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Troy Income & Growth

UK equities still look cheap, yet TIGT's portfolio holdings are proving relatively resilient...

Update
03 August 2023

Overview

Troy Income & Growth's (TIGT) long-term aim is to provide investors with durable UK equity market exposure, focussed on identifying the highest quality companies capable of generating sustainable income and capital growth. The overarching capital-preservation philosophy of Troy Asset Management and the fundamental, bottom-up focus of the investment team has resulted in a relatively benchmark-agnostic portfolio compared to other strategies within the UK Equity Income sector.

As discussed in **Portfolio**, the approach of TIGT's managers, Blake Hutchins and Hugo Ure, is centred around balancing quality, growth, and income. To achieve this, they seek companies that demonstrate robust cash flows throughout the market cycle in addition to low levels of capital intensity. This has led to a significant allocation to consumer staples and to companies and sectors that can be associated with generating recurring revenue streams. The lack of exposure to the high-yielding energy sector has impacted relative performance versus the peer group and benchmark over the short term, but Blake and Hugo maintain such areas are unlikely to provide sustainable dividend growth over the long term. They are comfortable forgoing the volatility associated with these sectors to maintain the trust's superior risk and downside protection characteristics (see **Performance**).

TIGT has delivered **Dividend** growth over the past two financial years, with the operational resilience of the portfolio reflected through the growth of the revenue per share of its underlying holdings. As they find the valuations of UK equities relatively attractive, the managers have cautiously increased **Gearing**, which at the time of writing is 3%, whilst maintaining a strict **Discount** control mechanism which helps dampen discount volatility and increase shareholder liquidity.

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Analyst's View

We believe TIGT offers a unique core exposure to a selection of high-quality UK companies which through their superior operational characteristics are capable of delivering sustainable dividend growth over the long term. In our view, it is an attractive way to invest over the long term for investors seeking a core holding, with the DCM providing some reassurance that discount volatility will be kept to a minimum and they will be able to buy and sell close to par.

Blake and Hugo focus on identifying capital-light companies that are less exposed to market cyclicality. This has resulted in a lack of exposure to high-yielding and top-performing sectors over the past couple of years. However, we believe the strength shown by several portfolio companies through their most recent dividend announcements highlights their resilience during an uncertain time for UK equities – an attractive feature in a volatile environment. Furthermore, Blake and Hugo have cautiously employed gearing to take advantage of the relatively attractive valuations, topping up existing holdings, and introducing new ones. As a result, we believe there may be a greater benefit for longer-term investors who have the patience to see Blake and Hugo's strategy play out, whilst minimising downside risk compared to those strategies resolute on delivering an immediate high yield.

BULL
Operational strength of underlying holdings likely to enhance the sustainability of dividend and capital growth
Superior risk and downside protection characteristics compared to the broader UK equity market and peer group
Discount control mechanism helps maintain shareholder value, enhance liquidity, and dampen discount volatility

BEAR
Low current yield relative to peers
May underperform during cyclically-driven market rallies
Gearing can magnify losses on the downside

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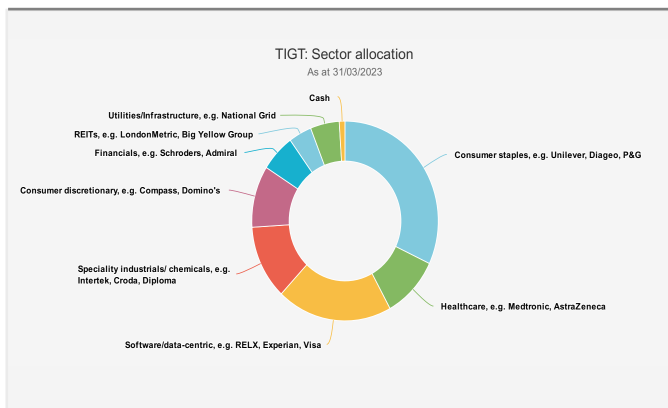
Portfolio

Troy Income & Growth (TIGT) has recently seen the managers and the board re-affirm the trust's core long-term objectives following the appointment of Bridget Guerin as the trust's new Chair in January 2023. This has provided more clarity which the board and investment managers hope will help TIGT become the defensive, UK equity dividend growth trust. They aim to achieve this through three very clear and deliberate aims:

- Deliver share price total return above the UK FTSE All Share over a five-year period.
- Dividend growth of 4% per annum.
- Deliver share-price volatility lower than the UK FTSE All Share.

