Alliance Trust plc

Update
04 July 2018

Summary

Alliance Trust has changed its spots dramatically, adopting a portfolio management approach that uses 8 sub-managers, each tasked with managing a highly concentrated portfolio, who are selected and overseen by Willis Towers Watson (WTW).

WTW allocate to managers so that stock selection is the key driver of returns, but weightings relative to country and sector are managed so that they are broadly in line with the MSCI AC World Index benchmark. As such and with net assets of c £2.7bn, ATST is a truly 'global' trust.

With only 9% invested in the UK, ATST is differentiated to peers. The UK is a much more significant part of the portfolio at nearest competitor Witan for example, where the UK makes up 34% of the trust's exposure, and within the AIC Global investment trust peer group where it averages 19%.

Now having had just over a year in the new form, shareholders have seen an improved performance, with the NAV rising by 13.7% since the start of April 17, outperforming the MSCI AC World index which is up 10.8%, and Witan which is up 13.2% (all figures to 19th June). ATST has achieved this with much lower volatility than most peers. The one year NAV standard deviation is 7.5%, which puts it in the top decile of the closed and open ended Global peer group according to data from Morningstar.

Alliance Trust is one of the UK's oldest and largest investment trusts, and has delivered a growing dividend to shareholders every year over the last 51 years. WTW have not proscribed any income requirement to any of the managers and so portfolio revenue has fallen somewhat in the last year. The board accepts that in providing a "smooth annual rise", it may be necessary to pay an uncovered dividend by drawing in part on revenue reserves, which they believe are sufficient to support a progressive dividend for the next five years.

ATST's discount narrowed significantly on the announcement of the change in strategy in January 2017, and has remained close to 5% since then.

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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 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).

WTW has a bench of 40 asset managers around the world, of which around 20 have agreed to provide exclusive segregated mandates 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 is run 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. Overall the portfolio is designed to benefit from having concentration, but own between 180 and 200 stocks.

More concentrated portfolios are becoming increasingly fashionable. This may be a reaction to the significant growth of passive investment strategies, but there is good academic evidence which points to the fact that concentrated portfolios do outperform (assuming the manager of the portfolio has skill).

WTW have long been followers of the theoretical advantages of concentrated portfolios, but are in the privileged position of being able to prove that in practice, it works too. They have been running a similar mandate for institutions (minimum $15m investment) which has demonstrated significant outperformance since it was launched in 2015, and has outperformed the MSCI ACWI benchmark by 2.7% pa (to 31 March 2018). By putting eight such portfolios together, Alliance trust shareholders benefit from all the advantages of concentrated portfolios, but with very little of the extra risk that such an approach necessarily engenders when applied by a single manager.

As the table below shows, the eight initially selected managers offer a mix of growth, value and quality styles. WTW equally allocate to each on a risk-weighted basis.

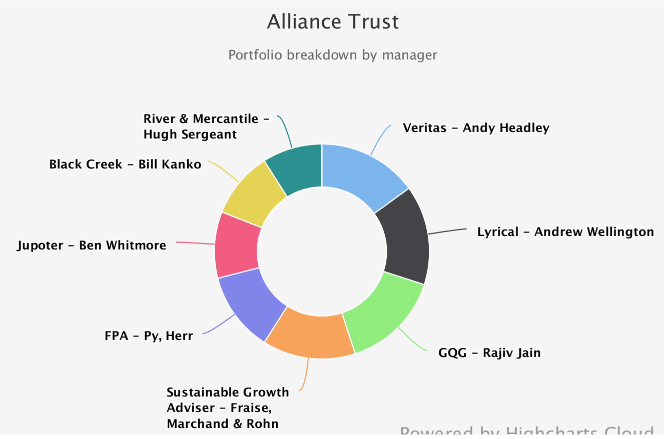
Manager Breakdown

MANAGER	PORTFOLIO FOCUS	HOLDINGS	STYLE
River & Mercantile	Global	20	Value
Jupiter Asset Management	Global	20	Value
Lyrical Partners	Global with a bias to US	20	Value
Sustainable Growth Advisers	Global	20	Growth
GQG Partners	Global + Emerging Markets	70	Growth
Veritas	Global	20	Quality
FPA	Global	20	Quality
Black Creek IM	Global	20	Quality

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.

