Edinburgh Investment Trust

Strong stock selection across EDIN's portfolio has been driving returns...

Update
29 November 2024

Overview

Under the management of Imran Sattar, Edinburgh Investment Trust (EDIN) has continued to build on its reputation as a strong core UK option for investors' portfolios. With nearly three decades of investment experience, Imran brings continuity to the portfolio, having worked closely with the trust's previous managers for many years before taking over as lead manager in February 2024, alongside a reinvigorated focus on a balanced, total-return-driven approach.

Over the past 12 months, EDIN has outperformed its benchmark by 5.4 percentage points, with much of this success attributed to strong stock selection. Key contributors include NatWest and Tesco, which benefitted from improved consumer and interest rate conditions, alongside Dunelm and AutoTrader, two cash-generative businesses that have reinvested capital effectively and delivered robust results.

Central to his strategy is identifying companies with an "economic moat" – those possessing structural growth potential and robust margins and benefitting from the protection of a material competitive advantage. Imran believes that companies with hard-to-replicate advantages can shield themselves from competitive pressures, preserving their market position and margins, whilst also having resilience and durability during periods of market volatility.

The UK, long seen as home to out-of-favour or undervalued sectors, currently features many companies trading at depressed valuations. Imran views this as an exceptional opportunity, noting many UK companies continue to boast the strong fundamentals and quality characteristics he is looking for. He argues there is potential for excellent long-term returns as the market corrects its mispricing over time. Accordingly, he has made several additions to EDIN's **Portfolio** over the year, selectively adding high-quality, attractively valued companies with strong economic moats and robust cash flows, including the London Stock Exchange Group, Sage, and Compass.

EDIN yields 3.7% at the time of writing and trades on a 10.3% discount, wider than its five-year average of 9.1% and the AIC UK Equity Income sector average of 3.6%.

Analysts:

Josef Licsauer
josef@keplerpartners.com

Analyst's View

We think Imran Sattar is off to an encouraging start. We believe his preference to stay style-agnostic—balancing aspects of both growth and value strategies in pursuit of total returns—positions EDIN as a compelling core holding, offering exposure to high-quality companies with strong earnings growth. Whilst we acknowledge investors may take time to build confidence in a new manager, so far under Imran's tenure this balanced approach has supported robust **Performance** and a growing **Dividend**, and we believe it could also serve investors well in volatile markets, particularly during periods where a single investment style is driving returns.

Despite strong relative performance over the past 12 months, EDIN's **Discount** of 10.3% remains wider than both its five-year average of 9.1% and the sector average of 3.6%. Whilst broader market pressures may have contributed to this disconnect, EDIN's relatively modest yield of 3.7%—in line with the FTSE All-Share Index but below the sector average of 4.3%—could have potentially deterred some income-focussed investors seeking higher yields.

That said, we think EDIN's diversified portfolio supports a more robust dividend growth profile than many in its sector and when combined with Imran's focus on quality, we argue this positions the trust well to deliver investors strong total returns. Consequently, we see the wider-than-average discount as an attractive entry point for investors and if the manager continues to outperform, we see scope for the discount to narrow, offering additional upside for investors.

BULL
Relative performance has been strong, supported by stock selection
No dogmatic style bias could mean the trust won't be as impacted in periods of sharp style rotations
Low OCF offers investors low-cost access to UK equities

BEAR
The UK market offers little exposure to certain high-growth sectors, like technology
Structural gearing can magnify losses in a falling market, as well as gains in rising ones
EDIN's dividend is lower than the sector average

Portfolio

With a career spanning nearly three decades, Imran Sattar has fully embraced a total return ethos for each strategy he has managed. Imran focusses on constructing well-diversified portfolios that balance growth, value, and recovery stocks, aiming to deliver investors a combination of capital and income growth over time. Despite his relatively short tenure on the management team of Edinburgh Investment Trust (EDIN), spanning just over a year, he has shown no deviation from this disciplined approach – a crucial driver behind the trust's strong **Performance** over the past 12 months.

Given Imran prefers employing a balanced approach, avoiding adherence to a single investment style, he is not constrained for opportunities. Instead, he can comb the entire UK market focussing on companies offering above-average earnings potential as well as some latent recovery. He also places a particular emphasis on attractively valued, cash-generative companies led by capable management teams, that have proven track records in deploying capital wisely. Whether to grow the business or return value to shareholders, Imran views this as critical to assessing a company's resilience and durability during market volatility.

