EDISON

Lowland Investment Company

Backing industrial stocks amid higher inflation

Investment trusts
UK equity income

1 November 2021

Price		**1,310.0p**
Market cap		**£353.9m**
AUM		**£433.3m**

NAV*		1,419.2p
Discount to NAV		7.7%

*Including income. As at 29 October 2021.

Yield		4.6%
Ordinary shares in issue		27.0m
Code/ISIN		LWI/GB0005368062
Primary exchange		LSE
AIC sector		UK Equity Income
52-week high/low	1,425.0p	891.0p
NAV* high/low	1,487.3p	959.7p

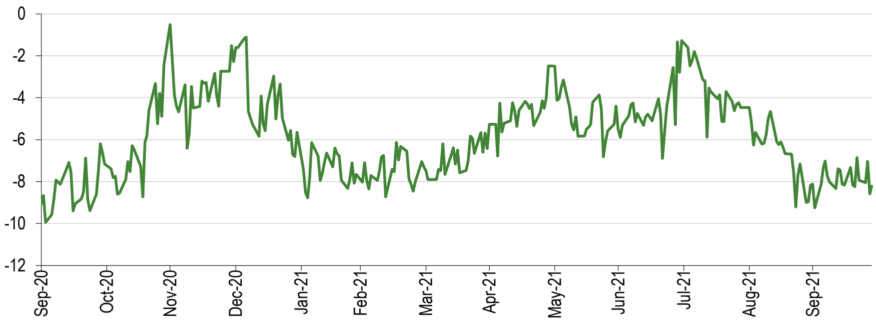
*Including income

Gross gearing*	16.0%
Net gearing*	15.0%

*As at 30 September 2021

Lowland Investment Company (LWI) co-manager James Henderson argues that the current environment of higher inflation and interest rate expectations and supply squeezes should favour industrial stocks that have pricing power and direct access to their end-markets. The trust currently has an industrials weighting roughly twice that of the UK large-cap index, underlining its credentials as an all-cap investor with a bias to value over all-out growth. Henderson and co-manager Laura Foll have turned in a good year of performance for the trust's FY21 (ended 30 September), with NAV and share price total returns in excess of 50%, well ahead of UK large-cap, mid-cap and high-yield equity indices. Despite this, and LWI's near-5% dividend yield, the trust currently trades at a discount to NAV of c 8%, wider than both short- and longer-term averages.

LWI's discount to NAV has widened despite strong 12-month performance



Source: Refinitiv, Edison Investment Research.

The analyst's view

LWI's income-orientated, valuation-aware approach to investing, as well as the UK market in which it invests, has been out of favour for several years as investors have favoured high-growth and particularly technology stocks in markets such as the US and China. The prospect of higher inflation and interest rates is now focusing the market's attention on real returns, and stimulus-driven infrastructure spending is likely to favour the old economy as much as the new. As such, the trust's income discipline and its managers' willingness to seek out interesting stocks in all sectors and regions of the UK could herald a better period – borne out by the most recent full-year performance.

Real yield and attractive valuation

At 28 October 2021, LWI's shares traded at a 7.7% discount to cum-income NAV. This is appreciably wider than the one-, three-, five- and 10-year average discounts of 5.9%, 6.1%, 6.1% and 4.1%, respectively. While in part this does reflect a general widening of investment company discounts amid increased market volatility, only two of the 17 largest trusts in the AIC's UK Equity Income sector traded at a wider discount in late October (Exhibit 8). This is despite LWI's 4.6% dividend yield being among the highest in the group, backed up by a significant post-COVID income recovery and representing a solid real yield versus the CPI inflation forecast at 4%.

Fund objective

Lowland Investment Company (LWI) aims to give investors a higher-than-average return with growth in both capital and income over the medium to long term by investing in a broad spread of predominantly UK companies. LWI measures its performance against the total return of the broad UK stock market.

Bull points

- Higher-than-forecast GDP growth, as well as moderately rising inflation and interest rate expectations, could be positive for UK equities.
- Actively managed, all-cap style allows managers to find less mainstream opportunities.
- Income discipline tends to do well when cash and bonds struggle.

Bear points

- Potential for policy error to choke off the economic recovery.
- Value-orientated investment style may go out of favour again.
- Income requirement can lead to a lack of flexibility in stock selection.

