Lowland Investment Company

Initiation of coverage

Seeking growth and growing income

Investment trusts

15 June 2016

Lowland Investment Company (LWI) invests across the UK equity market (with a small proportion in overseas stocks) to achieve above-average total returns. While it is a member of the UK Equity Income sector, its managers have a greater focus on capital growth, which drives dividend growth, in order to secure a rising income for the trust over time. In the past five years it has produced compound annual dividend growth of 7.9% and currently yields 3.7%. Long-term performance has been comfortably ahead of the FTSE All-Share Index benchmark, driven by the managers' focus on underappreciated recovery situations and a significant weighting towards mid-cap and smaller companies (two-thirds of the portfolio). Lead manager James Henderson has been in position since 1990 and the trust has been managed by Henderson Global Investors since its launch in 1963.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 350 HY (%)	FTSE 250 (%)
31/05/12	2.6	(2.9)	(8.0)	(3.1)	(9.7)
31/05/13	45.2	40.2	30.1	29.0	39.8
31/05/14	19.5	19.6	8.9	8.5	14.4
31/05/15	(0.1)	8.1	7.5	2.6	16.5
31/05/16	(6.0)	(8.1)	(6.3)	(8.5)	(2.8)

Source: Thomson Datastream. Note: Total returns in sterling.

Investment strategy: Diversified, multi-cap approach

LWI is managed by James Henderson (as lead manager since 1990) and deputy Laura Foll. They seek undervalued companies with strong management and the potential for above-average earnings growth. The multi-cap portfolio is split broadly equally between large, mid and small caps; the managers work closely with colleagues in the UK equity team at Henderson to source ideas from across the market. Company meetings and site visits are a key part of the process. The portfolio is diversified and positions are built and divested slowly to avoid binary risks.

Market outlook: Pockets of value amid volatility

Equity markets have experienced several months of volatility, driven by a combination of economic, geopolitical and monetary policy worries. This may persist in the short term given the summer months have historically seen lower trading volumes. There are pockets of value to be found across the UK stock market, however (particularly among small and mid-caps), and taking a diversified approach to limit stock-specific risk could help investors to ride out any ups and downs in the near term.

Valuation: Scope for discount to narrow

At 14 June LWI's shares traded at a 9.7% discount to cum-income NAV. This is wider than the averages over one, three and five years (2.3%, 0.5% and 1.8%), but lower than the five-year widest point of 10.9% reached in early March. Sentiment towards UK equity investment trusts – particularly those with a more domestic focus – has been affected by nerves ahead of the EU referendum; a vote to remain could see discounts narrow, as well as providing a potential boost to underlying holdings. LWI also has a 39-year record of maintaining or growing its dividend year-on-year.

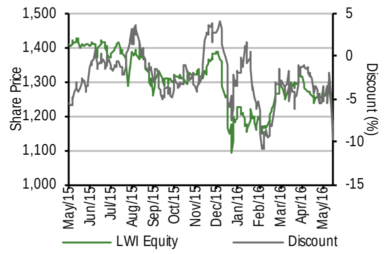
Price	**1,168.0p**
Market cap	**£315.6m**
AUM	**£397.6m**

NAV*	1,270.6p
Discount to NAV	8.1%
NAV**	1,292.9p
Discount to NAV	9.7%

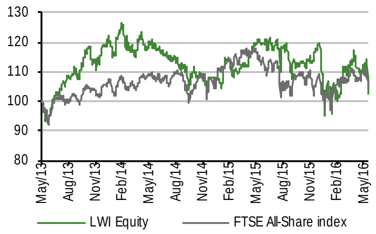
*Excluding income. **Including income. Data at 14 June 2016.

Yield	3.7%
Ordinary shares in issue	27.0m
Code	LWI
Primary exchange	LSE
AIC sector	UK Equity Income

Share price/discount performance



Three-year cumulative perf. graph



52-week high/low	1,423.0p	1,095.0p
NAV* high/low	1,469.5p	1,137.4p

*Including income.

Gearing

Gross*	17.0%
Net*	17.0%

*As at 30 April 2016.

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Edison profile page

Lowland Investment Company is a research client of Edison Investment Research Limited

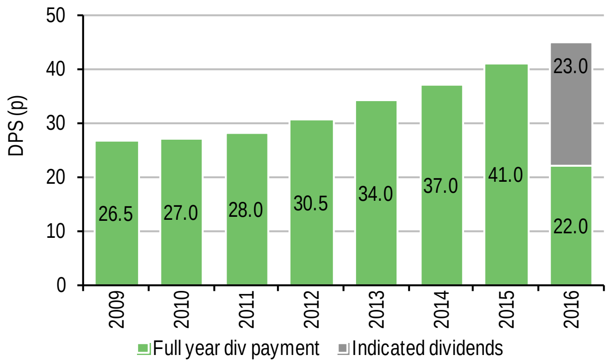
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
Lowland Investment Company aims to give shareholders a higher-than-average return with growth of both capital and income over the medium to long term through a broad spread of predominantly UK companies. It measures its performance against the total return on the FTSE All-Share Index.	■ 24 May 2016: Half-year results for the period ended 31 March. NAV TR +3.8% versus +3.5% for the FTSE All-Share benchmark. Share price TR +1.9%. Second interim dividend of 11.0p declared, payable at the end of July. ■ 23 March 2016: First interim dividend of 11.0p declared, payable at end-April.

