is one of the UK's oldest and largest investment trusts. Almost three years ago, on April 1 2017, the trust adopted a new approach which sees management of the portfolio outsourced to nine fund management groups in different parts of the world, each tasked with managing a portfolio comprised of a concentrated, bespoke selection of their fund managers' best ideas. The management groups in this stable – many of them otherwise out of reach for ordinary investors – are selected and overseen by Willis Towers Watson (WTW), which manages allocations toward them so that performance is primarily driven by stock selection in the long run, rather than by sector, style or country weightings.

In August 2019 WTW brought a new fund manager onto the roster. Vulcan Value Partners, a manager that WTW has known and liked for many years, was added when Vulcan reopened for new capacity.

In the first two years under the new strategy, ATST has generated strong returns relative to both the benchmark and comparable open and closed-ended global peer groups. The past year in particular has seen the trust deliver impressive returns, benefiting from the blend of both growth and value managers which the portfolio contains as the market has rotated slightly to the latter.

ATST's discount narrowed significantly around December 2016 when the trust announced the change in strategy. The trusts average discount in 2018 was 6% and the board continues to manage the discount, and is committed to buying back shares where necessary. Currently the trust trades at a discount of 4.1%, relatively wide in comparison to its peers.

Analyst's View

Alliance Trust is the one of the most competitively priced multi-manager funds available to UK investors in either the closed or open-ended fund universe.

The market volatility observed in 2019 is likely to continue into the foreseeable future, which could be beneficial for the active, bottom-up method approach which is common to most of the managers running money under the trust's umbrella. ATST's high-conviction, concentrated underlying portfolios offer the potential capacity for alpha generation. In addition the availability of WTW's vast resources – including one of the largest manager selection teams of any multi-manager - and the bespoke nature of the underlying portfolios give clear appeal for investors considering a multi-manager approach.

Alongside this, by putting the 'best ideas' portfolios together, shareholders can benefit from all the advantages of concentrated portfolios, but still benefit from diversification. An obvious additional benefit is that ATST has no 'key man risk' as would be the case were it managed by a single fund manager..

Key Information:

As at	02/01/20
Price (p)	850
Discount (%)	-4.1
OCF (%)	0.65
Turnover Ratio	65.3
Yield (%)	1.6
Gearing (%)	6
Ticker	ATST
Shares (£)	329,065,733
Market cap (£)	£2,764.2m

(per end Dec factsheet)

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The blending of the overall portfolio undertaken by WTW means that ATST has no specific stylistic, sectoral or geographical biases. WTW operates on a regionally unconstrained basis which they think allows their chosen managers maximum freedom to choose their best ideas. They argue that by restricting managers by sector or region you risk forcing them into a situation where they are buying a company because it is the best that is available within those constraints – not the best that is available overall.

ATST's balance between value and growth style stocks paid off in 2019, when it kept up with its peers during the first half of the year (with growth stocks driving performance), but then also performed strongly over the second half (when there was a shift to value stocks outperforming).

The board's clear commitment to discount control means a return to a double-digit discount is unlikely, yet the current discount of 4.1% is one of the widest in the AIC Global sector despite the trust's impressive performance over 2019.

Analyst's View

BULL	BEAR
Differentiated multi-manager approach, providing access to high conviction stock picking fund managers, not otherwise available to 'retail' investors	Still a relatively new strategy, although WTW has been running similar strategies for institutional investors for over ten years
Strong performance since the change of strategy, including continuation of an steady dividend record	Relatively low weighting to the UK (compared to the AIC peer group) could mean a relative headwind if sterling/UK equities benefit from a 'Brexit bounce'
Wide discount relative to peers	Structural gearing will amplify any downward movement in the portfolio value (and vice-versa)

Portfolio

April 2017 saw a significant change to the strategy at Alliance Trust when Willis Towers Watson (WTW) was appointed as the trust's manager. WTW is a global investment group that advises on, or runs, institutional funds for numerous clients, including pension funds and other sophisticated investors.

WTW's extensive resources mean that – on a worldwide basis – it is able to assess almost 4,000 funds a year through onsite meetings, research and operational due diligence. From its meetings it runs a list of 210 top-rated fund managers. Within these WTW runs a 'bench' of the top 20 most suitable for the ATST portfolio – all of which have agreed terms to run customised, highly active, concentrated portfolios. The top 20 are all mandates which are bespoke to WTW, and consist solely of these underlying fund managers' 'best ideas'. All 20 are under continuous watch by the WTW team, but only 8-12 of them will actually be running money for Alliance Trust at any one time. At the moment there are nine managers in the Alliance Trust portfolio.