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The fund managers: James Henderson and Laura Foll

The managers' view: Interesting industrials for income & growth

With the Office for Budget Responsibility projecting UK CPI inflation to exceed 4% over the coming 12 months, Henderson argues that equity income stocks should once again begin to look attractive in an environment in which cash and bond yields look set to struggle (even given expected increases in the Bank of England base rate) and highly rated growth stocks could see a reversal of fortune. 'In recent years, yield has not been a good valuation tool to use', he explains. While historically income fund managers may have chosen to sell holdings where yields had dropped as a result of strong capital performance, recycling gains into positions with higher dividend yields, the manager says that 'in the past few years the best have got better (putting further downward pressure on yields), while the challenged have remained so'.

As the market narrative moves away from the 'transitory' view of inflation, Henderson argues that rising prices and interest rates could help some of the companies – particularly in the industrial space – that have been left behind in the race for 'growth at any price' that has characterised much of the past five years in global equity markets. 'With raw material prices going up and increasing supply chain difficulties, UK industrial companies with pricing power are in a better place than in the previous period where manufacturers have been able to get components more cheaply in the Far East', he says. 'While their earnings may not have grown much on a five-year view, companies that have got through this difficult period could do better going forward.'

Exhibit 1: Industrial stocks offering 'value and income' in LWI's portfolio

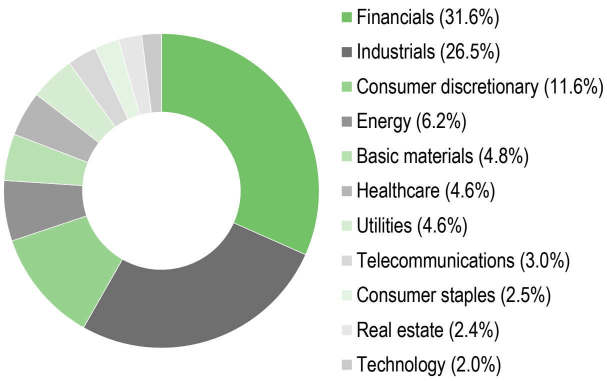
Company name	Industry subsector	Market cap £m	1y capital return %	Dividend yield* %
Hill & Smith	Metal fabrication	1,450.2	50.2	1.6
Castings	Industrial machinery	155.3	12.1	4.1
Ibstock	Cement	829.1	12.7	2.0
Morgan Advanced Materials	Electronic components	994.5	33.6	2.0
Redde Northgate	Industrial machinery	979.4	100.8	3.9
Ricardo	Engineering & contracting services	261.3	10.7	1.6

Source: Lowland Investment Company, London Stock Exchange, Edison Investment Research. Note: Data as at 28 October 2021. *Dividend yields based on previous 12 months.

LWI's income discipline means it seeks companies with sustainable yields, although it casts its net far wider than the 'usual suspects' among the UK's largest companies: more than half its portfolio is made up of companies with a market cap below £5bn. As shown in Exhibit 2, over a quarter of LWI's assets are invested in industrial companies, roughly double the sector's weighting in the main UK blue-chip index. This is an area that Henderson expects to benefit from the combination of higher inflation, increased economic activity (some of it as a result of government stimulus) and a supply squeeze. The companies may not be glamorous – Hill & Smith is a metal galvaniser, Castings operates iron foundries and Ibstock makes bricks, for example – but the manager says they have the potential to generate attractive returns through a combination of top-line growth and increased pricing power in the face of supply shortages. This in turn should feed through into sustainable dividends for their investors.

