EDISON

The Law Debenture Corporation

Solid foundations for continued future growth

Investment trusts

The Law Debenture Corporation (LWDB)'s NAV total return outperformed its benchmark FTSE All-Share Index in FY18, protecting investors from c 40% of the market decline. While returns for the year were negative, LWDB has performed well in absolute terms over three, five and 10 years to 31 January 2019, producing strong NAV and share price total returns under managers James Henderson and Laura Foll. The independent professional services (IPS) business, which makes up c 14% of LWDB's NAV on a fair value basis, performed strongly in its first full year under the new executive team of Denis Jackson (CEO) and Katie Thorpe (CFO), with 9% net revenue growth after seven years of broadly flat returns, contributing c 37% of LWDB's revenue earnings per share. With c 75% of LWDB's assets invested in the UK, a planned move from AIC Global to a UK sector should facilitate comparison with more similarly invested funds.

12 months ending	Share price (%)	NAV (%)	FTSE All-Share (%)	FTSE 250 (%)	FTSE World (%)
31/01/15	2.0	5.8	7.1	6.9	17.3
31/01/16	(11.3)	(5.4)	(4.6)	3.7	(0.1)
31/01/17	23.7	25.3	20.1	13.2	33.6
31/01/18	18.6	14.6	11.3	14.6	12.7
31/01/19	(2.7)	(2.2)	(3.8)	(5.0)	0.9

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

The market opportunity

LWDB invests globally but is strongly focused on quality UK companies trading at depressed valuations, with overseas holdings used to gain exposure to areas where there is no UK equivalent, such as Microsoft. The UK is currently the most undervalued of all major equity markets (Exhibit 2), and domestically focused stocks – where LWDB is finding many attractive opportunities – are more undervalued still. Adding in portfolio yield of 3.9%, there is potential for LWDB's broadly diversified selection of stocks to produce attractive total returns once Brexit uncertainty recedes.

Why consider investing in Law Debenture?

- Unique structure, with IPS business providing an important revenue stream while sheltering some of the NAV from short-term market movements
- Established fund management team with value-focused approach, delivering NAV outperformance of FTSE All-Share over one, three, five and 10 years
- New executive team driving IPS business growth – net revenues +9.0% in FY18
- 44-year record of dividend growth; total FY18 dividend of 18.9p, +9.2% on FY17
- Proposed move to an AIC UK sector facilitates comparison with close peers

IPS revenues should support a narrower discount

LWDB's current discount to cum-income NAV (with both debt and the IPS business at fair value) is 10.9%, which is broadly in line with recent history, and wider than the AIC Global, UK All Companies and UK Equity Income sector averages. While the market tends to apply a discount to trusts perceived to have 'complicating' factors, our view is that the important revenue contribution from IPS should support a narrower, not a wider discount. LWDB currently has net gearing of 3.0% and yields 3.2%, based on the FY18 total dividend, which was up 9.2% year-on-year.

1 March 2019

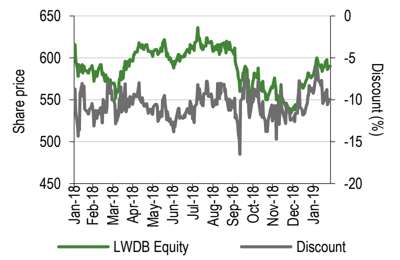
Price	**584.0p**
Market cap	**£691.4m**
AUM	**£894.3m**

NAV*	662.4p
Discount to NAV	11.8%
NAV**	655.3p
Discount to NAV	10.9%

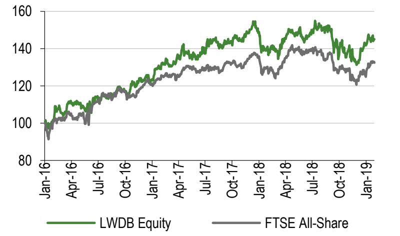
*Excluding income, with debt at par value. **Including income, with debt at fair (market) value. As at 22 February 2019.

Yield	3.2%
Ordinary shares in issue	118.4m
Code	LWDB
Primary exchange	LSE
AIC sector	Global
Benchmark	FTSE All-Share index

Share price/discount performance



Three-year performance vs index



52-week high/low	636.0p	534.0p
NAV* high/low	697.7p	609.8p

*Including income.

Gearing

Gross*	15.0%
Net*	3.0%

*As at 31 January 2019.

Analysts

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Edison profile page

The Law Debenture Corporation is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

LWDB's investment objective is to achieve long-term capital growth in real terms and steadily increasing dividend income to shareholders. The aim is to achieve a higher rate of total return than the FTSE All-Share Index through investing in a UK-biased global portfolio, diversified both geographically and by industry. LWDB's IPS business provides a regular flow of income, which augments the dividend income from the equity portfolio.

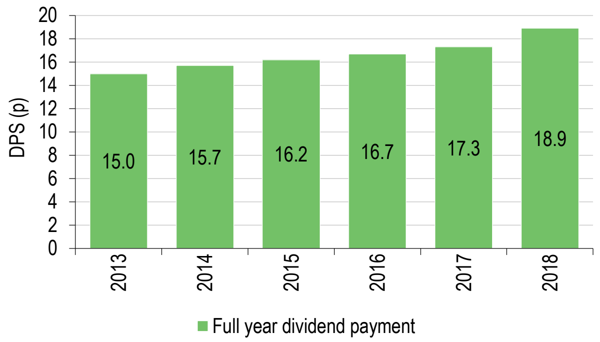
Recent developments

- 27 February 2019: Results for the year ended 31 December 2018. NAV TR -5.8% versus -9.5% for the FTSE All-Share Index; share price TR -11.6%. Final dividend of 12.9p declared, bringing the total to 18.9p, a 9.2% increase on FY17. IPS net revenues rose by 9.0% excluding exceptional items.
- 19 December 2018: LWDB's chief financial officer, Katie Thorpe, appointed to the board of directors with effect from 1 January 2019.

