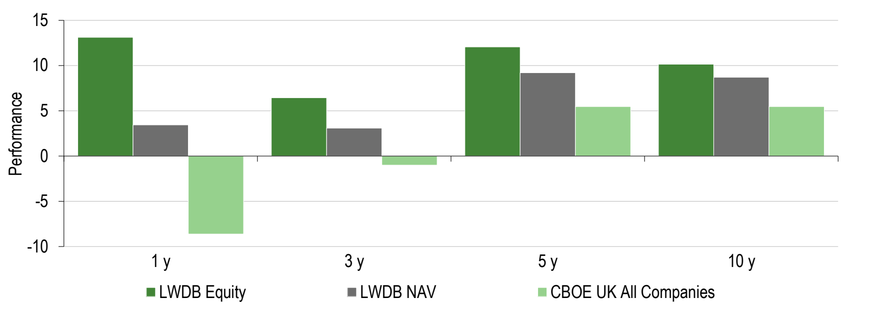
The Law Debenture Corporation

Strong IPS performance underpins FY20 returns

The Law Debenture Corporation (LWDB) made the most of its structure in 2020, with the revenue contribution from its independent professional services (IPS) business – which saw another year of strong growth – helping to overcome a shortfall in portfolio income after widespread UK dividend cuts, and driving an unanticipated 5.8% increase in the total FY20 payout. NAV total returns for the year ended 31 December were modestly positive, compared with double-digit declines for many UK Equity Income peers. The diversity of the underlying IPS businesses means CEO Denis Jackson is sanguine about prospects even in uncertain market conditions, while fund managers James Henderson and Laura Foll will continue to capitalise on the investment freedom the IPS income contribution provides.

Outperforming the broad UK index over one, three, five and 10 years



Source: Refinitiv, Morningstar, Edison. Note: Annualised total returns to 31 January 2021.

Why invest in UK equities now?

There are growing signs that the UK is beginning to emerge from almost five years in the investment wilderness. With the Brexit transition period now over and a strong COVID-19 vaccine roll-out, buyers have once more begun to turn their attention to these shores (evident in M&A activity), while valuations remain quite reasonable.

The analyst's view

It is highly unusual for a UK investment trust to come with a 130-year-old operating business attached, but what may once have been off-putting for investors (who often prefer things to be straightforward) has proved its worth in 2020. With the IPS businesses experiencing a third straight year of on-target revenue and profit growth, investors have benefited from both the absolute impact of the income contribution and the freedom it gives the managers to invest in top-performing non-yielders such as Ceres Power. The 5.8% increase in the total FY20 dividend was an unanticipated bonus for investors, given expectations of a much smaller rise.

Significant re-rating leads to small premium

Having historically traded at a c 5–15% discount, LWDB re-rated substantially in FY20, perhaps as investors began to recognise the value of the differentiated proposition. At 25 February 2021, the shares traded at a 2.8% premium to adjusted cum-income NAV (with both debt and IPS at fair value) and had a yield of 3.8%.

NOT INTENDED FOR PERSONS IN THE EEA

Investment trusts
UK equity income

26 February 2021

Price		**724.0p**
Market cap		**£857.6m**
AUM		**£975.5m**
NAV*		733.3p
Discount to NAV		1.3%
NAV**		704.3p
Premium to NAV		2.8%

*Excluding income, with debt at par value. **Including income, with debt at fair value. Published NAVs at 24 February 2021, adjusted for fair value of IPS business at 31 December 2020.

Yield		3.8%
Ordinary shares in issue		118.5m
Code/ISIN		LWDB/GB0031429219
Primary exchange		LSE
AIC sector		UK Equity Income
52-week high/low	725.0p	374.0p
NAV* high/low	704.3p	58.8p

*Including income, with debt at fair value.

Gross gearing*	13.9%
Net gearing*	13.0%

*Source: AIC, as at 31 January 2021.

Fund objective

The Law Debenture Corporation's investment objective is to achieve long-term capital growth in real terms and steadily increasing income. The aim is to achieve a higher rate of total return than the broad UK stock market through investing in a diversified portfolio of mainly UK equities with some international holdings. The IPS business provides a regular flow of income, which augments the dividend income from the equity portfolio.

Bull points

- Income from IPS business gives fund managers flexibility in portfolio construction and has been an important support to returns in FY20.
- Modest portfolio bias to value/cyclical stocks could lead to outperformance in a recovery.
- Overseas allocation diversifies portfolio risk.

Bear points

- Some areas of IPS business depend more on a buoyant economy.
- Recent rotation towards value stocks may not be sustained.
- Revenue reserves could be depleted if corporate dividend recovery is delayed.

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Good IPS performance sees fair value contribution grow

LWDB's IPS business is split into three divisions: pensions, corporate trust and corporate services. After several years of broadly flat growth (meaning a real-terms decline when inflation is taken into account), changes made to the structure and leadership of the company have paid off since early 2018, with aggregate revenue and profits growth across the three IPS divisions meeting the target range of mid to high single-digit growth in each of the last three financial years. This is particularly notable for FY20, given the dampening effect of the COVID-19 pandemic on economic activity.

For the year ended 31 December 2020, top-line revenue growth (net of cost of sales) of 8.5% was towards the high end of the target range, beating the 7.5% growth seen in FY19. Profit after tax was up 9.5%, again beating the 8.6% growth of the previous year. CEO Jackson is pleased with the performance, which he describes as a strong year for LWDB both as an investment proposition and as a set of businesses, adding that the focus continues to be on cementing and building on the progress made in the past three years.

As an example of LWDB's commitment to growing the business, in December 2020 it announced its first IPS acquisition since the 2007 purchase of whistleblowing specialist Safecall. The acquisition completed in January 2021 and hence is not reflected in LWDB's FY20 accounts. The company secretarial service line, bought for £20m from Konexo (a division of global law firm Eversheds Sutherland), will transform LWDB's capabilities in this area, boosting the number of company secretaries from three to 55, with the client base going from the tens to the hundreds. Jackson says the division will benefit from being a core part of LWDB's corporate services business, with opportunities for growth founded on the need for companies to keep up with changing government rules and frameworks, as well as the increasing trend to outsource such services rather than carrying them out in-house. 'If you are a Silicon Valley tech company looking to expand into 10 new global markets, you are going to need to set up and administer 10 subsidiaries, and as a tech company that is not your area of expertise, whereas we can provide a full suite of services,' the CEO explains. He adds that the opportunistic deal shows LWDB is willing to grow the IPS business both organically and through bolt-on acquisitions where appropriate.

