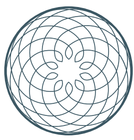


Kepler | Trust Intelligence

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

Troy Income & Growth

Update
07 January 2020

Seeking to identify and invest in a portfolio of high quality companies, TIGT seeks to generate sustainable dividends and income and capital growth...

Summary

Troy Income & Growth Trust (TIGT) invests predominantly in UK equities. Managed by Francis Brooke and Hugo Ure of Troy Asset Management, the trust reflects Troy's emphasis on capital preservation over the cycle, and owns a highly liquid portfolio of between 35-50 stocks matching Troy's preferred investment characteristics.

Whilst income generation is a goal of the trust, the managers of TIGT also seek to ensure this income is growing in real (inflation-adjusted) terms and is accompanied by capital growth **as discussed in the 'Dividend' section**. Revenue reserves could help support the dividend in the near future.

Within TIGT the focus is very much on bottom-up stock selection and seeking 'quality' companies, though they are cognisant of the wider market and economic dynamics. Whilst they prefer companies which exhibit non-cyclical characteristics with low capital intensity, they can be pragmatic in certain instances where only one of these criteria is met.

Net Asset Value (NAV) and share price volatility have typically been below that of the wider market. The latter is partially a function of the discount control mechanism (DCM) intended to improve liquidity and ensure the trust trades near to NAV with relatively low discount volatility **detailed in the 'Discount' section**. In recent years this has generally led to the trust issuing shares, helping to grow assets without diluting existing shareholders.

Troy recently celebrated the 10th anniversary of managing the trust, and over this period returns from TIGT have substantially outstripped those of the FTSE All Share Index. This has been achieved without the use of gearing. Recent returns have remained strong, with TIGT outperforming the index, having largely kept pace in rising markets whilst exhibiting lower drawdowns than the wider market.

Analyst's View

TIGT has outperformed the index over a number of years, with lower levels of volatility and retains a disciplined investment approach. A relatively concentrated portfolio and a preference for holding significant stock positions means investors are better able to benefit from the managers' analysis of individual companies, and TIGT has generally demonstrated positive alpha under the current management. At c. £265m, the trust is at an attractive level of assets, with good liquidity in its shares, and could be considered an attractive core holding in UK equities for most investors. This is particularly true for investors seeking to generate income from their portfolio, with TIGT offering a reasonable yield made resilient through reserves, whilst the DCM has been effective at lowering discount volatility since introduction.

Key Information:

As at	06/01/20
Price (p)	85.2
Discount (%)	0.7
OCF (%)	0.91
Turnover Ratio	10.9
Yield (%)	3.3
Gearing (%)	0
Ticker	TIGT
Shares (£)	322,931,987
Market cap (£)	275,052,853

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Pascal Dowling
+44 (0)203 384 8869

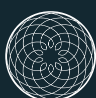
Thomas McMahon, CFA
+44 (0)203 795 0070

William Sobczak
+44 (0)203 598 6449

Callum Stokeld
+ 44 (0) 203 795 9719

Kepler Partners is not authorised to make recommendations to Retail Clients. This report is based on factual information only.

The material contained on this site is factual and provided for general informational purposes only. It is not an invitation or inducement to buy, sell or subscribe to any product described, nor is it a statement as to the suitability or otherwise of any investments for any person. The material on this site does not constitute a financial promotion within the meaning of the FCA rules or the financial promotions order. Persons wishing to invest in any of the securities discussed in the website should take their own independent advice with regard to the suitability of such investments and the tax consequences of such investment.



Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

Meanwhile, the shared investment philosophy across Troy Asset Management means that the managers have recourse to significant analytical resources. Recent moves to reduce the utilities exposure have had the effect of reducing the sensitivity to interest rates, and therefore one of the risks to stocks with their preferred characteristics. However, a general rally in UK stock markets might be reasonably expected to see TIGT trail on a relative basis due to its defensive nature.

