Aurora Investment Trust

Update
07 May 2019

Summary

Aurora Investment Trust is a highly-concentrated portfolio of UK-listed companies run with a clear bottom-up, value style. It has been run by Phoenix Asset Management since January 2016, which has marked a significant change of fortunes with net assets rising from only £15m to £125m, largely through share issuance.

The managers seek to invest in UK-listed businesses of all sizes to deliver strong absolute and relative returns, although they are able to invest up to 20% overseas, and up to 10% in unlisted securities. They interpret the work of Warren Buffett etc, and look to buy companies at valuations which they think are fundamentally undervalued by the market. They are both classic "value" investors, but also aim to work with some companies in the portfolio actively to help engineer a turnaround.

Their stock-picking focus is entirely bottom-up led, and a hallmark of their process is to run highly-concentrated portfolios (as of the end of March 2019, they hold just 16 stocks). They place great emphasis on doing their own homework on businesses, including meeting company management, customers and competitors and aim to own companies that are deeply out of favour. The team claim that they won't buy shares unless a company is trading at less than half what they consider its intrinsic value is.

This focus on value is clearly highlighted by the Morningstar style analysis, with zero percent of the portfolio in what they identify as "growth". This is the lowest weighting of any of the UK All Company trusts. Perhaps unsurprisingly therefore, the portfolio is currently packed with domestic economically-sensitive stocks such as Lloyds, Tesco, Morrisons and Sports Direct. The managers topped-up holdings in UK housebuilders during the sell-off in the latter part of 2018.

The managers' long-term track record on their open-ended, offshore Phoenix UK fund, is very strong, having delivered a net return of 509.8% between May 1998 to 31st March 2019, compared to a return of 186% from the FTSE All Share, representing outperformance of 323.7%. Since taking the reins of Aurora, the trust has marginally underperformed relative to the FTSE All Share, but beaten its average peer in the UK All Companies investment trust and open-ended sectors. However, it is worth noting that most of the relative underperformance was generated during the managers' first six months in the Brexit vote induced sell-off.

When Phoenix took over management of the trust, the share price rating significantly improved, and has consistently traded on a premium since then. The board has been very active in issuing shares, which means the trust now has net assets of £125m.

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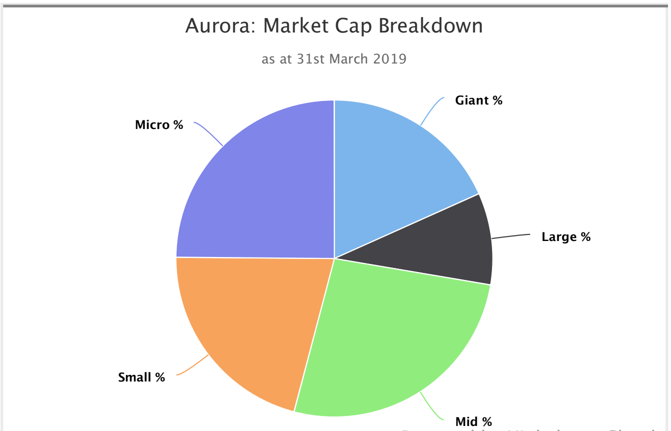
Portfolio

Gary Channon and his team at Phoenix Asset Management won the mandate to run Aurora in January 2016. They describe themselves as "fundamentalist" value investors, seeking to invest in UK-listed businesses of all sizes to deliver strong absolute and relative returns. Last year, the managers received shareholder approval to be able to invest up to 20% overseas, and up to 10% in unlisted securities. The managers interpret the work of Warren Buffett, Charlie Munger, Benjamin Graham and Phillip Fisher, and look to buy companies at valuations which they think are fundamentally undervalued by the market. They are both classic "value" investors, but also aim to work with some companies in the portfolio actively to help engineer a turnaround (such as Stanley Gibbons, Hornby etc). Their approach produces a portfolio that is highly-differentiated to other trusts in the IT UK All Companies sector.

Phoenix's typically likes to buy what they view as good companies that are cheap, temporarily having fallen out of favour due to short-term issues. The starting point of their process is an attempt to not lose money by only buying stocks with a decent margin of safety. Indeed, they say that they will never pay more than half of what they believe a stock is worth (or its intrinsic value, which they calculate by discounting future cashflows). The major features the team look for are companies that generate a high return on capital (at least 15%), have pricing power and are run by competent and honest management teams.

