Alliance Trust

ATST's core equity strategy continues to deliver in an uncertain environment...

Update
26 October 2023

Overview

Alliance Trust (ATST) provides investors with a well-balanced, stylistically neutral, global equity portfolio. ATST has delivered good performance versus its benchmark and peer group over the past three years, outperforming by 4.3% and 12.2% respectively (see **Performance**).

As discussed in **Portfolio**, ATST aims to offer a 'core' investment solution, providing retail investors a rare opportunity to access a sophisticated strategy typically reserved for institutional investors. The trust has been under the supervision of global investment manager Willis Towers Watson (WTW) since 2017, with the portfolio management responsibilities taken on by Craig Baker, Stuart Gray and Mark Davis. The trio boast of access to a unique selection of specialist managers, each entrusted with constructing a bespoke up-to-20-stock best-ideas portfolio, which the team can then allocate to, while minimising factor risks versus a global equity benchmark. Over the past year, good returns from their growthier managers have seen the team trim these positions and reinvest back into the more value-tilted managers.

The managers argue the current environment should continue to benefit stock pickers. However, notwithstanding this, and while performance has recently been good, the managers are wary of the outlook for markets overall and so have reduced **Gearing**.

In addition to their typically more generalist managers, in July 2023 they added Dalton Investments to their roster, asking them to provide a dedicated Japan allocation. Dalton's usual value-driven approach is further strengthened by an active engagement strategy aiming to benefit from the country's corporate governance reforms and a more promising macroeconomic environment.

ATST has delivered 56 consecutive years of **Dividend** growth, which has averaged 14% over the last five years, aided by 26% and 32% increase for the two previous financial years, producing a historic yield of 2.4%. The consistency is also reflected in ATST's **Discount**, which at 6.7% remains consistent with its long-term average.

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Analyst's View

In our view, ATST remains a strong 'fire and forget' option for investors looking to gain a broad exposure to global equity markets. The managers' style-balanced approach has delivered strong returns over what has been a volatile period, which we believe highlights the potential merits of taking a factor-neutral approach and focusing on stock picking instead of reading the tea leaves.

The addition of the Dalton Investments team in Japan is interesting, and provides shareholders with the potential to benefit from the revolution in corporate governance which has contributed to Japan becoming a popular pick amongst active managers this year. In our view, the strategy of focusing on corporate change to deliver returns offers the potential to generate attractive returns even in a troubled economic outlook.

We note the board is in a strong position to continue its track record of rising the dividend each year, a bumper year for earnings having led to a very healthy reserve position. With a yield of around 2.4% at the time of writing the trust is edging closer to contributing a meaningful amount of income, while the compounding effect of reinvesting the dividend offers an attractive way to invest for the long term.

BULL
Strong short- and long-term performance track record versus benchmark and global peers
Offers exposure to specialist managers through WTW's institutional style investment strategy
Dividend profile has continued to improve, and is supported by vast revenue reserves

BEAR
May underperform during trend-driven markets
As a core investment strategy, it can offer less diversification benefits relative to more specialist equity strategies
Gearing can enhance losses on the downside, although it has been reduced

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Portfolio

Alliance Trust (ATST) aims to provide investors with a well-balanced, core exposure to global equities. The strategy has been under the stewardship of the global investment management firm Willis Towers Watson (WTW) since April 2017 and provides a unique opportunity for retail investors to access a specialist, multi-manager strategy typically reserved for institutional investors. ATST is managed by Craig Baker, Stuart Gray and Mark Davis, who leverage WTW's vast network of investment professionals to help them identify what they believe to be best-in-class underlying managers. They believe that taking such an approach is the best way to unlock the trust's objective of maximising total returns, which is achieved through a combination of capital growth and a progressive dividend.

Craig, Stuart and Mark aim to maintain a stylistically neutral portfolio, capable of performing across the market cycle. Naturally, taking such an approach leads to a relatively high correlation to the broader equity market - 0.99 over the last five years – with the geographic and sector allocations like the benchmark by design. However, they believe by identifying high-quality, bottom-up-focused specialist managers it can provide the best opportunity to generate alpha over the long term, leading to a relatively high active share of 74%.