Forthcoming		Capital structure		Fund details	
AGM	April 2019	Ongoing charges	0.43%	Group CEO	Denis Jackson
Interim results	July 2019	Net gearing	3.0%	Managers	James Henderson & Laura Foll, Janus Henderson Investors
Year end	31 December	Annual mgmt fee	0.30% of portfolio NAV	Address	Fifth floor, 100 Wood Street, London EC2V 7EX
Dividend paid	September, April	Performance fee	None		
Launch date	1889	Trust life	Indefinite	Phone	+44 (0) 20 7606 5451
Continuation vote	No	Loan facilities	£115m long-term debt	Website	www.lawdebenture.com

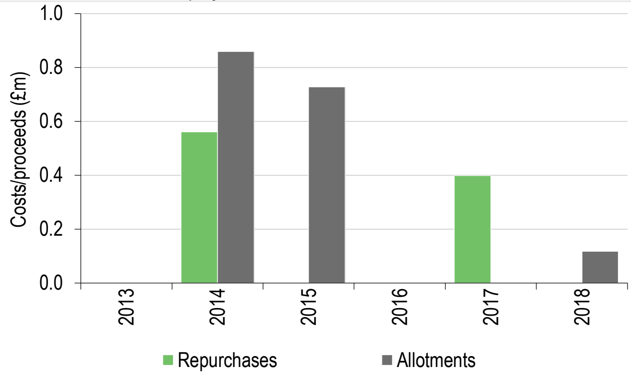
Dividend policy and history (financial years)

LWDB aims to deliver steadily increasing dividends, fully covered by revenue earnings, and has a 44-year record of increasing or maintaining its dividend.

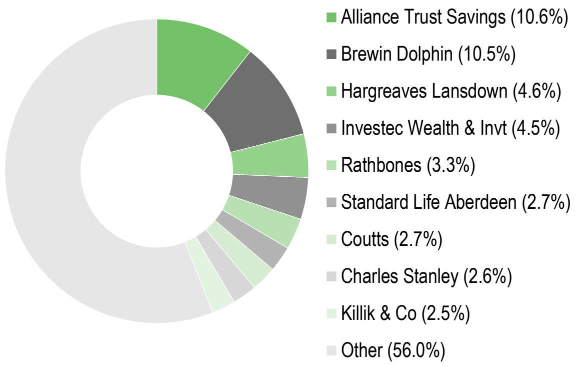


Share buyback policy and history (financial years)

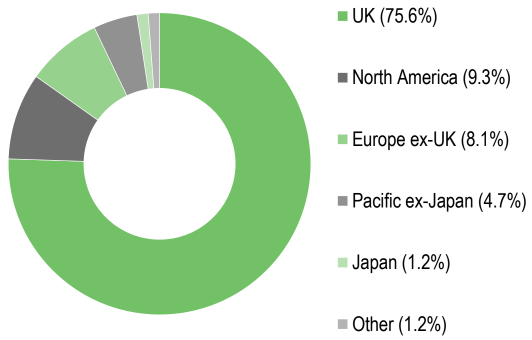
LWDB has no share buyback programme in operation. Purchases and allotment of shares refer to an employee share scheme.



Shareholder base (as at 31 December 2018)



Portfolio exposure by geography (as at 31 January 2019)



Top 10 holdings (as at 31 January 2019)

			Portfolio weight %	
Company	**Country**	**Sector**	**31 January 2019**	**31 January 2018**
Royal Dutch Shell	UK	Oil & gas producers	4.3	4.3
GlaxoSmithKline	UK	Pharmaceuticals & biotechnology	2.5	1.9
HSBC	UK	Banks	2.4	2.8
BP	UK	Oil & gas producers	2.4	2.2
Rio Tinto	UK	Mining	2.3	2.1
Rolls-Royce	UK	Aerospace & defence	2.1	2.0
Prudential	UK	Life insurance	2.0	2.0
Senior	UK	Aerospace & defence	1.9	2.2
Stewart Investors Asia Pacific	Asia Pacific	Pooled equity investments	1.9	2.2
RELX	UK	Media	1.8	1.6
Top 10 (% of holdings)			**23.6**	**23.8**

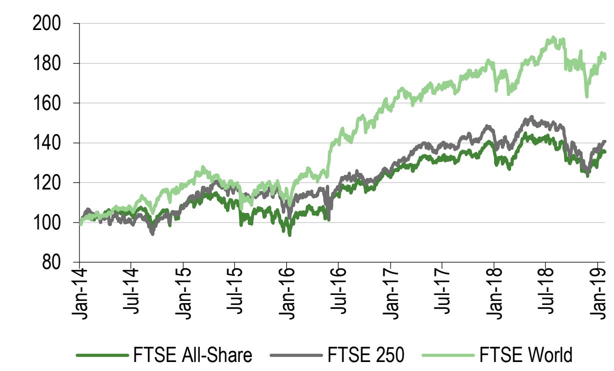
Source: The Law Debenture Corporation, Edison Investment Research, Bloomberg, Morningstar

Market outlook: Undervalued UK presents opportunity

Following a significant sell-off in global equity markets during the second half of 2018, stocks now look much more attractively valued versus history (Exhibit 2, right-hand chart). This is particularly true of the UK, where the 12-month forward P/E multiple is 12% below its five-year average, compared with 2% for the US and 3% for the world as a whole. The UK has suffered from negative investor sentiment since the referendum on EU membership in June 2016, although as shown in the left-hand chart, the FTSE All-Share and FTSE 250 indices have still produced total returns of c 40% since this point, even taking into account the sharp falls in late 2018. While it is true that investors with a global view would have enjoyed higher returns, partly owing to the weakness of sterling following the referendum, it is important to note the dominance of the US in the FTSE World index (56.9% of the total at 31 January 2019), and within that, the extent to which returns have been dominated by a handful of mega-cap technology and communications companies, whose best years of growth may arguably now be behind them. Conversely, the Bank of America Merrill Lynch monthly global fund manager survey continues to show respondents at their most underweight the UK versus history. For those investors who are willing to swim against the tide with regard to the UK, the combination of depressed earnings multiples and a high dividend yield (the Datastream UK index has a yield of 4.2%, 1.6pp above the Datastream World Index) suggests there is potential for investors to achieve good long-term returns once the Brexit overhang is removed. Meanwhile, a slowing in the pace of monetary tightening, combined with a reduction in tariff tensions between the US and its trading partners, could provide wider support for an improvement in global investor sentiment, even against a backdrop of moderating economic growth.