Exhibit 1: Fair valuation of IPS business

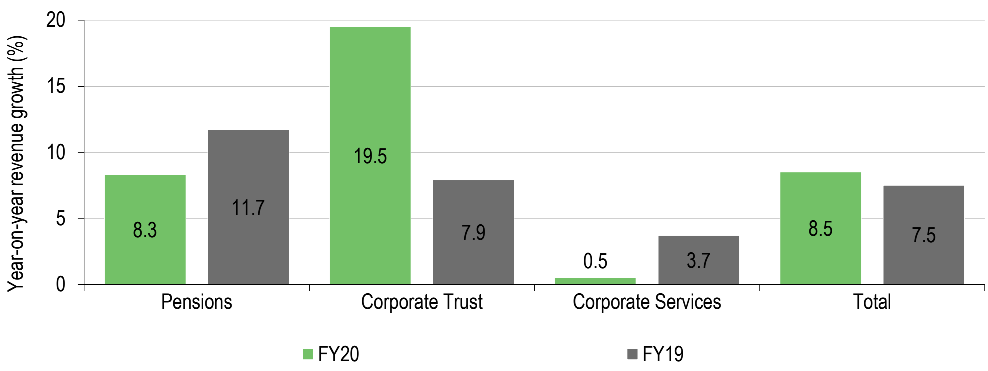
£000s unless stated	31 December 2020	30 June 2020	31 December 2019	30 June 2019
IPS valuation				
IPS EBITDA	13,335	11,734	11,515	10,828
EBITDA multiple (x)	9.4	8.7	9.2	9.2
Operational value of IPS	125,349	102,086	105,938	99,618
IPS surplus net assets	10,605	9,970	16,367	15,962
IPS fair value	135,954	112,056	122,305	115,580
IPS fair value per share (p)	115.1	94.6	103.5	97.8
LWDB fair value				
LWDB fair value per share as per IFRS financial statements (p)	615.2	515.6	655.8	619.4
IPS fair value adjustment per share (p)	95.1	75.2	77.7	72.2
Debt fair value adjustment (p)	(44.2)	(40.4)	(31.3)	(27.9)
LWDB fair value NAV per share (p)	646.7*	543.9*	702.2	663.7
IPS book value (IFRS) as % of total	3.3%	3.8%	4.0%	4.1%
IPS fair value as % total	17.8%	17.4%	14.7%	14.7%

Source: The Law Debenture Corporation, Edison Investment Research. Note: *After deducting 19.5p dividends.

Looking at each division in turn, the **corporate trust** business saw the strongest net revenue growth in FY20, up 19.5% (FY19: +7.9%). Dating back to 1889, corporate trust is the foundation of LWDB, acting as a bridge between the borrower/issuer of a loan or bond, and the lender/investor, as well as providing escrow service for merger and acquisition (M&A) transactions. The high level of growth during 2020 exemplifies the counter-cyclical qualities of the corporate trustee business, which – while it enjoys a solid level of contracted annual revenues in the 'good times' – is well placed to benefit in tough economic times from ad hoc post-issue work such as debt restructuring or the renegotiation of payment terms. This trend often continues well after the economy has begun to recover, such as following the global financial crisis, when post-issue work continued to grow for more than two years.

The **pensions** business experienced net revenue growth of 8.3% in FY20, down from 11.7% in FY19 and 14.7% in FY18 but still a fourth consecutive year of solid growth. Much of the governance work LWDB does for pension schemes is charged at an hourly rate, so income was down partly as a result of online meetings tending to be shorter than those conducted in person. LWDB is the UK's largest independent pension trustee, acting for more than 200 defined benefit (DB) schemes with over £350bn of assets and three million members. However, Jackson points out that the number of clients is less than 5% of the 5,500 DB schemes in the UK, 'so there is plenty of room to grow our market share in what we believe is a growing market'. Since 2017, LWDB has also offered Pegasus, an outsourced service for companies with defined contribution (DC) schemes, offering an end-to-end menu of services. The acquisition of the company secretarial business should provide good cross-selling opportunities in this area, as it brings a large number of strong existing corporate relationships under the LWDB umbrella.

Exhibit 2: Overall IPS revenue growth driven by divisional divergence in FY20



Source: The Law Debenture Corporation, Edison Investment Research

Corporate services, the largest division by net revenues (£12.2m of the £34.5m total), saw relatively weak growth in FY20, up 0.5% compared with 3.7% and 6.9% in FY19 and FY18 respectively. This business is split into three parts, with a 'service of process' role focused on cross-border commercial transactions, a company secretarial and accounting business that will be bolstered going forward by the acquisition completed in January 2021 from Konexo (discussed above), and the specialist Sunderland-based whistleblowing service Safecall, which LWDB has owned since 2007. Jackson recalls that he said at LWDB's AGM in April 2020 that some areas of the business would get 'a bloody nose' as a result of the pandemic, and that while the majority of IPS businesses held up well in 2020, the service of process business – which thrives on deals being done – had a difficult time as economic activity 'fell off a cliff'. However, with a strong referral network built up over many years, and continued focus on streamlining operations through the use of technology, the CEO says he is confident that the business will bounce back swiftly once the economy improves. Safecall experienced a record level of inbound calls from employees worried, for example, about COVID-19-related safety in the workplace, which Jackson says is 'enormously valuable' to the firm's corporate client base. While the volume of new business in FY20 was relatively low, as company managements were more 'focused on flying the plane', the CEO argues that the positive client experience demonstrates the value of the proposition, which should stand Safecall in good stead once the immediate crisis is over. 'The idea of employee welfare and the creation of whistleblowing channels is advancing in legislation and being adopted as best practice', he concludes.

As shown in Exhibit 1, the operational value of IPS (based on LWDB's internally derived multiple) rose by 18.3% in FY20 and the fair value of IPS per share rose by 11.2%, compared with growth of 21.0% and 17.0% respectively in FY19. At 115.1p per share (an increase of 21.7% since the H120 results), the fair value of IPS accounted for 17.8% of LWDB's net asset value (NAV) per share (with debt at fair value), a similar level to end-H120 but higher than at end-FY19. The IFRS book value fell from 26.0p to 20.0p per share (-23.1%) in FY20; the 95.1p per share fair value adjustment was a 22.4% increase from 77.7p in FY19.

