Troy Income & Growth

TIGT aims to provide a truly sustainable income and capital growth solution for the long term...

Update
16 November 2022

Overview

Troy Income & Growth (TIGT) takes a conservative, benchmark-agnostic approach to investing in predominantly UK equities, aiming to provide investors with a consistent return profile with a core focus on capital preservation and downside protection over the very long term. The managers target high-quality, dividend-paying companies that they believe currently provide or will provide investors with both capital growth and income.

As the chairman of the trust's board puts it, the shift in the investment strategy and rebasing of the **Dividend** since 2020 have "sharpened the focus on quality and sustainable dividend growth". The emphasis is on finding high-quality and fundamentally sustainable companies that may offer a lower dividend yield in the short term but have a greater chance of providing investors with dividend growth over the decades to come. As we discuss under **Portfolio**, this is reflected in the trust's differentiated sector allocations when compared to the FTSE All Share. This has led to disappointing performance in the short term, primarily through a lack of exposure to energy companies, which the managers believe are in structural decline. Additionally, TIGT has a greater exposure to growthier sectors that have witnessed a pullback from lofty valuations, along with the discounting effect that comes with progressively rising interest rates.

TIGT has a discount control mechanism designed to keep the shares trading close to NAV, and as performance has suffered over the past 12 months this has been utilised extensively. The discount at the time of writing is 1.9%, close to the one-year average of 1.6%.

TIGT has been ungeared for many years but has recently arranged a new gearing facility which the managers are utilising to facilitate the current 3% level of gearing.

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Analyst's View

We think managers Hugo Ure and Blake Hutchins's long-term focus could appeal to investors seeking a sustainable dividend who are committing capital for the long term. The benchmark-agnostic nature of TIGT provides the managers with the freedom to construct a portfolio aligned to their long-term objectives, away from the confines of any specific benchmark index. This flexible approach led the managers and board to make a strategic shift in 2020, with the aim of enhancing the sustainability of dividend and capital growth over the long term. In doing so current income levels have been compressed, which could prove off-putting for investors requiring an immediate higher level of income.

The lack of energy exposure is the key driver of recent underperformance. Whatever the short-term dynamics, we think it is likely the sector will continue to face headwinds in the light of net-zero commitments. As such we think TIGT's strategy could appeal to investors with strong ESG convictions or who are wary of the long-term future for capital or income returns in the sector.

In June, the board arranged a new **Gearing** facility after many years of not using gearing. We believe this should not unsettle more risk-averse investors since the managers are expected to remain conservative in their approach – as demonstrated by the current 3% gearing level. Any further gearing is expected to remain below 10% and to only be utilised if the managers see genuine opportunities to enhance returns ahead of the cost of using the facility.

BULL
Long-term, quality-focussed rebasing of the dividend is likely to improve the sustainability of future capital and income growth
Discount control mechanism helps minimise discount volatility and maintain high levels of shareholder liquidity
Benchmark-agnostic investment approach, focussed on providing investors with capital preservation and low-volatility returns

BEAR
Low current dividend yield versus peers
Underperformance in cyclical-focussed 'value' market rallies may be prolonged as geopolitical tensions and interest rate hikes remain likely to persist in the near term
Although conservative, the introduction of a new gearing facility may increase volatility and exaggerate downside returns

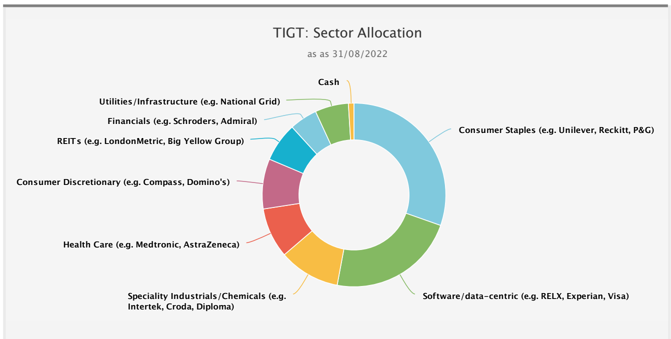
Portfolio

Troy Income & Growth (TIGT) aims to provide investors with a portfolio that has the potential to generate capital growth alongside sustainable and attractive income growth by predominantly investing in UK equities. The investment manager Troy Asset Management (Troy) has long been associated with a focus on downside protection (particularly during turbulent market periods), preserving the value of its investors' capital and taking an absolute rather than a relative return-focussed approach – a mantra that TIGT's managers Hugo Ure and Blake Hutchins aim to follow.