The portfolio is currently split across 11 strategies and ten specialist managers who have been tasked with constructing bespoke portfolios limited to their 20 best stock picks. The result is a higher conviction portfolio compared to some alternative multi-manager strategies, for example ATST currently has 205 individual holdings compared to Witan (WTAN) and F&C Investment Trust's (FCIT) 255 and 457 respectively.

Style exposures range from high-growth, such as Sands Capital and Sustainable Growth Advisors, to value-orientated strategies, such as Black Creek and Metropolis Capital. However, all the managers aim to include high-quality companies with strong balance sheets. They believe such companies will outperform over the long term, either through an exposure to structural growth trends or a positive re-rating as their fundamental value is realised. These holdings are the long-term building blocks of the portfolio, leading to a very low level of manager turnover, with the allocations periodically rebalanced in order to maintain the portfolio's limited factor risks versus the benchmark.

The Japan-focused strategy managed by Dalton Investments (Dalton), was introduced in July 2023. In a recent meeting, Stuart noted this was not a macro call, rather a reflection of Dalton's ability to identify high-

ATST Manager Allocations

MANAGEMENT COMPANY	STYLE	PORTFOLIO WEIGHT (%)
GQG Partners - Global GQG Partners - EM	Looks for large capitalisation, high-quality and sustainable businesses whose earnings growth should be more durable regardless of the macro environment.	20
Veritas Asset Management	Thematic investing identifies companies and industries that are well positioned to benefit from enduring growth trends.	14
Black Creek Investment Management	Value-orientated buyer of leading businesses across the market-cap spectrum. Long-term contrarian approach.	13
Sustainable Growth Advisors (SGA)	Seeks companies that have strong pricing power, recurring revenue generation, and long runways of growth.	11
Jupiter Asset Management	Looks for out-of-favour and undervalued businesses with prominent franchises and sound balance sheets.	10
Metropolis Capital	Focuses on identifying businesses undervalued by the market. Returns come from a combination of the 'value gap' closing and increases in the intrinsic value of the businesses.	10
Lyrical Asset Management	Focuses on businesses with attractive capital returns and the flexibility to react to all phases of the business cycle – US focused.	7
Vulcan Value Partners	Focuses on protecting capital and identifying companies with high-quality business franchises that could compound in value over the long term.	6
Dalton Investments	Value-focused strategy looking to actively engage to exploit mispriced opportunities in under-researched companies based in Japan.	5
Sands Capital	Follows a purely growth-orientated philosophy with a focus on finding high-quality, wealth-creating businesses using a fundamental, bottom-up research approach.	4
TOTAL		**100**

Source: Alliance Trust, as at 31/08/2023 quality, undervalued stocks that have the potential to appreciate over the longer term. The strategy is managed by CIO and founder James D. Rosenwald who established the firm in 1999. Headquartered in Los Angeles, with several other offices, including Tokyo, the team are experienced in managing a range of Asia-focused and global emerging markets strategies. The investment philosophy is value driven and, for this bespoke mandate, looks to exploit mispricing opportunities in the most under-researched companies in Japan. Naturally, this leads to a focus on small and mid-cap companies. Aside from the US concentrated strategies such as Lyrical Asset Management, including a country specific strategy is unusual, given their more typical use of global unconstrained strategies. However, Craig, Stuart and Mark believe James's 45-year history of investing in Japan, alongside his team of Tokyo-based analysts provides them with an opportunity to actively engage with operationally stable businesses to unlock shareholder value. James sees the best opportunity to achieve this as being through companies that have strong alignment between management and ownership which leads to longer-term capital allocation decisions.

In addition, Stuart noted corporate governance reforms are gradually leading to companies becoming more shareholder friendly. For example, the Tokyo Stock Exchange has implemented rules insisting companies disclose how they plan to increase their price-to-book ratios to 1x and return on equity above 8%. The managers believe this should deter companies from hoarding cash, leading to greater reinvestment, or distributing it to enhance shareholder value. Added to a more favourable macroeconomic climate, with lower interest rates and inflation compared to many Western economies, a weaker currency, and relatively cheap valuations, it may make Japan a more attractive place to invest over the long term.

