Witan

Witan has bounced back from Q1 2020, making the 7.6% discount potentially attractive...

Update
16 December 2020

Summary

Witan (WTN) offers investors an actively managed, but diversified, exposure to global equities. Using a manager-of-managers approach, WTN invests in a range of concentrated portfolios, each of which is managed by a third-party manager employed by the board. This approach means that shareholders benefit from diversification and active management, with little key-man or manager risk.

The roster of eight to 12 managers is overseen by Witan's executive team. Each of the underlying managers has their own investment style, with some being highly adaptable, meaning that the overall portfolio can adapt to changing economic conditions. The executive team can also make significant changes to the portfolio themselves by hiring and firing managers – which is much more easily done than if a trust only has one manager.

2020 has seen an unusual level of activity in this regard, as we discuss under the **Portfolio section**. These changes reflected a belief by Witan that growth (rather than value) and global (rather than regional) specialists are likely to deliver the best returns going forward. The result is a portfolio which contains a mix of companies with sustainable cash-flows, higher growth companies and high-quality cyclical businesses.

The last of these changes was effective on 01/09/2020. However, WTN has been performing well since equity markets stabilized, and Witan has now outperformed the benchmark for six consecutive months, clawing back a good proportion of the underperformance earlier in the year.

Witan currently yields 2.7%, and has increased its dividend every consecutive year for 45 years. Revenues in 2020 are likely to be around half of the 2019 level, but the board expects to use reserves to support continued dividend growth in 2020.

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Analyst's View

2020 was a curve-ball that has seen many trusts struggle. In the case of Witan, underperformance was very much concentrated in Q1. Witan employs structural gearing, historically at around 10% of NAV, which contributed to this underperformance. With gearing now at 12%, and the trust having outperformed the benchmark for six consecutive months (to 30/11/2020), we think Witan is very much back in business.

The executive team were quick to make changes to the portfolio and, with the inclusion of the new management teams, WTN is now decidedly more global and 'growthy' than it was in the past. That said, the portfolio retains elements of cyclicality. We think the current portfolio is well set up for the current environment – with manager stock selection resulting in an underweight to the US and overweight to the UK and Asia relative to the benchmark.

Witan's discount widened out during early 2020, but it has lagged the recovery elsewhere that has seen discounts move back to historically narrow levels. The shares currently trade at a 7.6% discount, and the board continues to repurchase shares. In our view, with the improved performance over the past six months and the re-jigged portfolio showing promise, there is clear potential for the discount to narrow in again.

In the current uncertain outlook for dividend income, the board's statement on Witan's dividend is reassuring. At 2.7%, based on last year's dividend level, it may prove attractive relative to many other income stocks.

BULL
Manager of managers approach offers diversified array of concentrated portfolios
Refreshed roster of managers, with an increasingly global approach
A reliable dividend, progressively growing for the past 45 years

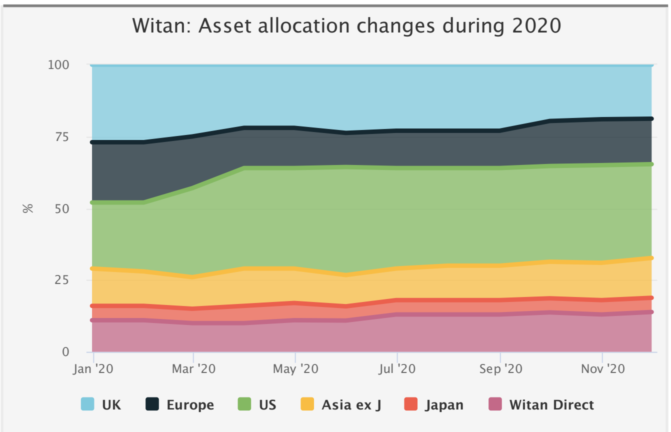
BEAR
UK overweight may lead trust to underperform global peers if UK experiences a no-deal Brexit
Poor performance in 2020 leaves performance behind the benchmark YTD
Gearing can exacerbate the downside

Portfolio

Witan can be seen as an active management 'one-stop shop', offering investors a very actively managed, but diversified exposure to global equities. The current 'manager of managers' approach was adopted in 2004, in which the trust uses its large scale to access a range of third-party managers at institutional fee rates. Each underlying manager invests in a relatively concentrated portfolio of their best ideas, oversight of which is managed by Witan's executive team. This approach gives shareholders diversification and the benefits of active management, but with reduced key-man or manager risk.

