EDISON

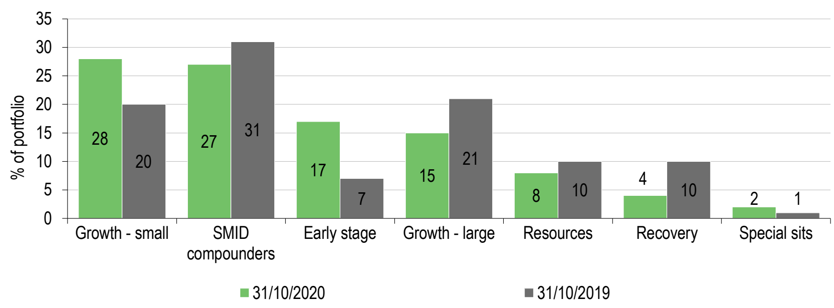
Henderson Opportunities Trust

Enthusiastically esoteric UK equity portfolio

Investment trusts
UK multi-cap growth

Henderson Opportunities Trust (HOT) has performed strongly since experiencing sharp NAV and share price declines in the Q120 market sell-off, powering to the top of the AIC UK All Companies sector over the past 12 months with an NAV total return of c 40% in the second half of 2020. Managers James Henderson and Laura Foll say performance has benefited from holding a number of 'next-generation leaders' in the UK. The portfolio is esoteric in its make-up and seeks to avoid being overly exposed to trends in the global and domestic economy. The managers continue to see good value opportunities across the UK market, particularly on AIM, and say their intention to maintain gearing at a 'decent' level (c 10–15%) is indicative of feeling the portfolio and market offer good value.

HOT's deliberately diverse portfolio exposure (end-FY20 and end-FY19)



Source: Henderson Opportunities Trust, Edison Investment Research

The market opportunity

The UK equity market has been broadly out of favour with global investors since the 2016 Brexit referendum and even an 11th-hour trade deal with the EU has been insufficient to close the Datastream UK Index's c 23% forward P/E discount to the World index. Given the depth of the UK market (particularly in the smaller company space) and its underperformance versus other global markets in 2020, opportunities should remain for those prepared to look beyond the obvious.

Why consider investing in HOT?

- Flexible UK portfolio with diversification built into its investment process.
- Value-tilted approach with a bias towards 'next generation' growth companies.
- Strong long- and short-term performance record and consistent dividend growth.
- Trades at a discount notably wider than its peer group average despite ranking at or near the top of the 12-strong AIC UK All Companies sector for NAV total return performance over one, three, five and 10 years.

Discount has narrowed, but is still wider than peers

At 12 January 2020, HOT's shares traded at an 8.6% discount to cum-income NAV. While noticeably narrower than the c 17% average discount over the past one, three and five years, this is appreciably wider than the c 5% average discount of its peers. HOT's 2.1% dividend yield is modestly lower than the peer group average.

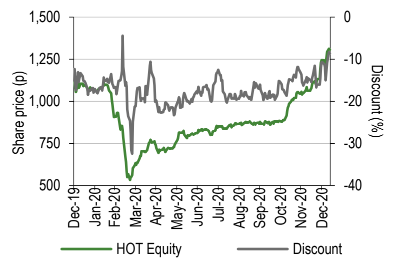
14 January 2021

Price	**1,307.5p**
Market cap	**£103.3m**
AUM	**£125.6m**
NAV*	1,430.2p
Discount to NAV	8.6%
NAV**	1,430.2p
Discount to NAV	8.6%

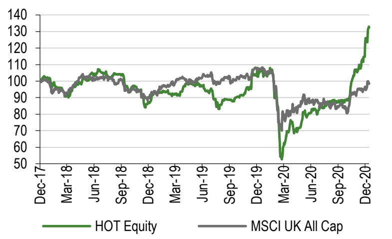
*Excluding income. **Including income. As at 12 January 2021.

Yield	2.1%
Ordinary shares in issue	7.9m
Code	HOT
Primary exchange	LSE
AIC sector	UK All Companies

Share price/discount performance



Three-year performance vs index*



52-week high/low	1,312.5p	532.0p
NAV** high/low	1,451.2p	699.1p

*Rebased to 100. **Incl. income.

Gearing

Gross*	13.0%
Net*	13.0%

*As at 30 November 2020.

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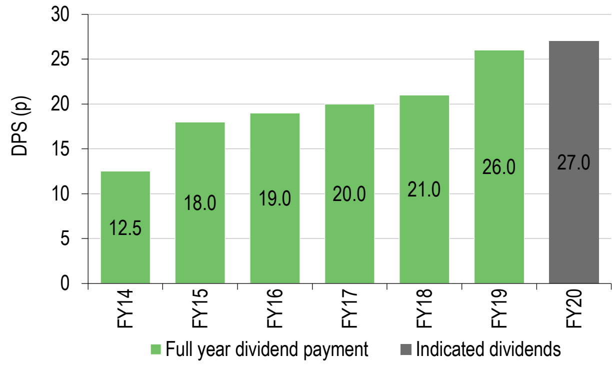
Edison profile page

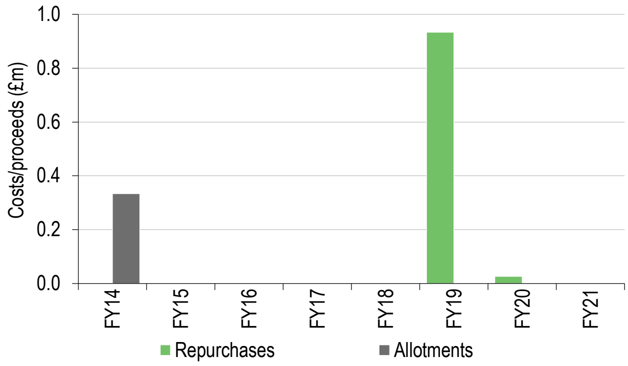
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
Henderson Opportunities Trust aims to achieve capital growth in excess of the broad UK stock market from a portfolio of UK investments. Stock selection is not constrained by the benchmark and there are no limits by sector or market capitalisation; therefore, the portfolio will differ materially from the index.	■ 10 December 2020: Peter Jones to retire as chairman at the FY20 AGM in March 2021. He will be replaced by Wendy Colquhoun, a director of HOT since September 2018. ■ 7 December 2020: Wendy Colquhoun appointed as a non-executive director of Capital Gearing Trust. ■ 24 September 2020: third interim dividend of 6.5p per share declared.

