Alliance Trust

ATST offers investors a ‘core’ equity exposure, utilising seldom-found managers and having recently upgraded its dividend...

Update
17 December 2021

Summary

Alliance Trust (ATST) follows a multi-manager approach to global equity investing, with the board having delegated the management of ATST to Willis Towers Watson (WTW), the global consultancy firm. The Alliance Trust Investment Committee team of Craig Baker, Stuart Gray and Mark Davis at WTW select a suite of managers from a long list identified by their manager research team.

As discussed under **Portfolio**, ATST’s underlying managers have very distinct styles. Each manager is asked to run a concentrated portfolio of their highest-conviction ideas, with the WTW team then weighting the managers in a way that ensures ATST’s factor risks do not deviate from those of its benchmark, the MSCI ACWI. The central idea behind this strategy is that over the long-run fundamentals should drive performance, even if they can be drowned out by noise in the short-term.

For much of the pandemic period, this balanced approach has been struggling against a market seeing strong stylistic outperformance. ATST’s underlying equity managers’ performance (a metric which removes the effect of underperforming legacy assets) was ahead of the benchmark until November, which saw a sharp correction in markets due to the emergence of the omnicron variant (which will hopefully be shortlived) as we discuss in the **Performance section**.

In the current year one of the most substantial changes to ATST has been a positive resetting of its **Dividend**. The board has proposed to substantially increase this, rebasing the dividend upwards to 5.825p a quarter. Annualising this payout, the trust offers a dividend yield of 2.3% on an ongoing basis. ATST has a track record of 54 years of consecutive dividend increases, with the board committed to continuing this record even at the higher level. ATST currently trades on a 7.4% discount, in line with its long-term average.

Analysts:

David Johnson

Analyst’s View

ATST, in our view, is a good example of a ‘core’ equity holding. This is not merely due to its on-benchmark risk profile, but also due to its ability to preserve the benefits of active management at the same time. ATST is often the only way that retail investors can access the services of the underlying specialist managers, as they seldom market their services to UK retail investors.

Additionally, ATST offers an enviable track record of dividend growth, and the higher payout should make the yield even more attractive. In a similar manner, ATST’s ESG characteristics remain superior to those of its benchmark, with the board’s clear commitment to ensuring ESG remains a core part of the strategy being an attractive feature. We believe ATST would also serve as a strong alternative to passive equity exposures, as it would not materially alter an investor’s risk profile while still retaining the potential for added alpha; alternatively, it may suit investors looking for a simple solution to broad equity market exposure.

During the pandemic, markets have been dominated by style, with growth outperforming substantially for long periods and a sharp snap-back for value in the middle. These movements have been unpredictable, based on developments in the pandemic rather than anything economic. The benefit of ATST’s approach is that the management team aren’t asked to predict these unpredictable moves. During strong trending markets this style will underperform, but it is over the long run that it needs to be judged.

BULL
Offers exposure to specialist managers not available elsewhere
Forthcoming dividend increase will lead to a higher future yield
Attractive characteristics for a ‘core’ equity allocation

BEAR
May underperform in momentum-driven markets
Gearing can amplify losses on the downside
Resurgence of pandemic may not suit balanced approach in the short term

Portfolio

Alliance Trust (ATST) offers investors a multi-manager approach to global equities, with the objective of maximising total return through a combination of growth in both capital and dividend. The stewardship of ATST's portfolio is the responsibility of the global consultancy firm Willis Towers Watson (WTW), which leverages a vast network of investment professionals to identify what it believes are best-in-class fund managers, with ATST often offering retail investors one of the few ways they can access the underlying specialist managers. ATST is currently managed by three members of WTW: Craig Baker, Stuart Gray and Mark Davis.

WTW has a highly sophisticated way of running a multi-manager portfolio which departs from the traditional model of allocating to a handful of pre-existing funds and tweaking the weights to express views on the market. WTW selects 20 from its 200 highest-rated managers from across the globe as a 'squad' of managers for the trust. It then selects eight to 12 of these to run a highly concentrated portfolio that should be made up of each manager's ten to 20 highest-conviction stocks. (The exception is GQG EM, which is permitted to go up to 60 stocks in the more volatile emerging markets region.) The remainder of the 20 managers sit on the 'sub's bench', allowing Craig and the team to sub them in, in order to alter positioning.