These managers are ultimately selected by the investment committee led by Craig Baker, the global chief investment officer for WTW. Craig is supported by co-portfolio managers Mark Davis and Stuart Gray, ensuring that there is no single 'key man risk' at WTW.

WTW favours managers who run concentrated portfolios with a high active share. By sub-dividing the Alliance Trust portfolio between different active managers with different investment styles, WTW intends that the inbuilt diversification will lead to smoother, more consistent returns for investors. The concentrated nature of these managers' stock selections is a unique aspect of the trust; and the portfolio is made up of fewer companies in a more typical multi-manager structure. The team at WTW conducted a vast amount of research into the performance of more concentrated portfolios, which illustrates that they tend to outperform. We previously looked at the data for active vs passive managers, and the impact of concentrated portfolios, in our sector piece '**Go big or go home**'. As we discussed in that piece, it is difficult to deny the overwhelming evidence that talented fund managers who are willing to back their convictions tend to outperform by the highest margin.

Given the unconstrained 'best ideas' nature of each underlying manager's remit, the investment committee keeps an eye on crossover between the stocks selected by each manager; and has observed that it tends to be fairly low due to the way the roster of managers is assembled, given that each manager has a distinct approach. In the unlikely event that a manager's stocks become too much like other holdings in the portfolio, WTW would reconsider its allocation to that manager. The current stable of managers can be seen in the table below.

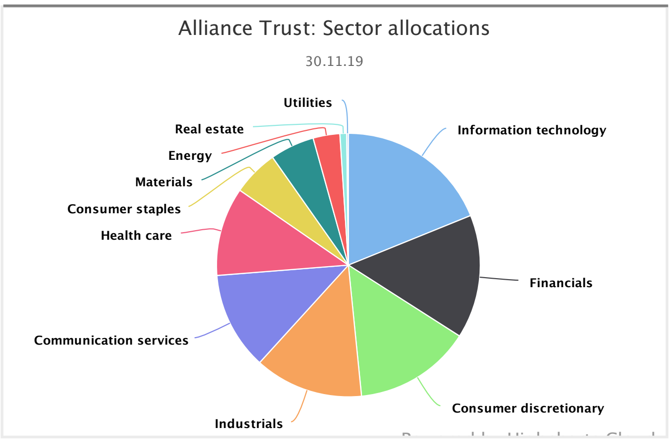
Allocations to managers are made so that stock selection is the key driver of returns, but from a top-down perspective the overall portfolio's weightings relative to country and sector are broadly in line with the MSCI AC World Index benchmark. If exposures become too different from that of the benchmark, the team will rebalance allocations to managers. Currently, ATST's largest exposures are towards information technology, financials and consumer discretionary, although the largest overweights relative to the benchmark come from consumer discretionary, communication services and industrials.

Manager Breakdown

MANAGER	STYLE	% OF EQUITY PORTFOLIO MANAGED
GQG Partners	Quality growth at reasonable price	14
Lyrical Partners	US value with quality tilt	13
Veritas	Thematic and quality	13
Black Creek IM	Undervalued market leaders	11
Sustainable Growth Advisers	Predictable, sustainable growth	11
FPA Investors	Long-term absolute value	10
Jupiter Asset Management	Value with quality bias	10
River and Mercantile	Recovery, value and timing	9
Vulcan Value Partners	Capital preservation, quality and value	9