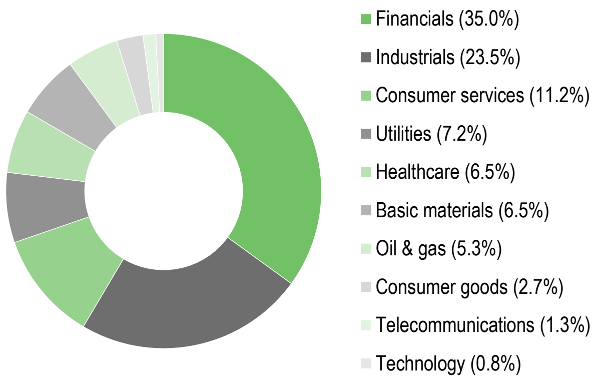
Considering some of the examples shown in Exhibit 1, Hill & Smith is a relatively large player in galvanised metal applications such as crash barriers, and is active on both sides of the Atlantic. Galvanising tends to take place close to the end-markets for the materials, which lessens the impact of global supply chain difficulties, thus increasing the attractiveness of regional operators. Ibstock is another beneficiary of this trend; higher raw material and energy costs as well as logistical issues will make it more attractive for UK housebuilders to source bricks domestically, particularly given the political importance of lower-margin activities such as building affordable homes. Meanwhile, Morgan Advanced Materials (a top 10 position in the LWI portfolio) has more than 70 manufacturing facilities worldwide for its range of high-tech industrial products (many of which are exposed to growing end-markets such as energy transition), which historically may have seemed inefficient, but now looks a smart move given the high cost of international freight. Redde Northgate, as a supplier of white vans to trade users, may be very far from high-tech, but is still helped by improving economic activity.

Exhibit 2: Sector exposure at 30 Sept 2021 (new ICB)



Source: Lowland Investment Company, Edison Investment Research

Exhibit 3: Sector exposure at 30 Sept 2020 (old ICB)



Source: Lowland Investment Company, Edison Investment Research

Elsewhere in the portfolio (Exhibit 2), financials remain an important weighting, with a diverse group of holdings from insurance (life, non-life and reinsurance) to major high street banks. The banks weighting has been built up over the past 12 months and Henderson sees them as a key beneficiary of a more inflationary and rising interest rate environment, as long as the Bank of England does not go too far in raising rates and thereby choke off the economic recovery – a risk of which policymakers will be keenly aware following the 'taper tantrum' of 2013.

During September, the managers added to existing holdings in Finsbury Foods, Chesnara, Headlam and Halfords. They also took a small new position in wealth manager Brooks Macdonald. Foll says a recent return to net inflows in the firm's managed portfolio service (which provides outsourced investment management to financial advisers) underlines the growth prospects for the business.

Performance: Absolute and relative gains in FY21

Exhibit 4: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	CBOE UK All Cos (%)	MSCI UK High Div Yld (%)	CBOE UK 250 (%)	CBOE UK Small Cos (%)
30/09/17	16.4	17.0	12.0	16.9	14.2	23.6
30/09/18	4.2	2.9	5.9	1.7	4.6	1.4
30/09/19	(11.9)	(9.6)	2.7	(1.1)	(0.3)	(7.3)
30/09/20	(24.6)	(24.8)	(17.9)	(16.3)	(16.1)	(13.8)
30/09/21	53.3	51.1	28.5	17.5	45.3	73.6

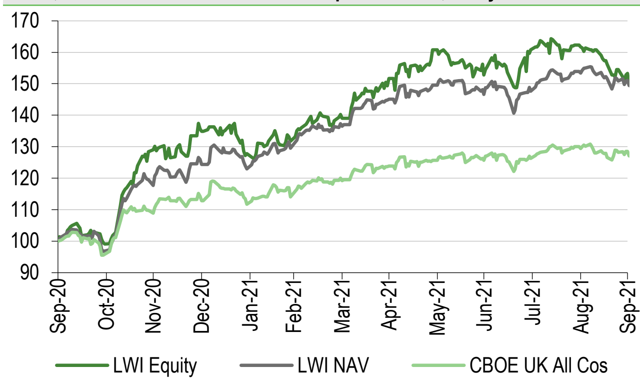
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

LWI has performed particularly well over the past 12 months to 30 September 2021 (also the trust's financial year end), outstripping all the comparator indices except the CBOE UK Smaller Companies (Exhibit 4). While Henderson is keen to stress that the lion's share of the outperformance came in the first half of the year, it is clear from Exhibit 6 that the outperformance continued in the second six months, albeit the most recent numbers have been flat to negative given the widespread market volatility seen in September.