Forthcoming		Capital structure		Fund details	
AGM	January 2017	Ongoing charges	0.6% (at 31 March)	Group	Henderson Global Investors
Annual results	December 2016	Gearing	17.0% net	Managers	James Henderson, Laura Foll
Year end	30 September	Annual mgmt fee	0.5% on net assets	Address	201 Bishopsgate, London EC2M 3AE
Dividend paid	Quarterly	Performance fee	Yes, see page 10		
Launch date	October 1963	Trust life	Indefinite	Phone	+44 (0) 20 7818 1818
Continuation vote	None	Loan facilities	Up to £85m, see page 10	Website	www.lowlandinvestment.com

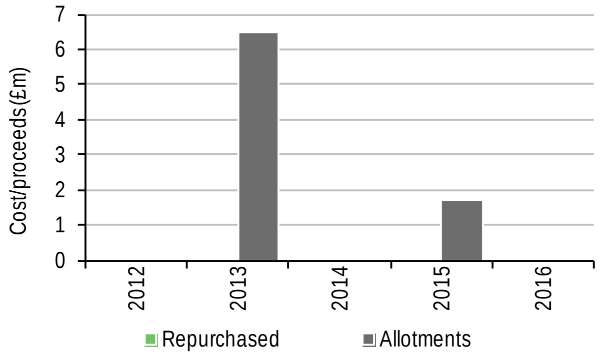
Dividend policy and history

Dividends are paid quarterly, in April, July, October and January. LWI aims to achieve a growing income for investors and has maintained or increased its dividend each year for the last 39 years.

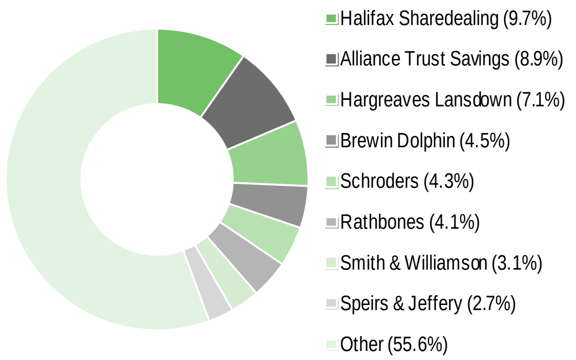


Share buyback policy and history

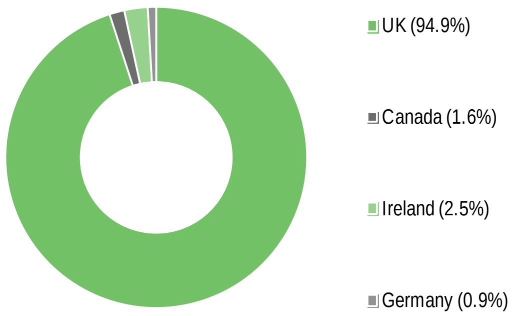
LWI's board has the authority to buy back up to 14.99% of shares but in practice this is not used. It may also issue new shares at a premium in response to investor demand.



Shareholder base (as at 4 March 2016)



Portfolio exposure by geography (as at 30 April 2016)



Top 10 holdings (as at 30 April 2016)

		Portfolio weight %	
Company	Sector	30 April 2016	30 April 2015*
Royal Dutch Shell	Oil & gas producers	4.4	3
Hiscox	Non-life insurance	2.7	2.3
Senior	Aerospace & defence	2.6	3.6
Phoenix Group	Life insurance	2.4	2.2
Scapa Group	Chemicals	2.3	N/A
HSBC	Banks	2.0	2
BP	Oil & gas producers	2.0	2.4
Irish Continental Group	Travel & leisure	1.9	N/A
Hill & Smith	Industrial engineering	1.8	2.1
Glencore	Mining	1.7	N/A
Top 10 (% of portfolio)		23.8	23.8

Source: Lowland Investment Company, Edison Investment Research, Morningstar, Bloomberg, Thomson. Note: *N/A where not in April 2015 top 10.

Market outlook: Cast net wider to limit volatility?

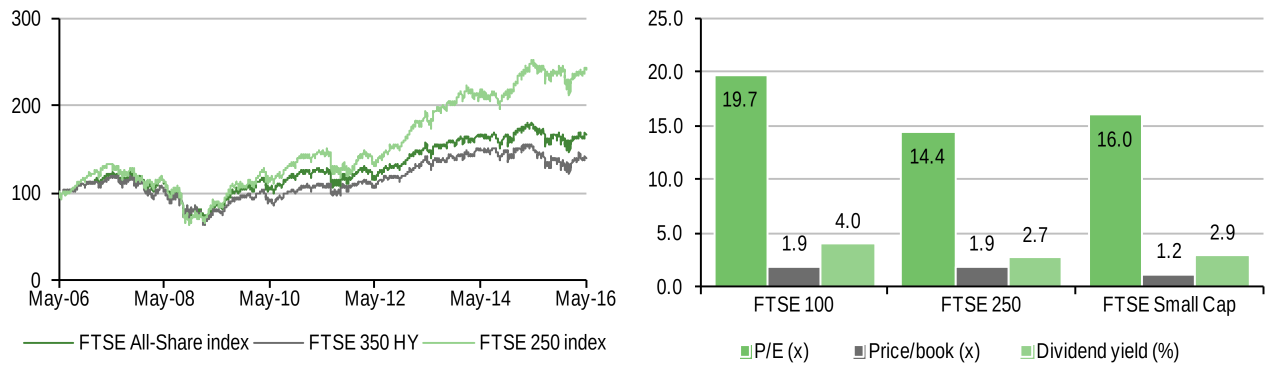
Global equity markets have been volatile in recent months, with investor nerves sparked by a combination of slower global economic growth, monetary policy divergence and, in the UK, uncertainty over the outcome of the forthcoming EU referendum. As we approach the summer months, when trading volumes are historically lower, this volatility may persist, although a vote for Britain to remain in the EU could provide a boost to the domestic market.

