Keystone Investment Trust is a client of Kepler Trust Intelligence. Material produced by Kepler Trust Intelligence should be considered as factual information only and not an indication as to the desirability or appropriateness of investing in the security discussed.

Keystone Investment Trust

Update
29 May 2019

Summary

Keystone (KIT) is managed by James Goldstone, who aims to generate long-term total returns with a valuation-based approach to buying UK equities. James aims to identify companies which are undervalued due to investor sentiment or past troubles and hold them while their valuations revert to fairer levels.

The attention he pays to the dividends on his portfolio companies, due to the implications they have for cash generation, management discipline and concerns for shareholders, means the yield tends to be higher than the typical growth fund. It is currently yielding 3.6%, which compares to the 4% average for the AIC UK Equity Income sector, despite the trust not specifically aiming for income. The trust has moved to a quarterly dividend, starting from the second half of the 2019 financial year, making it potentially more attractive to income investors.

James, who took over the portfolio in April 2017, believes the major area of undervaluation in the market since he took over has been and continues to be in companies with UK domestic earnings. In his view, the valuations on companies dependent on the UK economy have become irrational due to ongoing uncertainty around the terms of our exit from the EU and the economic consequences.

He has balanced this exposure to UK earnings with positions in international earners which are undervalued for different reasons, for example oil and gas companies. Just under 7% of the trust is also invested in gold mining companies, predominantly listed in North America, which should offer downside protection. He also holds a weighting in mid and small-cap growth companies, which he believes more than justify their current multiples.

The weighting to UK earnings has meant the trust has underperformed in recent years, as any resolution to the Brexit negotiations has been postponed and the uncertainty prolonged. The trust now languishes on one of the widest discounts in the sector at 13%. James believes that when investors' attention returns to fundamentals, there is significant outperformance potential in the portfolio.

As at	23/05/2019
Price (p)	1575
Discount (%)	-12.9
OCF (%)	0.55
Gearing (%)	9
Turnover Ratio (%)	37.3
Yield (%)	3.6
Ticker	KIT
Shares	13,518,799
Market cap (£)	212,921,084

Kepler View

This has been a rough period to be a value investor, but we agree with James that valuations on quality domestic earners are an opportunity – the question is when this value will be recognised. It likely requires a resolution to the Brexit process, even if that is a "hard Brexit", which would relieve the uncertainty and allow investors to focus on the fundamentals of individual businesses in the new environment. Sadly, this could take some time to arrive, with the decision currently postponed until October. The discount of 13% is intriguing, in our view, although it may take some time for the reversion of valuations to come through and the gap to close. In the meantime, James has positions in energy and miners as well as some mid-cap growth stories which could come good regardless.

Analysts:

William Heathcoat Amory
+44 (0)203 384 8795

Pascal Dowling
+44 (0)203 384 8869

Thomas McMahon, CFA
+44 (0)203 795 0070

William Sobczak
+44 (0)203 598 6449

Kepler View

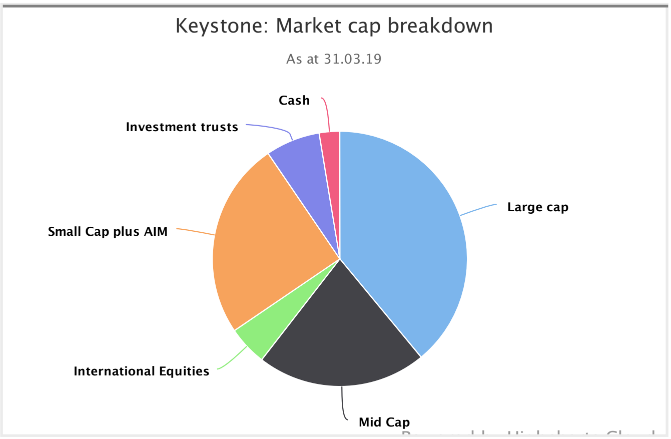
BULL	BEAR
A wide discount on a portfolio of out of favour stocks is an interesting value opportunity	The Brexit negotiations will likely weigh on the share price in the short term
The yield of 3.5% on the current discount is an attractive one to lock in	There is some legacy expensive debt which will weigh on the trust in weak markets
The trust pays a quarterly dividend	Value as a style is out of favour

Portfolio

Keystone (KIT) is managed by James Goldstone, who aims to generate long-term total returns with a valuations-based approach to buying UK equities. James aims to identify companies which are undervalued due to investor sentiment or past troubles and hold them while their valuations revert to fairer levels. The attention he pays to the dividends on his portfolio companies, due to the implications they have for cash generation, management discipline and concerns for shareholders, means the yield tends to be higher than the typical growth fund.