Each manager is chosen to complement the other managers, and they collectively cover a range of different regions and styles. Craig, Stuart and Mark work to keep the factor exposures of the portfolio close to neutral and ensure they are still getting the diversification they want at the top level. The individual fund managers are set free to focus exclusively on picking their best stocks. Craig and the team believe that this is what managers do best, and anticipating the twists and turns of the market and economy is largely a fool's errand. They accept they will underperform when a single style is driving the market, but believe that over the long run stock-specific fundamentals will win out.

The underlying portfolio is 208 stocks in total as of 31/10/2021. This is substantially lower than the typical number of stocks in a traditional multi-manager portfolio which allocates to pre-existing diversified funds or segregated mandates. The two closest peers in the closed ended space are Witan and F&C Investment Trust, which own 274 and 406 holdings respectively, according to Morningstar. The largest ten holdings in ATST make up 23.1% of the portfolio compared to 20.7% and 16.4% respectively.

Since taking over the strategy in April 2017 WTW has yet to fire any of its delegated managers – an indication of its confidence in them. However, as we outlined in our **prior note**, there have been occasions of unavoidable changes due to the delegated management company ceasing to operate. We show the current team below, with a brief description of their roles on the pitch.

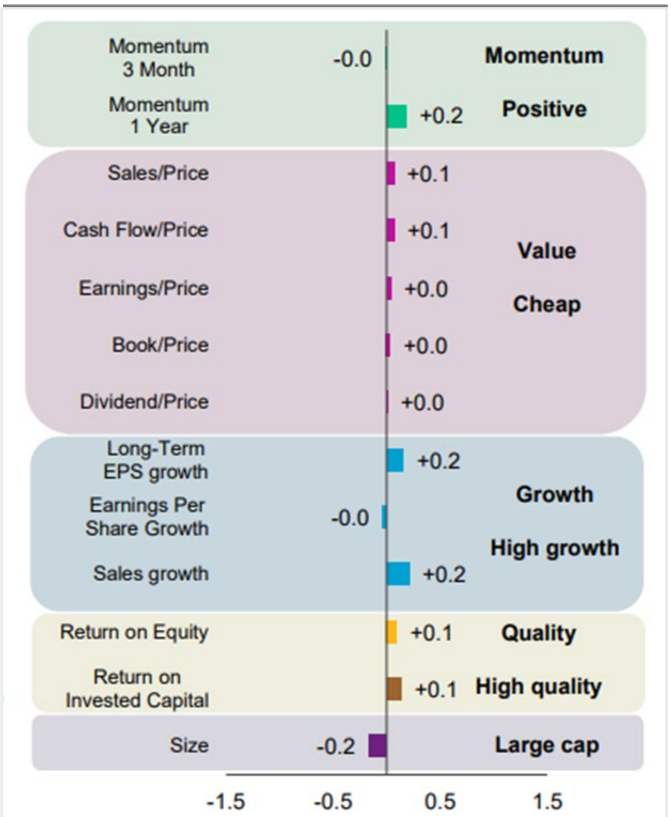
Delegated Managers

MANAGEMENT COMPANY	STYLE	CURRENT WEIGHT %
GQG GLOBAL	Look for high-quality and sustainable businesses whosestrengths should outweigh the macro environment.	14.5
GQG EM		6.7
VERITAS	Thematic investing to identify companies and industries that are well positioned to benefit from medium-term growth.	14.6
BLACK CREEK	Value-orientated buyer of leading businesses. Long-term contrarian approach.	11.9
SGA	Seeks companies that have strong pricing power, recurring revenue generation and long runways of growth.	11.9
METROPOLIS	Focusses on businesses undervalued by the market. Returns come from a combination of the closing of the 'value gap' and increases in the intrinsic value of the businesses.	10.7
LYRICAL	Focusses on businesses with attractive capital returns and the flexibility to react to all phases of the business cycle.	8
JUPITER	Seeks out-of-favour and undervalued businesses with prominent franchises and sound balance sheets.	8
SANDS	Follows a purely growth-orientated philosophy with a focus on finding high-quality, wealth-creating businesses using a fundamental, bottom-up research approach.	9.4
VULCAN	Focusses on finding quality businesses that have the ability to compound in value over the long term.	9.5
RIVER AND MERCANTILE	Its strengths are in smaller companies and recovery situations, identifying value at different stages of a company's life cycle.	6.4