As shown in Exhibit 2 below (left-hand chart), mid-cap stocks in the UK have enjoyed strong performance since the global financial crisis. In contrast, higher-yielding stocks in the large and mid-cap segment have underperformed the broad FTSE All-Share. This may suggest a focus on growth potential, rather than the highest dividends, has led to more attractive total returns over time.

Looking at valuations across the large-, mid- and small-cap constituents of the FTSE All-Share (right-hand chart), the FTSE 100 currently looks expensive compared with small and mid caps on a trailing P/E basis, while price/book values are lowest on average among the FTSE small-cap stocks, suggesting greater value may be available in this area. The FTSE 100 dividend yield of 4.0% is a figure that should be treated with caution; dividend cover on the FTSE 100 is as low as it was in the bear markets of 2002 and 2009, pointing to the real possibility of dividend cuts from some of the UK's largest companies. With this in mind, an investment strategy that blends stocks of different sizes, while retaining a focus on valuation and limiting stock-specific risk through diversification, could potentially take advantage of longer-term growth opportunities across the market even in an environment of heightened risk-aversion.

Exhibit 2: Market valuation and performance

Index performance over 10 years to end-May 2016 | Valuation metrics at 30 April 2016



Source: Thomson Datastream, Edison Investment Research, FTSE Russell

Fund profile: Growth and value with growing income

The Lowland Investment Company (LWI) began life in October 1963 with the aim of producing an above-average and rising income for shareholders from a diversified and actively managed portfolio of equities – an objective that remains largely unchanged (although it is now more focused on total return than income). It has been managed by Henderson Global Investors since launch, and has enjoyed considerable continuity of management, with just four lead portfolio managers across its 53-year history. Current Lead Manager James Henderson has worked on the trust since the 1980s; he is now assisted by Deputy Manager Laura Foll.

The trust uses the FTSE All-Share Index as a benchmark and takes a multi-cap approach to investing, with roughly one-third each in large, mid and small caps. This means its portfolio and performance are likely to diverge significantly from the index, which at 30 April was made up of 79.9% large-cap (FTSE 100), 16.7% mid-cap (FTSE 250) and 3.5% small-cap (FTSE Small Cap) stocks. LWI has a focus on growing income and, while its dividend yield of 3.4% is a little below the All-Share yield of 3.7%, it has produced compound annual dividend growth of 7.9% over the past five years, well in excess of the rate of inflation. The trust's managers take a value/recovery approach to investment, seeking companies whose underlying quality and growth prospects have not been appreciated by the market.

The fund managers: James Henderson and Laura Foll

The managers' view: Growth is the primary driver of income

While the trust sits in the UK Equity Income sector, LWI managers James Henderson and Laura Foll are firmly focused on growth as the primary driver of future income. "Income funds must grow their capital first and foremost because income is a product of capital. We believe that all the companies in the portfolio will grow," says Henderson. As a result, the managers are less focused on starting yield than on the potential growth in dividends that will result from improved operating performance in the companies they invest in, and they do not employ income-boosting measures such as option-writing. In addition, all costs (with the exception of the performance fee, which is a reward for capital appreciation) are charged to income, leaving capital intact to maximise future growth and therefore income potential. As a result, dividends have doubled on average every 10 years. One measure the managers do employ to enhance the revenue return is the use of gearing; with borrowing costs of 1.4% and an average dividend yield on the FTSE All-Share Index of 3.7% (at 30 April), running a relatively high level of gearing (17% at 30 April) allows them to generate income in excess of the cost of borrowing, as well as benefiting from any share price gains.

The LWI investment approach is very much bottom-up and the managers have a keen focus on meeting and assessing the quality of company managements, who are the primary driver of operational improvements and therefore recovery potential. An example of this is Conviviality Retail, where the managers say the CEO has driven a restructuring of the business, scaling back loss-making Bargain Booze outlets and acquiring a drinks distribution company.

With larger companies there is less focus on site visits but the quality of management remains important. While the lack of analyst coverage on smaller stocks can make it easier to spot underappreciated opportunities, the fact that large caps are well covered does not necessarily mean that prices fully reflect fundamentals. Blue-chip stocks may be added on swings in sentiment; examples include AstraZeneca in 2012, when Henderson says the market had failed to appreciate the potential of a new management team; and Glencore, where liquidity concerns caused the share price to fall as low as 68p in late September 2015 (at 1 June the shares closed at 128.9p) in spite of the enduring quality of the company's assets. Henderson notes that while the market seemed genuinely to expect that Glencore would go bust, he and Foll felt that the balance of probability was that it would not. "That's what buying recovery is about," he adds.