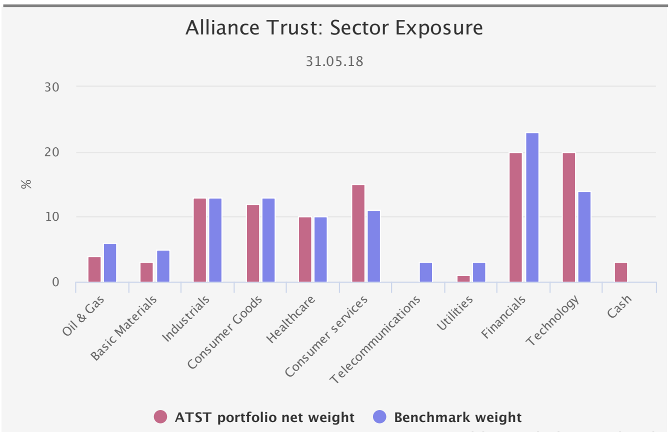
Fig.1: Current Allocations (As % Of Wtw Allocated Portfolio)



Source: Alliance Trust

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 are to technology and consumer services, whilst underweights are to financials, telecoms and utilities.

Fig.2: Sector Allocation

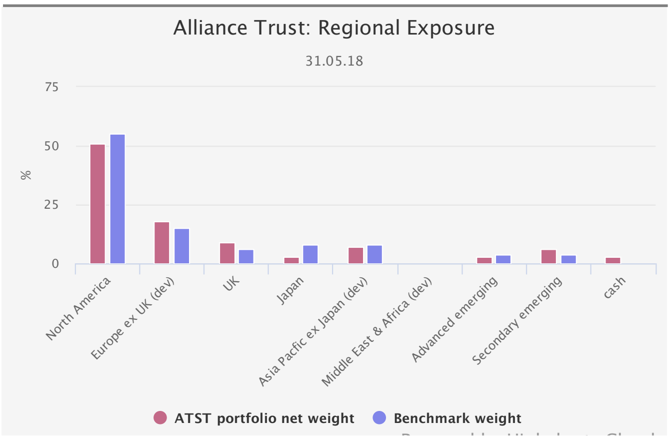


Source: WTW

ATST is a truly 'global' trust – in the sense that it provides proper exposure to 'the rest of the world' beyond our shores. With only 9% currently invested in the UK, ATST is highly differentiated to peers. The UK is a much more significant part of the portfolio at Witan for example, where it makes up 34% of the trust's exposure, and within the AIC Global investment trust peer group where it averages 19%.

The trust's largest regional weighting is toward the United States (51%), albeit modestly underweight relative to the benchmark. Europe ex-UK is the second largest weighting at 18%, while Asia & Emerging Markets comes third (16% in total).

Fig.3: Geographic Allocation



Source: WTW

Given the unconstrained 'best-ideas' nature of each sub-manager's remit, the management committee also keeps an eye on crossover between the portfolios. 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 their bench. In reality (and by design) this is very far from happening so far, with only one stock held by three managers, 16 stocks held by 2 managers, and the other 180 or so stocks only held by one of the managers.

Other portfolio holdings

Around 8% of ATST's assets remain invested in other areas, not managed by WTW. The largest of these is represented by the historic private equity portfolio, which has a value of £81.3m (or 3% of NAV) and still has commitments of £21.5m. We understand that the board are exploring a sale of these interests, which given the current febrile market for secondary private equity interests, could be achieved in the short term assuming there is enough interest. Other parts of this portfolio include unlisted mineral rights, which made a useful contribution to income (£2.8m, or 4.6% of total revenue) in the last financial year. As part of the sale of the fund management business, ATST owns Liontrust shares worth c. £6m, which will be held by the company until April 2019 at the latest. The trust has some small property investments (within funds) as well as the Alliance Trust headquarters building in Dundee, valued at £4.9m.