Source: Alliance Trust, as at 30/10/2021, % of net assets

In our opinion an attractive feature of the approach is their ongoing management of market risk, whereby ATST will have negligible deviations from the stylistic risk factors of its benchmark, the MSCI ACWI. We note that this is not done via the delegated managers, but rather through allocation decisions. Craig, Stuart and Mark allocate to each manager's portfolio with the intention of creating a factor neutral portfolio relative to ATST's benchmark, the MSCI ACWI Index. This means that ATST can offer investors a well-diversified portfolio that does not unduly expose them to any one style of investing, while still maintaining the potential to add alpha from stock selection (as shown by the trust's high active share, which is currently 74%). This is fundamental to the advantages ATST provides its investors, as by its very nature it acts as a 'core' equity strategy which is balanced across all risk factors, while still having the capacity to outperform wider equity markets. Morningstar holding data shows that ATST has an allocation of 28.3% to value stocks compared to 19.2% for F&C and 15.2% for Witan, indicating that is has maintained a much more balanced allocation despite the outperformance of growth for much of the pandemic period.

Fig.1: Current Factor Risks

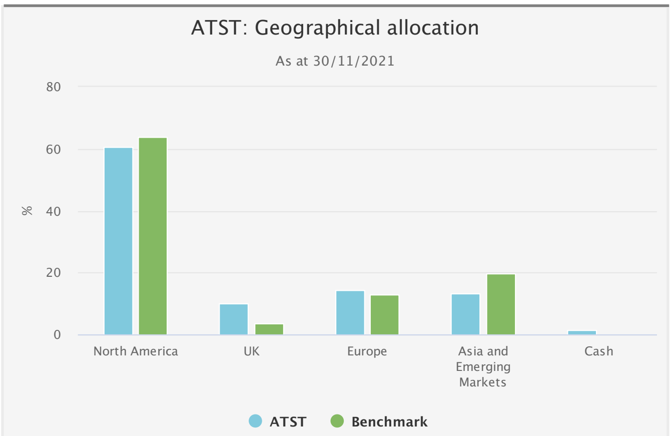


Source: Alliance Trust, as at 31/10/2021

In our recent meeting with the managers, they pointed out the current advantages ATST's broad-based approach to equity investing has had in 2021. The team point out the stark variations in style leadership that the market has seen over 2021, with value dominating the early months of the year thanks to the tail end of the reflation trade. Growth investing then rebounded over the third quarter, thanks to strong earnings figures as well as doubts emerging about the strength of the post-pandemic rebound. After a more ambiguous period, the emergence of the omicron variant has seen growth take another leg up – but it remains at heightened valuations which means it is arguably even more vulnerable to a correction should the next step in the pandemic be positive.

ATST's approach results in its geographical and sector positions tending to be close to the index. On a geographical basis the overweight to the UK is significant, which reflects the perceived value in the market. On a sector basis there are small overweights to the value sectors of financials, energy and materials.

Fig.2: Regional Allocations



Source: Alliance Trust

While it would be impractical to cover the rationale behind all of ATST's delegated managers, we highlight the approach and advantages of Sustainable Growth Advisers (SGA), ATST's most successful delegated manager in terms of contribution to the ATST strategy. SGA is an example of a sophisticated investment manager, with 18 years of operating history and $25bn in assets. SGA aims to identify companies which not only have reliable earnings growth and predictable compounding, but which also offer low volatility of earnings, with their approach to investing having the trappings of a 'quality growth' style. The team often view short-term disruptions to growth, like COVID-19, as opportune moments to add new positions. One of SGA's key advantages is the depth of human resources deployed by the company, with two analysts per company and three portfolio managers per strategy. The SGA team highlight the difficulty of sustaining consistently growing earnings in current markets, as they believe we are more likely to see falling global GDP growth than rising thanks to the slowing markets of China and the US, as well as stretched valuations and rising inflation. The SGA team highlight the current need to balance growth potential and valuation sensitivity, an idea which also directly supports the balanced approach of ATST.