The manager concentrates on UK equities from across the market spectrum, meaning an overweight to small and mid-cap stocks versus the index should be fairly consistent. James aims to hold stocks for at least three years, and the turnover figure for 2018 is more or less consistent with that at 37%, according to Morningstar data. Turnover was elevated in 2017 when James took over (in April), and refashioned the portfolio as he wanted it, and we expect the 37% number to fall further in 2019. The number of stocks in the portfolio has been in the 74 to 80 range over the past year.

Fig.1: Market Cap Allocation



Source: Invesco

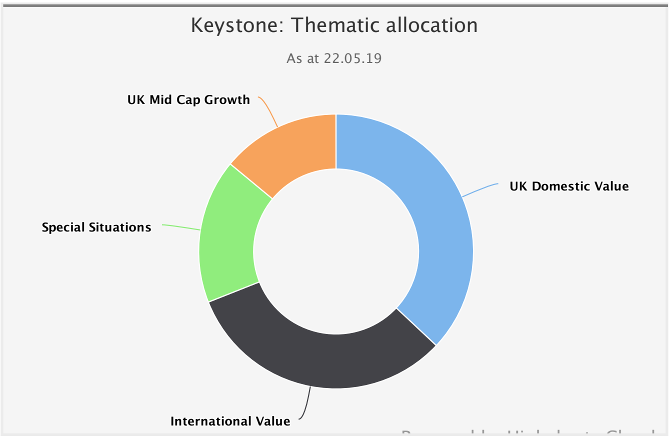
James' stock selection centres around valuation, with a focus on limiting the downside to his stock picks.

In terms of numbers, he looks principally at free cash flow generation, and forecasts out two to three years, calculating expected ROIC as well. He looks for situations in which there is a potential catalyst or a change in the company or market which could cause the mis-valuations he identifies to be corrected.

James pays special attention to the quality of the management teams and their track records in turning around companies. For example, the most recent new holding in the trust is manufacturing conglomerate Essentra. One of the reasons James bought in to the company was the past achievements of the new CEO Paul Forman at Coats, an industrial threads manufacturer which James has owned for several years in his portfolios. When we met James recently, he explained that good businesses that have fallen into difficulties but with good management teams aiming to turn things around was one of the more potent combinations. James looks for a record of managing the capital base appropriately and making the right choices regarding distributions to shareholders and reinvesting in the business. Dividend distributions are a key piece of evidence to that end. James also believes that a progressive dividend policy itself is evidence of an alignment between management and shareholders which gives him more confidence in a company.

James believes the major area of undervaluation in the market since he took over has been and continues to be in companies with UK domestic earnings. In his view, the valuations on companies dependent on the UK economy have become irrational due to ongoing uncertainty around the terms of our exit from the EU and the economic consequences. Although we have seen UK investors return to the market in greater numbers in 2019, the UK continues to be one of the least favoured places for international investors according to the Bank of America Merrill Lynch fund managers' survey. As a contrarian, value manager, James has built up an overweight position in those domestic-facing businesses which he regards as over-sold and also high quality. This is the largest thematic allocation in the fund, at 38%.

