STS Global Income & Growth

STS's focus on optimising the balance between quality income and growth may prove valuable in an uncertain market environment...

Update
31 May 2023

Overview

STS Global Income and Growth Trust (STS), formerly Securities Trust of Scotland, has been renamed following an internal review to better reflect the overall investment objective of the trust, which is to deliver a growing level of income and provide steady capital growth over the long term. This follows the board's decision to award Troy the investment mandate in November 2020, due to the ability of the current managers to deliver a rising income, capital growth and standout capital preservation characteristics. This has been demonstrated through their equivalent open-ended strategy, the Trojan Global Income Fund, as discussed in **Performance**.

STS's managers, James Harries and Tomasz Boniek, currently maintain a cautious approach due to the uncertain outlook for inflation and interest rates. The pair believe their focus on high-quality companies should offer some protection through those companies' competitive advantages, surplus cash flows and greater predictability of revenues, as demonstrated by their 40% allocation to consumer staples. The expectation is that such companies should be able to cope better with rising cost pressure and be less impacted by the increased cost of capital (see **Portfolio**).

James and Tomasz are seeking to optimise the income, quality and growth potential of the portfolio to deliver a sustainable and growing long-term income. The 2023 financial year showed signs of renewed strength through increased revenue per share, resulting in a higher historical dividend yield of 2.9%.

The introduction of the **Discount** control mechanism (DCM) in 2020 has significantly tightened the discount range and increased the liquidity of the trust, whilst maintaining shareholder value. This is consistent with Troy's overarching capital preservation strategy.

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Analyst's View

We believe James and Tomasz's ability to balance the income and growth potential of the portfolio has been demonstrated by the resilience of the revenues generated by STS's underlying holdings and is reflected in the latest, higher dividend. Given their focus on quality and less cyclical businesses, we believe that STS offers a good, long-term option for investors seeking a sustainable and growing dividend over the long term. We think this is particularly important given the elevated cost of debt, which is likely to impact portfolio company earnings and make income a more significant contributor to total returns. We note STS does not seek to maximise yield and higher payouts are available. To some extent, this reflects the underweight to companies that have benefitted from higher inflation, supply disruptions and Russia's invasion of Ukraine, such as oil and gas producers. However, we believe the ever-increasing pressure to transition away from fossil fuels supports the managers' decision and adds to the attraction of the approach.

We believe the strong risk-adjusted return track record of the strategy is particularly attractive, given the heightened levels of volatility seen across financial markets. We think this is thanks to James and Tomasz's patient, valuation-sensitive approach. Furthermore, we view their high conviction and unwavering commitment to quality a refreshingly benchmark-agnostic approach to income investing. Despite facing some challenges during periods when stylistic biases have driven returns, this has allowed them to consistently preserve shareholder value over the long term.

BULL
Superior record of capital preservation compared to peer group and equity market
The managers' increased focus on optimising income and growth offers the potential for sustainable dividend growth over the long term
Strict discount control mechanism ensures shareholder value, provides greater liquidity and constrains discount volatility

BEAR
May underperform during narrow stylistic-driven market rallies
Low current yield compared to peers, although dividends are growing
Higher OCF relative to the peer group average

Portfolio

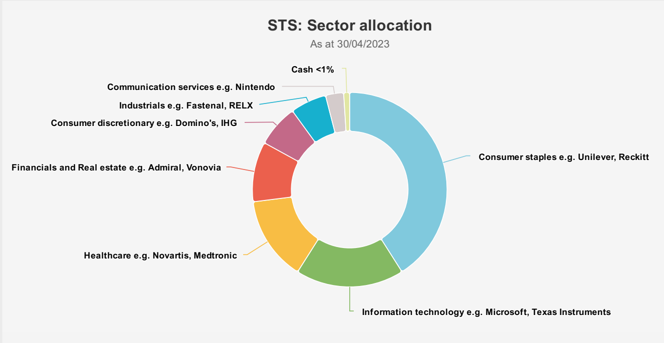
STS Global Growth and Income (STS), formerly Securities Trust of Scotland, has been renamed following an internal review by the board and managers who wanted the name to better reflect the trust's investment objectives and make that offering easily findable to new investors. This follows the board's decision to elect Troy to take over the investment management of the trust's assets in November 2020. The decision reflected the success and experience of portfolio managers James Harries and Tomasz Boniek in their equivalent open-ended strategy, the Trojan Global Income Fund. STS closely mirrors this strategy, which James and Tomasz manage with Troy's overarching investment philosophy of capital preservation and quality growth at its core, with the objective of providing shareholders with a rising level of income and long-term capital growth.