Alliance Trust Savings, the trust's savings platform subsidiary, remains as an asset on the trust's books with its own board. The platform, which has £15.8bn under administration, was profitable in 2016 but reported a loss of £6.1m before exceptional items for 2017. The holding's value was written down to £38.0m at 31 December 2017 (2016: £61.5m). The ATST board is actively pursuing the recruitment of a new chief executive for the business.

Peers

As we discuss above, the trust is aiming to benefit from concentration, but overall to hold a diversified portfolio of 180-200 stocks. Within the investment trust peer group, many have much longer lists of underlying holdings – including Foreign and Colonial with 509, Witan with 380, Bankers with 220 and F&C Global Smaller Companies at 195. We calculate that the average within the Global open and closed end universes is around 100 – although there are plenty of fund of funds, as well as trackers, that could be making this average very unrepresentative.

With only 9% invested in the UK, ATST is highly differentiated to peers. The UK is a much more significant part of the portfolio at Witan for example, where it makes up 34% of the trust's exposure, and within the AIC Global investment trust peer group where it averages 19%.

In terms of Morningstar style, the portfolio has a bias towards Growth (at 55%) which means it sits in the middle of the pack. With a one-year NAV volatility of only 7.5% (according to Morningstar data), the benefit of the work that WTW are doing fitting together uncorrelated portfolios, is being felt already, with ATST in the top decile of the closed and open-ended funds in terms of having a low volatility.

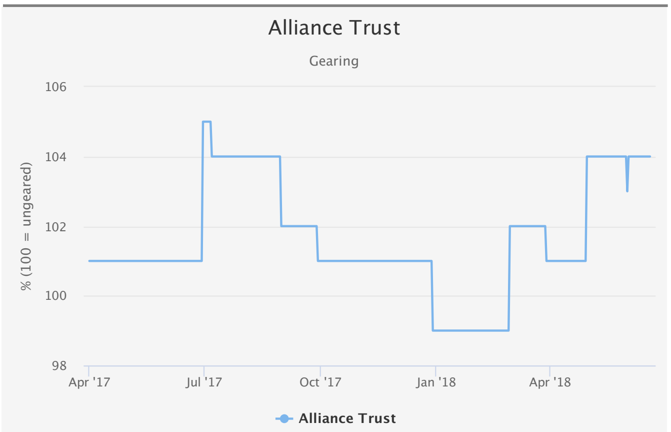
Gearing

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.

WTW have stated that for the majority of the time they expect gearing to be in the range of 0-10%. As the graph below shows, this has been the case, with gearing rarely rising above 4% reflecting WTW's conservative outlook. It should be noted that WTW aim to remain as close to fully invested on a net basis as possible most of the time, and therefore limited emphasis will be placed on short-term capital protection during periods when the index is in negative territory.

The trust has a nominal £100m of 15 year fixed rate borrowings, with significant additional borrowing via flexible bank loan facilities. This facility allows WTW to be up to 15% geared without consulting the board, and a further 15% with the board's permission.

Fig.4: Gearing



Source: Morningstar

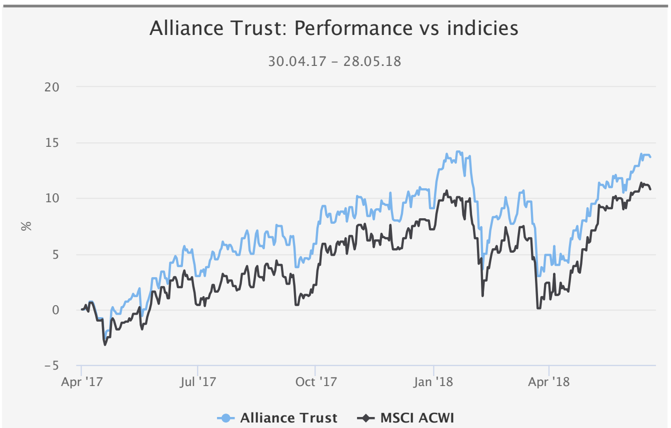
We note that derivatives may also come into play as a means to manage risk in the future, but there are no plans for derivatives in the portfolio at this stage.

