LIONTRUST
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GLOBAL FUNDAMENTAL

INCOME FUND | MONTHLY SUMMARY | AUGUST 2023

Past performance does not predict future returns

Summary

The Liontrust Income Fund seeks to offer attractive total returns to its investors while delivering dividend income to investors above the FTSE All Share Index.

The fund delivered strong performance in July (+252bps). Performance year-to-date (YTD) has been pleasing, delivering a total return of 5.76%, and satisfactory relative to our benchmark (+47bps). YTD the fund remains in the top quartile of the IA UK Equity Income comparator group.

July was relatively quiet from a trading perspective with the most significant change coming in the energy sector: We have initiated a c.3% position in Norway-listed **AkerBP** and funded this with a reduction of greater than 3% of NAV between **Shell** and **BP** which are each now c1.5% positions. We believe this trade benefits the portfolio in several ways:

i. AkerBP has one of the lowest cost upstream portfolios of any listed oil company in the world (source: Goldman Sachs). Commodity companies with projects near the bottom of the cost curve are an example of the Competitive Power of 'cornered resource'. Because it is able to make money even in low oil price environments, AkerBP's cashflows (and so dividends) should be highly resilient.

ii. AkerBP, even after Norwegian withholding tax of 15% on dividends, delivers a material income pick-up compared to Shell and BP, who are now directing more cashflow to buybacks.

iii. While we do not seek to take large macro bets in the portfolio, we acknowledge oil as a cyclical commodity and it has not escaped our attention that after a weak first six months of 2023, Brent quietly crept c.$10 higher in July and did so on very low speculative positioning – AkerBP allows us to maintain commodity exposure while freeing up capital to deploy into other opportunities.

AkerBP represents the only non-UK holding in the fund at present and is a good case study for one way that we envisage using our non-UK and other eligible asset class allowance (up to 20%) going forward, in order to achieve compelling yield/quality pick-ups vs opportunities in UK markets. The other rationale would be to access an investment opportunity that is unique to non-UK markets.

The top contributor to performance in July was **Watches of Switzerland** +48bps, which is the leading retailer of luxury watches in the UK and is in the process of establishing the same position in the larger, but more fragmented and less mature, US market. We have admired the business model for several years, believing it to possess several Competitive Powers (Scale, Branding and Cornered Resource). Over recent months the market has fretted over declines in second hand watch prices and shunned the stock for its lack of direct exposure to Chinese reopening and anticipated strong luxury spend. However, it is our conviction in the Competitive Powers of the business that allowed us to look through the short term and zig when others zagged, building a position at what we saw as attractive valuations. This was revealed in July when an inline set of numbers drove the shares up over 10% on the day of results. Other strong contributors in the month were **Howden** +43bps which delivered upgrades at its H1 update, and relatively new positions **MAN Group** +30bps and **LondonMetric** +25bps.

The biggest detractor from June's performance was wealth manager **St James Place** -32bps. This is the first time where a detractor we are writing about features due to what may be a thesis-breaking event as opposed to market ebbs and flows. We owned St James Place as we saw attractive market positioning in the high-growth UK wealth segment. We felt that the Competitive Powers in **Switching Costs** – generated from advice and relationships – and **Cornered Resource** – via the academy which produces a large proportion of new IFAs in the UK – would sustain a high margin and growing revenue stream, underappreciated by the market. With its 1H23 results it revealed a surprise fee cut, prompted by regulatory change, on some products for the most loyal clients. This challenged our belief in the pricing power of the business and is perhaps a lesson that switching costs in a regulated industry are a potentially fragile power. We materially reduced our position on the day of results. We continue to monitor the situation but with a significantly reduced exposure in the fund. **4Imprint** -28bps was also a detractor though, on an absence of newsflow, we put this down to a USD earnings stream in the face of GBP strength.

The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested. Please refer to the Key Risks for more information.

Dividend paying companies with Competitive Power: **RS Group**

Year-to-date our holding in RS Group (formerly known as Electrocomponents) has delivered a total return of -10.85% and been a key detractor from fund performance (-35bps). The company is a global distributor of industrial and electronic components. It has c.1.1 million customers who operate factories, workshops, warehouses and labs across a wide range of industries.

From its distribution centres around the world, stocking >750,000 items, it connects its customers with >2,500 suppliers, delivering the widgets, spare parts and consumables they need to keep their machines, equipment and people in good working order and safe. Fun fact – it ships a parcel once every two seconds.