Hugo and Blake have maintained a core focus on fundamental bottom-up stock selection that was initially instilled into the investment process of the trust by the former long-standing manager Francis Brooke. As part of the wider investment team at Troy the managers are surrounded by a wealth of resources, which include a 14-strong team of investment professionals, such as the income team's dedicated assistant fund manager Fergus McCorkell and investment analyst Aniruddha Kulkarni. Investment decisions are centred around a common and clear stock selection philosophy of identifying high-quality, capital-light and non-cyclical cash-generative businesses that will grow and not destroy investors' capital over the long term. The whole investment team make contributions to Troy's internally approved buy list of c. 170 stocks, and these can be included within any of the portfolios at the fund managers' discretion, depending on a fund's specific mandate.

In 2020 Hugo and Blake implemented a shift in the strategy which aims to enhance the potential for the portfolio to generate more sustainable, long-term dividend growth for investors alongside capital growth. In the words of board chairman David Warnock, this would provide a "sharpened focus on quality and sustainable dividend growth". Hugo and Blake have focussed on avoiding companies that are expected to fall short of being able to provide an attractive and growing dividend over the next decade and beyond. The chart below illustrates how this has been translated in terms of the portfolio's construction and individual holdings. Perhaps the most significant point to note for a UK-centric, income-focussed fund is the zero allocation to the energy sector, which includes the likes of oil majors BP and Shell, as well as the avoidance of sectors such as mining. The energy sector has performed well in the short term as a result of exogenous events including the Russia–Ukraine war. However, longer-term headwinds for the sector need to be considered, such as the global focus on decarbonisation, the capital intensity of exploration and maintaining operations, and the exposure to commodity prices and economic cycles. In addition, several of these factors also discount the mining companies from the investable universe, not least because of the unpredictability of free cash flows and cash conversion. In the short term the underweight to energy has been particularly harmful to relative returns, as the energy sector has been by far the strongest performer in the FTSE All Share in 2022 (see **Performance**). However, Hugo and Blake are trying to set up a portfolio for the long term and believe it would be a mistake to chase short-term returns in the sector given their belief that these businesses are more likely to struggle in the decades to come due to net-zero commitments.

Fig.1: Sector Allocation



Source: Troy Asset Management

The managers have maintained the core of the portfolio in sectors such as consumer staples, which is currently c. 32% of the portfolio and traditionally encompasses companies that provide high recurring revenue streams, clear structural growth drivers, pricing power and resilient operations in times of economic stress. An example of a company Hugo and Blake favour is Unilever, which has seen its allocation increase from 4.6% at the start of the year to 8.9% as at 30/09/2022. The company owns over 400 brands around the world, including recognisable household names such as Dove soap, Ben & Jerry's ice cream and Persil laundry detergents, plus it is a beneficiary of these brands' ability to consistently generate positive cash flows above the amount required to keep operating these businesses. Although short-term inflationary pressures have impacted the input cost prices of many of these companies, their brand loyalty and pricing power mean they have been able to pass this on to the end consumer. Such price rises have led to higher-than-expected sales for Unilever despite the volume of sales being 2% lower over Q2 2022.