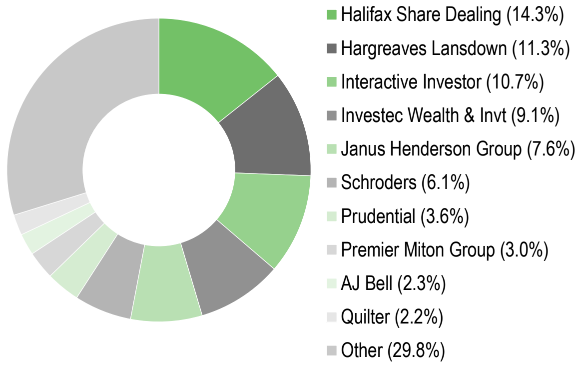
Forthcoming		Capital structure		Fund details	
AGM	March 2021	Ongoing charges	0.91% (FY19)	Group	Janus Henderson Investors
Annual results	February 2021	Net gearing	13.0%	Manager	James Henderson, Laura Foll
Year end	31 October	Annual mgmt fee	0.55%	Address	201 Bishopsgate, London, EC2M 3AE
Dividend paid	Jun, Sep, Dec, Mar	Performance fee	Yes (see page 11)		
Launch date	2007	Trust life	Indefinite, subject to vote	Phone	+44 (0) 20 7818 1818
Continuation vote	Three-yearly, next 2023	Loan facilities	£20m	Website	www.hendersonopportunitiestrust.com

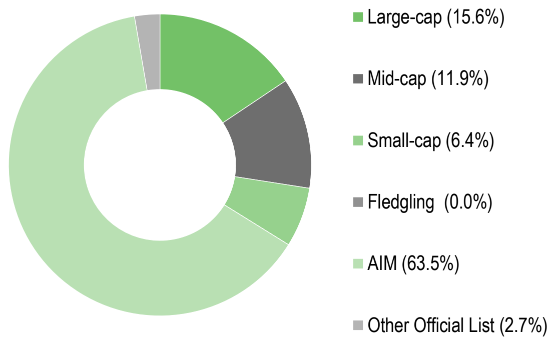
Dividend policy and history (financial years)	Share buyback policy and history (financial years)
Dividends have been paid quarterly since FY20 (previously twice a year in September and March). While income is a secondary objective to capital appreciation, HOT does seek dividend growth over time.	Renewed annually, the board has authority to buy back up to 14.99% of shares in issue. Buybacks are primarily undertaken with the aim of enhancing the NAV for shareholders, rather than limiting the discount to a specific level.





Shareholder base (at 17 November 2020)	Portfolio exposure by index (at 31 October 2020)





Top 10 holdings (at 30 November 2020)

			Portfolio weight %	
Company	**Index**	**Sector**	**30 November 2020**	**30 November 2019***
Blue Prism Group	AIM	Software & computer services	3.5	3.0
Ceres Power	AIM	Alternative energy	3.4	N/A
Oxford Instruments	Mid-cap	Electronic & electrical equipment	3.1	2.7
SigmaRoc	AIM	Construction & materials	2.9	2.3
Boku	AIM	Support services	2.9	N/A
Springfield Properties	AIM	Household goods & home construction	2.9	2.4
Serica Energy	AIM	Oil & gas producers	2.5	2.8
Tracsis	AIM	Software & computer services	2.4	3.1
RWS	AIM	Support services	2.3	4.1
Mirriad Advertising	AIM	Software & computer services	2.3	N/A
Top 10 (% of portfolio)			**28.2**	**27.8**

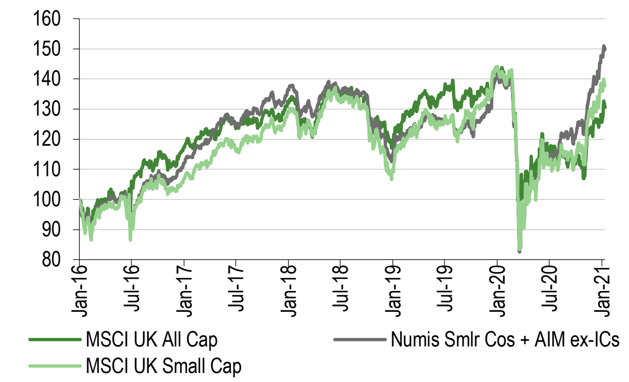
Source: Henderson Opportunities Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-November 2019 top 10.

