Foreign & Colonial Investment Trust

A quiet evolution

Investment trusts

Foreign & Colonial Investment Trust (FRCL) is the oldest UK investment trust and one of the largest and most liquid, with a market capitalisation of £2.2bn and a largely retail investor base. Manager Jeremy Tigue, who has run the trust since 1997, will retire at the end of 2014 and management will pass to Paul Niven from 1 July. The trust seeks growth in both capital and income from a globally diversified portfolio, which is evolving to reflect the recently adopted FTSE All-World index benchmark, resulting in a significant reduction in UK holdings.

12 months ending	Total share price return* (%)	Total NAV return* (%)	Total return blended benchmark* (%)	Total return FTSE All-World* (%)	Total return FTSE All-Share* (%)
28/02/11	15.4	14.0	16.8	14.2	17.0
29/02/12	1.9	1.4	1.5	0.7	1.5
28/02/13	17.4	17.3	17.3	15.7	14.1
28/02/14	10.6	8.5	7.4	7.4	13.3

Note: *Twelve-month rolling discrete performance. FRCL's benchmark index until 31 December 2012 was a composite of 40% FTSE All-Share Index and 60% FTSE World ex-UK Index. Since 1 January 2013 the benchmark is FTSE All-World Index.

Investment strategy: Diversified by design

FRCL was set up in 1868 to give "the investor of moderate means the same advantages as the large capitalists, in diminishing the risks of investment". Today its stated objective is to achieve long-term growth in capital and income from a global portfolio of equities (mainly listed, but also unlisted), with the use of gearing. It brings together portfolio managers from within management group F&C Investments, as well as outsourcing some mandates externally, and from 2014 will include a funds portfolio run by F&C's multi-managers Rob Burdett and Gary Potter.

Outlook: A fine balance between greed and fear

Global equities, as measured by the FTSE All-World index, performed well in 2013 (+21%), but the current year started with a modest correction on the back of macro worries. Developments in Ukraine have not so far had a sustained impact on markets, but nevertheless underline the potential for further volatility. The expectation of continued economic recovery, and equity valuations that are yet to enter clearly stretched territory, are positive factors for investors, but the current and future managers of FRCL have a conservative view on markets, and as a result the level of gearing has been dialled back to 5% in early March, compared with up to 14% in 2013.

Valuation: Controls keep discount in tight range

The current discount of 9.5% (including income, with debt at fair value) is close to its one-, three- and five-year averages, and has moved within a narrow range over the past year. FRCL has a discount control mechanism whereby it will buy back shares when the discount exceeds 10%. This means investors have some certainty that they will be able to achieve an exit at no worse than the long-term average discount. FRCL's discount is marginally wider than the 35-strong peer group, where seven trusts are currently trading at a premium. No shares have been bought back in 2014 to date.

12 March 2014

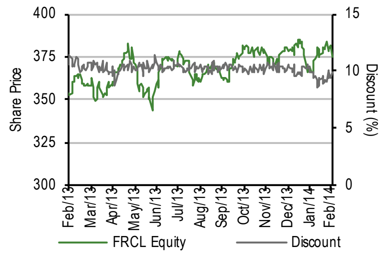
Price	**381.3p**
Market cap	**£2,175m**
AUM	**£2,715m**

NAV*	420.48p
Discount to NAV	9.3%
NAV**	421.12p
Discount to NAV	9.5%
Yield	2.4%

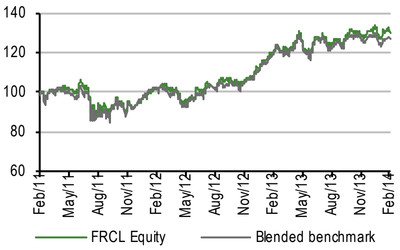
*Excluding income. **Including income. Data at 7 March 2014.

Ordinary shares in issue	570.4m
Code	FRCL
Primary exchange	LSE
AIC sector	Global Growth

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low	385.5p	343.5p
NAV* high/low	425.7p	379.2p

*Adjusted for debt at market value, including income.

