STS Global Income & Growth

STS's balance between quality income and growth may prove resilient in a challenging economic environment...

Update
08 December 2023

Overview

STS Global Income & Growth (STS) has announced it has agreed terms for the proposed combination of assets with Troy Income and Growth (TIGT) which is planned to take place by the end of March 2024. The combination is designed to deliver a more efficient investment solution for shareholders, with the core benefits coming from increased scale. Firstly, it will allow the enlarged STS to spread its fixed costs over a larger cost base, while improving liquidity and resources for marketing. Secondly, there has been a proposed reduction in management fees of 0.15% on assets above £250m. Finally, there will be a significant cost contribution by Troy, the investment manager of STS which is the equivalent to an 18-month fee waiver, subject to a cap of £1.1m, on the assets transferred from TIGT to STS (see **Charges**).

As discussed in **Management**, the enlarged STS will continue to be managed on the same basis as currently, under the supervision of STS's existing lead portfolio manager, James Harries, who has been supported by Tomasz Boniek and the wider investment team since November 2020, when Troy was awarded the mandate. Since then, STS's high-quality, high-conviction, buy-and-hold approach has resulted in it providing superior risk and downside protection characteristics with their focus on quality and capital preservation having been beneficial over what has been a prolonged period of volatility across financial markets (see **Performance**).

STS's Chairman, John Evans, said "The combined entity will create a larger investment trust with significantly reduced overall costs and expected improved liquidity which will continue to follow Troy's long term, quality-focused, conservative investment management style with a global opportunity set. We believe it is an attractive strategy for those with irreplaceable capital and in need of income". He continued to add, "We hope this represents an important step in us being able to offer this investment approach at scale in a closed ended vehicle."

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Analyst's View

In our view, the proposed combination of assets between the two Troy trusts, will bring many positive benefits for STS shareholders that come with its increased scale. The most attractive is the reduction in costs thanks to a larger asset base and a proposed reduction of 0.15% in management fees on assets greater than £250m. In addition, shareholders exchanging TIGT shares for STS shares will also benefit from the equivalent to an 18-month fee waiver creating less of a drag on returns over the period. The enlarged trust should be investable for larger investors and should be more liquid.

We believe STS is well positioned to offer an attractive, low-risk source of income and capital growth over the longer term. The focus on capital preservation, which is supported by an active effective discount control mechanism, is an attractive feature for investors looking to protect irreplaceable capital whilst generating a growing income. Furthermore, the larger asset base that will come with the merger bolsters the trust's resources if buybacks are required over a prolonged period.

In our view, James and Tomasz's benchmark-agnostic and balanced approach to income and growth should not be affected following the absorption of TIGT's assets. STS's current dividend yield is slightly lower than TIGT's, which may make it less suitable for investors seeking a sole source of income. However, we think James and Tomasz's high-quality, valuation sensitive approach provides them with a better opportunity to capture capital gains should the underlying holdings re-rate, whilst providing the basis for a sustainably-growing dividend over time. Furthermore, investors can access greater diversification benefits through a quality-focused, global opportunity set that may complement more traditional income strategies which tend to be more exposed to the value factor.

BULL
Strict discount control mechanism ensures shareholder value and liquidity
Capital preservation, absolute returns approach leads to lower volatility and superior downside protection
The merger of assets will increase assets and significantly reduce associated costs

BEAR
OCF currently higher than peer group average, although completion of merger will reduce costs
Low current yield compared to peers
Style bias can lead to periods of underperformance

Portfolio

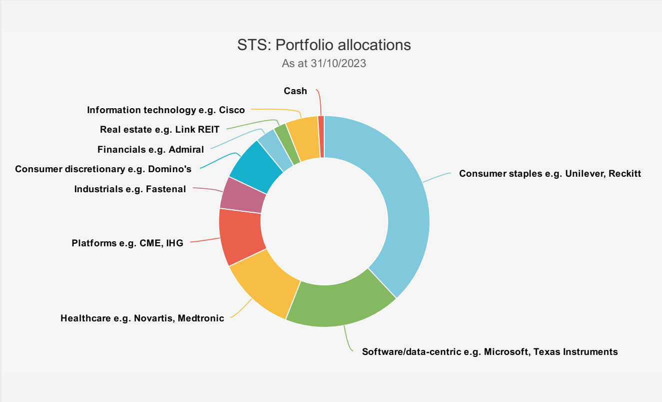
STS Global Income & Growth (STS) is managed with Troy's overarching investment philosophy of capital preservation and quality compounders at its core. James Harries and Tomasz Boniek have managed STS since Troy was awarded the mandate in November 2020. At the end of the last financial year, the trust was renamed to better reflect its strategic objectives of providing shareholders with a rising level of income and long-term capital growth via investment in global equities. Announcement of the combination of assets between STS and Troy Income and Growth (TIGT) is not expected to affect James and Tomasz's management style or the construction of the STS's portfolio.