We discuss in our **previous note** the investment process that is utilised by all members of Troy's investment team. However, it is important to reiterate the emphasis on bottom-up, fundamental analysis that is undertaken regarding individual stock selection. From Troy's investible universe of c. 170 stocks, James and Tomasz identify those that they think can deliver on their capital growth and progressive income objective. The focus is on high-quality, attractively-valued companies that can demonstrate operational strengths and competitive advantages in their sectors, which are typically accompanied by opportunities to sustainably grow their income. This further narrows Troy's already unique quality-growth investment universe, which rarely identifies opportunities in sectors exposed to market cyclicality or that are operationally capital intense, such as aerospace and defence, energy and mining.

Instead, James and Tomasz focus on identifying companies that demonstrate resilience across the market cycle, particularly during periods of market uncertainty. This is reflected in STS's protective characteristics, discussed in **Performance**. As a result, they are not willing to sacrifice long-term quality for a current high yield. Rather, they focus on companies that can consistently generate surplus cash flows that are exposed to long-term structural growth opportunities. Considering this, the managers see greater opportunity in sectors such as consumer goods, healthcare and business software, i.e. information technology, as shown in the chart below.

The managers' investment process naturally leads to a relatively benchmark-agnostic portfolio versus not only typical global indices, but also compared to alternative trusts found in the global equity income sector. This is demonstrated by the trust's beta to the MSCI All Country World Index of 0.68 versus the 0.87 average beta of the peer group, since James and Tomasz took over the mandate. Despite some strong performance in 2022 by sectors not typically found in STS's portfolio, such as energy and banks, James and Tomasz believe this is more reflective of the spike in inflation and interest rates, rather than the fundamental strengths of these businesses, which they believe are likely to fare worse in a recessionary environment. As such, they have not altered their approach and have taken the opportunity to profit from elevated valuations. They have reallocated capital to offer investors a more diverse range of income generating holdings, whilst aiming to optimise the balance between the portfolio's income and growth characteristics.

Fig.1: Sector Allocation



Source: Troy Asset Management

The managers are conscious of the uncertain macro outlook. However, the operational strengths of the underlying holdings and their exposure to longer-term growth trends should positively contribute to future earnings and dividend growth. The managers' focus on quality has begun to positively impact STS's dividend growth, which they believe is likely to make a greater contribution to returns in the near future, given the likelihood of a period of sluggish capital growth in a recessionary environment. Furthermore, James and Tomasz find that their sources of quality income growth are relatively diversified. For example, contributions are made by: repeat purchase consumer goods companies, such as Unilever, Nestle and Pepsi; enterprise digital spending companies, such as Microsoft, Accenture and Paychex; and also historically dependable income producers, such as Medtronic, LINK REIT and McDonalds, which we discuss in our **previous note**. As we discuss in the **Dividend section**, this has bolstered STS's underling revenue return by 8.9%, resulting in a 5.5% year-on-year increase in dividend payouts, which has led to an improved historical yield.

James and Tomasz believe their holdings should be able to continue to raise prices through more sustainable competitive advantages. For example, Admiral Group was a strong performer during the pandemic, as it continued to receive premia from customers, despite their inability to travel. Rising inflation has put pressure on input and labour costs associated with repairs, however, to the disbelief of the market, they have been able to pass on these prices through premia. The company's niche target market - young men in fast cars – has provided them with a data set through which they have been able to develop the right pricing strategies to make a profit through the underwriting cycle. Consequently, the insurance risk has been offloaded to Munich Re. This is an example of a company exploiting its competitive position, bought at an attractive valuation.

The table below shows the strength of STS's value and quality characteristics compared to the global index, the MSCI World excluding Financials Index.