Fig.2: Thematic Allocation



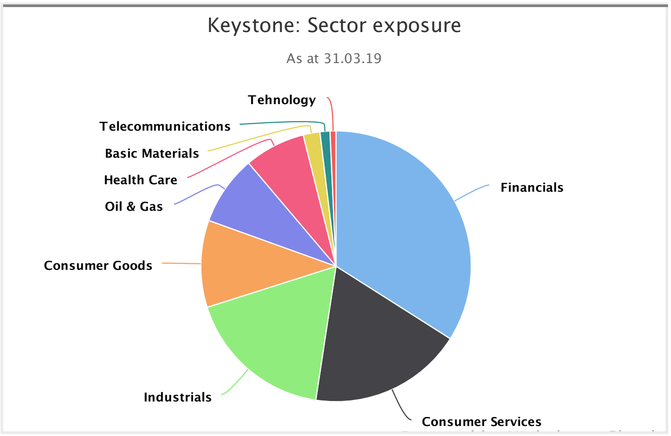
Source: Invesco

The UK domestic banks fall into this classification. James has 4.3% invested in the company and another 0.55% in Sherborne Investors, the activist fund which owns a 5% position in Barclays. This is together therefore the second-largest position in the fund behind BP at 5.4%. James believes that the bank is being undervalued by the market principally due to its exposure to the UK, which represents around 50% of its earnings. James' analysis suggests the bank's shares will have to double to reach their intrinsic value, and he finds the valuations multiple of 0.6 times book value to be compelling. This is particularly so given that the bank's management is adamant that it will hit its key performance targets of 9% ROE in 2019 and 10% in 2020.

James also believes that the market has fundamentally misunderstood the strength of Barclays balance sheet due to technical reasons to do with the classification of the risk-weighted capital which they are forced to carry on their balance sheets. While the balance sheet has shrunk in recent years, the sterling amount of capital required to be held in certain categories has not yet fallen, so the capital positions is stronger than it appears. One of the advantages of working within a large investment house such as Invesco is the access that this gives fund managers to companies, and James has had great access to the Barclays management team, which has added to his confidence that the market is fundamentally wrong on this stock.

The position in banks is one major change that the manager has made since taking over the trust. He has taken a zero-weighted position up to 8%. The trust also has a 2.7% position in RBS, another bank which is out of favour thanks to its domestic earnings. James expects the bank to buy back stock in the market as the government sells down its stake. The trust also has a significant position in insurers which helps the financial weighting be the highest in the portfolio.

Fig.3: Sector Allocation



Source: Invesco

Whilst he has stuck to his view that UK domestic earnings are undervalued, James recognises the risk in the positioning. Over the last six months James has said he is careful to only buy companies he views as structural winners. For example, within the retail sector he holds Next and JD Sports, both of which have produced good trading updates in recent quarters, despite retailers as a whole being under pressure.

This perceived weakness of the retail sector is another source of contrarian ideas. Next, which looks cheap on P/E, P/B and P/CF metrics, despite generating strong cash flow growth over 17 years, is a classic example. In James' view, the market is valuing it as a bricks and mortar retailer despite its success in transitioning its mail order business to online. The company's online sales are growing at a similar rate to market darling Boohoo, but investors are effectively getting the store sales for free. James has 3.3% in Next, a top ten position. JD Sports has continued to generate strong EPS numbers, and this has now started to be recognised by the market. The shares had peaked at just over £5 in September before declining in he indiscriminate fourth quarter sell-off. This year, however, they have rocketed to £6.33. While James thinks the shares are closer to fair value now, he thinks there is more to go.

Top Ten Positions

HOLDING	% OF PORTFOLIO
BP	5.4
Barclays	4.3
AJ Bell	3.9
Tesco	3.4
Next	3.3
Coats	3.2
Shell	3
RBS	2.7
BAT	2.6
Babcock	2.1

Source: Invesco, as at 31.03.19

The largest thematic exposure is to UK domestic earnings, but James has hedged this exposure to some extent with positions in dollar earners he finds to be undervalued for different reasons. He has 8.3% in oil and gas, a sector he finds attractive thanks to the newfound capital discipline of the companies. He also holds a position in gold miners, worth around 5% of the fund spread among a basket of five different stocks. These act as an insurance policy which pays the shareholder, as they provide strong dividends and cashflows with the possibility of a "payout" in capital gains, in a market crisis. These stocks add dollar exposure to the portfolio as well as a "crisis hedge". However, all holdings in the fund have to be there on their own merits first, and macro-economic reasoning only enters the process at the final stage, as James tries to understand and balance out the risks he is taking in the portfolio.

What sets this trust apart from being a straightforward "value" play is its bucket of higher-growth names. James has 13% of the fund in UK mid-cap growth names. Here he is happy to own apparently expensive holdings when they have genuine barriers to entry and a scalable business model, as well as a track record of at least three years' growth which justifies their current multiple and their strong forecasts.