Gearing (at 31 January)

Gross	8%
Net	8%

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Edison profile page

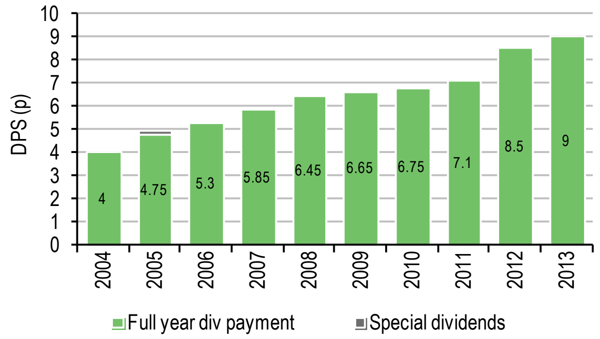
Foreign & Colonial Investment Trust is a research client of Edison Investment Research Limited

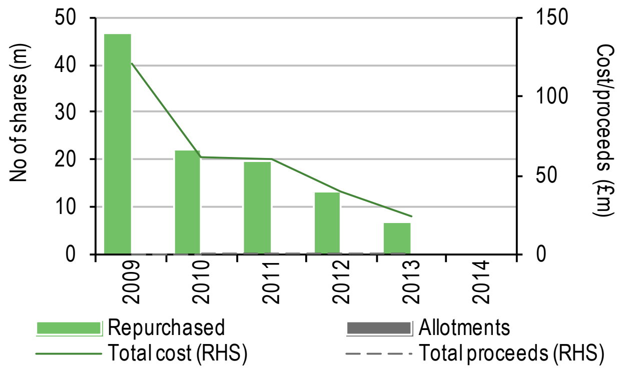
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
Foreign & Colonial Investment Trust's (FRCL) investment objective is long-term growth in capital and income from a portfolio of primarily listed global equities, but also including unlisted investments. FRCL's benchmark index is the FTSE All-World Index. Until 31 December 2012 it had a composite benchmark of 40% FTSE All-Share Index and 60% FTSE World ex-UK Index. This note uses a blended benchmark to take account of the change. Gearing and the management of liabilities are important elements of FRCL's strategy.	4 March 2014: Annual results released for the year ended 31 December. Retirement of Jeremy Tigue and forthcoming appointment of Paul Niven announced. 19 December 2013: Third interim dividend of 2.1p announced.

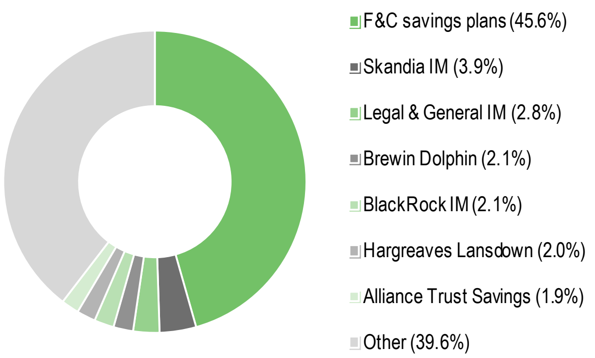
Forthcoming		Capital structure		Fund details	
AGM	29 April 2014	Ongoing charges*	0.86%	Group	FCAM/F&C Investments
Half-year results	August 2014	Net gearing	8.0%	Manager	Jeremy Tigue (until 30 June 2014)
Year end	31 December	Annual mgmt fee	0.365% of market cap	Address	Exchange House, Primrose Street, London EC2A 2NY
Dividend paid	Quarterly	Performance fee	None		
Launch date	1868	Trust life	Indefinite	Phone	+44 (0) 800 136 420
Continuation Vote	None	Borrowing facilities	Various – see page 7	Website	www.foreignandcolonial.com

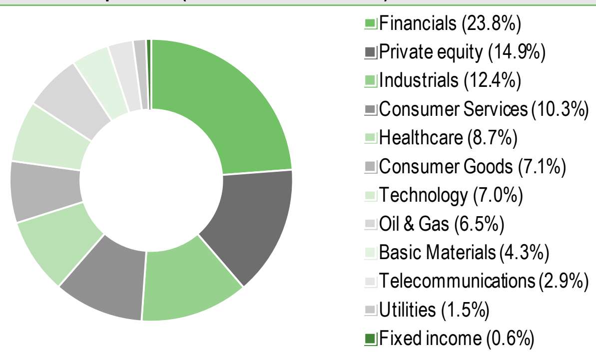
Dividend policy and history	Share buyback policy and history
Dividends are paid quarterly in February, May, August and November.	Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.