A cornerstone of Imran's strategy is investing in companies with what he calls an "economic moat". These are companies with structural growth potential and strong margins, supported by competitive advantage that others in the industry struggle to replicate. Such advantages, or "moats", help shield these companies from competitive pressures, preserving their market position and long-term potential.

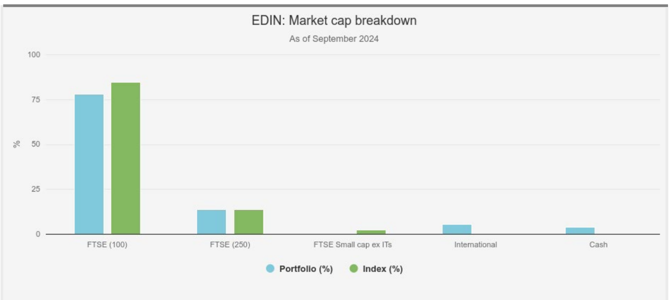
Despite his strict requirements for inclusion in the portfolio, Imran believes the opportunity set within the UK market has widened under the current conditions. The UK has garnered a reputation for housing out-of-favour or downtrodden sectors comprised of undervalued companies. However, Imran views the current undervaluation as an opportunity rather than a limitation, recognising the potential for long-term recovery and a chance to unlock long-term value in this overlooked market.

This perspective has prompted him to invest in several new, high-quality companies with strong fundamentals that are trading at material discounts, including large-cap stock Sage, a global leader in accounting software. Sage's recent dip in organic revenue growth, he argues, has created a valuation opportunity that could lead to a strong rerating as the market corrects its mispricing over time. Imran has also increased some of his existing and key long-term growth holdings, including the London Stock Exchange Group and Compass on valuation grounds.

Outside of large-caps, Imran has also identified opportunities further down the market-cap scale, notably in mid-caps. This is an area of the market that can often be a good hunting ground for less well-known opportunities offering greater capital and dividend growth potential compared to their larger counterparts. A notable addition here includes Grainger, a leading provider of private rental homes. Strong demand for rental properties, coupled with new energy efficiency regulations, has led him to believe that private rental landlords may face increasing challenges, positioning operators like Grainger to benefit.

True to his strategy, Imran has taken the opportunity to trim some positions in the portfolio's strongly performing stocks such as Marks & Spencer, Centrica, and BAE Systems. This has allowed him to fund the above changes and offer up some more capital to relocate into other undervalued opportunities elsewhere.

Fig.1: Market Cap Breakdown



Source: Liontrust, as of 30/09/2024

Like many managers in the sector, Imran has the flexibility to invest up to 20% of the portfolio in overseas companies. However, the trust's current non-UK allocation sits at around 6%, a notably low level over Imran's career but around average in the context of the wider peer group. Whilst he acknowledges the appeal of a number of high-quality businesses overseas that could complement EDIN's portfolio, he emphasises the truly exceptional opportunity set within the UK. Attractive valuations versus history, and indeed relative to international markets, have reduced Imran's need to go overseas for quality stocks, meaning most of his focus is on home-soil opportunities.

That said, Imran remains open to international opportunities but ensures that what allocation he does have represents meticulously selected businesses with the kind of characteristics or features that are not readily available in the UK market. This is exemplified by his decision to increase EDIN's position in the US-listed Verisk. Imran sees Verisk as filling a gap not met by UK companies in the data space, offering high barriers to entry, around 50% profit margins and strong cash flows. These factors are further complemented by Verisk's shareholder-friendly practices, including growing dividends and share buybacks, which Imran views as enhancements to EDIN's income streams and capital return potential.

Examining EDIN's key portfolio characteristics in the table below reveals that the trust trades at a higher price-to-earnings (P/E) figure than the index, indicating it's more expensive. However, we think this premium can be justified given the portfolio's focus on high-quality companies. The underlying companies exhibit stronger growth rates and higher returns on equity relative to the index, reflecting their superior potential for long-term performance. Additionally, the portfolio's holdings carry significantly less debt than the broader market, bolstering their resilience during periods of market stress or rising interest rates which increase the cost of debt. We think that this financial stability adds an extra layer of defensiveness to the trust.