So far 2023 has seen an unexpected resurgence in technology companies spurred on by significant cost cutting in the sector, and higher-than-expected market growth, largely driven by the expectation of peak interest rates and the applications of AI. Strong returns to growth strategies have led to the managers trimming these positions and reinvesting in others. For example, they have added to the typically large-cap defensive GQG this year following weaker performance. Meanwhile they have trimmed allocations to high beta, risk-on strategies such as Vulcan, Lyrical, Sands and later on SGA, which indirectly reduced the overall exposure to the 'magnificent seven' US mega-cap technology stocks that benefitted from the AI rally - reducing ATST's already underweight allocation.

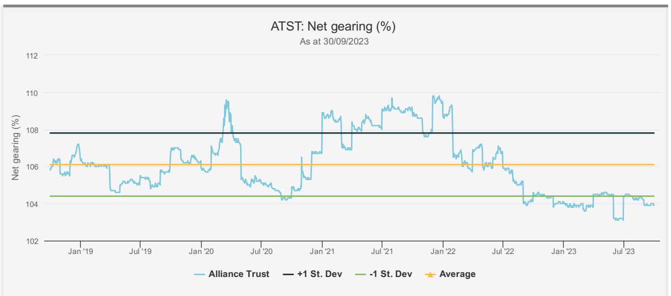
The allocation to Dalton was largely financed through a reduction in Black Creek, due to its c. 25% allocation to Japan. Black Creek's performance was also impacted by a lower exposure to the magnificent seven. However, it had some success through individual names such as the logistics company Kuehne + Nagel and the cement business Heidelberg Materials. Black Creek's managers have also been active in recycling capital, focusing on individual companies rather than the sector exposure. For example, they invested in the Spain-based Amadeus, which is a software solutions provider for the tourism industry. As the industry and the share price recovered, they have recycled it back into more attractively valued names such as the fertiliser business Nutrien, which is about 40% off its highs.

A pullback in valuations of specific names has also seen managers, including Metropolis, buy back into a former holding Howdens Joinery. As interest rates put pressure on housing and construction industries, they believe it to be a valuation opportunity to buy into a quality business for the long term. Similarly, Jupiter has seen a valuation opportunity in Nokia, which has a strong position in the networking and communications business, strong balance sheets at an attractive valuation, with good growth potential. Stuart noted that it is hard to see a specific theme through the individual buys and sells, highlighting the more diverse sources of returns from ATST that ultimately stem from the fundamental, stock-picking focus of the underlying managers.

Gearing

ATST's gearing is managed by WTW and, where market conditions permit, they can utilise gearing of up to 18% of net assets at any given time, although the board can extend this to up to 30%. However, since the start of 2022 the team have taken a more cautious stance, with net gearing reducing from close to 10% to 4.5%, as at 30/08/2023. This is at the lower bound of the five-year range which has averaged 6.1% over the last five years, and at the lower end of the trust's more typical 7.5% to 12.5% gross gearing range. The decision to make this reduction was taken due to the perceived heightened levels of market uncertainty, and the elevated risks to earnings across equity markets and the higher hurdle rate associated with the sharp rise in interest rates. Furthermore, in a recent meeting Stuart noted they believe the pathway back to a more stable global equity market environment is likely to be volatile rather than smooth and, therefore, they are likely to remain cautious in their overall outlook.

Fig.1: Five-Year Net Gearing



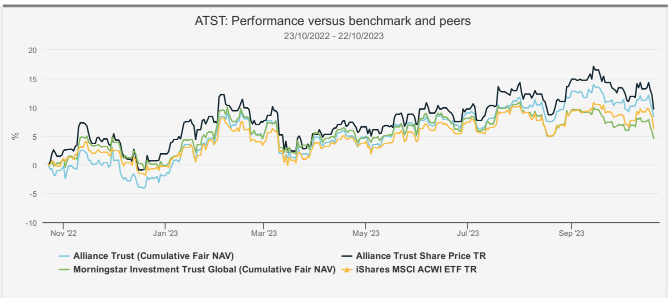
Source: Morningstar

ATST utilises a combination of long- and short-term gearing. Currently, ATST has £160m in fixed-rate loans outstanding, or 5.2% of net assets, as at 05/10/2023. These are set to mature on a range of dates between 2029 and 2053. In addition, ATST had drawn down £63.5m of its £250m approved borrowing facilities, which are due to expire in December 2023, plus an accordion option of a further £50m.

