

# Standard Life Equity Income Trust

Unconstrained approach to UK equity investing

Standard Life Equity Income Trust (SLET) has been managed by Thomas Moore since 2011. He aims to generate above-average income and real capital and income growth from a portfolio of UK equities, which is invested across the market cap spectrum. Following an index-agnostic approach, the manager has restructured SLET's income stream over the past few years and shareholders are now enjoying a higher distribution, with less revenue going into reserves. The board has recently announced a higher than previously forecast final dividend for FY17 and says the annual dividend in FY18 will be at least 5% higher than the FY17 distribution. SLET's current dividend yield is 3.5%.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 100 (%)	FTSE 250 (%)
31/12/13	33.1	32.8	20.8	18.7	32.3
31/12/14	5.1	5.2	1.2	0.7	3.7
31/12/15	15.5	13.3	1.0	(1.3)	11.2
31/12/16	(10.9)	(3.3)	16.8	19.1	6.7
31/12/17	23.8	20.8	13.1	11.9	17.8

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

## Investment strategy: Benchmark-agnostic approach

Moore adopts Standard Life Investments' (SLI) 'Focus on Change' philosophy, seeking companies with strong cash flow (hence an ability to pay high and/or growing dividends) that are trading at reasonable valuations. He invests across the market cap spectrum; at end-November 2017, more than 60% of the portfolio was invested outside of the large-cap FTSE 100 companies (Exhibit 1). The index-agnostic approach means that stock and sector weightings can vary meaningfully from the benchmark FTSE All-Share Index; the current largest overweight sector is financials, which comprises c 45% of the portfolio (c 1.7x the index weighting), and the trust retains a zero weighting in healthcare (c 8% of the index). Net gearing of up to 25% is permitted; at end-November 2017, it was 12.0%.

## Market outlook: Small-caps more attractively valued

Over the last five years, smaller-cap stocks have outpaced the total returns of the FTSE 100 Index. However, on a P/E multiple basis smaller-cap stocks remain more attractively valued, despite forecast faster earnings and dividend growth than large-cap companies and better dividend cover. Investors seeking UK equity exposure may be attracted to a fund that invests across the market cap spectrum, seeking companies with above-average income and growth potential.

## Valuation: Discount in a narrowing trend

SLET's current 3.7% share price discount to cum-income NAV is close to the low end of the 1.8% to 10.8% range over the past 12 months. It compares with the averages of the last one, three, five and 10 years (range of 2.7% to 5.5%). The discount has been in a narrowing range since March 2017. SLET's FY17 dividend is 11.0% higher than in FY16 and represents the 17th consecutive year of increased annual distributions; its current dividend yield is 3.5%.

## Investment trusts

17 January 2018

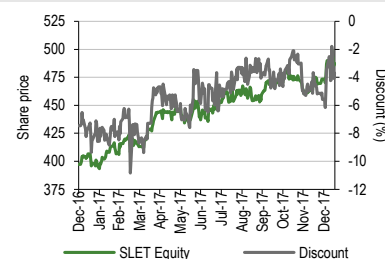
**Price** 487.5p  
**Market cap** £240m  
**AUM** £272m

NAV\* 500.8p  
Discount to NAV 2.6%  
NAV\*\* 506.2p  
Discount to NAV 3.7%

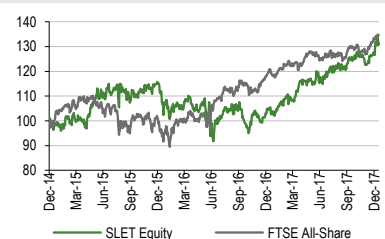
\*Excluding income. \*\*Including income. As at 15 January 2018.

Yield 3.5%  
Ordinary shares in issue 49.2m  
Code SLET  
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 500.0p 393.5p  
NAV\*\* high/low 509.1p 430.4p

\*\*Including income.

## Gearing

Gross\* 12.0%  
Net\* 12.0%

\*As at 30 November 2017.

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## Exhibit 1: Trust at a glance

### Investment objective and fund background

Standard Life Equity Income Trust (SLET) aims to provide shareholders with an above-average income from their equity investment while also providing real growth in capital and income. It seeks to achieve this through a diversified portfolio of between 50 and 70 equity holdings. The benchmark is the FTSE All-Share Index.