Returns

Alliance Trust in its old shape had underperformed its benchmark and the average trust in the Global sector over one, five and ten years.

Now having had just over a year in the new form, shareholders have benefited from improved performance. As the graph below shows, the NAV has risen by 13.7% since the start of April 17 in cum-fair NAV terms, outperforming the MSCI AC World index which is up 10.8%, and its nearest competitor Witan which is up 13.2% (all figures to 19th June). The trust is, so far, ahead of WTW's objective of outperforming the benchmark by 2% pa.

Fig.5: Performance

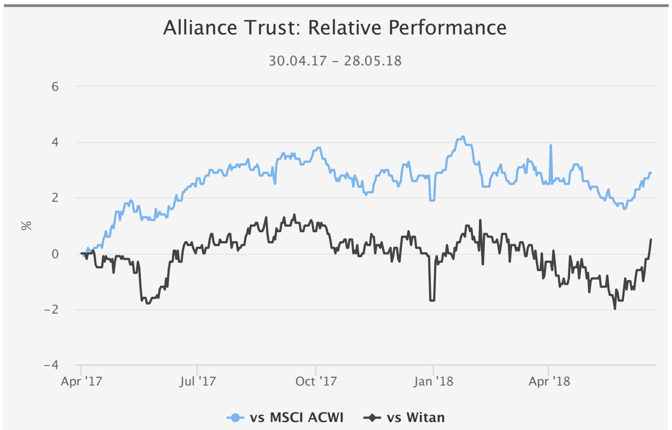


Source: Morningstar

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 – performance is likely to reflect the direction of travel of the index, with limited capital protection during periods when that direction is negative.

Relative to investment trust peers, ATST has been very much in the middle of the pack with NAV performance ranking 12 out of 21 on a 12 month basis. However, ATST has achieved this with much lower volatility than most peers. The one year NAV standard deviation is 7.5%, which puts it in the top decile of the closed and open ended Global peer group according to data from Morningstar. Those that have beaten ATST in absolute terms have been much more exposed to high-growth companies and/or the US equity markets (of which ATST is underweight). The WTW team observe that relative performance is best for them during periods of time when "stock fundamentals" impact share prices, and less well when "macro" events are dictating stock prices. They believe that the recent stronger relative performance illustrated in the graph below is illustrative of exactly this phenomenon.

Fig.6: Relative Performance



Source: Morningstar, Kepler Partners

Dividend

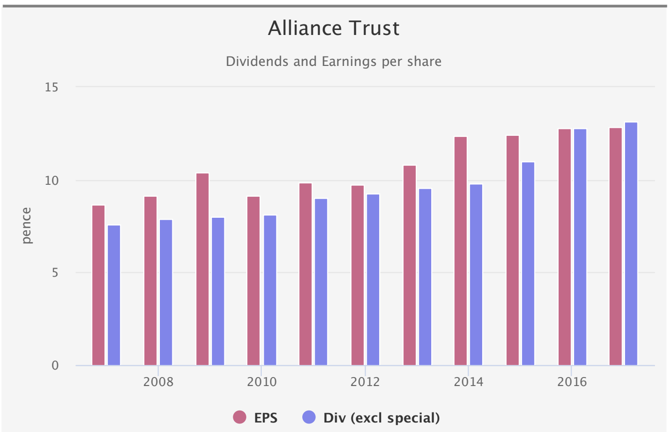
The changes to the investment portfolio, in effect for just over a year now, have had a quite a large impact on the revenue earned by the trust. Part of this is because WTW have not proscribed any income requirement to any of the managers, in order that they truly put only their best ideas into each portfolio. All of the underlying mandates are for each manager to achieve outperformance on a "total return" basis. Portfolio revenue has fallen somewhat, from £84m in the 2016 financial year, to £60m in the past year.