In addition, the managers consider companies both from a capital growth perspective and in terms of income/dividend growth. We note under **Performance** that companies such as Experian and Croda International have experienced a significant de-rating year to date; however, they have contributed (or will be expected to contribute) significantly to positive performance over the longer term. Croda is a Yorkshire-based speciality chemicals company that produces 'critical' inputs into anything from anti-ageing creams to stabilisers for vaccines. The company has been able to provide investors with over 30 years of uninterrupted dividend growth, which has been driven by free cash flow and a successful c. 90% cash conversion rate, with half the profits being utilised for dividend payments and the other half for reinvestment. The company recently announced that its first-half performance for 2022 was ahead of expectations and included record sales and profit margins – a reflection of higher sales growth and a higher return on sales. In addition, the US government has committed to investing up to $75m in a new factory to boost mRNA production, with Croda itself investing up to $58m in a new site to expand its US manufacturing capacity. The company's relatively low dividend yield of c. 1.7% has not deterred TIGT's managers from continuing to view the company as an attractive source of both capital and income growth for investors over the long term. Another example of a company favoured by the managers is RELX, which is currently a 7.1% holding in the portfolio and has seen a consistent compound annual growth rate in free cash flow of 6% (or even higher on a per-share basis, reflecting regular share buybacks) and an average level of cash conversion of c. 92% since 2005. These characteristics are able to translate into long-term and sustainable dividend payouts, as evidenced by the increase in the company's next periodic dividend, which is equal to a 9.8% increase from last year.

The wide disparity between the quality and sustainability of companies available to UK equity income investors is stark. Hugo and Blake believe the c. 6% dividend-yielding companies like the telecoms company Vodafone, or the mining company Anglo American will likely destroy investors' capital over the long run. They believe Vodafone's poor conversion of accounting profits into cash, shrinking profit margins and the continued funding of elevated dividend levels through debt, and Anglo American's unpredictability of cash flows and a highly volatile (and sometimes negative) average cash conversion rate of c. 62% may ultimately lead to a fall in future income. With this in mind, the managers have a focussed approach on high-quality but potentially lower-dividend-yielding companies that aim to grow whilst providing a genuinely sustainable dividend over time, which they think are more likely to provide investors with a reliable long-term future income stream.

Top Ten Holdings In Portfolio

HOLDING	WEIGHT (%)
Unilever	8.9
Diageo	7.9
RELX	7.1
Reckitt Benckiser Group	6.1
Experian	4.2
Compass Group	4.1
GSK	4
AstraZeneca	3.7
Paychex	3.4
Croda International	3.3
Total	**52.7**

Source: Troy Asset Management, as at 30/09/2022

As one might expect, the managers' focus on high quality inevitably leads the portfolio to have a higher valuation than the benchmark. In the table below we highlight the metrics that indicate the relative expensiveness of the portfolio, such as the P/E and P/B ratios. Although the portfolio's valuations may remain comparatively expensive, the recent sell-off in the markets that has particularly impacted longer-duration, higher-valued growth stocks may provide opportunities for the managers to add to existing holdings through the use of a new **Gearing** facility. We have experienced a turbulent period in the markets – especially for growthier sectors, which typically perform badly during interest rate hiking cycles. However, the quality and resilience of the firms within the portfolio when compared to the benchmark can be demonstrated through the return on invested capital (ROIC, a financial performance measurement that determines a company's ability to efficiently utilise all forms of capital available) and net margin figures.

Portfolio Characteristics

	TIGT	BENCHMARK
P/E ratio	16.8	11.6
P/B ratio	3.6	1.6
Net margin	22.9%	13.1%
ROIC	16.6%	11.6%

Source: Morningstar, as at 31/07/2022 (TTM basis)

Gearing

In June this year TIGT took out a gearing facility after many years of having no gearing at all, and over a year since the last facility expired. TIGT has a three-year revolving loan facility of £15m, with an option to extend it to £20m at any time, avoiding the expense of any undrawn commitment fees on the additional £5m (if utilised). If fully drawn down this would amount to c. 9% of NAV; however, as of the latest factsheet (for September) gearing has been introduced at a conservative level of 3% and following a recent meeting including Hugo, Blake, and the board, it is likely they will maintain a conservative gearing figure over the long term.