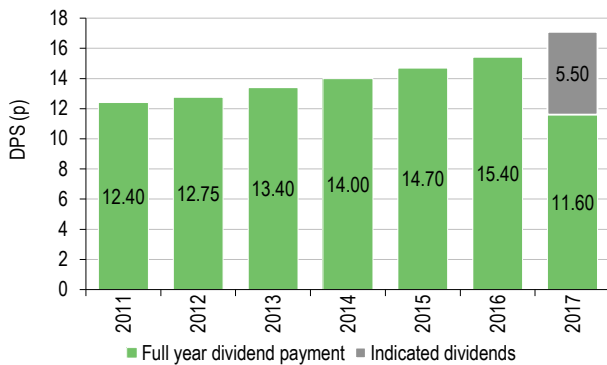
### Recent developments

- 5 December 2017: Final results for 12 months ending 30 September 2017. NAV TR +14.7% versus benchmark TR +11.9%. Share price TR +15.9%. Announcement of a final dividend of 5.5p.
- 1 September 2017: Announcement of a third interim dividend of 4.0p.
- 24 May 2017: Interim results for six months ending 30 March 2017. NAV TR +7.2% versus benchmark TR +8.1%. Share price TR +2.5%. Announcement of a second interim dividend of 3.8p.

Forthcoming		Capital structure		Fund details	
AGM	January 2018	Ongoing charges	0.87% (FY17)	Group	Aberdeen Standard Investments
Interim results	May 2018	Net gearing	12.0%	Manager	Thomas Moore
Year end	30 September	Annual mgmt fee	0.65% to £250m, then 0.55%	Address	1 George Street, Edinburgh, EH2 2LL
Dividend paid	Quarterly	Performance fee	None	Phone	+44 (0)345 600 2268
Launch date	14 November 1991	Trust life	Indefinite	Website	<a href="http://www.standardlifeinvestments.com">www.standardlifeinvestments.com</a>
Continuation vote	Five-yearly, next 2021	Loan facilities	£30m with Scotiabank		

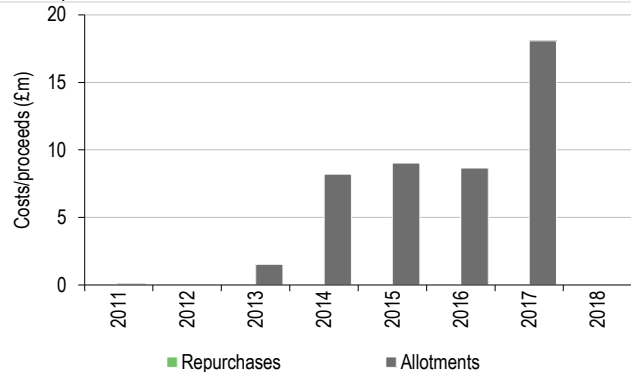
### Dividend policy and history (financial years)

Dividends are paid quarterly in March, June, September and January. It is the board's intention that SLET should achieve long-term real (ie above inflation) growth in its dividend.

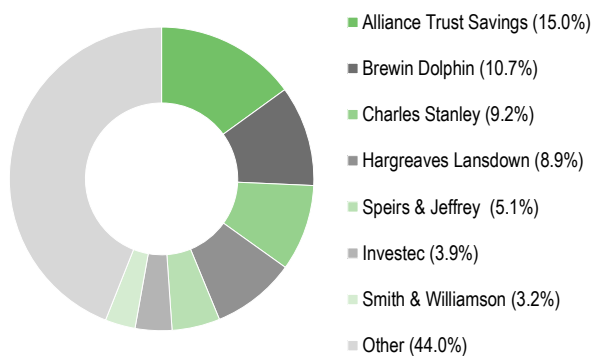


### Share buyback policy and history (financial years)

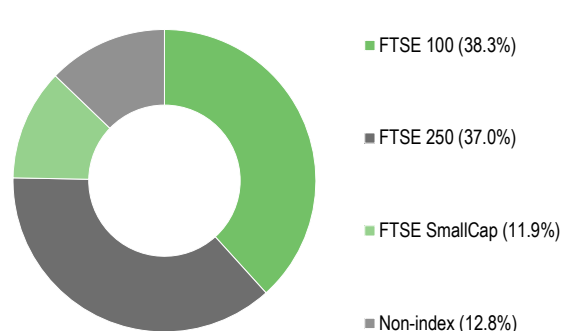
SLET may buy back up to 14.99% or allot up to 10% of ordinary shares annually to manage a discount or a premium. Figures include shares issued as a result of subscription share exercise.