Portfolio Operating Metrics

VALUE			QUALITY		
	STS	MSCI World NR (£) (excl. financials)		STS (%)	MSCI World NR (£) (excl. financials) (%)
P/E (NTM)	16.7x	17.1x	Operating margin	27.1	13.5
Free Cash Flow Yield	5.8%	5.2%	Return on capital	16.9	9.4
Dividend Yield (NTM)	3.6%	2.3%	Return on equity	29.1	16.5

Source: Troy Asset Management, as at 28/02/2023

James and Tomasz remain cautious in deploying further capital. Alongside higher levels of inflation and higher interest rates, the pair note that, despite falling from their peaks, equity market valuations remain high relative to history. As such, they are happy to wait for them to return to more affordable levels. However, this has also presented an opportunity to rotate out of positions that have performed well into opportunities the managers feel are more sustainable in terms of valuations and structural growth. Again, this is to increase the quality of the portfolio without diminishing the income. Examples are the sales of the money transfer company Western Union and pharmaceutical giant GSK. The latter was sold before the share price was impacted by the Zantac legal case, which followed a period of robust performance. This was partly due to dollar strength, but also the demerger of GSK's consumer healthcare business, Haleon. This led James and Tomasz to conclude that the valuation was less attractive than it had been for a long time.

In a high-conviction portfolio, with 33 holdings and over 50% in the top ten, there is high competition for capital. Recent sales facilitated the topping up of higher-conviction positions, such as Nintendo, which we covered in our **previous note**. However, sales can also finance positions in future opportunities. The three biggest opportunities the managers see are in consumer goods, non-bank financials businesses and high-quality industrial companies. With persistent levels of inflation and a higher cost of capital, the pair believe that consumer goods companies may soon be available at attractive valuations. Non-bank financials include Admiral, as well as derivatives exchange CME Group, which has been benefitting from high levels of volatility in capital markets. Finally, high-quality capital-light industrial businesses include existing holdings in the highly diversified construction equipment distributor Fastenal, based in the US, and the UK-based multinational information and analytics company RELX. These companies have been performing strongly, which is reflected in their lofty valuations.

Finally, STS's unrestricted global mandate means the managers can allocate to the strongest companies, in terms of their financial performance and market positioning, leading to a portfolio purely based on the fundamental strengths of the underlying holdings. The recent investment in Texas Instruments has contributed to STS's 53% majority weight to the US and represents a quality business exposed to structural growth opportunities. Recently, the trailing-edge semiconductor sector experienced a slowdown; however, Texas Instruments is a highly profitable business with an attractive margin structure, which has been a natural beneficiary of the China and American trade war and the reshoring of manufacturing. 32% of the portfolio is invested in UK equities. However, most of these holdings generate global revenues, such as Diageo and Unilever, which have high exposure to emerging markets' revenues. This is reflected in the lower 7% underlying revenues figure attributed to the UK. As a result, STS also benefitted from sterling weakness over 2022, particularly against the dollar, increasing the value of overseas investments and the dividends that they pay.

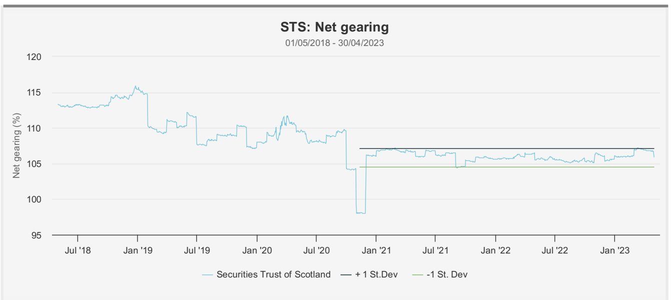
Gearing

The overarching investment philosophy taken by Troy's investment team of capital preservation means they take a moderate approach to gearing. The board has commented that it appreciates the usefulness a modest level of gearing can have on enhancing portfolio returns. STS's latest net gearing figure is 7%, as at 30/04/2023. This is at the upper bound of James and Tomasz's range since they started managing the mandate and reflects the number of valuation opportunities they are seeing in the market. We understand it is very unlikely that the level of gearing will be increased to beyond 10% in the future. However, it is possible that it may be increased from the current level if equity market valuations fall.

STS has total debt facilities available of £25m, with £15m drawn down as at the financial year end of 31/03/2023. This includes borrowings via a seven-year multi-currency banking facility, which is fully drawn and matures in

September 2023. Additionally, STS has a £10m revolving facility that pays a floating rate. This was renewed for another two years and expires at the end of September 2023, but was unutilised as at 31/03/2022. Gearing has been a useful tool for the managers to enhance the income earnings of the trust. The board has stated that facilities will be renegotiated ahead of the September 2023 expiry date.

