City of London

CTY has benefitted from strong stock picking and the structural advantages of investment trusts...

Update
01 March 2024

Overview

Like its namesake, longevity permeates the City of London Investment Trust (CTY). CTY has the longest track record of any trust, having raised its dividend for 57 consecutive years (see **Dividend section**). Much of this track record can be attributed to Job Curtis who has managed the trust for approaching 33 years. Job's investment philosophy has clearly been critical to CTY's success, but so too is the ability to tuck away surplus income into a reserve, and thereby smooth income payouts to shareholders.

This is very much an actively managed portfolio, with an expected number of holdings between 80 and 90. Part of Job's approach is to maintain a broad spread of investments. By not taking large stock or sector positions when compared to the benchmark, Job and his deputy manager David Smith believe that their stock selection will add value but at the same time does not expose investors to undue risks. In the **Portfolio section**, we illustrate how Job prefers companies that are not hostage to fortune, or 'turn-around' stories.

CTY's board believes that gearing will enhance returns over the long term, and so took advantage of the previous low interest rate environment by arranging long-term, low-cost debt (see **Gearing section**). At 7%, CTY's gearing level remains significantly below the five-year average, and below the average of the peer group. In our view, this chimes with Job's cautious and practical approach to investing for the long term.

CTY's significant size puts it at an advantage. In the recent interim results, the board announced a management fee reduction from 0.325% to 0.3%, effective 1st January 2024. Low charges are one of the contributors to the virtuous circle that CTY finds itself in, enabling it to continue to issue shares and grow its asset base.

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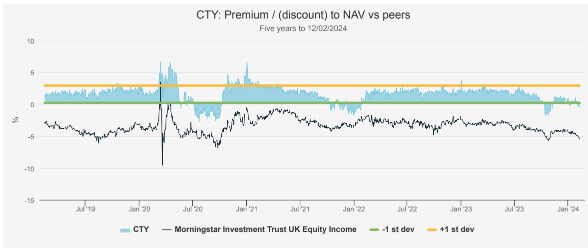
Key Information:

Price (p)	392.50
Discount/Premium(%)	-0.58
OCF (%)	0.37
Gearing (%)	0.06
Yield (%)	5.2
Ticker	CTY
Market cap (£)	1,952,853,012



Kepler View

Weathering the occasional storm is part and parcel of long-term investing, and in our view, the inherent advantages that investment trusts have, combined with Job's stock-picking skills have clearly helped. Having been a portfolio manager for nearly 33 years, Job's experience is one of the unique aspects of CTY. The trust has consistently delivered on its objectives for many years, and in our view—given the repeatable investment process that emphasises spreading risks and investing based on fundamentals—it is in a strong position to continue to do so.

This is an active strategy, and so positive attribution from stock selection is the hallmark of success. Whilst Job has unequivocally added value over the years from his stock picking, the unique tools employed by investment trusts have also added to returns. As we show in the **Performance section**, Job's stock selection has been strong over the past decade, but gearing has also contributed to returns more years than not. We also note that share issuance has contributed consistent and significant value to shareholders, in some years making a considerable dent in offsetting the trust's already low ongoing charges (see **Charges section**).

Over the last five years, CTY's average premium to NAV has been 1.2%, which compares to the current slight discount to NAV of 0.6%. In our view, CTY's lower discount volatility is as much a result of the board's share issuance and buyback activity, as it is the high-quality proposition that CTY represents as a long-term investment vehicle. If the past is anything to go by, the opportunity to buy CTY's shares on a small discount may not prove to be around for long.

BULL
Very low OCF of 0.37%
Consistency and experience of manager who has delivered long-term outperformance of the FTSE All-Share Index in capital and income terms
57-year track record of progressive dividend increases

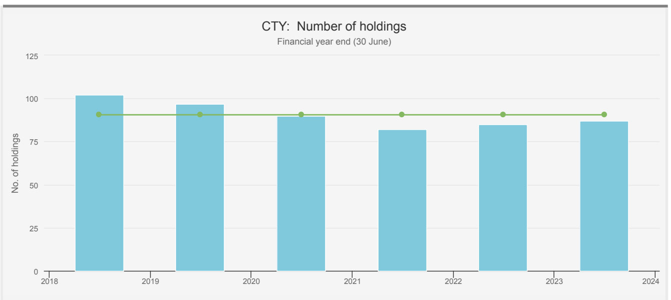
BEAR
Cautious approach means that NAV performance can underperform in some market conditions
Income track record highly attractive, so manager might risk long-term capital growth in trying to maintain it
Structural gearing can exacerbate the downside

