Standard Life UK Smaller Companies

Managers bullish on the outlook for the trust

Investment trusts
UK smaller companies

26 April 2021

Price		**653.0p**
Market cap		**£647m**
AUM		**£725m**

NAV*		706.6p
Discount to NAV		7.6%

*Including income. As at 22 April 2021.

Yield		1.2%
Ordinary shares in issue		99.1m
Code/ISIN		SLS/GB0002959582
Primary exchange		LSE
AIC sector		UK Smaller Companies
52-week high/low	653.0p	437.0p
NAV* high/low	706.6p	474.0p

*Including income.

Net gearing*	5.5%

*As at 16 April 2021.

Standard Life UK Smaller Companies (SLS) is managed by Harry Nimmo and Abby Glennie at Aberdeen Standard Investments (ASI). They are positive on the outlook for UK small-cap stocks given the start of a new economic cycle. The managers are encouraged that several investee companies are issuing positive trading statements and reinstating their dividends, and while valuation is a secondary consideration they note that several of the trust's holdings are currently trading on inexpensive valuation multiples. The managers explain that while SLS historically underperforms during periods of what they describe as 'dash for trash' when its quality, growth and momentum-focused stocks are less favoured by investors, these periods tend not to last long, and they are confident in the investment process's ability to deliver above-average returns over the long term.

SLS's NAV versus the reference index – strategy favours growth rather than cyclical market leadership

Source: Refinitiv, Edison Investment Research

The analyst's view

UK equities have been out of favour with global investors for a long time, in part due to Brexit uncertainty, and are very attractively valued versus the world market, so there is potential for a revaluation if sentiment improves. The rollout of the UK's COVID-19 vaccine programme has been considerably quicker than for the majority of other countries, which means the UK economy could rebound significantly in coming months once lockdown measures are eased, while pent-up demand could provide an additional growth kicker. Although SLS's relative performance has suffered during the recent rotation to value/cyclical stocks in the UK stock market, the managers' proprietary investment process has generated superior returns over the long term across multiple economic cycles. Hence now may be an opportune time for investors to consider looking at or revisiting the trust.

Scope for a narrower discount

SLS is currently trading at a 7.6% discount to cum-income NAV, which is wider than the 4.7% to 6.3% range of average discounts over the last one, three, five and 10 years. While the trust's dividend was held steady in FY20, over the last five years, the annual distribution has compounded at a growth rate of 5.8% pa.

Fund objective

Standard Life UK Smaller Companies Trust (SLS) aims to achieve long-term capital growth through investment in a diversified portfolio mainly consisting of UK-quoted smaller companies. Performance is measured against the Numis Smaller Companies plus AIM ex-Investment Companies Index.

Bull points

- Long-term record of strong absolute and relative performance.
- Proprietary investment process driven by the Matrix.
- Shares of smaller companies tend to perform relatively better than those of larger businesses.

Bear points

- SLS's relative performance struggles during the early stage of an economic cycle.
- Modest dividend yield, given focus on capital growth rather than income.
- UK market may remain out of favour with global investors.

Analysts

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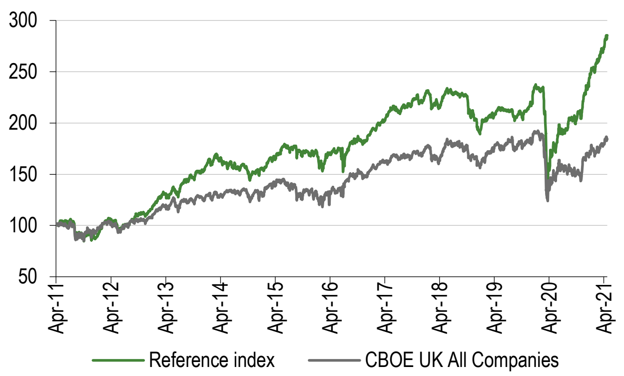
Market outlook: In recovery mode

UK equities, and smaller-cap stocks in particular, have recovered from the coronavirus-led market sell-off in early 2020 (Exhibit 1, LHS). However, there is potential for further upside as business conditions improve – the success of the COVID-19 vaccine rollout along with a nationwide lockdown has led to a reduction in the number of, and the severity of, virus infections, which is allowing the economy to gradually reopen. In addition, for those people that have remained employed during the pandemic, many have been able to boost their savings meaning that pent-up demand is likely to provide an additional kicker to economic growth later this year. This environment could mean that consensus earnings and dividend expectations are too conservative.