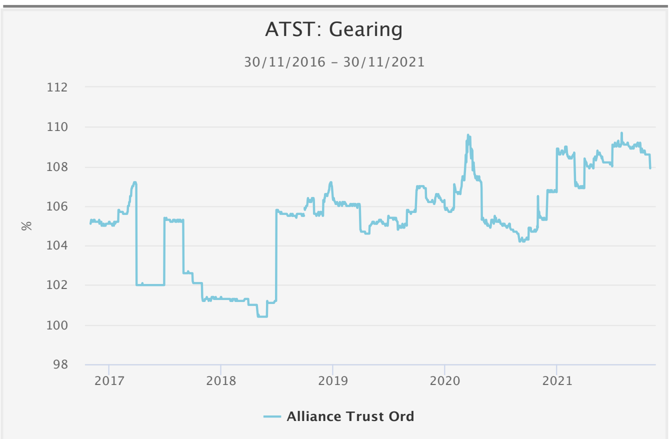
Another manager worth highlighting is Lyrical Asset Management (LAM), whose disciplined value-biased approach has been a major contributor to the trust's performance during the reflation rally. LAM is led by manager Andrew Wellington, with WTW remarking that the relatively small size of his team makes them suited to running concentrated portfolios. WTW was attracted to Andrew's somewhat unique quality-orientated and value-conscious investment approach, with his approach favouring eclectic and concentrated portfolios that act as a major source of active share for ATST. Andrew invests in small- and mid-cap companies, yet thanks to his sensible view on capacity management, his portfolio remains robust despite their concentration. LAM is an example of a professional investment manager whose services are not offered elsewhere to UK retail investors.

Gearing

ATST utilises a combination of long- and short-term gearing, with the overall effective level set within a range by the board. ATST currently has gross gearing of 10%, or 6.7% net. ATST has broadly maintained its 10% gross gearing since the start of 2021, reflecting the team's generally positive view of equity markets but also their awareness of risks stemming from global economic uncertainty (e.g. risks stemming from the pandemic, China's political and economic situation or rising inflation).

WTW utilises gearing in a strategic manner, equally distributing capital across all delegated managers and increasing ATST's overall market exposure when it is believed the market environment is conducive to positive returns.

Fig.3: Five-Year Gearing



Source: Morningstar

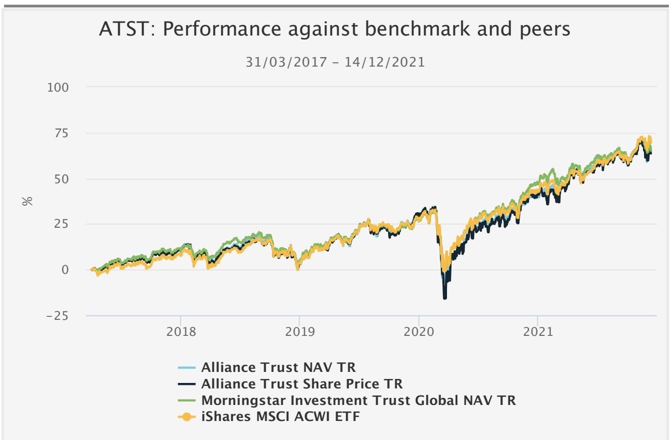
Performance

ATST has generated an NAV total return of 62.9% since the change of mandate on 1 April 2017 (to 14/12/2021). This compares to the 68.8% total return of the iShares ETF investing in its benchmark over the period, and the 64.5% weighted average NAV total return of the AIC Global sector.