### Shareholder base (as at 6 November 2017)



### Portfolio exposure by market cap (as at 30 November 2017)



### Top 10 holdings (as at 30 November 2017)

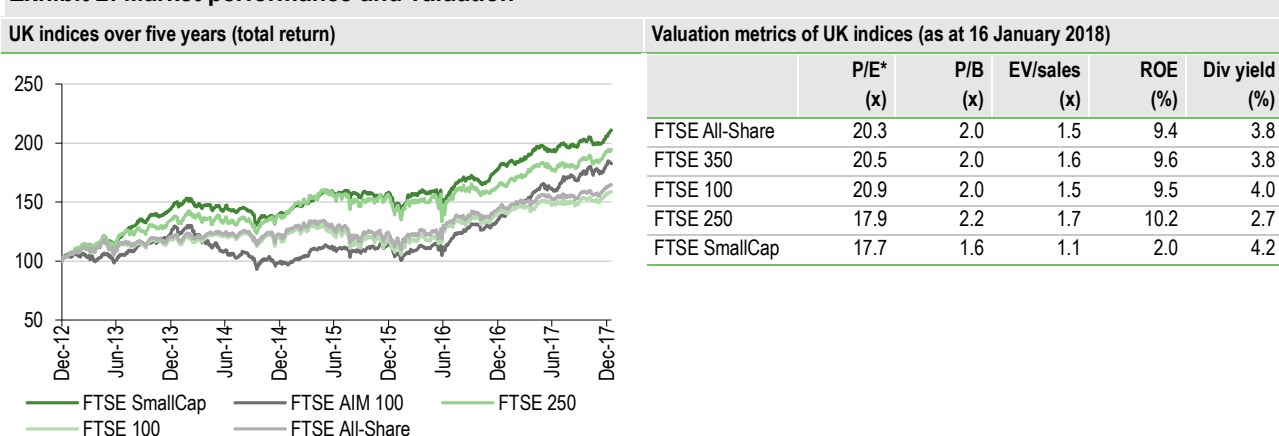
Company	Sector	Portfolio weight %	
		30 November 2017	30 November 2016
Aviva	Life insurance	2.9	3.4
Royal Dutch Shell	Oil & gas producers	2.9	N/A
Prudential	Life insurance	2.9	2.3
Sage	Software & computer services	2.8	3.4
BP	Oil & gas producers	2.7	N/A
Micro Focus	Software & computer services	2.7	2.7
River and Mercantile	Financial services	2.6	N/A
Close Brothers	Banks	2.6	2.4
Rio Tinto	Mining	2.5	3.9
HSBC	Banks	2.5	N/A
<b>Top 10</b>		<b>27.1</b>	<b>29.6</b>

Source: Standard Life Equity Income Trust, Edison Investment Research, Bloomberg, Morningstar. Note: \*N/A where not in November 2016 top 10.

## Market outlook: Smaller-caps retain lower P/E ratings

The total return of UK indices over the past five years is shown in Exhibit 2 (left-hand side). The FTSE SmallCap, FTSE 250 and FTSE AIM 100 indices have all outperformed the performance of the large-cap FTSE 100 Index. UK equities have performed particularly strongly since mid-2016 as economic data have been better than many would have expected following the result of the UK's European referendum. As shown in Exhibit 2 (right-hand side), on a P/E basis, the valuation of large-cap companies remains less attractive than the valuation of smaller-cap companies. While large-cap companies have a competitive dividend yield, data from SLI suggest that smaller companies with the potential to generate sustained growth are able to grow their dividends at a faster pace than large-cap companies, and also have better dividend cover. Investors seeking income from UK equities may wish to consider a fund that invests across the market-cap spectrum and has generated consistent outperformance versus its benchmark.