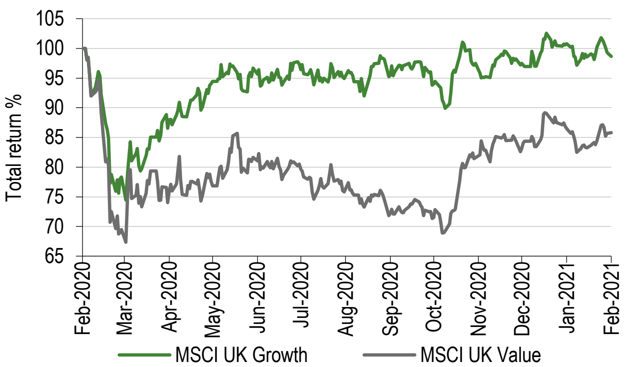
The fund managers: James Henderson and Laura Foll

The managers' view: A subtle bet on UK recovery

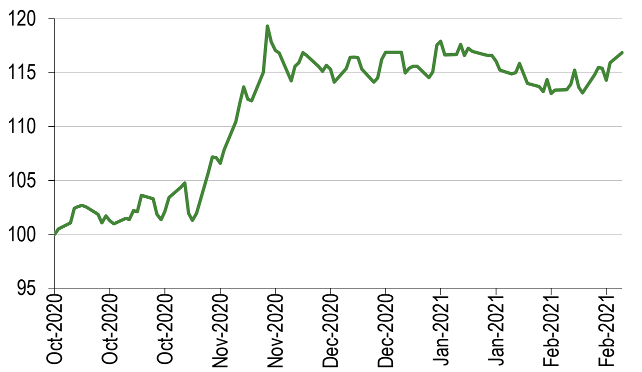
After several years (broadly since the 2016 EU referendum) in which the UK equity market has been hugely out of favour with global investors, Henderson and Foll say that although this dynamic has somewhat reversed in recent months (particularly evident in the strength of sterling versus the US dollar), there is still a big valuation discount versus the rest of the world. The same is true within the UK market itself, where the disparity between the performance of popular and out-of-favour stocks has been extreme. The performance of 'value' versus 'growth' stocks since positive news on a COVID-19 vaccine began to emerge in late 2020 (see Exhibit 3) is seen as validating the managers' modest rotation into out-of-favour stocks such as BT Group and UK high street banks (see Current portfolio positioning) during FY20. Furthermore, an increase in M&A activity can be viewed as proof that investors see the value in UK stocks such as insurance group RSA, which the managers sold after it was bid for in 2020. 'There is value in the UK, and it will come out one way or the other', says Henderson.

Exhibit 3: UK value and growth stock performance

Total return performance of UK growth and value indices over one year (£)



MSCI UK Value relative to MSCI UK Growth since 1 October 2020



Source: Bloomberg, Edison Investment Research

Both managers stress the importance of LWDB's IPS business to overall returns in the difficult market conditions of 2020. Foll says that when modelling for expected portfolio dividends in the year ahead, it is unlikely that there will be an immediate return to 2019 levels following last year's widespread dividend cuts, so the income contribution from IPS (historically around one-third, although much higher in FY20) will remain a key element in allowing the managers to look at lower- or non-yielding stocks while still meeting LWDB's investment objective of providing a steadily increasing income.

Looking ahead, the managers say the portfolio's current positioning is a subtle rather than an extreme way of betting on a UK recovery. The recent move to a modest overweight versus the benchmark in UK banks – where there is a good chance of dividends being reinstated at some point this year – is an expression of this, as is the increased level of portfolio gearing, which is currently at the higher end of the typical 0–20% range.

Asset allocation

Current portfolio positioning

At end-December 2020 there were 137 stocks in LWDB's investment portfolio, a marginal increase from 134 a year earlier. Concentration in the top 10 holdings (see Exhibit 4) declined slightly from 21.2% to 20.3% over the period, as the managers took profits in strongly performing positions, recycling the proceeds into more attractively valued opportunities.

Changes in geographical weightings during the year (Exhibit 5) were modest, with the managers using gearing to add to the UK allocation while taking profits in some US stocks such as Microsoft and Johnson & Johnson. Henderson and Foll note that the overseas holdings – which by their nature are non-benchmark positions – added value for investors, particularly in the US and Europe. Non-UK stocks are held principally where they offer something that is not available in the domestic equity market, such as carmakers General Motors in the US and Toyota in Japan, or US semiconductor company Applied Materials.

Exhibit 4: Top 10 holdings (as at 31 December 2020)

			Portfolio weight %	
Company	**Country**	**Sector**	**31 December 2020**	**31 December 2019**
Ceres Power	UK	Oil equipment services & distribution	3.0	1.5
GlaxoSmithKline	UK	Pharmaceuticals & biotechnology	2.8	3.6
Rio Tinto	UK	Mining	2.5	2.1
Herald Investment Trust	UK	Pooled equity investments	2.2	1.5
Royal Dutch Shell	UK	Oil & gas producers	1.9	3.4
BP	UK	Oil & gas producers	1.8	1.8
Prudential	UK	Life insurance	1.6	1.6
National Grid	UK	Electricity	1.5	1.6
Morgan Advanced Materials	UK	Industrial goods & services	1.5	1.4
HSBC	UK	Banks	1.5	1.9
Top 10 (% of holdings)			**20.3**	**21.2**

Source: The Law Debenture Corporation, Edison Investment Research

Exhibit 5: Portfolio geographic exposure (% unless stated)

	Portfolio end-December 2020	Portfolio end-December 2019	Change (pp)	Allocation guidelines
UK	82.1	80.7	1.4	55–100
Europe ex-UK	10.1	7.8	2.3	0–10
North America	5.4	8.3	(2.9)	0–20
Japan	1.1	1.1	0.0	0–10
Pacific ex-Japan	0.9	0.9	0.0	0–10
Other	0.4	1.2	(0.8)	0–10
	100.0	**100.0**		

Source: The Law Debenture Corporation, Edison Investment Research

In sector terms (Exhibit 6) there was also little in the way of dramatic change over the year. The largest upward shifts in weighting were a 2.9pp increase in basic materials (buoyed by a strong performance from Rio Tinto and the initiation of a position in Anglo American) and a 1.9pp rise in the oil & gas weighting. Somewhat counterintuitively, renewable energy players such as Ceres Power and ITM Power (the top two contributors to LWDB's portfolio performance in FY20) are included in the oil & gas sector, and although these positions were trimmed several times on the back of strong performance, the gains were more than enough to offset declines from oil majors Royal Dutch Shell and BP. Henderson and Foll also added to a position in US oil services company Schlumberger – another example where there is no comparable UK-listed stock – during the year. The firm had suffered as a result of several years of capex cuts by oil producers, but should benefit as spending ramps up in reaction to the need to invest in energy transition. The largest reduction in weighting over the year was in healthcare (-3.7pp), following the sales of positions in AstraZeneca and Johnson & Johnson.