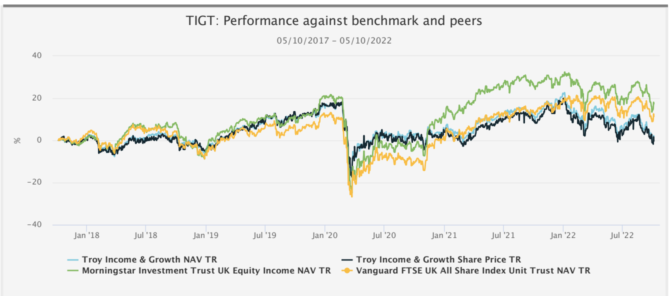
TIGT had previously not had a gearing facility in place since 24/04/2021. The facility expired and was not renewed on this date in order to save on the cost of rolling over a facility that was not being used. However, the board believes it was appropriate to reintroduce such a facility to enable the efficient management of the trust's balance sheet, and to potentially "generate a return in excess of the cost of borrowing" when the board sees a tactical opportunity to do so.

Performance

A critical element of the managers' approach is capital preservation and downside protection for investors over the long term. The underperformance of the trust since the start of the year has impacted some long-term figures; however, extending the performance from the start of when Troy took over the mandate paints a positive picture. From 01/08/2009 to 31/10/2022 TIGT has outperformed the FTSE All Share Index (its comparator 'benchmark') achieving an annualised NAV total return of 8.2% compared to 7.6%. Furthermore, over the same time horizon TIGT has demonstrated a lower volatility (as measured by the NAV standard deviation) of 10.9%, compared to its benchmark's 12.6% and its peer group the Morningstar UK Equity Income sector's average of 13.2%. The trust's ability to offer downside protection is also worth noting. Its maximum drawdowns during periods of market turbulence have been significantly lower than those of its benchmark and peer group, and over this time period TIGT's maximum drawdown has been -18.7% compared to the benchmark's -25.1% and the peer group's -28.5%.

As we can see in the graph below, performance figures have been negatively impacted over the past five years by the portfolio's tilt to higher-quality stocks, which the managers initiated in 2020. Over the five years to 07/11/2022 TIGT has generated an NAV total return of 3.4% and a share price return of 0.2%, compared to the 19.8% average return of the peer group and a 14.5% return from the benchmark.

Fig.2: Five-Year Performance



Source: Morningstar

Past performance is not a reliable indicator of future results.

The managers' evolution of the strategy was founded on the belief that some sectors were likely to be structurally threatened. As a result, they rotated into sectors that they thought would do a much better job of compounding dividends and capital over the long run. Since then, we have experienced an extremely volatile period which has included the coronavirus pandemic and the recovery from it, as well as persistent inflationary pressures, supply-chain delays and the breakout of the Russia–Ukraine war more recently. The timing of the strategy change has been unfortunate and has undeniably led to short-term underperformance as sectors such as energy and materials, in which the managers do not invest, have rallied very strongly. For example, the FTSE All Share energy sector has generated a return of c. 12.5% over the past 12 months to 07/11/2022 and makes up c. 12% of the benchmark. TIGT's overweight allocation to consumer staples, which accounts for c. 32% of the trust's portfolio versus 15.6% of the benchmark, generated a return of 3.5% over the same period. Despite the recent rally in the market over July 2022, this drag on performance has persisted and is reflected in TIGT's 12-month performance to 07/11/2022, a period which saw it generate a total return of -11.8% compared to the benchmark's -1.4% and the peer group's -6.9%.