Distributors are businesses we are positively pre-disposed to. Specialised audio visual (AV) equipment distributor Midwich is another example from the portfolio. The industry plays an important and enduring role in supply chains, benefiting both manufacturers (providing a go-to-market channel to access a fragmented customer base) and customers (who can consolidate purchases via a one-stop shop). Margins are generally modest although, aside from inventory, the models are asset light and so returns are attractive. Moreover, the markets are generally characterised by long tails of mom-and-pop type operations, which struggle to compete on product breadth and depth as well as customer service and on time performance – it is this that means the big get bigger. Notwithstanding recent lacklustre share price performance, we continue to regard RS Group as a best-in-class distributor, benefiting from a differentiated business model and with the opportunity to compound market share for a sustained period.

A key feature of RS's business model is that the majority of its sales (c.2/3rds) are captured via digital channels. The company was originally founded as a mail-order catalogue distributor and so pivoting over time from this to e-commerce was a natural progression. Customers now expect seamless 24/7 service, including simple, easy-to-navigate websites and mobile apps, and have less patience for clunky catalogues and opaque order-tracking systems. On this note, RS's digital penetration is among the highest in the world and compares to traditional local distributors at <10%. Not only does this make RS easier to do business with, but it generates a wealth of data to inform evidence-based decision making around marketing, pricing, range and customer service. Another differentiator is RS's ability to provide value-added solutions. While product selection and convenience are crucial, many customers are looking for more. RS offers several problem-solving services such as vending, asset maintenance and analytics and procurement tools, which in aggregate account for c.25% of group revenue. Evidence of RS's advantaged business model has been its ability to organically outgrow its underlying markets in recent years by a factor of c.2-3x. Over the past decade it has grown its earnings by a compound growth rate (CAGR) of c.16%.

Our investment philosophy is that 'quality dividend investing works best' and we apply a systematic framework to understand and identify quality. RS Group demonstrates the five building blocks we look for across our portfolio holdings.

- It generates **attractive returns on invested capital** (ROIC), achieving c.20% (post-tax) in FY23a, a number which has trended pleasingly higher in recent years. These high returns create distributable cashflows for reinvestment into both organic and bolt-on growth opportunities. RS has achieved a 5 and 10-year EPS compound annual growth rate (CAGR) of c.18% and c.16%, respectively.
- As dividend-focused investors we want **clean, cash generative financial models**. RS reports relatively straightforward accounts with few adjustments to earnings. Over the past three years cumulative free cash flow to net profit conversion has been c.75%, with the shortfall primarily working capital related, as the company has been investing in additional inventory as it broadens its product range and seeks to deliver high levels of customer service.
- RS Group operates with a **prudent balance sheet**, with net debt/EBITTDA at c.0.2x as at FY23a. This will increase modestly, with it having completed a couple of acquisitions post-period end, but remains at <1.0x on a pro-forma basis. This is a conservative, but appropriate, amount of leverage given some cyclicality to its end-markets. It has no material provisions or pension deficit.
- **Attractive Underlying Markets**. Market growth is somewhat cyclical and linked to global industrial production, which averages c.1.5-2.0% per annum through the cycle. Optically, this might appear unexciting. However, the market is large, with management estimating an addressable market of >£470bn, and many competitors are independent businesses and regional firms specialising in a narrow product offering, with limited service solutions and less developed digital capabilities. This combination provides significant scope for RS to differentiate and grow its business, with current market share at <1% globally and c.5% in its most mature market, the UK.

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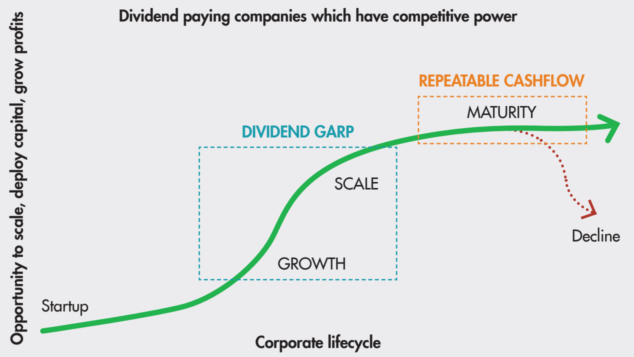
- We look for **skilled, motivated management** and a contributor to RS Group's share underperformance this year is likely attributed to both the former CEO and CFO, whom we held in high regard, leaving the business due to unconnected personal reasons. We have had the opportunity to meet the new CEO, Simon Pryce, and were impressed by his vision to build on the group's market position while further enhancing operational processes. Some of our colleagues made money investing in Ultra Electronics, where Pryce was formerly CEO, prior to its takeover in 2021; and, we have had positive interactions with the new CFO, Kate Ringrose, during her time at Centrica.