Performance

Craig, Stuart, and Mark manage ATST with a total return focus in mind, through a combination of capital growth alongside a progressive dividend. They aim to provide investors with a core strategy, capable of performing across the market cycle, which is approximately factor neutral, allowing stock picking to be the key driver of returns. This has proven particularly valuable in volatile markets, and over the last 12 months ATST generated a NAV total return of 8.4% versus the peer group's average total return of 4.6%, as at 20/10/2023. In addition, ATST has outperformed the MSCI ACWI Index, as illustrated in the chart below, using the iShares ETF, which generated 6.3%. This is particularly impressive, given the dominance of a relatively narrow cohort of US mega-cap tech stocks named the 'magnificent seven' (Amazon, Alphabet (Google), Apple, Meta, Microsoft, Nvidia and Tesla), which ATST has had a consistent underweight allocation to compared to some strategies in the peer group and the benchmark.

Fig.2: 12-Month Performance



Source: Morningstar

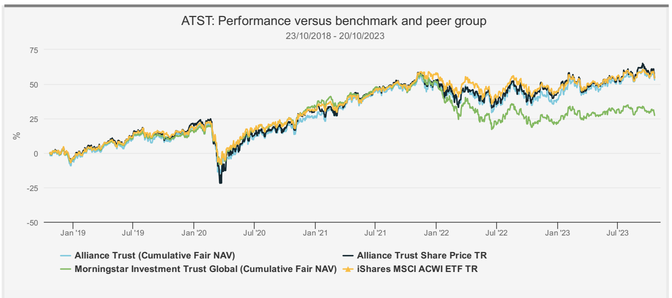
Past performance is not a reliable indicator of future results.

At times this underweight has created a drag on performance, with the underweight to Apple, NVIDIA and Tesla being the top three detractors this year to the end of July. However, the sources of returns have been more diverse compared to the peer group and benchmark over this time, with ATST's overweight positions in Alphabet and Amazon providing an equally positive contribution to the other three top contributors: Petrobras, Baidu and Mercado Libre. This is further demonstrated by seven out of the ten managers generating positive returns, ranging from the top performer over the first half of 2023: value, quality-focused Vulcan, which was followed by the growth-focused Sands.

In a recent meeting, Stuart noted the gains among tech-related stocks has not always extended to more speculative areas of the market, which suggests investors are being more discriminating between companies with strong current earnings and those whose valuations rest on potential profitability in the future. Ultimately, they believe ATST's outperformance reflects their underlying managers' stock picking ability, with companies performing well at different points in varying market conditions.

ATST's three-year performance has been impressive, particularly considering the strong stylistic biases that have driven global equity market returns. Over this time ATST has generated a NAV total return of 27.4% versus 2.8% and 25.4% generated by the (weighted average) sector and the benchmark respectively. Over five years ATST has delivered a NAV total return of 53%. This is in line with the benchmark, which generated 54.2% over the same period. However, what's more impressive is the 25.7% outperformance of the peer group, and the 19.7% outperformance of the equally weighted MSCI ACWI Index, which highlights the impact the magnificent seven have had on the index and the more diversified contribution to return from ATST's underlying holdings.

Fig.3: Five-Year Performance



Source: Morningstar

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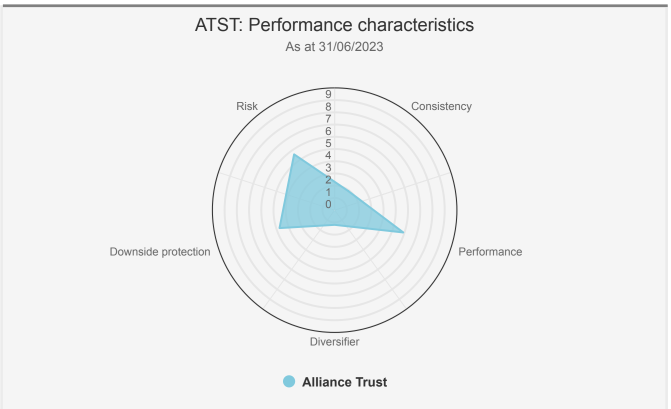
Below is our KTI Spider Chart. This shows ATST's five-year performance characteristics versus an expanded peer group of all global equity investment trusts, across generalist and specialist sectors. A selection of key characteristics is considered, with ten being the maximum score, and a higher score indicating a superior performance in that characteristic. ATST's portfolio is displaying reasonable risk characteristics over the period. However, despite the strong performance, this five-year period has included strong style-based rallies in growth and value which, at times, has been more beneficial to specialist strategies with greater allocations to technology and biotech for example. Therefore, ATST's stylistically neutral portfolio means the consistency of winning periods has been below average.