Top ten position Coats Group is one example. The company, which manufactures sophisticated threads, has major deals with Nike and Adidas and has built a competitive niche, not least because of the ESG credentials it can bring as a global company, which are harder for cheaper local competitors to achieve. There is huge growth potential in the company thanks to certain high margin segments in which it is currently operating, such as Kevlar and lightweight fabrics, and the potential for future applications in the auto industry.

The trust does have the ability to buy international equities, but James only uses this when the UK market can't give him what he wants – for example he has looked overseas to boost his exposure to oil and gas and to gold miners. James has also taken positions in investment companies buying overseas property such as Phoenix Spree Deutschland and Dublin-focused Hibernia REIT. Additionally, James can in theory buy unquoted investments, although such holdings in the portfolios were inherited from the previous manager and are being wound down.

Overall the portfolio has been slightly de-risked since James took over, with slightly more international earnings exposure, although the key theme remains the undervaluation of UK domestic earnings. James continues to top and tail positions in a contrarian fashion, and is aiming to weather the stormy macro environment until fundamentals once again dominate stock performance.

Gearing

The trust owes £32m on a pair of long-term debentures, which make up 12.5% of current net assets valued at par. James does have some flexibility with his gearing levels through an overdraft facility too, although he is required to keep to a limit of 115% exposure and is expected to make sales if market movements cause the gearing position to rise higher than this. In recent months he has reduced the gearing by building up cash levels, and gearing stood at 10% at the end of March. James tells us it has since fallen further to around 5%.

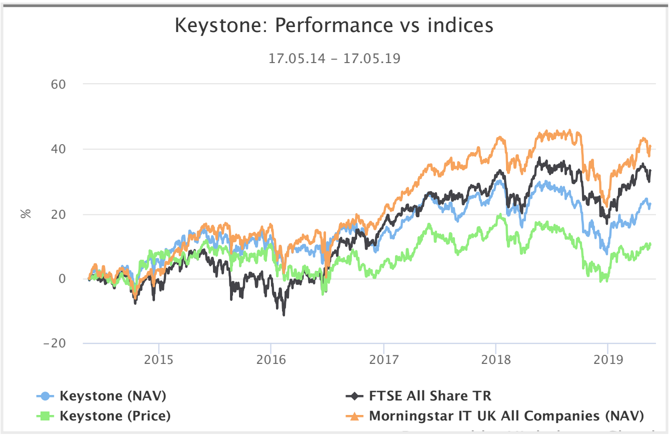
The debentures are expensive, with a weighted average cost of 6.77% a year, but the smaller of the two will mature in 2020, reducing the debt by £7m, which will be welcome given the cost. The remaining debenture matures in 2023.

The trust also has preference shares paying 5% worth £250,000, or less than 0.01% of net assets.

Returns

The trust's exposure to UK domestic earners on valuation grounds has led to it underperforming the benchmark and sector in NAV total return terms since the June 2016 Brexit referendum. The pain has grown steadily worse, despite a couple of rallies in relative performance when a resolution to Brexit seemed possible or near – in the first quarter of 2017 and in January 2019. But it has been a rough period for value investing in the UK, and James is clear that it will take a resolution to the Brexit process for this dynamic to change.

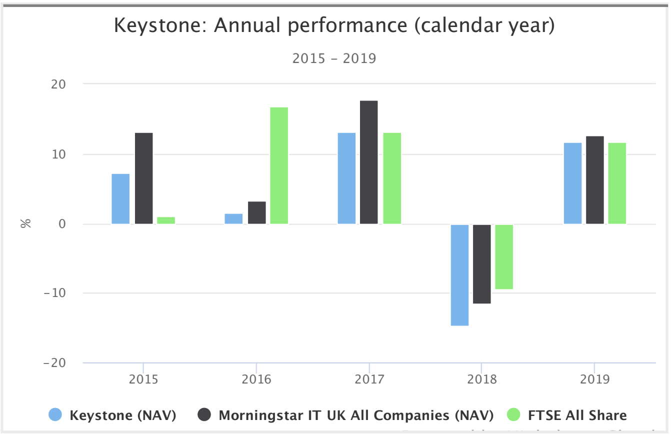
Fig.4: Five-Year Performance



Source: Morningstar

To some extent, James inherited this position from his predecessor Mark Barnett, who shares a similar focus on valuations. NAV total return relative performance of the trust actually dipped before the 2016 vote, when its portfolio lagged a strongly rising market thanks to a lack