Exhibit 2: Market performance and valuation

UK all-cap and mid-cap indices versus FTSE World over five years



12m forward P/E valuations and dividend yield for Datastream indices

	Last	High	Low	5-year average	Last as % of average	Dividend yield
UK	12.5	15.7	11.3	14.2	88	4.2
US	16.7	19.0	14.8	17.0	98	2.0
Europe	12.7	15.5	11.6	13.7	93	3.5
Japan	13.0	15.9	12.3	14.1	92	2.3
Asia ex-Japan	12.9	14.2	11.3	12.7	102	2.5
World	14.4	16.3	13.0	14.8	97	2.6

Source: Refinitiv, Edison Investment Research. Note: Valuation data at 26 February 2019, using Datastream indices.

Fund profile: 130 years of doing things differently

LWDB was set up in 1889 to facilitate the issue of corporate debentures, an area from which its IPS business still derives a substantial portion of its revenues. Today, the company operates as two distinct businesses – an investment trust (c 86% of fair value NAV), with a diversified investment portfolio mainly invested in UK equities, and a provider of independent professional services (c 14% of fair value NAV) covering pensions, corporate trusts and corporate services (see IPS performance and fair value, below). The investment trust portfolio is managed by James Henderson and Laura Foll at Janus Henderson Investors, who aim to achieve long-term capital growth and steady growth of income over time. The contribution to income from the IPS business (37% of the revenue return per share in the year ended 31 December 2018) gives the investment managers greater flexibility to seek capital growth, while remaining confident in LWDB's ability to extend its 40-year record of increasing or maintaining its dividend.

Although it invests globally, LWDB uses the FTSE All-Share Index as a benchmark, reflecting the dominance of the UK in the investment portfolio. Under existing allocation guidelines, the proportion in the UK is expected to be between 55% and 80%, with between 0% and 20% in the US, and between 0% and 10% in each of Europe, Japan, Asia ex-Japan and rest of the world. However, LWDB has announced that it will seek to move from its current Association of Investment Companies (AIC) Global sector to one of the UK sectors. With the UK sector definitions stipulating a maximum overseas exposure of 20%, the managers have indicated that the proportion of UK investments is likely to rise moderately from the current 75.6%; it would be reasonable to expect an adjustment in the allocation guidelines as a result. Gearing is permitted up to 20%, and stood at 3% (net) at 31 January 2019.

At a corporate level, LWDB is led by Chief Executive Officer Denis Jackson, who has been in post since the beginning of FY18, and Chief Financial Officer Katie Thorpe, who joined in the summer of 2018.

IPS performance and fair value

LWDB has slightly adjusted the way it presents its IPS business, and now looks at it as three rather than four divisions: pensions, corporate trusts and corporate services (which now includes whistleblowing services, previously a separate division). FY18 marked the business's first full year under CEO Denis Jackson, and saw a significant increase in revenues (net of cost of sales) across all three divisions, leading to overall net revenue growth of 9.0% compared with FY17. Profit after tax (excluding a gain on the disposal of Nordic Trustee Holdings in FY17) was up 10.0%. A similar level of revenue growth is being targeted for FY19, which marks a step-change from seven years of broadly flat returns up to the end of FY17. Initiatives begun during FY18 include a greater focus on cross-selling services, and investing in IT systems to improve efficiency. During the year, LWDB appointed a chief technology officer, David Williams, who Jackson says can help to ensure that the company is "at the front end of best practice via technology".

Looking at IPS by business area, the **pensions** business marks its 50th year of operation in 2019. LWDB is the UK's largest and longest-established independent pension trustee service provider, acting for 200 of the country's 5,500 defined benefit (DB) schemes, including those of around a quarter of the companies in the FTSE 100 index, as well as an increasing number of defined contribution (DC) schemes. Top-line revenues for the pension trustee business in FY18 were £9.5m, an increase of 14.7% on £8.3m in FY17, which Jackson stresses is the result of new work (whether new clients or additional services for existing clients), rather than price increases. The pension trustee business is very 'sticky' – LWDB CFO Katie Thorpe comments that the average duration of client relationships is nearly 10 years. LWDB offers a range of pension trustee services, including sole trustees for smaller schemes. In 2017, it launched an outsourced pension administration and governance service, Pegasus, which saw significant demand growth in FY18, often from larger schemes. Jackson says that recent moves – such as Work & Pensions Secretary Amber Rudd's call for harsh prison sentences for employers who mismanage company pension schemes – will increase the focus on governance in pensions management, leading to growth opportunities for providers of professional trustee services as long-serving lay trustees retire. Looking ahead, LWDB plans to: capitalise on growth opportunities from building its referral partner network; use technology to create smarter working practices and maximise revenue; continue to increase its penetration of the DC pensions market; and scale up the Pegasus business significantly.