Market outlook: Think differently in extraordinary times

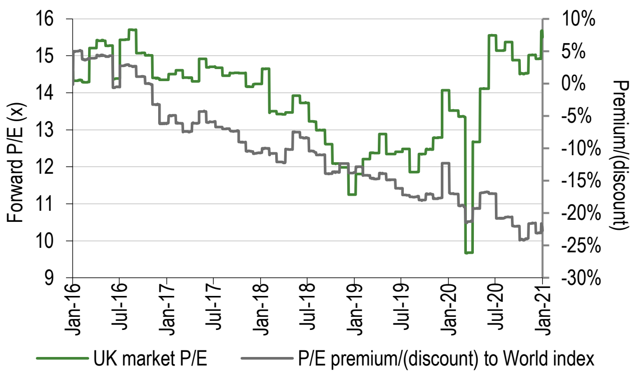
The year 2020 will doubtlessly linger in the memories of all those who make it through the coronavirus pandemic and experience its extraordinary effects throughout the world. What would have been unthinkable 12 months ago – widespread curbs on individual freedoms to promote public safety, overwhelming pressure on health services and a death toll approaching two million people – has become commonplace, although there have been bright spots such as the pace of effective COVID-19 vaccine development and fiscal and monetary stimulus to support economies.

Exhibit 2: Market performance* and valuation

Performance of UK all-cap and small-cap indices over five years



UK market forward P/E and premium/discount versus world market



Source: Refinitiv, Edison Investment Research. Note: *Performance 1 January 2016 to 12 January 2021, rebased to 100. Valuation data at 12 January 2021.

As we enter 2021, the picture remains clouded, with the pandemic still accelerating and new strains of the virus emerging. It would be easy to argue the relatively muted impact on global stock markets in 2020 – the sharp sell-off in Q1 was followed by a swift rebound and many indices ended the year close to all-time highs – means the year ahead is likely to be more challenging for investors. But while it is true some markets may have been overenthusiastic in looking past the pandemic (notably the US, where the 12-month forward P/E valuation on the Datastream US Index stands at 24.2x, essentially a decade high and 49% above the 10-year average), there are still pockets of value to be found. The UK equity market lagged much of the rest of the world in 2020, given a high COVID-19 infection and death rate, a less-than-convincing government response to the pandemic and the shadow of a no-deal Brexit. The broad UK market (measured here by the MSCI UK All Cap index) ended the year down 11.3% in total return terms (Exhibit 2, LHS) and UK dividends fell by c 40%. As shown in the right-hand chart in Exhibit 2, the Datastream UK index is at a c 23% P/E discount to the World index, although in absolute terms, the current 15.5x forward P/E is also towards the high end of the 10-year range, and 20% above the 10-year average.

So will this be the UK's year? To try to answer that question definitively is as foolish now as it would have been in January 2020, but what seems clear is that investors can help themselves by fishing in as broad a pool as possible. In income terms, the problem of dividend concentration among large-cap stocks came to a head last year, with oil companies taking the opportunity to rebase payouts to a permanently lower level and banks being mandated to suspend their dividends in anticipation of increased loan loss provisions. Yet away from the largest stocks, while some companies may have withheld dividends out of prudence, in many cases their balance sheets remain strong and there is potential for significant dividend growth once mass vaccination tips the balance against further lockdowns. And while the large-cap market may be short on technology stocks and healthcare innovators (although an honourable mention is due to AstraZeneca for its low-cost COVID-19 vaccine), both areas are alive and well in the small- and micro-cap area. Extraordinary times require a flexible mindset and a willingness to ride out short-term setbacks, but the opportunities are doubtless there for investors who are prepared to think differently.

Fund profile: Seeking opportunities across the UK

HOT has existed in its current form since 2007, but dates back to 1988 when it was launched as Henderson Strata, focusing first on global smaller companies and later on UK micro-caps. HOT has an all-cap UK equity mandate, although it retains a distinct bias towards smaller companies and a value-tilted investment style. The trust has been managed since 2007 by James Henderson, first alongside Henderson Strata's manager Colin Hughes and latterly (since Hughes's retirement in 2018) with Laura Foll, who co-manages other mandates with Henderson including Lowland Investment Company (LWI) and The Law Debenture Corporation (LWDB).

HOT's all-cap focus gives it the flexibility to seek out fast-growing smaller companies (including those listed on the junior index AIM, which make up more than 60% of the portfolio) while potentially limiting volatility through holding larger companies (currently c 16%). Although its benchmark is an all-cap UK index, the trust's portfolio differs significantly from the index, which is c 78% large cap, thus performance is also expected to diverge from the benchmark. HOT is a member of the Association of Investment Companies' UK All Companies sector.

Gearing – which the managers believe is accretive to long-term investment returns – is permitted up to 25% of net assets at the time of drawdown (15% without prior board approval), and stood at 13% at 30 November 2020. Portfolio construction is largely unconstrained, although the trust must hold between 70 and 100 stocks. Unlisted securities are limited to 10% of gross assets at the time of investment and up to 15% may be held in investment companies (including investment trusts). Up to 30% may be held in cash and bonds, but in practice HOT tends to be fully invested in shares.

The fund managers: James Henderson and Laura Foll

The managers' view: Backing 'next-generation leaders'

HOT's managers comment that the extraordinary backdrop of the past 12 months has favoured companies that are disruptors in their sectors over incumbents that may have enjoyed dominant positions in the past. Foll says 'One of our themes is companies that are "next-generation leaders" in a variety of sectors, such as alternative energy (Ceres Power, ITM Power) and communications – for example Next Fifteen (rather than WPP).' She argues that these companies will take market share and be structural growers. 'For those companies that are in structural decline, the decline has been quicker than expected, but those taking market share have done so faster than anticipated.'