As we mentioned in our previous note, this builds on a more significant shift in the investment strategy which took place in 2020 which has seen TIGT's senior fund managers, Blake Hutchins and Hugo Ure, focus on balancing quality, growth, and yield to achieve these objectives. This has resulted in a relatively concentrated portfolio of 42 holdings and the top ten accounting for 48.5%. The managers are free to invest away from the confines of the benchmark and tend to favour large, profitable, high-quality companies, that offer defensive characteristics due to the resilience of their operations and dividend growth. Many of the companies in the portfolio are familiar household names which are particularly visible in the trust's largest sector allocation, consumer staples, which makes up 32% of the portfolio, including Unilever, Diageo and Procter & Gamble. This is shown in the chart below which illustrates the sector allocations in terms of the managers' own views of the portfolio's exposures. Through the stability of the cash flows, such companies can offer a line of defence in a period of high inflation during which they are able to pass the increased input costs onto the end consumer.

Fig.1:Sector Allocation, Managers' View



Source:Troy Asset Management

As is the case across all of Troy's investment strategies, Blake and Hugo are seeking companies with less volatile cash flows and low levels of capital intensity. Naturally, this means they avoid companies within industries such as oil, gas, and mining. This has had an impact on NAV performance more recently, however, the pair are looking to position the portfolio to deliver consistent returns over the very long term whilst also maintaining the overarching capital-preservation investment philosophy employed across all of Troy's investment mandates (see **Performance**). With the assistance from Troy's 14-strong investment team, the income team's dedicated assistant fund manager Fergus McCorkell, and investment analyst Aniruddha Kulkarni, Blake and Hugo base their investment decisions on a case-by-case basis by taking a bottom-up approach. One such example is the information and analytics giant RELX plc. The company has provided an almost metronomic growth in free cash flow of 8% pa since 2007, with almost all its profit being converted into cash with a 91% average cash conversion rate over the last ten years. This can be contrasted with companies such as Anglo American which is a commodity-linked, cyclical, and capitally intensive business with a far more unpredictable free cash flow profile and cash conversion ratio. These characteristics led to dividend volatility, evidenced by the positive impact on yields from high commodity prices in 2021 which was followed by a 40% decline in 2022.

This investment approach is applied across all portfolio holdings and extends to companies like multi-year holding Next, with the continued scaling of its distribution platform forming the foundation of the investment thesis. The consistency of cash flows, market-leading positions and defensive properties of the companies they invest in has resulted in a significant allocation to healthcare and a growing allocation to speciality industrials/ chemicals which include companies such as Croda. The latter produces 'critical' inputs across a range of everyday products including vaccines and has provided investors with over 30 years of uninterrupted dividend growth (see previous note).

As may be expected, Blake and Hugo's focus on identifying high-quality businesses, capable of generating growing dividends (funded from genuinely surplus cash flows), that are priced at attractive valuations leads to a portfolio which has superior quality and growth operating metrics compared to the broader UK equity market, as shown in the chart below. However, we can see that the portfolio dividend yield is estimated to be slightly below the index over the 12 months from 31/03/2023. This is, in part, a reflection of the managers' aims to maintain a balance between quality, growth, and yield to enable the long-term sustainability of the dividend. Blake and Hugo want to avoid the risks that can be associated with chasing higher yields and believe the optimal starting yield is between 2-4%, translating into a dividend growth rate of between 5-8%. This provides a reasonable yield without choking the reinvestment and growth prospects of the companies in the portfolio. They believe this long-term dividend growth is a key advantage over savings accounts and

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bonds, which may pay higher yields at the moment but cannot deliver capital growth. However, Blake and Hugo do remain flexible in their approach, allowing them to maintain allocations to sectors such as tobacco which are competitively valued and able to generate the target return of investment through the dividend alone. They monitor their relatively small weightings in the sector and believe there are added diversification benefits which can come from such holdings.