The **corporate trusts** service was the foundation of LWDB's IPS business in 1889, and acts as a bridge between the borrower/issuer of a loan or bond and the lender/investor, protecting the interests of the investors. The business's income, which rose by 5.8% in FY18, comes from a mixture of acceptance and special fees, and annuity-type annual fees over the life of the loan note or bond. Two-thirds of the annual revenue base is contracted, with most of those fees enjoying inflation-linked uplifts. The business took on 250 trustee engagements in FY18, acting as trustee to bonds with an issuance value of nearly £600bn. Jackson comments that FY18 was the second-best year since the global financial crisis in terms of new corporate trusts business (a 24% year-on-year increase in new business fees), which will translate into higher recurring revenues in the coming years. Special fees account for a significant proportion of income, and may arise from situations such as restructurings, ratings downgrades or defaults, as required by the trust deed. Jackson explains that in unfavourable market conditions, new issuance may stall, but LWDB can still earn significant fees from acting for investors (in its capacity as the legal creditor) in the event of a default. While court actions can be lengthy and the rate of recovery uncertain, this does provide an element of counter-cyclicality in terms of the business's revenues. The focus for the corporate trusts business in the coming year is to: continue to build its customer base in growing specialist areas such as infrastructure and social housing; deepen relationships with banks and law firms in order to leverage its network; and continue to develop its international capability. Jackson says LWDB is also seeking a partner to help it meet demand to offer a level of return on clients' cash in escrow.

LWDB's **corporate services** business helps clients establish and maintain legal entities such as special purpose vehicles, through the provision of company secretarial, governance, accounting and administrative services, as well as independent whistleblowing services through its Safecall subsidiary. Corporate services made the largest contribution to IPS revenues in FY18, with net income of £11.7m, up 6.9% on FY17. Most of the business is international, but may require a local agent for process serving; LWDB has offices in London, Jersey, New York, Delaware and Hong Kong, and is targeting growth in Latin America and Asia, where it is under-represented. Jackson comments that many international businesses favour the English legal system but otherwise have no need for a UK office. Looking ahead, LWDB intends to grow corporate services via cross-sales to existing customers of the IPS business, and is implementing smart technology initiatives to increase automation and improve efficiency in service of process.

Included within corporate services, Safecall is LWDB's smallest business unit but was the fastest-growing in FY18, with revenues up 15.4% in FY18 and 44% over three years, exceeding £1.6m for the first time. Based in Sunderland, the whistleblowing service is largely staffed by former police officers, who are experienced in dealing sensitively with victims and witnesses while establishing the facts of a case. Jackson explains that this sets the business apart from some competitors, which are less specialised and operate more of a 'call-centre' approach. FY18 saw LWDB invest in a relaunched website and a new technology platform for Safecall, which has been designed in partnership with potential as well as existing clients, to ensure its fitness for purpose. With increased corporate and public focus on compliance, governance and issues such as workplace harassment, Jackson says it feels like it is "the right time" for Safecall, which LWDB has owned since 2007, but which has only recently begun to grow meaningfully.

LWDB carries its IPS business in its statutory IFRS financial statements at book value, which is substantially below the estimated fair or market value of the businesses. In order to enable investors to make a more accurate assessment of LWDB's fair value, the management provides an independently assessed estimate of IPS fair value, based on an appropriate multiple of historical EBITDA. As shown in Exhibit 3, the EBITDA multiple, which was c 8.0x in FY16 and FY17, has been raised to 8.4x following the strong performance of the businesses throughout FY18. The multiple is based on observed market valuations for an undisclosed basket of broadly similar companies (adjusted for differences in size, liquidity, margins and growth rates), although there are few if any direct comparators for the IPS business as a whole.

Exhibit 3: Fair valuation of IPS business

£000s unless stated	31 December 2018	30 June 2018	31 December 2017	31 December 2016
IPS valuation				
IPS EBITDA	10,424	10,440	9,797	9,880
EBITDA multiple (x)	8.4	8.4	7.9	8.1
Operational value of IPS	87,562	87,696	77,396	80,028
IPS surplus net assets	16,844	22,800	17,176	9,908
IPS fair value	104,406	110,496	94,572	89,936
IPS fair value per share (p)	88.2	93.5	80.0	76.1
LWDB fair value				
LWDB fair value per share as per IFRS financial statements (p)	566.27	638.21	633.28	560.73
IPS fair value adjustment per share (p)	66.36	70.08	61.59	62.37
Debt fair value adjustment (p)	(18.56)	(20.00)	(25.32)	(24.62)
LWDB fair value NAV per share (p)	614.07	688.29	669.53	598.48
IPS book value (IFRS) as % of total	3.9%	3.8%	3.0%	2.3%
IPS fair value as % total	14.4%	13.6%	12.0%	12.7%

Source: The Law Debenture Corporation, Edison Investment Research

The operational value of IPS rose by 13.1% in FY18 and the fair value of IPS per share rose by 10.25%, although it declined slightly in the second half of the year following an exceptional increase (+16.9%) in H118. At 88.2p per share, the fair value of IPS accounted for 14.4% of LWDB's NAV per share (with debt at fair value) at end-FY18, up from 12.0% at 31 December 2017, although it should be noted that this increase can be partly accounted for by the fall in overall NAV during the year. (Had the NAV remained static, the fair value of IPS would have risen from 12.0% to 13.2% over the year.) The IFRS book value rose from 18.4p to 21.8p per share (+18.5%) in FY18; the 66.4p per share fair value adjustment was a 7.8% increase from 61.6p in FY17.