Asset allocation

Investment process: Diversified portfolio with a recovery focus

LWI's Lead Manager James Henderson has been in position since 1990 (making him one of the longest-serving fund managers, according to June 2015 data from the Association of Investment Companies) and also worked as assistant manager on the portfolio during the 1980s. Now assisted by Deputy Manager Laura Foll, Henderson describes the LWI investment approach as essentially unchanged since the trust was launched in 1963: focusing on recovery situations, with a broad spread of large, medium-sized and smaller companies.

LWI's investment approach is based on four key tenets. First, that over the long term a bias to smaller and mid-cap companies has tended to produce better investment returns, and should continue to do so given these companies' superior growth characteristics. Second, long-term returns from equities exceed the cost of borrowing, so a geared investment strategy should add more in the form of extra investment returns than it costs in interest. Third, the UK has many world-leading companies in areas such as aerospace, and focusing on these areas of excellence has tended to translate into superior returns; and fourth, dividend growth is a driver of long-term value and goes hand-in-hand with capital growth and is therefore an important area of focus for the trust.

Henderson and Foll are part of a well-resourced UK equity team at Henderson Global Investors, and share ideas with other fund managers and sector specialists across the team. Meetings with companies are a key part of the process, with the managers undertaking several hundred meetings and site visits each year. They see company management as one of the most important factors in identifying possible investments, noting that a good management team can navigate a difficult economic backdrop, while poor management can get it wrong even in the good times.

While the managers do not use specific quant screens to filter their investment universe of more than 1,500 companies, their focus on buying good companies cheaply means they employ a range of valuation criteria, such as P/E ratios, price/book value and enterprise value (EV) to sales. They note that while many equity income managers screen out companies with market capitalisations below about £300m, the small-cap end of the spectrum often offers superior earnings growth and a P/E discount to the wider market.

LWI is diversified across a large number of stocks, with 124 holdings at 30 April 2016. The portfolio encompasses early-stage smaller companies, strongly growing mid-caps, big name blue-chips and recovery stocks of all sizes, with roughly one-third each in large, mid and small caps. The small-cap part of the portfolio includes companies listed on the Alternative Investment Market (AIM), where analyst coverage is often patchy or non-existent, meaning the managers can find companies that have been overlooked by the majority of investors.

Position sizes are relatively small, with the vast majority of holdings having less than a 1% weighting. New holdings generally come in to the portfolio at c 30bps and are gradually built from there. Henderson says that rather than being a high-conviction process, LWI's approach is about the probability that a stock is cheap in relation to its growth potential. The managers like to buy into stocks when sentiment is poor, in order to gain the maximum recovery potential, and say they only buy companies with real potential for sales and earnings growth. An example is Glencore, bought in November 2015 when there were widespread fears that the company would be unable to service its debt; this position was the largest positive contributor to LWI's performance in the half-year ended 31 March.

The managers say that having a long stock list means they are able to make bold decisions in a small way, taking positions in stocks that they might eschew on risk grounds if they were running a more concentrated portfolio. Starting small also means they are less troubled by trying to time the market; they are more likely to buy cheap shares slowly and sell expensive shares slowly than to try to call the top or bottom of a company's valuation. The sell discipline works in the same way as the approach to new holdings: trimming positions slowly once they have reached valuations where the managers feel the market has more fully appreciated a company's potential. There is no specific price target or valuation limit that would trigger a sale; for instance, AIM companies Johnson Service and Scapa would no longer be classed as value/recovery stocks and the managers say they have kept the positions for longer than they might have if there were a specific price or valuation target; where a company has evolved and can sustain a higher valuation than originally thought, it is likely to be kept rather than sold. Turnover is low, averaging only 12.1% over the past five years, which implies an average holding period of eight years and four months.

While LWI is an equity income trust, the managers are more focused on growth in both capital and income than on high starting yields, and they may take positions in companies that are not currently paying a dividend (Standard Chartered and Anglo American are recent examples).

Up to 15% of the portfolio (5.2% at 30 April) may be held in stocks outside the UK. Foll says that such positions tend to be in stocks where there was no UK equivalent, such as German semiconductor company Infineon. There are no current plans for the managers to increase the number of non-UK holdings. 'Non-UK' is defined by country of listing rather than by area of business; many of LWI's biggest holdings, such as Standard Chartered and Glencore, derive the majority of their revenues from outside the UK, adding a layer of economic diversification.

Current portfolio positioning

At 30 April 2016 LWI held 124 stocks, making it the second-most diversified portfolio in a sector where the weighted average number of holdings is 68. It is also one of the least concentrated in the UK Equity Income peer group, with 23.8% of assets invested in the top 10 holdings, compared with a peer group weighted average of 42.1%.

The split of the portfolio by market capitalisation at FY15 was 30% FTSE 100, 31% FTSE 250, 18% FTSE Small Cap, 12% AIM and 9% 'other' (half of which was in overseas stocks, with some of the balance representing unquoted holdings); this is in line with the broad aim to have one-third each in large, mid-cap and smaller stocks.