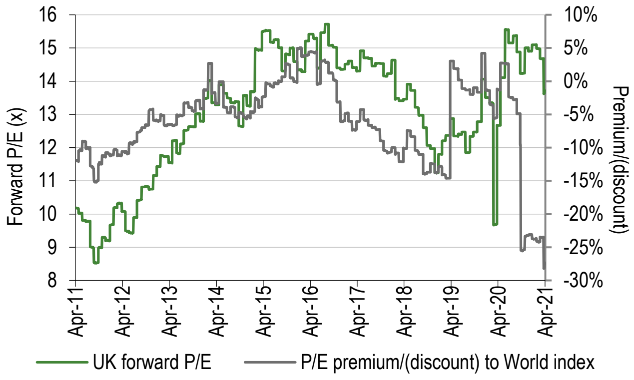
Due to uncertainty following the Brexit vote in June 2016, UK stocks have been out of favour with global investors for a long time. The Datastream UK index, is currently trading on a 13.7x forward P/E multiple, which is a 27.5% discount to the world market, and considerably wider than the 6.0% average discount over the last decade. This favourable valuation backdrop and the outlook for a robust improvement in the domestic economy suggest that equity investors could benefit from an allocation to the UK, while it should be noted that smaller companies have outperformed larger businesses over the long term as shown in the 10-year chart below.

Exhibit 1: Market performance and valuation

Performance of UK indices (last 10 years)



Valuation of UK equities (Datastream indices, last 10 years)



Source: Refinitiv, Edison Investment Research. Note: SLS's reference index is the Numis Smaller Companies plus AIM ex-Investment Companies Index (Numis Smaller Companies ex-Investment Companies Index to 31 December 2017). Data as at 23 April 2021.

The fund managers: Harry Nimmo and Abby Glennie

The managers' view: Focus on quality, growth and momentum

Glennie explains that SLS's Numis plus AIM Ex-Investment Trusts reference index broadly covers the bottom 10% of the UK stock market with company market caps below £1.5bn. She notes that it is important to include AIM-listed stocks in the trust's investible universe as the businesses are very diverse and a substantial number are increasing their profitability and paying dividends, while having good corporate governance standards. Glennie stresses that SLS's investment process for more than 20 years has been focused on quality, growth and momentum, and this continued in 2020 following the outbreak of the coronavirus pandemic. The managers believe that this strategy is 'really how you drive outperformance in smaller companies'. Emphasising the quality aspect of the process, which contributes to lowering the fund's risk profile, Glennie and Nimmo seek companies with strong balance sheets, that enable them to invest and grow, while having experienced and highly regarded management teams. They stress the importance of company meetings forming part of their fundamental research and favour firms that are run by their founders.

The managers look for businesses where they believe there is potential upside to consensus earnings expectations, which is the momentum element of SLS's investment process.

Commenting on 2020, Nimmo says 'it was a difficult year for us in many ways as there were some dramatic changes in markets. First off, we did extremely well – our process of focusing on quality growth and momentum provides real resilience in difficult market conditions'. This was evident in the March 2020 market sell-off as 'this was one of the best months of relative performance as our stable, growth, quality stocks, held up better than the market'. The manager explains that SLS performed well as small-cap stocks started to recover, led by quality growth companies, up until the announcement of positive COVID-19 vaccine trial data in early November last year. 'Now the discovery of the vaccine changed all that, and what you've seen since then has been a reversion – a massive sector rotation to what I call cyclical stocks, that can benefit from things getting better'. Nimmo says that we have seen this before, likening the current environment to the aftermath of the banking crisis in mid-2009, describing it as a 'dash for trash'. He continues 'we have just stuck religiously to our investment process of quality, growth and momentum, led by our Matrix system that helps us to find a shortlist of stocks; we don't try and turn the portfolio around in response to top-down changes'. The managers accept that there will be periods when SLS underperforms the reference index but say that market recovery rally phases are typically short and during these periods the trust's absolute performance remains strong. They have a positive outlook for UK smaller companies due to an improving economy, the passing of Brexit and the expectation that ultra-low interest rates are likely to continue. While valuation is a secondary consideration, Nimmo notes that following the market rotation several of SLS's portfolio companies are trading on relatively inexpensive multiples, while recent trading statements have been generally positive, with upward estimate revisions, dividend reinstatements and furlough grants being paid back, which he finds very encouraging. However, he is mindful that the economic recovery will have 'bumps in the road' and unemployment is likely to rise significantly as the furlough scheme ends. Nevertheless, the manager believes that we are past the worst effects of the pandemic, in a new economic cycle and 'that the next couple of years will be a good time for smaller companies relative to large caps' given that in the early/recovery stage of an economic cycle, small-cap stocks tend to outperform.

Current portfolio positioning

At end-March 2021, SLS's top 10 positions made up 31.4% of the fund, which was a lower concentration compared with 33.9% a year earlier; eight positions were common to both periods. There were higher weightings to AIM stocks (+7.2pp) and other (+2.5pp) with lower weightings to mid- and large-cap stocks (-3.6pp and -3.5pp respectively) and Numis Smaller Companies plus AIM (-2.8pp).

