

Equity Research; ISAs a “cautious” approach

Research
Report

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A “cautious” ISA – “will this be your cup of tea?”

It is not a trick question!

Q: “So when is the pound in your pocket, worth more than a pound in your pocket?”

A: “When the pound in question is moved to an ISA”.

To a rational investor a pound in the ISA tax shelter, is worth more than one elsewhere. That is because the tax shelter brings long term tax savings that are cumulative in nature helping the ISA pound to achieve a higher growth rate. Hence the ISA pound becomes the more valuable asset.

Assuming an investor has the requisite cash it is hard to argue against holding it in an ISA and making judicious use of the annual ISA allowance. The merits of this investing approach have been well documented. Often investors achieve this by simply transferring in cash from an existing portfolio, or from savings or monthly income payments.

In recent years the concept of “ISA millionaires” has become a reality with some investors who opened Personal Equity Plans (PEPs) and TESSA’s (tax exempt special savings accounts) in the early 1990s claiming to have accumulated over £1m of tax free assets. This approach harnesses the long term returns from portfolio investment in a tax free environment. The difference in returns is especially stark in a low interest rate environment (see below).

Assuming £100 of ISA cash invested in UK equities delivers £4 of income :-

| A/C | “ISA” a/c | Trading a/c | “Bank” a/c | “Pocket” |
|-----------------------------------|-----------|-------------|------------------------------------|----------|
| Pre- tax return | £4 | £4 | £0.25 | £0 |
| Basic Rate Tax Payer (7.5%) | £4 | £3.70 | £0.25* | NA |
| Higher Rate Tax Payer (32.5%) | £4 | £2.70 | £0.25 (up to £500 allowance) | NA |
| Additional Rate Tax Payer (38.1%) | £4 | £2.47 | £0.1375 (no allowance; tax at 45%) | NA |

Source; CSS Investments Ltd

*First £1,000 of savings interest is tax free for basic rate payers

It follows that a rational investor might take a “cautious” approach to investing in an ISA – this would assist in growing both capital and income over time. Taking a cautious

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approach usually implies a strategy that mixes investment trusts.

Investment trusts have two values, notably the value of the fund's net assets and the market capitalization of the trust. If the market cap is significantly lower (a large discount) than the net assets the trust's board of directors might decide to buy back the shares to narrow the discount. This mechanism ensures the fund's value and market capitalization have a direct relationship that whilst not perfectly synchronized is unlikely to exceed a 10% difference.

For a cautious investor we select four investment trusts covering different areas within the global equity market; i) Bankers Trust (global blue chip), Mercantile Investment (UK Mid cap shares), Dunedin income & Growth (UK blue chip high yield) and Electra (UK & International private equity).

Bankers Investment Trust – UK 250 – BUY

Bankers Investment Trust is a UK based investment trust offering diversified global blue chip equity exposure; broadly the spread is North America (28.9%), UK (15.4%), Europe (13.9%) Japan (8.6%), Emerging Asia (18.1%), other Emerging markets (11.4%) and Developed Asia Pacific (ex Japan) 3.7%. The portfolio had net assets of £926.7m end October 2016.

The managers of Bankers Investment Trust have followed a policy of reducing exposure to sterling assets from 55% in 2006 to under 30% in 2016 preferring to invest in higher growth international markets. This has served investors well particularly given the more precarious nature of sterling since the EU referendum last June which has significantly boosted the sterling value of Bankers' overseas investments.

The 2016 annual report points to Bankers' impressive ten year performance – the total return has been c. 240% - the dividend has grown from 9.5p to 17p equating to a 6% compound growth rate. The board has flagged a further dividend hike of 6% for 2017 taking the payout to 18p per share.