Source: Alliance Trust

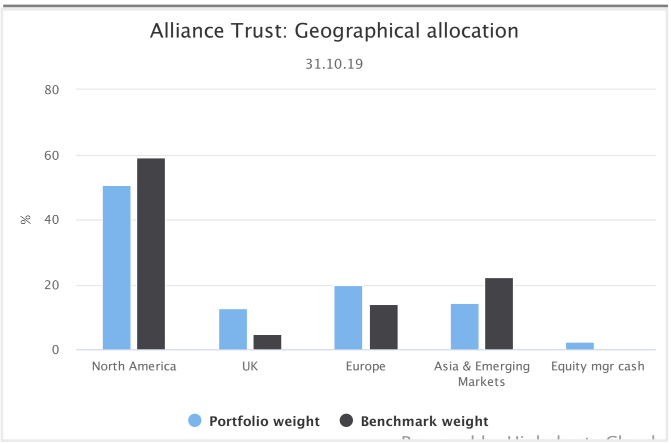
Fig.1: Sector Allocation



Source: WTW

The team does not believe in using a combination of regional managers and global managers, as in their view that approach can mean managers end up buying a company just because it is the only one available within the constraints they've set, rather than focusing on true 'best ideas'. Instead, ATST is a truly global trust – providing exposure to the best companies the managers can find across a wide range of geographic areas and sectors. Although the trust is overweight to the UK in comparison to the MSCI ACWI, relative to AIC Global peers its 12.4% weighting is low. In fact, according to Morningstar, six trusts in the 16-strong sector have more than double ATST's exposure to the UK. The trust's largest regional weighting is towards North America (50.6%), although this is underweight relative to the benchmark's weighting of 58.9%.

Fig.2: Geographic Allocation



Source: WTW

In our previous notes we mentioned that ATST had been gradually reducing the percentage of its assets that are not invested in global equities. Over time these non-core assets have been sold as have the trust's subsidiary companies, Alliance Trust Investments and Alliance Trust Savings business. At the end of 2019, non-core assets had been reduced to zero.

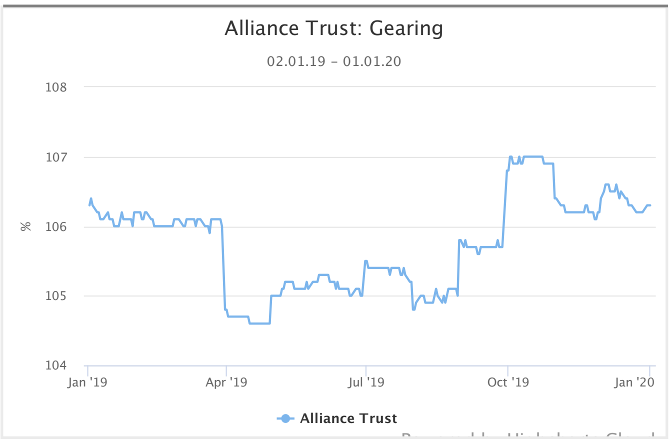
Gearing

ATST has a combination of structural (fixed) and flexible gearing in place. WTW manage the trusts' gearing level in accordance with the policy set by the trust's board. WTW maintained a gross level of gearing of around 8% in 2019. It is the responsibility of WTW to decide tactically what level of net gearing is appropriate, taking into account the levels of cash that each underlying manager has at any time. Each of ATST's underlying managers has latitude to hold up to 10% in cash, but cannot employ gearing themselves.

The graph below shows historical net gearing levels, which have typically been around the 5% mark since WTW was appointed. In September 2019, however, the gearing level increased, reflecting WTW's more positive outlook. Since then it has marginally slipped back.

November 2018 saw the board take advantage of the low-yield environment, issuing fixed-rate long-dated financing of £60m. This issuance reduced the company's fixed long-term borrowing costs from 4.3% to 3.7%.

Fig.3: Gearing

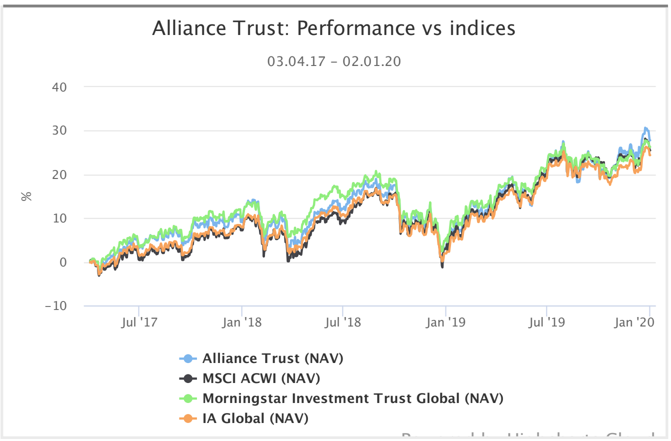


Source: Morningstar

Performance

Since ATST changed its spots in 2017, shareholders have seen markedly improved performance. As can be seen below, over the period from April 2017 (when WTW was appointed) to 2 January 2020, the company has generated NAV total returns of 27.1%, outperforming the benchmark MSCI ACWI (25.5%), the AIC Global peer group (26.4%) and the IA Global peer group (24.4%).