Witan is a truly global trust, although the trust's benchmark of 85% MSCI ACWI, and 15% MSCI UK IMI reflects the trust's history (having incorporated in 1909) in having a large percentage of UK individual investors. The 15% exposure to the UK in the benchmark is a nod towards the 'home bias' that many of these investors look for. Over periods, the UK 'overweight' relative to global equities (and other global trusts) has at times cost the trust in relative performance terms, but particularly so since the 2016 Brexit referendum. The graph below shows how the look-through geographic exposure of the trust has evolved this year (excluding the Witan Direct portfolio, of which more later). Over time, shifts in exposure come through the actions of the underlying portfolio managers, but the more dramatic alterations – such as that seen in the first half of this year – have been a result of changes in the manager roster. These changes (discussed further down) have brought the trust closer to the benchmark weightings, although Witan remains underweight in the US by 10% relative to the benchmark, and overweight to the UK (+11%) and Europe (+8%).

Fig.1: Geographic Exposure Changes Over 2020



Source: Witan, to 31/11/2020

Witan's underlying manager roster is likely to number between eight to 12 at any given time. The selection of these managers is overseen by Witan's executive team led by Andrew Bell, but formally appointing them is the board's responsibility. The executive team will narrow down the field of potential new managers if the decision has been made to change any, and then propose those that they are happy to have in the portfolio to the board. The board then participates in an interview process and, in consultation with the executive team, decides on appointments. As we discuss in the **Management section**, members of the board have extensive investment management experience and are in a strong position to make informed choices.

We think 2020 has shown the value of having an adaptable, 'manager of managers' approach. Over the short term, Witan is expected to have low turnover in managers. Investment decisions at the underlying level, made through the underlying, highly active, managers, should mean that the trust's exposure will be dynamic and adapt to the investment environment as circumstances change. However, Witan made an unusually large number of changes to the manager roster in 2020. Some of these changes were predetermined, while others were in response to the extraordinary market environment. Having underperformed the benchmark (partly as a result of being significantly underweight in the US), the reshaped portfolio has performed much more strongly relative to the benchmark. At the time of writing, it has now outperformed the benchmark for the past six consecutive months.

As we note above, the COVID-19 market selloff prompted a radical change to the manager line-up, in total representing around a third of portfolio funds. These changes were fully implemented by the end of August 2020 and involved Witan exiting investments with two European managers, a UK manager and a US-based global value manager, with proceeds reallocated to global managers WCM, and Jennison. The current line-up of managers can be seen in the table below.

The new managers, WCM, and Jennison Associates are global growth managers, and are both based in the US. Their selection represents a belief by Witan that value managers might continue to struggle over the long term. WCM has more of a quality growth bias; investing in companies that it believes have growing competitive advantages, strong corporate cultures and solid balance sheets. Jennison on the other hand is more 'growthy', and looks for innovative business which is creating structural changes in the industries it operates in. Witan's initial positions are a 'less than full' allocation, which the team hope to build up over time. Their addition clearly increases the 'growth' exposure of the overall portfolio, but it is worth noting that there remains plenty of cyclicality in the portfolio through the likes of Lansdowne and Artemis. Relative to the benchmark, the portfolio is currently c. 4% overweight to growth, and c. 10% underweight to value.