Fig.2: Five-Year Net Gearing

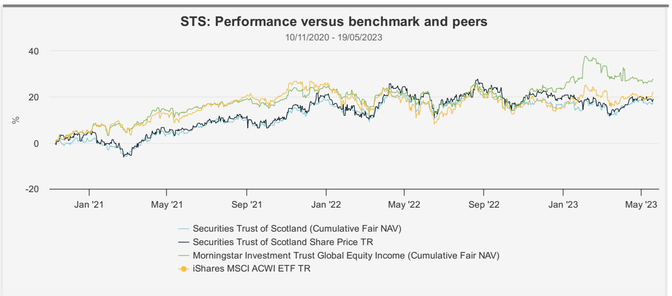


Source: Morningstar

Performance

James and Tomasz's investment strategy is focussed on generating capital growth over the long term, alongside a consistent and growing dividend. In our view, since taking over the investment mandate in November 2020, the pair have overseen a relatively stable level of performance. This is particularly true when taking into account the relatively attractive risk characteristics of the trust, which we discuss later. As illustrated in the chart below, STS's performance was noticeably stronger up until Q4 2022, which we believe was due to the managers' focus on high-quality companies that were able to perform as inflationary pressures and the rising cost of debt impacted higher-growth areas of the market that place a greater reliance on future cash flows. However, since the end of the cyclical rally in October 2022, STS has lagged strategies that have had a greater exposure to the relatively narrow tech-focussed rally. This rally has seen gains through an easing of inflation expectations, alongside the possibility of reaching peak interest rates later this year. This has impacted their longer-term performance figures and, since taking over the management of the trust, STS has generated a NAV total return of 17.4%. This compares to the global equity income sector's average NAV total returns of 27.7%, and the global equity market's 22.2% over the same period, as illustrated in the graph below using the iShares MSCI ACWI ETF as a proxy.

Fig.3: Performance Since Troy Took Over Mandate



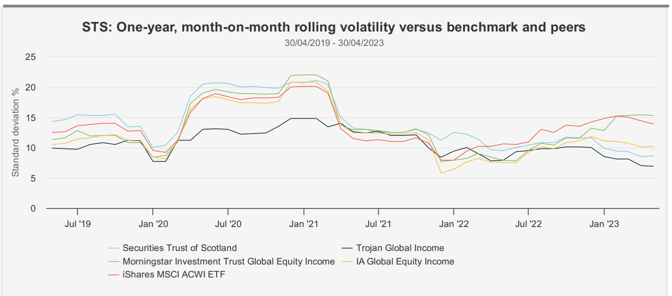
Source: Morningstar

Past performance is not a reliable indicator of future results.

However, Troy's overarching investment philosophy is a benchmark-agnostic, absolute returns focussed approach with a focus on capital preservation and strong risk-adjusted returns, particularly during turbulent market periods. In our **previous note**, we focussed on the maximum drawdowns that had been experienced by the managers across both of their global equity income strategies over the past five years. We demonstrated the significant outperformance of STS and the strategy relative to the peer group and broader equity market.

To bolster this, the chart below illustrates the one-year, month-on-month rolling volatilities of the strategies over the past five years. As we can see, the Trojan Global Income Fund's volatility has proven to be consistently low and was especially protective during the coronavirus pandemic. This is further demonstrated by the strategy's 15.6% standard deviation, compared to the sector average and the broader equity market's average of 20% over the past five years, as at 30/04/2023. We can also see that since the start of 2022, both the open-ended fund and STS under Troy's management have demonstrated more consistent and lower volatility characteristics compared to the peer group and broader equity market. We note that the relatively higher volatility of STS compared to Trojan Global Income Fund is likely to be caused by the trust's ability to use gearing, although this is employed with caution. We believe this is a testament to the high quality and resilience of the businesses James and Tomasz invest in, which we believe , in a persistently high-inflation, high-interest rate environment may prove particularly valuable.