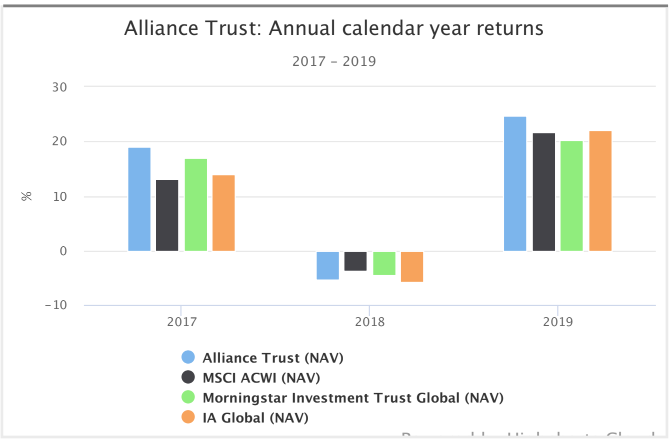
Fig.4: New Strategy Performance



Source: Morningstar

On an annual calendar year return basis, the trust has outperformed in two of the three years since the change in strategy. The first year, 2017, saw strong NAV total returns of 18.6%, against a backdrop of world markets characterised by macroeconomic and political uncertainty: an environment in which stock pickers generally performed well. On the other hand, 2018 was a more difficult environment for generating alpha, with the trust marginally underperforming the benchmark in a downward year for equity markets. In hindsight, this could be expected given the portfolios' underweight relative to the US and the IT sector, and the disproportionate impact of the FAANG (Facebook, Apple, Amazon, Netflix, Google) group of stocks.

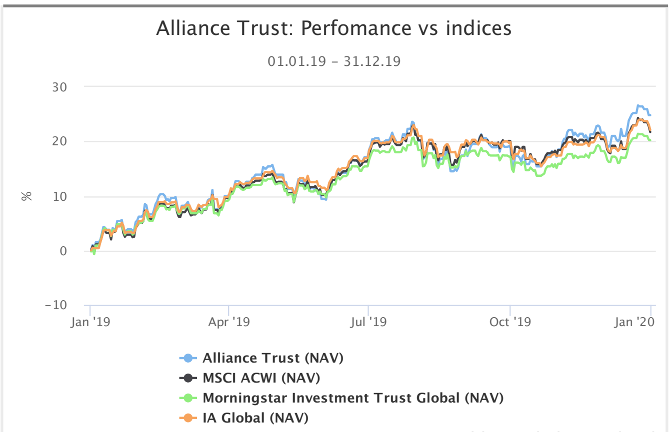
Fig.5: Annual Calendar Year Returns



Source: Morningstar

In the 2019 calendar year, the trust's performance was good, with NAV total returns of 23.1%. This is considerably more than the AIC peer group average return of 20.2%, while also ahead of the benchmark (21.7%). As the graph below shows, 2019 was a tale of two halves. The first half of the year saw growth companies rebound after a torrid 2018, with those hit hardest during Q4 2018 rebounding most strongly. During this period the MSCI World Growth Index had total NAV returns of 12.2%, in comparison to 6.9% from the MSCI World Value Index. Although Alliance Trust does not divulge performance data of individual managers, we anticipate that the likes of GQG and Sustainable Growth Advisers were likely to have been the standout performers in the trust over that period. However, the second half of the year saw a reversal in trends, with value stocks coming back into favour. This is where firms such as First Pacific and Lyrical will have likely come into their own. However, taken as a whole, both scenarios illustrate the benefits of WTW's 'no bias' style and capacity to outperform regardless of the market conditions.