Portfolio

Like its namesake, longevity permeates the City of London Investment Trust (CTY). CTY has the longest track record of any trust raising its dividend in consecutive years (57 years). Much of this track record can be attributed to the same manager—Job Curtis—who has managed the trust for approaching 33 years. As one might imagine, chalking up such a strong result for shareholders over such a long period requires a lot more than just luck. Job's investment philosophy has clearly been critical to his success in delivering on CTY's objectives, but relative to open-ended funds, CTY's ability to tuck away surplus income into a reserve, and thereby smooth income payouts to shareholders, also puts it at a distinct advantage. Weathering the occasional storm is part and parcel of investing, and in our view, the inherent advantages that investment trusts have, but also Job's inherent conservatism and caution have both clearly helped.

Part of Job's approach is to maintain a broad spread of investments. By not taking particularly big stock or sector positions when compared to the benchmark, Job and his deputy manager David Smith believe that over the long term, their stock selection will add value. At the same time, investors are not exposed to undue risks. As we discuss in the **Performance section**, this is reflected in the long-term track record, which shows that stock selection over the years has been strong and consistent, with positive contributions in six out of the last ten financial years. Despite the desire to spread risks, this is very much an actively managed portfolio, with an expected number of holdings between 8 and 90. This target has remained relatively stable over time but has varied around the 90 holdings level since the decision was taken in 2018 to modestly increase portfolio concentration from the c.100+ holdings at the time. We show the change over time (as of the financial year end) since 2018 in the graph below.

Fig.1: Number Of Holdings In Portfolio



Source: Janus Henderson

Job's cautious and common-sense approach can also be seen in the types of companies that he typically favours. Dividend yield is amongst his favoured valuation metrics, but he will always take into consideration the macroeconomic backdrop. Job targets investments into companies with strong balance sheets that can offer resilience, which is especially important for cyclical companies, which need to be able to demonstrate to Job the potential for sustainable cash generation, which will support dividends and capital expenditure for future growth. This balance sheet strength is an important consideration for Job, in that he prefers companies that are not hostage to fortune, or 'turn-around' stories. Instead, they must have a degree of predictability, and therefore likely to be able to pay a dividend for the foreseeable future.

This preference comes through in practice, as was illustrated in a recent call to discuss the interim results. Job highlighted that he had missed out on Rolls-Royce's strong recovery in share price during the six-month interim period ending 31/12/2023. However, noting the strong performance of the defence sector as a whole, Job has benefitted from the strength in BAE's share price, which is now the largest position in the portfolio in absolute terms. Job had originally bought BAE because of its attractive valuation, and top-quality management team. However, with many countries re-arming and spending higher proportions of GDP on defence, BAE is in a strong position to benefit. Rolls-Royce has performed better over this short period but was in a significantly less advantageous position previously. As an investment, Job saw it as a higher risk, and a recovery in its share price depending on a recovery of its civil aerospace business. Job tends to avoid bottom-fishing for deep-value bargains like Rolls-Royce, given the risks and volatility that tend to come with these investments.

Job's investments can include contrarian ideas, but these will always be weighed against the risks. A recent purchase of Burberry, a new entrant to the portfolio in the interim period, illustrates the nuances between valuation and risk. Burberry's shares had fallen by 40% from their 12-month high but has an iconic brand and is very profitable. Importantly, the company has a very strong balance sheet and continues to pay a dividend which represents a yield of over 4%. On a P/E of c. 15x, Job believed that it was an interesting opportunity to buy a high-quality company at an attractive valuation. Noting the potential headwinds from the Chinese market and the potential for a slowing global economy, Job initiated a holding with a half-position (representing around 0.3% of NAV) in November 2023.

Job's stock picking is based on his own analysis and that of his colleagues at Janus Henderson, and being aware of valuations, he tends to trim stocks that have performed well compared to the wider market and recycle capital into other companies showing good value credentials. He does not buy stocks just because they are a large constituent of the benchmark index. That said, FTSE 100 constituents are typically the mainstay of the portfolio. As we show below, the portfolio is well diversified, with the top ten holdings representing one-third of the portfolio, with no holding of greater than 4.2%. Job has the latitude to invest up to

20% in overseas markets, which on occasion he makes full use of. Given valuations in the UK are low when compared to comparators trading on stock exchanges abroad, it is perhaps not surprising that c. 13% is invested abroad (as of 31/01/2024). Job observes that around two-thirds of CTY's underlying revenues (through its investments) originate overseas, and therefore shareholders are benefitting from cut price exposure to similar end markets. UK-listed companies also tend to pay higher dividends, especially amongst the large and mega caps, which makes it an excellent place in which to invest for growth and income.