**Exhibit 2: Market performance and valuation**



Source: Thomson Datastream, Edison Investment Research, Bloomberg. Note: \*P/E is current, based on cash earnings.

## Fund profile: Unconstrained by the benchmark

SLET was launched in 1991 and has been managed by SLI since November 2005. The lead manager since May 2012 has been Thomas Moore (having been co-manager since November 2011). He aims to generate an above-average level of income along with real growth in capital and income. The manager is unconstrained by the stock and sector weightings in the benchmark FTSE All-Share Index, and the portfolio is typically made up of between 50 and 70 stocks. Turnover is generally between 20% and 35% pa. As shown in Exhibit 1, more than 60% of the portfolio is held in mid- and small-cap stocks, which is a much higher weighting than the benchmark (c 20%). At the time of investment, a maximum of 10% of net assets may be in a single stock and the top 10 positions will not make up more than 50% of the portfolio. The board has delegated gearing responsibility to the manager, within a range of 5% net cash to 15% net gearing. At end-November 2017, net gearing was 12.0%; modestly higher than the c 10% historical average.

## The fund manager: Thomas Moore

### The manager's view: Benefits of index-agnostic approach

Moore highlights the benefits of investing across the market cap spectrum, seeking companies with sustainable dividends and long-term capital growth. He notes the high level of dividend concentration in the FTSE All-Share Index, where in 2016 the largest 10 dividend-paying

companies contributed more than 50% of total index income. The investments that the manager makes in mega-cap companies are for stock-specific reasons. Examples include BP and Royal Dutch Shell, which have lowered their breakeven costs of production leading to better dividend cover, and HSBC, which has undergone a period of major restructuring aiming to generate higher revenue and earnings growth.

The manager has confidence in the underlying cash flow generation of companies in SLET's portfolio, which should lead to robust dividend growth for the trust. He is also able to find companies whose cash flow generation he believes is underappreciated, offering the potential for a positive share price revaluation. Moore views the current investment backdrop as more benign than in 2016, which was affected by the UK's European referendum, and believes that the second stage of the Brexit negotiations could herald a better UK political environment. In aggregate, SLET's portfolio companies generate c 55% of their revenue in the UK. While this is roughly double the UK revenue exposure within the benchmark, it is in line with the trust's historical exposure. The manager has no difficulty in finding high-conviction UK domestic investments, with the ratings gap between UK domestic stocks and the broader market (FTSE 350) remaining the largest since 2008. Moore believes that UK inflation has likely peaked around 3% and that the real wage gap will close, which will benefit domestic UK companies through higher consumption. He notes that the level of employment is high and asset prices have risen, helping to ensure that debt service costs are manageable. Moore believes that if the UK consumer was struggling, evidence would have emerged in 2017.

## **Asset allocation**

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### **Investment process: SLI's 'Focus on Change' philosophy**

Moore and SLI's UK Equity team follow the company's 'Focus on Change' philosophy, believing that at different times of the economic cycle there are different factors that drive stocks and markets. The thesis is that over the long term, stock prices are driven by company fundamentals, but over shorter time periods, share price moves can be less rational. The broad investment universe of c 1,500 stocks is screened using SLI's proprietary stock-screening matrix; factors include share price momentum, earnings growth and revisions, valuation and dividend yield. Potential investee companies are analysed with the following questions in mind: what are the key drivers and issues for the stock; what is changing; what is assumed in the price; what will make the market change its mind about the stock; and what specific triggers are there? An assessment of a company's corporate governance track record is also an important consideration. SLET's resulting portfolio comprises 50-70 holdings and position sizes are determined by the manager's level of conviction. Because Moore follows an index-agnostic approach, stock and sector weightings can vary significantly versus the benchmark. Risk is monitored using SLI's sophisticated risk modelling system, which includes pre-trade analysis.