Shareholder base (as at 28 February 2014)	Distribution of portfolio (as at 31 December 2013)





Top 10 holdings (31 January 2014 compared with 31 January 2013)

			Portfolio weight %	
Company	**Country**	**Sector**	**31 January 2014**	**31 January 2013**
Pantheon Europe Fund V	UK/Europe	Private equity	2.3	2.5
Harbourvest V Direct Fund	Global	Private equity	1.9	2.2
Doverstreet VII	Global	Private equity	1.4	1.9
BP	UK	Oil & gas	1.4	1.3
Pantheon Europe Fund III	UK/Europe	Private equity	1.3	2.1
HSBC	UK	Financials	1.2	1.3
GlaxoSmithKline	UK	Healthcare	1.2	1.3
Harbourvest Buyout Fund VII	US	Private equity	1.2	1.4
Royal Dutch Shell	UK	Oil & gas	1.2	1.3
Vodafone	UK	Telecoms	1.1	n/a**
Utilico Emerging Markets	UK	Funds	n/a**	1.2
Top 10			**14.2**	**16.3**

Source: Foreign & Colonial Investment Trust, Edison Investment Research, Morningstar, Bloomberg. Notes: *Ongoing charges include the look-through expense of managing the private equity portfolio. **In portfolio on stated date, but not in top 10.

Market outlook: Continued volatility in prospect

Strong performance from global equities in 2013 masked a wide divergence between advanced and emerging markets (FTSE All-World Developed +29%, FTSE AW Emerging +4%), as the US Federal Reserve's decision to taper its asset purchase programme caused liquidity to flow back to the developed world in anticipation of higher yields to come. While economic recovery looks set to be sustained, with the International Monetary Fund forecasting economic growth of 2.8% and 3.0% respectively in 2014 and 2015 for the US, and 3.7% and 3.9% globally, risks remain, exemplified by Russia's intervention in Ukraine, which has the potential to unsettle markets more significantly if events take a turn for the worse.

Taking the Datastream world index, with share prices outpacing earnings growth, the forward P/E has expanded from 12.7x to 14.0x over the last year. This is above the 10-year average of 12.9x, but still some way short of the 15.8x high point. In this context, market progress this year is likely to be contingent on corporate earnings progress matching or beating expectations and a relatively benign geopolitical environment. A diversified global portfolio, such as FRCL, may provide a measure of insulation from specific areas of volatility.

Fund profile: New manager and changed benchmark

FRCL was launched in 1868 as a government bond fund, but changed its remit to invest in equities during the 1920s. It aims to achieve long-term growth in capital and income, and has increased its dividend (which it now pays quarterly) for 43 years in a row. It is one of the largest members of the Association of Investment Companies' Global peer group, and since the start of 2013 has used the FTSE All-World Index as its benchmark. Before this it had a composite benchmark of 40% FTSE All-Share Index and 60% FTSE World ex-UK, and FRCL's relatively high UK exposure reflects the adjustments still underway to bring the trust closer to the new benchmark. The portfolio is highly diversified, with almost 600 individual holdings at the end of January 2014. FRCL is unusual in that it also has a significant weighting to private equity (14.9% at end January), mainly through funds of funds. Adding in the outsourced US equity exposure and a small allocation to global funds, almost half the assets in the FRCL portfolio are managed by third parties (at end January). The top 10 holdings at 31 January (dominated by private equity funds) make up 14.2% of the portfolio, while the top 10 direct equity holdings account for only 9.7% of the portfolio, compared with the weighted average for the peer group of 25.3%. The trust has had only two managers in the past four decades, with Jeremy Tigue at the helm since 1997. Tigue, who joined F&C in 1981 and has spent his entire career with the management company, has announced he is to retire at the end of 2014, and will hand over the FRCL portfolio to Paul Niven, F&C's head of multi-asset investment, on 1 July. Niven has been at F&C since 1996, with most of the mandates he oversees being institutional and therefore not in the public domain. While performance on the mutual funds for which Niven is a named manager has been unexciting, the board of FRCL has indicated that the performance of his institutional mandates was an important factor in its decision to appoint him.