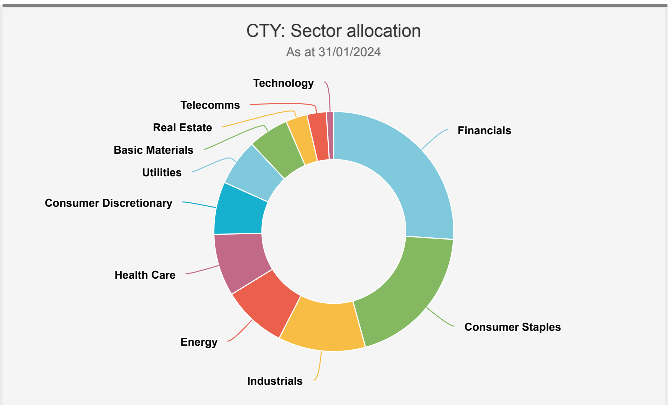
Top Ten Holdings As At 31/01/2024

COMPANY	% OF PORTFOLIO
BAE Systems	4.2
RELX	3.9
Shell	3.9
HSBC	3.6
Unilever	3.4
AstraZeneca	3.1
3i Group	2.9
British American Tobacco	2.9
BP	2.8
Tesco	2.7
Total	**33.4**

Source: Janus Henderson

We show below the latest sector breakdown, which illustrates CTY's largest exposure remains in financials, which currently constitute just over a quarter of the portfolio. Despite the appearance of risk towards one sector, companies held within this sector are relatively diverse, with life insurance groups, financial services, and 3i included. 3i remains a strong contributor, largely as a result of the impressive performance of European discount retailer Action group, which represents c. 70% of 3i's portfolio. High Street banks also feature, which continue to benefit from rising interest rates.

Fig.2: Sector Exposure



Source: Janus Henderson

Having been the portfolio manager for nearly 33 years, the length of Job's experience is one of the unique aspects of CTY. The trust has consistently delivered on its objectives for many years, and in our view—given the repeatable investment process that emphasises spreading risks and investing based on fundamentals—it is in a strong position to continue to do so.

Gearing

CTY's board believes that gearing will enhance returns over the long term. The board took advantage of the previous low interest rate environment, and as a result, CTY has a long-term source of low-cost debt finance. In our view, this will be a long-term structural advantage to the trust: if inflation stays high, then it will eat away at the real value of the principal, but over the long-term equities should deliver nominal returns well ahead of inflation. On a cashflow basis too, shareholders are benefitting. The current portfolio yield of 4.8% is considerably higher than the cost of this debt, and any income growth that Job is able to achieve will be enhanced by the gearing, meaning dividend growth will be higher than it would otherwise be as a result.

Fixed-Rate Gearing

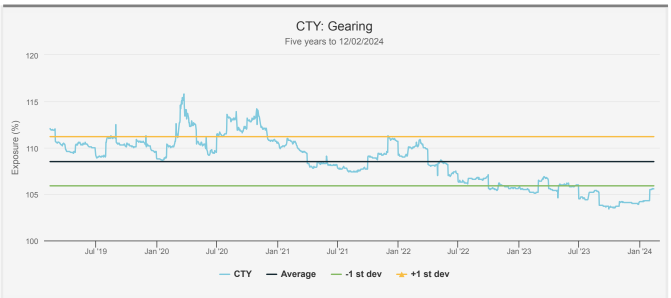
NOTE	MATURITY YEAR	AMOUNT (£M)	RATE (%)
Secured notes	2029	35	4.53
Secured notes	2046	30	2.67
Secured notes	2049	50	2.94
Average/total/wtd ave.	**2041**	**115**	**3.35**

Source: Janus Henderson, Kepler Partners

In addition to the £115 million of long-term structural gearing, CTY has a more flexible overdraft facility of up to £120m available to be deployed tactically. Gearing decisions are the responsibility of the manager but discussed at board meetings and with the Chairman between times, and Job continues to not employ any of the flexible gearing given the relatively high cost. We show below the last five years of gearing, illustrating that since interest rates increased, CTY's gearing level has come down, and at 7% (as of 31/01/2024) remains significantly below the five-year average. When compared to the AIC UK equity income peer group, CTY is also below the average of the peer group, which according to statistics from JPMorgan Cazenove is c. 11%. In our view, this chimes with Job's cautious and practical approach to investing for the long term.