The below tables of major performers in the benchmark and some of the worst performers in the portfolio show that BP and Shell have performed very strongly year to date, and they have recently announced record quarterly profits due to persistently elevated oil and gas prices as the Russia–Ukraine conflict rumbles on. Furthermore, TIGT's high-conviction holdings that are exposed to some more tech-focussed industries have been victims of the broader tech sector sell-off and lofty valuations. However, the managers note companies such as Experian that have experienced a reduction in earnings from 35x to 22x, maintain an earnings yield of c. 5% and are expected to generate 7–9% organic revenue growth over this financial year, may present an opportunity to add to such positions from a long-term valuation perspective. In addition, companies like Fever-Tree have underperformed on the back of poorer-than-expected earnings due to supply-chain issues and the increased cost of raw materials. These current headwinds are reflected in a net return of -68% year to date for the company, and in a reduction in TIGT's allocation from 1.73% at the start of the year to 0.8%.

Year-To-Date Performance: Benchmark Against TIGT

BENCHMARK: VANGUARD FTSE ALL SHARE INDEX UNIT TRUST		
Company	**Benchmark allocation (%)**	**YTD performance (%)**
Shell	7.5	42.4
HSBC Holdings	4.2	8.8
BP	3.7	35.4

TROY INCOME & GROWTH		
Company	**Allocation (%)**	**YTD performance (%)**
Experian	4.2	-25.5
Croda Int.	3.3	-35.4
Fever-Tree	0.8	-67.9

Source: Morningstar, as at 30/09/2022

Past performance is not a reliable indicator of future results

Despite this underperformance, the managers remain confident that their decision to shift the strategy to have an increased focus on 'quality' – a core element of Troy's investment philosophy – rather than 'value' will prove successful over the long run. Since 2020, this has led to the managers focussing their attention on high-quality companies within the industrial/chemical sectors such as Croda International, which is a speciality chemicals business, and Intertek, which is one of three diversified, global and publicly listed testing, inspection and certification companies. In addition, several core portfolio holdings have experienced a gradually increasing allocation within the portfolio and have continued to positively contribute to performance, such as the pharmaceutical company AstraZeneca and the largest global food services company Compass Group. These have 'benefitted' from the pandemic and the reopening that ensued, as has Unilever, one of the largest multinational consumer goods companies in the world. Such companies share a commonality in high recurring revenue streams, clear structural growth drivers and strong pricing power.

Key Year-To-Date Performers

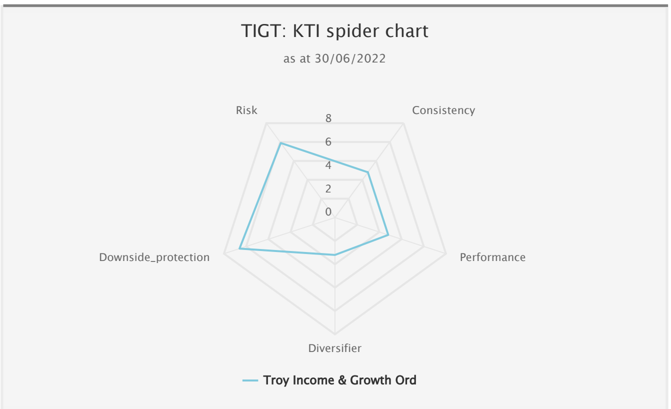
TROY INCOME & GROWTH		
Company	**Allocation (%)**	**YTD performance (%)**
AstraZeneca	3.7	17.4
Compass Group	4.1	10.8
Unilever	8.9	3.6

Source: Morningstar, as at 30/09/2022

Past performance is not a reliable indicator of future results

Below is our proprietary KTI Spider Chart. This shows how TIGT has performed versus the other 21 trusts within the AIC UK Equity Income sector over the past five years in a selection of key categories. Each category is scored out of ten. The scores are based on returns over the last five years with scores then normalised to the peer group, with a higher score indicating superior performance in that characteristic. As can be seen below, TIGT has been able to offer investors downside protection and also relatively low levels of risk, as is a common feature across Troy's investment product offerings. However, TIGT's alpha-generating relative performance is around the peer group average, reflecting weaker recent data points for the reasons discussed above.