Operating Metrics

		TIGT (%)	FTSE ALL SHARE INDEX (%)
Quality	Operating margin (LTM)	20.3	13.3
	Operating margin (LTM)	19.6	15.5
Growth	Consensus EPS growth (3Y Fwd)	7.7	0.1
	Consensus Sales Growth (3Y Fwd)	4.3	0.5
Yield	Earnings yield (NTM)	5.9	8.5
	Portfolio dividend yield (NTM)	3.3	4.1

Source: Troy Asset Management, as at 31/03/2023

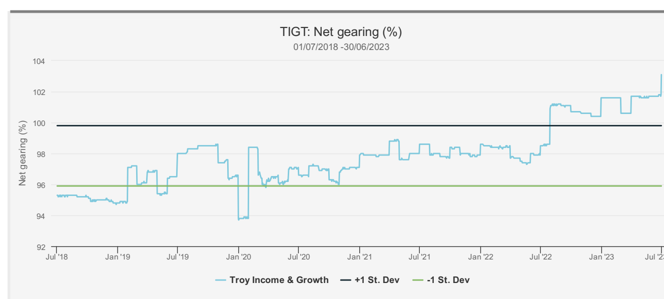
Blake and Hugo have been encouraged by recent dividend announcements which have seen a number of core holdings experience up to ten percent dividend growth. This includes long-term holdings RELX, Reckitt, Croda, and their holding in the distribution business Bunzl. Blake and Hugo are seeking long-term value creation for TIGT's shareholders through sustainable cash flows, where they see strong management teams allocating capital effectively. Bunzl is such an example where cash has been successfully reinvested into the business' organic growth and through regular, small roll-up acquisitions whilst continuing to provide shareholders with a strong sustainable payout of 35-40% of earnings leading to a 30-year unbroken dividend track record, at a compound annual growth rate of 9.6%.

With this in mind, it is easy to see why Blake and Hugo believe that the UK market in general still provides opportunities for investors, especially given its relatively cheap valuations compared to international markets. During a recent meeting, they highlighted a range of companies in the portfolio that are trading at, or below their 10-year average P/E ratio. They have seen this as an opportunity to add to their existing positions including Bunzl and Admiral, which is a clear leader in the UK car insurance market. They have also added to the global consumer goods company Reckitt in January 2023. Furthermore, they have looked to lean into new positions that are trading at uncontroversial and attractive valuations, including Swiss pharmaceutical company Roche which provides a 3.7% dividend yield and 7% free cash flow; the defensive software subscription company Sage, and the diversified engineering business Smiths Group which was introduced to replace the holding in safety equipment specialist Halma as it offered greater value at a P/E of 17x and 3% dividend yield.

Gearing

In June 2022, TIGT took out a gearing facility after many years of having no gearing at all, and over a year since the previous facility had expired. Currently, TIGT has a three-year revolving loan facility of £15m, with an option to extend it to £20m at any time, avoiding the expense of any undrawn commitment fees on the additional £5m. If fully drawn down this would amount to c. 11% of net assets. As of September 2022, £5 million had been drawn down from this facility at a rate of 1.2% above SONIA (which at the time of writing is 4.93%). Blake and Hugo are seeing valuation opportunities in the UK equity market, however, as of the latest factsheet (for June 2023), net gearing remains at 3%. This is a conservative level, especially if one compares it to the average for the UK Equity Income sector's average gearing of 10.2% according to JPM Cazenove, as of 27/07/2023. This reflects the cautious, capital-preservation investment philosophy typically associated with Troy's strategies.

Fig.2: Five-Year Gearing



Source: Morningstar

Performance

We believe TIGT's superior downside protection and long-term risk-adjusted returns to be a highly attractive feature. Since Troy took over the mandate in July 2009, TIGT has generated an annualised return of 8.2% compared to the FTSE All Share Index (benchmark) and UK Equity Income sector average of 7.8% and 9.1% respectively, as of 30/06/2023. However, the standout statistic is the low annualised standard deviation over this period of 14.6% which compares to a sector average of 20.6%, and the benchmark's 18.9%.

At the start of the five-year chart below we can see how TIGT was outperforming both the benchmark and the

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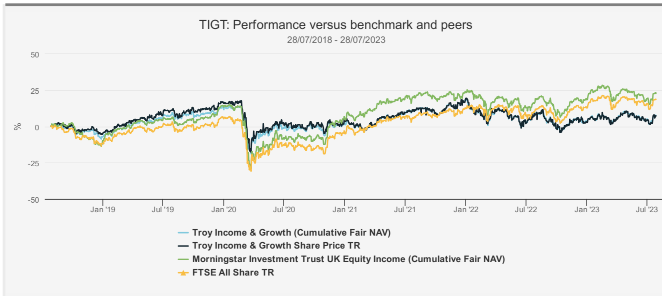
wider peer group coming into the start of the coronavirus pandemic. This was partly a reflection of the capital-preservation characteristics and quality of holdings favoured by investors during the stock market correction in 2018 – something that was also evident during, and immediately after the shock from the pandemic.