Exhibit 6: Portfolio sector exposure (% unless stated)

	Portfolio end-December 2020	Portfolio end-December 2019	Change (pp)
Financials	23.8	24.8	(1.0)
Industrials	22.0	23.2	(1.2)
Oil & gas	11.6	9.7	1.9
Basic materials	9.3	6.4	2.9
Consumer services	8.9	10.2	(1.3)
Consumer goods	6.2	5.2	1.0
Health care	5.2	8.9	(3.7)
Utilities	4.8	4.0	0.8
Pooled equity invts	4.7	4.1	0.6
Telecommunications	1.9	1.1	0.8
Technology	1.6	2.4	(0.8)
	100.0	**100.0**	

Source: The Law Debenture Corporation, Edison Investment Research

The managers have increased LWDB's use of gearing, which rose to 13% net at 31 January 2021 (calculated using the previous methodology; see Gearing section). The funds have mainly been deployed in UK companies, particularly in the banking sector, where there is now a marginal overweight versus the benchmark. Henderson points out that provisioning for bad debt as a result of the COVID-19 pandemic has been substantial, and with the expectation of a pick-up in the UK economy over the next couple of years leading to a likely rise in long-dated bond yields, banks' return on equity is likely to surprise on the upside on a two-year view, a situation that has not yet been priced in by the market. The managers already owned HSBC, Lloyds and NatWest, but have added to these holdings as well as taking a new position in Barclays. Henderson and Foll have also bought telecom operator BT Group, as well as adding to the position in Vodafone. While they say BT has been 'pretty dire' in recent years, the managers say their confidence has been boosted by a more favourable regulatory backdrop, with Ofcom and the government recognising that the UK needs well-invested communications infrastructure (such as increasing use of fibre) in order to compete globally. Henderson comments that the market is not currently recognising capex by telecom firms as a good thing, but that there is potential for the companies to make a good return on their investments, which should result in stronger future growth. While BT is not currently paying a dividend, it should offer a 'healthy' c 6% yield once the payout is reintroduced.

In addition to the sales mentioned above, the managers also exited the position in Flutter Entertainment (formerly Paddy Power Betfair), which 'did very well very quickly', and insurer RSA was sold following a takeover bid.

Performance: Another solid year, backed by IPS growth

Exhibit 7: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	CBOE UK All Companies (%)	CBOE UK 250 (%)	MSCI World (%)
31/01/17	23.7	23.8	20.9	13.8	32.8
31/01/18	18.6	14.6	11.3	14.5	11.9
31/01/19	(2.7)	(2.8)	(3.9)	(6.5)	1.6
31/01/20	9.5	9.0	10.5	18.3	18.2
31/01/21	13.1	3.4	(8.6)	(5.4)	11.4

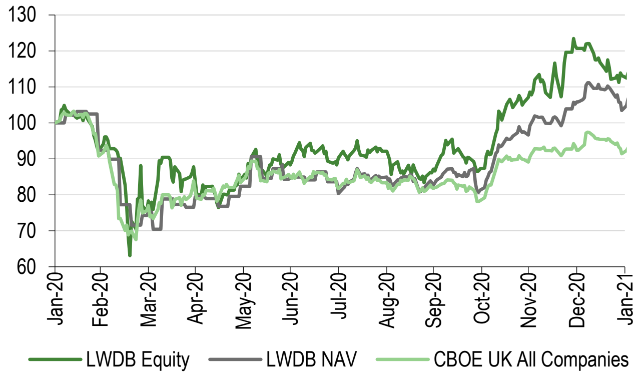
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

In FY20, LWDB produced an NAV total return of 3.6% with debt at par value (2.0% with debt at fair value, which is the measure used in our performance data), and a share price total return of 12.9%, strongly outperforming the broad UK equity index benchmark, which declined by 9.8%. (These figures differ from those in Exhibit 7, which shows discrete years' performance to 31 January). Excluding the IPS business (therefore broadly representing the investment portfolio), we calculate that the NAV declined by 8.0% with debt at fair value during FY20, again outperforming the benchmark.

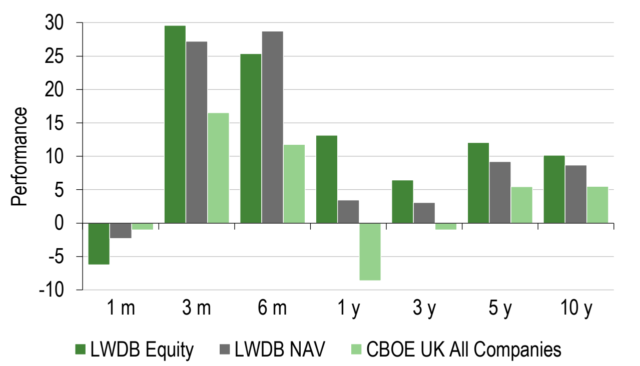
As shown in Exhibit 8, the outperformance has been particularly marked in the period since October 2020, pushing NAV and share price total returns over both three and six months to more than 25%, compared with returns on the CBOE UK All Companies Index (used as a proxy for the benchmark) of c 10–15%. Notwithstanding the beneficial effect of its performance during the pandemic, LWDB also has a strong longer-term track record, outperforming the index over three, five and 10 years, with NAV total returns of c 9% pa over both five and 10 years, a period that has been characterised by low to negligible returns on other assets such as bonds and cash. Looking at returns relative to indices in Exhibit 9, LWDB has also outstripped the returns on UK mid-cap companies (historically a higher-growth area than the market as a whole), and has even beaten the MSCI World Index (heavily dominated by the big US technology stocks that have led the charge in the most recent leg of the equity bull market) over some of the more recent periods, possibly as a result of the recent strength of sterling.

Exhibit 8: Investment trust performance to 31 January 2021

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Exhibit 9: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to CBOE UK All Companies	(5.3)	11.2	12.2	23.8	24.3	35.5	54.2
NAV relative to CBOE UK All Companies	(1.3)	9.2	15.2	13.2	12.9	19.1	35.1
Price relative to CBOE UK 250	(5.3)	5.3	0.6	19.6	15.2	29.7	11.1
NAV relative to CBOE UK 250	(1.4)	3.4	3.3	9.4	4.7	14.0	(2.8)
Price relative to MSCI World	(4.9)	18.1	12.6	1.6	(9.8)	(11.1)	(14.0)
NAV relative to MSCI World	(0.9)	16.0	15.7	(7.1)	(18.1)	(21.8)	(24.7)

Source: Refinitiv, Edison Investment Research. Note: Data to end-January 2021. Geometric calculation.

In terms of the drivers of performance in FY20, some have been top-down and some have been bottom-up. Foll explains that having entered 2020 with a lower-yielding portfolio than many UK Equity Income peers (given the flexibility afforded by the income contribution from the IPS business), LWDB was less affected by the severe share price falls experienced by many higher-yielding companies that were forced to either to suspend dividends temporarily or rebase them permanently.