As well as having more holdings in these next-generation leaders than the managers' other portfolios, Foll comments that many of the stocks in HOT's portfolio are also not dependent on the health of the economy. While some companies, such as Scottish housebuilder Springfield Properties, are quite economically sensitive, others, such as Ceres Power and process automation software company Blue Prism, are far less so. 'The portfolio benefits from being quite esoteric and not being too exposed to the economy when the economy has been quite difficult,' the manager says, giving the example of Mirriad Advertising (another early-stage holding), one of the best-performing stocks in the portfolio during FY20. 'Mirriad has really interesting technology. Using pre-existing video content, it can retrospectively and seamlessly put advertising into a film, for example making a coffee cup branded. It has a partnership with Tencent and has just signed up a big US broadcaster. It is completely scalable, and if the technology is adopted widely there is a lot of growth potential.'

Of course, in such a deliberately diverse portfolio, not every stock has been immune to the effects of COVID-19 and some industrial stocks were hit particularly hard. Fastjet, Rolls-Royce and Senior are all heavily exposed to civil aerospace, where the end market has been 'just awful – so much worse than in the global financial crisis and even after 9/11,' says Foll. Given the financial pressure on airlines, many new aircraft orders have been cancelled, which has knock-on effects for companies such as Senior and Rolls-Royce that are part of the supply chain, although Foll argues that on any return to normality, both companies' valuations are 'extraordinarily' low. 'While they may have c 50% of sales to civil aerospace, they also have exposure to other areas such as defence, and the valuations are so low that you can almost disregard the civil exposure and it would still be good value,' she adds. Rolls-Royce and Senior both participated in the market bounce of late 2020, with their share prices rising by 56% and 63% respectively, although they remain more than 50% underwater versus this time last year. The two names are still held in the portfolio, albeit at sub-1% positions, while Africa-focused, low-cost airline Fastjet delisted from AIM in August 2020 and HOT's position has been written down to zero.

One industrial stock where the managers see better times ahead is support services firm Ricardo, a consultancy that works in the automotive industry but has a strong environmental focus, helping companies to reduce emissions and carbon intensity. In the first UK lockdown, the efficiency implications of the firm's consultants being unable to visit clients meant earnings fell substantially, and Foll says the company was reluctant to reduce its headcount as the consultants are highly specialist and therefore hard to replace. 'It took them a while to make the decision to let some people go, so they had costs but not revenues,' she explains. However, long-term demand for Ricardo's services is strong, as companies work towards net zero emissions targets. 'Of all the top detractors in FY20, the share price reaction for Ricardo has been very severe and the long-term structural tailwinds are still there, so we are still very confident,' adds Foll.

Asset allocation

Investment process: Deliberately diverse

Henderson and Foll describe HOT as 'a good mixer' for a portfolio, bringing diversification as well as the possibility of significant capital appreciation from its smaller company and early-stage holdings. The managers run the trust with a similar philosophy to their other funds, based on valuation awareness, diversification and in-depth research. As HOT has no specific income requirement (although it does seek to grow its distributions over time), the managers are less concerned about the need to mitigate the impact of any dividend cuts and are therefore able to hold a slightly more concentrated portfolio of c 70–100 stocks, compared with c 80–120 for LWI and up to 150 for LWDB. The trust has a higher active share (variance from the benchmark) than the managers' other portfolios and a higher level of risk, owing to its tendency to hold bigger individual positions, and the larger proportion of smaller company holdings – in particular those listed on AIM – whose share prices may be more volatile.

HOT's investment universe is effectively made up of all the companies listed in the UK. Interactions with companies are a key part of the selection process, with the managers undertaking several hundred meetings and site visits each year. The COVID-19 pandemic has not reduced the number of interactions, although it has meant most have been carried out online. Henderson and Foll 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. Although the managers do not use specific quantitative screens to whittle down the large number of stocks in their investment universe, 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 to sales. They note that the small-cap end of the spectrum often offers superior earnings growth and a P/E discount to the wider market, albeit with the risk of lower liquidity and greater volatility of returns.

The managers divide HOT's portfolio holdings into seven classifications, or 'sleeves' (an approach they have recently adapted for LWI). Each sleeve contains stocks that are likely to perform better or worse at different points in the market cycle and, while the list may look esoteric, Henderson says the seven classifications (each with an indicative exposure range) are based on different ways of looking at valuation and the diversification should reduce the overall volatility of NAV performance over time. The sleeves are as follows:

- **Small- and mid-cap compounders (20–40% of the portfolio):** quality, usually well-established companies with strong management, offering long-term compounding of returns as they grow. At 31 October 2020 (end-FY20), this was the second largest exposure, at c 27%.
- **Growth small cap (20–40%):** these earlier-stage quality companies with correspondingly higher growth rates were the largest element of the portfolio (28%) at end-FY20.
- **Large cap (10–30%):** familiar names that nevertheless offer operational quality and long-term growth potential. These can increase the liquidity of the overall portfolio and may also be an important source of yield. Given widespread dividend cuts by larger companies, exposure at 31 October was towards the lower end of the range, at c 15%.
- **Early stage/university spinouts (0–20%):** although these may be unproven and can be risky, their prospects are largely uncorrelated to market moves and they may offer significant profit potential as assets are commercialised. After a strong period of performance in 2020 (it is notable that this category includes many technology and healthcare companies), they made up c 17% of the portfolio at end-FY20, up c 10pp compared with a year earlier.
- **Natural resources (5–15%):** positioning will depend on the commodity cycle (which was polarised in 2020, with low oil prices and high iron ore demand), but these cyclical stocks can add portfolio diversification. At 31 October, exposure was c 8%.
- **Recovery (0–20%):** contrarian value opportunities made up c 4% of the portfolio at end-FY20. The low level for this specific sleeve may be explained by the entire UK stock market (including the constituents of the other sleeves) arguably offering a 'contrarian value opportunity' in 2020.
- **Special situations (0–10%):** distinct from recovery stocks in that they offer a specific catalyst for change, such as a restructuring, rather than simply being out of favour. These accounted for 2% of the portfolio at 31 October 2020.