Summary Of Manager Exposure

MANAGER	GEOGRAPHIC AREA	STYLE	% AS AT 31/11/2020
Veritas Investment Management	Global	Fundamental value, real return objective	20
Lansdowne Partners	Global	Global developed markets	19
Lindsell Train	Global	Long-term growth	14
Witan Direct Holdings	Direct	Specialist funds	9
WCM	Global	Quality growth	9
GQG Partners	Emerging Markets	Quality at a reasonable price	6
Matthews Asia	Asia	Quality dividend paying companies	6
Artemis	UK	Recovery / Special solutions	6
Jennison	Global	High growth businesses	5
Latitude Investment Management	Global	Global 'best in class' businesses	3
GMO	Climate change	Companies addressing climate change	3

Source: Witan, Kepler Partners LLP

Witan's executive team believe that global portfolios are likely to deliver the best results going forward while recognising that certain regions and sectors such as Asia, emerging markets, biotechnology, and climate change, are better served by specialist managers. As a result, in the future the team expect that around two thirds (65%, +/- 5%) of the portfolio will be invested by global managers. Of the remainder 10% (+/- 5%) will be invested by UK focused managers, and 10-15% through "specialist or newly established managers". The GMO strategy is specialist, targeting companies that are expected to benefit from efforts to curb or mitigate the effects of climate change while Latitude (based in London) represents a manager in the 'relatively new' camp.

As readers of this note will likely attest to, investment trusts can sometimes offer that 'little bit extra' to a standard fund – whether it is using the closed-end structure to invest in less liquid or more concentrated portfolios, using leverage to enhance returns or enabling an investor to take advantage of a discount in the hope that a change in sentiment will lead to the discount narrowing. Witan's executive team have long experience of investing in investment trusts, and so up to 10% of the portfolio can be invested in such opportunities (known as the Witan Direct portfolio). Trusts held are those deemed attractive investments in their own right, usually within a relatively specialist area, and perhaps with a discount kicker if the team get their timing right. Holdings in this part of the portfolio include Syncona (a life sciences investor), Apax Global Alpha, **BlackRock World Mining**, and Princess Private Equity.

In terms of outlook, the Witan team are optimistic – both from an underlying portfolio basis and that their approach is structurally suited to outperforming global equities. They believe the underlying companies are well positioned to weather the unusual environment that the global economy finds itself in.

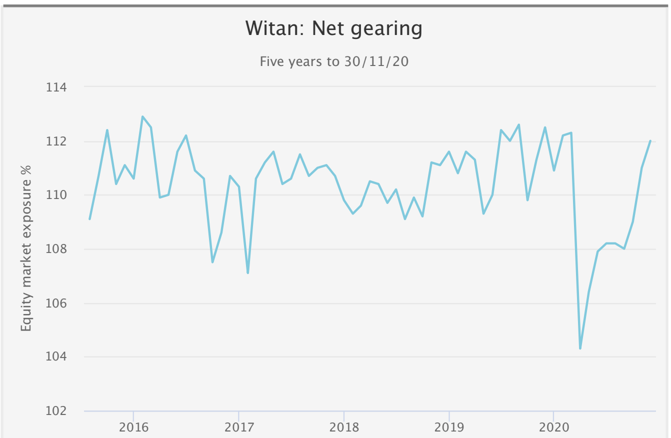
Gearing

Witan employs structural gearing to enhance returns for shareholders. Over the past ten calendar years, it has been a net contributor to returns (after interest costs) in eight of them. Unfortunately, 2020 may not be a year in which it added to returns. The graph below illustrates the month end net gearing over the last year. At the start of 2020, the team were relatively bullish on prospects which meant that the trust was above what the managers see as a neutral level of gearing of 10%. When equity markets fell precipitously, the trust's gearing (relatively fixed) as a proportion of NAV (which had fallen significantly with the market) rose to c. 15%. It is the board's long-standing policy not to allow gearing to rise to more than 20%, other than temporarily and in exceptional circumstances.

The outlook at the time was very unclear, and the underlying managers were experiencing highly volatile equity markets. Witan therefore decided to reduce effective gearing to 4% in mid-March to protect capital until the outlook became clearer. Witan invests using managed accounts with each management team. Instead of redeeming capital from these accounts to de-gear, Witan sold index futures which brought equity exposure down, and thereby reduced effective exposure quickly and inexpensively. When market conditions had returned somewhat to normal, gearing was re-applied to allow the fund to participate in much of the equity market recovery.