Fig.4: KTI Spider Chart



Source: Morningstar, Kepler calculations

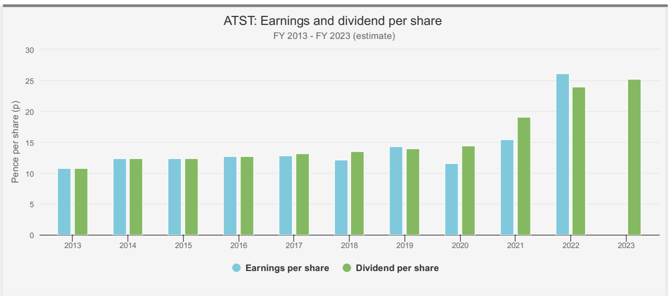
Past performance is not a reliable indicator of future results.

Dividend

ATST has provided its shareholders with a progressive dividend over an impressive 56-year period. This makes it one of only four trusts to hold such a record, and maintains its coveted status as an AIC 'dividend hero'. The trust pays four quarterly dividends, which the board aims to be of roughly equal amounts rather than to include a higher final payment, and to increase year-on-year. A sharp rise in income generated in 2022 means the board was able to increase the dividends expected for 2023, while also making a significant contribution to the revenue reserve.

During the current financial year (2023), the first interim dividend payment increased by 4.3% on the payments made last year. In addition, the second interim dividend was increased by a further 2.6% to 6.34p per share. Barring unforeseen circumstances, this increased level is expected to be at least maintained for the third and fourth interim dividends. We understand the board expects the 2023 total dividend to be at least 5% higher than 2022 dividend, as is illustrated in the chart below. Based on ATST's share price on 20/10/2023, this implies a prospective dividend yield of 2.4%. This compares to the global sector's simple average yield of 2%. Whilst the growth and sustainability of ATST's dividend is impressive, there is not a specific income target, and its yield is unlikely to suit more income-focused investors.

Fig.5: Earnings And Dividend Per Share



Source: Alliance Trust

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Management

ATST has been managed by Willis Towers Watson (WTW) since April 2017. WTW is a global investment group with a wealth of experience in providing investment management advice and services that are tailored to the specific needs of their clients. This is typically reserved for institutional clients, such as pension funds, insurance companies, sovereign wealth funds, or wealth management companies. As at the end of 2022, WTW manages over $163bn for institutional investors and advises on $4tn. ATST offers retail investors an opportunity to gain access to WTW's multi-manager expertise and underlying managers.

ATST is currently managed by three members of WTW: Craig Baker, Stuart Gray, and Mark Davis. The trio form ATST's investment committee, which determines manager selection and asset allocation, as well as providing the ongoing monitoring of the delegated managers. 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 has 20 years of experience and 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 25 years of investment experience and runs WTW's portfolio management team in Europe, the Middle East, and Africa.

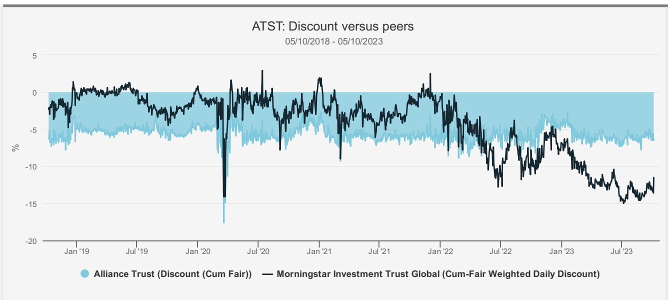
We note that ATST's chairman Gregor Stewart's nine-year tenure will come to an end at the end of 2023. Following a competitive process, existing board member Dean Buckley will take the reins.