The fund manager: Jeremy Tigue/Paul Niven

The manager's view: Proceeding with caution

Foreign & Colonial's portfolio is undergoing a period of change as it adjusts to its new FTSE All-World benchmark, although the continued weighting to private equity – at 14.9% but expected to move down towards its 10% target – adds a differentiating component to the portfolio. Manager Jeremy Tigue has begun the process of transferring the portfolio to Paul Niven, who formally takes over on 1 July. As head of Multi-Asset at F&C, Niven is responsible for mandates that blend a range of different asset types, although the intention is for FRCL to remain equity focused.

At 50.5% of the benchmark, but only 28.9% of the portfolio, there is currently a large underweight to US equities, but Tigue and Niven are unlikely to reverse this precipitately, as they feel US valuations may be stretched and see better opportunities elsewhere in markets such as Europe and Japan. Tigue's long-term underweight to Japan hurt relative performance in 2013 as the market surged on hopes of reform under Prime Minister Shinzo Abe. Weightings in all non-UK markets are likely to rise as a result of the formation of the new global multi-manager portfolio (see Portfolio positioning, below). However, while the emerging markets allocation may rise over the medium term, Niven says he is circumspect about the immediate prospects for the developing world, as like-for-like comparisons show EM stocks may not be as cheap as they appear, and headwinds persist from Fed tapering and the commodity cycle remaining weak.

Asset allocation

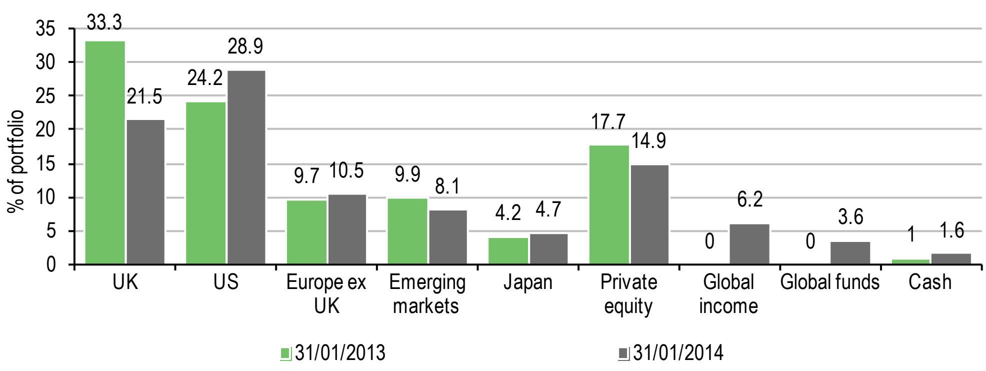
Investment process: Finding the best managers

The large and diverse portfolio of Foreign & Colonial is assembled on a top-down basis, informed by the manager's views on asset allocation, risk and the use of gearing. The process has evolved under Jeremy Tigue's tenure and the trust is now made up of a set of sub-portfolios managed either by specialist teams within F&C Investments, or – as with the US and private equity allocations – outsourced to specialist third-party managers. FRCL chairman Simon Fraser describes the manager's remit as being "to find the best managers either internally or externally". Paul Niven, who takes over as manager on 1 July, chairs F&C Investments' asset allocation committee and will continue to apply a diversified and multi-asset approach to FRCL. The portfolio is actively managed and is not restricted by geographical or industry weightings in the benchmark. In practice this has led to significant divergences in some areas, notably the weighting in private equity, currently c 15% of the portfolio, and a long-term underweight to Japan, which has been reversed slightly over the past year. The trust is structurally geared, with a 25-year debenture due to mature at the end of 2014, in addition to short and longer-term loans in a variety of currencies (see Capital structure section below). The manager can deploy gearing of up to 20% of assets, although the gearing level has fallen back over the past two years as markets have risen, and at the time of writing stood at c 5%, a further fall from the latest published figure of 8% at the end of January. FRCL aims to achieve long-term growth in both capital and income, and has raised its dividend (which it now pays quarterly) in each of the last 43 years. To help meet its income requirement, in 2013 the manager introduced a global income sub-portfolio, which now accounts for just over 6% of assets.