Whilst the portfolio and revenue objectives have changed, the board's dividend policy has not. Whilst there is no guarantee that it will continue to do so, for over 51 years Alliance Trust has paid out rising dividends to shareholders. Notwithstanding the changed investment portfolio, the board has reaffirmed its commitment to progressive dividends, and accepts that it may be necessary to use its revenue reserves to pay an uncovered dividend. Their 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. They have stated that even with a reduced level of income, the revenue reserves as they stand are sufficient to support a progressive dividend for the next five years.

Reflecting the change in the portfolio, but also helping to boost distributable income, the board has 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. Last year's dividend was 13.16p per share, an increase of 3% over the 2016 dividend. At this level the shares currently yield 1.7%, which compares to the AIC Global sector average yield of 1.3% (and the MSCI ACWI yield at the end of May of 2.41%).

Based on this dividend, Alliance Trust has revenue reserves of 2.25x the annual dividend, or nearly 30p per share.

Fig.7: Dividend



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 24 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 31 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 19 years' investment experience and has significant prior research experience in various equity mandates. Stuart Gray has 14 years' investment experience. Stuart has been a member of the global equity research team for 13 years and has headed the emerging markets research team.

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 115-strong research team around the world, including 50 who are focused on equity research and 21 who look at long-only global mandates. 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. 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 have 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 35 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 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 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 20 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. 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 20 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 20 years' investment experience and is supported by co-portfolio manager Charles Richardson. They have worked together for almost 20 years including the last 13 years at Veritas, since founding the business in 2003.

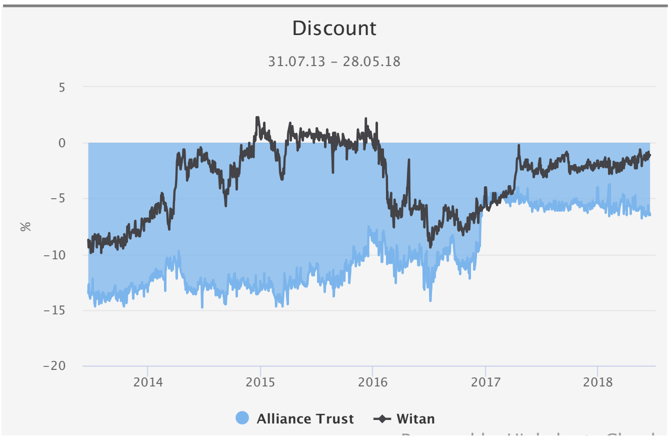
Veritas focuses on active equity management, utilising its proprietary 'Real Return' approach since inception of the firm. Veritas employs an absolute mind-set when valuing companies and dispenses with any reference to indices when constructing the portfolio. Veritas describe the firm's overall approach 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 this 5% level, and they report that during the last financial year, "As supply and demand have moved towards a state of equilibrium, share buybacks have reduced over the course of the year". In 2018 so far, the trust has bought back around 7.4m shares, or 2% of the shares outstanding at the start of the year, and representing a return of capital of around £50m. The last share buyback was on 28 June, after a two month period of no action.

Fig.8: 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 given the impact of economies of scale. Historically this has been the case, with an OCF ranging between 0.38% and 0.8% over the past ten years.

The board announced earlier this year that they will be targeting a maximum OCF of 0.65% at the current size of the company, including the cost of executive functions such as company secretarial and investor relations. Over the last financial year, they were able to report an OCF of 0.54%, although from 1st April the board calculate an OCF of 0.62%.

This compares favourably with Witan which has an OCF of 0.75%, and also charges a performance fee. It also compares well with the AIC Global investment trust peer group which has a weighted average OCF of 0.60% (Source: JPMorgan Cazenove).

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