Portfolio Characteristics

	Portfolio	Index
12-month FWD P/E (x)	17	12
Return on equity (%)	29	13
Operating margin (%)	21	11
Net debt/EBITDA (x)	1	1
Estimated EPS growth (%)	9	7

Source: Liontrust, as of 30/09/2024. *Operating margin and Net debt are ex-banks

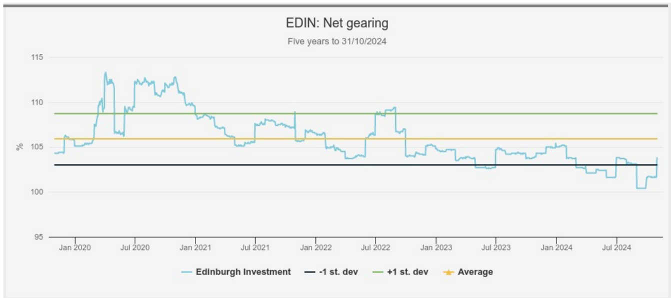
With its emphasis on quality, profitability, and financial stability, we think EDIN provides investors access to a diversified selection of companies well-positioned to deliver steady capital and income growth over time. These attributes, in our view, support the trust's valuation premium and make it a potentially compelling option for those seeking UK exposure, particularly given its wider-than-average **Discount**.

Gearing

The board views gearing as a tool to enhance returns over the long run whilst acknowledging that it can increase sensitivity to falling markets. To manage this risk, the board has a stated policy to prevent gearing from exceeding 25% of NAV. Currently, the trust's long-term borrowings equate to £120m at par, which, if fully utilised, would represent only about 10% of net assets, well within the stated limit. Effective gearing is taken out through four tranches, averaging 23 years to maturity at a fixed blended cost of 2.4% per annum – highly attractive in the context of today's higher interest rate environment.

According to the latest factsheet, EDIN's net gearing is 2.2%, towards the lower end of its range in recent years. This reflects, in part, the fall in the fair value of the debt as market yields have risen. However, the other driver is the trust's c. 3.6% cash position, which has increased as lead manager Imran Sattar has taken profits from strongly performing holdings such as BAE Systems and Centrica. Imran is gradually redeploying this cash, consistent with his disciplined investment approach, into high-quality opportunities that he believes are undervalued and poised for significant rerating as market mispricing is corrected over time.

Fig.2: Gearing

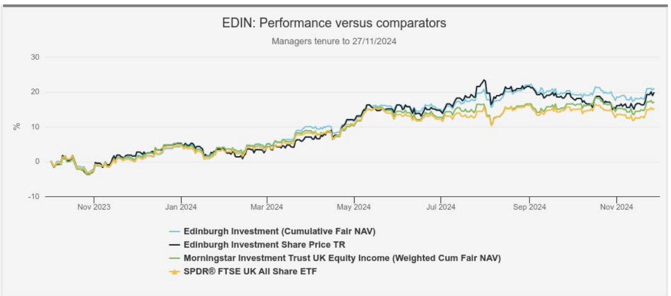


Source: Morningstar

Performance

Imran Sattar has picked up where his predecessors left off, with EDIN showcasing strong relative returns over the past 12 months against its benchmark, the FTSE All-Share Index. Imran officially took the mantle of lead portfolio manager in February 2024, following his time as deputy manager from October 2023. However, Imran made most of his portfolio adjustments between these dates, making October a reasonable starting point to assess his impact on performance, in our view. Over this period, EDIN has delivered NAV total returns of 20.9%, outperforming the benchmark and Morningstar Investment Trust UK Equity Income sector returns by 5.4 and 3.9 percentage points, respectively.

Fig.3: Performance Under Imran's Tenure



Source: Morningstar
Past performance is not a reliable indicator of future results.

We think the outperformance over this period is noteworthy, particularly given the current landscape, which is marked by challenges such as geopolitical tensions, polarised political climates, and uncertainties surrounding the pace of interest rate cuts. Equally impressive is the breadth of contributors across the portfolio, with returns driven by a diverse range of holdings rather than a single sector or heavily weighted stock.

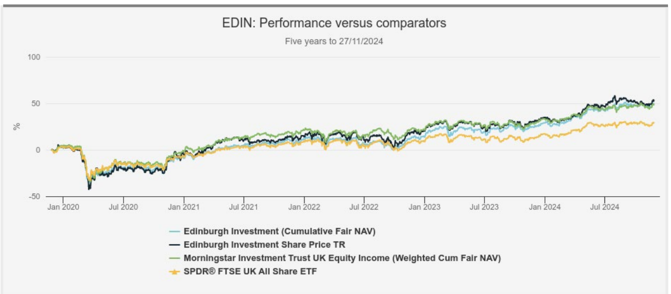
Two standout performers during this period were NatWest and Tesco, which benefitted from improved consumer and interest rate conditions. Other notable contributors included Dunelm and AutoTrader, two cash-generative businesses that have effectively reinvested capital and delivered robust annual results. Lithuanian-based Baltic Classifieds Group – a leading online classifieds platform serving sectors like real estate, automotive, jobs, and services – also performed strongly. Imran highlights it boasts a dominant position in Eastern Europe, reporting strong results and a promising growth outlook for the coming year.