Fig.4: Rolling Volatility



Source: Morningstar

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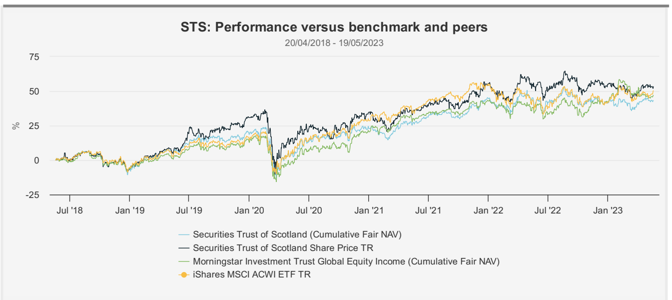
For completeness, we note that over the past five years, STS has generated a total return of 43.1%, which compares to the 47% and 50.3% generated by the AIC Global Equity Income sector and the broader equity market, respectively. However, to a large extent, this reflects the performance of the previous manager.

Fig.5: Five-Year Performance



Source: Morningstar

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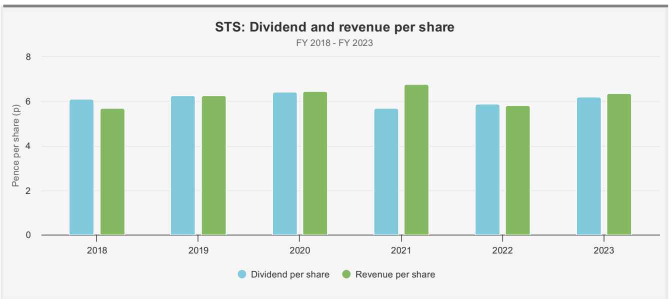
Dividend

Following the appointment of Troy as the trust's investment manager in November 2020, the board believed it beneficial to rebase the dividend. This was to account for the significant change in strategy and the cessation of the previous managers' use of option writing to enhance income generation, with James and Tomasz seeking to generate income from the dividend payments made by the portfolio's underlying holdings. Unsurprisingly, this has impacted STS's historical yield, which at the time of writing, is 2.9%. This is at the lower end of the global equity income sector's simple average yield of 3.4%.

The dividend was rebased to a level that could facilitate the rebuilding of the trust's revenue reserves. As we discuss in the **Portfolio section**, James and Tomasz's focus on quality is intended to mean the growth prospects of the portfolio provide investors with greater consistency of total return compared to strategies that look to generate additional yield by investing in high-dividend-paying companies. In their view, such companies are of a poorer quality, e.g. oil majors. This is further evidence of the managers' commitment to striking a balance between providing capital and income growth for investors, which in their view, will serve shareholders' interests better over the long term and should provide the board with the required firepower to commit to a progressive dividend policy.

The managers of STS seek to provide investors with a regular income, which is paid in quarterly instalments in April, July, October and January. For the financial year ending 31/03/2023, STS paid out 6.2p per share, which represents an increase of 5.5% on the previous financial year's dividend of 5.875p per share, following the rebasing of the FY 2020 dividend of 6.41p. Importantly, revenue per share also increased from 5.82p to 6.34p, or 8.9%, which highlights the renewed strength of the portfolio's underlying holdings compared to the first full-year's revenue generation under the new managers. In part, the managers attribute this to weakness in sterling, which as we explain in the **Portfolio section** positively impacts the earnings received in foreign currency. Despite the recent rebound in sterling, the managers are confident they can continue to grow the income. The board can pay dividends from the substantial realised capital gain reserves, but would likely only do so as a last resort.

Fig.6: Dividend And Revenue Per Share



Source: Troy Asset Management

Management

STS has been managed by senior fund manager James Harries and assistant manager, Tomasz Boniek, since Troy Asset Management took formal control of STS's portfolio on 12/11/2020. Following a competitive tender process, Troy was awarded the mandate in November 2020 following a pitch of the global equity income strategy managed by James and Tomasz within the Trojan Global Income Fund.

James has more than 20 years' experience investing in global equities and joined Troy in 2016 to establish the Trojan Global Income Fund. Prior to this, James had been a fund manager at Newton Investment Management, where he established and managed the Newton Global Income Fund. Under his management, this grew to c. £4.5bn and was ranked first in its sector over ten years. James is also co-manager of the Trojan Ethical Global Income Fund.

James is assisted by Tomasz, who is also co-manager of the Trojan Ethical Global Income Fund and assistant manager of the Trojan Global Income Fund. Tomasz joined Troy in 2017, having had a background in hedge fund equity and credit strategies.