The underperformance is the result of two unrelated factors. In 2019 and 2020 a narrow band of stocks drove the majority of global equity returns. In the case of 2020, c. 45% of the MSCI ACWI's returns came from just five stocks: Amazon, Apple, Microsoft and Google (Alphabet) (FAAMG). Apple alone accounted for 17% of the benchmark's return over the period. However, ATST had an overall lower allocation to large-cap stocks than its benchmark. This domination of a narrow band of companies favoured ATST's more concentrated global sector peers (i.e. not the multi manager funds) which can have a higher active weight to these companies. Craig, Stuart and Mark point out the huge impact that equity market concentration has, as an equally weighted portfolio of the MSCI ACWI would have returned a mere 36.8% since they took over the ATST mandate, indicating how much of the performance has been driven by the larger stocks. The second, and arguably larger, contributor to ATST's relative performance has been the presence of a number of legacy assets which WTW inherited when it took over the mandate. While these assets have now been disposed of, their presence was ultimately a drag on the trust's performance given their underperformance against global equity markets, as well as the long period it took to dispose of them.

Importantly, though, if we consider the performance of the equity portfolio alone (i.e. the performance of the underlying managers' portfolios), ATST was outperforming its benchmark until November 2021. From 1 April 2017 ATST's equity portfolio returned 65.8% to the end of October, compared to the 64.7% of its benchmark. Sadly,

Fig.4: Performance Since Change In Manager



Source: Morningstar

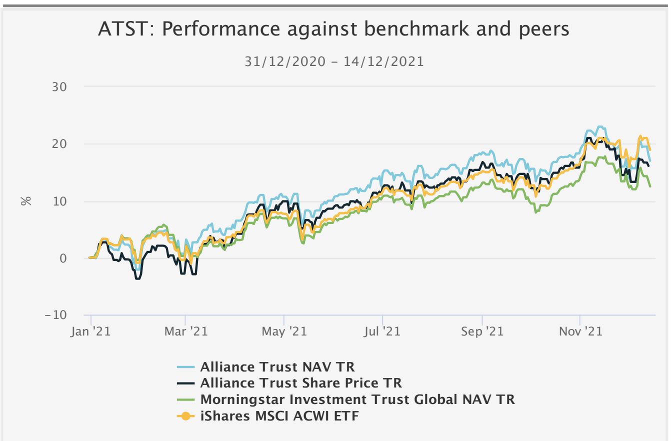
Past performance is not a reliable indicator of future results.

the emergence of the omnicron variant has seen some turmoil in markets, and November was a poor month for the trust versus its benchmark. Since ATST took over the mandate the underlying equity return, to end November, was 62.4% versus the 66.5% of the MSCI ACWI.

2021 has been a far more positive time for ATST's approach, with the market no longer being supportive of the same narrow band of stocks as it was during 2020. Over the period ATST has returned an NAV total return of 17% compared to the 18.9% of the ETF and 12.5% average NAV total return of its peer group (as at 25/11/2021). Since the start of the year style leadership has changed hands frequently, with periods in which stock selection was more important than either growth or value too.

Stock selection has been a net positive contributor to the trust's 12-month performance. Lesser-known companies like the Australian software developer Atlassian and the Singaporean internet company Sea have been amongst the top contributors. The team highlight the strong relative performance of their managers during this period, with the majority of them having outperformed their benchmarks over the last year, even if their respective styles were out of favour. However, the biggest outperformers have been Lyrical Asset Management and Vulcan Value Partners, both of which are quality-value managers that were able to capitalise on the opportunities presented by the reflation trade. We nonetheless note that ATST's active underweights to Apple and Tesla, as well as its holdings in select underperforming emerging market stocks, have led it to fall behind its benchmark over Q3.

Fig.5: Year-To-Date Performance

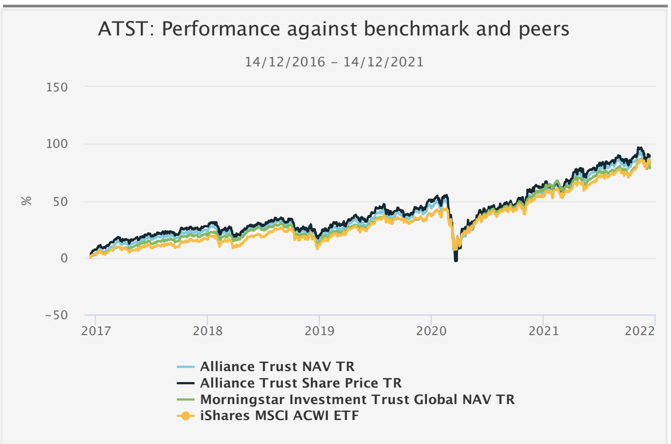


Source: Morningstar

Past performance is not a reliable indicator of future results.