Henderson and Foll's long-term approach to investing tends to result in a relatively low level of portfolio turnover, although they point out this will naturally vary across the different sleeves. While compounders (usually the core of the portfolio) are designed to be held indefinitely, growth large-cap and recovery stocks may be traded more frequently, either as a source of liquidity or because the expected recovery has occurred. Turnover on an annualised basis in H120 was 12.3%, which was significantly lower than 25.1% in FY19 (implying an average holding period of around four years), probably as a result of limited trading activity during the coronavirus-driven equity market dislocation in the second half of the period (1 February to 30 April 2020). The managers take an active but measured approach to topping up and reducing holdings, to lock in gains and mitigate the possibility of future losses.

Current portfolio positioning

At end-November 2020, there were 90 holdings in HOT's portfolio (including positions written down to zero), compared with 89 a year earlier. Concentration was broadly unchanged over the 12 months, with the top 10 holdings accounting for 28.2% of the total at 30 November 2020, compared with 27.8% at end-November 2019. Seven of the top 10 holdings were common to both periods.

As shown in Exhibit 3, in sector terms, the largest changes over the 12 months to end-November 2020 were a 4.4pp increase in oil & gas (largely due to the rather counterintuitive classification of alternative energy stocks in the 'oil & gas' sector) and a 3.6pp decrease in technology. Industrials remains the largest absolute weighting, at around a quarter of the portfolio, although this is an area that has been problematic in the past year, particularly in the aerospace segment, which has been hit hard by restrictions on air travel (see The managers' view).

Exhibit 3: Portfolio sector exposure (% unless stated)

	Portfolio end-November 2020	Portfolio end-November 2019	Change (pp)
Industrials	24.1	25.8	(1.7)
Financials	19.4	21.5	(2.1)
Technology	15.4	19.1	(3.6)
Oil & gas	11.7	7.3	4.4
Consumer services	11.7	9.8	1.9
Basic materials	6.5	5.9	0.7
Consumer goods	4.4	3.7	0.7
Healthcare	4.2	5.1	(0.9)
Utilities	1.6	0.6	1.0
Telecommunications	1.0	1.2	(0.2)
	100.0	**100.0**	

Source: Henderson Opportunities Trust, Edison Investment Research

While most changes in the portfolio have been on stock-specific grounds, Foll points out there has been a higher number of exits than normal due to companies being taken over. The largest of these was patent translation specialist SGL, which was bid for by its competitor and HOT's ninth largest holding, RWS. The managers sold ahead of completion of the transaction to avoid 'doubling up' on RWS, which had already been trimmed substantially on valuation grounds. Eland Oil & Gas was also acquired by a competitor (Seplat, also London listed and focused on oil exploration and production in Nigeria), while gene-editing specialist Horizon Discovery was acquired at a substantial premium by US diagnostics firm PerkinElmer. Aggregated Micro Power was taken private at a c 30% premium to its pre-bid price, while digital media outfit Be Heard Partnership (a very small position in HOT's portfolio) was bought out by marketing agency MSQ. Foll says: 'We tend to sell on the announcement, as the chances of a competing bid are pretty rare, and we can sometimes sell above the bid price.'

New holdings include Fonix Mobile, AFC Energy, EQTEC, Anglo American and Aviva. Foll explains that Anglo American (which sits in the natural resources bucket although it is a large-cap stock) is more diversified than Rio Tinto, another of HOT's resources holdings. 'Anglo has copper and precious metals, not just iron ore,' the manager says. 'There is structural demand for copper from electric vehicles and Anglo has a new copper mine coming on in Peru. It has a low valuation and pays an attractive yield.' Insurance group Aviva – bought at a substantial discount to book value – is in the large-cap sleeve and is just over a 1% position. Foll says that under new CEO Amanda Blanc (formerly a non-executive director of the company), progress is finally being made on genuinely simplifying the business as 'she is selling off a lot of peripheral assets and seems to be achieving sale prices at considerably above the group average of 0.5x book.'

AFC Energy and EQTEC are both alternative energy names in the early-stage sleeve, building on a theme that has been running since the purchases of hydrogen fuel cell players Ceres Power and ITM Power. 'We have been reducing Ceres Power to fund these two new positions,' says Foll. AFC Energy is also involved with fuel cells but has a different end market from Ceres, working to replace diesel generators in heavy industry, such as on construction sites. EQTEC operates in waste-to-energy and is further along the road to commercialisation than its competitor Velocys (also in the HOT portfolio), with a few projects up and running already. 'Both AFC and EQTEC are still early stage, but we thought it would be good to recycle some of our profits from Ceres into next-generation companies – Ceres is now over £2bn so it felt prudent to reduce it,' says Foll.

Henderson and Foll added to several existing positions via placings in the spring of 2020. Lockdown-hit Gym Group and Hollywood Bowl both raised money to strengthen their balance sheets. 'In both cases, when they were allowed to open, membership and trading held up well,' Foll explains. 'With one lane on and one lane off (to facilitate social distancing), Hollywood Bowl was operating at full capacity. The demand is clearly there but the lockdowns have been difficult.' UPVC window company Safestyle also raised cash to help it through the pandemic, while Franchise Brands – a drain maintenance and cleaning company – conducted a placing to give it firepower for

M&A. 'With all these companies, part of the reason to support the placings is that they will emerge to a weaker competitive environment on the other side,' says Foll. 'Gym Group's competitors are small independents that might not make it; the same is true for Hollywood Bowl, or Safestyle with smaller window sellers – they could take over some independents and would benefit from that when trading normalises.'