Exhibit 2: Top 10 holdings (at 31 March 2021)

Company	Sector	Portfolio weight %	
		31 March 2021	31 March 2020*
Kainos Group	Technology	4.6	3.7
Future	Consumer services	4.0	3.3
Gamma Communications	Telecommunications	3.9	3.8
XP Power	Industrials	3.3	N/A
Hilton Food Group	Consumer goods	2.7	3.9
Team17 Group	Consumer services	2.7	2.7
Cranswick	Consumer goods	2.7	3.9
GB Group	Technology	2.6	N/A
Marshalls	Industrials	2.5	3.5
Games Workshop	Consumer goods	2.4	2.8
Top 10 (% of portfolio)		**31.4**	**33.9**

Source: SLS, Edison Investment Research. Note *N/A where not in end-March 2020 top 10.

Exhibit 3: Portfolio market cap exposure (ex-cash and gearing, % unless stated)

	Portfolio end-Mar 2021	Portfolio end-Mar 2020	Change (pp)
Large cap	1.8	5.3	(3.5)
Mid-cap	26.9	30.5	(3.6)
Numis Smaller Companies plus AIM	56.5	59.3	(2.8)
AIM	12.2	5.0	7.2
Other	2.5	0.0	2.5
	100.0	**100.0**	

Source: SLS, Edison Investment Research. Note: Numbers subject to rounding.

Considering SLS's sector exposure, over the 12 months to the end of March there was a higher weighting to financials (+3.0pp) with a lower weighting to industrials (-4.5pp). Nimmo emphasises that SLS's sector allocation is a product of the managers' bottom-up stock selection. Particular areas of focus within the portfolio are financial services (holdings include AJ Bell, Impax Asset Management, Liontrust Asset Management and Mattioli Woods); software such as Kainos, which provides digitalisation services; and leisure goods companies providing in-demand products such as computer and hobby games, and musical instruments. These are all examples of growth businesses; 'we tend to downplay the more cyclical sectors', Nimmo adds.

Exhibit 4: Portfolio sector exposure (ex-cash and gearing, % unless stated)

	Portfolio end-Mar 2021	Portfolio end-Mar 2020	Change (pp)
Industrials	25.0	29.5	(4.5)
Financials	19.1	16.1	3.0
Consumer services	17.8	18.2	(0.4)
Consumer goods	17.3	15.6	1.6
Technology	13.1	11.8	1.3
Telecoms	5.5	6.3	(0.8)
Healthcare	1.7	2.5	(0.7)
Basic materials	0.5	0.0	0.5
	100.0	**100.0**	

Source: SLS, Edison Investment Research. Note: Numbers subject to rounding.

Looking at SLS's portfolio activity in early 2021, trading in January was higher than normal because some of the best-performing positions were reduced as they were removed from the reference index following an annual rebalancing, such as GB Group, Kainos, Diploma, Future and Games Workshop. Proceeds were reinvested into:

- **Bytes Technology Group** – an IT hardware and software provider to both the private and public sectors. The position was initiated in the December 2020 initial public offering. Bytes is a value-added technology reseller with a strong record of sales and profit growth and cash generation. It is well diversified, with c 5k customers and the top 10 representing only 8% of gross profit. The company operates in a very fragmented market and despite having a top 10 position, only has a 3% market share providing strong future growth opportunities.
- **Impax Asset Management** – this specialist asset manager has a strong performance track record in environmental, social and governance (ESG) and sustainability investing. Nimmo and Glennie say the company is well positioned to continue its recent success given its reputation. They believe ESG and sustainability is an unstoppable force, giving them confidence in the momentum of the Impax story, while its management has 'built a platform of impressive quality in terms of process and scalability'.
- **Hilton Food Group** was added to on share price weakness as the company posted good results and the managers believe that the investment case still holds true.

In February, the managers initiated three new holdings. **Treatt** is a supplier of natural and authentic flavours in a growing global market (Edison client; our latest note was published in April). Venture capital specialist **Draper Esprit** has a dominant market position focused on early-stage investment in technology-driven businesses (Edison client; see our research including a recent initiation note here). Luxury retailer **Watches of Switzerland** is a global operator with strong and enduring relationships with watch manufacturers. SLS's position in **Aveva** was sold as its share price has appreciated significantly and the firm is now a large-cap company.

In March, SLS participated in the initial public offering of review platform **Trustpilot**, a company that is expanding its international operations. This is a founder-led firm, which the managers believe is a high-quality, growth business with a strong brand name. There is a new position in **Mortgage Advice Bureau**, which operates a fast-growing network of mortgage intermediaries. The company has a strong competitive position and is rolling out new initiatives that should ensure continued sales growth and higher margins. These holdings were funded by trimming SLS's large-cap exposure, that had resulted from positive share price performance.

