

# Lowland Investment Company

Multi-cap growth and income with focus on value

Lowland Investment Company (LWI) is a UK equity income investment trust with a focus on growing capital and income. It has been managed since 1990 by James Henderson at Henderson Global Investors; during 2016 Laura Foll, who has assisted Henderson since 2013, was named joint manager. LWI invests in 100+ mainly UK companies across the market cap spectrum, generally with about one-third of its portfolio respectively in large, mid-cap and smaller stocks. It has recently increased its gearing with an issue of 30-year loan notes, locking in a long-term fixed borrowing cost of 3.15%. LWI's managers note that they are finding many attractive opportunities to buy undervalued stocks with good long-term growth potential, at dividend yields that comfortably exceed the cost of borrowing. The discount is currently wider than longer-term averages.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 350 HY (%)	FTSE 250 (%)
31/03/13	33.4	27.6	16.8	17.4	24.3
31/03/14	25.7	21.7	8.8	8.8	19.9
31/03/15	(6.6)	2.6	6.6	3.8	7.9
31/03/16	2.7	(1.9)	(3.9)	(7.2)	1.7
31/03/17	16.0	20.6	22.0	26.7	15.3

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

## Investment strategy: Find value with growth potential

LWI's managers favour cash-generative companies with good capital and income growth potential, and aim to buy stocks when they are out of favour and undervalued by the market. The investment process is research-intensive and bottom-up, with hundreds of company meetings undertaken each year. The stock list is relatively long (122 companies at 31 March 2017), and includes companies from across the market cap spectrum, including some that may be lower-yielding but offer better future growth prospects. Up to 20% may be invested outside the UK.

## Market outlook: UK election adds layer of uncertainty

The surprise announcement of a UK general election on 8 June caused a surge in the value of sterling and an attendant decline in the value of overseas earners that have driven the performance of the FTSE 100 index since last summer. The election campaign will add uncertainty to a picture already clouded by Brexit negotiations. With average valuations at high levels, particularly among the blue-chips, investors may be rewarded by taking a more selective and index-agnostic approach.

## Valuation: NAV remains strong as discount widens

At 25 April, LWI's shares traded at a 5.5% discount to cum-income net asset value. While in line with the one-year average, this is wider than longer-term averages (3.1%, 2.0% and 3.7% respectively over three, five and 10 years). NAV total returns continued strongly into April, running ahead of share price performance, which led to a widening discount. At 3.1%, LWI's dividend yield is towards the lower end of its peer group, but dividend growth has compounded at 10% pa over the last five financial years, compared with 2.2% for retail price inflation.

### Investment trusts

3 May 2017

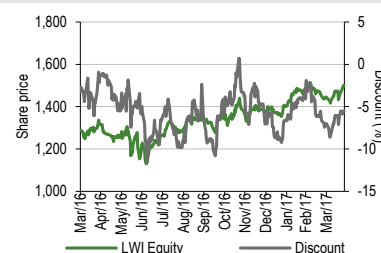
**Price** 1,500.0p  
**Market cap** £406m  
**AUM** £492.2m

NAV\* 1,578.5p  
Discount to NAV 5.0%  
NAV\*\* 1,588.1p  
Discount to NAV 5.5%

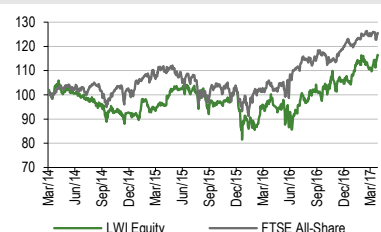
\*Excluding income, with debt at fair (market) value. \*\*Including income, with debt at fair (market) value. As at 25 April 2017.

Yield 3.1%  
Ordinary shares in issue 27.0m  
Code LWI  
Primary exchange LSE  
AIC sector UK Equity Income  
Benchmark FTSE All-Share

### Share price/discount performance



### Three-year performance vs index



52-week high/low 1,512.0p 1,130.5p  
NAV\*\* high/low 1,588.1p 1,194.2p

\*\*Including income.

### Gearing

Gross\* 13.6%  
Net\* 13.0%

\*As at 31 March 2017.

### Analysts

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

**Exhibit 1: Company at a glance**
**Investment objective and fund background**

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.