Source for all metrics: company financials, 31 July 2023

While the products RS supplies are generally part of its customers' indirect spend (i.e. consumables or linked to repair and maintenance), rather than part of the end-product itself, demand is still linked to overall factory/facility utilisation rates and as global industrial production has moderated this year, RS's previously stellar sales growth has stuttered, prompting mid-high single digit % consensus earnings downgrades. This has been compounded by a de-rating of the multiple. While the market is currently asking us difficult questions, applying our *Competitive Powers* framework allows us to retain conviction that the future for this company remains bright. As a reminder, Powers are strategic traits that underpin potential for a company to generate persistently attractive returns. We believe RS Group has three of the seven Competitive Powers - Scale Economies, Switching Costs and Counter Positioning, which should position it as a long-term structural winner in the industry.

- **Scale Economies:** Although RS still has low market share, it is considerably larger than most of its competitors. It uses its scale to improve back-office efficiency, obtain better terms from manufacturers (including its RS Pro private label range) and build deeper relationships with customers, for instance through investment in digital tools and value-added services which can be amortised across a global customer base.
- **Counter Positioning:** As discussed, RS's history as a catalogue business has positioned it today as a 'branch-lite, digitally-led' model. Many of its competitors still have large legacy branch footprints and are having to manage the challenge of optimising operating costs for a multi-channel proposition – investing in service, price and multi-channel distribution puts pressure on those that have been slower to evolve their branch networks. An analogy here would be the travails of big-box retailers (and associated stranded overheads), in the face of the growth of e-commerce. As a first mover, RS is able to continue investing in digital leadership while large parts of the industry remain hamstrung by legacy physical assets and so are slower to respond.
- **Switching Costs:** RS's strategy is to drive customer loyalty and recurring revenue through value-add relationships. In addition to the strong digital offering valued by its customers, RS also creates loyalty through its RS PRO own-brand range (c.13% of group sales) which offers customers high quality, competitively priced product. Moreover, the value-added solutions (c.25% of group sales) offering, discussed earlier, through both software (e.g. procurement tools) and hardware (e.g. vending machines, machine monitoring devices), deeply embeds RS Group within its customers' day-to-day operations. This creates, we think, a type of procedural switching cost, shifting the business relationship from purely transactional to strategic.

RS Group sits within the Dividend GARP portion of portfolio, formed of companies in the growth phase of the corporate S-Curve. Our hypothesis with this group of stocks is that 'when underpinned by competitive power, value-added growth can persist for longer than may be priced in'. They generally pay a dividend, though still with plenty of runway to reinvest their cashflows and grow their businesses, we expect returns to be driven by compound profit (and ultimately dividend) growth.



Dividend GARP: 'When underpinned by Competitive Power, value-added growth can persist for longer than may be priced in.'

Repeatable Cashflow: 'Cashflows underpinned by Competitive Power are durable, yet sometimes undervalued.'

GARP: growth at a reasonable price
Source: Liontrust

RS offers a prospective dividend yield of 3.0% (FY1-2e)[1] and we believe its Competitive Powers, aligned with attractive market structure, will allow it to continue delivering double-digit growth in earnings, cashflow and dividends over the medium term. The stock trades on a blended forward P/E of 12.8x (FY1-2e)[2] vs. its own 5-yr average of c.20x and is on a prospective FCF yield of 6.2%[3]. We came across an interesting datapoint recently (source: HSBC) suggesting less than 1% of all RS Group shares traded in the past 10 years have traded at a lower forward P/E multiple than the current one, which gives some sense of downside protection. While we calculate that intrinsically the stock can justifiably trade on a high-teens multiple through the cycle, we believe we can make strong shareholder returns without a re-rating. We have been adding to our position in recent weeks.

Fund performance year-to-date has been pleasing. We are, though, focused on the more substantial opportunity that exists to grow our investors' wealth and dividend income over the long-term (and indeed our own, as substantial investors in the strategy). We remain confident that our process, identifying dividend paying companies with Competitive Powers, gives us a framework to capture superior risk adjusted returns. As ever, we thank you for your interest and continued support.

[1, 2 & 3] Bloomberg, as at 31 July 2023

Discrete performance

To previous quarter 12 months ending (%)	Jun-23	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust Income C Acc GBP	9.5	0.7	19.0	-13.1	6.5
FTSE All-Share	7.9	1.6	21.5	-13.0	0.6
IA UK Equity Income	4.3	-0.3	25.4	-13.6	-2.5
Quartile	1	2	4	2	1

Source: FE Analytics, as at 30.06.23. Liontrust Income Fund, primary share class performance, C Accumulation GBP, total return (net of fees, interest/income reinvested) versus FTSE All-Share and IA UK Equity Income comparator benchmarks. Quartiles and rankings, as at 30.06.23, generated on 06.07.23

Key Risks and Disclaimer

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result. The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay. This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments. The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings. Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash. Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

In reference to any component (where applicable) of a fund's investment process that uses external ESG data, there may be limitations to the availability, completeness or accuracy of ESG information from third-party providers, or inconsistencies in the consideration of ESG factors across different third-party data providers, given the evolving nature of ESG.

The level of income is not guaranteed. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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