Portfolio positioning

Foreign & Colonial's geographical exposure is still undergoing a period of change following the move to its new benchmark, the FTSE All-World Index, at the start of 2013 (see Exhibit 2 below).

Exhibit 2: Change in allocations over the year to 31 January 2014



Source: Foreign & Colonial Investment Trust, Edison Investment Research

Previously the benchmark was a composite of 40% FTSE All-Share and 60% FTSE World ex-UK, and the trust had a c 40% allocation to UK equities in recognition of this. The UK weighting had fallen to 21.5% by the end of January 2014, and manager Jeremy Tigue says this will fall further to c 10% in the near future. The private equity weighting, at 14.9%, is still above the target allocation of 10%, but is on course to fall as the maturing portfolios continue to throw off cash as a result of realisations. The chairman has stated that the board will review the allocation to private equity, and the diversified but costly fund of funds approach to the asset class, once the target level is achieved. Because of the high UK weighting and the allocation to private equity, FRCL's portfolio is underweight all other geographical areas (Exhibit 3), most notably the US, which makes up half of the FTSE All-World index. Industry sector weightings (included in Exhibit 1) are generally slightly below index levels (another side effect of the private equity weighting, meaning only 85% of the portfolio is invested in equities), with the principal divergences being an overweight position in financials (1.8 percentage points above the index weight) and a larger underweight to consumer goods (-6pp versus the index).

At the time the new benchmark was adopted in 2013, Tigue also put in place two new sub-portfolios – global income and a 'special situations' portfolio of global funds. Performance from the global funds portfolio in 2013 was lacklustre, up 1.3% compared with a 7.4% increase in the FTSE All-World Index, and FRCL has decided to appoint Rob Burdett and Gary Potter, co-heads of multi-manager at F&C Investments, to bring a more professional approach to running this portfolio. This will lead to increased turnover in the short term, as Burdett and Potter have been given a 'clean slate' to run the portfolio without legacy holdings. Proceeds from the reduction in the UK weighting will be redeployed to the global multi-manager portfolio, which will grow as a result from its current c £50m level to £250m, or roughly 10% of FRCL's total assets.

The smaller UK weighting will be run on a more focused basis with a shorter stock list of 40-50 names, and day-to-day responsibility for UK equities will pass from Julian Cane to Michael Ulrich and Rodger McNair at F&C Investments. Ulrich runs F&C's UK Mid Cap fund, while McNair is manager of Investors Capital Trust. The US equity allocation continues to be split between T Rowe Price, Barrow Hanley, F&C US Smaller Companies Trust (FSC) and a segregated US small-cap portfolio run in-house by F&C's Nish Patel. FSC is likely to be renamed after the investment trust followed its manager, Robert Siddles, to Jupiter Asset Management.