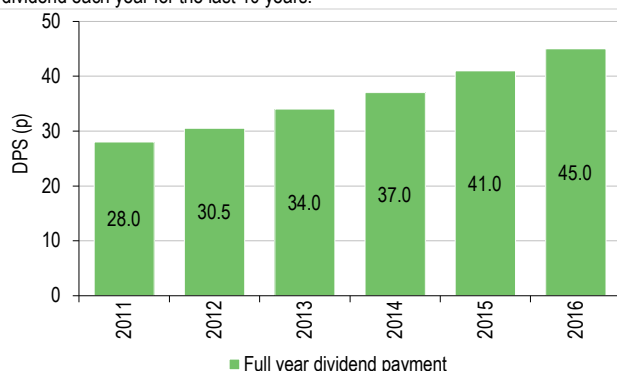
**Recent developments**

- 29 March 2017: First interim dividend of 12.0p declared for FY17.
- 24 January 2017: All resolutions passed at AGM.
- 13 December 2016: Annual results for the year ended 30 September. NAV TR +12.2% versus +16.8% for the FTSE All-Share index. Over five years LWI's NAV TR was +105.6%, share price TR +104.9% and FTSE All-Share +68.9%. Total dividend for the year of 45.0p, an increase of 9.8% on FY15.

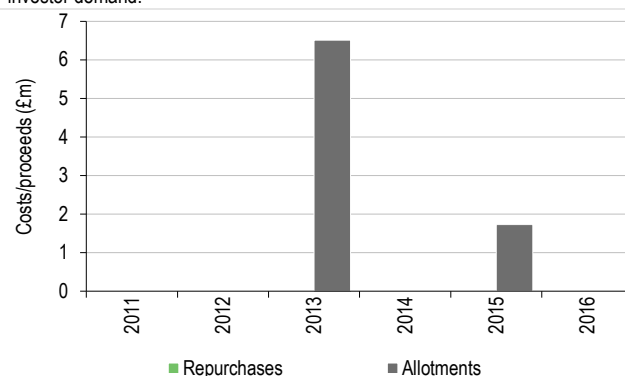
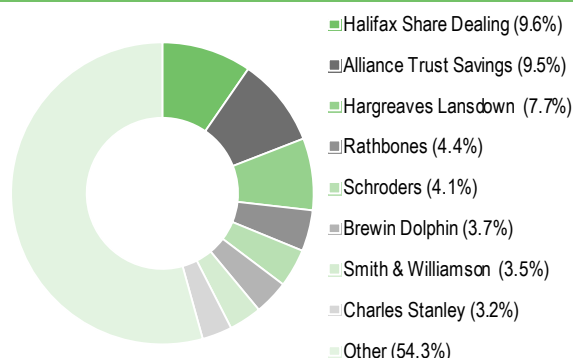
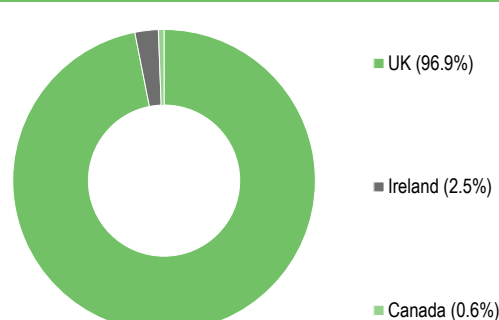
Forthcoming		Capital structure		Fund details	
AGM	January 2018	Ongoing charges	0.63%	Group	Henderson Global Investors
Interim results	May 2017	Net gearing	13.0%	Manager	James Henderson, Laura Foll
Year end	30 September	Annual mgmt fee	0.5% of net assets	Address	201 Bishopsgate, London EC2M 3AE
Dividend paid	Quarterly	Performance fee	Yes, see page 7	Phone	+44 (0) 20 7818 1818
Launch date	October 1963	Trust life	Indefinite	Website	<a href="http://www.lowlandinvestment.com">www.lowlandinvestment.com</a>
Continuation vote	None	Loan facilities	Up to £90m, see page 7		