Fig.3: Five-Year Performance



Source: Morningstar

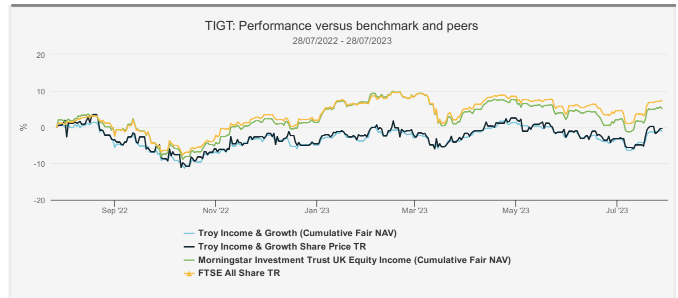
Past performance is not a reliable indicator of future results.

However, over the past couple of years generating outperformance has proven challenging. We believe this is in large part due to the fundamentally risk-averse investment strategy Blake and Hugo employ which has resulted in limited exposure to cyclically driven and capital-intensive businesses. This means the strategy has avoided the typically more volatile earlier-stage technology companies that felt a direct benefit from the work-from-home contingent, in addition to a zero allocation to sectors such as energy and mining, which have benefitted from Russia's invasion of Ukraine and the surplus demand for commodities caused by global supply chain constraints. Therefore, over the past five years, TIGT has generated a NAV Total return of 7.3% compared to the benchmark and peer group's respective total returns of 18.6% and 22.7%.

The fallout from Russia's invasion continued to impact energy markets and bolster returns generated by energy majors throughout most of 2022. Furthermore, inflationary pressures and therefore, interest rate rises which are only now showing possible signs of peeking, have bolstered the share price performance of traditional banking institutions not held in TIGT. During 2022 in particular, this had been working in the favour of strategies with a greater allocation to these sectors. Therefore, TIGT's total return of -1.1% over the past 12 months represents an underperformance of the benchmark, and the peer group's total returns of 7.2% and 5.1% respectively, as shown in the chart below.

In a recent meeting, the managers noted that more recently the portfolio preserved capital well during March's mini banking crisis and the trust's six-month performance to 27/07/2023 has been more in line with what they would expect from this strategy as one of the top three performers in the sector according to JPM Cazenove.

Fig.4: 12-Month Performance



Source: Morningstar

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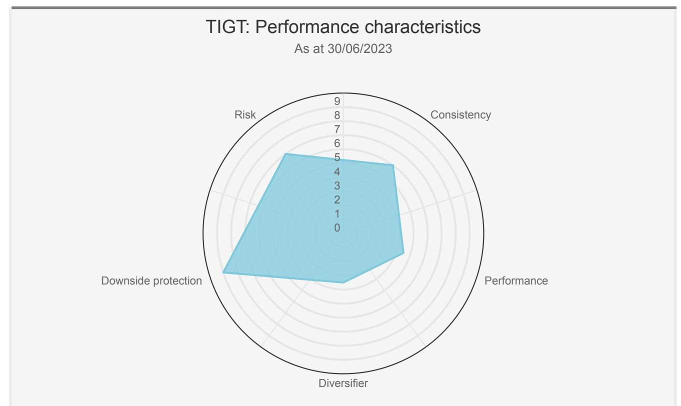
The renewed focus on generating sustainable dividend growth for the trust's investors over the long term means that during cyclically-driven market rallies it has been unsurprising to see a period of underperformance. However, over time, the apparent operational strength of the portfolio and recent resilience around some dividend announcements from several of the portfolio's underlying holdings (see **Portfolio**) highlights the potential suitability of the trust for more patient, longer-term investors.

A key feature across all of Troy's strategies is the overarching focus on the preservation of capital over the long term. Below is our proprietary KTI Spider Chart which shows how TIGT has performed versus the other 21 trusts within the AIC UK Equity Income sector over the past five years across five key categories, with ten being the maximum score for each. The chart captures the lag in performance versus the peer group over this period, however, TIGT has been able to offer a significant amount of downside protection over this time, alongside an above-average score for risk associated with the portfolio's returns – a valuable characteristic in uncertain environments.