Analyst's View

BULL	BEAR
Tends to offer superior downside protection relative to the market	May lag on a relative basis if UK equity markets rally
Track record of growing dividends above inflation, which remain well covered	Negative sensitivity to moves in GBP have been a tailwind, but could reverse
DCM keeps liquidity high and price volatility low	
Fundamental independent research and access to a highly experienced team	

Portfolio

Troy Income & Growth Trust (TIGT) focuses on investing in UK equities with the aim of generating both income and capital growth. Managed by Francis Brooke and Hugo Ure of Troy Asset Management, TIGT shares the same emphasis on capital preservation over the cycle which is common to Troy portfolios, focusing on fundamental investment research to identify high-quality companies which can deliver long-term returns.

The managers seek to construct a highly liquid, relatively concentrated portfolio of between 35-50 holdings, selected from a distilled investment universe. With a commonality in investment approach across Troy as a firm, analytical resources can be shared across teams and are used to create a universe of attractive companies.

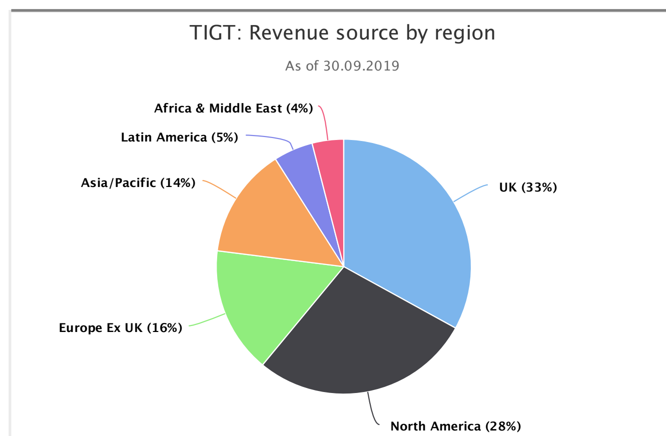
Whilst TIGT has the ability to invest in overseas companies, the focus is on UK equities, narrowing their investment universe of companies which meet Troy's criteria down to around 100 (compared to c. 200 companies in the global universe, though this continues to grow as the company grows and is able to apply greater analytical resource).

This universe is constructed by looking at a variety of factors, with the managers ideally looking for stocks with resilient business models unlikely to be significantly affected by short-term economic cycles, which also require relatively low capital investment on an ongoing basis. They do, however, track the business cycle and can invest at the margin in more cyclical or capital-intensive businesses when the valuation or point in the cycle is right; the presence of both these factors in a company, however, will usually preclude investment. Certain quantitative screens are used for idea generation and as a detached check on their qualitative analysis, but most of the input is qualitative in nature. Brokers are not generally used for idea generation, though the managers will consult with certain brokers who are highly specialised in certain sectors about sectoral trends.

Management meetings are considered an integral and important part of assessing the quality, sustainability and outlook for a business's operations, with the team looking for companies with strong pricing power. These companies tend to have strong brand or franchise value, with 'sticky' customer relationships, relatively high costs to switching and barriers to entry within the industry. Companies within the trust's investment universe will typically display strong free cash flow, allowing them to invest internally in growth with little or no recourse to external capital raises. As a result, TIGT's median holding has a free cash flow margin roughly double that of the wider FTSE All-Share's median.

Diversification of revenue sources and a wide customer base is also desirable, as is unique intellectual property and the ability to leverage this across networks. This is reflected in the underlying weighted revenue exposure to the TIGT portfolio, with the 33% of revenue generated in the UK the highest regional exposure despite the fact that c. 87% of the portfolio is held in GBP assets (with 9.6% in USD and 3.2% in CHF).