The fund managers: James Henderson and Laura Foll

The managers' view: Opportunities in unloved domestic stocks

Henderson and Foll comment that the capitulation in parts of the UK market in December 2018 presented them with opportunities to buy favoured, high-quality companies at very depressed valuations. They note that while the FTSE All-Share Index total return for 2018 was -9.5%, the mid-cap FTSE 250 Index fell by 13.3%. Among the stocks to which they added on weakness are homeware retailer Dunelm, whose share price has rallied by more than 50% since the start of 2019, and water utility Severn Trent (a FTSE 100 company), which Foll describes as a very good-quality utility company that was trading close to its regulated asset value. Its share price has risen by c 12% year-to-date (at 26 February). They also took a new position in housebuilder Taylor Wimpey, their first foray into the sector in several years. It was purchased at 1.3x book value but quickly rallied to 1.7x; the shares also offered a dividend yield of c 11% on the purchase price. Taylor Wimpey's share price has risen by 25% year-to-date, but thanks to a 20% increase in total FY19 dividends announced in late February, its prospective yield is still an eye-catching 10.7%.

Notwithstanding Taylor Wimpey's exceptional yield, Henderson comments that it is becoming increasingly difficult for UK equity income funds to offer a yield above that of the FTSE All-Share Index, which remains stubbornly above 4%. In this regard, he says, the revenue contribution to LWDB from the IPS business is a significant benefit, as it gives him and Foll a wider choice of stocks while still providing a reasonably high and growing yield. Figures from the Link Asset Services (formerly Capita) UK Dividend Monitor show that more than one-third of UK dividends in 2018 came from just five companies. While four of these – Royal Dutch Shell, HSBC, BP and GlaxoSmithKline – are in the LWDB portfolio, the managers view the fifth, British American Tobacco, as representative of an industry in long-term decline, and therefore not in tune with their approach of seeking quality global companies with significant future growth prospects.

The managers have been net buyers of stocks in recent months, using LWDB's gearing, which stood at a net 3% at 31 January 2019. Henderson says that while he and Foll might increase gearing to as much as 10% (particularly in the event of a disorderly Brexit at the end of March, which would be likely to spark significant price weakness in UK equities), it will always tend to be lower than for the other trusts they run, as "LWDB has advantages without needing gearing on top", because of the contribution from the IPS business.

Looking ahead, Henderson says that while UK equity valuations are still quite low and the dividend outlook more robust, he and Foll are not making any major moves until the road ahead is clearer. "There will be days of panic between now and the end of March, but at the moment, we are a little more cautious," adds Foll. With c 65% of portfolio company revenues coming from overseas, compared with c 75% for the FTSE All-Share, Henderson explains that LWDB is more geared to Brexit than either the benchmark or many of its competitors. "We are very domestic – that's where the value is, and we are not apologising for it," he concludes.

Asset allocation

Investment process: Patient, diversified approach with UK bias

LWDB's fund managers describe their investment approach as providing a 'one-stop shop' for investors seeking a portfolio of quality listed companies. Henderson and Foll aim to mitigate company-specific risk by holding a diversified portfolio, while a strong focus on the UK limits the impact of currency fluctuations for sterling-based investors. The portfolio has historically been built within set geographical parameters (Exhibit 4), although these are likely to change somewhat following the trust's planned move from the AIC Global sector to one of the UK sectors. LWDB's UK exposure is currently expected to be in a range of 55% to 80%; it has tended to be at the higher end of this range (75.6% at 31 January 2019) but will probably rise a little further, given the AIC's expectation that funds in its UK equity sectors have at least 80% of their assets invested in UK stocks. It is not yet known whether the other geographical guidelines will be retained, but we believe any change is unlikely to have a material impact, since the UK is the only market with a minimum allocation above zero. The purpose of the overseas allocation is to give access to areas where there is no compelling UK equivalent; for example, Henderson says, the trust holds Microsoft because there are effectively no quality large-cap UK technology stocks.

For the core UK portfolio, Henderson and Foll select stocks on a bottom-up basis, aiming to provide a good spread of sectors but without any constraints relative to industry weightings in the benchmark FTSE All-Share Index (as shown in Exhibit 5, LWDB's sector exposure differs markedly from that of the index). They look across the market capitalisation spectrum for growing businesses trading at valuations that do not reflect their long-term growth prospects. The managers sit within Janus Henderson's global income team, giving them access to a flow of overseas stock ideas from the team's analysts. Henderson and Foll are responsible for UK and North American stocks, while LWDB's European holdings are now selected by James Ross, following the retirement of Tim Stevenson. Asian and emerging market exposure comes via open- or closed-ended funds chosen by Henderson and Foll; this offers easier settlement than holding individual stocks, as well as giving access to specialist managers and a broader range of underlying holdings.

The list of stocks is relatively long (139 names at 31 December 2018), which reflects both the managers' desire for a diversified portfolio, and the fact that they tend to build and exit positions gradually, to avoid market timing risk. Only 38 of the 139 positions at end-FY18 were larger than 1% of NAV, and none of these were stocks purchased during the year. Henderson reports that the average starting position is c 0.3% of NAV, with further additions over time dependent on the risk profile of the stock.

LWDB's objective is to provide long-term growth and steadily increasing income, but the revenue contribution from the IPS business (37% of FY18 revenue return per share) means the managers are empowered to buy stocks that are relatively low-yielding or do not pay dividends at all. The exception to this is when deploying the gearing, when they will tend to focus on relatively defensive stocks with dividend yields above the cost of borrowing (currently c 4.6%), which can provide immediate upside. The overall portfolio yield is currently 3.9% on a 12-month forward basis.

The managers have a patient approach to investing, and portfolio turnover remained low at 15.4% in FY18 (FY17: 14.0%), implying a holding period of six-and-a-half years. Positions may be reduced and ultimately sold where strong returns have led to valuations becoming stretched, limiting future upside potential.

Current portfolio positioning

At 31 December 2018, there were 139 holdings in the LWDB portfolio, up from 137 at end-FY17. This included seven collective investment funds, which made up 6.9% of the total (FY17: nine funds and 10.6% of the total). The top 10 holdings at 31 January 2019 accounted for 23.6% of the portfolio, virtually unchanged on 23.8% a year earlier (see Exhibit 1).