The managers' natural inclination is to reduce positions that have done well in favour of other opportunities that may be less well appreciated in the market, but Foll explains that she and Henderson have been increasingly focused on 'running their winners.' 'It's all quite company specific, which is the nice thing about HOT,' she says. 'While we have reduced Ceres Power, we have not reduced Mirriad Advertising or Ilika; in both these cases their market cap is still very low relative to their potential size.'

Performance: Strong short- and long-term record

Exhibit 4: Five-year discrete performance data

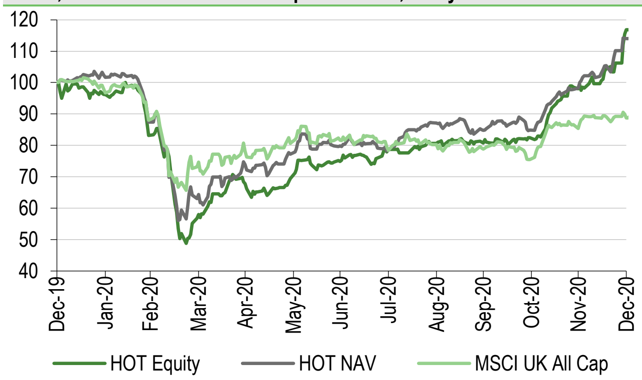
12 months ending	Share price (%)	NAV (%)	MSCI UK All Cap (%)	Numis Smlr Cos + AIM ex-ICs (%)	MSCI UK Small Cap (%)	MSCI UK Mid Cap (%)
31/12/16	(5.6)	11.0	17.3	12.0	6.8	3.3
31/12/17	32.7	24.8	13.1	21.9	21.0	9.1
31/12/18	(12.8)	(14.1)	(9.8)	(15.8)	(15.0)	(15.8)
31/12/19	23.8	18.2	18.3	22.2	30.0	19.6
31/12/20	16.8	14.0	(11.3)	4.9	(4.9)	(5.9)

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

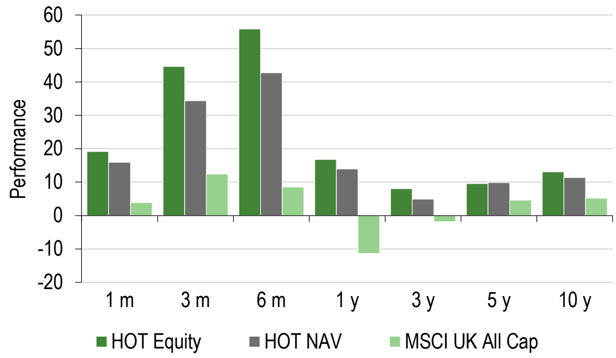
HOT's performance was hit particularly hard in the first part of the coronavirus crisis, with its NAV total return declining by more than 40% in the Q120 market sell-off, while its share price fell by c 50%. However, its diversified portfolio has served it well in subsequent months, given the mix of growth/technology companies (which did well in the initial rebound) and more value-type situations, which surged ahead in late 2020 following news of successful COVID-19 vaccine trials and an 11th-hour trade deal between the UK and European Union. As shown in Exhibit 5, HOT is now well ahead of the broad UK stock market (represented here by the MSCI UK All Cap index) over both the short and long term. While undoubtedly helped by NAV and share price total returns of 42.8% and 55.9% respectively in the second half of calendar 2020, it is important to note the longer-term annualised returns of c 10–13% over both five and 10 years.

Exhibit 5: Investment trust performance to 31 December 2020

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.

Looking at relative performance In Exhibit 6, HOT has outperformed not just the broad UK market but also both MSCI UK mid- and small-cap indices as well as the Numis Smaller Companies Plus AIM (excluding investment companies) index, which has more crossover with the trust's portfolio, building on an already strong 10-year record in both absolute and relative terms.

Exhibit 6: 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 MSCI UK All Cap	14.7	28.7	43.6	31.7	33.2	25.8	107.4
NAV relative to MSCI UK All Cap	11.7	19.5	31.5	28.5	22.1	27.5	77.8
Price relative to Numis Smlr Cos + AIM ex-ICs	9.9	19.1	19.2	11.3	16.9	7.3	61.9
NAV relative to Numis Smlr Cos + AIM ex-ICs	7.0	10.6	9.1	8.6	7.2	8.7	38.7
Price relative to MSCI UK Small Cap	11.3	20.8	28.0	22.8	19.9	16.3	40.4
NAV relative to MSCI UK Small Cap	8.3	12.2	17.2	19.8	10.0	17.9	20.3
Price relative to MSCI UK Mid Cap	13.8	28.8	33.3	24.1	32.9	47.8	130.1
NAV relative to MSCI UK Mid Cap	10.7	19.6	22.1	21.1	21.9	49.8	97.2

Source: Refinitiv, Edison Investment Research. Note: Data to end-December 2020. Geometric calculation.

Exhibit 7: NAV total return performance relative to MSCI UK All Cap index over three years

Source: Refinitiv, Edison Investment Research. Note: Rebased to 100, data from 31 December 2017 to 12 January 2021.

During FY20 (ended 31 October), many of the portfolio's strongest performing stocks came from among the 'next-generation leaders' discussed in the Managers' view section. These included Ceres Power, Blue Prism, LoopUp, Mirriad Advertising and battery technology company Ilika. The managers were particularly impressed with the operational performance of Ceres Power, which has entered a manufacturing partnership with Bosch and signed a 'really impressive commercial deal' with a Korean partner, which lends scale in terms of manufacturing and gives credibility to the technology given the due diligence requirements of such an agreement. Although the position has been trimmed during the year, Ceres Power remains HOT's second largest holding.