Fig.1: Tigt: Underlying Sources Of Revenues



Source: FactSet via Troy Income & Growth

Companies meeting the 'quality' criteria are generally added to the wider Troy universe; this does not automatically lead to investment, and companies added will not be retained indefinitely if they deteriorate in the desired criteria. The universe is reviewed formally on a fortnightly basis, with significant share price moves, operational updates, and attendant changes to valuation multiples attached to those businesses highlighted. They also continue to meet with management on an ongoing basis.

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

As well as highlighting potential changes in the quality-based criteria of a business, these reviews of the universe also serve to highlight potential buying opportunities; if the managers observe a move to a more attractive valuation they can re-evaluate and potentially introduce this stock. The valuation discipline also results in some more tactical portfolio turnover, with positions occasionally reduced or exited on valuation concerns. The managers have recently reduced their holding in Sage for this reason, though they remain happy to hold the remainder of their position.

Large-cap stocks will not generally exceed 6% of NAV, mid-caps 4%, and small caps 2%. Occasionally positions will be held at smaller levels of individual exposure when they can be considered part of a basket of stocks, with PHP (c. 1.6%) and Assura (1.4%) good examples of a combined exposure.

The selling discipline emphasises exiting positions as soon as possible when they believe there has been a fundamental change to a company's operations and/or environment, or if they believe their original investment thesis was mistaken.

This could be seen in the managers' recent decision to exit Centrica. Their confidence in this business had deteriorated because they felt the political environment offered too great a risk to it, with consequent concerns over Centrica's future ability to meet dividends and offset regulatory burdens. This exit also helped to reduce their exposure to the utilities sector, which now stands at c. 4%.

With most of the portfolio in highly liquid stocks, this can generally be accomplished quickly; presently the managers estimate they could liquidate c. 80% of TIGT's portfolio in less than a day if necessary (as of 31/08/19).

At a sector level this investment process naturally lends itself to overweight exposure to areas such as consumer goods, healthcare and specialist financials, whilst typically avoiding exposure to areas such as airlines, miners or life insurance. This, it should be noted, is a consequence of an investment approach which primarily focuses on bottom-up stock analysis, as opposed to a specific aim.

TIGT aims to balance between opportunities with both higher- and lower- than-market levels of yield; at present, they are aligning the portfolio slightly towards a lower headline yield, believing the superior dividend cover and cash flows they identify in these companies makes them more attractive at this time.

This relative attractiveness is in part reflective of the managers' observations of the economic cycle. At the aggregate levels, corporate margins globally are relatively high, yet some areas are beginning to exhibit some margin pressures. Wage pressures are, in certain areas such as retailing, beginning to weigh on profitability, though the managers note that most of their holdings which are exposed to these pressures (such as WHSmith and Compass Group) have contingency measures in place. Productivity growth has remained weak, but high margins in select areas are beginning to attract new entrants whilst they see increased signs of pushes for innovation.

Although this has the potential to affect TIGT holdings, the managers note that their holdings often have certain advantages from intangibles, such as intellectual property.

An example of this is TIGT's holding in Victrex, to which they have been adding. Victrex is the world's leading producer of the PEEK polymer, a plastic polymer with a variety of applications in a diverse array of areas such as aerospace, medicinal, energy, engineering, automotive and electronics. Whilst PEEK has not been protected by patent for nearly two decades, Victrex, who originated the product, have managed to retain a c. 70% global share of the market. This is because production of PEEK is complex, and the entry costs of establishing the necessary processes represent a barrier to entry to many potential competitors. With a market leading manufacturing process, Victrex is able to maintain leadership whilst re-investing in R&D capabilities and maintaining attractive EBIT margins of c. 39%.

There is an element of cyclicality to this stock, and the wider market can overreact to short-term events. Troy has also previously exited the position on valuation concerns. However, as there is net cash on the balance sheet, and with the business having generated compounded annual sales growth rates from 2003-2018 of 10.6% (whilst expanding margins), the managers believed the entry multiple of c.17.5x P/E was attractive to access the structural growth trends the company continues to benefit from.