Troy's 14-strong investment team operate a centralised equity research process which culminates in a single buy-list of c. 170 companies. The bottom-up approach is centred around identifying high-quality companies capable of delivering compounding, absolute returns across the market cycle. This naturally limits the opportunities in sectors like energy, mining and aviation because of their cyclicality to the market and high capital intensity. For STS, James and Tomasz also seek companies that can generate sustainable dividend growth and high returns on capital. This should be backed up by a strong balance sheet, which gives them the confidence to invest with conviction over the long term – demonstrated by a low 12-month turnover ratio of 10% according to Morningstar. This makes the competition for capital fiercely contested, resulting in a benchmark-agnostic strategy with 32 holdings and low beta of 0.68 versus the MSCI ACWI, which compares to the 0.87 average of the peer group.

STS is also unrestricted in terms of geographical allocation, with James and Tomasz seeking the strongest companies in terms of their financial performance and market positioning. This has resulted in a 50% exposure by listing and by revenue to the US. In terms of listing the UK allocation is 32% but the global nature of these businesses means in terms of revenue exposure it falls to 8%. Over the course of the previous financial year, ending 31/03/2023, STS's limited exposure to a weaker sterling increased the value of the overseas investments and the dividends they received – we note that since the September 2022 lows, sterling has strengthened by 15% as at 13/11/2023.

In a recent meeting, James noted they are cautious on the outlook for markets and believe the economic environment will remain structurally different to the one that preceded the start of the most recent interest rate hiking cycle. They believe interest rates and inflation are likely to remain higher for longer with opportunities to generate capital growth more limited which is likely to make dividend growth a more important contributor to total returns. Therefore, a portfolio that balances its exposure to high-quality income with long-term capital growth could be a more valuable allocation. STS is concentrated on large-cap global leaders that have a competitive advantage and pricing power. Consumer staples makes up 40% of the portfolio and includes allocations to Unilever, Procter & Gamble and Reckitt Benckiser (largest holding). The managers expect these companies to grow persistently over time due to their well diversified and recurring sources of revenue, which also offer some inflation protection, and an opportunity for margin expansion should cost pressures subside.

Fig.1: Portfolio Allocations



Source: Troy Asset Management

Business software providers, platforms and data-centric companies such as Microsoft, CME Group and RELX that supply core resources for business are also held, the managers believing they can deliver more predictable revenue streams with less sensitivity to economic environment. Such companies have also shown robust levels of dividend growth. IHG experienced 61% dividend growth, boosted by 33% revenue growth and a 27% increase in operating profit from the return to travel following the pandemic. Auinfoatic Data Processing's dividend growth is up 20%, and CME, RELX and Microsoft's dividend growth are all up by 10% on a 12-month basis. These defensive characteristics are also seen within the healthcare sector, with holdings in a global leader in medical technology, Medtronic, Swiss pharmaceuticals and diagnostics company Roche Holdings, and Novartis which has benefitted from the spin-off of Sandoz, increasing capital and managerial attention towards Novartis's core medicines business. These holdings have contributed to the robust dividend growth since James and Tomasz took over and bolstered the trust's revenue per share and revenue reserve (see **Dividend**). Moreover, having allocations to high-quality and dependable companies is reflected in the trust's superior downside protection and risk characteristics (see **Performance**).

Balance sheet strength and an ability to generate surplus cash can also reduce the need for external financing and naturally boosts companies' operational resilience. In our view, this is a particularly attractive feature in the current higher interest rate and inflationary environment.

In **our previous note** we discussed how Admiral Group successfully navigated the pandemic resulting in a significant rise in distributable dividends over this period. More recently, James and Tomasz have added to their position in Link REIT - the largest REIT in Asia. REITs have typically been at the bottom end of the quality spectrum and the hardest hit during the sharp interest rate hiking cycle. However, the managers expect high-quality real estate to be relatively defensive during what they are expecting to be a period of sluggish growth. Therefore, they took part in Link's March 2023 rights issue, seeing it recapitalise before competitors, which they fear may still have to raise money. James noted that this highlights the nimbleness and foresight of the management team and now makes Link one of the lowest levered REITs in the sector putting them in a very strong position relative to what may be forced sellers of assets. They add that Link may get a further boost if interest rates peak or are cut.