Exhibit 4: Portfolio geographic exposure vs allocation guidelines (% unless stated)

	Portfolio end-January 2019	Portfolio end-January 2018	Change (pp)	Allocation guidelines
UK	75.6	71.7	3.9	55-80
North America	9.3	9.6	(0.3)	0-20
Europe ex-UK	8.1	8.5	(0.4)	0-10
Pacific ex-Japan	4.7	5.4	(0.7)	0-10
Japan	1.2	2.2	(1.0)	0-10
Other	1.2	2.6	(1.4)	0-10
	100.0	**100.0**		**100.0**

Source: The Law Debenture Corporation, Edison Investment Research

In terms of geographical exposure (Exhibit 4), the UK weighting has risen somewhat over the past 12 months and, as noted above, is likely to rise a little further in order to meet the requirements of the AIC's UK sectors. North American exposure was broadly static, although there was a change in the underlying holdings, with a new US technology hardware stock, Lam Research, added during FY18. The long-term holding in US healthcare equipment manufacturer Becton Dickinson (0.9% of the portfolio at end-FY18) was sold after the end of the period. European exposure was also broadly unchanged, while the Pacific, Japan and 'other' weightings all fell, partly as a result of exits from two long-standing closed-end fund holdings, Templeton Emerging Markets (TEMIT) and Schroder Japan Growth. Foll says the Schroder fund was sold after the discount to NAV narrowed following strong performance, while the exit from TEMIT was due to the managers' increased caution on the outlook for emerging markets, because of ongoing global trade tensions.

Exhibit 5: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-December 2018	Portfolio end-December 2017	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Industrials	24.8	28.3	(3.5)	10.9	13.9	2.3
Financials	20.7	18.2	2.6	21.2	(0.4)	1.0
Oil & gas	10.8	9.4	1.4	14.3	(3.5)	0.8
Healthcare	8.9	7.5	1.4	8.5	0.4	1.0
Consumer services	7.4	8.5	(1.1)	11.5	(4.1)	0.6
Basic materials	7.3	7.1	0.2	7.8	(0.5)	0.9
Pooled equity invts	6.9	10.6	(3.7)	5.1	1.8	1.4
Consumer goods	4.5	5.9	(1.4)	13.9	(9.4)	0.3
Technology	3.7	1.9	1.8	1.0	2.7	3.7
Utilities	3.6	1.5	2.1	2.8	0.8	1.3
Telecommunications	1.4	1.2	0.2	3.1	(1.7)	0.5
	100.0	**100.0**		**100.0**		

Source: The Law Debenture Corporation, Edison Investment Research

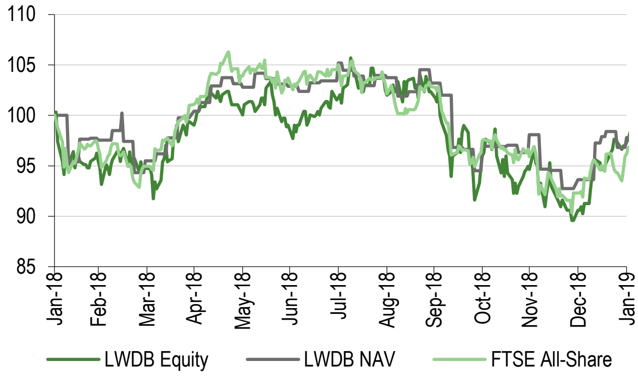
In sector terms (Exhibit 5), the biggest portfolio changes over the year were a 3.7pp reduction in pooled equity investments (noted above; Syncona was also sold after moving to a significant premium to NAV), and a 3.5pp fall in industrials. There was a noticeable change in the portfolio mix in this sector, with the largest purchase in FY18 being UK construction firm Kier Group (bought in December at 360p a share, following a rights issue that had caused the share price to halve), while Swiss sanitaryware maker Geberit and Swedish lock specialist Assa Abloy were also added in construction and materials (now 5.2%, from 3.4% at end-FY17). Most other industrial subsector weightings declined, notably support services (from 4.1% to 2.0%). Reflecting the managers' view that UK domestic stocks remain historically out-of-favour, they have taken new positions in housebuilder Taylor Wimpey and pub company Greene King. The year also saw significant increases in exposure to UK utility companies Severn Trent and National Grid (collectively 2.9% of the portfolio at end-FY18, from 1.0% at end-FY17) and additions to homeware retailer Dunelm and cruise operator Carnival. Royal Bank of Scotland was purchased after the end of the period.

Gearing remained relatively low in absolute terms, but rose during the year on a net basis from 1% to 3%. The managers would consider increasing the gearing further in order to take advantage of short-term price falls in good-quality UK companies in the event of a disorderly Brexit scenario.

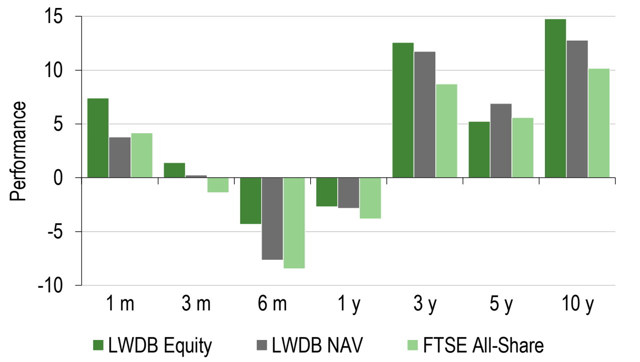
Performance: Protecting on the downside in FY18

Exhibit 6: Investment trust performance to 31 January 2019

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



Price, NAV and benchmark total return performance (%)



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

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

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE All-Share	3.1	2.8	4.5	1.2	11.1	(1.6)	50.4
NAV relative to FTSE All-Share	0.3	2.3	1.5	1.7	9.3	7.0	27.1
Price relative to FTSE 250	0.3	2.0	5.4	2.4	15.8	(5.5)	0.7
NAV relative to FTSE 250	(2.5)	1.4	2.4	2.9	14.0	2.8	(14.8)
Price relative to FTSE World	2.9	3.1	0.6	(3.5)	(6.1)	(27.5)	16.6
NAV relative to FTSE World	0.1	2.5	(2.2)	(3.1)	(7.6)	(21.1)	(1.4)

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2019. Geometric calculation.