Fig.6: 2019 Performance



Source: Morningstar

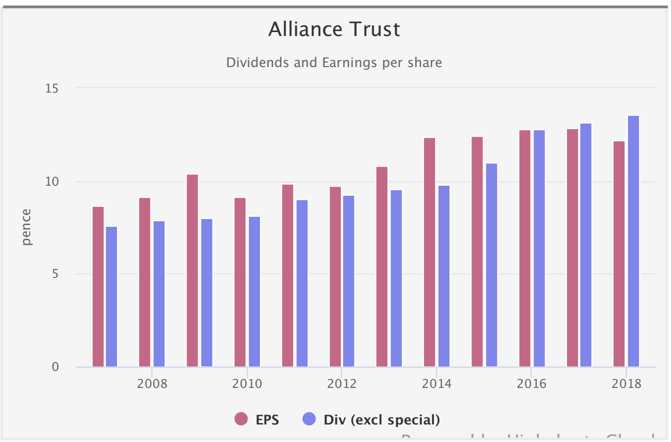
Dividend

Out of the entire investment trust universe, ATST has one of the strongest track records for increasing its dividend year on year. The trust has achieved a rising level of dividends for 52 years and is likely to declare another increase for 2019 – equalling the longest unbroken track record of rising dividends in the industry. The most recent full-year dividend (2018) equated to 13.55p per share, an increase of 3% over the 2017 dividend. Although ATST's shares yield only 1.6%, this compares favourably to the rest of the AIC Global sector, where the weighted average yield is 1.3% (source: JPM Cazenove).

As the graph below shows, dividend cover has retreated somewhat as a result of the changes to the way ATST's assets are invested. Each manager has a total return mandate, with no target set for income. At the time of the changes, the board noted that it expected revenue earnings to decline based on projections provided by WTW, and that it was prepared to supplement income with the trust's previously built-up revenue reserves so that a progressive dividend could be maintained. As such, ATST had to dip into those reserves to a small degree in 2018. The board also announced another change designed to lessen the blow to the income account, which was to start charging a quarter of costs to revenue (three quarters to capital) – a reduction from the previous policy of charging one third to revenue. So far for FY19, only three of the four dividends have been declared, and two paid, each at 3.49p per share.

Revenue reserves currently stand at £107.7m, equivalent to 33p per share. ATST indicates that, assuming revenues are unchanged from 2018 levels, revenue reserves would allow the trust to have '25 years of dividend cover'. A more usual measure is as a proportion of the historical dividend, which we calculate as 2.38x the historical dividend. This provides plenty of firepower for the board to support the dividend for the foreseeable future, even if revenue growth does not come through from the underlying portfolio. In addition, WTW could hire managers with a greater focus on income.

Fig.7: Dividend



Source: Alliance Trust

Management

Willis Towers Watson (WTW) is a large global investment group that places a great deal of emphasis on fundamental analysis and due diligence in order to identify skilled managers. Craig Baker, the global chief investment officer at WTW, with 25 years' investment experience, chairs the investment committee which is responsible for ATST's portfolio. This investment committee selects the managers, and monitors and oversees their performance; it also reviews portfolio blending and risk controls, and implements any gearing and hedging requirements.

The other members of the committee are Mark Davis and Stuart Gray. David Shapiro, having been part of the investment committee, decided to retire from full-time portfolio management, and left WTW at the end of September 2019. Stuart Gray has assumed David's role as co-portfolio manager alongside Mark Davis. Stuart was previously a member of the Equity Portfolio Management Group at WTW and a member of the investment committees for their equity funds. Mark has 20 years' investment experience and runs WTW's portfolio management team in EMEA. Between its members, the investment committee at WTW has more than sixty years' service to call on. Supporting the committee, WTW has a 120-strong research and portfolio management team. Together, they run assets of $133bn for around 200 institutional clients with multi-manager structures, and have £2.3trn under advice.

WTW has provided a brief rundown of the trust's managers, which we reproduce here.

Bill Kanko | Black Creek Investment Management

Toronto, Canada

Bill Kanko is founder and president of Black Creek, with 36 years' experience in the industry. Prior to founding Black Creek in 2004, Bill was the lead manager for both the AIM Trimark Fund and the Trimark Select Growth Fund, which had outstanding performance during his leadership from 1999 to 2004.

Bill is a long-term investor, looking for companies that are growing, are leaders in their markets, and are gaining market share. These companies tend to benefit from huge barriers to entry and sustainable competitive advantages.

Pierre Py & Greg Herr | First Pacific Advisors, LLC (FPA)

Los Angeles, USA

Pierre Py and Greg Herr, who have an average of over 20 years' experience in the industry, have worked together at FPA since 2011. Pierre, the managing director, previously worked at Harris Associates, Salomon Brothers and Goldman Sachs.