Performance: Recent relative hit from cyclical recovery

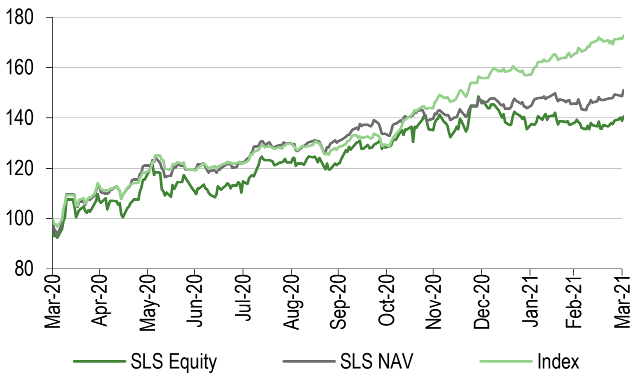
Exhibit 5: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	Index* (%)	Numis Smaller Cos plus AIM ex-ICs (%)	CBOE UK Smaller Cos (%)	CBOE UK All Companies (%)
31/03/17	18.5	20.8	18.8	21.4	18.9	22.6
31/03/18	28.3	18.3	6.1	7.0	7.0	1.2
31/03/19	(7.8)	0.5	(4.1)	(4.1)	(3.1)	6.2
31/03/20	(1.1)	(9.2)	(23.2)	(23.2)	(25.3)	(19.1)
31/03/21	38.9	48.6	71.3	71.3	75.0	26.6

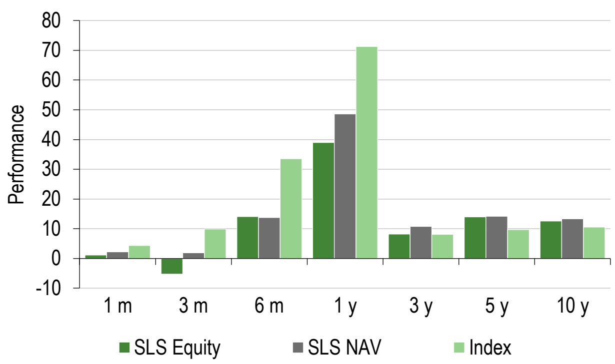
Source: Refinitiv. Note: All % on a total return basis in pounds sterling. *Index is Numis Smaller Cos plus AIM ex-Investment Companies (Numis Smaller Cos ex-Investment Companies to 31 December 2017).

Exhibit 6: Investment trust performance to 31 March 2021

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



Price, NAV and index total return performance (%)



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

In H121 (ending 31 December 2020), SLS's NAV total return of +22.1% lagged the reference index's +30.8% total return (share price total return +32.4% leading to a narrower discount). The managers have consistently explained that while the trust has a long-term record of outperformance versus the reference index, the process typically struggles to keep up during a market recovery phase as investors focus on companies that have been particularly weak during a crisis; these are businesses that generally do not meet SLS's investment criteria. The trust's recent period of underperformance has occurred following news about positive COVID-19 vaccine trials in early-November 2020. Nimmo and Glennie say that recovery rallies are rare and occur during rising markets of extreme small-cap popularity, such as in spring 2009 following the trough of the global financial crisis.

During H121, SLS's largest positive contributors to performance were Kainos (announced that results would be materially ahead of expectations and the dividend was reinstated); Jet2 (seen as a likely winner in the holiday market when travel resumes, although the company has suspended flights and holidays until at least 23 June 2021 due to uncertainty over the UK government's travel proposals); and Ergomed (a contract research organisation to the pharmaceutical industry that has benefited from COVID-19 business). The largest detractors to performance were Hilton Food Group (investors are concerned its business will suffer once restaurants are allowed to reopen); RWS (the market considers that its acquisition of SDL was low grade); and Boohoo (negative headlines about contractors running sweatshops and avoiding taxes – the position was sold).