The second half of 2018 was a period of significant equity market volatility, with most global markets seeing sharp declines towards the end of the year. LWDB's NAV total return for the year was -5.8%, which, while negative in absolute terms, was well ahead of the FTSE All-Share Index total return of -9.5%. Henderson and Foll comment that the low-beta, defensive nature of the portfolio means it is less exposed to market movements, noting that investors in LWDB were protected against c 40% of the index decline in FY18. The revenue contribution from the IPS business is an important element of total returns in a falling equity market, and portfolio income was also strong in FY18 (up 8% year-on-year).

The two largest positive contributors to LWDB's FY18 portfolio performance were GKN and Sky, both of which were sold following takeover bids. Microsoft produced the third-best performance, underlining the benefit of LWDB's ability to invest overseas, while industrial stock Accsys Technologies and pharmaceutical giant GlaxoSmithKline also contributed positively. The top five contributors added £14.6m (c 1.8% of starting NAV) to returns in FY18, with an average share price total return of +41.5%. Microsoft, Accsys Technologies and GlaxoSmithKline are all still held by LWDB, and collectively made up 5.2% of the portfolio at the year end.

In terms of detractors, the biggest was AIM-listed African airline Fastjet, which suffered from competitive pressures in its core market. Industrial stocks DS Smith and Senior both saw cyclical share price falls after several years of very strong performance, while mega-cap financial stocks Prudential and HSBC also detracted from returns. The top five detractors cost LWDB £24.5m (3.1% of opening NAV), with an average share price total return of -37.3%. With the exception of HSBC (-5.9% year-to-date), all the top detractors have recovered well so far in 2019, with DS Smith, Senior and Prudential all posting double-digit gains between 1 January and 26 February.

As shown in Exhibits 6 and 7, LWDB's NAV total return has outperformed the benchmark FTSE All-Share Index over all periods under consideration, both short- and long-term. The share price total return has outperformed the benchmark over all periods except five years. Absolute returns have been particularly strong over three and 10 years, with annualised share price and NAV total returns of c 12-15%, compared with c 9-10% for the benchmark. As a multi-cap portfolio, it is interesting to note that LWDB has also outperformed the mid-cap FTSE 250 Index over most periods. The short-term record versus the FTSE World index is also good. However, over periods of one year and longer, LWDB – which is predominantly invested in the UK – has underperformed the global index, which was buoyed by the strength of the dominant US market, with returns for UK investors enhanced by the weakness of sterling following the Brexit referendum in 2016.

Exhibit 8: NAV total return performance to 31 January 2019 (%) with debt at par value and fair value

	One month	Three months	Six months	One year	Three years	Five years	10 years
NAV ex-income, debt at par value	4.1	(0.1)	(7.8)	(3.0)	47.2	48.0	263.6
NAV cum-income, debt at fair value	4.4	0.9	(7.0)	(2.2)	40.5	40.5	235.3

Source: The Law Debenture Corporation, Morningstar, Edison Investment Research

We noted in our last report that recent rises in bond yields had reduced the fair value of LWDB's relatively high-coupon debt (although it remains higher than the book value, which has the effect of reducing the NAV with debt at fair value). This trend has persisted in recent months, with the fair value of the debt falling to £136.1m at end-FY18, compared with £137.8m at end-H118. This means fair-value NAV has continued to outperform par-value NAV over periods of one year and less (Exhibit 8).

Discount: Broadly average with scope to narrow

At 28 February 2019, LWDB's shares traded at a 10.9% discount to cum-income NAV (with both debt and the IPS business at fair value). This was wider than earlier in the month – when the discount hit a 12-month low of 6.1% – owing to a combination of a modestly declining share price and a rising NAV. The current level of discount is broadly in line with the averages over one and three years (10.6% and 9.5%), but is wider than the averages over five and 10 years, which stand at 7.6% and 8.3%, respectively. Historically, LWDB's shares traded at a premium to NAV because the share price included an implied fair value of the IPS business, while it was accounted for in the NAV at cost. However, LWDB has reported the fair value of IPS since the beginning of 2016, and has restated its NAVs for the 10 years prior to the change, enabling investors to make a meaningful assessment of performance and valuation over time. LWDB's current discount is appreciably wider than the average for the AIC investment company universe (currently 2.7%), reflecting the fact that the UK – which is the primary focus of the investment portfolio – remains out of favour with investors. (By way of context, the average discount for trusts in the UK All Companies sector is currently 7.7%.) This suggests there is scope for LWDB's discount to narrow once Brexit-related uncertainty subsides.

Exhibit 9: Share price discount to NAV (including income) over three years (%)

Source: Refinitiv, Edison Investment Research

Capital structure and fees

LWDB is structured as a conventional investment trust, with a single class of share. At 26 February 2019, there were 118.4m ordinary shares in issue. Each year, the board may repurchase up to 14.99% of shares, and allot shares up to 5% of the issued share capital, in order to manage a discount or a premium. There is no formal discount control mechanism, and in practice all allotments and repurchases in recent years have been of small amounts of shares in relation to the employee share ownership scheme.