In sector terms, the largest weighting on both an absolute basis and relative to the FTSE All-Share Index is in industrials. The managers note that industrials is a sector with huge variety (encompassing aerospace & defence, general industrials, electronic & electrical equipment, industrial engineering, industrial transportation and support services) and very different end market exposure. Holdings in this area include Johnson Service, a linen hire company focused on the hotel sector; civil aerospace stocks such as GKN, Senior and Rolls-Royce; and Hill & Smith, a galvanising company that also makes crash barriers for roads and is thus a beneficiary of current improvements in highways infrastructure, a factor the managers feel has not been fully appreciated by the market. The industrials sector also contains companies with exposure to the oil and gas market, such as world-leading pump maker Weir Group, bought in anticipation that capital expenditure in the oil industry will begin to recover once oil prices normalise. The largest position, in Royal Dutch Shell, has benefited from recent rises in the oil price, with its share price up 31.6% at 1 June from a 12-month low reached in January.

Basic materials is the second-largest overweight. While this does include some exposure to mining stocks such as Glencore and Anglo American (the latter, a position built in late 2015, has been trimmed recently after a quicker-than-expected recovery), the bulk of the weighting is in non-mining areas such as chemicals (Scapa, Croda, Elementis, Carclo and Velocys made up 6.2% of the portfolio at 31 March) and forestry/paper.

Exhibit 3: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end April 2016	Portfolio end April 2015	Change (% pts)	Index weight	Active weight vs index (% pts)	Trust weight/ index weight (x)
Industrials	26.8	28.1	-1.2	10.5	16.3	2.6
Basic materials	13.4	13.7	-0.3	5.5	7.9	2.4
Financials	25.0	24.5	0.5	24.1	0.9	1.0
Technology	1.2	0.7	0.5	1.5	-0.3	0.8
Consumer services	11.0	8.6	2.3	12.3	-1.3	0.9
Utilities	2.4	2.9	-0.4	4.0	-1.6	0.6
Oil & gas	8.5	9.4	-0.8	11.2	-2.6	0.8
Telecommunications	2.4	1.4	1.0	5.2	-2.7	0.5
Healthcare	4.3	3.6	0.7	8.6	-4.4	0.5
Consumer goods	4.9	7.2	-2.3	17.2	-12.3	0.3
	100.0	100.0		100.0		

Source: Lowland Investment Company, Edison Investment Research. Note: Ranked by active weight.

Financials are the second-largest absolute weighting, with a bias towards the insurance sector, one of manager James Henderson's specialisms. Among the banks, Standard Chartered, HSBC and Barclays are held.

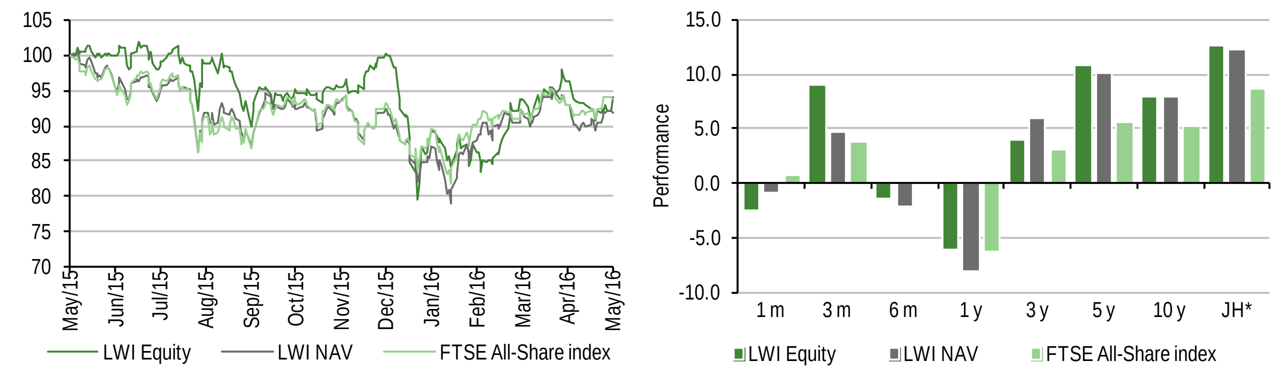
While all market sectors are represented in the portfolio, the biggest underweight is to consumer goods, an area that the managers feel is trading on unjustifiably high valuations given low organic growth rates. British American Tobacco has been sold in the current financial year; Foll notes that it is on a high-teens P/E in spite of struggling to grow its earnings.

There is a small exposure to two unlisted stocks. One of these is Wadworth, the Wiltshire brewery, which has been held in the portfolio since the 1960s, returning many times its original cost. The other is a recent addition, Oxford Sciences Innovation, a university spinout that exists to develop and commercialise intellectual property arising from research at Oxford University. Foll says it is a small, unusual investment that offers real capital growth potential, although owing to the binary nature of the ventures it backs, it is a relatively risky position and made up just 0.3% of the portfolio at 31 March.