Exhibit 3: Geographic allocations and performance to 31 December 2013

	Portfolio weight %	Benchmark weight %	Trust active weight %	Portfolio performance* %	Performance relative to benchmark* %
UK	21.9	8.0	13.9	18.7	-0.9
North America	29.1	50.5	-21.4	35.1	5.3
Europe ex UK	10.7	15.9	-5.2	29.6	2.4
Japan	4.7	8.3	-3.6	23.0	-1.6
Emerging markets	8.4	17.3	-8.9	-7.4	-3.4
Global income	6.2	0.0	6.2	8.9	N/A
Global funds	4.1	0.0	4.1	1.3	N/A
Private equity	14.9	0.0	14.9	8.2	N/A
	100.0	**100.0**	**0.0**		

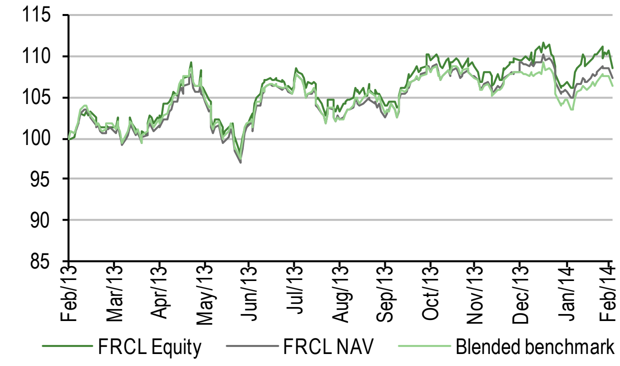
Source: Foreign & Colonial Investment Trust, Edison Investment Research. Note: *Performance in CY13.

Performance: Close to index despite divergent portfolio

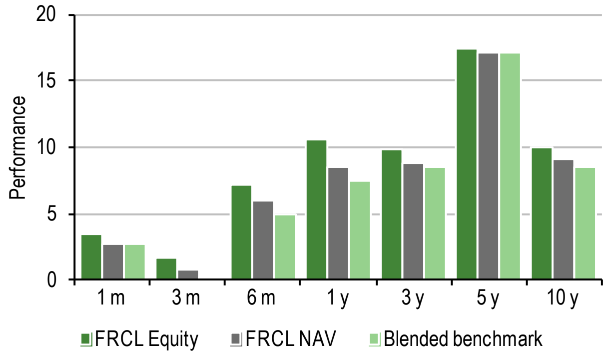
As Exhibit 4 shows, FRCL's net asset value total return has been in line with or mildly outperformed its benchmark over one, three and six months and one, three, five and 10 years (three, five and 10 years annualised). Exhibit 5 reveals periods of moderate volatility versus the benchmark (40% FTSE All-Share and 60% FTSE World ex-UK until 31 December 2012 and FTSE All-World Index thereafter), although overall performance has again been in line. Given FRCL's weighting to private

Exhibit 4: Investment trust performance to 28 February 2014

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



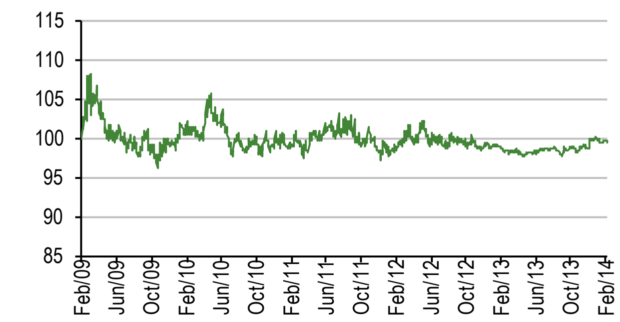
Price, NAV and benchmark total return performance (%)



Source: Foreign & Colonial Investment Trust, Thomson Datastream, Edison Investment Research. Note: Three, five and 10 years annualised.

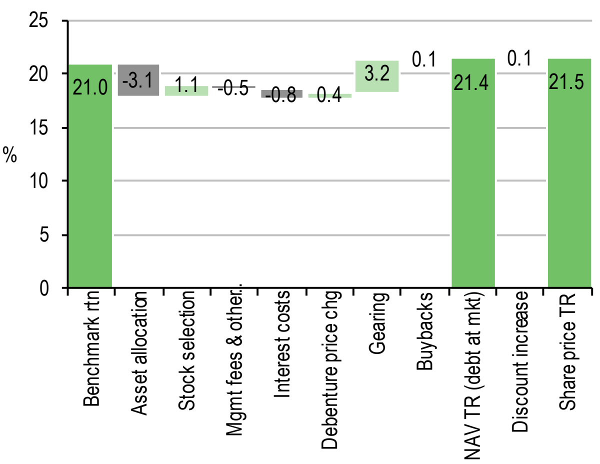
equity (at 14.9% at the time of writing it is at its lowest level since 2009) and its fluctuating UK allocation, it would not be correct to conclude that the trust is a closet tracker, particularly as the level of gearing (which can be deployed as a means of increasing the listed equity exposure) has varied widely over the same period in response to market conditions, and stood at 8% at the end of 2013. Exhibit 6 shows the attribution of performance in 2013 – a year in which the upside in the benchmark was captured, but the positive effect of gearing and stock selection was offset by negative contributions from asset allocation and costs, meaning overall performance almost exactly matched the benchmark return.