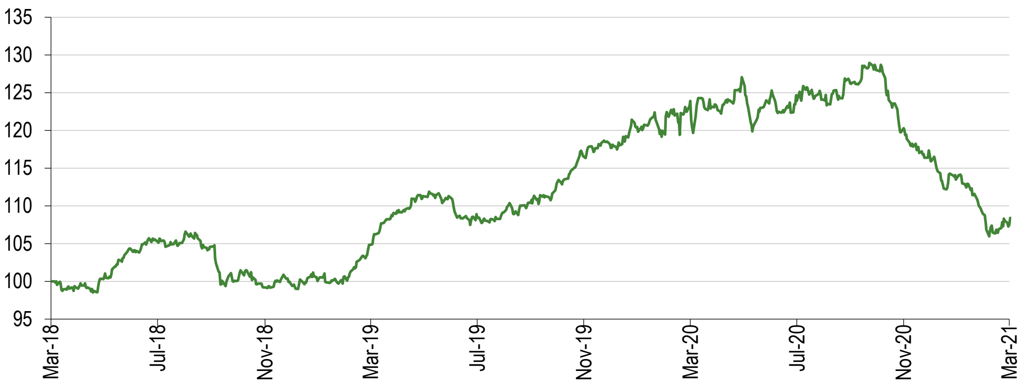
Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to index*	(3.1)	(13.8)	(14.6)	(18.9)	0.4	21.2	20.7
NAV relative to index*	(2.1)	(7.3)	(14.8)	(13.2)	7.5	21.9	28.8
Price relative to Numis Smaller Cos plus AIM ex-ICs	(3.1)	(13.8)	(14.6)	(18.9)	0.4	17.5	42.0
NAV relative to Numis Smaller Cos plus AIM ex-ICs	(2.1)	(7.3)	(14.8)	(13.2)	7.5	18.2	51.5
Price relative to CBOE UK Smaller Companies	(4.3)	(20.2)	(25.2)	(20.6)	(0.0)	19.4	64.4
NAV relative to CBOE UK Smaller Companies	(3.3)	(14.2)	(25.4)	(15.1)	7.1	20.1	75.5
Price relative to CBOE UK All Companies	(3.2)	(10.3)	(4.3)	9.8	16.5	42.7	83.4
NAV relative to CBOE UK All Companies	(2.2)	(3.5)	(4.6)	17.4	24.7	43.6	95.8

Source: Refinitiv, Edison Investment Research. Note: Data to end-March 2021. Geometric calculation. *Index is Numis Smaller Cos plus AIM ex-Investment Companies (Numis Smaller Cos ex-Investment Companies to 31 December 2017).

Looking at SLS's relative performance in Exhibit 7 and as explained above, the trust has lagged the reference index in recent months as investors have focused on a cyclical recovery. This has negatively affected SLS's one-year numbers although the trust remains ahead of the index over the last three, five and 10 years. It has outperformed the broad UK market over the last one, three, five and 10 years.

Exhibit 8: NAV total return performance relative to index over three years



Source: Refinitiv, Edison Investment Research

Peer group comparison

Exhibit 9: Selected peer group at 23 April 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Standard Life UK Smaller Cos	647.3	51.8	42.8	116.4	266.7	(7.7)	0.9	No	106	1.2
Aberforth Smaller Companies	1,357.5	78.1	12.3	57.4	169.7	(5.4)	0.8	No	106	2.2
Aberforth Split Level Income	153.3	101.4	4.9			(12.3)	1.3	No	131	5.2
BlackRock Smaller Companies	915.1	63.0	38.0	117.1	281.3	(6.1)	0.7	No	108	1.7
BlackRock Throgmorton Trust	803.6	76.8	59.2	148.3	334.9	0.5	0.6	Yes	125	1.2
Henderson Smaller Companies	926.3	69.6	38.1	106.3	305.5	(3.6)	0.4	Yes	110	1.9
Invesco Perpetual UK Smaller	197.9	53.4	35.3	94.2	257.5	(10.3)	1.0	No	100	3.3
JPMorgan Smaller Companies	308.3	82.4	61.0	132.5	284.2	(4.0)	1.0	No	109	1.4
Miton UK Microcap	109.6	107.6	51.3	87.9		(2.8)	1.6	No	100	0.1
Montanaro UK Smaller Companies	260.3	40.6	31.5	71.1	142.4	(3.1)	0.8	No	105	3.5
Odyssean Investment Trust	125.8	54.7				(2.8)	1.5	Yes	100	0.0
Oryx International Growth	209.0	90.7	90.2	139.7	493.6	(11.2)	1.6	No	100	0.0
Rights & Issues Investment Trust	187.8	56.3	18.9	85.1	322.7	(5.7)	0.5	No	100	1.3
River and Mercantile UK Micro Cap	132.6	80.9	52.7	156.5		(5.8)	1.3	Yes	100	0.0
Strategic Equity Capital	181.3	49.3	29.1	60.6	249.0	(13.5)	1.1	Yes	100	0.4
Simple average	**434.4**	**70.4**	**40.4**	**105.6**	**282.5**	**(6.3)**	**1.0**		**107**	**1.6**
Rank (out of 15 funds)	**5**	**13**	**6**	**6**	**7**	**11**	**9**		**7**	**9**

Source: Morningstar, Edison Investment Research. Note: *Performance as at 22 April 2021 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