Performance: Strong longer-term record

Exhibit 4: Investment trust performance to 31 May 2015

Price, NAV and benchmark total return performance, one-year rebased | Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures and performance under James Henderson (JH, since 30 October 1990) annualised.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years	JH*
Price relative to FTSE All-Share index	(3.2)	5.0	(1.5)	0.3	2.4	27.4	29.4	145.4
NAV relative to FTSE All-Share index	(1.6)	0.9	(2.2)	(1.8)	8.5	23.5	27.6	129.8
Price relative to FTSE 350 HY	(1.4)	4.8	(2.4)	2.7	10.3	31.4	54.1	109.6
NAV relative to FTSE 350 HY	0.2	0.7	(3.1)	0.5	16.8	27.3	52.0	96.2
Price relative to FTSE 250 index	(5.0)	4.3	(1.5)	(3.3)	(13.3)	2.3	(11.0)	12.5
NAV relative to FTSE 250 index	(3.4)	0.2	(2.1)	(5.4)	(8.2)	(0.9)	(12.2)	5.3
Price relative to FTSE Small Cap	(2.9)	2.6	(3.9)	(6.2)	(16.8)	(6.4)	29.2	177.1
NAV relative to FTSE Small Cap	(1.3)	(1.4)	(4.5)	(8.2)	(11.8)	(9.3)	27.4	159.3

Source: Thomson Datastream, Edison Investment Research. Note: *JH is performance under James Henderson, since 30 October 1990. Data to end-May 2016. Geometric calculation.

LWI has a strong longer-term performance record in both absolute and relative terms, with annualised total returns (share price and NAV) of c 8-10% over five and 10 years compared with c 5% from the FTSE All-Share (Exhibit 4). The trust splits its portfolio roughly one-third each between large, mid-cap and smaller stocks so it is also instructive to look at performance versus some subsets of the FTSE All-Share (Exhibit 5). Share price and NAV total returns have also beaten the higher-yield segment of the FTSE 350 over most periods, although there is some underperformance versus the mid-cap FTSE 250 and the FTSE Small Cap, where returns have exceeded those on larger companies in recent years.

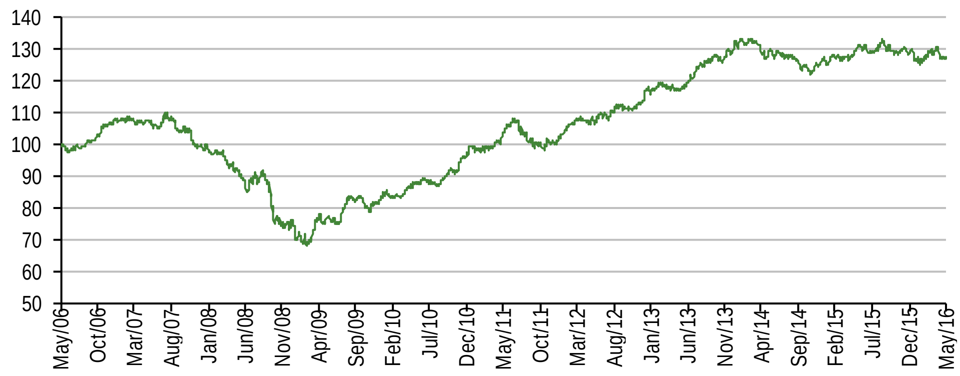
Over the 25 years under manager James Henderson – a period that has covered the UK's ERM exit, the tech boom and bust and the global financial crisis, as well as five Prime Ministers, two recessions and a fall in the Bank of England base rate from 13.875% to 0.5% – annualised returns are a creditable c 12% in both share price and NAV terms, compared with 8.8% for the FTSE All-Share (Exhibit 4). Looking at returns over this longer period indicates that in aggregate the manager has added value across the full range of market conditions, outperforming not just the benchmark but also the high-yield, mid-cap and small-cap indices (Exhibit 5).

The recent performance history has been more challenging, with negative returns over one, six and 12 months in a period of volatility for global stock markets, exacerbated in the UK by fears over the outcome of the EU referendum. Many of the areas on which LWI is focused, such as engineering, aerospace and areas of the financial sector, have struggled to perform in the last six to 12 months, although the trust's focus on recovery situations means there could be a boost from the removal of Brexit uncertainty, particularly if – as widely expected by bookmakers, if not necessarily by opinion polls – the UK votes to remain in the EU. In relative terms, NAV performance has also lagged the FTSE All-Share Index over six and 12 months, which may partly be explained by the market favouring growth over value stocks, which are more of a focus for LWI. However, this preference for growth has arguably been in place for much of the past five years, and LWI's three- and five-year outperformance of the benchmark is perhaps more notable in this context.

Over six months to 31 March the top contributors to NAV total return were mining stocks Glencore and Anglo American, ferry operator Irish Continental Group, packaging firm RPC and galvaniser Hill & Smith, which together added 2.9% to NAV. The main detractors were industrial chain manufacturer Renold, chemical company Velocys, St Modwen Properties, Standard Chartered bank, and support services stock Interserve, which between them reduced the NAV total return by 2.4%.

As shown in Exhibit 6, LWI's outperformance of the FTSE All-Share was particularly notable during the five years following the global financial crisis, since when relative performance has been flatter, although sufficient to overcome the three-year rolling performance fee hurdle (at least 10% outperformance of the benchmark) at FY15.