Videoconferencing firm LoopUp (a competitor of Zoom) was the largest detractor from performance in FY19, and although it was the biggest positive surprise in FY20, a disappointing trading update in December 2020 caused another big fall in the share price, and the position has since been exited.

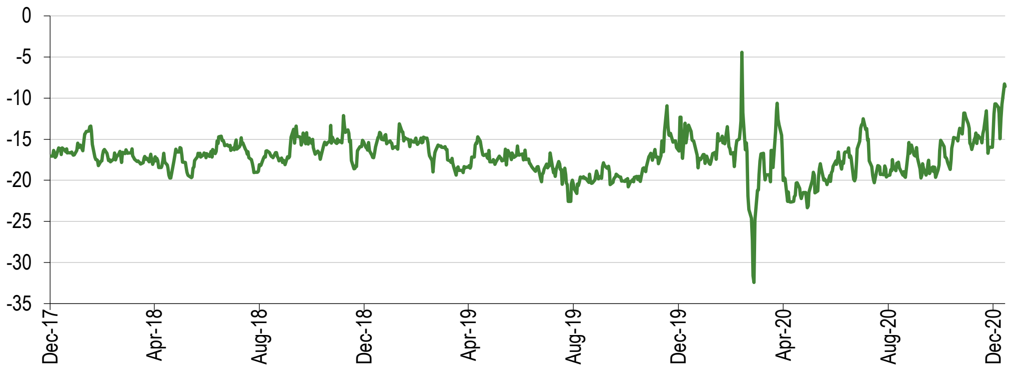
While the broad market rally towards the end of 2020 favoured stocks that had done less well in the earlier part of the year, most of HOT's best performers continued to do well, evidencing the structural tailwinds at work. In the last two months of the year, Blue Prism's shares rose a further 11.4%, Mirriad Advertising was up 21.9% and Ceres Power surged by another 88%, bringing its market cap to more than £2bn. Ilika's 135.6% share price increase was so large that the company posted an announcement to the market reminding investors that mass-market commercialisation of its products was still dependent on further technical development and successful manufacturing scale-up.

The worst-performing stocks in FY20 unsurprisingly included aerospace stocks Rolls-Royce, Senior and Fastjet, as well as support services firm Ricardo (all also covered in the Managers' view section). While Rolls-Royce and Senior both made good gains (50%+) in the November/December market rebound, Ricardo's share price remains only c 8% above its March 2020 low point, suggesting plenty of further recovery potential. Meanwhile, the share price of shopping-focused REIT Hammerson (which had significant difficulties even before the pandemic, but whose recovery potential will now take much longer to realise) has effectively remained flat since a highly dilutive rights issue in September 2020.

Discount: On the verge of a sustained re-rating?

At 12 January 2021, HOT's shares traded at an 8.6% discount to cum-income NAV. This is noticeably narrower than both short and longer-term averages (17.3%, 17.1%, 17.1% and 15.8% respectively over one, three, five and 10 years) following strong performance in Q420, a period in which the trust's 34.5% NAV total return was eclipsed by a 44.7% total return on its share price. In common with most investment trusts, HOT experienced significant discount volatility during the COVID-19 driven market sell-off and subsequent rebound in Q120. Having reached a five-year narrowest point of 4.4% on 12 March as the fall in closed-end fund prices generally lagged the faster decline in share prices of underlying holdings, HOT's discount then widened to a 10-year high of 32.4%, before rebounding to trade in a more normal range of c 10–20%. The current 8.6% discount, while narrow in the context of HOT's history, remains one of the widest in the AIC UK All Companies sector (perhaps in reaction to the high weighting in less liquid AIM stocks) despite the trust's above average short- and long-term returns (Exhibit 9). It will be interesting to see if the recent period of outperformance can translate into a more sustained improvement in HOT's rating.

Exhibit 8: Share price discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

Structured as a conventional investment trust, HOT has one class of share, with 7.9m ordinary shares in issue (unchanged over the past 12 months) at 12 January 2021. The board has an annually renewed authority to buy back up to 14.99% of shares, or allot shares up to 10% of the issued share capital. However, these powers are used infrequently and the 102,483 shares bought back during 2019 were the first repurchases in eight years. The primary reason for undertaking share buybacks is to enhance the trust's NAV when the discount is wide and the underlying holdings look particularly undervalued, rather than as a means of managing the discount.

HOT may gear via its £20m unsecured loan facility, which represents c 18% of net assets. At 30 November 2020, net gearing was 13%, which is seen as a broadly neutral level. Gearing had risen as high as 18% at end-March 2020, but this was a function of a falling portfolio NAV because of the coronavirus-led market sell-off, rather than a proactive decision to increase borrowing. For the rest of the year net gearing was broadly between 11% and 15%, the same as in 2019.

Henderson Investment Funds, HOT's alternative investment fund manager (AIFM) under the AIFM Directive, receives an annual management fee of 0.55% of net assets. A performance fee (15% of any outperformance of the benchmark) may also be paid, subject to a cap on total management and performance fees of 1.5% of average net assets. HOT outperformed its broad UK index benchmark in FY20 by c 11.2pp in NAV total return terms; however, as the trust's share price and

NAV per share were both lower at the end of the financial year than at the beginning, no performance fee is likely to be payable. Any underperformance versus the index (or any unrewarded outperformance over the fee cap) is carried forward and set against outperformance or underperformance in subsequent years. A performance fee was last paid for FY17 and ongoing charges for FY19 (when no performance fee was paid) were 0.91%.

There is a continuation vote every three years, with the next due at the March 2023 AGM. At the last vote in 2020 (as well as at the previous one in 2017), more than 99% of votes cast were in favour of continuation.

