Edinburgh Investment Trust Newsletter

James de Uphaugh, Fund Manager | Spring 2021

Welcome to the inaugural Edinburgh Investment Trust quarterly newsletter, in which we will give you an in-depth update on our thoughts about the UK equity market and the stocks held in the Trust.

Executive summary

Build back better is more than just a political slogan. It speaks to a common theme that stretches across the Edinburgh Investment Trust portfolio as a result of our fundamental stock analysis and individual investment approaches. Businesses that embody this theme typically have some form of **digital advantage**, operate in markets with **more demand than supply** and have the **ability to deploy capital** to generate a healthy rate of return. While the current rotation in markets might have further to go, we believe businesses with these characteristics have potential to deliver more powerful returns for shareholders over the long run, well beyond the mean-reversion trade.

Businesses with follow through

After a year of fairly persistent social restrictions around the world, investors have firmly set their sights on reopening opportunities as the vaccine rollout continues apace, most notably in the US and UK. And while the alphabet soup of "V", "W" and "K" style recoveries is no longer common parlance, markets appear to be preparing for a powerful stimulus-induced, pent-up-demand backed resurgence in activity. Chancellor Rishi Sunak kept the taps open in the recent UK Budget, for example, announcing a further £65bn in support measures, while Biden's $1.9trn stimulus package has added spice to recovery expectations. While there remains a great deal of debate about the reflationary potential of these measures, the US bond market has started to test how far the Fed will let yields climb before intervening. The glamour growth/momentum trade in the US has been a primary casualty of this new paradigm and 'value' investments have started to see a mean reversion that has been many years in the waiting.

We are not actively looking to participate in a battle of styles, nor are we positioning for a particular economic path. We manage a flexible, all-weather portfolio with a blend of stocks that are a function of the global perspective of the Majedie investment team. The portfolio thus contains a range of idiosyncratic stock-driven opportunities.

In the last year, we have been impressed by the quality of many company management teams and their foresight to use the crisis as an opportunity to improve operationally and grow market share. They are not tied to one particular sector or investment style but typically have a highly advanced digital element to their business, operate in markets with positive supply and demand dynamics and have the wherewithal and ability to generate a decent return on capital.

Customer-focused technology

Beyond obvious areas such as online retail, the digital transformation is creating long-term winners in unlikely areas such as old economy capital intensive industries and construction equipment. **Ashtead Group** is a great example of the latter. The business is a key player in the equipment rental market in the US, an area that is inherently cyclical. However, its scale and best-in-class digital interface and App has helped the business weather the Covid storm very well. Ashtead's technical ambitions were resoundingly clear during a recent conference call with CEO Brendan Horgan. He wants the company's technology credentials to be recognised beyond the rental equipment market. The business is now developing systems to monitor and improve the company's role in the circular economy and to have a bigger impact on reducing carbon emissions.

RELX is a company which has made a highly successful transition from the print world to digital over the past decade. It has plans to augment its valuable science, legal and insurance databases with new artificial intelligence tools and applications to the benefit of its customers.

Positive supply and demand dynamics

Businesses operating in markets where demand is outstripping supply offer particular attractions within this build back better theme. This is critical for corporate profitability when dealing with the pressures of inflation. Companies operating in markets with strong demand typically have superior cash flows and deliver a steady return on equity for investors. Our holdings in housebuilders are benefiting from this dynamic: **Redrow** and **Bellway**.