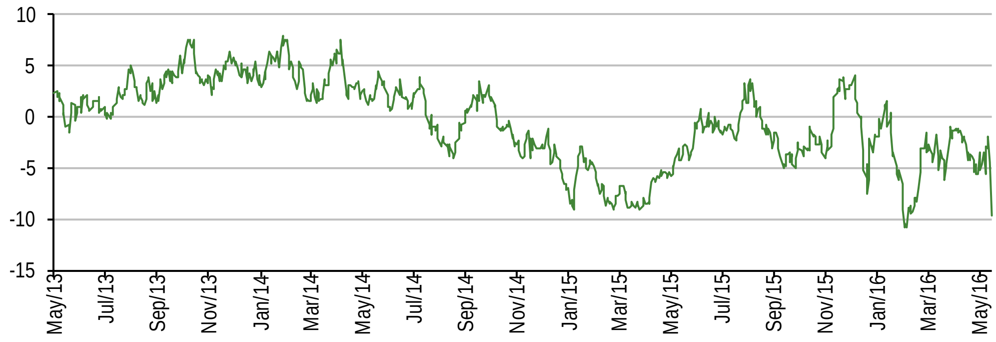
Exhibit 5: NAV performance relative to FTSE All-Share Index over 10 years



Source: Thomson Datastream, Edison Investment Research

Discount: Wider than average in short-term volatility

Exhibit 6: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

At 14 June LWI's shares traded at a 9.7% discount to cum-income net asset value. This is somewhat wider than the one-, three- and five-year averages of 2.3%, 0.5% and 1.8% respectively, and only a little narrower than the five-year widest point of 10.9% reached in early March 2016. The discount has tended to widen when sentiment is poor towards domestically orientated and particularly smaller and mid-cap UK companies; this was seen in the run-up to the 2015 General Election and has once more been in evidence as the referendum on Britain's membership of the EU approaches. As shown in Exhibit 7, LWI spent much of the period from mid-2013 to late 2014 trading at a premium to NAV. While the managers and board do not favour the use of share buybacks to manage a discount, preferring to ride out short-term bumps in sentiment without shrinking their asset base, LWI will issue shares to manage a premium, and last did so around the turn of 2016, when the premium touched a 12-month high of 4%.

Capital structure and fees

LWI is a conventional investment trust with a single class of share; at 14 June there were 27m ordinary shares in issue. While it has the authority to buy back up to 14.99% of shares a year, this has not historically been used. LWI may allot up to the equivalent of 10% of its shares annually to manage a premium, and has tended to do so if the premium to NAV has exceeded 5%. So far in the current financial year 130,000 new shares have been issued, raising £1.73m.

The trust may gear up to a maximum of 29.9% of net assets and the board and managers view 15% as a neutral level of gearing (being the midpoint between 0% and 30%). Gearing is via two short-term facilities, a two-year £25m loan with ING Bank and a three-year £60m facility with Scotiabank, with a combined interest rate of 1.4%. At H116 £64m of borrowing was drawn, representing net gearing of 15.3%; this had risen slightly to 17% at 30 April. Given the low cost of borrowing and the portfolio yield of c 4%, the managers view the use of gearing as income-enhancing while short-term interest rates remain low.

Henderson Investment Funds Ltd acts as the trust's Alternative Investment Fund Manager (AIFM) under the AIFM Directive, and delegates investment management to Henderson Global Investors. Henderson is paid an annual management fee of 0.5% of average net assets (measured quarterly). A performance fee may be paid subject to certain conditions. If LWI's NAV total return is more than 10% above the total return on the FTSE All-Share Index (the hurdle rate) over the average of the last three years, the fee earned is 15% of the outperformance above the hurdle rate. There is a cap on total annual fees such that the management fee plus the performance fee may not exceed 0.75% of average net assets. Management fees, company expenses and borrowing costs are charged to the revenue account, but the performance fee is taken from capital. An amendment was made to the performance fee policy at H116 and the fee will now only be paid if LWI's NAV has increased over the three-year measurement period. This means that regardless of the level of outperformance of the benchmark, no fee is paid if absolute returns are negative.

Dividend policy and record

Since 2013 LWI has paid dividends quarterly (previously twice a year, with a transitional year of three dividends in 2012), with the aim of contributing to above-average total returns. Dividends are paid in April, July, October and January and the total annual dividend has been maintained or grown year-on-year for the last 39 years. For the period from 2009 to 2015 dividends have increased at a compound annual rate of 7.2%. In recent years the first three dividends have been set at the level of the final dividend for the previous year, while the final dividend has tended to be 1p higher. So far in FY16 two interim dividends of 11p have been paid and the board has indicated it intends to pay a total dividend of 45.0p for the year, a 10.8% increase on the 41.0p paid in FY15. Net revenue earnings per share at H116 were 13.7p, although the trust's income is skewed towards the second half of its financial year (for H115 net income was 15.3p per share but the total for FY15 was 46.4p; this was boosted by special dividends that may not be repeated in FY16). LWI charges almost all of its costs to the revenue account yet has still fully covered its growing dividend in each of the last five financial years and added to its revenue reserve, which was sufficient to cover c 70% of the annual dividend at FY15. Based on its 14 June share price of 1,168p and its last four dividends, LWI currently yields 3.68%.

Peer group comparison

LWI is a member of the Association of Investment Companies' UK Equity Income peer group, a large and competitive sector with 23 constituents. (Exhibit 8 below excludes one small trust trading at an anomalously large premium.) The peers include trusts that concentrate explicitly on mid-sized and/or smaller companies, as well as those with a large-cap focus and those, such as LWI, that take a multi-cap approach. The sector also includes trusts with growth-orientated and value-biased investment approaches. This diverse range of strategies has led to a similarly wide dispersion of returns. Over one year to 27 May, LWI's NAV total return ranks it towards the lower end of the peer group, although over three and five years returns are closer to the weighted average. NAV total returns over 10 years (encompassing the years both before and after the global financial crisis) are the fourth-highest in the peer group. Risk-adjusted returns as measured by the Sharpe ratio are also broadly average.