**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 40 years.


**Share buyback policy and history (calendar years)**

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 31 March 2017)**

**Portfolio exposure by geography (as at 31 March 2017)**

**Top 10 holdings (as at 31 March 2017)**

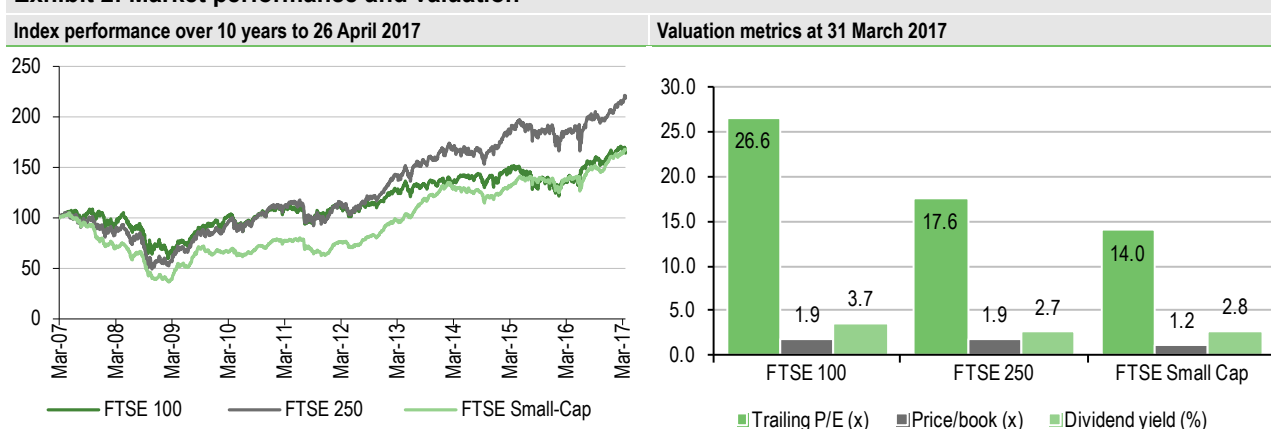
		Portfolio weight %	
		31 March 2017	31 March 2016*
Company	Sector		
Royal Dutch Shell	Oil & gas producers	5.1	4.1
Phoenix Group	Life insurance	3.0	2.6
HSBC	Banking	3.0	1.9
Hiscox	Nonlife insurance	2.7	2.9
Prudential	Life insurance	2.3	N/A
Senior	Aerospace & defence	2.2	2.7
Standard Chartered	Banking	2.1	N/A
GKN	Automobiles & parts	1.9	1.7
Headlam Group	Household goods & home construction	1.9	N/A
Irish Continental Group	Travel & leisure	1.8	2.0
<b>Top 10 (% of holdings)</b>		<b>26.0</b>	<b>23.4</b>

Source: Lowland Investment Company, Edison Investment Research, Bloomberg, Morningstar. Note: \*N/A where not in March 2016 top 10.

## Market outlook: Snap election increases uncertainty

After a strong start to the year, the large-cap FTSE 100 fell back on the surprise announcement of a general election in the UK. A sharp rise in the value of sterling as markets factored in the possibility of a stronger Brexit negotiating position caused a decline in the share prices of the overseas earners that had driven the blue-chip index higher. Conversely, the more domestically focused mid-cap FTSE 250 index rallied on the news. As shown in Exhibit 2 below (left-hand chart), the FTSE 250 has significantly outperformed both the large- and smaller-cap indices over the past decade, albeit with a higher level of volatility, particularly following the UK's EU referendum in June 2016. Notwithstanding this, from a valuation perspective (right-hand chart) the average P/E multiple (based on historic earnings) for the FTSE 100 index looks elevated compared with the FTSE 250 and FTSE Small-Cap indices. While the blue-chip index currently offers a much higher dividend yield, concerns have been voiced about concentration of dividends in a handful of stocks, in particular oil companies, where any further falls in the oil price could render payouts unsustainable. Given the heightened levels of uncertainty that are likely in both the short and medium-term, investors may prefer a fund with the flexibility to select stocks from all segments of the market, and the discipline to ensure it is not overpaying for growth.

**Exhibit 2: Market performance and valuation**



Source: Thomson Datastream, Edison Investment Research

## Fund profile: Long-term capital and income growth

Listed on the London Stock Exchange since 1963, the Lowland Investment Company (LWI) invests mainly in UK companies, with the aim of achieving above-average returns with growth in both capital and income. It has been managed since launch by Henderson Global Investors, with James Henderson as fund manager since 1990. In 2016, Laura Foll (who has worked alongside Henderson on the trust since 2013) was appointed joint manager. The managers take a value/recovery approach to investment, focusing on stocks whose quality and growth prospects appear under-appreciated by the market.