Over 2020, Witan has also been making adjustments to its structural gearing, to bring the interest cost down and increase flexibility. The high coupon 6.125% 2025 secured bond was repaid during May: with an upfront payment of capital and a near equivalent saving in interest costs until 2025, meaning that the net cost was relatively small. As a result, Witan now has fixed rate borrowings of £155m, equivalent to 9.2% of NAV, paying a blended interest rate of 3%. On top of this the trust also has £100m of flexible credit facilities to increase gearing if desired. Gearing is now at 12%, reflecting the executive team's more bullish outlook.

Fig.2: Gearing



Source: Morningstar

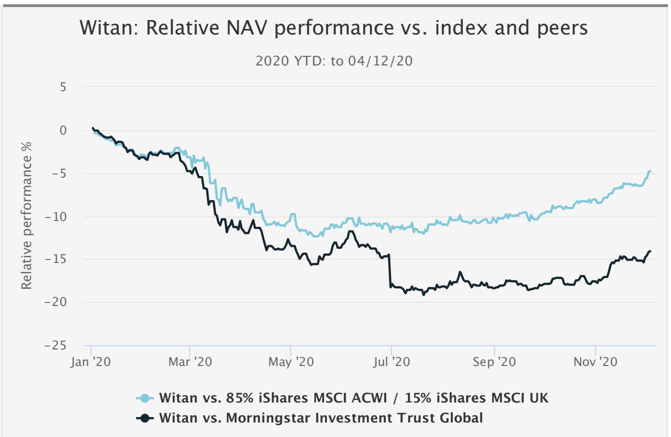
Performance

Witan's formal objectives are to outperform its composite benchmark and raise the dividend significantly faster than the rate of inflation. Despite the difficult background for equity income and the trust's dividend receipts this year, the board remains determined to continue to build on the strong record of dividend growth as we discuss in the **Dividend section**. In terms of relative performance, Witan had a very difficult first half of the year. However, as the graph below shows, since May relative performance compared to the benchmark (85% MSCI ACWI, 15% MSCI UK) flattened off. Positive relative performance has started to accelerate as a wider selection of companies (other than technology) have participated in positive returns in Q4. Indeed, at the time of writing (early December 2020), Witan has now outperformed the benchmark for six consecutive months.

In our view, this is excellent news for shareholders (and potentially the discount – see **Discount section**), and shows the merits of having a 'manager of managers' approach. Whilst changes to the roster are expected to be relatively few over the short term, Witan's setup enables the executive team to take decisive action if they see fit. The graph below shows relative performance – with an upward trajectory of a line showing Witan outperforming the respective index, or downward representing underperformance.

Witan's benchmark has evolved over time, with the current hybrid of 85% global (MSCI ACWI) and 15% UK (MSCI UK IMI) having been adopted on 1 January 2020. The UK weighting is incorporated to reflect the typical home-bias of the legion of private investors, many of whom have long used Witan as a long-term savings vehicle. The use of a global index reflects the board and manager's view that the best investment returns will be generated by active managers with as few top down constraints – as to which geographic region they invest in – as possible. There is no requirement for the portfolio to mirror the benchmark, and asset allocation changes are expected to be made with regards to expectations of the best returns rather than driven by benchmark considerations.

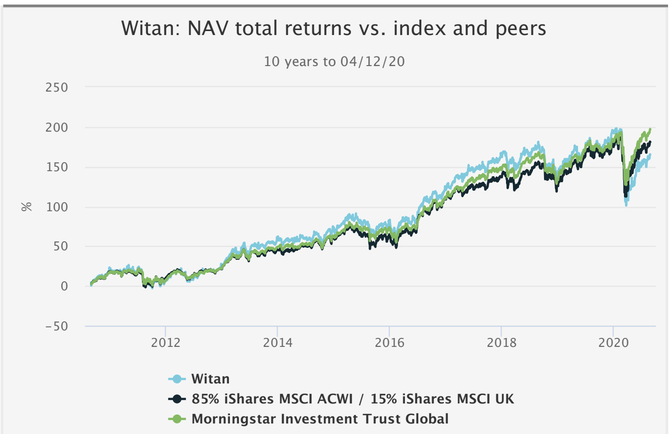
Fig.3: 2020 NAV Performance



Source: Morningstar

Over the long term, Witan has performed strongly relative to the current benchmark (albeit 2020 has seen it fall behind in total return terms over ten years) as we illustrate in the graph below. Over the past five years, up to 4 December 2020, Witan has delivered an NAV total return of 70.1% compared with iShares MSCI ACWI return of 94.2% and the iShares UK ETF return of 22.4% (combined 85/15, this is an equivalent 83.4% return). The weighted average for the AIC's Global peer group has delivered 94.2% over the same period. This return is one that reflects the heavier 'growth' bias of a lot of the trusts in the sector over this period, not to mention their unfettered global benchmarks (i.e. less weighting to the UK).