They invest across the market-cap spectrum, with the trust underweight mega- and large-caps relative to the FTSE All Share. The portfolio is otherwise relatively equally weighted between micro, small and mid-caps as at 31st March 2019, as the graph below shows.

Fig.1: Market Cap Breakdown



Source: Morningstar

It is worth noting at this stage that Phoenix's approach to investing is almost entirely bottom-up, as the managers pay no attention to macroeconomics. Instead, they place great emphasis on doing their own leg work on each potential holding. As the managers put it, they aim to understand the "nuts and bolts" of how businesses make money and "walk the aisles of supermarkets to understand UK food retail, visit hundreds of building sites to understand housebuilders" and even "attend obscure German conferences about steel to understand more about engineering".

This focus on value is clearly highlighted by the Morningstar style analysis, with zero percent of the portfolio in what they identify as "growth". This is the lowest weighting of any of the UK All Company trusts. Another difference is the highly concentrated nature of the portfolio. The managers guide that the portfolio is only likely to be made up of between 12 and 20 stocks (there are currently 16 holdings) making it the most concentrated across the AIC's UK equity sectors. Some 76% of the portfolio is invested in the top ten holdings.

Top Ten Holdings

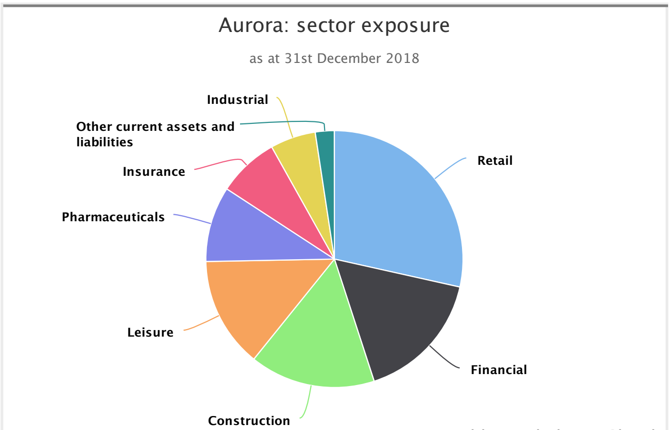
NAME	% OF PORTFOLIO
Sports Direct	9.8
Dignity	8.6
Llloyds	8.4
Bellway	8.3
Tesco	8.2
Randall & Quilter	7.8
GlaxoSmithKline	7.6
Redrow	5.7
Phoenix SG Ltd (Stanley Gibbons)	5.6
EasyJet	5.6

Source: Phoenix, as at 31 March 2019

As we discuss in the gearing section, the managers are happy to run up high cash weightings. Cash levels are primarily a function of the number of attractive opportunities available.

Unsurprisingly, given the value investment philosophy, the portfolio is currently packed with domestic economically-sensitive stocks such as Lloyds, Tesco, Morrisons and Sports Direct. In their recent quarterly report, the managers note that the UK high street is under severe pressure, but that consumer spending remains strong. They believe that there will be winners as well as losers, and have invested in those businesses which they believe

Fig.2: Sector Breakdown



Source: Aurora

will profit from, or survive, the internet retailing onslaught. It goes without saying that if the impact of Brexit does begin to bite on UK consumers in general, Aurora's investments are likely to come under pressure.

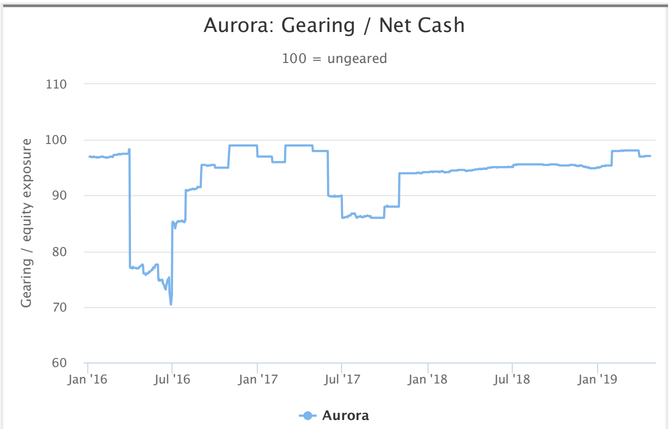
The managers are very much focused on long-term returns and view risk as permanent capital loss rather than short-term volatility. As we look at in the performance section, their long-term numbers show that there are clearly merits to their investment strategy. However, their long-term investment horizon allowed them during the market sell-off in the latter stages of 2018 to rotate the portfolio into what they viewed as higher "upside to instrinsic value", building up the trust's weighting to housebuilders once again, which the team had previously sold down (from 18% of the portfolio to 10%) thanks to what they saw as full valuations in March 2018.