Valuations are a fundamentally important part of Troy's overarching patient and disciplined capital approach. James noted that despite the challenges faced by Diageo and Hershey's this year (see **Performance**), he believes they remain excellent long-term franchises and as long-term value holders they must be willing to hold to the upper end of historic trading ranges. That said, he took advantage of Hershey's higher share price at the start of the year to top slice the position and reallocate to better value opportunities. One example being an exchange offer where Kenvue, the former consumer health division of Johnson & Johnson, was spun out. Recent poor performance, which James attributes to selling pressures as a small holding in portfolios, has made the valuation more attractive leading to an increase in the position to c. 2%. He cites the increased focus from management and concentration on the strong brands as a reason for the valuation to recover.

James believes the industrials sector is beginning to offer value and the potential to grow at a faster rate than the consumer staple businesses they hold; however, he is patient to wait for valuations to be more attractive. In addition to Texas Instruments, the economic slowdown presented an opportunity to initiate a position in Canadian National Railway (CNR). Railroads provide an unreplaceable asset which provides a predictable compounding capital over long periods. They also have pricing power and structural advantages which James believes should become more valuable as the long-term decarbonisation of the economy becomes more important. CNR is also offering its highest dividend yield in a decade, with a 1% position; James and Tomasz will look to add to the position if the valuation becomes more attractive.

In our view, the table below shows STS's superior value and quality characteristics versus the MSCI World ex. Financials Index. In particular, we highlight the quality metrics across operating margin, return on capital and return on equity which are reflective of portfolio companies' operational resilience and Troy's focus on quality management teams. Although the portfolio is not modelled on any specific inflation or interest rate outcome, given James and Tomasz's cautious outlook, they believe this combination of dividend and capital growth should be attractive, with the portfolio's low risk characteristics providing particular security for investors with irreplaceable capital.

Gearing

STS's board appreciates the usefulness of a modest level of gearing for enhancing income and improving future portfolio returns, and as a policy the board permits gearing of up to 20% of shareholders' funds. However, in a recent meeting, James reiterated the overarching capital preservation investment philosophy taken by Troy's investment team. This leads to a more cautious approach, and we understand it is very unlikely that the level of gearing will be increased to beyond 10% in the future. That said, STS's net gearing is 6.7% as at 31/10/2023 which is close to the upper bound of James and Tomasz's range since they started managing the mandate, reflecting the number of valuation opportunities they are seeing in the market.

Since the end of the last financial year (31/03/2023), STS's long-term and revolving credit facilities have expired. These have been replaced with a new £20m multi-currency revolving credit facility with an accordion option giving

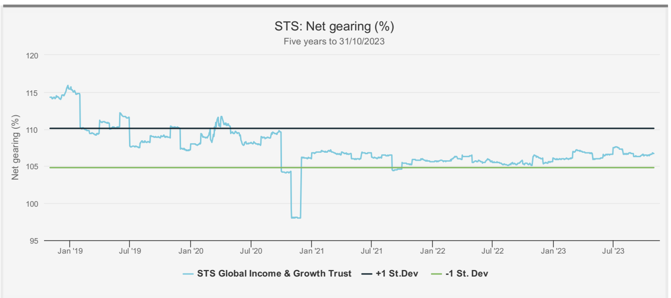
Portfolio Operating Metrics

VALUE			QUALITY		
	STS	MSCI World NR (£) (excl. financials)		STS (%)	MSCI World NR (£) (excl. financials) (%)
P/E (NTM*)	16.1x	16.4x	Operating margin	28.7	13.3
Free Cash Flow Yield	5.9%	5.3%	Return on capital	18.2	8.8
Dividend Yield (NTM*)	3.8%	2.3%	Return on equity	29.6	15.5

*Forecast for next 12 months
Source: Troy Asset Management, as at 31/10/2023

them the right to increase its line of credit by £5m with the lender. Currently drawn under this facility is £15.7m (in a combination of sterling, euros and US dollars). Given the high interest rate environment, we believe it is a sensible decision to keep debt as a short-term facility rather than locking in long-term debt at higher rates. That said, the current interest charged on the RCF is high using SONIA (5.19%) or equivalent plus a margin of 155bps.