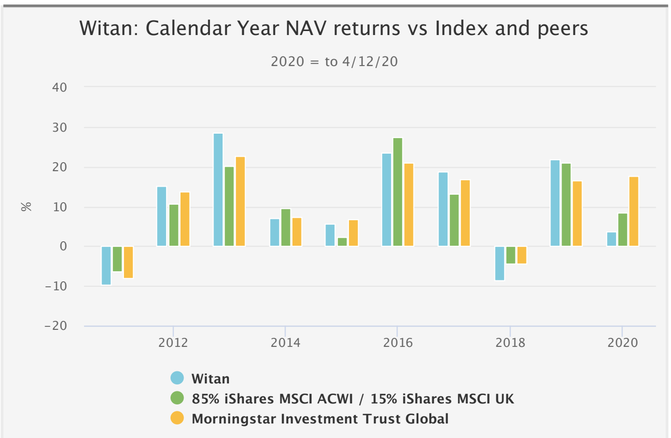
Fig.4: Ten Year NAV Performance



Source: Morningstar

As an actively managed portfolio, Witan's NAV performance is expected to deviate from that of the benchmark. As such, Witan will have periods of underperformance as well as outperformance – as illustrated in the graph below. However, rather than being wedded to one manager on whose track record a trust relies on, Witan's approach means that one manager is only ever a contributor to that track record. This should mean that it is far easier for the executive team to rotate the manager roster to keep up with market events, expectations or take in new, emerging opportunities. As the experience of 2020 has so far shown, this is a valuable tool and one that we would hope means that recent outperformance over the benchmark can continue.

Fig.5: Calendar-Year NAV Returns



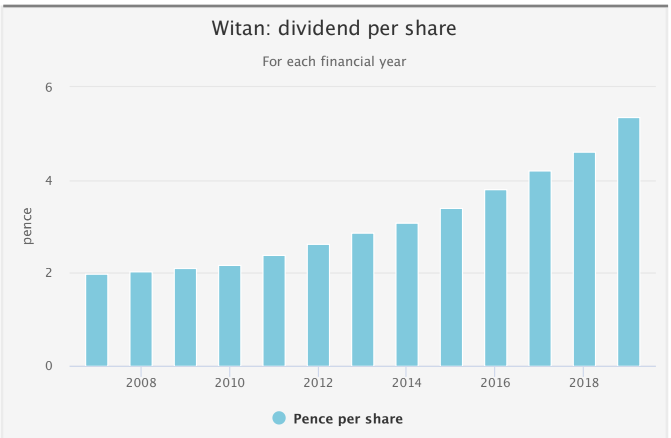
Source: Morningstar

Dividend

Witan is a solid member of the **AIC's Dividend Heroes**, representing a cadre of trusts which have grown their dividends for more than 20 years in a row. Witan's record of 45 years of consecutive dividend increases is impressive and helps explain why the board has stated that they expect to grow the dividend for 2020. This comes despite the fact that revenue earnings per share are likely to be down around 50%, thanks to the unprecedented effect on dividends from COVID-19 lockdowns around the world. At the current share price Witan yields 2.7% on a historic basis. Interim dividends are paid quarterly in June, September, December with a final balancing payment for the financial year ending December paid in March. The March dividend payment will reflect the difference between the three quarterly dividends already paid, and the payment decided for the full year.

As of the most recent annual report in December 2019, the trust has revenue reserves of c. £71.1m – which is the equivalent of c. 1.5x the annual dividend. The board has committed to use revenue reserves to support the dividend as much as they need to but have also noted that capital reserves are potentially available if warranted. At the same time, we understand that the board will only use capital reserves to bridge a shortfall until one might reasonably expect the dividend to be covered by income receipts once again, thereby ensuring it is truly sustainable over the ultra-long-term.