Over the last five years ATST has generated an NAV total return of 83.4% compared to the 82.8% NAV total return of its benchmark and 78.6% AIC Global sector average (as at 14/12/2021), although some of this period was under a very different strategy.

Fig.6: Five-Year Performance



Source: Morningstar

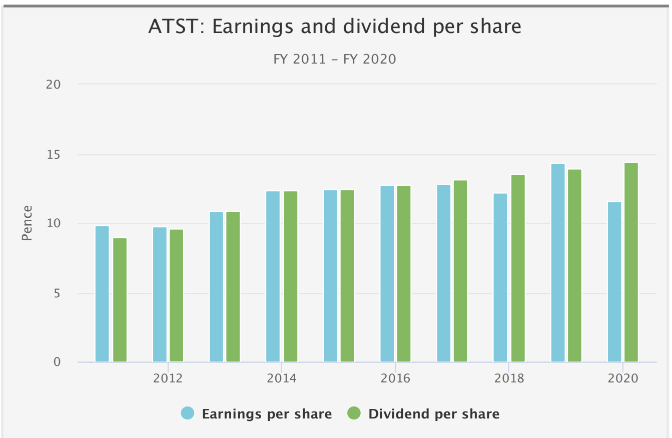
Past performance is not a reliable indicator of future results.

Dividend

ATST operates with the dual mandate of capital and income growth, with ATST having one of the longest track records of consecutive dividend increases of any investment trust. ATST's 54 years of consecutive dividend raises rank it joint second within the AIC's dividend heroes, a collection of trusts which have managed to grow their dividend for at least 20 consecutive years.

On 1 November 2021 the board announced a change in ATST's dividend policy which will see it offer a higher yield than in the past. The dividend has been reset upward, to 5.825p a quarter. Annualising this, the trust offers a dividend yield of 2.3% on an ongoing basis. We note that the board intends to maintain its progressive dividend policy at the rebased level. The board's capacity to sustain the dividend is a direct result of ATST's strong dividend reserve, which we estimate to be 56 times the newly proposed dividend.

Fig.7: Revenue And Dividend Per Share



Source: Alliance Trust

Management

The board delegated the management of ATST to Willis Towers Watson (WTW) in April 2017. WTW is a global provider of investment management advice and solutions tailored to the specific needs of clients, with $168bn of assets under management and $3.4tn under advice. WTW's services are typically reserved for professional clients such as pension funds, insurance companies or sovereign wealth funds. This makes ATST one of the few ways retail investors can access WTW's investment expertise.

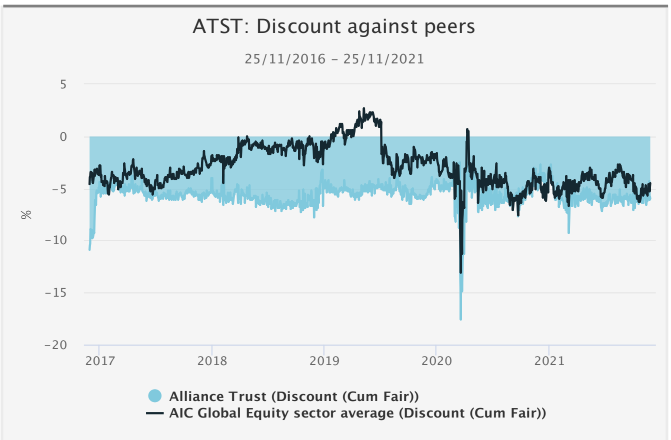
ATST is currently managed by three members of WTW: Craig Baker, Stuart Gray and Mark Davis. The trio form ATST's investment committee and determine manager selection and asset allocation, as well as providing the ongoing monitoring of the delegated managers. This committee selects the managers, then monitors and oversees their performance. It also reviews portfolio blending and risk controls, implementing any gearing and hedging requirements. Craig Baker, WTW's global chief investment officer, chairs the investment committee and has over 25 years of investment experience. Stuart is a member of the equity portfolio management group at WTW and a member of the investment committee for the group's equity funds. Mark has more than 20 years' investment experience and runs WTW's portfolio management team in Europe, the Middle East and Africa.