Within the portfolio, three of the top five stocks by FY20 performance (Ceres Power, ITM Power and Herald Investment Trust) are zero-yielders by nature. Hydrogen fuel cell company Ceres Power was already close to a top 10 holding at end-FY19, after the managers participated in a capital raise late in the year, but came into its own in 2020, with a share price rise of almost 400%. Having sold several times into share price strength, reducing the holding by c 50%, at end-FY20 the stock was the largest position in the LWDB portfolio, at 3.0% of the total versus 1.5% a year earlier. While Ceres makes hydrogen fuel cells, ITM Power, the second largest contributor to FY20 performance (share price +537% in 2020), makes the 'green' hydrogen to put in the fuel cells, using electrolysis rather than the traditional methane-based method. Both have capitalised on the increasing impetus to decarbonise the global economy, and have benefited from joint ventures with established

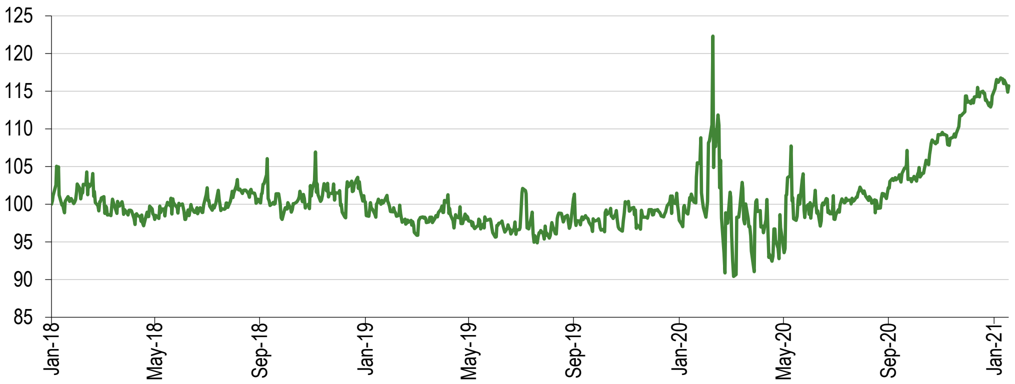
European engineering companies (for example, Bosch with Ceres, and Linde with ITM) to help them develop more quickly than their balance sheets would otherwise have allowed.

Herald Investment Trust, which is managed by Katie Potts and invests mainly in small tech and media firms in the UK and overseas, is a long-term core LWDB holding, illustrating the managers' willingness to invest via closed-end funds in more specialised areas. The trust produced an NAV total return of 37.0% in 2020 and has made cumulative gains of c 160% over the last five years.

Rounding out the top five performers are two more familiar names, Rio Tinto and Royal Mail. Miner Rio Tinto benefited from the strength of the iron ore price in 2020, as many government fiscal responses to the pandemic focused on boosting infrastructure investment. Meanwhile, Royal Mail was also a COVID-19 beneficiary, as a huge move to online shopping during lockdowns drove volumes in its more profitable parcels business up by c 30%. Foll points out that the ongoing shift in Royal Mail's business mix from letters to parcels has required a substantial change in its logistics networks, a process that of necessity has accelerated during the pandemic. Unlike many UK companies, Rio Tinto has declared a record dividend in respect of FY20, up more than 25% in US dollar terms on the 2019 payout. Royal Mail did not pay a dividend in 2020 but is widely expected to reinstate it in 2021 given the strength of its operating and share price performance.

Together, the top five performers contributed almost £60m to LWDB's investment returns in 2020, while the five biggest detractors had a negative impact of just over £40m. The top five detractors were Royal Dutch Shell, Hammerson, GlaxoSmithKline (GSK), BP and HSBC. Shell and BP both suffered in a weaker oil price environment, and have permanently rebased their dividends (by two-thirds and half respectively), drawing a line under several years of investor concerns that their payout ratios were unsustainable. While the subsequent rise in the oil price has meant both companies trade on attractive free cash flow yields of c 13%, Foll says it remains to be seen if this is as attractive as it outwardly seems, given increasing energy transition pressure is likely to lead to higher capital expenditure and potentially fewer marginal buyers for the shares of oil majors.

Exhibit 10: NAV performance versus CBOE UK All Companies Index over three years



Source: Refinitiv, Edison Investment Research

GSK saw the smallest share price fall among LWDB's top detractors in FY20, and Henderson and Foll continue to view it as a source of long-term opportunity. Sales of GSK's shingles vaccine have been hit after the US Centers for Disease Control (CDC) said it could not be administered within 14 days of a COVID-19 vaccine, and the company may be seen as being 'behind the curve' relative to its UK-listed peer AstraZeneca, as its main COVID-19 vaccine (in partnership with Sanofi) is still in development. The managers point out that while GSK's earnings should be resilient based on its relatively defensive end markets (vaccines, pharmaceuticals and consumer healthcare), it may see subdued growth in near-term earnings given its ongoing investments to boost its research and development (R&D) pipeline, including a strategic investment in mRNA vaccine player CureVac during 2020. Hammerson, a retail-focused real estate company, had not been in a strong financial position pre-COVID-19, and the effect of the pandemic on the retail sector meant it was forced into a highly dilutive capital restructuring during 2020. While it remains in the LWDB portfolio on the chance of recovery, it accounted for just 0.64% of the total at end-FY20. HSBC, the fifth-largest detractor, saw its share price hit by widespread expectations that COVID-19 would cause a big increase in loan loss provisions, as well as a regulator-mandated suspension of its dividend. However, Henderson and Foll remain cautiously optimistic on the prospects for the UK high street banks (see The managers' view).