### **Current portfolio positioning**

In terms of sector exposure, over the past 12 months the largest increases are financials (+9.4pp) and oil and gas, which has gone from a zero weighting to 7.1% of the portfolio. SLET's energy exposure is unlikely to increase meaningfully as moving down the market-cap spectrum below the mega-caps is a long list of exploration and production companies, which the manager says have unattractive cash flow characteristics. The largest decreases in sector exposure are consumer services (-7.3pp) and telecoms (-6.1pp). SLET continues to have no exposure to the healthcare sector, as the manager considers that industry fundamentals are unappealing, which will limit the ability for healthcare companies to pay dividends over the medium term. Another notable feature of SLET is its c 45% weighting in financial companies; the manager explains that exposure is

diversified, including holdings in life insurers such as Aviva and Prudential, non-life insurers such as Beazley and Direct Line Insurance, and asset managers such as Ashmore and Premier Asset Management, as well as banks such as Close Brothers and HSBC.

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

	Portfolio end-November 2017	Portfolio end-November 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Financials	45.1	35.7	9.4	26.7	18.3	1.7
Industrials	16.4	15.4	1.0	11.1	5.3	1.5
Consumer services	10.0	17.3	(7.3)	11.1	(1.1)	0.9
Oil & gas	7.1	0.0	7.1	12.7	(5.6)	0.6
Consumer goods	6.0	9.1	(3.1)	15.6	(9.6)	0.4
Technology	5.5	6.3	(0.8)	1.2	4.3	4.5
Basic materials	5.3	4.9	0.4	7.2	(1.9)	0.7
Telecommunications	2.6	8.7	(6.1)	3.6	(1.0)	0.7
Utilities	2.1	2.6	(0.5)	2.8	(0.7)	0.7
Healthcare	0.0	0.0	0.0	8.0	(8.0)	0.0
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

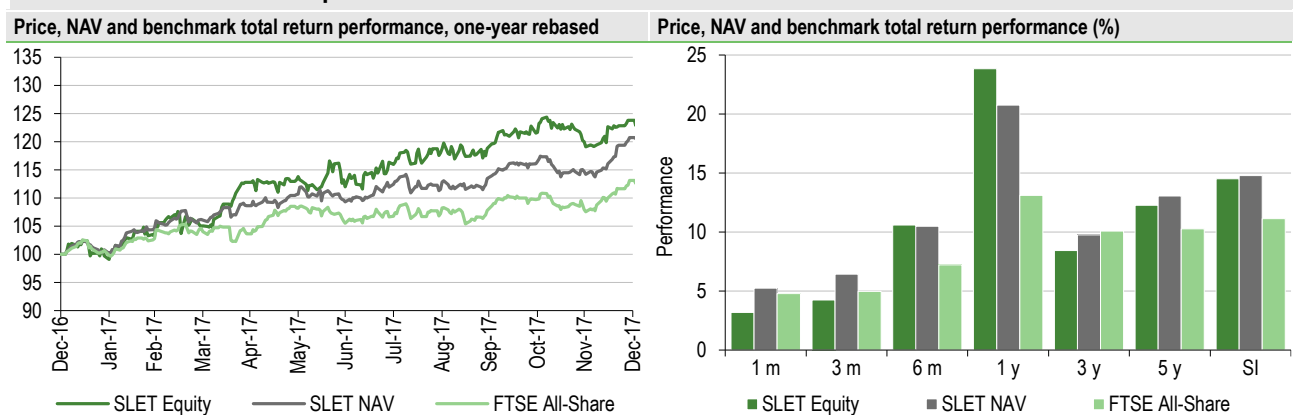
Source: Standard Life Equity Income Trust, Edison Investment Research. Note: Adjusted for cash and gearing.

Comparing sector weightings to when we last published a note on SLET in [August 2017](#), there is less consumer exposure. The manager took some profits ahead of the snap UK general election in June 2017. These include auto retailer Inchcape, housebuilder Persimmon and replacement window and door manufacturer Safestyle UK. Inchcape has both UK and overseas exposure; the manager had concerns about the domestic market. Persimmon had delivered very strong returns, but Moore says that the company is experiencing rising costs and that a director had been selling some Persimmon shares. Safestyle UK was a top 10 holding; however, business conditions have deteriorated and the company has issued a series of profit warnings.

Moore has recently initiated a position in British American Tobacco (BAT), which he was able to buy during a period of share price weakness due to potential news on nicotine regulation by the US Food and Drug Administration. BAT is one of the leading global tobacco companies with significant exposure to emerging markets. There is potential for the company's novel nicotine products to drive higher revenue growth, and its shares are currently yielding c 3.5%.