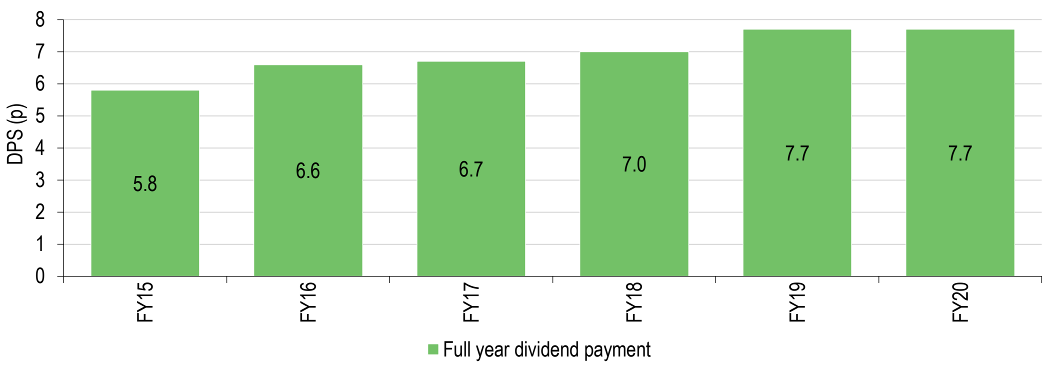
SLS is a member of the AIC UK Smaller Companies sector. In Exhibit 9 we show the largest funds with market caps greater than £100m. The 15 companies employ a variety of investment approaches – SLS's is unique with its use of the Matrix and the focus on quality, growth and momentum. Its relative performance has taken a knock in recent months following news about positive COVID-19 vaccine trials last November as investors have gravitated towards businesses that were negatively affected during the pandemic – these are companies that are unlikely to fulfil SLS's investment criteria. The trust's NAV total returns are above average over the last three and five years, while lagging over the last one and 10 years. It should be noted that relative rankings can change significantly depending on market conditions; in our last note published on 23 November 2020, SLS's NAV total returns were significantly above the averages over one, three, five and 10 years. The trust's discount is wider than the mean, its ongoing charge is below average and its gearing is below the mean. Unsurprisingly, given SLS's focus on capital growth rather than income it has a below-average dividend yield.

Dividends

SLS pays semi-annual dividends in April and late October or early November. The board aims to distribute around a third of the total annual distribution as the interim dividend with around two-thirds as the final dividend. Over the last five financial years, the trust's annual dividend has compounded at a growth rate of 5.8% pa. Based on its current share price, SLS offers a 1.2% dividend yield.

In H121, SLS's revenue return of 3.41p per share was 26.2% lower than 4.62p per share in H120 due to the negative effects of COVID-19 on investee company profitability. The board held the interim dividend steady at 2.70p per share. It will continue to monitor the pace of the recovery of the trust's revenue account and take this into consideration when determining the level of the FY21 final dividend. At the end of H121, SLS had £7.2m in revenue reserves, which is c 0.9x the last financial year's total distribution.

Exhibit 10: Dividend history since FY15



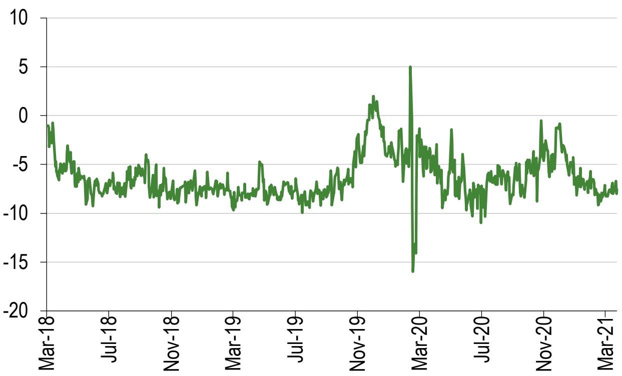
Source: Bloomberg, Edison Investment Research

Discount: Wider than historical averages

SLS's current 7.6% discount to cum-income NAV compares with the 0.5% to 11.0% range of discounts over the last 12 months. It is wider than the 6.2%, 6.3%, 6.0% and 4.7% average discounts over the last one, three, five and 10 years respectively.

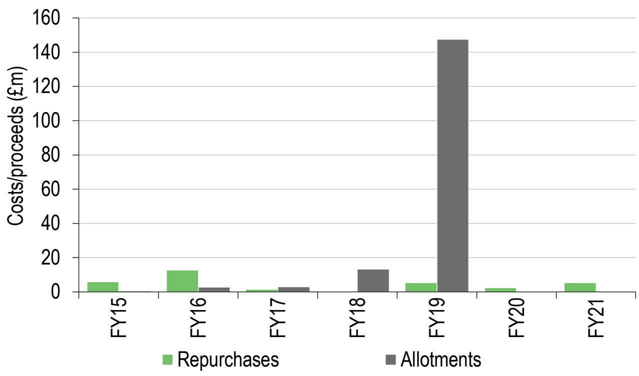
The board continues to operate a discount control mechanism, targeting a maximum 8% share price discount to cum-income NAV in normal market conditions. Renewed annually, it has the authority to repurchase up to 14.99% of SLS's share capital. During H121, the board did not believe the trust's discount fairly reflected its long-term performance compared with its peers and shares were repurchased at a lower discount than historically. Over the period, c 697.5k shares were bought back (c 0.7% of the share base) at a cost of c £3.9m. The weighted average price was 554.04p per share, which equated to an average discount of 6.1%. SLS also has a discretionary tender mechanism in place, although none have been undertaken since June 2015, as the board considers share buybacks are the primary method to manage the trust's discount.