Whilst there is a slight shift to slightly lower-yielding parts of the market and universe, turnover remains relatively low, but the managers note that sensitivity to interest rate movements has fallen within the portfolio, partially as a result of reducing exposure to utilities and partly as a result of additions to positions which benefit from a rising rate environment, such as IG Group and Lloyds. There has also been a slight shift towards UK revenue generators, though this is marginal.

Gearing

TIGT does not presently have any gearing in place, and as per the September 2019 factsheet, has net cash of c. 1.8%. It does, however, have a £20m gearing facility it could use.

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

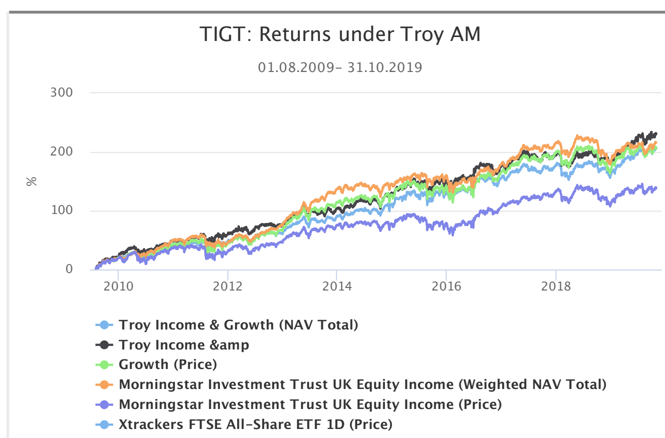
In line with the loss-aversion that underlines the investment process, the managers are reluctant to employ gearing. However, on occasions they may do so if they observe compelling valuation opportunities and signs of severe market stress. With regards to the latter, indicators such as a spike in market volatility may be taken as a contrarian opportunity to add to positions via gearing, but a qualitative assessment of the environment will be undertaken first as opposed to reflexive buying of stocks.

Performance

Returns since the current management team took over TIGT in August 2009 have been strong, with NAV and share price total returns of 205% and 231% respectively as of 31/10/19; share price returns have been boosted by a significant narrowing in the discount following the implementation of the Discount Control Mechanism in January 2010.

This compares favourably with a passive exposure to the benchmark (via an ETF; when referring to benchmark returns in the below graph, this is based on an ETF tracking the FTSE All-Share) and sector price returns of 138% and 216% over the same period. Weighted average sector NAV returns over this basis have been in line with the NAV returns of TIGT at 206%; however, TIGT has achieved this without gearing and with a lower level of volatility incurred. It is also worth highlighting the outperformance of the FTSE 250 and mid cap stocks over this period, where TIGT generally has lower exposure than its peers.

Fig.2: Tigt: Returns Under Current Management Vs Peer Group And Benchmark



Source: Morningstar

Returns have benefitted from greater resilience to falls in the market. This can be seen by looking at the relative returns of TIGT shares to the market over rolling 12-month periods: the median relative return for TIGT is stronger in periods where the FTSE All-Share declined as compared to those where it rose.

Table Of Returns 01.08.2009- 06.11.2019

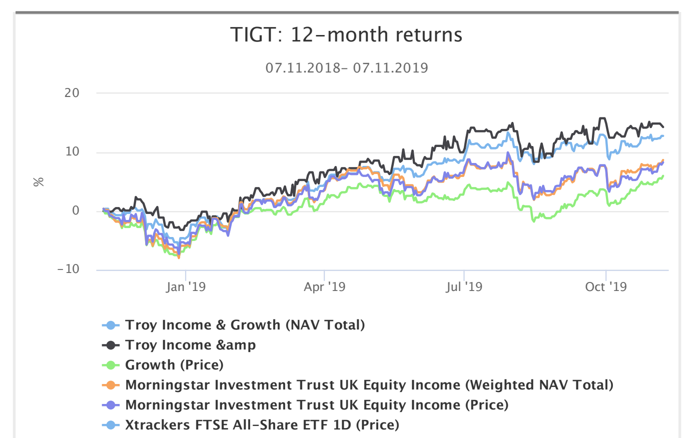
	MEDIAN RELATIVE TIGT SHARE PRICE RETURNS	HOW OFTEN TIGT SHARES OUTPERFORMED
When benchmark positive over previous 12 months	-0.35%	48%
When benchmark negative over previous 12 months	10.64%	97%