The investment spread (194) with the highest single investment (2.48%) considerably diversifies stock specific risks. The top 25 holdings are c. 29.25% of total investments.

| Bankers Investment Trust forecast | | | | | | | |
|-----------------------------------|--------------|---------|------------|---------|---------|-----------|-----------------|
| Year End | Revenue (£m) | Gearing | Ret PS (p) | DPS (p) | NAV (p) | Yield (%) | Share Price (p) |
| Oct-16 (A) | £24.9m | 2.5% | 71.5 | 17 | 756 | 2.1 | 798 |
| Oct-17 (F) | £26.2m | 2.5% | 94.1 | 18 | 850 | 2.3 | |

Source: www.fidessa.com

The strong performance of global equities during H1 2016 is supportive to the extent that we expect further growth in NAV to end October 2017 to c.850p per share.

| | | |
|----------------|------|----------------------|
| Company | BNKR | Key Catalysts |
|----------------|------|----------------------|

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| | | |
|------------------------------|---------------|---|
| Share Price | 798p | <p>Bankers Investment Trust reported net asset value per share of 837.3p as at 20th June 2016. The recent run up in the shares has left the discount to net assets at just 4%. This is above its three year average of 1.8% but less than half the 8.9% discount in mid February 2016.</p> <p>The team demonstrated a particular expertise in China with its investments there jumping 44.2% v 14% for the China CSI 300 index.</p> <p>The low expense ratio of 0.45% p.a. is a key positive for Bankers Investment Trust.</p> |
| Target Price | 925p | |
| 52 Week Hi/Low | 801p/ 551p | |
| 5 YR Hi/ Low | 801p/ 401p | |
| Shares O/S | 122.61m | |
| Market Capitalisation | £978.4m | |
| Avg. Daily Volume | 70k | |
| Dividend Yield | 2.3% | |

Key Risks to Price Target

- i) The discount to net assets from current levels of 4% could increase if enthusiasm for investment trusts declines
- ii) Short term demand for Bankers Investment Trust will be sensitive to expectations of a share buyback
- iii) Sensitive to movements in global capital markets

Dunedin Income & Growth UK All Share BUY

Dunedin Income & Growth invests primarily in the UK (81.24%). Other countries have far lower exposure, France (6.76%), Switzerland (6.63%) Denmark (1.49%), Italy (0.55%) with other countries, Australia, Spain, Netherlands, USA all sub 0.55%.

The trust was founded back on 1 February 1873 – it has a focus on high and sustainable yield which means it invests heavily in the UK high dividend favorites, BAT, GSK, Royal Dutch Shell, HSBC, Prudential, Astra Zeneca, Vodafone, BP, Provident Financial, Imperial Brands and National Grid. Dunedin's board recognize that the focus on income has constrained its managers from investing in lower yielding higher growth opportunities and is slowly reducing exposure to UK high yield blue chips.

The board does employ gearing, which magnifies investment returns in rising and declining market conditions. Recent net gearing (debt less cash/ total funds) is c. 6.1% which would not make a significant difference to portfolio returns. In October 2015, Dunedin issued £30m of 3.99% senior notes due 2045 to refinance a 7.875% debenture that falls due in 2019. This was seen positively as locking in cheap long term funding.

The charge structure is competitive with 0.45% levied on the first £225m, 0.35% on the next £200m and 0.25% over £425m p.a. on the net assets of Dunedin. Dunedin's net assets have grown 56.7% over the last 5 years compared to £58.6m for the UK All Share Index.

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| Dunedin Income & Growth | | | | | | | |
|-------------------------|--------------|--------------------|---------|---------|---------|-----------|-----------------|
| Year End | Revenue (£m) | Return (per share) | EPS (p) | DPS (p) | NAV (p) | Yield (%) | Share Price (p) |
| Jan-16 (A) | 20.36 | -28.94 | 12.11 | 11.40 | 237 | 4.30 | 265 |
| Jan-17 (A) | 21.96 | 43.83 | 12.55 | 11.70 | 270 | 4.41 | |

source: www.fidessa.com

There are no consensus forecasts for the Dunedin Income & Growth Investment Trust.