Fig.2: Five-Year Net Gearing

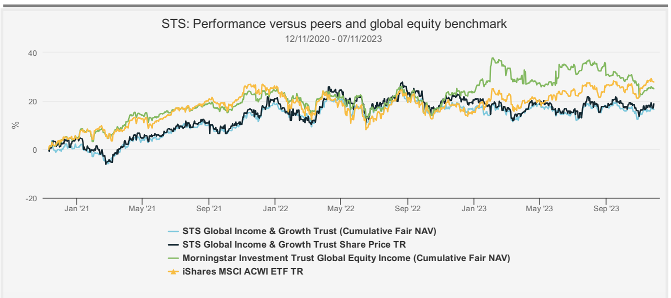


Source: Morningstar

Performance

Since James and Tomasz took over the management of the trust in November 2020, STS has generated a NAV total return of 16.5%. As we discuss later in this section, Troy's strategies typically have excellent protective characteristics which have proven particularly valuable during turbulent market conditions. Following a strong period of consistent growth up to Q4 2022, the expected easing of inflation and peak interest rates has contributed to a resurgence in a narrow cohort of US mega-cap technology stocks, bolstered by the euphoria in artificial intelligence which STS has limited exposure to. The concentration of these stocks in global equity indexes and strategies that have a greater correlation to them has meant STS's benchmark-agnostic, consumer business focused strategy has lagged over this period with the iShares MSCI ACWI Index and the global equity income sector generating a return of 25% and 27.8% respectively, as at 27/11/2023.

Fig.3: Performance Since Troy Took Over Mandate



Source: Morningstar

Past performance is not a reliable indicator of future results.

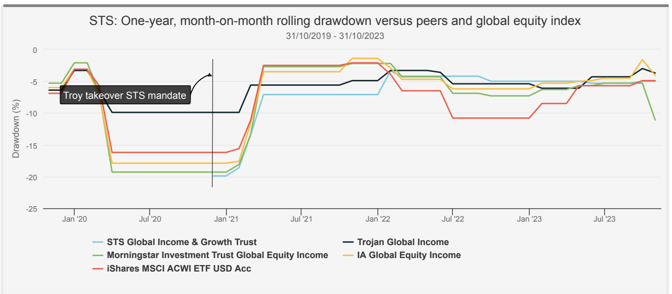
In particular, over the last 12 months James and Tomasz have seen investors' concerns around the potential change in consumer behaviour relating to the take-up of GLP-1 receptor drugs (weight loss) and the cost-of-living crisis. This has impacted spending for companies such as drinks brands conglomerate Diageo, the confectioners Hershey and tobacco companies such as British American Tobacco.

However, there have been some strong performers over the last 12 months. Microsoft is the only 'magnificent seven' holding in the portfolio and has performed well. Additionally, good returns have been delivered by platforms-provider CME Group which benefitted from increased rates trading alongside the staple-like business analytics-provider RELX. Other net contributions to returns have come from idiosyncratic events. For example, Domino's Pizza has been a strong long-term performer in a volatile market that is struggling to find its long-term trend. The introduction of a new CEO and the resolution of conflicts with franchisees has provided them with an operational boost leading to stronger recent results and a share price increase of c. 30% in sterling terms this year to date.

Although capital growth may have lagged broader equity markets, we believe the benefits of holding STS are more evident when taking into account the attractive risk characteristics. The overarching capital preservation focus of Troy is evident through James and Tomasz's ability to produce strong risk-adjusted returns – a key performance indicator across Troy's roster of investment mandates.

The pair have demonstrated how their focus on high-quality companies and an overweight to consumer driven, staple-like companies have minimised drawdowns, as shown in the chart below. This was particularly true during the pandemic and over 2022, represented by the longer standing, open-ended Trojan Global Income Fund, which we have used as a proxy for the current STS management style before James and Tomasz took over and the discount control mechanism was implemented in November 2020, as highlighted in the chart below. This is particularly evident versus the wider global equity benchmark.

Fig.4: Rolling Drawdown

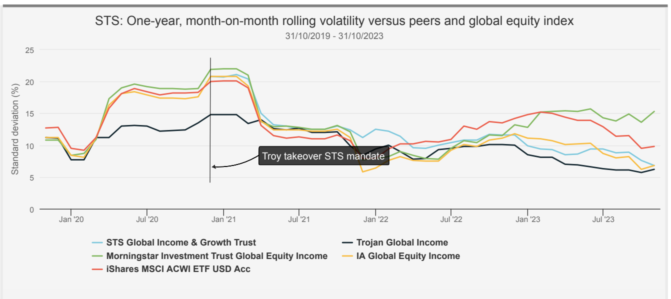


Source: Morningstar

Past performance is not a reliable indicator of future results.

