

Sweet or sour?

Three months in, we check up on our list of discount opportunities...

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In our February article 'Sweet Treats', we launched our list of discount opportunities - trusts we felt had the potential to see their discounts close significantly and, in turn, supercharge investors' returns. Our list has had a good beginning to its life, with the majority seeing their discounts close slightly in the almost three months since, aided by a good period for the markets.

The investment trust universe has seen its average price rise by 3.2% since 13 February, as the below graph shows. We can trace the rally in the market to the meeting of the Federal Reserve's interest rate setting body, the FOMC, on the 20 March. Shortly after that meeting, global equity markets began their rise, as investors lowered their expectations for future interest rates.

PERFORMANCE OF INVESTMENT TRUSTS

Source: Morningstar

Our eight trusts have outperformed this rising market on average, thanks both to superior NAV returns and the closing discounts. The average share price rose 4.5%, and the average discount narrowed on our portfolio by 0.5%, significantly higher than the 0.2% on the IT universe as a whole. Here we analyse the movements in the trusts' discounts and share prices since our last review, before adding a new opportunity to the list in a new sector.

Sweetener

The ability to pick up shares trading on a discount to net asset value is one of the distinctive opportunities which closed-ended funds offer. Of course, trusts can trade on a discount for many reasons and some of them are justified, but the share price movements of investment trusts are subject to the same biases and inefficiencies which the shares of all companies are – they tend to overreact to news and trends tend to be taken further than fundamentals would warrant. This means that they can throw up opportunities for the value-minded investor who has enough patience to wait for the unjustified discount to close.

The chief benefit to this is accelerating returns: a trust which sees its NAV rise and its discount close at the same time can generate extremely attractive returns, with a similar effect to being geared in a bull market. But buying on a discount can also give a greater margin of safety on the downside. Once the bad news is priced in, the chance of a discount widening further diminishes and the likelihood of board action to support or close the discount increases.

This list represents the best potential opportunities we see for relatively short-term gains boosted by discount movements. We view these as "satellite" positions around our core picks for growth and income. The trusts are, when selected, trading on wide discounts (at least 10% in absolute terms), which we think have the potential to close over the short-to-medium term, but most importantly, have the potential to produce attractive NAV returns (in relative or absolute terms) as well.

Our original eight trusts are an eclectic bunch. This is unsurprising at this current late point in the economic cycle. The average discount on the IT universe has come in from around 16% in 2008 and 8% in 2012 to around 2% at the time of writing. As such, opportunities tend to be in more idiosyncratic situations, largely to do with governance or management of the company or a highly specific, specialist asset class.

Performance review

PERFORMANCE OF LIST

	13TH FEB 19 DISCOUNT	19 APRIL 19 DISCOUNT	CHANGE IN DISCOUNT	SHARE PRICE RETURN
Oakley Capital Investments	-31.1	-25.8	5.3	9.3
Menhaden	-28.6	-24.1	4.5	10.7
Tetragon Financial	-47.5	-44.9	2.6	5.6
Baring Emerging Europe	-11.4	-10.2	1.2	3.9
Aberdeen Standard Asia Focus	-11.3	-11.2	0.1	1.2
River and Mercantile UK Micro Cap	-11.6	-13.5	-1.9	-1.5
Aberdeen Smaller Companies Income	-12.8	-15.8	-2.9	5.7
Henderson Opportunities	-14.1	-18.8	-4.7	0.7
MSCI AC World				5.8
FTSE All Share				5.2

Source: Morningstar

While three of our eight trusts have seen their discounts widen, in two of these cases we believe this is purely a result of share prices having failed to keep pace with a sharp rally in the NAV. **Aberdeen Smaller Companies Income** (ASCI) and **Henderson Opportunities Trust** (HOT) have seen share price rises of 5.7% and 0.7% respectively, but the discounts have widened by 2.9% and 4.7% making these discount opportunities even more of an opportunity! It seems that the cloud of uncertainty around the Brexit process has meant that investment trust investors remain sceptical of the sharp rally in the UK equity market. In fact, UK equities have outperformed the global market since 13 February, with returns of 6% for the FTSE All Share compared to 3.5% for the MSCI World. We would interpret the results from ASCI and HOT as highly favourable so far, with the managers of both trusts generating market beating returns, but investors not yet giving them the benefit of the doubt.

PERFORMANCE OF UK AND WORLD EQUITIES

Source: Morningstar

In the case of **Aberdeen Smaller Companies Income**, we continue to believe that the change in management last year could lead to a re-rating. Since September 2018, the trust has been run by Abby Glennie, one of the two UK small cap managers in the Standard Life Smaller Companies team, which has an outstanding track record of generating strong total returns with a quality growth style. Abby works alongside Harry Nimmo, whose Standard Life Smaller Companies Trust trades on an 8% discount, but has frequently traded on a premium when UK small caps are more in favour. ASCI's process has moved toward alignment with Harry's, with the only differences coming from the income skew of the mandate.