Discount

ATST is currently trading on a 6.7% discount. This compares to the AIC Global sector's simple average discount of 11.9% according to JPMorgan Cazenove, as of 20/10/2023. We believe this reflects ATST's relatively balanced, stylistically neutral portfolio, which over the past five years has proven to offer some resilience.

The chart below illustrates ATST's relatively low level of discount volatility, which has typically traded closer to its five-year average discount of 5.7%. This compares to the global sector which, with an average discount of 4.4% over the same period, has proven significantly more volatile, particularly since Q4 2021 – although we note that the discount volatility of some larger, growthier trusts such as Scottish Mortgage (SMT) will have exaggerated this compared to an unweighted sector discount.

Fig.6: Five-Year Discount



Source: Morningstar

Although there is no formal discount-control policy in place, one of the board's strategic objectives is to maintain a stable discount. There may be a longer-term ambition to transition the trust's share price to a premium. The active buyback policy also helps maintain shareholder value and liquidity, whilst also being accretive to total returns over the long term. Over the last financial year, ending 31/12/2022, the board repurchased 15.5 million shares at an average discount of 6.3%. This equated to 5.0% of the shares in issue at the start of this period and enhanced the NAV total returns by 0.3%. Since the start of 2023, the board has repurchased a further 8.4 million shares, or 2.9% of the shares in issue at the start of 2023.

Charges

ATST's ongoing charges figure (OCF) was 0.61% for the latest financial year, ending 31/12/2022. This remains below the board's target upper bound of 0.65% and considerably lower than the 0.75% simple average OCF of the global sector, according to JPMorgan Cazenove, as of 20/10/2023.

Included in the OCF is a management fee. However, 2022's OCF reflects superseded management fee arrangements. From 01/01/2023, the management fee will be charged using a lower, tiered rate at 0.57% on ATST's market capitalisation less than or equal to £2.5bn, 0.54% on greater than £2.5bn up to and including £4bn, and 0.52% on more than £4bn. This new structure means that fees should fall more sharply as the trust grows, and we note that a management fee charged on market capitalisation rather than NAV incentivises the manager to close the discount.

ATST currently has a KID RIY of 0.99% compared to the 1.35% simple average of its peers, although calculation methodologies can vary between trusts.

ESG

ATST's board believes the integration of ESG is a key component of a core, long-term equity offering. Therefore, WTW ensures that, during the selection of external managers, there is evidence of strong ESG practices throughout the investment process that can meet WTW's own ESG criteria. Although WTW hopes to ensure that the ESG risks they have identified are accounted for, WTW will not compromise ATST's return potential to fulfil ESG or ethical objectives. For example, when assessing climate risks WTW uses an internal metric of Climate Transition Value at Risk (CTVaR) which analyses some 450 scenarios that would potentially need to occur if we are to succeed in meeting the 'well below 2°C' global warming target set by the Paris Accords, as well as what would need to happen to various industries to hit that target.

The board has set explicit ESG restrictions and targets, which WTW must ensure are met. For example, the ambitious objective of achieving a net-zero portfolio by 2050, in line with the Paris Accords. In practice, carbon neutrality must be achieved across the board which may prove more challenging, given ATST's diverse range of holdings which is unlikely to include large single positions in low-emission companies. The board also enforces an exclusionary policy applied to companies with material amounts of revenue coming from thermal coal or tar sands and involvement in controversial weapons. Furthermore, the board has also been improving the level of ESG disclosures by improving the detail in the trust's annual report and producing regular reports on engagement activities, which can be read **here**.

Although each of the managers actively engages with the stocks that they own, and retain voting rights, the board asked EOS at Federated Hermes to supplement engagement activities. EOS is a service which collates the assets of various professional investment managers to ensure its voice has 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 over $1.6tn in assets under advice.

ATST's Morningstar Sustainability Rating has improved to 'average' relative to its wider global equity peer group (of open- and closed-ended funds). We would argue that the board has been successful in ensuring that ATST meets the required level of ESG integration needed to be considered a core strategy for many investors.

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