Fig.6: Dividends



Source: Witan, Comparative figures prior to 28 May 2019 have been restated due to the five-for-1 share split on 28 May 2019

Management

Witan is internally managed by a team headed by Andrew Bell, who became CEO in 2010 and sits on the board of directors. We would comment that there are multiple benefits to being self-managed, including the alignment of interests: there is no question of an investment decision being influenced by what is better for a management company, which may be investing in the same or similar assets in other vehicles. Another benefit is that employees are wholly focussed on Witan's portfolio, which is unlike other investment houses where analysts could be working for multiple clients.

Witan has a multi-manager approach, using a range of third-party managers that are investing in concentrated portfolios. Changes are expected to be relatively infrequent but, as we discuss in the **Portfolio section**, the executive team can act fast and with conviction if they feel they need to. 2020 is a case in point, and the team made some dramatic changes which took effect in September 2020. Following this there are now ten external managers, including smaller allocations to two specialist or newly established managers, not including the Witan Direct portfolio.

Managers are formally reviewed at least once a year, but are reviewed more frequently than that by the executive team. We understand the intention to be that managers are unlikely to be replaced due to short-term performance relative to their benchmarks. Instead the replacement of managers is more likely to happen in cases of unexplainable performance, investment mandate changes, or changes at the management company. If a change is to be made, then the board has ultimate responsibility – advised by the executive team. In the case of the changes made during 2020, the executive team narrowed down the field of potential new managers to four companies – all of which they would have been happy to have in the portfolio. It was then down to the board to decide on who were formally appointed. The breadth of experience represented by Witan's nine board members facilitates this process; with diverse skills being brought to the table from the likes of Ben Rogoff (current Polar Capital Technology fund manager), Paul Yates (ex-CEO of UBS Global Asset Management UK) and Gabrielle Boyle (Senior Fund Manager and Head of Research at Troy Asset Management). Andrew Ross (previously chairman of Cazenove Capital Management) became Chairman in April 2020, and Rachel Beagles (Chairman of the AIC) was appointed as a director in July 2020.

Witan is able to use its large size (net assets of £1.9bn) to negotiate attractive fees with the managers it has selected. Up to 10% of the portfolio may be invested directly by the executive team in specialist collective funds. These funds may represent undervalued asset categories, or funds viewed as longer-term generators of superior returns – potentially, but not always, with a discount kicker. A further 10-15% may also be allocated in smaller mandates to third-party managers, where Witan believes there is strong potential to add value; which the team view as possible managers for the future or as specialists.

Investment Managers

MANAGER	AREA	STYLE
Artemis	UK	Recovery / special situations
GMO	Climate Change	Companies addressing climate change
GQC Partner	Emerging Markets	Quality at a reasonable price
Jennison Associates	Global	High growth businesses
Lansdowne Partners	Global	Global developed markets
Latitude	Global	Global 'best in class' businesses
Lindsell Train	Global	Long-term growth
Matthews Asia	Asia	Quality dividend paying companies
Veritas Investment Management	Global	Fundamental value, real return objective
WCM	Global	Quality growth

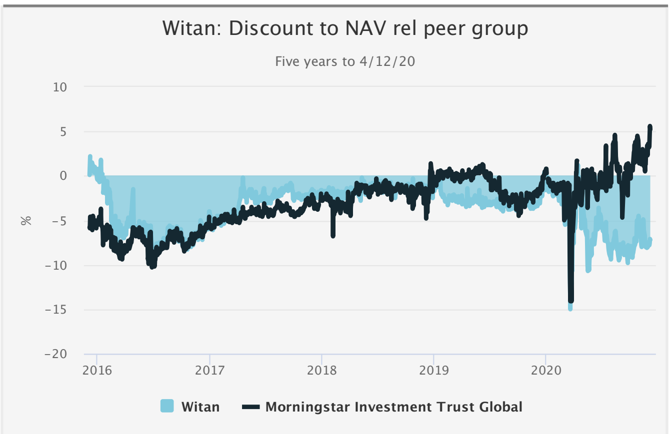
Source: Witan

Discount

In our view, it is Witan's underperformance during Q1 that has led to the discount not recovering its previous level. As the graph below shows, for a number of years now Witan has tended to trade at a small discount to NAV. 2016 had its own specific circumstances, which saw the placing of shares from a former large shareholder (this was a technical issue rather than one related to performance). Currently the trust trades at a discount of 7.6%, wider than the one-year average of 5.6% and the sector weighted average discount currently of 2.7% (the chart below shows the unweighted average).