Gearing

Given the highly concentrated nature of the portfolio and value approach, it isn't too surprising to see the trust doesn't employ gearing. The managers note that the primary reason for not using leverage is because they don't want to be forced to do something that would permanently destroy capital, such as selling a cheap stock in a downturn to reduce the gearing ratio.

Secondly, if they don't find enough stocks that fit their criteria, the managers are more than happy to let their cash weightings increase until better value opportunities present themselves. In the run-up to the Brexit vote, for example, cash accounted for more than 20% of the NAV, but the managers put that money to work prior to and after the vote.

Fig.3: Returns



Source: Morningstar

In May 2017, cash levels increased once again, reflecting the team's decision to half the exposure to UK housebuilders, which had made up 28% of the portfolio in early 2017. It is an area of the market that had rallied very strongly which meant that to the team, the attractiveness of these shares had waned as a result. Since the latter half of 2017, cash has consistently represented around 5% of NAV.

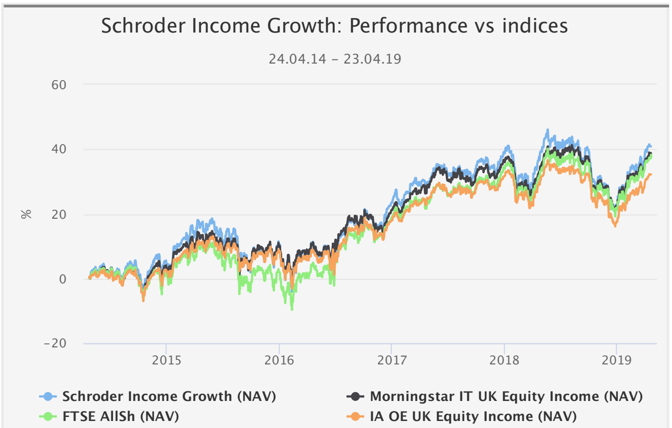
Performance

In appointing the Phoenix Asset Management, Aurora Investment Trust has a very different strategy from the previous incumbent. As such, performance analysis prior to January 2016 is largely irrelevant. In appointing Phoenix, aside from a completely different approach, the board were clearly attracted by their long-term track record of their open-ended, offshore Phoenix UK fund. This fund has delivered a net return of 509.8% between launch in May 1998 to 31st March 2019, compared to a return of 186% from the FTSE All Share – outperformance of 323.7%.

Since Gary and the team at Phoenix fully took charge of Aurora in January 2016, the trust has marginally underperformed relative to the FTSE All Share, but beaten its average peer in the UK All Companies investment trust and open-ended sectors. However, as the graph below shows, most of the relative underperformance was generated during the managers' first six months at the helm as their high weightings to domestic cyclicals weighed on returns in the Brexit vote induced sell-off.

This sell-off led to the managers deploying the large majority of the cash they had on the balance sheet into existing positions, and since then the trust has outperformed the index despite the significant headwinds that the "value style" has had over this period. It is worth noting that the trust has less of a headwind relative to peers, in that as we discuss in the charges section, the manager doesn't charge a base management fee.

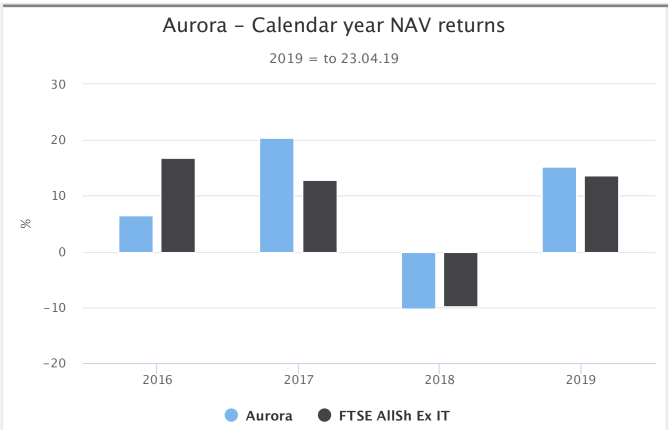
Fig.4: Performance



Source: Morningstar

Given the highly concentrated portfolio and marked value approach, past returns have tended to differ quite significantly from the benchmark, as illustrated in the graph below. However, despite having a concentrated portfolio and narrow exposure to "value" situations, the trust does not stand out over the past three years in terms of the risk statistics. For example, the maximum drawdown is in line with the median for the peer group (-18%), as well as volatility (13.5%).