In addition, James and Tomasz's strategy has delivered superior volatility characteristics with the Trojan Global Income Fund consistently the lowest versus the peer group and global benchmarks. STS has converged with this strategy offering similar characteristics when compared to the global equity income sector and the equity benchmark, although we expect it to be slightly higher given the trusts ability to utilise gearing. This is reflected through STS's sector low standard deviation of 13.6% over the period that James and Tomasz have managed the trust, compared to 16.1% and 16.4% for the sector and the global equity index respectively.

Fig.5: Rolling Volatility

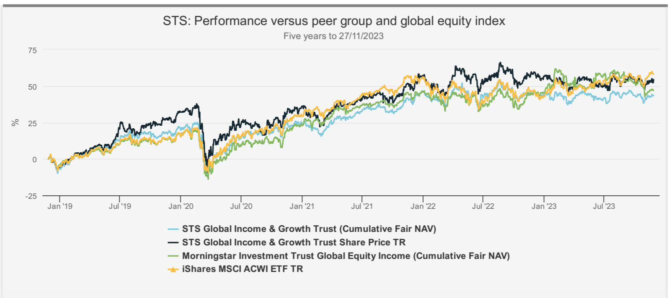


Source: Morningstar

Past performance is not a reliable indicator of future results.

Over the past five years, STS has generated a NAV total return of 43.3%, which compares to the 46.9% and 58.2% generated by the AIC global equity income sector and the broader equity market respectively. We note that a larger part of this performance reflects the previous manager.

Fig.6: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

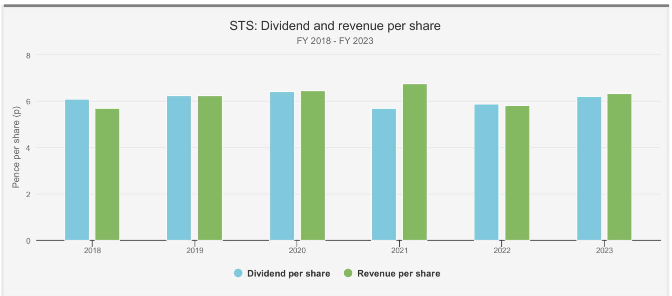
Dividend

STS aims to provide investors with a regular and rising income alongside long-term capital growth. Following the appointment of Troy as investment manager in November 2020, the board believed rebasing the dividend would be beneficial given the change in the strategy, starting at a level which would help rebuild the trust's revenue reserves and ensure the progressive dividend over the long term.

The previous managers' use of option writing to enhance income generation also ended. Instead, James and Tomasz take a simpler approach which looks to generate income from the dividends paid from the portfolio's underlying high-quality holdings. They believe such holdings should provide investors with greater consistency of total returns compared to strategies that look to invest in higher dividend-paying companies which can be poorer quality. We believe this is 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.

However, this approach has impacted STS's dividend yield which at 2.9% is at the lower end of the global equity income sector's simple average yield of 3.9%, as at 30/11/2023. STS's dividend is paid in quarterly instalments in April, July, October and January. For the financial year ending 31/03/2023, STS paid a total dividend of 6.2p per share, an increase of 5.5% on the previous financial year's dividend and an 8.8% increase from 2021 when the dividend was rebased following the change of manager. Importantly, revenue per share also increased by 8.9%, highlighting the renewed strength of the portfolio's underlying holdings compared to the first full-year's revenue generation under the new managers. In addition, c. 50% of income came from US dollar denominated dividends, the weakness in sterling over the period boosted earnings received in foreign currency and has therefore boosted the revenue reserve. This has given James and Tomasz a higher degree of confidence that they should be able to provide a progressive dividend. The board can pay dividends from the substantial realised capital gain reserves but would likely only do so as a last resort.

Fig.7: Dividend And Revenue Per Share



Source: Troy Asset Management

Management

STS has been managed by James Harries and Tomasz Boniek since 12/11/2020, following a competitive tender process where Troy was awarded the mandate in November

2020 following a pitch of the global equity income strategy managed by James and Tomasz since 2016.

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 set up 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.