LWI uses the FTSE All-Share as a performance benchmark, but its portfolio – split roughly one-third each between large, mid-cap and smaller companies – differs significantly from the index, which is heavily weighted towards the largest companies. Portfolio construction is largely unconstrained, with a limit of 20% on overseas-listed holdings in order to comply with the AIC UK Equity Income sector requirements; in practice this allocation is used to access attractive business areas where no UK-listed equivalent is available. FTSE 100 holdings are not expected to make up more than 50% of the portfolio by value. While the trust is in the UK Equity Income sector, the managers have a total return approach and may take positions in companies that do not currently pay a dividend.

## **The fund managers: James Henderson and Laura Foll**

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### **The managers' view: Reasons to be cautiously optimistic**

Henderson and Foll have recently been net buyers of stocks, finding value opportunities in more domestic and smaller companies, as well as some self-help situations in bigger stocks such as International Airlines Group and Royal Mail. The managers note that dividend yields on the kind of companies they have been buying are well in excess of the cost of borrowing, "and as long as we are confident that dividend growth is coming through, it would be wrong to be too bearish on equities". Strong dividend growth in the portfolio has continued since the start of the year, with conservatively run, cash-generative companies such as Headlam, DFS and Shoe Zone declaring special dividends on top of ordinary dividend increases of between 4.1% and 8.7%. This contrasts with the picture for the FTSE All-Share index, where dividend growth has been slowing (currency benefits notwithstanding).

The trust's remit to invest across the market cap spectrum has proved beneficial so far in FY17, with a performance boost from lower-yielding but faster-growing small- and mid-caps. With companies that show strong earnings momentum continuing to re-rate, the managers have taken profits in stocks that have done particularly well, and reinvested in lower-rated but higher-yielding recovery situations.

From a macro perspective, LWI's managers point out that with price inflation outstripping wage growth, there will be real pressure on consumers from the second half of this year. Rising prices are partly a result of the fall in sterling since the Brexit vote; however, there are some beneficiaries of the weaker pound in the portfolio, such as manufacturing and industrial companies that sell overseas. Further sterling weakness would boost the value of dollar dividends from some larger UK companies, and could also increase the attractiveness of British firms to overseas buyers, which could result in an increase in cross-border mergers and acquisitions. Should confidence in the UK economy wane during the Brexit negotiations and the snap general election campaign, the managers argue that LWI's genuinely diverse portfolio should be an advantage.

## **Asset allocation**

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### **Investment process: Multi-cap approach with recovery focus**

LWI's investment approach has remained essentially unchanged since its launch in 1963, seeking capital growth and a growing income from a recovery-focused portfolio of large, mid-cap and smaller companies. Four key tenets underpin the strategy: that the superior growth characteristics of small and mid-cap companies should make them better long-term investments; that a geared investment strategy is appropriate given that long-term equity returns have tended to exceed the cost of borrowing; that dividend growth goes hand-in-hand with capital growth as a driver of long-term performance; and that UK companies that are global leaders in their field have the potential to provide superior returns.

In order to uncover the best investment opportunities, Henderson and Foll undertake several hundred company meetings each year, as well as sharing information across the wider UK equity team at Henderson Global Investors. The managers filter the investment universe of c 1,500 companies using a range of valuation criteria, and aim to build a diversified portfolio of early-stage smaller companies, strongly growing mid-caps, big-name blue-chips and recovery stocks of all sizes. At the end of December 2016, one-third of holdings were constituents of the FTSE Small-Cap, FTSE Fledgling or AIM indices. These companies tend to be less well-covered by analysts, which means fund managers who do their own research can spot opportunities that may have been overlooked by the wider market. The managers say they only buy companies with real potential for sales and earnings growth, and prefer to invest when sentiment is poor, in order to maximise recovery potential.

Because the portfolio is diversified across 100+ companies, individual position sizes tend to be fairly modest, with most holdings outside the top 20 making up less than 1% of the total. New holdings generally enter the portfolio as 30bp positions and are built from there. The long stock list means the managers can make bold decisions in a small way, by backing companies that might be seen as too risky in a more concentrated portfolio. Rather than being a high-conviction process, LWI's approach is based on the probability that a stock is cheap in relation to its growth potential. The gradual approach to building and divesting positions means the managers avoid the risks associated with trying to time the market. Just as the process hinges on slowly buying good stocks when they are cheap, the sell discipline centres on gradually disposing of holdings once they have reached valuations where further upside appears limited.