Henderson Opportunities Trust, on the other hand, we view as more of a Brexit rebound play or at least one to possibly hold until the next cyclical rally in the UK. The trust, managed by James Henderson and Laura Foll, has a tendency to be significantly geared, run high levels of small and mid-cap exposure and has cyclical and value tilts. The shares and the discount have been highly volatile in the past, and we think this is one that could trade at par when investors next seek geared exposure to a bull market.

The other trust which has seen a widening discount, **River & Mercantile Micro Cap**, has also seen a slight rise in NAV but a share price fall of 1.9%. Whether this widening discount is thanks to a lack of investor appetite down to Brexit related fears, or thanks to dissatisfaction from existing holders (at the AGM held on 27 February, two resolutions passed with substantial dissenters (around 21% of shareholder voted against the two resolutions)) it is hard to tell. In our view, neither is a particularly relevant factor, and does nothing to alter our opinion that the investment thesis remains intact. Competitors Miton UK Micro-Cap and Downing Strategic Micro-Cap both trade on discounts of around 10% narrower, despite significantly worse performance over all time periods. As readers may recall, RMMC saw its discount widen out following the dismissal of former manager Philip Rodrgis in December 2017. However, his replacement, George Ensor, has worked on the trust since it launched, and the investment process is relatively well defined, being based on a number of screens which River & Mercantile use across their funds. We continue to believe it makes little sense for the trust to trade on a wider discount than the micro-cap (as well as the UK Small Companies) peer group. RMMC specialises in an area with few options, and there is scope for a much higher rating when appetite towards UK small caps recovers.

Turning to those trusts which have seen their discounts close, the three biggest movers were those trusts originally on the three widest discounts – albeit not in that order. The most significant has been **Oakley Capital**, which has seen its discount close by 530 basis points. Since we highlighted the trust it has posted strong results for 2018, with NAV total return up 9.4% from the previous 30th June 2018 NAV. In our recent note, we highlighted that the trust has generated strong long-term NAV total returns, and has outperformed the FTSE All Share over three years. Being a directly invested private equity fund, the portfolio is highly concentrated and subject to single stock shocks (both positive and negative). However, recognising the persistent discount, the board has implemented a number of reforms to attempt to tackle it, including a commitment to never issue shares at a discount to NAV, greater disclosure of underlying portfolio companies, investor meetings and capital markets days, and a renewed commitment to buy back shares. In addition, the manager tells us that the AIM listing is also being reviewed. The most recent buyback was on 15 March, when 404,100 shares were repurchased, or 0.2% of share capital. We think the discount move so far is a validation of our original thesis, and with the average discount on the listed private equity sector 800bps narrower than OCI's current discount, there is plenty more potential to aim for.

Menhaden's discount has narrowed by 4.5% since Valentine's Day, thanks to a sharp share price rally in the second week of April. When we covered the trust in early February, we noted press rumours of a potential sale of the trust's largest investment, X-Elio, worth 19.1% of the portfolio. As we understand it, the holding has been the subject of a bidding contest, with the announcement of the winner expected in this post-Easter period. Part of the discount narrowing could be a result of investors anticipating a successful conclusion of this process, and (possibly) an uplift to the valuation on the sale. As we highlighted in our February update, we believe the trust has undergone a significant evolution, and is no longer simply a "green" fund, but rather a value fund with a strong sustainability tilt to its investment process. Performance has significantly improved, with the trust up 14.5% in NAV total return terms over a year, compared to an AIC Global sector average of 10.2%. The share price has risen by 18.2% over one year, reflecting the narrowing discount. Having a highly concentrated portfolio does present NAV risks, and there is potential discount / share price risk if we receive any adverse news on the potential X-Elio sale. However, over the medium term, we see further discount tightening as strongly possible, particularly given the continuation vote due in May 2020.

Tetragon is the third trust to have seen substantial discount tightening already, of 2.6%. As we have previously highlighted, it is a complex vehicle, which may have contributed to investors steering clear in the past. The portfolio includes a diverse number of "alternative" strategies, such as those investing in convertible bonds, event driven equity strategies, and bank loans. It also owns stakes in a number of asset management companies (30% of NAV), many of which manage the company's capital. The variety and the types of strategies should mean that NAV is uncorrelated to equity markets, we believe, which together with the historic return profile (consistent double-digit NAV total returns), if repeated, could make this a highly attractive investment. The complications with Tetragon include the corporate governance angle – Tetragon's principals Reade Griffith and Paddy Dear have a controlling shareholding, as well as relatively high fees.