Peer group comparison

Exhibit 11: Selected peer group as at 19 February 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	**Net gearing	Dividend yield
Law Debenture Corporation	**857.4**	**12.2**	**19.1**	**62.8**	**144.1**	**0.6**	**No**	**5.1**	**113**	**3.6**
Aberdeen Standard Equity Inc Trust	157.8	(9.6)	(12.5)	6.8	70.0	0.9	No	(8.4)	112	6.3
BlackRock Income and Growth	38.5	(2.9)	6.2	30.8	77.5	1.2	No	(7.3)	107	4.1
BMO Capital & Income	314.1	(7.5)	7.9	49.9	100.6	0.6	No	(2.8)	106	4.0
BMO UK High Income Units	112.2	(3.4)	5.6	34.4	84.3	1.0	No	(10.0)	109	4.5
Chelverton UK Dividend Trust	36.1	(2.5)	(8.8)	22.8	182.6	2.1	No	(7.1)	145	5.8
City of London	1,550.0	(9.4)	0.8	25.1	98.7	0.4	No	2.9	109	5.2
Diverse Income Trust	372.4	16.6	20.0	44.1		1.1	No	(4.1)	100	3.5
Dunedin Income Growth	432.6	3.5	25.2	66.5	106.2	0.6	No	(3.6)	109	4.3
Edinburgh Investment Trust	969.4	(1.1)	0.7	11.3	118.8	0.6	No	(8.9)	106	4.3
Finsbury Growth & Income	1,918.9	(0.5)	22.9	67.6	239.6	0.6	No	(0.7)	101	1.9
Invesco Income Growth	155.8	(9.7)	5.1	22.3	100.0	0.7	No	(7.3)	108	4.4
JPMorgan Claverhouse	380.1	(5.6)	4.5	42.9	97.2	0.7	No	(3.0)	116	4.5
JPMorgan Elect Managed Inc	73.0	(4.8)	0.0	25.2	83.3	0.8	No	(3.9)	106	4.9
Lowland	319.5	(6.5)	(8.5)	26.8	106.7	0.6	No	(8.1)	114	5.1
Merchants Trust	559.9	(3.6)	10.2	48.0	95.3	0.6	No	0.9	115	5.9
Murray Income Trust	983.2	(1.8)	19.9	56.3	105.6	0.6	No	(2.8)	111	4.1
Schroder Income Growth	196.4	(1.7)	7.4	38.9	107.7	0.9	No	(0.8)	110	4.4
Shires Income	73.4	(1.5)	9.7	54.1	121.6	1.0	No	(8.4)	118	5.5
Temple Bar	676.8	(13.2)	(5.7)	28.2	85.7	0.5	No	(8.5)	115	3.8
Troy Income & Growth	235.6	(11.4)	4.4	21.1	97.2	0.9	No	(1.3)	100	2.8
Value and Indexed Property Income	94.8	(12.7)	(9.5)	8.7	56.0	1.4	No	(15.6)	124	5.6
Simple average (22 funds)	**477.6**	**(3.5)**	**5.7**	**36.1**	**108.5**	**0.8**		**(4.7)**	**112**	**4.5**
LWDB rank in peer group	**5**	**2**	**5**	**3**	**3**	**20**		**1**	**8**	**19**

Source: Morningstar, Edison Investment Research. Note: TR = total return. *Performance as at 18 February 2021 based on (un-restated in LWDB's case) cum-fair NAV. **Net gearing is based on end-January figures as supplied to the AIC and represents total assets less cash and equivalents as a percentage of net assets.

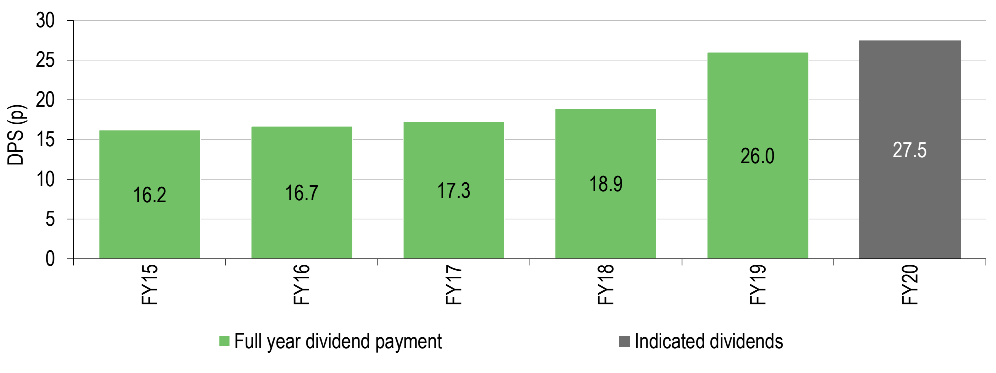
Until May 2019, LWDB was a member of the Association of Investment Companies' Global sector. However, it has always had a high weighting to the UK and a focus on income as well as capital growth, so it was deemed to be a more appropriate constituent of the UK Equity Income sector, where it now resides. This is a diverse peer group of 24 funds, with LWDB currently being the fifth largest. However, given the IPS business makes up c 17% of LWDB's NAV and supplies a large part of the trust's total income, it is hard to draw direct comparisons with any of the peers (even Lowland, which is also managed by Henderson and Foll). There has been a degree of consolidation and management change in the UK Equity Income sector over the past year, particularly among funds with a longstanding bias to the value style of investment, with Edinburgh Investment Trust changing managers from Invesco to Majedie Asset Management, while Perpetual Income & Growth (also formerly managed by Invesco) has merged with Murray Income Trust, which is now the third largest constituent in the peer group.

Performance has been challenging for UK income funds as a result of the COVID-19 pandemic and associated corporate dividend cuts, and the vast majority of the UK Equity Income sector has seen negative returns over one year, even given the cyclical recovery towards the end of 2020. LWDB's NAV total returns are well above the peer group average over one, three, five and 10 years, ranking second, fifth, third and third respectively. Only Diverse Income Trust (a multi-cap fund, which saw substantial benefits from holding a put option on the main UK large-cap index in early 2020) has done better over one year, and LWDB's return is 15.7pp above the sector average. Ongoing charges are among the lowest in the group, with none of the constituents paying a performance fee. Having re-rated noticeably in recent months (see Discount section), LWDB now stands at the highest premium to cum-income NAV, with all but two of the other peers trading at a discount (sector average of 4.7%). Net gearing is modestly above average. The trust's 3.6% historic dividend yield is 0.9pp below the average, ranking 19th. However, the revenue contribution from the IPS business means LWDB's yield is arguably more secure than for those funds that rely solely on corporate dividends for their portfolio income, given it may take more than a year for UK dividends to recover meaningfully.

Dividends: IPS revenue contribution proves its worth

LWDB has achieved a 42nd consecutive year of increasing or maintaining its dividend, with the FY20 final payment of 8.0p bringing the total for the year to 27.5p, a 5.8% increase on the FY19 total dividend of 26.0p. This underlines the value of the IPS business to the trust's shareholders in a year when UK corporate dividends fell by 44%, according to the Link Dividend Monitor. In normal circumstances LWDB derives around one-third of its income from the IPS business, although the figure for FY20 was close to two-thirds, as IPS revenues (net of cost of sales) grew by 8.5% while dividend income in the investment portfolio fell by 38.6%. The somewhat better outturn for investment income compared with the market as a whole principally reflects two things: first, the managers' freedom to invest in lower- or non-yielding assets as a result of the IPS contribution to total income (generally speaking, lower-yielding UK companies were less constrained by COVID-19-related pressure on dividend payouts), and second, their ability to allocate outside the UK (c 15% of the portfolio at end-FY20), where dividend cuts were not so widespread. Although LWDB's total revenues fell by 15.1% (investment income plus IPS revenues net of cost of sales) in FY20, the trust has been able to increase its dividend thanks to its healthy revenue reserve (£12.9m, or 10.9p per share at 31 December 2020, after deducting both the FY19 final dividend and the first three dividends of FY20).