## Performance: Solid outperformance versus benchmark

**Exhibit 4: Investment trust performance to 31 December 2017.**



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and since inception performance figures annualised. Since inception (SI) refers to tenure of Thomas Moore, appointed as sole manager on 14 May 2012.

Absolute returns are shown in Exhibit 4. Over the past 12 months, SLET's NAV and share price total returns of 20.8% and 23.8%, respectively, are meaningfully ahead of the benchmark's 13.1%

total return. Significant contributors to performance include holdings in asset managers River and Mercantile and Premier Asset Management, which have benefited from positive fund flows and revenue growth, and not holding pharmaceutical companies Shire and GlaxoSmithKline. Exhibit 5 shows SLET's relative returns. The trust's NAV has outperformed the FTSE All-Share Index benchmark over almost all periods shown, despite a marked period of underperformance in mid-2016 due to the outperformance of large-cap companies with overseas earnings. SLET is structurally short US dollar exposure and long sterling; as a result, the manager says that fund performance is a challenge when sterling is weak. The manager is encouraged that investment sentiment has changed, and says that there is now more of a focus on company fundamentals, rather than on the macro environment, which has dominated the past 18 months. He notes that companies posting strong results are enjoying a positive re-rating, and in aggregate, smaller-cap companies are now outperforming the largest UK companies.

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

	One month	Three months	Six months	One year	Three years	Five years	SI
Price relative to FTSE All-Share	(1.5)	(0.7)	3.2	9.5	(4.4)	9.4	18.3
NAV relative to FTSE All-Share	0.4	1.4	3.1	6.8	(0.8)	13.3	19.9
Price relative to FTSE 100	(1.8)	(0.8)	3.4	10.6	(3.1)	13.4	23.6
NAV relative to FTSE 100	0.2	1.3	3.3	7.9	0.5	17.5	25.3
Price relative to FTSE 250	(0.8)	(0.6)	1.9	5.1	(8.7)	(6.9)	(4.0)
NAV relative to FTSE 250	1.2	1.5	1.8	2.5	(5.3)	(3.5)	(2.7)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-December 2017. Geometric calculation.

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



Source: Thomson Datastream, Edison Investment Research

## Discount: Narrowing trend since early 2017

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



Source: Thomson Datastream, Edison Investment Research

Looking at SLET's discount over the last three years (Exhibit 7), the widest discount of 11.3% occurred on 3 November 2016, a period characterised by heightened investor risk aversion ahead of the US presidential election. Since March 2017, SLET's share price discount to cum-income NAV has been on a narrowing trend. The current 3.7% discount is towards the low end of the 1.8% to 10.8% range of the past 12 months. It compares to the averages of the past one, three, five and 10 years of 5.5%, 3.8%, 2.7% and 4.1%, respectively.

## Capital structure and fees

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Following the final conversion of SLET's subscription shares in December 2016, which increased the share count by 8.6%, SLET has a single class of share; there are 49.2m ordinary shares in issue. The trust has a £30m bank lending facility with Scotiabank; the current cost of debt is c 1.3%. At end-November 2017, SLET's net gearing was 12.0%. The manager says that he is comfortable with the trust's level of gearing given the opportunities he sees to buy high-growth dividend companies at reasonable valuations. However, he has active discussions with the board about the level of gearing. Having been geared during a Brexit-induced market sell-off, Moore manages the level of gearing more actively; for instance he lowered the level of gearing ahead of the snap UK general election. This proved to be a correct decision and provided the manager with some dry powder to invest in companies that became oversold following the election result.

Standard Life Investments receives an annual management fee, which is charged 30% to revenue and 70% to capital, representing the board's expectation of the split of returns over the long term between income and capital, respectively. The fee is calculated as 0.65% on the first £250m and 0.55% on total assets above £250m (prior to October 2016 it was 0.65% of total assets). FY17's ongoing charges of 0.87% were 9bp lower than in FY16.