Exhibit 11: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 12: Buybacks and issuance



Source: Morningstar, Edison Investment Research

Fund profile: High-conviction UK small-cap equities

Launched in August 1993, SLS is quoted on the Main Market of the London Stock Exchange. Since 1 September 2003, the trust has been managed by Harry Nimmo at Aberdeen Standard Investments (ASI). He aims to generate long-term capital growth from a diversified portfolio of UK smaller companies. On 17 November 2020, it was announced that Nimmo's colleague Abby Glennie was appointed as SLS's co-manager with immediate effect.

The fund is comprised of c 50 of the managers' highest-conviction investment ideas. SLS's performance is measured against the Numis Smaller Companies plus AIM ex-Investment Companies Index (the Numis Smaller Companies ex-Investment Companies Index before 1 January 2018).

To mitigate risk, at the time of purchase SLS may hold no more than 5% of total assets in a single position, no more than 5% in companies with a market cap below £50m, and the managers tend not to invest in 'blue sky' (not yet profitable) companies, although up to 5% is permitted. Up to 50% of the portfolio may be invested in companies that are constituents of the broad AIM index. The managers may vary the trust's level of gearing between a net cash position of 5% and net gearing of 25% of NAV (at the time of drawdown). At 16 April 2021, net gearing was 5.5%. To provide some context, over the last decade, the financial year-end position has ranged from 4.6% net cash to 8.8% net gearing.

SLS started life as Edinburgh Smaller Companies in 1993, with Standard Life Investments (now Aberdeen Standard Investments) assuming management in 2003. The trust merged with Gartmore Smaller Companies Trust in 2009 and with Dunedin Smaller Companies Investment Trust in October 2018.

Investment process: Using the proprietary Matrix

The managers follow seven principles for successful small-cap investing:

- **Focus on quality to enhance return and reduce risk** – factors include the strength of a company's relationship with its customers, the existence of long-term contracts and an element of pricing power. Firms with high or unsustainable levels of debt are generally avoided.
- **Look for sustainable growth** – portfolio companies often provide niche products or services.
- **Momentum** – run your winners and cut your losers.
- **Concentrate your efforts** – use of the proprietary screening tool known as the Matrix helps identify suitable candidates for inclusion in the portfolio and reduces the risk that time is spent on stocks that do not meet the required criteria.
- **Invest for the long term** – identify the great companies of tomorrow and hold them for the long term, which helps to maximise returns and reduce trading costs.
- **Management quality** – high ownership and involvement by founders and CEOs with long tenures are viewed positively.
- **Valuation aware** – this is a secondary consideration.

Nimmo and Glennie aim to generate long-term capital growth from a diversified portfolio of smaller-cap UK equities. They use the Matrix, which is a screening tool based on a series of 13 quality, growth and momentum factors including forecast earnings and dividend growth, earnings revisions, valuation, share price momentum, balance sheet strength and the level of directors' dealing to whittle down the investible universe of around 500 stocks to around 100 that are deemed worthy of further consideration. The most important factor, at 35% of the Matrix weighting, is earnings revision momentum because back-testing shows this is the most predictive measure of future share price performance. Stocks are assigned a Matrix score between +40 and -40, with those between +10 and +40 deemed potential buy candidates and those between -10 and -40 potential sells. Companies considered for inclusion in SLS's portfolio are subject to further in-depth analysis and meeting company managements is an integral part of the research process. In keeping with other ASI investment teams, the managers have a strong focus on a company's ESG credentials.

Given the managers' long-term perspective, the average holding period for SLS's investments is around six years, although a number of names have been in the fund for more than a decade. Positions may be trimmed or sold if there is a deterioration in the Matrix score, the original investment thesis no longer holds true, they have grown to more than 5% of the portfolio, or there is a higher-conviction name identified. The disciplined investment process has been employed since ASI took over management of the fund in 2003 and has delivered creditable performance through economic and market cycles.

SLS's approach to ESG

ASI has more than 1,000 investment professionals, including c 50 ESG specialists around the world. It encourages companies in which it invests to adhere to best practice in the areas of ESG stewardship. ASI believes this can be achieved by entering a dialogue with company management to encourage them, where necessary, to improve their corporate standards, transparency and accountability. By making ESG central to its investment capabilities, ASI seeks to deliver robust outcomes as well as actively contributing to a fairer, more sustainable world. It considers ESG factors are financially material and affect corporate performance; companies that have higher standards tend to outperform those that do not.