Exhibit 12: Dividend history since FY15



Source: Bloomberg, Edison Investment Research

The dividend policy was recently revamped in order to provide shareholders with a higher, more regular income and greater certainty over the level of payments. Since the beginning of FY20 (1 January 2020), the trust has paid dividends quarterly rather than semi-annually, in July, October, January and April. The FY19 dividend represented a step-change in the level of payments, being c 38% higher than in FY18, which makes the increase for FY20 even more notable given the market backdrop. Annual dividends have grown at a compound rate of 11.2% pa from FY15 to FY20 (see Exhibit 12).

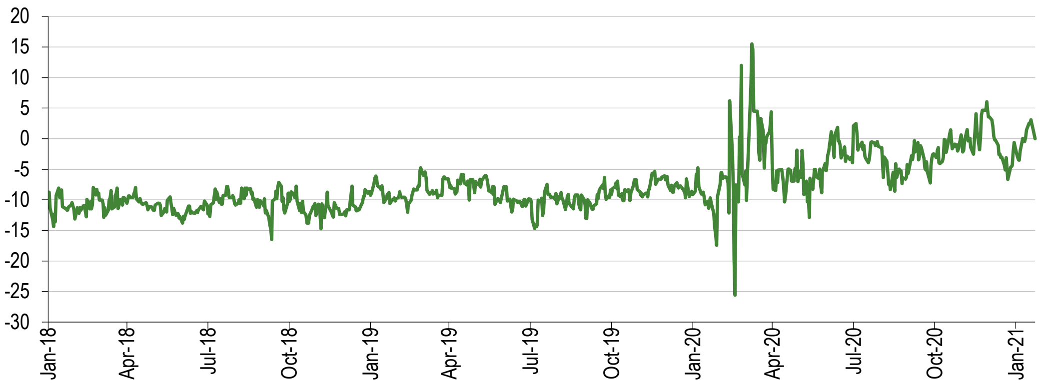
Based on the current share price and the FY20 total dividend of 27.5p, LWDB has a prospective dividend yield of 3.8%.

Discount: Sustained re-rating since Q120 volatility

At 24 February 2021, LWDB's shares traded at a premium to cum-income NAV of 2.8% (with both debt and the IPS business [at 31 December 2020] at fair value). This is an appreciable shift from the long-term discount range of c 5–15% (Exhibit 13). In common with most investment trusts, LWDB saw greater volatility in its rating during the early part of the coronavirus pandemic, with the discount reaching a 10-year high of 25.6% on 19 March 2020 during the indiscriminate market sell-off, before bouncing back to a decade-highest premium of 15.5% on 7 April as the share price moved ahead of the recovering NAV. Arguably of more interest is what has happened since this period of widespread volatility. As trading conditions normalised in the summer of 2020, LWDB's rating moved into a range broadly between a 5% discount and a 5% premium to cum-income NAV. This may have come about as a result of greater market appreciation of the more secure income stream from the IPS business amid deep and widespread UK dividend cuts affecting most equity income funds. The current rating compares to average discounts of 3.2%, 7.5%, 8.1% and 6.3% respectively over one, three, five and 10 years. (Longer-term averages are based on restated NAVs reflecting the fair value of IPS, which were not reported prior to the beginning of 2016.)

LWDB has no formal discount control policy in place, although in our view the directors may consider allotting new shares should they trade at a premium to NAV for a sustained period; an announcement made to the stock market on 25 February 2021, reminding investors of the existing authority to issue shares, would seem to validate this opinion.

Exhibit 13: Share price premium/discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Fund profile: Income benefits from unusual structure

Founded in 1889, LWDB is unusual in that it is both an investment trust and has an operating business set up to facilitate the issue of corporate debentures, an area that still provides a significant revenue stream today. At end-FY20 (31 December), the diversified investment portfolio made up c 83% of fair value NAV, while the IPS business, which has three divisions – pensions, corporate trusts and corporate services – accounted for c 17% of NAV. The IPS business has always provided a significant revenue stream to the company, typically c 30% of the total, although given the widespread dividend cuts as a result of the COVID-19 pandemic and the effect of lockdowns on economic activity, this rose to c 66% of revenues in FY20.

The investment portfolio is managed with the aim of achieving long-term capital growth and a steadily increasing income from a portfolio of c 130–140 stocks, overseen by James Henderson and Laura Foll at Janus Henderson Investors. There is a bias towards the UK (c 82% of the portfolio at end-FY20), although overseas stocks are also held. The revenue contribution from the

IPS business gives the managers more freedom to invest in lower-yielding stocks while still allowing the trust to keep up its long record of maintaining or increasing its annual dividend (+5.8% in FY20).

LWDB is a constituent of the AIC's UK Equity Income sector, and measures its investment performance versus a broad UK stock market index (for comparison purposes in this note we have used the CBOE UK All Companies Index). The trust is structurally geared through two tranches of long-term debt (par value of £115m) at a blended interest rate of c 4.6%.

At the corporate level, LWDB is led by CEO Denis Jackson, supported by Chief operating officer Trish Houston, Chief financial officer Hester Scotton, and General counsel Kelly Stobbs.

Investment process: Bottom-up and long term

LWDB's investment portfolio is managed on a bottom-up basis by co-managers Henderson and Foll, aiming to provide investors with a diverse selection of quality companies, mainly made up of those listed in the UK, although up to c 20% may be invested overseas, primarily where there is no compelling UK equivalent. As with their other portfolios (which include Lowland Investment Company and Henderson Opportunities Trust), they run a relatively long list of stocks, broadly spread by sector and market capitalisation, in order to mitigate company-specific risk. At 31 December 2020 there were 137 holdings, a marginal increase on 134 at end-December 2019. The managers invest directly in the UK, North America, Japan and Europe (where James Ross is responsible for stock selection), while the small allocation to Asia-Pacific ex-Japan and other markets tends to come via funds.

Investment choice is based on a rigorous assessment of company fundamentals, with a focus on finding growing businesses whose current share prices do not reflect their long-term growth prospects. Henderson and Foll are able to draw on the broad global research resources of Janus Henderson Investors, which can be particularly helpful in terms of overseas stock selection.

The significant revenue contribution from the IPS business gives the managers the freedom to invest more in low- or non-yielding stocks where there is greater capital growth potential (Ceres Power, currently the largest holding, is an example of this). Amid the widespread UK dividend cuts of 2020, the IPS contribution means LWDB has been able to continue its long record of maintaining or increasing its annual dividends without needing to draw on its revenue reserves to the same extent as some other trusts.