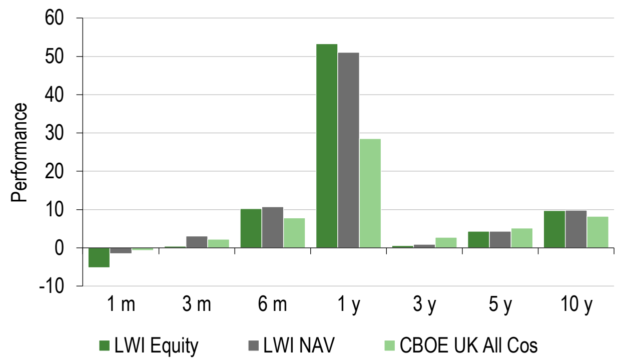
Contributors to the strong 12-month performance have included the increased weighting in high street banks, which in most cases have reinstated dividends following their suspension in 2020 at the height of the pandemic. Some of LWI's holdings have seen their share prices more than double over the past year (to 28 October 2021), including Redde Northgate (+101%), engineering firm Renold (+177%) and news publisher Reach (+184%). Henderson comments that a decrease in the market value of LWI's debt has also boosted fair value NAV (fixed-rate debt tends to revalue downwards when interest rate expectations are higher), and gearing, which stood at 15% at end-September, has contributed positively as well.

Exhibit 5: Investment trust performance to 30 September 2021

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

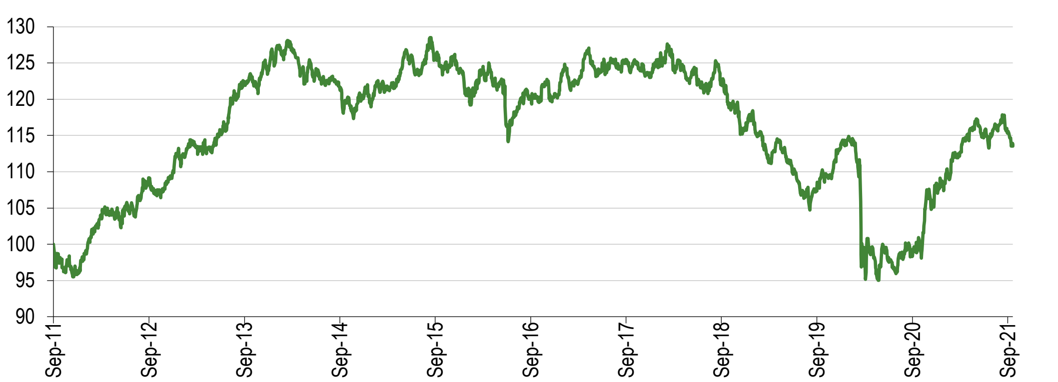
Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to CBOE UK All Cos	(4.5)	(1.8)	2.2	19.3	(6.0)	(4.0)	15.0
NAV relative to CBOE UK All Cos	(0.8)	0.8	2.7	17.5	(5.3)	(3.8)	15.6
Price relative to MSCI UK High Div Yld	(0.3)	2.4	9.5	30.5	4.7	6.8	38.2
NAV relative to MSCI UK High Div Yld	3.6	5.2	9.9	28.6	5.6	7.0	39.0
Price relative to CBOE UK 250	(0.9)	(3.9)	0.3	5.5	(16.2)	(15.0)	(22.0)
NAV relative to CBOE UK 250	2.9	(1.3)	0.8	4.0	(15.6)	(14.9)	(21.6)
Price relative to CBOE UK Small Cos	(5.9)	(2.1)	(3.2)	(11.7)	(26.7)	(29.1)	(20.9)
NAV relative to CBOE UK Small Cos	(2.3)	0.5	(2.8)	(13.0)	(26.1)	(29.0)	(20.4)

Source: Refinitiv, Edison Investment Research. Note: Data to end-September 2021. Geometric calculation.

Given LWI's income discipline (which Henderson notes has been out of favour as an investment style in recent years), it is worth noting the trust's strong long- and shorter-term performance versus the MSCI UK High Dividend Yield Index. As shown in Exhibit 6, LWI has outperformed this index in both share price and NAV terms over three, six and 12 months and three, five and 10 years, with particularly notable outperformance over one year. This is testament to the trust's active, all-cap approach, with significant holdings in smaller and AIM companies and a focus on dividend growth rather than simply a high starting yield, which may indicate a stock with poor prospects.