Fig.5: KTI Spider Chart



Source: Morningstar, Kepler calculations

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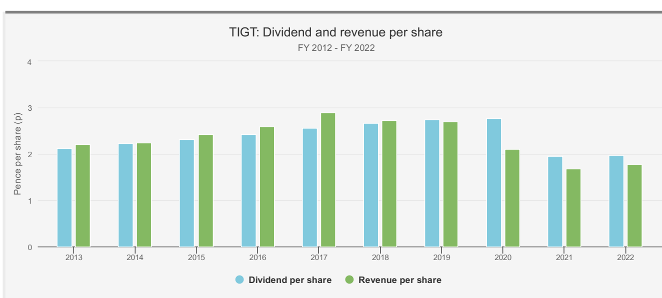
Dividend

In a recent reaffirmation of the overall strategy, TIGT's board and portfolio managers decided to firm up the income target to aim to achieve a dividend growth rate of 4% per annum or above, market conditions permitting. This follows their decision made in 2020 to refocus the portfolio to target the most sustainable sources of dividend growth over the long run, whilst maintaining Troy's capital-preservation ethos. As discussed in **Portfolio**, Blake and Hugo are focussed on balancing companies' quality, with their exposure to long-term structural growth opportunities deriving dividend growth. As a result, they are willing to forgo traditionally higher-yielding dividend-payers in the UK, which the managers believe to be within structurally declining or low-growth sectors such as energy and high-street banks. They believe such sectors have seen a progressive decline in quality and will struggle to generate growth and cover their cost of capital. The managers consider these companies' high payout ratios coupled with weak underlying fundamentals to be unsustainable.

This strategic shift led to a deliberate rebasing of the dividend in 2021 to 1.96p per share from 2.78p in 2020. This was a level that the managers believed was supportive of sustainable dividend growth. For the financial year ending 30/09/2022, TIGT paid an annual dividend of 1.97p per share, representing a deliberately cautious increase of 0.5% on the previous financial year. This translates into a historic yield of 2.8%, which is low compared to the sector's simple average of 4.8% according to JPM Cazenove, as of 27/07/2023. However, revenue per share increased from 1.68p to 1.77p or 5.3% over the previous financial year which highlights the resilience of the portfolio's underlying holdings and is particularly positive given the lack of exposure to sectors such as energy and financials.

TIGT pays a quarterly dividend in equal instalments and the two latest dividend declarations of 0.5p and 0.51p represent growth of 4% on last year's second quarter dividend - a growth rate that is in line with the newly clarified aims of the trust and one the managers believe is sustainable. As we show in the graph below, TIGIT has been paying an uncovered dividend since the 2021 rebased level. We note that TIGT has a very strong reserve position with which to support the dividend in the future if necessary, with total distributable reserves of £53.4m as of 30/09/2022, equivalent to over seven times the dividends paid last year.

Fig.6: Dividends And Revenue Per Share



Source: Morningstar

Management

TIGT is managed by Hugo Ure and Blake Hutchins of Troy Asset Management (Troy). Francis Brooke, who had been on the management team since joining Troy in October 2004, left the team at the end of December 2021. Francis is a Troy stalwart and has now taken on a new role as executive vice chairman of the firm.

In our view, Hugo's long experience on the trust (he was named manager in 2015 and has been involved with the management of the Trust since Troy won the mandate in 2009) puts him in a good position to ensure continuity, whilst Blake Hutchins also has around three years' experience on the trust and the team. Hugo has also been the lead manager of the Trojan Ethical Income Fund since its inception in 2016. Blake is highly experienced in the industry and joined the TIGT team in 2019 following his time at Investec Asset Management (now called Ninety One), where he served as lead manager and co-manager of the UK Equity Income Fund and Global Quality Equity Income Fund respectively. Blake also manages the Trojan Income Fund.

Having Hugo and Blake in place several years prior to Francis' departure whilst also announcing these changes a year in advance shows the thoughtfulness that has gone into the trust's long-term succession planning. This should provide investors comfort with respect to the continuity of the investment management style.

Hugo and Blake are supported by Fergus McCorkell, who is the assistant fund manager of TIGT and the Trojan Income Fund. Fergus also has joint responsibility, alongside the rest of the investment team at Troy, for the analysis of global companies and their selection across Troy's portfolios.

Discount

TIGT is currently trading at a discount to NAV of 1.8%. This compares to the AIC UK Equity Income sector's simple average discount of 5.2% according to JPM Cazenove, as of 27/07/2023.