## Current portfolio positioning

At 31 March 2017, LWI had 122 holdings, spread across FTSE 100, FTSE 250, FTSE Small-Cap and non-FTSE All-Share (FTSE Fledgling and AIM) stocks. The top 10 holdings made up 26.0% of the total, 2.6pp higher than a year previously. The vast majority of positions are below 1% of the portfolio, which the managers argue diversifies the income stream, as well as enabling them to invest selectively in riskier stocks with higher growth potential.

**Exhibit 3: Portfolio sector exposure vs FTSE All-Share index (% unless stated)**

	Portfolio end-March 2017	Portfolio end-March 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Financials	30.9	25.2	5.7	25.7	5.2	1.2
Industrials	26.8	27.0	-0.2	10.9	15.9	2.5
Consumer services	11.3	11.0	0.3	11.4	0.0	1.0
Oil & gas	9.9	7.4	2.6	11.9	-2.0	0.8
Basic materials	7.8	13.7	-6.0	7.0	0.8	1.1
Consumer goods	5.9	4.9	1.0	15.5	-9.6	0.4
Healthcare	4.2	4.7	-0.4	9.4	-5.1	0.5
Telecommunications	1.4	2.5	-1.0	3.8	-2.4	0.4
Utilities	1.4	2.5	-1.0	3.6	-2.1	0.4
Technology	0.3	1.2	-0.9	0.9	-0.6	0.3
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Lowland Investment Company, Edison Investment Research. Note: Portfolio sector weightings are approximate.

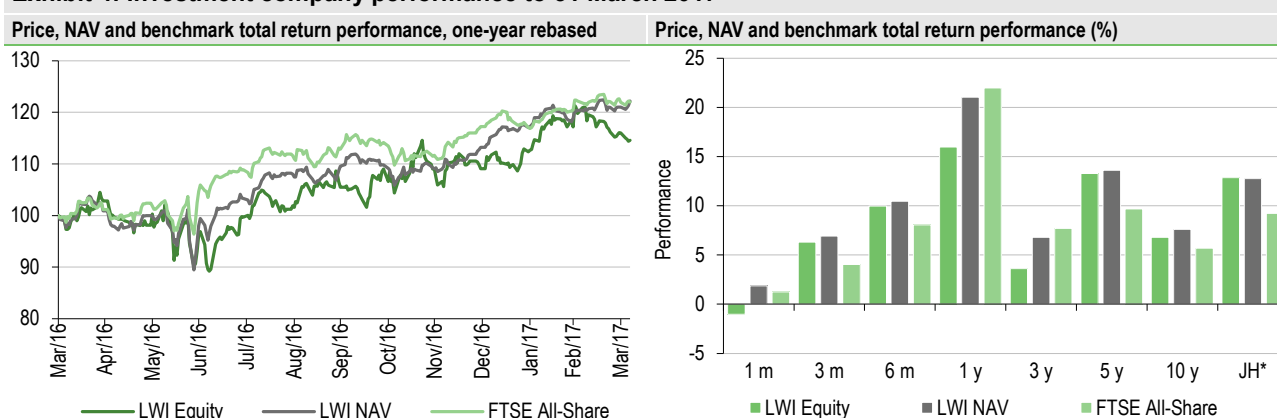
Much of the recent portfolio activity has centred on taking profits in stocks with earnings momentum that have done well and are now trading on extended valuation multiples. The proceeds from these sales, as well as from the increased level of gearing (up to 13% from 6% at the 30 September FY16 year-end), have been put to work in areas where the managers see value. Such positions include Henderson Opportunities Trust (also managed by James Henderson), which offers exposure to high-growth smaller companies and is trading at a discount to NAV; as well as larger companies like Royal Mail (sold at c £5 after the Brexit vote and bought back at c £4), which the managers say is attractively valued, and International Airlines Group, which could be better placed than peers in a post-Brexit world. Other new positions include insurance companies Randall & Quilter and Aviva and car dealer Marshall Motors, while the managers have also added to existing holdings in DFS and Shoe Zone. The latter three are all domestically focused, offering medium-term recovery potential but attractive valuations given the tougher period expected for the UK economy.