Pierre and Greg typically employ a long-term value investment approach, investing in companies that they believe have sustainable business models, exhibit financial strength, and are run by operationally strong managers; and whose stocks trade at a significant discount to the FPA team's estimate of intrinsic value. For Alliance Trust the team will look to balance this discount with the businesses' ability to produce an attractive and sustainable dividend yield.

Rajiv Jain | GQG Partners, LLC

Fort Lauderdale, USA

Rajiv Jain is the chairman and chief investment officer of GQG and serves as the sole portfolio manager for each of the firm's strategies. With 21 years of emerging markets experience, Rajiv is among the longest-tenured investors in global and emerging markets equities. He launched GQG in June 2016, having previously worked at Vontobel Asset Management for 22 years, as co-CEO from July 2014, and as chief investment officer and head of equities from February 2002. He started at Vontobel as a co-portfolio manager in 1994. He was named Morningstar International Fund Manager of the Year in 2013.

Rajiv looks for high-quality and sustainable businesses through a fundamental investment process using both traditional and non-traditional sources of information. Ideally, these quality businesses have enduring underlying strengths, which manifest in a variety of economic environments. The result has been portfolios designed to provide capital protection in down markets and attractive returns to long-term investors over a full market cycle. GQG has an emerging markets mandate as well as a global portfolio for the trust, with particular focus on emerging markets companies.

Ben Whitmore | Jupiter Asset Management

London, UK

Ben Whitmore, who has 21 years' experience in asset management, joined Jupiter in 2006 from Schroders. Ben is supported by Dermot Murphy, who has worked at Jupiter since 2014.

Ben is well known as a long-standing practitioner of contrarian value investing, targeting companies he considers to be out of favour and undervalued. This approach has proved successful for his Jupiter UK Special Situations Fund.

Andrew Wellington | Lyrical Asset Management

New York, USA

Andrew Wellington serves as the firm's chief investment officer and managing partner, and has been involved in active portfolio management for over 20 years, the last eight at Lyrical. He previously worked at Neuberger Berman, where he became the sole portfolio manager for the institutional US mid-cap value product, more than tripling assets under management.

Value matters most to Lyrical and the team also maintains a strict discipline of investing in quality companies that it considers are relatively easy to analyse. The team believes that the combination of value, quality and a straightforward business model creates resiliency in the portfolio and the greatest likelihood of long-term absolute performance and outperformance.

Hugh Sergeant | River and Mercantile Asset Management

London, UK

Hugh Sergeant is the chief investment officer for equities at River and Mercantile, and was one of the founding partners in 2006. He has over 30 years' experience and was previously head of UK equities at Société Generale Asset Management, and prior to that at UBS Phillips & Drew and Gartmore.

The team invest in 'recovery equities' using an investment philosophy called PVT (Potential, Valuation & Timing); and through a process which helps them identify value at different stages of a company's lifecycle, by giving signals from a timing perspective as to when that value might be unlocked.

Fraise, Marchand & Rohn | Sustainable Growth Advisers (SGA)

Stamford, USA

George Fraise, Gordon Marchand and Rob Rohn founded SGA in 2003 and have, on average, over 30 years' investment experience each, having also worked together before SGA. While the three portfolio managers share a common approach to evaluating businesses and structuring portfolios, their personality attributes are also complementary in important ways.

SGA focuses on building concentrated portfolios of unique, high-quality global growth businesses that possess strong pricing power, offer recurring revenue generation, and benefit from attractive long runways of growth.

Andrew Headley | Veritas Asset Management

London, UK

Andrew Headley has over 21 years' investment experience and is supported by co-portfolio manager Charles Richardson. They have worked together for nearly 20 years, including 16 years so far at Veritas (which they founded in 2003).

Veritas focuses on active equity management, and has used a proprietary 'real return' approach ever since the inception of the firm. Veritas employs an absolute mindset when valuing companies, and dispenses with any reference to indices when constructing the portfolio. Veritas describes the firm's overall approach as investing in a concentrated portfolio of good-quality companies at the right price.