Baring Emerging Europe has seen its discount come in by 1.2%. It now sits at 10.2%, but was as low as 8% at the end of February after a sharp rally in the NAV. We still think the likely

continuation vote provides comfort on the downside. By our calculations, the shares need to trade on an average discount of 7% or less until 30 September to avoid a tender offer early next year, which should mean the discount doesn't widen much further in the interim. We also think there is huge potential in this portfolio purely on an NAV basis. The Emerging Europe market is deeply out of favour, with the MSCI benchmark trading on a forward P/E of just 6.8 times. Meanwhile, manager Matthias Siller has generated more alpha against the benchmark over three and five year periods than all but one trust in the global emerging markets sector.

Aberdeen Standard Asia Focus has seen the smallest discount movement since February, with a marginal 0.1% movement. The share price has also been relatively dull, with a 1.2% gain. This is unsurprising given the return of risk appetite to markets which has seen the MSCI AC Asia Pacific Index rally 4.7%. AAS has a quality tilt, which is more in demand in struggling or sideways markets and means it is relatively light on cyclical and economically sensitive stocks, which are the quickest to move in rallies. We still believe that the next few years in Asian markets are likely to be more favourable to the trust than the last few, which saw growth and momentum styles dominate. Furthermore, the main reasons for expecting a re-rating remain intact. Hugh Young, one of the most experienced fund managers in the market, was named lead manager in November as part of an overhaul requested by the board. The number of holdings has been cut and the concentration in the highest-conviction names raised, and we believe these changes increase the chance of significant outperformance in the future. As such, the discount of 11.2% looks unwarranted relative to the sector weighted average discount of 4.9%.

A new pick

While we are pleased with the results so far from our picks, none of the discount movements have been close to what we believe is their full upside potential. In the case of the three biggest movers, Oakley, Menhaden and Tetragon, they remain on exceptionally wide discounts relative to peers, which we think are unwarranted and have significant potential to close further. As we have explained above, in the case of the three laggards, widening discounts have occurred despite rising NAVs, and we would expect the share prices of the trusts to catch up with the market eventually. However, we recognise the possibility that in the short term the ongoing uncertainty around Brexit may lead to these discounts being more volatile. We are comfortable with all three picks, nonetheless.

We have decided to add **Schroder Japan Growth** to the discount opportunities list. It has been managed by Andrew Rose since November 2007, but in February 2019 he announced he would be leaving the industry this June. This has led to the discount widening significantly. According to Morningstar data, since the 7 February, the trust's discount has widened from 10.4% out to 12.5%. Over this period of rising risk appetite, the gap between the trust and the sector's discount has widened from 600 basis points to 800.

DISCOUNT

Source: Morningstar

Even prior to this announcement, the gap between the trust's discount and that of the peer group was at the wider end of its range, which we attribute to the value style being out of favour. Over five years the trust has traded on an average discount to its sector of 3.6%; the figure is now 7.9%. We would expect the stylistic disadvantage to swing round in the trust's favour over the medium to long term too, so this could be an interesting entry point in our view.

DISCOUNTS OF SECTOR AND TRUST

	SCHRODER JAPAN GROWTH	MORNINGSTAR IT JAPAN	GAP
5yr average	-8.7	-5.1	-3.6
06-Feb	-10.4	-4.3	-6.1
19-Apr	-12.5	-4.6	-7.9

Source: Morningstar

As for Andrew's departure, management will pass to his deputy, Masaki Taketsume. This is a planned transition, which is one reason we have confidence in picking up this trust now. Masaki Taketsume has worked on Schroder's Japanese equity desk since 2007, and moved over to London in 2014 to work closely with Andrew in anticipation of his retirement. He has therefore had ten years' experience in the team and three years working closely with Andrew on this trust. Certainly, there will be a period of adjustment whilst investors get to grips with the new manager, but over the medium to long term we think there is significant potential for the discount to narrow.

UPDATED LIST

NAME	TICKER	LATEST NAV DATE	NAV	MARKET PRICE	DISCOUNT (CUM FAIR) 19/04/2019
Aberdeen Smaller Companies Income	ASCI	24/04/2019	3.31	2.81	-15.8
Aberdeen Standard Asia Focus	AAS	24/04/2019	12.01	10.60	-11.5
Baring Emerging Europe	BEE	24/04/2019	8.54	7.83	-10.2
Henderson Opportunities	HOT	24/04/2019	11.92	9.90	-18.8
Menhaden	MHN	31/03/2019	1.03	0.80	-24.1
Oakley Capital Investments	OCI	31/12/2018	2.79	2.09	-25.8
River and Mercantile UK Micro Cap	RMMC	24/04/2019	1.93	1.64	-13.6
Schroder Japan Growth	SJG	24/04/2019	2.08	1.87	-12.6
Tetragon Financial	TFG	28/02/2019	22.90	12.80	-44.9
Portfolio average					-19.7

Source: Morningstar

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