Healthy returns on capital

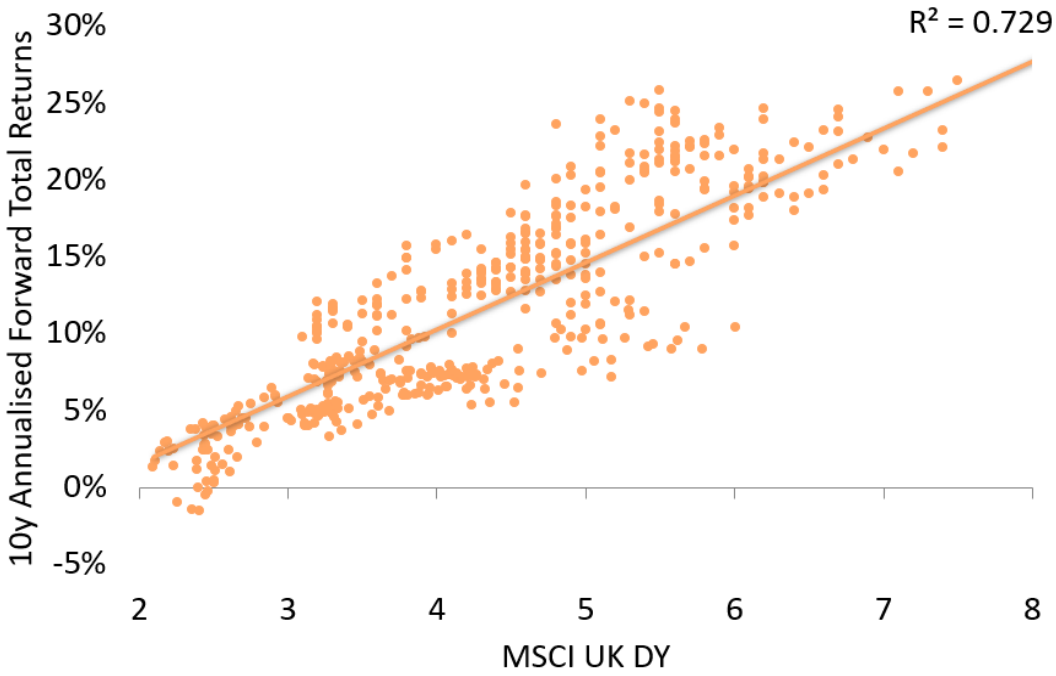
Finally, build back better businesses are those with the ability to deploy capital at a healthy rate. Capital is still extremely cheap compared to history. A decade of financial repression and low demand has seen the marginal return on capital shrink to very low levels. While there is a great deal of optimism about the growth outlook, several structural headwinds remain in place – high government debt levels, ageing populations, environmental concerns and technological advancements. In the near term, growth numbers will be flattered by pent-up demand and the rebasing of data. The long-term outlook, however, appears more nuanced. Hence, while cyclical companies that have highly commoditised services might enjoy a strong initial recovery phase, they will find achieving decent returns on capital hard work beyond that period. Companies that have the ability to deploy incremental capital and have the sort of franchise that enables them to earn a good return on that are going to be quite rare and valuable and will provide a decent follow through for investors. **Electrocomponents** and Ashtead are great examples of this theme from the Trust's portfolio, with both able to deploy incremental capital at high rates, which is particularly attractive at a time when returns across asset classes continue to be very low.

World class companies at low valuations

We end this newsletter with the points we made about the attractive valuation of the UK stock market during the April 2021 webcast that is available to view on the Trust's webpage. As we described, Brexit uncertainty, political paralysis in Westminster and the shock of Covid-19 have all been powerful headwinds that prompted many global investors to avoid the UK market, which for many was almost an embarrassment in a global portfolio. The good news is that all three of these headwinds are ending: the successful roll out of the vaccine in Britain is turning heads around the world and, looking ahead, investment returns could be very attractive.

We unashamedly believe that valuation is an important component of future return. This hasn't been evident when it comes to wider market returns in recent years in what has been an unusual liquidity environment, but longer-term history can be a better guide.

Figure 1: UK equities 10-year total returns at different entry dividend yields (MSCI UK since 1970)



Source: Citi; MSCI February 2021

The chart in Figure 1, which expresses the relationship between starting dividend yield and subsequent ten-year annualised returns commencing at different months, shows two things very clearly. First, for the long-term investor, there is a relationship between dividend yield and total return. It is a similar trend when using other valuation lenses such as earnings and price to book. You don't need to be a value investor to believe that valuation is an important component of future returns. This should be an obvious point for investors seeking returns, but has been largely forgotten in the past decade when liquidity and momentum were such powerful drivers of share prices.

Second, the UK market is offering a current dividend yield of over 3.1%, which appears conservative compared to analyst forecasts for 2021 and provides the basis for a healthy future total return, one which should beat inflation and is higher than many international peers. The world desperately needs investment returns at the moment given low underlying prospective returns in most asset classes.

Clearly 2020 was a painful year for profits and was the great dividend reset for the UK market, where companies were presented with the opportunity to return dividends to sustainable payments. It is fair to say the UK index was weighted to more capital intensive and lower return sectors in the past, where profits and dividends have fallen. While this has impacted market returns, the good news is that our market is now much more diversified and skewed towards higher return companies; no single sector accounts for more than 10% of the index.

In summary, we believe now is an exciting time to be an active investor in UK equities through Edinburgh Investment Trust. Brexit clouds have now parted, and the vaccine rollout has been impressive. UK equity valuations are far more attractive than many global peers and, as we highlight above, the market is home to businesses with real follow through – the sorts of companies that can underpin attractive returns for shareholders over the medium term.

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