C. T. Fitzpatrick | Vulcan Value Partners

Alabama, USA

In September 2019, WTW added Vulcan Value Partners (VVP) to the investment strategy. VVP is a boutique equity manager based in Alabama, with over $12bn of assets under management. The company was established in 2007 by C.T. Fitzpatrick, who has over 30 years' experience and is the lead portfolio manager. He is further supported by a 15-strong investment team.

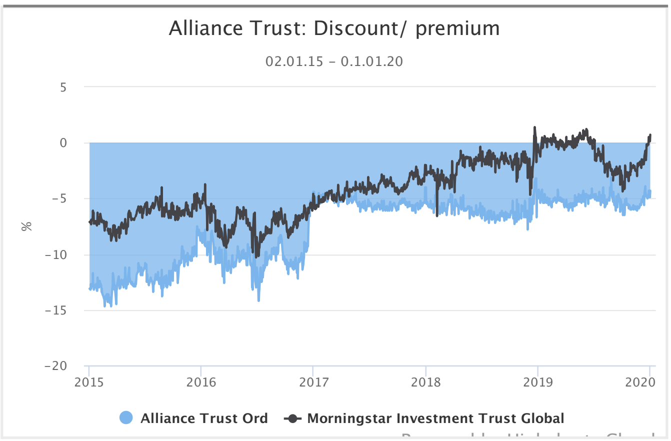
Having been closed since 2015, VVP reopened for new investors in 2019. WTW has known C.T. for a long time, and so has taken advantage of the opportunity to act. Despite having 'value' in the name, VVP is not a typical value manager. C.T. looks for a small number of high-quality businesses that the company would want to own if the share price reached their target price. The firm aims to take advantage of market volatility to present buying opportunities, instead of being a victim of that volatility.

Discount

For a long time prior to the new strategy being announced, ATST traded at a relatively wide discount, as the graph below shows. However, the discount narrowed significantly on the announcement of the new WTW-backed approach in December 2016, and has remained close to 5% since then.

Having bought back 145 million shares in 2017, including 95.5 million from the then largest beneficial shareholder, activity has been dramatically reduced over the past few years. For example, over 2019, only 0.13% of shares in issue (approximately 440,000) have been purchased for cancellation.

Fig.6: Discount



Source: Morningstar

Charges

ATST is one of the most competitively priced multi-manager vehicles available to UK investors. And despite its 'manager of managers' approach, the OCF for the trust currently sits at just 0.65%, considerably less than the AIC Global sector simple average of 0.71%. WTW is entitled to a fixed fee. There is also an ad valorem fee (proportionate to the value of) based on the market capitalisation of the company after deduction of the value of non-core assets. 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. No performance fees are payable.

The KID RIY for the trust sits at 0.89%, the lowest in the AIC Global sector, where the simple average is 1.33%. We note, however, that calculation methodologies can vary among companies.

ESG

When we asked the managers they told us that responsible investing is at the core of the investment process for ATST, although it does not take moral positions on stocks. Instead, the team at WTW believe responsible investing is about improving returns for investors and helping to reduce risks. This involves applying ESG practices throughout the entire investment process, from selecting the managers to looking at the portfolio from a top-down basis. For example, when the WTW team are looking at the underlying managers, responsible investing is fully embedded in the rating process and the ongoing monitoring of the company. The investment committee expects a fund manager to demonstrate processes that identify and assess material ESG factors for their target companies, while also expecting that manager to engage and vote to protect and enhance the long-term value of the assets.

From a top-down basis, the investment committee will look at the combined portfolio relative to the benchmark and peers. This involves looking at portfolio resilience (risk exposures and universe comparison), carbon analytics (carbon emissions and carbon intensity), climate impact (the return impact of changes in temperature and associated natural catastrophes) and bottom-up industry exposures (top industries' climate-related opportunities and risks). WTW uses the data to review stock holdings by manager and, if necessary, challenge the managers on some of the stocks with less attractive ESG profiles.

Furthermore, in August 2019 the board hired the specialist Hermes Equity Ownership Services to help with ESG engagement. Hermes has close to $500bn of assets under advice. It engages with investee companies on behalf of the trust, and provides advice to WTW and the stock pickers on corporate engagement, voting and public policy. The mandate Hermes has covers a wider range of issues than one might anticipate, including climate change, executive remuneration, human rights and cyber security. The board hopes that Hermes' advice will help to protect and enhance the performance of underlying portfolio companies, while ensuring alignment of the management of these companies with investors.

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