| Company | DIG | Key Catalysts |
|-----------------------|----------------|--|
| Share Price | 265p | The share buyback programme so far has been modest, Dunedin has repurchased 3.57m shares to date (and about £1.1m worth over FY2017) and is expected to seek permission to buyback shares at the AGM to manage the level of discount relative to the peer group. There is scope to increase the share buyback to c. £5m p.a. though the board have not yet flagged a change of policy on the buyback. Net assets were reported at 295.4p (22 June 2017) hence a 9.27% discount to net assets looks attractive relative to a discount range of 12% to 7.5% over the last year. |
| Target Price | 300P | |
| 52 Week Hi/Low | 271p/ 209p | |
| 5 YR Hi/ Low | 276p/ 195 p | |
| Shares O/S | 150.1m | |
| Market Capitalisation | £397.5m | |
| Avg. Daily Volume | 52k | |
| Dividend Yield | 4.30% | |

Key Risks to Price Target

- i) Sensitive to high yield UK blue chip companies and weak sterling.
- ii) Portfolio yield might reduce over FY2018 as the manager adopts a more growth orientated strategy
- iii) Share buyback might be delayed or continue to be relatively muted

Mercantile Investment Trust – UK 250- BUY

Mercantile Investment Trust is a leading UK equity trust with assets in excess of £2bn and over 130 years in existence. The trust's focus is on UK companies, outside the FTSE 100 with established track record and significant growth prospects. The trust typically invests mainly in FTSE 250 companies.

Mercantile Investment Trust has low annual management charges of 0.4% and operating/ administrative charges of 0.08%. The board has a gearing policy to operate within a range of 10% net cash to 20% gearing. The dividend policy for 2018 comprises three payments of 10.5p with a variable final dividend.

According to the 2017 annual report (Mercantile has a 31st January financial year end) the trust reported 5 year net asset growth of 102.3% against the benchmark return of

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99.7%, however over 10 years, net asset growth is 91.3% v ten year benchmark gains of 112.8%. The board noted that over H1 2017 its portfolio was incorrectly positioned for the EU Referendum on 23rd June. Nevertheless the board outperformed during H2 2017 with net asset value (NAV) per share rising 3.06% to 1921p by FY17.

The Conservative government has lifted expectations of lower corporate taxes. In November 2016 the PM promised to offer the lowest G20 corporation tax rate by 2020, this suggests the rate will decline to 17% by 2020 from the current level of 19%. This is a key positive for UK midcaps, assuming the government delivers on this policy.

| Mercantile Investment Trust | | | | | | | |
|-----------------------------|-------------------|-----------------|------------|---------|---------|-----------|-----------------|
| Year End | Gross Return (£m) | Net Return (£m) | Ret PS (p) | DPS (p) | NAV (p) | Yield (%) | Share Price (p) |
| Jan-16 | 234.20 | 213.8 | 221.9 | 43.75 | 1864 | 2.29% | 1907 |
| Jan-17 | 101.58 | 81.6 | 88.1 | 46.75 | 1921 | 2.45% | |

source: www.fidessa.com

There are no consensus forecasts for Mercantile Investment Trust.

| Company | MRC | Key Catalysts |
|-----------------------|-----------------|---|
| Share Price | 1907p | <p>Large 12% discount to net assets per share of 2166.7p (7th June 2017) is at the upper end of the normal discount to NAV of between 8%-11%.</p> <p>The Board repurchased 9.4% of ordinary share capital via a share buyback program out of a total buyback authorization of 14.99% of share capital to be held in Treasury or cancelled at a later date. We expect further buybacks up to 14.99% over FY18. The impact of the buybacks should be to narrow the discount to NAV.</p> <p>NAV at 2166.7p has jumped 12.8% since FY17.</p> |
| Target Price | 2100p | |
| 52 Week Hi/ Low | 1975p/ 1375p | |
| 5 YR Hi/ Low | 1975p/ 943p | |
| Shares O/S | 84.27m | |
| Market Capitalisation | £1.6bn | |
| Avg. Daily Volume | 124k | |
| Dividend Yield | 2.29% | |

Key Risks to Price Target

- i) Sensitive to UK macro-economic factors, i.e. interest rates, fiscal policy
- ii) Discount to net assets is normally between 8%- 11.5%
- iii) UK Mid Cap P/E now 22x hence relatively expensive compared to recent multiples.