In line with its focus on achieving capital growth and a growing income rather than a high starting yield, LWI's dividend yield is towards the lower end for the sector. Gearing is above-average and the discount is around the median. LWI's ongoing charges are among the lowest in the peer group (only two trusts have lower charges), although it is one of five funds to charge a performance fee. For the half-year ended 31 March 2016 LWI's ongoing charges including the performance fee (accrued but not payable unless the hurdle is met at FY16) were 0.7%, which is still in line with the peer group average.

Exhibit 7: UK Equity Income investment trusts as at 27 May 2016

% unless stated	Market cap £m	TR 1 year	TR 3 year	TR 5 year	TR 10 year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
Lowland	343.6	(8.0)	18.5	64.4	115.5	0.6	Yes	(4.1)	117.0	3.4	(0.7)	0.4
BlackRock Income & Growth	46.5	(2.2)	24.2	42.7	49.1	1.2	No	(0.1)	98.0	3.4	(0.5)	0.4
City of London	1,242.7	(3.1)	18.7	57.7	106.0	0.4	No	1.3	110.0	4.2	(0.5)	0.4
Diverse Income Trust	358.1	7.3	52.0	112.1	--	1.3	No	5.0	100.0	3.2	0.2	1.5
Dunedin Income Growth	325.3	(9.8)	1.3	31.4	54.7	0.6	No	(11.2)	115.0	4.7	(0.8)	(0.0)
Edinburgh Investment	1,363.8	1.3	31.3	78.8	129.8	0.6	No	(0.8)	113.0	3.5	(0.4)	0.6
F&C Capital & Income	253.5	(1.4)	14.4	41.5	66.7	0.7	No	2.3	109.0	4.0	(0.4)	0.3
Finsbury Growth & Income	802.0	2.1	34.5	97.3	194.3	0.8	No	1.1	104.0	2.2	(0.2)	0.7
Invesco Income Growth	159.3	(3.9)	21.2	65.5	108.8	0.9	No	(7.7)	107.0	3.6	(0.6)	0.4
Investment Company	17.1	1.9	18.6	48.7	105.8	2.6	No	(5.3)	100.0	5.8	(0.1)	0.4
JPMorgan Claverhouse	305.8	(5.5)	16.2	46.7	77.0	0.7	Yes	(9.9)	118.0	3.5	(0.6)	0.3
JPMorgan Elect Managed Inc	50.8	(5.1)	16.0	46.5	50.5	0.8	No	(2.4)	95.0	3.8	(0.7)	0.3
Merchants Trust	436.0	(11.4)	1.9	34.8	53.9	0.6	No	(9.9)	123.0	5.4	(0.7)	0.0
Murray Income Trust	444.0	(7.7)	4.3	35.8	63.9	0.7	No	(6.8)	108.0	4.5	(0.7)	0.1
Perpetual Income & Growth	918.5	(3.7)	28.2	78.5	142.7	0.7	Yes	(3.7)	117.0	3.7	(0.6)	0.6
Schroder Income Growth	167.6	(6.8)	20.4	54.4	93.4	1.0	No	(8.3)	109.0	3.9	(0.6)	0.4
Shires Income	61.2	(8.5)	12.4	54.2	55.7	1.0	No	(10.4)	122.0	5.4	(0.8)	0.3
Small Companies Dividend	31.8	3.1	59.9	137.2	69.4	2.0	Yes	(5.5)	131.0	3.8	0.1	1.1
Standard Life Equity Income	189.9	(2.9)	29.6	65.1	110.2	1.0	No	(1.1)	111.0	3.6	(0.7)	0.6
Temple Bar	715.5	(6.5)	7.6	48.4	112.8	0.5	No	(6.0)	103.0	3.5	(0.6)	0.1
Troy Income & Growth	197.9	2.1	28.1	63.4	33.5	1.0	No	1.2	100.0	3.4	(0.2)	0.6
Value And Income	102.4	(4.4)	12.0	43.8	70.6	1.4	Yes	(28.3)	124.0	3.0	(0.6)	0.2
Sector weighted average		(2.7)	21.9	65.0	110.6	0.7		(3.0)	110.6	3.7	(0.5)	0.4
LWI rank in sector	9	19	13	8	4	20		11	6	19	16	9

Source: Morningstar, Edison Investment Research. Note: TR=NAV total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 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 total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

EDISON

The board

There are currently five non-executive directors on the board of LWI. Chairman (since 2012) Peter Troughton CBE has been a director of the trust for 25 years, beginning in 1990. A former chief executive of Rothschild Asset Management, he will step down from the board at the January 2017 AGM and will be succeeded as chairman by Robbie Robertson, who has been on the board since 2011. His background is in industrials and he is a former chief executive of Tarmac Group. Kevin Carter and Karl Sternberg, who have backgrounds in investment management, were both appointed in 2009. The newest director, Duncan Budge (who has also spent his career in investment management), joined the board in 2014. Rupert Barclay, a qualified accountant and business strategist who became a director in 2000, stood down with effect from the 2016 AGM in January.

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