TIGT introduced a strict discount control mechanism (DCM) in 2010, shortly after Troy's 2009 appointment as the trust's investment manager. The DCM is designed to minimise discount volatility to 2-3% of Net Asset Value and

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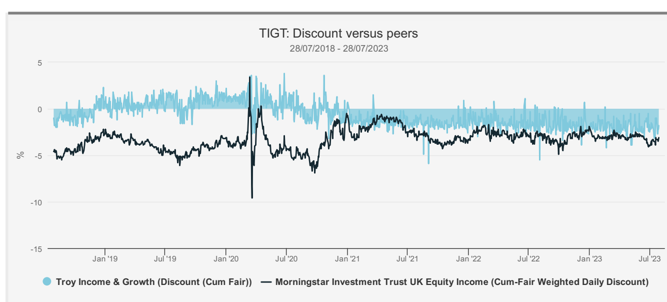
maintain shareholder value – as is consistent with Troy's overarching capital-preservation philosophy. It also serves to enhance liquidity. The board is committed to ensuring that supply and demand for the trust's shares are met on a daily basis by either buying back or issuing shares. The managers recognise that whilst investors are often able to choose the time of investment, even long-term investors can experience unexpected demands for capital, and at such times, liquidity and a near-zero discount are valuable features of an investment trust.

TIGT has been successful in maintaining this lower level of discount volatility with an average discount of -0.7% over the last five years, compared to the average 3.3% discount for the sector. For most of 2019 and 2020, this necessitated issuing shares, however, since the start of 2021, TIGT has traded on a modest but persistent discount resulting in the implementation of buybacks. Since the start of 2022, the trust has bought back 61,710,000 shares, the equivalent to 19.7% of those in issue at the start of the period (excluding treasury shares).

We think this is likely due to a period of underperformance which has seen cyclically tied sectors such as energy rally (see **Performance**), along with the rebasing of the dividend to a lower level in 2021 (see **Dividend**). However, we believe low discount volatility should appeal to many investors, particularly those investing for income who may prefer stable portfolio values and the ability to adjust their holdings by buying or selling close to NAV.

Fig.7: Five-Year Discount



Source: Morningstar

Charges

TIGT's latest ongoing charges figure (OCF) is 0.89% which is marginally higher than the sector simple average of 0.80%, according to JPM Cazenove, as of 23/06/2023. However, TIGT's OCF was calculated prior to a cut in the management fee in January 2022 from a flat 0.65% fee to 0.55% on the first £250m of net assets (i.e. excluding any gearing facility) and 0.5% for net assets above £250m. As such we expect charges to be lower on an ongoing basis, and if the trust's assets under management are able to grow from here, then investors will enjoy further benefits with the tiered cost structure now in place.

The Key Information Document Reduction in Yield (KID RIY) figure is 0.97% compared to a sector simple average of 1.43% according to JPM Cazenove, as of 27/07/2023. However, it should be cautioned that calculation methodologies can vary between trusts.

ESG

Troy integrates ESG considerations into its stock selection process. The managers view the addition of ESG analysis as well aligned with their long-term focus and emphasis on the sustainability of returns. The purchase and integration of third-party ESG data which is used as a core part of the investment process potentially enhances the validity of Troy's own research. This data is used to identify any additional risks that could materially impact current and potential investee companies within the investment universe over the long term, such as a lack of proactive management of their social impact and environmental footprint.

Troy's inherent focus on quality throughout its investment approach tends to provide some natural alignment with ESG considerations, with 68% of the portfolio aligned to, or in the process of being aligned towards a net-zero pathway, according to MSCI ESG research and Troy. This approach has contributed towards the avoidance of miners and oil majors and has driven the smaller-than-average carbon footprint of the current holdings, especially when compared to the FTSE All Share Index. As of 23/06/2023, the trust has a 'Low Carbon Designation' from Morningstar Sustainalytics and an 'above average' sustainability rating. These are both designations applied to funds that exhibit fewer ESG-related risks than is typical of their peers.

As noted in the **Management Section**, Hugo Ure is the lead fund manager of the Trojan Ethical Income Fund and was responsible for the development of Troy's responsible investment approach and strategy. TIGT's managers follow Troy's house view in that they "may seek to deliver environmental or social impact where doing so is aligned with improving the risk and return profile of the investment"; however, they "will not seek environmental or social impact at the expense of returns". This leads us to believe that TIGT may not be wholly appropriate for an investor requiring a specific set of exclusionary requirements due to the absence of an exclusionary mandate. Yet as the ratings suggest, the trust could appeal to investors who generally favour a portfolio tilted towards companies with a higher sustainability profile.

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