Exhibit 5: Five-year NAV total return vs benchmark



Source: Thomson Datastream, Edison Investment Research. Note: Rebased to 100.

Exhibit 6: Performance attribution in 2013

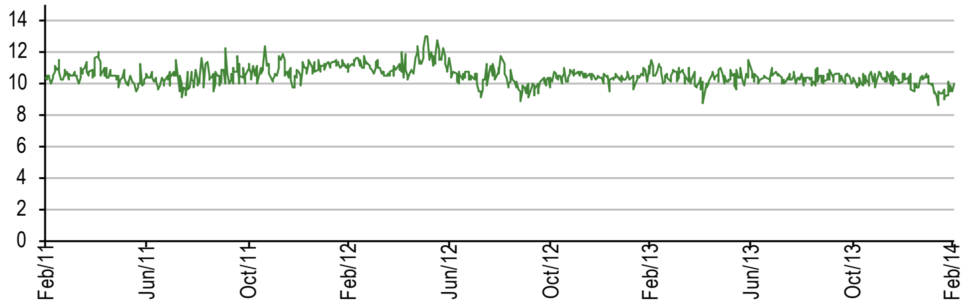


Source: Foreign & Colonial IT, Edison Investment Research. Note: All figures are percentages.

Discount: Less volatile, but still higher than peers

FRCL operates a discount control mechanism whereby the board will buy back shares if the discount to net asset value exceeds 10%. This mechanism was put in place in 2005 and has materially reduced discount volatility. At 7 March the discount stood at 9.5% (NAV at fair value, including income), compared with a one-year average of 10.2% and a three-year average of 10.5%. The peer group average discount at 28 February was 9.0%. In early February this year FRCL's discount touched a three-year low of 8.6%, and the tighter discount over recent years can be observed in the chart of share buybacks in Exhibit 1. No shares have been bought back since October 2013.

Exhibit 7: Discount over three years (NAV with debt at fair value, including income)



Source: Thomson Datastream, Edison Investment Research. Note: Positive values indicate a discount.

Capital structure: End in sight for expensive debt

Foreign & Colonial has one class of share, with 570.4m 25p ordinary shares in issue. It uses gearing to enhance potential investment returns, but like many of its peers it has been hampered by expensive long-term debt – in FRCL's case, a 25-year £110m debenture taken out in 1989 at an interest rate of 11.25%. Half the interest on the debenture, which matures at the end of 2014, is charged to the income account, and the manager says that removing this debt will add 1p per share to FRCL's revenue return next financial year. Lower interest rates in recent years have given FRCL more flexibility over its gearing, and in 2012 the trust took out a seven-year loan for the equivalent of £100m, half in US dollars and half in yen, with a blended interest rate of 3.25%. The effect of weakness in the dollar and yen versus sterling means the value of the liability stood at £87m at the time of writing. Short-term loan facilities of £200m were arranged at the end of 2013, with the option to borrow a further £200m. However, the actual level of gearing is currently low relative to history, having fallen from 14% to 8% during 2013 and touching 5% in early March, as the manager feels the upside of a geared position is limited at current valuations. The manager receives an annual fee of 0.365% of the market capitalisation of FRCL, calculated and paid monthly in arrears. Ongoing charges, which include the expense of managing the outsourced segments of the portfolio, were 0.86% for the year to 31 December 2013 (2012: 0.90%) and are expected to fall towards c 0.8%.