Fig.5: Returns



Source: Morningstar

of exposure to oil and gas and mining in a period in which the raw materials rebounded strongly; dollar earners were then rewarded following the vote to leave the EU in June. The whole peer group lagged the market substantially thanks to this currency effect. James took over in April 2017, and in that year returns were actually marginally ahead of the FTSE All-Share Index as concerns about Brexit waned. However, in 2018, as the deadline drew nearer without agreement, and the global context became more troubling, the underperformance accelerated through the year. The trust rebounded faster than the market in the global recovery in January, but then as the March deadline for Brexit drew nearer domestic underperformed once again.

James tells us that ETF action has compounded the issue. Those companies in the JPM domestic earners index, which is tracked by ETFs, have been highly volatile and sold off together on sentiment towards the outcome of Brexit. We believe that over the medium term there will be a rebound in the UK market as whatever deal is reached with the EU, a veil of uncertainty will have been lifted, and international investors will become less inclined to play the domestic / international trade through ETFs. However, when this will happen is much harder to predict given the current political turmoil.

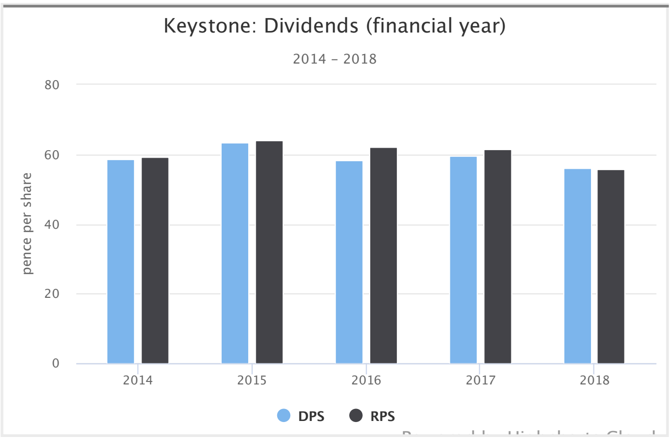
In the meantime, it is important to note that James has hedged this exposure to domestic earnings. The holdings in gold miners bring with them a long dollar exposure, and there are a number of holdings with more overseas exposure, as detailed in the portfolio section. In early 2019 James has been adding to the gold miners to further balance his domestic earnings exposure and due to his increasing concerns about the global economy, the US/China trade war and the increasing likelihood of easier monetary policy, especially in the US.

Dividend

James' value discipline and the UK market being out of favour have led to the trust trading on a 3.6% yield, which compares to a 4% average for the AIC UK Equity Income sector, although the trust sits in the UK All Companies sector. The company's objective is to maximise total return, but the board and the manager consider dividends to be a crucial component of that return. In recognition of the importance of income to many investors, the board has moved to a quarterly payment frequency, starting from the second half of the 2019 financial year. Two quarterly dividends will be declared before the 30 September year end, with the trust having paid a 24p dividend for the first half under the old semi-annual timetable.

Dividends have risen and fallen from year to year with revenues and special dividends on the portfolio. However, in our view the value approach means the trust is likely to yield more than the average UK All Companies trust over the medium to long term, and the switch to quarterly dividends and use of reserves mean the board is likely to place more emphasis on the dividend in the future. The company's interim dividend this year required the board to dip into reserves, which we estimate were roughly 0.7 times the 2018 annual dividend after it was paid.