Source: Morningstar

With this in mind, it is unsurprising that risk-adjusted returns have been strong over much of the managers' tenure. Whilst risk-adjusted returns were not as strong on a trailing basis for much of 2017, this is understandable given the context. This period generally encompasses data from 2016-17, during a period where cyclical, capital intensive sectors such as mining generated significant outperformance in a strongly rising market. Given the managers seek to avoid exposure to companies with precisely these kinds of characteristics, investors should be reasonably sanguine that TIGT lagged in this kind of environment, as it demonstrates consistency of process.

Recent returns have remained strong, with the trust outperforming over the previous 12 months. In part this was a result of greater resilience in the market drawdown seen in Q4 2018, but TIGT has also continued to outperform as the market has rallied in 2019. Flattening yield curves have been a tailwind to many of the kind of 'quality' stocks that TIGT holds, whilst for much of 2019 weaker sterling has benefitted the underlying reported earnings of many of its holdings (as weaker sterling sees overseas sales translated to a higher reported number in sterling). Sterling weakness has, however, started to reverse in recent weeks.

Fig.5: Tigt: 12 Month Returns



Source: Morningstar

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

TIGT is likely to continue to exhibit positive sensitivity to sterling weakness going forward. The managers take the view that, in the majority of instances, the benefits from hedging any overseas currency exposure from overseas holdings do not merit the costs, particularly as sterling has in effect been in decline for much of the past 80 years. The underlying companies, **as discussed under the 'Portfolio' section**, generate a majority of their sales overseas.

Dividend

TIGT currently yields c. 3.3%; the trust targets a mixture of income and real (i.e. inflation adjusted) income growth (as well as capital growth). Dividends are paid quarterly, though there is no specific set dividend target. The managers have been successful at increasing the dividend over every financial year since 2010 (having taken over management of the trust in August 2009).

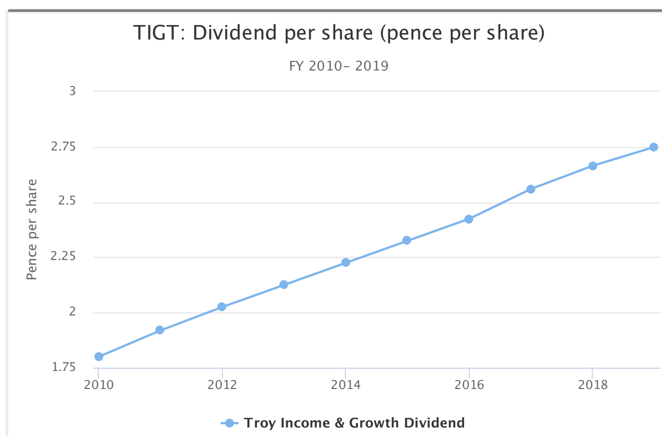
Whilst the portfolio's overall level of yield is considered important, stocks are not expected to contribute equally to this. Acknowledging that payout ratios (the proportion of earnings paid out to shareholders) have risen significantly in the UK over a sustained period, the managers believe the FTSE 100 payout ratio of 60% hides significant divergences within the index, including some companies with better dividend cover.

For optimal portfolio management, there are certain instances when the managers' aversion to companies which are either cyclical and/or capital intensive is outweighed by other factors. For example, they currently hold some exposure to BP and Royal Dutch Shell, noting that the high level of dividends are experiencing improving levels of cover, whilst cash generation remains very strong.