Dividend policy: 44th successive increase on the cards

Since February 2013, FRCL has paid dividends quarterly. The dividend for the year ended 31 December 2013 was 9.0p, 5.9% over the 8.5p paid in 2012, compared with a 2.7% increase in RPI inflation, and the 43rd successive annual increase. Only four investment trusts have a longer record of uninterrupted dividend growth. Revenue earnings for 2013 were 7.7p per share, so the increased dividend was partly covered by a transfer from FRCL's large revenue reserve, which now stands at 12.5p per share. The board has indicated that the dividend for 2014 is likely to be at least 9.3p, a further increase of 3.3%. Going forward, the revenue account is expected to be enhanced by a reduction in the amount that FRCL pays F&C for its savings scheme, where costs have been transferred to individual investors, from the maturity of the expensive debenture at the end of this year, and from dividend growth from underlying holdings.

Peer group comparison

Exhibit 8 provides a peer group comparison for the Association of Investment Companies' global sector, of which there are 35 constituents. The global sector is diverse, with weightings to the UK varying from 11% to 72%. The table includes those trusts with a market capitalisation of more than £300m and UK weightings of between 11% and 46%. FRCL's current UK weighting is close to the mean within this group, but is expected to fall to 10% over the coming weeks as the new global multi-manager portfolio is created, which will give it the lowest UK weighting of any of its peers (albeit still above the FTSE All-World benchmark weight of 8%). FRCL is one of the larger trusts in this peer group and its relatively large allocation to private equity is a distinguishing feature. Within the sector, FRCL's net asset value total return places it 21st over one year, 14th over three years and 16th over five years. In terms of risk-adjusted returns, FRCL has the eighth highest Sharpe ratio over three years, falling to 21st place based on its one-year Sharpe ratio, although it is close to the weighted average in both cases. Its ongoing charge is the fifth lowest in the sector and its yield is above the weighted average.

Exhibit 8: Global investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount/ Premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
Foreign & Colonial IT	**2149.9**	**8.7**	**29.2**	**120.1**	**0.6**	**No**	**-9.8**	**107.0**	**2.4**	**0.9**	**0.7**
Alliance Trust	2564.7	6.0	23.9	93.5	0.7	No	-10.8	113.0	2.1	0.6	0.5
Bankers	655.8	12.7	31.8	114.4	0.5	Yes	-0.7	103.0	2.5	1.2	0.7
British Empire Securities	708.7	0.6	13.4	92.9	0.7	Yes	-12.7	100.0	2.2	0.0	0.3
F&C Global Smaller Companies	429.4	15.2	49.0	213.0	0.8	Yes	1.5	98.0	0.8	1.6	1.1
Monks	901.8	12.8	17.0	108.6	0.6	No	-12.3	105.0	1.0	1.4	0.4
Personal Assets	559.7	-5.5	14.5	66.5	1.0	No	-0.4	92.0	1.7	-0.6	0.6
Scottish Investment Trust	641.9	7.0	26.8	104.0	0.7	No	-10.6	99.0	2.3	0.6	0.6
Scottish Mortgage	2682.3	26.1	45.9	237.3	0.5	No	0.5	112.0	1.3	1.3	0.7
Witan	1264.1	13.1	34.8	139.6	0.7	Yes	-6.0	107.0	2.2	1.2	0.7
Sector weighted average		**8.8**	**26.7**	**110.5**	**0.8**		**-9.0**	**105.6**	**2.1**	**0.9**	**0.6**

Source: Morningstar 28 February 2014. Selection is drawn from trusts with over £300m market cap and between 11% and 46% of assets in the UK. Notes: TR = total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

All directors are non-executive and independent of the investment manager. They are Simon Fraser (chairman, a board member since 2009), Sarah Arkle (2011), Sir Roger Bone (2008), Stephen Burley (2008), Francesca Ecsery (2013), Jeffrey Hewitt (2010), Christopher Keljik (2005) and Nicholas Moakes (2011).

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