Discount

ATST currently trades on a 7.4% discount, wider than the 2.7% simple discount its peer group trades on. ATST's current discount is in line with the 5.9% average discount it has traded on over 2021. In fact, since WTW took over as manager in April 2017, ATST has traded on an average discount of 5.6%. However, this represents a substantial narrowing from its pre-2017 discount, reflecting a positive re-rating after it was announced that WTW would take on the trust's management. While ATST's discount remains in line with its historical average, we believe that is a partial reflection of the underperformance of broad-based global equity strategies. As such, if the current market climate remains positive for more balanced strategies such as ATST, then it may be the catalyst the strategy is waiting for to see its discount narrow.

The board operates a discount control mechanism, and while there is no explicit discount which will trigger a buyback, the board does monitor the stability of the discount and will take advantage of any significant widening to use buybacks to generate additional returns for shareholders. Over the last 12 months the board has repurchased 13m shares – equal to 4% of the pre-purchase issuance – and these are typically repurchased when the trust trades on a c. 6% discount.

Fig.8: Five-Year Discount



Source: Morningstar

Charges

ATST has a current OCF of 0.64%, in line with its peer group's simple average OCF of 0.63%, which includes all investment management expenses incurred by the trust (£12m over the 2020 financial year). WTW is entitled to a £1.5m fee per annum (equivalent to c. 0.05% of net assets), increasing in line with the UK Consumer Prices Index (CPI), plus 0.055% per annum of the market capitalisation of ATST after deduction of the value of both non-core assets and subsidiaries. Each of the underlying managers is entitled to an ad valorem management fee, generally based on a percentage of the value of assets under management for the trust. No performance fees are payable, and fees are generally taken 25% from revenue and 75% from capital profits.

ATST currently has a KID RIY of 0.89% compared to the 1.33% simple average of its peers, although calculation methodologies can vary between trusts.

ESG

ESG is a fundamental part of the board's vision for ATST, with the board having set an objective of net carbon neutrality for the trust by 2050, the deadline set by the Paris Accords. The board's dive towards a more ESG-compliant strategy is a direct result of its desire for ATST to be an attractive 'core' equity product: one which can offer advantages to multiple investor types across many generations, including ESG-conscious investors. ATST also utilises an exclusionary screen to avoid owning companies which derive more than 25% of their revenues from thermal coal and tar sands.

Another advantage that WTW's stewardship provides its shareholders is through the company's wealth of ESG experience, which it uses to ensure that each of its delegated managers meets its onerous ESG requirements. This is not utilised because of an ethical standpoint, but to ensure that the managers can account for the ESG risks that WTW has identified. For example, when assessing climate risks WTW use an internal metric of Climate Transition Risk – the CT VaR which analyses some 450 scenarios that could potentially occur if we are to succeed in meeting the 2°C global warming target set by the Paris Accords, and what would need to happen to various industries in order to hit this target. The team also assess the trajectory of 30 key commodity prices under similar conditions. When analysing ESG risks, the WTW team will observe them at both aggregate portfolio level and manager level. The team remark that a key part of their ongoing monitoring of their delegated managers is to identify those which are not doing enough to continually improve their ESG credentials.

Morningstar has assigned ATST a sustainability rating of 'average' when compared to the wider global equity universe of both open- and closed-ended funds. We note that ATST has received a higher sustainability score than its benchmark, with the ETF equivalent having received a sustainability rating of 'below average'. ATST has also received Morningstar's 'low carbon' designation, while also having a lower carbon risk score than its benchmark.

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