As shown in Exhibit 3, the largest absolute weighting is in financials, which has also shown the biggest increase over 12 months to 31 March 2017. As well as having relatively large positions in insurance and financial services, the managers have added to their holdings in banks over the past year, with HSBC and Standard Chartered both among the top 10 stocks. The managers continue to favour industrials, which make up the largest overweight versus the FTSE All-Share index (+15.9pp). The biggest reduction in exposure over the 12 months has been to basic materials, as positions in mining companies were reduced following a strong recovery in the sector.

## Performance: Outperforming over many periods

LWI has a strong long-term performance record, producing annualised NAV and share price total returns of 12.8% since 1990 under manager James Henderson. Annualised total returns are also ahead of the benchmark FTSE All-Share index over five and 10 years (Exhibit 4, right-hand chart). Although absolute returns over the last 12 months were strong (left-hand chart), relative performance was affected by the mid- and small-cap sell-off in the wake of the UK's EU referendum, and this has also had an impact on three-year performance versus the benchmark. However, over H117 (to 31 March), LWI outperformed the All-Share, with returns driven by small and mid-cap companies with earnings momentum, such as adhesives company Scapa, concrete specialist Somero, carpet firm Headlam, chain and gear manufacturer Renold and gas-to-liquid fuel company Velocys. Most of these positions were reduced into share price strength, with the managers adding to weaker performers such as 4D Pharma, where they felt share price falls were not justified by fundamentals.

**Exhibit 4: Investment company performance to 31 March 2017**



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	(2.2)	2.2	1.8	(4.9)	(10.9)	17.6	11.0	137.1
NAV relative to FTSE All-Share	0.6	2.8	2.2	(0.8)	(2.5)	19.2	19.9	132.3
Price relative to FTSE 350 HY	(2.5)	3.4	1.3	(8.5)	(8.9)	19.6	23.1	94.4
NAV relative to FTSE 350 HY	0.3	4.0	1.8	(4.5)	(0.3)	21.2	33.0	90.4
Price relative to FTSE 250	(2.4)	0.8	2.5	0.6	(12.0)	(1.0)	(10.1)	15.5
NAV relative to FTSE 250	0.4	1.4	3.0	5.0	(3.7)	0.3	(2.9)	13.2
NAV relative to FTSE Small Cap	(4.5)	0.5	(0.6)	(3.2)	(13.3)	(14.1)	16.3	171.2
NAV relative to FTSE Small Cap	(1.7)	1.1	(0.2)	1.1	(5.0)	(12.9)	25.6	165.7

Source: Thomson Datastream, Edison Investment Research. Note: \*JH is performance under James Henderson, since 30 October 1990. Data to end-March 2017. Geometric calculation.

**Exhibit 6: NAV total return performance relative to benchmark over 10 years**



Source: Thomson Datastream, Edison Investment Research



## Discount: Wider than average with scope to narrow

At 25 April, LWI's discount to cum-income NAV stood at 5.5%. This is in line with the one-year average but wider than the three-, five- and 10-year averages (3.1%, 2.0% and 3.7% respectively), although it has narrowed from c 9% earlier in the month. The discount reached a five-year high of 11.6% on 8 July 2016, shortly after the Brexit vote. LWI's discount is currently wider than the 3.6% average for the UK Equity Income peer group and the 3.5% average for the AIC investment company universe, but with scope to narrow further should the positive performance trend be sustained.

**Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)**



Source: Thomson Datastream, Edison Investment Research

## Capital structure and fees

LWI is a conventional investment trust, with 27.0m ordinary shares in issue. While the board has authority to buy back or allot shares to manage a discount or a premium, in practice the buyback power has not been used, and the most recent allotments were in December 2015. The trust may gear up to 29.9% of net assets, and has previously used short-term borrowing to achieve this. However, in order to lock in historically low long-term borrowing rates against a backdrop of higher inflation, in January 2017 LWI issued £30m of 20-year loan notes with a fixed coupon of 3.15%. There is also a three-year borrowing facility of up to £60m with Scotiabank. Net gearing stood at 13.0% at 31 March 2017, slightly below the approximately mid-teens long-term average.