The board has a constant eye on discount-related issues and, as a result of the discount widening this year, has made a significant number of buybacks – and continues to do so. The board's objective is that the shares should trade on a sustainable low discount or premium to NAV. With net assets of £1.9bn, Witan is a long way from being constrained in how many shares it is able to buy back in our opinion. In our view, therefore, with the board remaining engaged in protecting discount volatility on the downside, the 7.6% discount is wider than historic averages and could prove to be an opportune entry point.

Fig.7: Discount



Source: Morningstar

Charges

Witan aims to use its large size to negotiate attractive fees from the underlying managers, which are lower than those available through the publicly available funds that the managers run.

In 2019 the ongoing charges, excluding performance fees, were 0.79%, which is not far from the peer group's simple average of 0.67%. Two of the managers at the time were eligible for a performance fee which meant that including these costs, the OCF rose to 0.87%. In 2020 only one manager (with 7% of the portfolio) is eligible for a performance fee, and that manager is not currently entitled to any fee as it is below its high-water mark.

Witan has a KID RIY of 1.69%, including interest and transaction costs, relative to the sector simple average of 1.45%. Historic performance fees of 0.08% are included in this figure. It is worth noting that calculation methodologies can vary, and that this figure also includes the look-through KID RIY figures of the private equity funds held in the direct holdings portfolio.

ESG

Witan's ESG approach is evolving, as is the case with many managers. However, Witan – as a manager of managers – has to take a different approach to many other trusts which only have one manager or management team. In February 2020 Witan became a signatory to the UN's Principals of Responsible Investment (PRI). All of Witan's existing managers are also signatories to the UNPRI.

James Hart, who works with Chief Executive Andrew Bell, has just completed his annual review of the underlying managers' ESG credentials. When we caught up with him recently, he commented that Witan sees itself as a responsible investor. His review sought to understand and reassure the Witan board that each of their managers are taking into account ESG issues in their analysis of investments. In his view, these can be ethical issues, but they are first and foremost financial risks and he seeks to ensure that all of the underlying companies in the portfolio – however they are selected – behave in a way that doesn't cause risks for shareholders. James commented that many aspects of ESG have been fully implemented in the investment process or philosophy for years. In the case of newly appointed manager WCM, James observes that one of the key investment criteria that the managers look for in an investment is that each company is a 'win, win, win' business. In their view a company will only be successful over the long term if it operates in such a way that it grows revenues without exploiting customer loyalty, does no harm to society and has a strong corporate culture which values its employees while growing its competitive advantage.

In other respects, Witan's holding in the GMO Climate Change Fund is another reflection of ESG. The Witan team share GMO's belief that climate change is one of the world's biggest problems, and the fund seeks to invest in companies which provide solutions to help mitigate or adapt to climate change. This has been a successful investment to date, and Witan hopes to make future investments in the sustainable investment area.

According to Morningstar, Witan's current portfolio scores an "average" on their Morningstar Sustainability Rating, when compared to the "Global Equity Large Cap" peer group. In monitoring the underlying managers, Witan's executive team regularly review reports from managers of when ESG breaches occur in underlying portfolios. The team then look into the detail of any such breaches, whether processes or stock specific, with the aim of making sure that Witan's executive team are fully satisfied that ESG is being properly taken into account, and by implication managers are not just making a 'nod' toward ESG.

In our view Witan qualifies as a potential investment for investors who want an ESG aware manager, although it is unlikely to qualify for purists. We understand that this year's annual report, to be published in March 2021, will cover Witan's approach to ESG in detail.

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