Glennie explains that for SLS, 'ESG is really embedded at the core of our research process; it is a key aspect of the focus on quality and the lower risk approach that we take'. Last year an ESG specialist joined the small-cap desk, which has 'really helped us in terms of that depth and breadth of ESG expertise that we have'. The manager says 'we also work closely with ASI's large and very knowledgeable central ESG investment team'. She explains that for smaller companies, 'we very much look at both the risks and the opportunities that ESG aspects present'. Nimmo and Glennie regularly engage with company management teams, including on ESG aspects. Glennie says it is important to highlight a couple of nuances for smaller companies. While external ESG data are used, for these firms 'it is not an ideal process, because many of the companies are not covered, or many of them are actually covered badly. So, what we find is, it is a real opportunity for us to add value by doing that fundamental research ourselves'. Also, smaller companies often have limited internal resources to focus on ESG, so many are 'actually quite keen to engage with us and we are able to help advise them and encourage them towards those ESG aspects required by shareholders' Glennie adds.

Gearing

SLS has a £45m unsecured loan agreement with Royal Bank of Scotland International, maturing on 31 October 2022, made up of a five-year, fixed-rate term loan of £25m at 2.349% and a five-year £20m revolving credit facility. At 16 April 2021, the trust had net gearing of 5.5%.

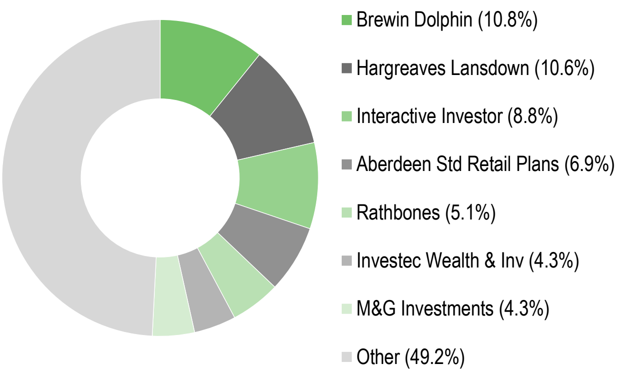
Fees and charges

ASI is paid a tiered management fee of 0.85% per year, up to £250m of SLS's NAV, 0.65% per year between £250m and £550m and 0.55% per year above £550m. In H121, SLS's ongoing charges ratio (OCR) was 0.87%, which was 1bp lower than 0.88% in FY20. The OCR has declined for the last five financial years (and is now at the lowest level in the company's lifetime), helped by a management fee reduction from 1 July 2018 and economies of scale following the Dunedin Smaller Companies Investment Trust merger in October 2018. In addition to the investment management fee, ASI also receives a secretarial and administration fee, which was previously capped at £150k pa. With effect from 1 January 2021, this has been reduced to a fixed amount of £75k pa, which should have a modest positive impact on SLS's OCR.

Capital structure

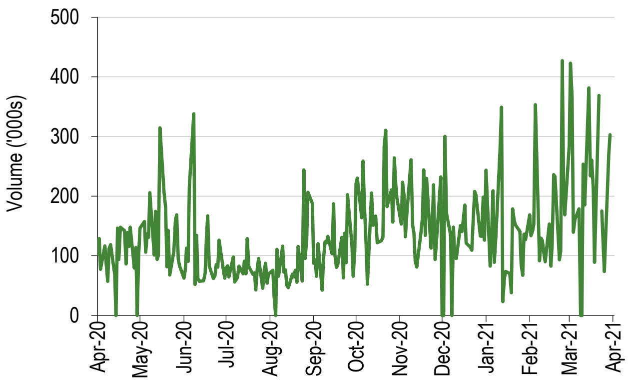
SLS is a conventional investment trust with one class of share; there are currently 99.1m ordinary shares in issue, with 5.0m held in treasury. Its average daily trading volume is c 140k shares.

Exhibit 13: Major shareholders



Source: Bloomberg, at 31 March 2021

Exhibit 14: Average daily volume



Source: Refinitiv. Note: 12 months to 23 April 2021.

The board

Exhibit 15: SLS's board of directors

Board member	Date of appointment	Remuneration in FY20	Shareholdings at end-FY20
Liz Airey (chairman since 1 April 2020)	21 August 2019	£23,276	40,000
Caroline Ramsay	22 August 2016	£27,800	4,545
Tim Scholefield	20 February 2017	£25,200	5,964
Ashton Bradbury	2 July 2018	£23,700	10,000
Alexa Henderson	8 October 2018	£23,700	2,942

Source: SLS. Note: *If Airey had been chairman for the whole of FY20, her remuneration would have been £35,000.