Henderson Global Investors is paid an annual management fee of 0.5% of average net assets. A performance fee may be paid if LWI's NAV total return performance is more than 10% above the total return on the FTSE All-Share index, subject to certain conditions ([see our initiation note for a full explanation](#)). For FY16, ongoing charges were 0.63% and no performance fee was paid.

## Dividend policy and record

LWI pays dividends quarterly, in April, July, October and January. The final dividend has tended to set the level for the first three interims of the following year. For FY16 LWI paid total dividends of 45.0p, fully covered by income. This was a rise of 9.8% on the previous year. Dividends have grown at a compound annual rate of 10.0% from FY11 to FY16, compared with 2.2% for RPI inflation over the same period. Over 25 years to 30 September 2016 the compound annual growth of dividends was 7.1%, compared with 2.7% for RPI inflation. Dividends have been maintained or increased for each of the last 40 years. A first interim dividend of 12p has been declared for FY17. Based on the 25 April share price of 1,500p and the last four declared dividends, LWI currently yields 3.1%.

## Peer group comparison

The AIC UK Equity Income sector is one of the largest investment trust peer groups, with 23 constituents. Exhibit 8 below shows the 11 largest. Trusts in the sector follow a diverse range of strategies in terms of the size of companies they target and their investment style. Unsurprisingly, this leads to a wide dispersion of returns. Over one, five and 10 years, LWI's NAV total returns are ahead of the weighted average for the peer group, ranking in the top quartile over five and 10 years and in first place over one year. Returns are somewhat below average over three years. Ongoing charges are below average, although LWI is one of only four trusts in the sector that may also levy a performance fee. The discount is wider than the average, gearing is slightly above average and, in line with its focus on capital and income growth, rather than a high starting yield, LWI's 3.2% dividend yield is below the peer group average.

**Exhibit 8: AIC UK Equity Income investment trusts with assets over £300m as at 18 April 2017**

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)
<b>Lowland</b>	<b>387.2</b>	<b>19.3</b>	<b>23.5</b>	<b>92.1</b>	<b>105.3</b>	<b>0.6</b>	<b>Yes</b>	<b>(7.2)</b>	<b>113</b>	<b>3.2</b>
City of London	1,404.4	12.3	25.3	74.1	85.9	0.4	No	1.9	105	4.0
Diverse Income Trust	366.2	8.6	27.7	124.6	--	1.2	No	0.1	100	3.0
Dunedin Income Growth	382.9	18.3	16.1	53.1	46.5	0.6	No	(8.8)	115	4.6
Edinburgh Investment	1,422.5	12.6	40.0	89.8	109.4	0.6	No	(5.0)	113	3.4
Finsbury Growth & Income	1,049.1	16.4	46.5	124.7	179.3	0.7	No	0.6	103	1.9
JPMorgan Claverhouse	371.0	18.6	26.2	79.9	69.8	0.8	No	(4.3)	112	3.4
Merchants Trust	514.0	15.4	15.6	59.8	47.7	0.6	No	(6.2)	119	5.1
Murray Income Trust	516.2	18.9	20.7	62.0	67.4	0.8	No	(6.9)	106	4.2
Perpetual Income & Growth	913.6	8.7	24.2	89.0	120.0	0.7	Yes	(8.6)	115	3.5
Temple Bar	831.2	16.1	16.6	65.5	105.6	0.5	No	(2.9)	100	3.3
<b>Sector weighted average</b>		<b>14.1</b>	<b>28.2</b>	<b>83.4</b>	<b>96.9</b>	<b>0.7</b>		<b>(3.5)</b>	<b>109</b>	<b>3.5</b>
<b>LWI rank out of 23</b>	<b>8</b>	<b>1</b>	<b>14</b>	<b>4</b>	<b>5</b>	<b>18</b>		<b>18</b>	<b>7</b>	<b>20</b>

Source: Morningstar, Edison Investment Research. Note: TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

## The board

LWI has five non-executive directors. Robbie Robertson became chairman at the January 2017 AGM on the retirement of Peter Troughton; he has served on the board since May 2011. Karl Sternberg was appointed in January 2009, and Kevin Carter in October 2009. Duncan Budge became a director in July 2014. The newest director, Gaynor Coley, joined the board in November 2016 and is a qualified accountant who has worked as a director of the Eden Project and Kew Gardens. The other directors have backgrounds in industry and investment management.

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