The managers note that there is a high disparity in income generation within the FTSE 100 and All-Share, with c. 48% of income in the All-Share generated by the top 10% of companies. Moreover, there is a wide range of yields available within the FTSE All-Share; whilst a generalisation as opposed to a rule, the managers of TIGT note that often those companies with lower yields exhibit superior dividend growth (and, unsurprisingly, better dividend cover), and that these companies are often reinvesting in their businesses to drive growth. By contrast, companies exhibiting higher headline yields often show less ability to grow these dividends, and show poorer dividend cover. There is a weighting towards 'older economy' companies within these companies, often where reinvestment into the core business would not necessarily represent good capital allocation.

There has been a slight move towards lower yielding, but more resilient, stocks within the portfolio, reducing headline yield slightly.

Fig.6: Tigt: Dividend Per Share

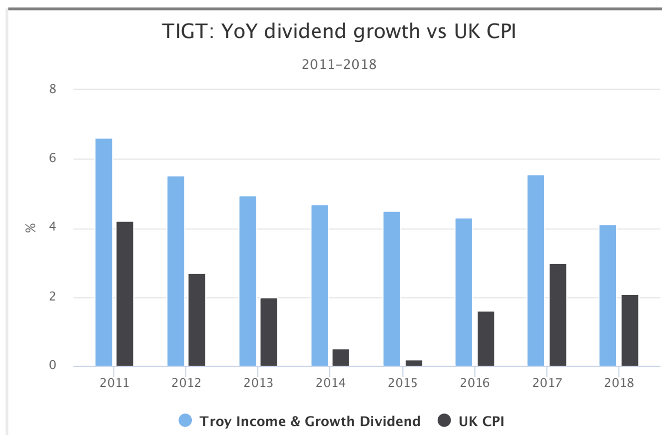


Source: AIC

Revenue reserves were c. 50% of the dividend at the last annual report, and the board is supportive of using them, if necessary, to top up the dividend if the managers feel it necessary to move to a lower-yielding portfolio. Up to 10% of revenue reserves can be used each financial year for this purpose. The board has exercised this option in the most recent reporting period, drawing on c. 1.3% of revenue reserves to ensure the dividend continues to grow in real terms; they retain substantial further reserves.

Dividends have increased in real, as well as nominal, terms, with year-on-year growth in dividends consistently outpacing UK CPI under the current management.

Fig.7: Tigt: Year On Year Increases In Dividend Per Share Vs Uk Cpi



Source: Morningstar and AIC

Management

Troy Asset Management was awarded the mandate to manage TIGT in July 2009. The trust is jointly managed by Troy's Francis Brooke and Hugo Ure. Francis has been with Troy since June 2004, and has been manager of TIGT since Troy was awarded the management contract; he also

Disclosure – Non-Independent Marketing Communication. This is a non-independent marketing communication commissioned by Troy Income & Growth. The report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on the dealing ahead of the dissemination of investment research.

co-manages the Trojan Income Fund. Hugo joined Troy in 2009, and has co-managed TIGT and the Trojan Income Fund for a number of years; he also manages the Trojan Ethical Income fund, and is Troy's Head of Responsible Investment.

The managers are able to draw on the wider resources of Troy Asset Management, with a number of analysts covering global stocks.

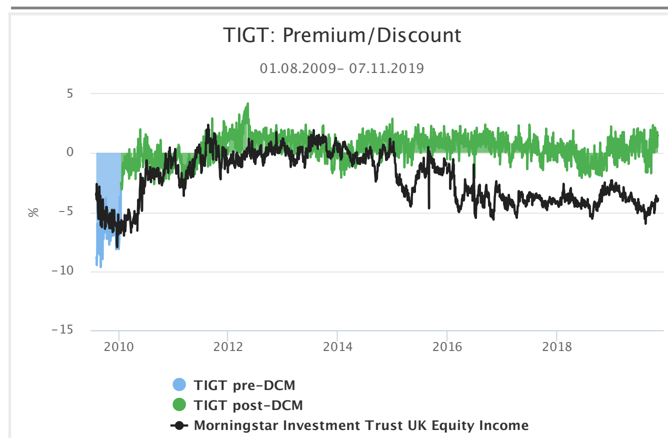
They also have significant input from Blake Hutchins and Fergus McCorkell, who both have significant input on UK equity income portfolios. Blake joined Troy in 2019 from Investec Asset Management to co-manage the Trojan Income Fund, where he was the lead manager on the UK Equity Income fund and co-manager on the Global Quality Equity Income fund. Fergus has been with Troy since 2017, and has significant experience in Troy's approach to stock analysis.

The board consists of four directors with senior executive experience across a range of companies and sectors, who collectively and individually hold significant exposure to TIGT and are actively engaged with the trust's management.

Discount

TIGT currently trades on a premium of c. 0.8% (as of 06/11/19). The trust operates a Discount Control Mechanism (DCM), with a Share Issuance Programme allowing for the issuance of up to 80m new shares. This mechanism was implemented shortly after Troy took over management of TIGT in January 2010. The period since has seen a substantial narrowing of the discount, and the trust has more commonly traded on a premium since this period, as can be seen below.

Fig.8: Tigt: Premium/Discount Under Current Management



Source: Morningstar

The board have been very active in operating the discount control mechanism, with net new issuance of 18,455,000 shares (as of 04/11/19) since the half-annual report on 31/03/19 and a further 140,000 shares issued from treasury; in the six months prior to this there was net issuance of a further 1,500,000 shares.

A total of 140,000 shares were bought back at a discount to NAV during this period. Net issuance, excluding shares issued from treasury, raised c. £15m over the period 31/03/19-07/11/19.

This has included sizeable recent activity, with c. 9,605,000 shares issued since the end of the previous reporting period (on 30/09/19) up to 04/11/19, raising c. £7.9m at a premium to NAV.

Discount volatility has been lower than that of the sector since the implementation of the DCM (on 14/01/10) at 1.04% (compared to a sector discount volatility of 2.02%). The operation of the DCM has also improved liquidity, with a high turnover of shares as a proportion of market cap relative to the peer group.

The board believes TIGT has capacity to expand before it reaches its optimal operational size, so issuance is likely to continue provided the trust remains at a premium. As assets under management grow there should be concomitant reductions in charges.

Charges

TIGT has an expected ongoing charge figure (OCF) of 0.91% in the year to 2020, against a sector average of 0.62%. The board hope, however, to reduce this further in the near future. Growth in AUM has and should continue to help achieve this, with share issuance at a premium to NAV under the DCM raising c. £15m in assets over the period since 31/03/19.

Management fees were reduced in January 2019, and are now charged at 0.65% p.a. The Key Information Document Reduction in Yield (KID RIY) figure is 1.29%, compared to a sector average of 1.16%, although we caution that methodologies vary.

Fees are charged at 65% to capital and 35% to income.

ESG

ESG considerations are considered as inputs into the stock analysis process. This includes analysis of both positive and negative ESG issues, and how they impact upon business performance. The managers do not employ

a rigid, quantitative 'scoring' system, but instead try to understand how ESG factors are impacting business performance, and how they can engage as active owners to improve ESG matters.

Often this can result in positive developments for business operations; for example, Victrex (**as discussed in the 'Portfolio' section**) are increasingly looking into how they can more efficiently regain and recycle their polymers, which the managers believe can add to their competitive advantage in this market.

Disclaimer

This report has been issued by Kepler Partners LLP. **The analyst who has prepared this report is aware that Kepler Partners LLP has a relationship with the company covered in this report and/or a conflict of interest which may impair the objectivity of the research.**

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to market products or make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR **TERMS AND CONDITIONS**

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 9/10 Savile Row, London W1S 3PF with registered number OC334771.