The managers tend to build and exit positions gradually, with an average starting position of c 0.3% of the portfolio (with c 135 stocks, the overall average position size is c 0.75%). Portfolio turnover is relatively low, at 16.5% for FY20 compared with c 13.9% for FY19 (using the US Securities and Exchange Commission (SEC) methodology now applied across Janus Henderson's funds), implying a holding period of more than six years. The managers will gently trim positions that have done well, and may also sell out of holdings where there has been a deterioration in fundamentals.

LWDB's approach to ESG

LWDB approaches environmental, social and governance (ESG) issues in a variety of ways. On the investment side, Janus Henderson's policy is to discuss any material issues directly with investee companies and monitor for improvement. The firm says fund managers are not afraid to exit positions where investee management fails to deliver expected improvements. In addition, Henderson and Foll favour companies that are actively seeking to address ESG issues, such as Ceres Power and ITM Power, two of the top-performing positions in FY20. ESG issues are considered both directly by the fund managers, and also by the experienced responsible investing team at Janus Henderson. At present they do not explicitly screen out companies based on ESG ratings, as such ratings are still an emerging area and the data quality is not always consistent.

Many of the IPS operational areas are focused on providing governance benefits to clients and their stakeholders. Within the IPS business itself, the move to a new 'green' office building in 2020 allowed for the digitisation of decades of paperwork and a move to new paperless ways of working. The firm monitors its carbon footprint and anticipates a reduction in business travel post-pandemic, given the robustness of many of the virtual meeting solutions that have been widely adopted over the past year. Investment trusts do not generally have any employees, but as an obvious exception to this, LWDB says it is proud that all its three senior leadership appointees in the past year are women. The company acknowledges that there is more to do on improving ethnic diversity, and has said it is committed to progressing this further in 2021.

Gearing

LWDB is permitted to gear up to 50% of net assets, although in practice it has rarely exceeded 20% on a net basis. The trust is structurally geared via two tranches of long-term debt: £40m of 6.125% guaranteed bonds maturing in 2034, and £75m of 3.77% senior secured bonds maturing in 2045. Because of the current low level of bond yields compared with the higher coupons on LWDB's debt, the fair or market value of the debt is currently £166.4m, compared with £115.0m for the par value. Using the fair value of the debt, gross gearing currently stands at 20.3%, with net gearing of 13.0% at end-January 2021 reflecting cash offsetting some of the borrowings.

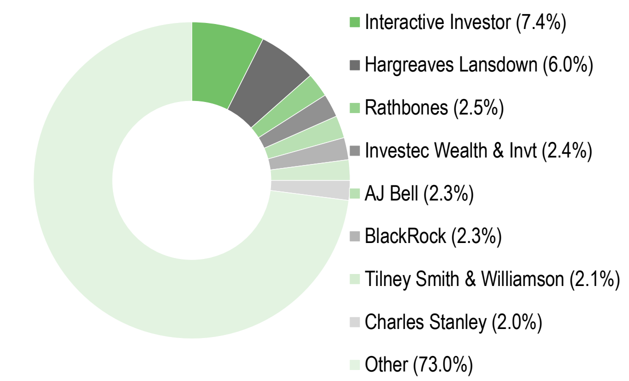
LWDB has updated the methodology for its gearing calculation, resulting in a reduction in the figure submitted to the AIC for 31 December 2020 from 12% to 9% in the FY20 accounts. Thus the end-January figure is likely to be reduced by a similar amount.

Fees & charges

Janus Henderson Investors, which manages LWDB's investment portfolio, is paid an annual management fee of 0.30% of net assets (excluding the net assets of the IPS business). This was previously charged 100% to the revenue account, but since the start of FY19 has been allocated 25:75 between the revenue and capital accounts, reflecting the expected split of future returns. There is no performance fee, and LWDB's ongoing charges (0.55% at end-FY20) are among the lowest of any investment trust, and 0.25pp below the average for the AIC UK Equity Income sector (see Exhibit 10).

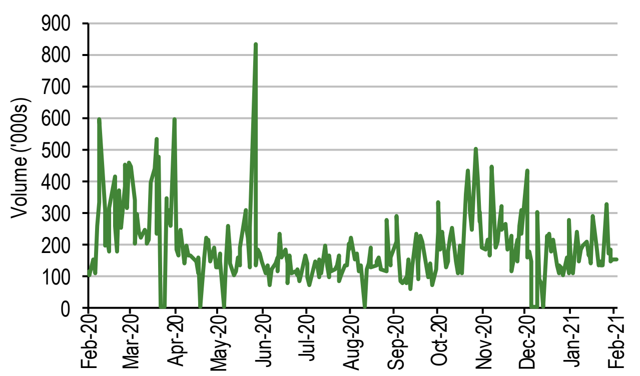
Capital structure

Exhibit 14: Major shareholders



Source: Bloomberg, as at 22 February 2021

Exhibit 15: Average daily volume



Source: Refinitiv. Note: 12 months to 22 February 2021.

LWDB is structured as a conventional investment trust, with one class of share. At 31 December 2020, there were 118.5m ordinary shares in issue. While LWDB's board has the authority to repurchase up to 14.99% of the shares, or allot shares up to 5% of the issued share capital, there is no formal discount control policy, and in practice all allotments and repurchases in recent years have been in respect of LWDB's employee share ownership scheme. During FY20, 25,552 shares were allotted under the company's Save as you Earn (SAYE) scheme.

As shown in Exhibit 14, LWDB's shareholder base is diverse, with the largest two holders (accounting for 13.4% of the shares) being platforms used by retail investors. Trading liquidity (Exhibit 15) is good, with an average of 190,558 shares (0.16% of shares in issue) changing hands each day in the 12 months to 22 February 2021.

The board

Exhibit 16: LWDB's board of directors

Board member	Date of appointment	Remuneration in FY20	Shareholdings at end-FY20
Robert Hingley (chairman)	Oct 2017 (Apr 2018)	£87,550	4,870
Robert Laing (remuneration cttee chair)	April 2012	£TBC	12,300
Denis Jackson (CEO)*	January 2018	£643,000	8,513
Trish Houston (COO)*	September 2020	£151,000**	1,564
Mark Bridgeman (audit & risk cttee chair)	March 2013	£TBC	4,513
Tim Bond	April 2015	£45,320	0
Claire Finn	September 2019	£45,320	0

Source: The Law Debenture Corporation. Note: *Executive directors. **Pro-rata (base salary of £230k pa).

During FY20, Katie Thorpe (formerly chief financial officer) resigned from LWDB's board as she left the company to pursue another opportunity. She has been replaced as CFO by Hester Scotton, who is a member of LWDB's executive leadership team but not a board director. The newly appointed chief operating officer, Trish Houston, has joined LWDB's board. Director Robert Laing will step down at the April 2021 AGM, and Claire Finn (appointed to the board in 2019) will take up his role as chair of the remuneration committee.

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