Fig.3: KTI Spider Chart



Source: Kepler Partners, Morningstar

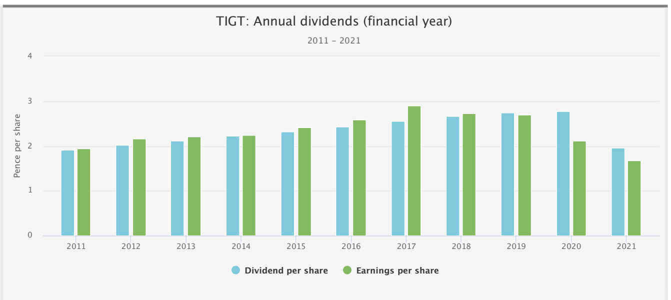
Past performance is not a reliable indicator of future results.

Dividend

In 2020, TIGT's board and managers decided to refocus the portfolio on where the best dividend growth will be in the long run with the best potential for capital preservation and growth. This meant focussing on the best sectors and stocks which they believed would provide an exposure to sustainable long-term structural growth opportunities and dividend growth opportunities, as well as avoiding chasing yield in what they believed to be structurally declining sectors such as energy and high street banks. This has resulted in a shift away from traditionally higher-yielding dividend-payers in the UK, which the managers believe have seen a progressive decline in quality and will struggle to generate growth and cover their cost of capital. The managers considered these companies' high payout ratios coupled with weak underlying fundamentals to be unsustainable. Hugo and Blake have been adding to companies they think have stronger fundamentals such as Diageo, the multinational premium alcoholic beverages company that has produced over 20 years of uninterrupted dividend growth and has been a positive contributor to performance since its purchase by the trust.

This shift has led to a deliberate rebasing of the dividend to a level that the managers believe can support long-term dividend growth. The dividend in 2021 was 1.96p per share, compared to 2.78p per share in 2020. TIGT's historic yield is 2.9%, which is low compared to the sector's simple average of 4.8% (Source: JPMorgan Cazenove, as at 07/11/2022). TIGT pays a quarterly dividend in equal instalments; however, the latest dividend declaration announced on the 15/09/2022 has resulted in a final payment for the financial year (FY) 2022 (ending in September 2022) of 0.50p (a 0.01p increase on the previous quarter's 0.49p dividend), which will increase the total dividend paid on the previous financial year from 1.96p per share. TIGT has a very strong reserve position, with total distributable reserves of £53.4m as at the time of the last annual report, equivalent to over seven times the dividends paid last year.

Fig.4: Annual Dividends



Source: Morningstar

Management

TIGT is managed by Hugo Ure and Blake Hutchins of Troy Asset Management (Troy). Francis Brooke, who had been on the management team since joining Troy in October 2004, left the team at the end of December 2021. Francis is a Troy stalwart, and has now taken on a new role as executive vice chairman of the company.

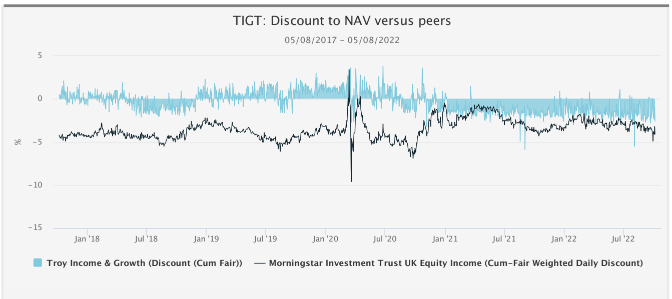
In our view Hugo's long experience on the trust (he was named manager in 2015) puts him in a good position to ensure continuity, while Blake Hutchins also has around two years' experience on the trust and three years on the team. Hugo is head of responsible investment at Troy, which also reflects his role as lead manager of the Trojan Ethical Income Fund since its inception in 2016. Blake is highly experienced in the industry and joined the TIGT team in 2019 following his time at Investec Asset Management (now called Ninety One), where he served as lead manager and co-manager of the UK Equity Income Fund and Global Quality Equity Income Fund respectively. Blake also manages the Trojan Income Fund.