Fig.5: Returns



Source: Morningstar

Dividend

The trust has no hard and fast dividend policy, with the managers' focus being on total returns and long-term capital growth.

Aurora currently has a (prospective) dividend yield of 1.9% and the managers state that the dividend will be a function of the dividends paid by the companies they own. Indeed, they note that there will be no attempt to "smooth" or "flatter" the dividend going forward. The board has recommended a dividend of 4p per share for the last financial year (ending 31st December 2018), representing an increase of 45% from that paid last year.

Management

Phoenix Asset Management was founded in 1998 and Gary Channon, who is lead manager on Aurora, is a co-founder of the firm and has been chief investment officer since inception.

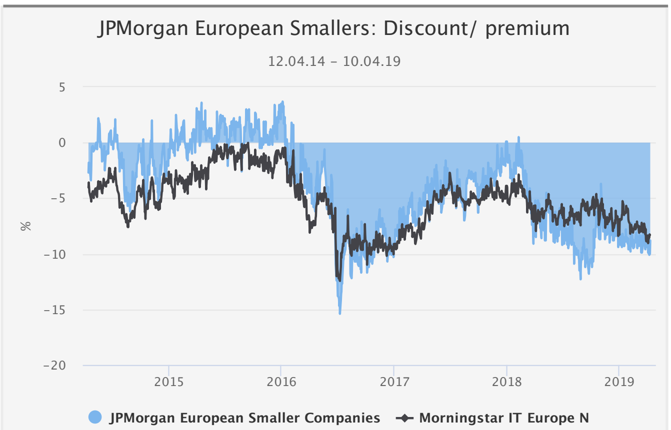
He has worked within the financial services industry for more than 30 years, having held positions at Nikko Securities Europe, Goldman Sachs and Nomura before setting up Phoenix. He is supported by a dedicated team of deputy managers and analysts in the group's investment team, three of which (Tristan Chapple, Charlotte Maby and James Wilson) are partners at the firm.

Apart from Phoenix's permanently employed research team, the team relies on the help of interns, friends and family to visit supermarkets, shops, banks etc. to talk to customers and see how companies act in the real world – which is a distinctive feature of their investment strategy.

Discount

Prior to Phoenix Asset Management being awarded the mandate, as a result of its small size and poor NAV returns, Aurora had historically traded at a very wide discount to NAV. As the graph below shows, the announcement of Phoenix's appointment – starting in January 2016 - had an immediate effect on the discount. Since then, the board has been issuing shares, and the trust has traded at a consistent premium rating. At the time of writing the shares are on a premium of 1.6%, a significant premium to investment trust peers in the UK All Companies sector (weighted average discount of 7.1% according to Numis). In our view the premium to NAV highlights the clear demand for Phoenix's highly differentiated investment approach. The board doesn't have a distinct discount policy, which is worth bearing in mind. Having taken on the trust with net assets of around £15m, at the time of writing assets stand at £125m – representing a considerable success for both the board and manager. The company has a continuation vote every three years, the next being on 10 June 2019.

Fig.6: Discount



Source: Morningstar

Charges

Aurora Investment Trust has a highly-differentiated approach to fees. Phoenix charges no annual management fee, just a performance fee, and the managers earn nothing unless they beat the FTSE All Share over defined periods.

The fee is one third of returns in excess of the FTSE All Share, although it is paid in Aurora shares rather than cash, and the manager is restricted from selling these shares for a further three years. This fee is capped at 4% of NAV in rising markets and 2% in falling markets.

At the last year end (31st December 2018), the cumulative underperformance since the appointment of Phoenix was 4.4%. As such, no fee was due. To further align the interest of the managers and long-term investors, if during a three-year period the trust's outperformance has reversed – the performance fee is "clawed back". As such, if at the end of a three-year period the outperformance the managers were initially paid for is no longer there, the managers lose some or all of their performance fee.

The "performance fee only" arrangements means that Aurora has a relatively low OCF despite its relatively small size. In the year to 31st December 2018, the OCF was 0.44% (down from 0.54%).

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