Dividend policy and record

With effect from the start of FY20 (1 November 2019), HOT moved from paying twice-yearly to quarterly dividends. Although the trust primarily seeks to achieve capital growth rather than income, it also aims to grow its annual distribution over time. Many of HOT's underlying holdings pay dividends and its portfolio yield was over 4% in late 2020.

So far for FY20 (ended 31 October), HOT has paid three quarterly dividends of 6.5p per share, in June, September and December. If this rate were to be extrapolated for the final dividend in March 2021, the FY20 distribution would match the 26p paid in FY19, which itself represented something of a step-change compared with total dividends of 21p, 20p, 19p and 18p per share in the four previous financial years. However, given HOT's long record of year-on-year dividend growth (going back to FY10), it would be reasonable to expect a small uplift in the FY20 total dividend even against a backdrop of widespread UK dividend cuts (HOT's revenues in H120 were c 40% lower than in H119). When the new quarterly schedule was announced in the FY19 annual report (published on 7 February 2020, before COVID-19 became widespread outside China), the board guided that FY20 dividends would be likely to total 27.0p (3x 6.5p and a final 7.5p). Dividends were fully covered by income in four of the previous five financial years (there was a 0.8p per share shortfall in FY18) and HOT had revenue reserves of £1.9m (c 24p per share) at end-H120, which should give it some leeway to support the FY20 dividend at the level suggested. On this basis, HOT has a prospective dividend yield of 2.1%.

Peer group comparison

HOT is a member of the Association of Investment Companies' UK All Companies sector. This is a peer group for funds that invest in UK equities but do not have a specific income mandate (covered by the UK Equity Income sector) or an explicit small-cap focus (UK Smaller Companies). However, as can be seen in Exhibit 9, all 12 of the UK All Companies funds pay dividends, while some of them focus exclusively on mid-cap or mid- and small-cap companies, so to a certain degree the distinctions between the three sectors are blurred. HOT itself, while explicitly an all-cap mandate, is currently heavily weighted (over 80%) towards smaller and medium-sized companies, including those listed on AIM. Currently the third smallest trust in the group, HOT will soon become the smallest following the liquidation of Jupiter UK Growth (with a rollover option into an open-ended fund managed by Brown Advisory) and the merger of Invesco Perpetual Select with Invesco Income Growth. Most peers are still relatively small, with six of the remaining nine below a £300m market cap.

Looking at NAV total return performance, the UK market rebound in the last quarter of 2020 has helped propel HOT to the top of the pile over the 12 months to 11 January (where it is one of only four funds to have produced a positive return). It ranks second over three years, first over five years and third over 10 years, illustrating the potential long-term benefits of a flexible and diversified approach in rapidly changing market conditions. Despite this, it has the one of the widest discounts to NAV in the group, at c 4pp above the average. Ongoing charges are competitive, although a performance fee may be payable; this is also true of four other funds in the group, an unusually high proportion for what is effectively a mainstream equity sector. Following a significant rise in HOT's share price (+12.2% in calendar year 2020 and +134.0% from the 23 March low point to the end of the year) against a backdrop of widespread UK dividend cuts, the trust's 2.1% dividend yield is now somewhat below the peer group average of 2.4%, ranking ninth out of 12 funds.

Exhibit 9: AIC UK All Companies sector at 12 January 2021*

% 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 (cum-fair)	Net gearing	Dividend yield
Henderson Opportunities Trust	**103.3**	**16.1**	**16.7**	**70.8**	**193.5**	**0.9**	**Yes**	**(8.6)**	**113**	**2.1**
Artemis Alpha Trust	154.8	8.5	20.1	53.9	52.4	1.0	No	(9.2)	100	1.3
Aurora	155.1	(6.7)	10.0	51.8	(10.0)	0.4	Yes	(3.0)	100	1.9
Baillie Gifford UK Growth	349.2	7.9	15.4	52.9	106.3	0.7	No	2.8	100	2.7
Fidelity Special Values	721.8	(8.0)	(3.8)	38.1	132.1	0.9	No	0.4	117	2.4
Independent IT	287.7	0.8	0.5	65.6	194.5	0.2	No	(9.9)	100	1.5
Invesco Perp Select UK Equity	45.0	(6.5)	(0.6)	27.1	155.4	0.9	Yes	(2.5)	119	3.9
JPMorgan Mid Cap	264.0	(5.2)	4.6	38.0	202.8	0.9	No	(9.5)	111	2.6
Jupiter UK Growth	33.9	(20.3)	(21.4)	(7.4)	20.5	1.2	Yes	(2.0)	100	2.7
Keystone	212.6	(8.0)	(3.4)	15.3	101.6	0.5	Yes	(3.2)	109	3.3
Mercantile	1,907.6	(2.0)	14.4	50.2	161.1	0.5	No	(3.7)	109	2.7
Schroder UK Mid Cap	216.4	(2.8)	9.7	44.7	169.9	0.9	No	(7.5)	108	2.2
Sector average (12 funds)	**371.0**	**(2.2)**	**5.2**	**41.7**	**123.3**	**0.7**		**(4.7)**	**107**	**2.4**
HOT rank in sector	**10**	**1**	**2**	**1**	**3**	**3**		**9**	**3**	**9**

Source: Morningstar, Edison Investment Research. Note: *Performance to 11 January 2021 based on ex-par NAV. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

There are five directors on HOT's board, all non-executive and independent of the manager. Chairman Peter Jones, who has been a director since 2011 and in his current role since 2016, will stand down at the March 2021 AGM and will be replaced by Wendy Colquhoun, who has served on the board since 2018. The other directors and their years of appointment are Chris Hills (2010), Frances Daley, chairman of the audit committee (2015) and Davina Curling (2019). The continuing directors have professional backgrounds in law, investment management and accountancy.

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