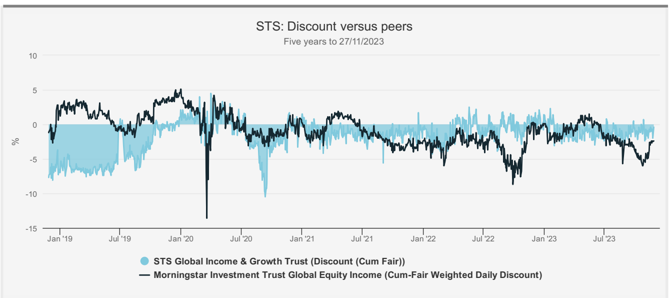
Tomasz is a fund manager within Troy and is also co-manager of the Trojan Ethical Global Income Fund and assistant manager of the Trojan Global Income Fund. Tomasz joined Troy in 2017, having had a background in hedge fund equity and credit strategies.

Discount

STS introduced a formal discount control mechanism (DCM) when Troy was appointed as the trust's investment manager in November 2020. This feature is used to ensure that in normal market conditions, shares trade consistently close to their net asset value to maintain shareholder value, minimise discount volatility and ensure sufficient liquidity. This is a feature across all investment trusts managed by Troy and consistent with the firm's overarching capital and liquidity preservation philosophy.

In our view, the introduction of the DCM has been successful since STS is currently trading on a 1.8% discount versus the 3.4% discount of the global equity income peer group average, as at 30/11/23. Furthermore, the board has been able to maintain a narrow discount/premium range since Troy took over the investment management responsibilities with an average discount of 1.1% versus the peer group average discount of 1.8%.

Fig.8: Five-Year Discount



Source: Morningstar

In achieving this lower level of discount volatility, the board has committed to buying back shares when there is excess supply and issuing when there is excess demand. Financial markets have faced a turbulent period since the DCM was introduced, resulting in the board being a net purchaser of shares. During this time there were several opportunities for the board to issues shares, particularly over 2022 when the demand for low volatility and capital preservation strategies was high. However, expectations of a plateau of interest rate rises and an easing of inflationary pressures has increased investors risk appetite and the need for STS's board to increase buybacks to enhance the net asset value of the remaining ordinary shares which has equated to a reduction of 14.9% of the NAV since the end of the financial year ending 31/03/2022. Following the proposed merger with TIGT, the larger asset base bolsters the trust's resources if buybacks are needed over a prolonged period.

Charges

STS's latest ongoing charges figure (OCF) is 0.94%. At this level, it satisfies the board's ambitions to keep the OCF at or below 1.0%. However, following the proposed merger of assets with TIGT we expect the OCF to significantly reduce given the adjustment in the tiered annual management fee structure which is linked to STS's net assets. Currently, Troy receives 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. The new tiered management fee structure will see 0.55% charged on net assets up to £250m and 0.50% on anything above, which could lead to a material reduction in the OCF.

It should be noted that, with regards to the TIGT merger, Troy has agreed to contribute towards the costs of the proposals an amount equal to the management fees payable to it in respect of the assets transferred to STS under the scheme for a period of 18 months, subject to a cap of £1.1 million.

The latest Key Information Document Reduction in Yield figure (KID RIY) is 0.96%, which is significantly lower than the simple peer group's average of 1.36%. However, calculation methodologies may vary.

ESG

ESG analysis is fully integrated across Troy's roster of investment strategies. The firm's long-term buy-and-hold approach and focus on quality has natural synergies with considering stock-specific ESG and sustainability characteristics. Troy's in-house fundamental research process places a particular focus on climate change, corporate governance and the quality of management as factors which the team believe will make a firm better placed to navigate the ever-changing investment landscape. This research is supported by external research and data providers including MSCI, ISS and Bloomberg.

Meetings with company management teams are a key part of the stock selection process as all members of the Troy investment team actively engage with portfolio companies to encourage better behaviours. The long-term holding periods allow for progress on engagement to be tracked with any engagement expected to be constructive, have a clear objective and be material in nature.

That said, STS does not have any exclusion criteria, as demonstrated by its investment in tobacco which James and Tomasz believe continues to offer defensive characteristics and a high and reliable stream of income – evidence they are looking to balance risks against opportunities to deliver their above-average returns and below-average volatility objective. Therefore, we believe STS is not necessarily fit for investors with strict negative screening requirements. That said, the portfolio has an average sustainability rating by Morningstar Sustainalytics, and it also holds the low carbon designation which is likely to appeal to investors requiring a lower carbon solution.

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