Electra Private Equity UK 250 BUY

Electra Private Equity is a private equity investor for over 25 years achieving investment returns in excess of the UK All Share index. It has an objective to achieve a return on equity of between 10%-15% per annum by investing in unlisted high growth investments. Typically Electra invests £30m- £100m in minority positions in UK and

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International companies alongside founders, other private equity firms, corporate and IPO investors. It can also invest higher amounts £40m- £150m in UK companies with an enterprise value of £300m.

Electra's share price has grown from 40p in 1980, to a high of £51.10 earlier in 2017. 2017 has however marked a major changes, Electra has made significant realisations (sales of unlisted private equity holdings) and following those sales it has paid out £26.12 per share (ex -dividend 6th April 2017) and 914p per share (ex-dividend 8th June 2017). The payout policy targets a 3% payout to investors by way of cash dividends or share buybacks.

Electra terminated its management and investment guideline agreement with Epiris Managers, in June 2017 and taken control of their own affairs. The unlisted investment portfolio comprises significant investments in TGI Fridays, Photobox, Hotter Shoes and Knight Square. Together these are worth c. 700p per share (1 June 2017).

| Consensus profit estimates; Electra Private Equity | | | | | | | |
|--|--------------|--------------|---------|---------|---------|-----------|-----------------|
| Year End | Revenue (£m) | Pre Tax (£m) | EPS (p) | DPS (p) | P/E (x) | Yield (%) | Share Price (p) |
| Sept-16 | 756 | 536 | 432 | 122 | 12.1 | 7.08 | 1721 |
| Sept-17 | 875 | 538 | 935 | 3526 | NM | NM | |
| Sept-18 | 160 | 103 | 176 | 134 | 17.2 | 7.57 | |

source: www.fidessa.com

The consensus forecast suggests the payout at c.134p in 2018 given the 2017 disposals. This payout (£51.3m) is ambitious given the reduced investment portfolio c £383m could be expected to return c. £30m.

| Company | ELTA | Key Catalysts |
|-----------------------|-----------------|--|
| Share Price | 1721p | <p>Electra has updated the market advising of a pro-forma net asset value of £769m post the 914p payout, comprising £386m cash and £383m net investments equating to net assets per share of 2008p.</p> <p>Four directors have acquired Electra shares in recent days paying up to 1847p per share.</p> <p>Electra is now starting Phase II of its strategic review, the result of which will be announced in Q4 2017. The outcome of Phase II could entail further realisations or conclude that Electra makes further new investments.</p> |
| Target Price | 2100p | |
| 52 Week Hi/Low | 5110p/ 1720p | |
| 5 YR Hi/ Low | 5110p/ 1630p | |
| Shares O/S | 38.28m | |
| Market Capitalisation | £658.8m | |
| Avg. Daily Volume | 46.6k | |
| Dividend Yield | 7.57% | |

Key Risks to Price Target

- i) Sensitive to UK macro-economic factors, i.e. interest rates, taxation given mid cap and small cap nature of investments.

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- ii) Valuation is more sensitive to legacy investments such as TGI Fridays
- iii) Outcome to Strategic Review Phase II will be a key driver going forward for the payout plan

(NB. "PBT"- profit before tax, "EPS" earnings per share, "DPS" dividend per share, "P/E" price to earnings, "NM" not meaningful)

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Please be aware that the following disclosures of Material Interests are relevant to this research note:

Bankers Investment Trust **Relevant disclosures:** <2>

Dunedin Income & Growth **Relevant disclosures:** <2>

Mercantile Investment Trust **Relevant disclosures:** <2>

Electra Private Equity **Relevant disclosures:** <2>

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