Fig.6: Dividends



Source: Morningstar

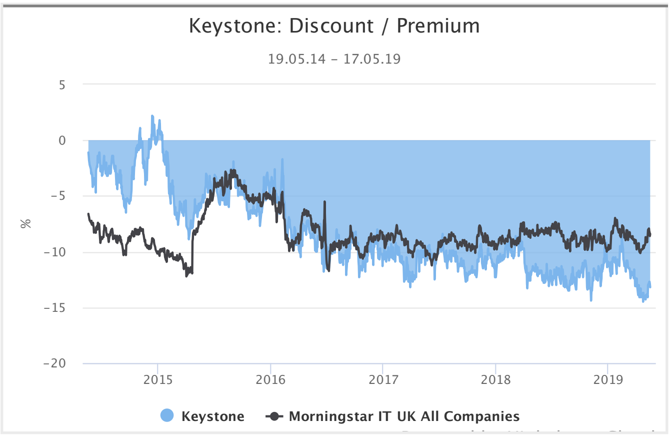
Management

James Goldstone took over this trust in April 2017 from Mark Barnett. James has slowly taken on more of Mark's responsibilities after the latter became head of UK equities, testament to the esteem in which he is held by Invesco. James joined the group from the sell-side in 2012, and from May 2014 has managed pension portfolios, handsomely outperforming the FTSE All Share over his tenure. James became co-manager of the Edinburgh Investment Trust in April 2016, and took over Invesco Perpetual Select Trust UK Equity share portfolio in October of that year and Keystone the following April. He has experience as co-manager of the Invesco Pan European Equity Fund and as Head of Pan European sales at Banco Espirito Santo, which gives him relevant knowledge and experience for the non-UK stocks in this trust.

Discount

The trust's discount has been wider than the sector average since the 2016 Brexit referendum. It currently stands at 12.9% compared to the sector weighted average of 8.4%, according to the AIC. In 2016, the whole sector saw discounts widen following the Brexit vote and the subsequent reduction in appetite for UK assets. However, the value approach taken by James and his predecessor Mark Barnett has seen the trust more exposed to domestic UK-facing stocks, which has led to the wider discount. This could prove to be an opportunity should the sentiment to domestic UK stocks reverse, but the negotiations have proved prolonged and contentious and so the risk is that the process is drawn out further and the discount applied to UK earnings remains. We have seen a growing number of investors take a more positive view on UK domestic earnings this year on valuation grounds, and we agree that eventually this value anomaly will revert, but the ongoing political turmoil surrounding the negotiations make it hard to be confident as to when this will occur.

Fig.7: Discount



Source: Morningstar

Although the board has the authority to buy back shares, it has preferred not to do so. The board believes that there is mixed evidence on whether buybacks will actually close the discount if an investment style is out of favour. The board is cognisant that the trust is likely to trade on a relatively wide discount until there is more certainty around the macro backdrop and in particular the UK's exit from the European Union.

Charges

The trust has ongoing charges of 0.54%, making it cheaper than the 0.63% weighted sector average of the UK All Companies sector, according to JPM Cazenove stats. The management fee is just 0.45%, but the trust also has a performance fee. This is charged at 15% of the outperformance of NAV over the FTSE All Share on a rolling three year basis, with a 1.25% per annum hurdle rate and a total fee cap of 1.5%. The performance fee was not charged in the financial year to September 2018, and the trust is behind the benchmark by 11.3% since 1 October 2016, so a performance fee being charged this year is unlikely, even if the fund substantially outperforms from here.

Keystone Investment Trust is a client of Kepler Trust Intelligence. Material produced by Kepler Trust Intelligence should be considered as factual information only and not an indication as to the desirability or appropriateness of investing in the security discussed.

Important Information

Kepler Trust Intelligence is a website owned and managed by Kepler Partners LLP. Material produced by Kepler Trust Intelligence should be considered a marketing communication, and is not independent research.

This report has been issued by Kepler Partners LLP for communication only to eligible counterparties and professional clients as defined by the Financial Conduct Authority. **Its contents are not directed at, are not to be communicated to, may not be suitable for and must not be relied on by retail clients.**

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research. The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules.

Past performance is not necessarily a guide to the future. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. Independent financial advice should be taken before entering into any financial transaction. This website is published solely for informational purposes and has no regard to the specific investment objectives, financial situation or particular needs of any person.

PLEASE SEE ALSO OUR **TERMS AND CONDITIONS**

A copy of the firm's conflict of interest policy is available on request.

Kepler Partners LLP is a limited liability partnership registered in England and Wales at 9/10 Savile Row, London W1S 3PF with registered number OC334771.

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority.