Alliance Trust

Update
27 February 2019

Summary

Alliance Trust (ATST) is one of the UK's oldest and largest investment trusts and has delivered a growing dividend to shareholders every year over the last 52 years.

In 2017, the trust changed its spots dramatically, adopting an innovative portfolio management approach that uses eight managers, each tasked with managing a bespoke highly-concentrated portfolio, selected and overseen by Willis Towers Watson (WTW). WTW chooses a line-up of stock pickers that has similar characteristics to the MSCI ACWI benchmark, in terms of style, country and sector exposures, to ensure that performance is primarily driven by stock selection in the long run. As such, and with net assets of c.£2.7bn, ATST is a truly 'global' trust.

Having had nearly two years in the new form, the equity portfolio has generated a decent return during what could be considered a difficult global market for active stock selection. The equity portfolio has risen by 10.4% since the start of April 2017 to January 2019, outperforming the MSCI ACWI index by almost 1.6%. Relative performance was somewhat hindered over 2018, as we saw a much smaller than usual number of (large cap) companies outperform the index during the first nine months of the year and a strong, broad-based market correction in the final quarter.

ATST's discount narrowed significantly on the announcement of the change in strategy in January 2017 and the board continues to manage the discount where necessary. Over 2018 the trust traded on an average discount of 6% and this has since come in to the current discount of 4.9%.

Portfolio

Alliance Trust announced the latest evolution of its investment strategy in December 2016, and the transition of the portfolio was complete by the middle of April 2017. Alliance Trust has continued to be a global equities portfolio, but one which reflects the concentrated 'best ideas' picks of a range of eight managers selected by Willis Towers Watson (WTW).

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WTW has a large institutional research team that can filter a universe of thousands of equity products down to a small list of highly rated portfolio managers. Only a subset of these are suited to running very concentrated portfolios and, at the time of writing, around 20 have agreed to provide exclusive segregated mandates to WTW consisting solely of their "best ideas" stocks – usually only twenty names to a portfolio. Eight of these managers have been combined for Alliance Trust. Each mandate has freedom to invest on a global basis with a high active share, although one of the managers also runs a more diversified emerging markets portfolio and another has been selected because of their bias towards the US.

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As we noted in our previous research (**Go big or go home**), more concentrated portfolios are becoming increasingly fashionable. We suspect that this is a reaction to the significant growth of passive investment strategies, but also the increasing academic evidence which points to the fact that concentrated portfolios do outperform (assuming the manager of the portfolio has skill). WTW has long been a subscriber to the theoretical advantages of concentrated portfolios but is in the privileged position of being able to prove that in practice, it works too. The institutional Towers Watson Global Equity Focus Fund has outperformed the benchmark MSCI World Index by 1.9% pa since it was launched in 2015 (to January 2019).

The managers are selected, intentionally, to think differently and have different investment styles and approaches. The table below shows that the eight initially selected managers offer a mix of growth, value and quality styles. WTW equally allocates to each on an approximately risk-weighted basis.

Manager Breakdown

MANAGER	PORTFOLIO FOCUS	% OF EQUITY PORTFOLIO MANAGED	STYLE
Lyrical Partners	Global with a bias to US	16	Value
GQG Partners	Global + Emerging Markets	15	Growth
Veritas	Global	13	Quality
Sustainable Growth Advisers	Global	13	Growth
FPA	Global	12	Quality
Black Creek IM	Global	12	Quality
Jupiter Asset Management	Global	10	Value
River & Mercantile	Global	9	Value

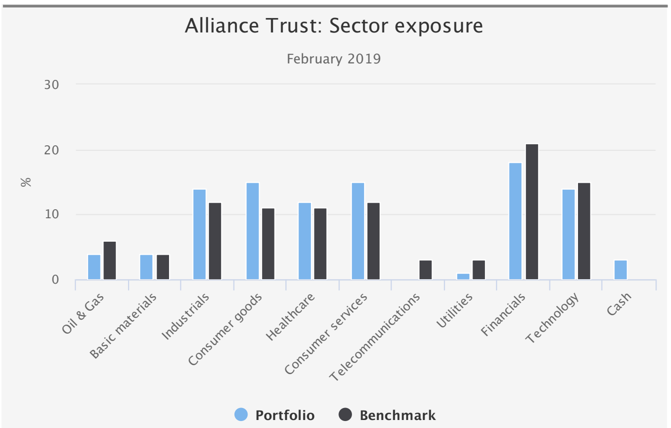
Source: Alliance Trust plc

The process of choosing each sub-manager, monitoring performance, and finessing the overall shape of the portfolio is led by an investment committee chaired by Craig Baker, WTW's global chief investment officer, and including Stuart Gray, a senior member of the research team, and the two co-portfolio managers, David Shapiro and Mark Davis. This ensures that as with the multi-manager approach, there is no single key-man risk at WTW either.

On an ongoing basis they will allocate and reweight assets to the different sub-portfolio managers in order to shape the whole portfolio, using cashflows to maintain a roughly equal risk contribution from each manager.

They allocate to managers so that stock selection is the key driver of returns, but that weightings relative to country and sector are broadly in line with the MSCI AC World Index benchmark. In the graph below, we think it noteworthy that whilst at an individual sub-portfolio level, they differ very greatly from the index, the portfolio as a whole sits relatively close to the index in terms of sector allocation. The only noteworthy overweights – all bi-products of bottom-up stock selection - are to consumer goods and consumer services, whilst underweights are to financials, telecoms and utilities. Interestingly, technology has gone from being one of the trust's largest overweights to an underweight position, illustrating the shift from being fair value to potentially overvalued.

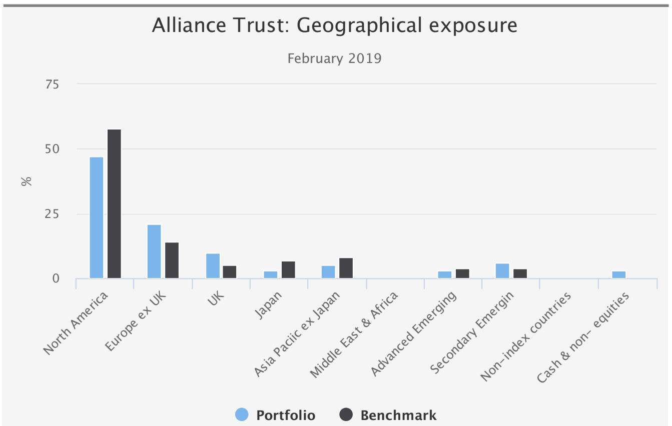
Fig.1: Sector Allocation



Source: WTW

ATST is a truly 'global' trust – in the sense that it provides proper exposure to 'the rest of the world' beyond our shores. Although the trust is overweight to the UK in comparison to the MSCI ACWI, relative to peers the 13% weighting is insignificant. As such, ATST has one of the lowest exposures to the UK in the AIC Global sector, where the average is 33% (JPM Cazenove).

Fig.2: Geographic Allocation



Source: WTW

The trust's largest regional weighting is toward the United States (45.8%), although this is underweight relative to the benchmark. Europe ex UK is the second-largest weighting at 22%, while Asia & Emerging Markets comes third (16.1% in total).

Given the unconstrained 'best-ideas' nature of each sub-manager's remit, the investment committee also keeps an eye on crossover between the portfolios, which tends to be low due to the managers' distinct approaches. In the unlikely event that a manager's stocks became too much like the other holdings in the portfolio, WTW would likely redeem the entire allocation and select another manager from its bench.

In our last note we mentioned that around 8% of ATST's assets remained invested in other areas not managed by WTW. However, this figure has come down considerably over the past seven months to less than 3% and will soon be negligible, as the company rids itself of non-core assets, with the board's objective to simplify the trust. Despite representing just 1.4% of the trust's total assets, Alliance Trust Savings has gained a lot of attention, as the subject of a high-profile sale process. Interactive Investor emerged as the winning bidder, with the transaction expected to close (subject to regulatory approval) around June this year. We see this as a positive step for the trust, with the resulting proceeds of £40m being invested by WTW and getting ever closer to the trust having a pure focus on the global equity portfolio. Once the Alliance Trust Savings transaction is completed, only around 1% of NAV will remain outside the global equity portfolio and that too is due to disappear eventually.

Gearing

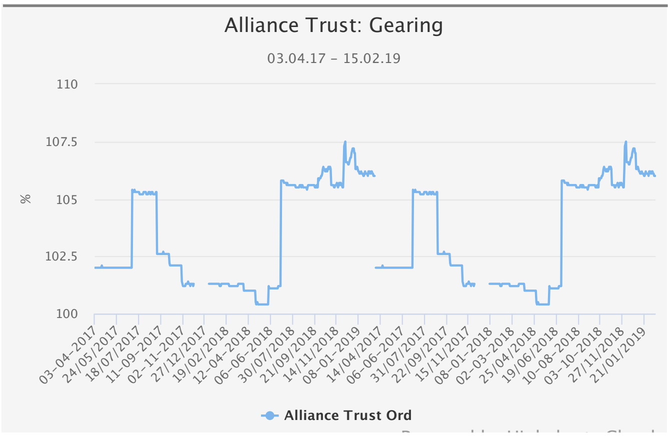
Each of the underlying managers within the ATST portfolio has latitude to hold up to 10% cash, but cannot employ gearing themselves. The board's policy is that gross gearing will typically be between 7.5% and 12.5% and that net gearing will be less than this but not significantly so. It is primarily the responsibility of WTW to decide what level of net gearing is appropriate, taking into account the levels of cash that each of the underlying managers has at any time.

The graph below shows historic net gearing levels, with net gearing rarely rising above 4% reflecting WTW's conservative outlook at the current time.

It should be noted that WTW aims to remain as close to fully invested on a net basis as possible most of the time. The trust therefore has limited structural downside protection during periods when the index is in negative territory, with the emphasis for capital preservation and long-term capital growth being placed on the underlying managers' stock selection.

We note that derivatives may also come into play as a means to manage risk in the future, but there are no plans for derivatives in the portfolio at this stage.

Fig.3: Gearing



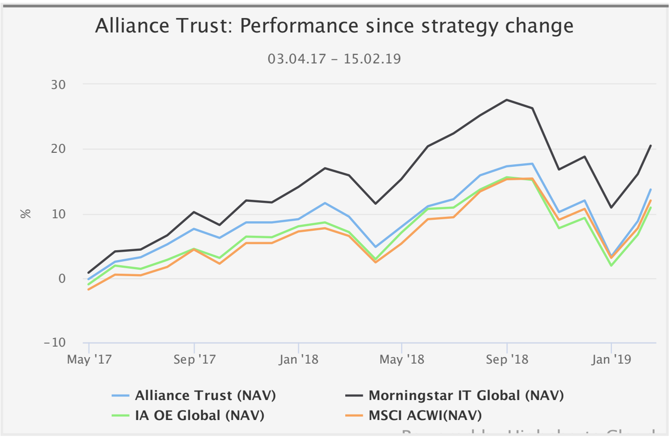
Source: Morningstar

Returns

Having had nearly two years in the trust's new form, shareholders of Alliance Trust have unarguably benefitted from improved performance. As the graph below shows, the NAV has risen by 13.7% since the start of April 2017 in cum-fair NAV terms, outperforming the MSCI AC World index which is up 12%.

As the graph also illustrates, given the nature of the trust's asset allocation – with country and industry weightings unlikely to deviate much from the MSCI AC World index, and the portfolio usually fully invested – we would expect performance to reflect the direction of travel of the index, but to be less volatile than some peers during periods of uncertainty. The one-year NAV standard deviation is 12.7% (2018), which puts it in the bottom half for volatility of the AIC Global peer group according to data from Morningstar.

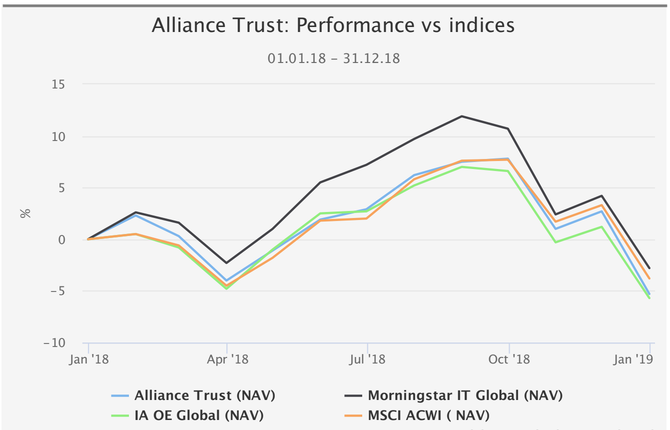
Fig.4: New Strategy Performance



Source: Morningstar

Last year, in what was a difficult year for stock pickers, saw the trust marginally underperform the benchmark, as can be seen below. However, this could be expected under the approach taken by WTW. The 'FAANG' stocks contributed to a huge proportion of stock market returns, illustrated by the fact that the MSCI World Index returned 3.8%, but the median stock returned -2.1%, an "outperformance" by the index of 5.9%. So far this year (to 18th Feb 2019), ATST has delivered a NAV outperformance of the MSCI AC World Index of c. 1%, up 9.7% relative to the index return of 8.4% (Source JPMorgan Cazenove).

Fig.5: 2018 Performance



Source: Morningstar

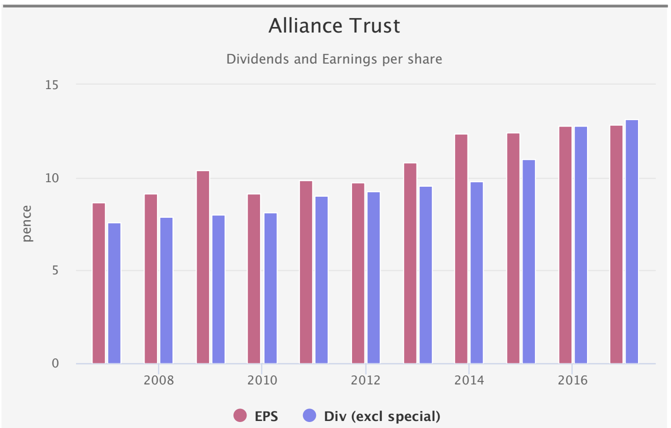
Dividend

For over 50 years Alliance Trust has paid out rising dividends to shareholders and with a yield of 1.8%, compares favourably to the AIC Global sector where the weighted average yield is 1.3%.

Notwithstanding the changed investment portfolio, the board has reaffirmed its commitment to progressive dividends, and has the ability to use its revenue reserves to pay an uncovered dividend. Its intention is to have a "smooth annual rise" in dividends, whilst utilising "an element" of revenue reserves to cover this dividend when income is depressed.

Reflecting the change in the portfolio, but also helping to boost distributable income, the board decided that from 1st Jan 2018, the company will charge a quarter of costs to revenue (and three-quarters to capital), down from one-third which was the previous policy. The previous full year dividend (2017) equated to 13.16p per share, an increase of 3% over the 2016 dividend. So far for FY18, only three of the four dividends have been paid, however they currently total 10.167p per share, a 3% increase from the 9.87p from the first three dividends in 2017.

Fig.6: Dividends



Source: Alliance Trust

Management

WTW's core belief is that high conviction active management is the key to long-term returns and that "genuinely skilled active managers" do exist. Typically, therefore, WTW favours active managers that run concentrated portfolios and have high active share, and by sub-dividing a given portfolio between different active managers with different investment styles, it hopes this in-built diversification will lead to smoother, more consistent returns for investors.

The firm places great emphasis on due diligence in order to identify such managers. Craig Baker, the global chief investment officer at WTW with 25 years investment experience chairs the investment committee that is responsible for ATST's portfolio. This investment committee selects the managers and monitors and oversees their performance; it reviews portfolio blending and risk controls and implements any gearing and hedging requirements

Others on the investment committee are Stuart Gray, a senior researcher, and David Shapiro and Mark Davis, co-portfolio managers. David Shapiro has 32 years' investment experience. He is a senior portfolio manager and a former head of the global equity research team at WTW. Prior to this he was an equity fund manager for 17 years. Mark has 20 years' investment experience and runs WTW's portfolio management team in EMEA. Stuart Gray has 15 years' investment experience researching equity managers on a global basis. Stuart's role is to bring WTWs institutional research content to the Alliance Trust investment committee.

The investment committee for Alliance Trust closely resembles the committee which runs the WTW Global Equity Focus Fund, an institutional mandate which has developed a strong track record pursuing a similar strategy to ATST. Between them the investment committee have more than sixty years' service under their belts at WTW. Supporting them WTW has a 130-strong research and portfolio management team. Together, they run $115bn for around 200 institutional clients with multi-manager structures.

The research team undertakes nearly 1,000 meetings with potential fund management partners in the equity space every year and then, having created a shortlist, scores a sub-set of these fund managers on a 1-3 scale, based on numerous meetings with each manager as it approaches a conclusion. WTW will only use those which pass its operational due diligence tests and receive the highest rating '1' – of which there are around 40 in the world running global equity mandates at any given time and a further group running concentrated regionally-biased strategies. All of the managers who will run the underlying portfolios for Alliance Trust are in this grouping and WTW has a 'wait list' of several alternative managers across a range of different styles.

WTW has provided a brief run-down of the sub-portfolio managers, which we reproduce here:

BILL KANKO - BLACK CREEK INVESTMENT MANAGEMENT

Toronto, Canada (www.bcim.ca)

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

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

PIERRE PY AND GREG HERR - FIRST PACIFIC ADVISORS, LLC (FPA)

Los Angeles, USA (www.fpafunds.com)

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

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

RAJIV JAIN - GQG PARTNERS, LLC

Fort Lauderdale, USA (www.gqgpartners.com)

Rajiv Jain is the chairman and chief investment officer of GQG and serves as the sole portfolio manager for each of the firm's strategies. With 21 years of emerging markets experience, Rajiv is among the longest tenured investors in global and emerging markets equities. He launched GQG in June 2016, having previously worked at Vontobel Asset Management for 22 years; as co-CEO (from July 2014) and chief investment officer and head of equities (from February 2002). He was named Morningstar International Fund Manager of the Year in 2012.

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

BEN WHITMORE - JUPITER ASSET MANAGEMENT LTD

London, UK (www.jupiteram.com)

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

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

ANDREW WELLINGTON - LYRICAL ASSET MANAGEMENT

New York, USA (www.lyricalam.com)

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

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

HUGH SERGEANT - RIVER AND MERCANTILE ASSET MANAGEMENT

London, UK (http://www.riverandmercantile.com/river_and_mercantile_asset_management/equity_funds)

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

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

FRAISE, MARCHAND & ROHN - SUSTAINABLE GROWTH ADVISERS (SGA)

Stamford, USA (www.sgadvisers.com)

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

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

ANDREW HEADLEY - VERITAS ASSET MANAGEMENT

London, UK(www.veritas-asset.com)

Andrew Headley has over 21 years' investment experience and is supported by co-portfolio manager Charles Richardson. They have worked together for almost 20 years including the last 15 years at Veritas, since founding the business in 2003.

Veritas focuses on active equity management, utilising its proprietary 'Real Return' approach since inception of the firm. Veritas employs an absolute mind-set when valuing companies and dispenses with any reference to indices when constructing the portfolio. Veritas describe the firm's overall approach as investing in a concentrated portfolio of good quality companies at the right price.

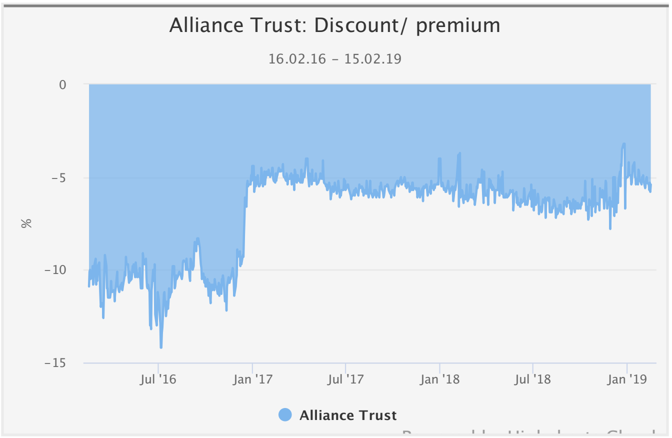
Discount

As the graph below shows, for a long time prior to the new strategy being announced for ATST, it traded at a relatively wide discount. However, ATST's discount narrowed significantly on the announcement of the change in strategy in December 2016, and has remained close to 5% since then.

This was achieved by a strong commitment from the board to maintain the discount at a 5% level, however share buybacks were reduced considerably over 2018 relative to other years. During the year, the trust bought back around 14m shares.

The board's clear commitment to tackling the discount means a return to a double-digit discount is therefore unlikely (although not impossible). Having witnessed the reversal of fortunes at Witan under a 'manager of managers' approach we would not rule out the trust moving to a premium, in time, once the new managers have delivered a long enough period of strong performance.

Fig.7: Discount



Source: Morningstar

Charges

Being amongst the larger savings vehicles for retail investors in the UK, it is fair to expect that Alliance Trust should also be amongst the cheapest.

The OCR was 0.65% for 2018. Although the trust's ongoing charges are greater than the AIC Global average of 0.58%, it compares favourably with Witan for example who charge 0.79% excluding performance fees.

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