## Dividend policy and record

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SLET pays quarterly dividends in March, June, September and January. In FY17, the annual dividend of 17.1p was 11.0% higher than the 15.4p dividend paid in FY16 and represents the 17th consecutive year of dividend increases. The FY17 distribution includes a final indicated dividend of 5.5p, which was revised up from an initial indication of 5.2p; the total dividend was 1.12x covered by income. SLET continues to benefit from both ordinary dividend receipts and special dividends. Over the past five years, its annual dividend has compounded at an annual rate of 6.0%, which is well above the rate of UK inflation over the period. The board has announced that the FY18 total dividend will be at least 5% higher than the FY17 distribution, and payments will be spread more evenly. The intention is that the first three interim dividends will be equal, with the final dividend dependent on the level of income. SLET's current dividend yield is 3.5%.

## Peer group comparison

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SLET is a member of the AIC UK Equity Income sector, which is made up of 24 trusts. Exhibit 8 compares the 15 largest; each has a market cap in excess of £200m. SLET's NAV total return ranks first over one year (6.4pp above average). It is broadly in line with the average over three years despite a meaningful period of underperformance following the result of the UK's European referendum, and SLET is above average over both five and 10 years, ranking fifth out of 15 funds and sixth out of 14 funds, respectively. The trust has a smaller-than-average discount and it has an above-average ongoing charge, although no performance fee is payable. SLET's gearing is higher than average, while its dividend yield is in line with the selected peer group average.

**Exhibit 8: Selected peer group as at 16 January 2018\***

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Standard Life Equity Income	239.7	18.9	35.6	80.5	139.0	(2.5)	0.9	No	112	3.5
City of London	1,525.7	10.9	31.8	68.4	125.6	1.1	0.4	No	108	3.9
Diverse Income Trust	395.0	16.9	44.2	105.8		0.1	1.2	No	100	3.1
Dunedin Income Growth	397.7	9.9	26.7	51.4	87.3	(10.1)	0.7	No	113	3.9
Edinburgh Investment	1,381.4	6.5	29.4	82.0	139.0	(8.1)	0.6	No	109	3.7
F&C Capital & Income	332.3	17.6	49.9	72.2	104.8	2.1	0.6	No	104	3.2
Finsbury Growth & Income	1,238.8	16.9	48.3	109.5	269.8	0.1	0.7	No	102	1.9
JPMorgan Claverhouse	404.8	14.4	40.2	80.8	121.2	(5.3)	0.8	No	113	3.3
Lowland	426.2	15.7	41.0	77.7	166.4	(5.9)	0.6	Yes	111	3.4
Merchants Trust	554.5	13.2	33.0	59.3	89.6	(7.5)	0.6	No	105	4.8
Murray Income Trust	544.2	11.3	31.4	57.9	101.1	(6.7)	0.7	No	103	4.0
Perpetual Income & Growth	924.5	7.4	19.4	72.7	139.3	(8.3)	0.7	No	106	3.6
Schroder Income Growth	205.0	10.7	36.0	77.5	141.0	(7.9)	1.0	No	100	3.2
Temple Bar	890.7	8.9	33.7	63.8	170.4	(4.9)	0.5	No	96	3.1
Troy Income & Growth	230.4	7.7	31.6	68.3	53.2	0.6	0.9	No	100	3.3
<b>Average</b>	<b>646.1</b>	<b>12.5</b>	<b>35.5</b>	<b>75.2</b>	<b>132.0</b>	<b>(4.2)</b>	<b>0.7</b>		<b>105</b>	<b>3.5</b>
<b>SLET rank (out of 15 funds)</b>	<b>13</b>	<b>1</b>	<b>7</b>	<b>5</b>	<b>6</b>	<b>6</b>	<b>4</b>		<b>3</b>	<b>7</b>

Source: Morningstar, Edison Investment Research. Note: \*Performance as at 15 January 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

There are five directors on the board of SLET; all are non-executive and independent of the manager. Chairman Richard Burns was appointed as a director in 2006 and assumed his current role in December 2014. The senior independent director is Jeremy Tigue; he joined the board in 2014 and assumed his current role in December 2015. Josephine Dixon was appointed in 2011 and Mark White in 2013. The newest member of the board is Caroline Hitch; she was appointed in January 2017 following the retirement of Keith Percy. Hitch has more than 30 years' investment management experience, most recently with HSBC, and has been a non-executive director of Schroder Asian Total Return Investment Company since February 2015.

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