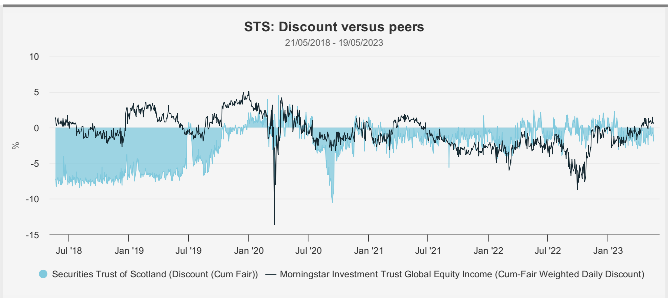
Discount

STS is trading at a 1% discount to NAV at the time of writing. This compares to the AIC Global Equity Income sector's simple average discount of 2.4%, according to JPMorgan Cazenove, as at 19/05/2023.

The trust introduced a discount control mechanism (DCM) when Troy was appointed as the trust's investment manager in November 2020. This is a consistent feature of investment trusts managed by Troy and designed to minimise discount volatility, ensure sufficient liquidity and maintain shareholder value – consistent with Troy's overarching capital and liquidity preservation philosophy. This has resulted in a significantly narrower discount range that has had an average discount of 1% since its implementation, which is narrower than the peer group's discount of 1.8% over the same period.

Maintaining this lower level of discount volatility has resulted in the board's net repurchase of 5.6 million shares since the start of the DCM, or 5.3% of the number of shares in circulation at the start of the period. This has included both share buybacks at a discount, which can be expected to enhance the net asset value of the remaining ordinary shares, and issuance during stronger NAV performance, particularly over 2022.

Fig.7: Five-Year Discount



Source: Morningstar

Charges

STS's latest ongoing charges figure (OCF) of 0.94% is the highest within the AIC Global Equity Income sector, which has a simple average OCF of 0.7% according to JPMorgan Cazenove, as at 19/05/2023. Included within this OCF is a tiered annual management fee, which is charged at 0.65% of the net assets up to £750m, 0.55% of net assets between £750m and £1bn and 0.5% of net assets above £1bn. At the time of writing, STS's NAV is £221m, which means shareholders are yet to benefit from potential economies of scale that such a structure can offer. However, the board and the managers maintain their ambitions to grow the net assets of the trust through strong performance and share issuance, with a renewed focus on marketing the trust and emphasising its merits. As an investment manager, Troy has demonstrated a track record of growing other trusts successfully, such as Personal Assets and Troy Income & Growth, so investors may very well enjoy a reduction in the OCF in due course.

The current Key Information Document Reduction in Yield figure (KID RIY) is 1.09%, which is materially lower than the simple peer group's average of 1.36%, although we would caution that calculation methodologies can vary.

ESG

James, Tomasz and the rest of the investment team at Troy fully integrate ESG analysis across all their investment strategies. The firm's long-term buy-and-hold approach and focus on quality enhances the need to consider stock-specific ESG and sustainability characteristics. A particular emphasis is on corporate governance and the quality of management, with manager meetings being a key part of the stock selection process. The in-house fundamental research is supported by external research and data sourced from MSCI, ISS and Bloomberg.

Furthermore, all members of the Troy investment team actively engage with portfolio companies to encourage better behaviours. The long-term holding periods benefit this and allow for progress on engagement to be tracked. Troy's Global Income strategy conducted 17 engagements with ten companies during 2022, which included topics such as board independence or oversight, climate change and natural resources and public health. For example, following the announcement of the UK Health and Care Act 2022, which will restrict paid-for online advertising of certain foods, Troy initiated conversations with Domino's Head of Sustainability on their strategy. This has resulted in year-on-year progress by reducing salt, sugar and fat content across the menu, and a requirement by Domino's to enhance reporting on health and nutrition using quantitative metrics, KPI's and progress reports.

The portfolio has been given an 'above average' sustainability rating and low carbon designation from Morningstar Sustainalytics. STS does not have any exclusion criteria, as demonstrated by its investment in tobacco, so will not necessarily be a fit for investors with strict negative screening requirements. However, STS could prove suitable for investors inclined towards a lower-carbon, higher ESG-rated portfolio.

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