Conversely, several stocks detracted from performance. The most significant was Rentokil, the pest control company, followed by Spirax-Sarco, a steam and fluids engineering firm. Spirax has faced prolonged challenges with an inventory unwind, particularly in its life sciences division following the pandemic, which has hurt earnings. Rentokil, meanwhile, has struggled with operational issues, especially in integrating its US acquisition Terminix. Despite these near-term setbacks, Imran remains confident in both businesses' longer-term prospects, citing their high-quality growth potential. He views these as temporary setbacks in growth and execution rather than indicators of deeper structural issues.

Overall, Imran expresses satisfaction with EDIN's recent performance but emphasises the importance of looking ahead. He remains steadfast in adhering to his disciplined process in order to deliver robust total returns, attributing his optimism to the operational, financial, and strategic strength of the trust's underlying businesses, rather than short-term share price movements.

For completeness, we've also included EDIN's five-year performance below. The trust delivered NAV total returns of 49.6% compared to the FTSE All-Share Index's return of 30.6%. However, we acknowledge that this period also reflects the performance of the previous managers. An ETF tracking the FTSE All-Share Index is also shown below for comparison.

Fig.4: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

Whilst we think it's reasonable for investors to take time to build confidence in a new manager, we believe Imran is off to an encouraging start. We also think the approach employed to EDIN is further supported by Imran's longer-term track record. This is something we covered in a **previous note**, but in short, Imran has employed this total return strategy consistently on the open-ended side through his fund Liontrust UK Equity, generating alpha in some tricky years, including 2020.

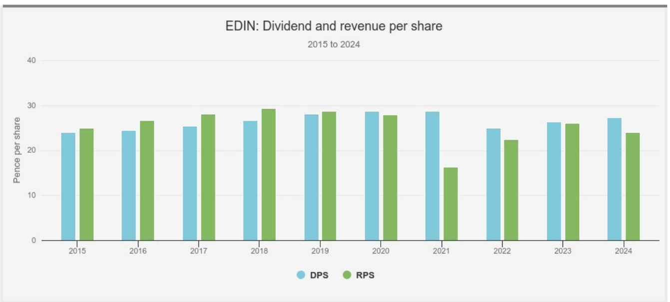
Dividend

Imran follows a total return philosophy, emphasising the importance of building a well-diversified portfolio that balances growth, value, and recovery stocks to deliver a combination of capital and income growth over time. On the income front, the aim is to deliver dividend growth exceeding the rate of UK inflation. Whilst this objective is particularly challenging during environments of unusually high inflation, something we've experienced in recent years, we think it becomes far more attainable when inflation is in a more 'normal' range.

For example, UK CPI inflation over the trust's latest reporting period (the half year to September 2024) fell from 3.2% to 1.7%, though it ticked up slightly in October to 2.3% because of higher energy costs. Against this backdrop, though, EDIN compares favourably, delivering a 3.0% increase in its dividend, demonstrating the ability to meet the inflation objective. The portfolio's underlying revenue also rose, up 13.3% from 11.54p to 13.08p, with net income reaching £19.6m by the end of the period. Whilst this marks an improvement from the same period last year, the board anticipates that dividends paid to shareholders for the full year will modestly exceed income, leading to a small reduction in reserves. However, the trust retains healthy reserves, which as of September 2024, stood at approximately £45.3m, covering around 95% of last year's dividend.

At a yield of 3.7%, we acknowledge that EDIN may not boast one of the highest payouts in the sector, although it is in line with the yield of the FTSE All-Share Index. More importantly, however, we believe that the earnings potential in many of the trust's underlying holdings positions it well for generating solid total returns going forward. With a focus on diverse income streams, the support of healthy reserves, and a clear commitment to dividend growth, we think EDIN is well-placed to deliver sustainable income and capital growth for long-term investors.

Fig.5: DPS & RPS



Source: Morningstar

Management

Lead portfolio manager Imran Sattar brings nearly three decades of industry experience to EDIN. He joined Liontrust in April 2022 as part of the acquisition of Majedie Asset Management and now leads the Liontrust Global Fundamental team. Imran assumed the 'official' mantle of EDIN's lead manager in February 2024, following his predecessor's retirement, though he had been working with the team for many years prior and has been making investment decisions since October 2023. Before joining Majedie in 2018, he was a managing director and fund manager at BlackRock, managing UK equity portfolios with combined assets exceeding £2bn.