Gearing is permitted up to a maximum of 50% of net assets, although in practice it would not be likely to go above 20%. LWDB has long-term borrowings with a nominal value of £115m, made up of two tranches: £40m nominal of guaranteed secured bonds maturing in 2034, with a coupon of 6.125%, and £75m nominal of senior secured notes maturing in 2045, with a coupon of 3.77%. The fair or market value of the debt was £136.1m at 31 December 2018, which is higher than the book value because the current low level of interest rates means higher-coupon debt is deemed more valuable. At fair value, the borrowings represented available gearing of 17.5% of fair value NAV at end-FY18. However, LWDB has significant cash on its balance sheet (£124.1m at end-FY18), and net gearing at 31 January 2019 was 3.0%.

The investment portfolio manager, Janus Henderson Investors, is paid an annual management fee of 0.30% of net assets (excluding the net assets of the IPS business), with no performance fee. Ongoing charges for FY18 were 0.43%, unchanged on FY17, ranking LWDB among the top 10 lowest-cost investment companies in the AIC universe (covering more than 400 funds), where the average ongoing charge is 1.25%.

Dividend policy and record

LWDB has a 44-year record of maintaining or increasing its total annual dividend, which is paid in two instalments – an interim payment in September, and a final dividend approved at the AGM in April and paid shortly afterwards. The revenue from the IPS business is an important differentiating factor for the trust, as it supports the payment of a higher dividend without constraining the manager to focus exclusively on higher-yielding stocks. For FY18, a recommended final dividend of

12.9p per share brings the total for the year to 18.9p, a 9.2% increase on FY17. The comparable increase from FY16 to FY17 was 3.6%. The total dividend has grown by 54.9% over the past 10 years (a compound annual rate of 4.5%), which compares with UK retail price inflation of 34.1% over the same period.

The revenue return for the investment trust portfolio in FY18 was 13.21p per share, a 14% increase on FY17. Normalised IPS earnings of 7.87p per share were 9.2% higher than in FY17, although 2.72p per share of exceptional IPS earnings in FY17 meant the group revenue return per share declined slightly (by 1.8%) to 21.26p in FY18, from 21.66p the year before. The 18.9p FY18 dividend is 1.125x covered by income. Based on the current share price and the FY18 total dividend, LWDB has a yield of 3.2%, broadly in line with the average for the peer group shown in Exhibit 10, and well above the 1.4% average yield for the trust's current AIC Global peer group.

Peer group comparison

LWDB is a member of the Association of Investment Companies' (AIC) Global sector, but is something of an outlier in the 20-fund group because of its high weighting in the UK. Below in Exhibit 10, we bring together a group of funds with between 55% and 80% of their assets (LWDB's current allocation range) in the UK as at 31 January 2019, according to the AIC. Three of the funds are in the Global sector, three are in the UK Equity Income sector, and three are UK All Companies funds (trusts in the UK sectors typically have at least 80% of their assets invested in the UK). LWDB is the largest fund in the group. In NAV total return terms, LWDB's performance ranks fourth and second of nine funds over one and three years, and fourth and fifth of eight funds over five and 10 years. Average returns are skewed by the very strong performance of Lindsell Train Investment Trust (LTI), which also trades at an extreme premium to NAV because of the value the market ascribes to its stake in investment manager Lindsell Train. If LTI is excluded, LWDB's NAV total returns are above average over all periods shown. LWDB's ongoing charges are the second-lowest in the group, and total expenses are potentially the lowest of all, as the lowest-charging fund, Woodford Patient Capital, may charge a performance fee whereas LWDB does not. LWDB's 10.0% discount to cum-income ranks it towards the lower end of the peer group, while its gearing is somewhat below average. Its 3.2% dividend yield is among the highest of the funds that do not sit in an income sector.

Exhibit 10: Selected peer group as at 26 February 2019*

% 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
AIC Global										
Law Debenture Corporation	**697.4**	**1.6**	**39.9**	**37.6**	**273.6**	**0.4**	**No**	**(10.0)**	**103**	**3.2**
Lindsell Train Investment Trust	296.0	18.0	110.6	196.2	575.8	0.9	Yes	72.8	100	1.4
Majedie Investments	147.8	1.0	25.4	47.8	130.9	1.0	No	(9.8)	111	4.0
AIC UK Equity Income										
Dunedin Income Growth	372.2	4.8	35.1	24.4	221.3	0.6	No	(8.3)	117	5.3
Shires Income	78.0	(2.3)	35.5	31.9	302.9	1.0	No	1.1	121	5.0
The Investment Company	14.2	(4.5)	7.3	11.1	495.8	2.7	No	(12.4)	100	6.5
AIC UK All Companies										
Artemis Alpha Trust	115.4	(8.4)	21.5	8.2	119.7	0.9	No	(16.3)	100	1.8
Fidelity Special Values	694.9	(0.0)	39.1	38.2	307.8	1.0	No	1.2	112	2.0
Woodford Patient Capital Trust	692.2	10.3	7.9	--	--	0.2	Yes	(11.8)	118	0.3
Peer group average	**345.3**	**2.3**	**35.8**	**49.4**	**303.5**	**1.0**		**0.7**	**109**	**3.3**
LWDB rank in peer group (9 funds)	**1**	**4**	**2**	**4**	**5**	**8**		**6**	**6**	**5**

Source: Morningstar, Edison Investment Research. Note: *Performance to 25 February 2019. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

There are six directors on LWDB's board, four of whom are non-executive and independent of the manager. Robert Hingley joined the board in October 2017 as part of a succession plan, and became chairman in April 2018 on the retirement of Christopher Smith. The other non-executive directors are Robert Laing (senior independent director), who was appointed in 2012, Mark Bridgeman (chairman of the audit committee), who became a director in 2013, and Tim Bond, who joined the board in 2015. The two executive directors are The Law Debenture Corporation Chief Executive Officer Denis Jackson (who joined the board on 1 January 2018), and Chief Financial Officer Katie Thorpe, who took up her position in June 2018 and was appointed to the board with effect from 1 January 2019. The directors have professional backgrounds in investment management, corporate finance, accountancy and law.

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