Having Hugo and Blake in place several years prior to Francis's departure whilst also announcing these changes a year in advance shows the thoughtfulness that has gone into the trust's long-term succession planning. This should provide investors with some comfort with respect to the continuity of the investment management style.

Discount

TIGT is currently trading on a discount of 1.9% (as at 08/11/2022). The trust has a discount control mechanism (DCM) which was implemented in 2010, shortly after Troy took over the management of TIGT, and is designed to keep volatility to a minimum. This means the board issues shares when the trust is trading on a premium and buys back shares when it is trading on a discount. For most of 2019 and 2020 this necessitated issuing shares, but the trust has fairly persistently traded on a discount since early 2021, which has seen the board implement buybacks. We think this is likely due to a period of underperformance as energy and mining companies have rallied, along with the rebasing of the dividend to a lower level. We think the low discount volatility should appeal to many investors, particularly those investing for income who may prefer stable portfolio values and the ability to adjust their holdings by buying or selling close to NAV.

Fig.5: Five-Year Discount



Source: Morningstar

In keeping with the emphasis Troy's investment philosophy places on the preservation of capital and maintaining liquidity for investors, TIGT's board believes the DCM remains "accretive to NAV per share", with the operation of a DCM helping to dampen the amplification of losses by aiming to minimise discount volatility if a shareholder requires their capital at a price close to the NAV. Over the course of 2022 to 7 November the trust has bought back 34,883,000 shares or 11.1% of those in issue at the start of the period (excluding treasury shares).

Charges

According to the latest factsheet (from 31/08/2022), TIGT has an ongoing charges figure (OCF) of 0.88% which is marginally higher than the sector simple average of 0.79% given by JPMorgan Cazenove. However, this was calculated prior to a cut in the management fee in January 2022 from a flat 0.6% fee to 0.55% on the first £250m of net assets and 0.5% for net assets above £250m. As such we expect charges to be lower on an ongoing basis, and if the trust's assets under management are able to be grown, then investors will enjoy further benefits with the incremental cost structure now in place.

The Key Information Document Reduction in Yield (KID RIY) figure is 1.2% compared to a sector simple average of 1.43%, although we do caution that calculation methodologies can vary between trusts.

ESG

Troy has integrated ESG considerations into its stock selection process, and some elements of the existing investment process have simply been formalised, such as for example the fundamental research associated with assessing the strength of corporate governance culture. However, the purchase and integration of third-party ESG data which is used as a core part of the investment process potentially enhances the validity of Troy's own research. This data is used to identify any additional risks that could materially impact current and potential investee companies within the investment universe over the long term, such as a lack of proactive management of their social impact and environmental footprint.

Troy's inherent focus on quality throughout its investment approach tends to provide some natural alignment with ESG considerations, with 57% of the portfolio aligned to, or in the process of being aligned towards, a net-zero pathway (Sources: the MSCI and Troy). This approach has resulted in the avoidance of miners and oil majors and has contributed to the smaller-than-average carbon footprint of the current holdings, especially when compared to the FTSE All Share Index. Furthermore, as at 30/06/2022 the trust has a 'Low Carbon Designation' from Morningstar Sustainalytics (a subsidiary of Morningstar specialising in ESG ratings) and an 'above average' sustainability rating. These are both designations applied to funds that exhibit fewer ESG-related risks than is typical of their peers.

As noted in the **Management section**, Hugo Ure is the lead fund manager of the Trojan Ethical Income Fund and head of responsible investment at Troy. TIGT's managers follow Troy's house view in that they "may seek to deliver environmental or social impact where doing so is aligned with improving the risk and return profile of the investment"; however, they "will not seek environmental or social impact at the expense of returns". This leads us to believe that TIGT may not be wholly appropriate for an investor requiring a specific set of exclusionary requirements due to the absence of an exclusionary mandate. Yet as the ratings suggest, the trust could appeal to investors who generally favour a portfolio tilted towards companies with a higher sustainability profile, plus TIGT's carbon footprint is low relative to that of peers.

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