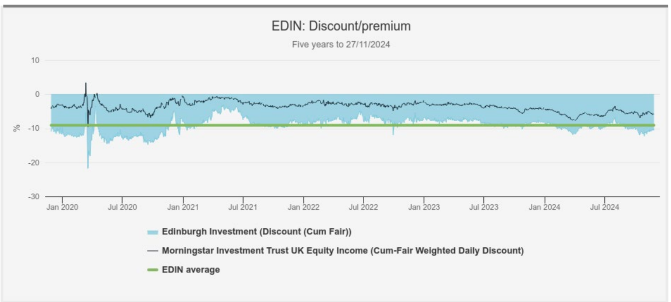
Emily Barnard, EDIN's deputy manager, is a fund manager on Liontrust's Global Fundamental team with nearly a decade of investment experience. Like Imran, she joined Liontrust in April 2022 as part of the acquisition of Majedie Asset Management where she worked as an equity analyst for six years, covering a broad range of sectors. Emily took on the role of EDIN's deputy manager earlier this year.

Discount

Over the past 12 months, EDIN has demonstrated strong relative **Performance** against its benchmark, with returns driven by stocks across the portfolio. However, despite strong performance EDIN's discount has widened to 10.3%, surpassing both its five-year average of 9.1% and the AIC UK Equity Income sector average of 3.6%. We believe this disconnect can be attributed to broader market pressures that have dampened sentiment, a trend also reflected in wide discounts across the investment trust sector. Additionally, EDIN's relatively modest yield of 3.7%, whilst in line with the FTSE All-Share Index, falls short of the sector average of 4.3%, potentially deterring income-focussed investors seeking higher yields.

Despite this, we view the current discount as an attractive entry point for investors looking for differentiated exposure to the UK. EDIN's well-diversified portfolio of quality companies, many also boast strong earnings growth potential, supports both a robust dividend and capital growth profile. If EDIN continues to deliver strong performance and dividend growth, we see the potential for the discount to narrow, enhancing shareholder returns.

Fig.6: Discount



Source: Morningstar

Whilst the board has not set a specific target level, it views share buybacks as a valuable tool whilst the discount persists and given current levels, it has been proactive in managing the discount's volatility. During the six months to September 2024, the trust repurchased 2% of its shares, followed by an additional 2,030,000 or 1.4% shares to 27/11/2024. Alongside buybacks, the board has undertaken marketing initiatives to raise the profile of the management team and their strong performance, aiming to further "crack the discount nut".

Charges

According to EDIN's latest factsheet, its ongoing charges figure (OCF) is 0.48%, lower than the AIC UK Equity Income sector's weighted average of 0.57% and a reduction from the previous year's OCF. In April 2024, a revised management fee scale was introduced, charging 0.45% per annum on the first £500m of market capitalisation, 0.40% on the next £500m, and 0.35% on any amount beyond that. Based on EDIN's market cap at year-end, this new structure is expected to reduce the pro-forma management fee by approximately 11% compared to the old management fee structure. The fees remain allocated 70% to capital and 30% to revenue. We think that management fees based on market capitalisation, rather than the NAV, incentivise the managers to reduce or narrow the discount over time.

According to EDIN's latest Key Information Document (KID), EDIN's KID RIY stands at 0.94%. However, we note the regulation around KID RIYs is changing, and a consensus on how they should be calculated has not yet been formed.

ESG

Liontrust Asset Management is committed to sustainable integration across the business to achieve better outcomes for both investors and society. This includes enhancing how it engages with companies, improving reporting practices, and expanding its dedicated sustainability resources. Lead portfolio manager Imran Sattar, along with his deputy manager Emily Barnard, embeds ESG analysis throughout the investment process, arguing that well-managed companies with strong governance practices tend to make more successful long-term investments.

The investment strategy focusses on assessing the key risks and opportunities each current or potential holding faces over a three to five-year investment horizon, including ESG-related areas such as climate change. Imran also argues that responsible ownership, centred on active engagement, is the most material way he can have an impact on companies. This approach not only deepens an understanding of the companies within the investable universe but also strengthens conviction in each investment whilst enhancing the ability to foster positive change.

As of October 2024, Morningstar scored EDIN three out of five globes for sustainability when looking across open- and closed-ended funds in the UK equity income sector.

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