Exhibit 7: NAV performance versus CBOE UK All Companies over 10 years



Source: Refinitiv, Edison Investment Research

Peer group comparison

Th Association of Investment Companies' UK Equity Income sector, of which LWI is a member, is one of the largest peer groups, with 22 funds in total. In Exhibit 8, we show the 17 largest, all with a market cap above £100m. Although all the peers aim to reward shareholders with a mixture of income and growth from a portfolio largely (at least 80%) made up of UK equities, the sector encompasses a wide variety of investment approaches, from concentrated large-cap portfolios such as Finsbury Growth & Income (FGT), to all-cap selections such as Diverse Income Trust, Lowland and Aberdeen Standard Equity Income. In recent years, when the market has rewarded investors with more of a quality growth slant, LWI's NAV performance has struggled to keep up with the peer group average, ranking 14th and 13th respectively over three and five years to 26 October 2021 and a respectable seventh over 10 years. However, the trust's greater focus on value and recovery stocks has meant it was very well positioned for the market rotation that began in late 2020, and over the past 12 months only two funds rank higher than LWI: Temple Bar and Merchants Trust, both of which also have more of a 'value' tilt.

The UK Equity Income sector is one of the most competitive on fees, and LWI's 0.6% ongoing charge is below the average of 0.7%, ranking eighth. There are no longer any funds in the sector that may levy a performance fee. Discounts to NAV have recently widened across the group as equity markets have experienced a bout of increased volatility, and LWI's 8.0% discount at 27 October 2021 is the third widest (and is also above-average in a historical context – see page 1). Gearing is currently (based on 30 September data) the second highest in the peer group, while the trust's 4.6% dividend yield is also above average, ranking fourth in the sector.

Exhibit 8: Selected peer group as at 27 October 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Lowland	**352.6**	**48.4**	**14.1**	**22.9**	**138.5**	**0.6**	**No**	**(8.0)**	**115**	**4.6**
Aberdeen Standard Equity Income	168.1	40.1	4.8	16.7	105.2	0.9	No	(9.3)	113	5.9
BMO Capital & Income	349.8	37.4	27.2	42.5	132.2	0.6	No	(2.3)	106	3.6
BMO UK High Income Units	121.2	23.7	18.8	21.4	96.3	1.0	No	(4.6)	109	4.2
City of London	1,750.5	30.6	17.9	26.3	120.6	0.4	No	(0.2)	108	4.9
Diverse Income Trust	413.5	32.7	36.3	51.4	252.6	1.1	No	(0.9)	100	3.3
Dunedin Income Growth	481.5	26.5	43.0	49.5	130.8	0.6	No	(1.4)	107	3.9
Edinburgh Investment Trust	1,062.4	38.2	12.7	14.6	126.5	0.4	No	(9.7)	107	3.9
Finsbury Growth & Income	1,980.8	16.9	32.0	57.9	254.8	0.6	No	(4.1)	100	1.9
Invesco Select UK Equity	148.8	40.0	36.6	40.2	191.3	0.9	No	(5.0)	110	3.5
JPMorgan Claverhouse	449.4	40.4	28.3	42.3	152.6	0.7	No	(1.3)	117	4.1
Law Debenture Corporation	946.4	48.0	45.6	65.4	191.6	0.6	No	(2.2)	113	3.7
Merchants Trust	688.4	63.5	40.2	55.7	158.1	0.6	No	(0.0)	111	4.9
Murray Income Trust	1,052.1	27.5	40.1	49.3	135.3	0.5	No	(7.2)	110	3.8
Schroder Income Growth	206.3	31.1	21.5	30.9	125.0	0.9	No	(1.9)	109	4.3
Temple Bar	721.5	50.9	6.5	14.6	100.6	0.5	No	(7.5)	108	3.6
Troy Income & Growth	246.9	15.4	17.0	23.4	114.0	0.9	No	(1.1)	100	1.9
Simple average (17 funds)	**655.3**	**36.0**	**26.0**	**36.8**	**148.6**	**0.7**		**(4.0)**	**108**	**3.9**
LWI rank in peer group	**11**	**3**	**14**	**13**	**7**	**8**		**15**	**2**	**4**

Source: Morningstar, Edison Investment Research. Note: *Performance as at 26 October 2021 based on cum-fair NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100=ungeared).

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