The benefit of CTY's low-cost gearing is captured in the 'NAV with debt at fair value' calculation, which, for the last three financial years has been a positive tailwind to returns. That said, in the interim period to 31/12/2023, with interest rates falling, this tailwind turned into an accounting headwind, with the market value of the debt rising, and detracting from NAV growth. Aside from the valuation impact, it is worth remembering that gearing does exacerbate the downside. In this respect, Job believes that CTY's portfolio beta will, typically, be around 0.9 to 0.95, so he reasons that CTY's NAV beta should not necessarily be significantly higher than the wider market even after gearing is employed.

Fig.3: Gearing



Source: Morningstar

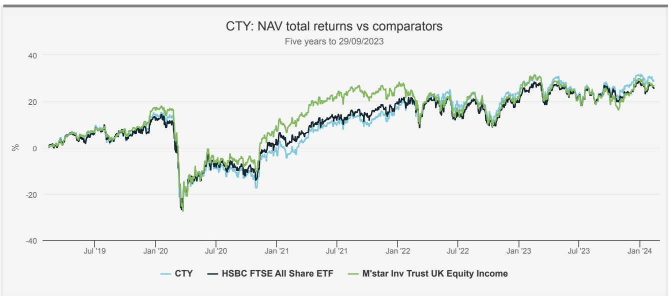
Performance

Job has been managing CTY for a very long time, now approaching the 33rd anniversary of him taking over management of the trust. As we discuss in the **Portfolio section**, he invests for the long term and uses his long experience to pick stocks based on fundamentals and valuations. He has clearly made a significant contribution to CTY's 57-year track record of consecutive dividend increases and was formally joined by David Smith as deputy fund manager in 2021.

Despite CTY being famous for the longevity of its progressive dividend, it is important to remember that aside from a high level of income, the formal objective is also to provide shareholders with capital and income growth. Job's record in this regard is good. Since he took over management of the trust, CTY has delivered a NAV total return of 1,345%, which compares to the FTSE All-Share Index return of 1,031%, an outperformance of 314 percentage points. Shorter term, in the ten years to 13/02/2024 CTY's NAV total return was 69.7%, compared to a FTSE All-Share ETF return over the same period of 60.3%, an outperformance over this period of 9.4%. As we discuss in the **Dividend section**, CTY's dividend is significantly higher than that of the benchmark, meaning that over this period, shareholders have had total return outperformance and a higher income.

As we show below, over the past five years, CTY's total return NAV outperformance has been 4%. As we show in the table further below, which breaks down performance relative to the benchmark in each financial year, relative returns have not been consistent. One would expect this from an active strategy such as that employed by CTY. In particular, over the last five years, relative returns were negatively impacted in the financial year ending June 2021 by an underweight exposure to growth stocks. And in 2023, CTY underperformed because of an underweight to banks and energy. It is impossible to get it right every year, but with Job attempting to spread risks across the portfolio at all times, over the long term the benefit of his stock picking should come through, and hopefully deliver long-term outperformance. It is this that has allowed Job to successfully navigate market cycles over his long tenure.

Fig.4: Five-Year Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Positive attribution from stock selection is the hallmark of a successful active investment strategy. However, the unique properties of investment trusts can also add to shareholder returns. As such, we think it is worth looking at the table below, which shows CTY in a good light in this

Past Ten Years: Est. Performance Attribution (Relative To FTSE All-Share Index)

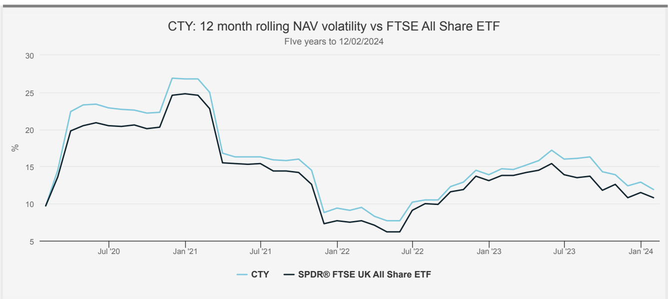
FINANCIAL YEAR ENDING 30 JUNE	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Stock selection	1.14	4.08	1.54	-3.84	-2.89	2.99	0.90	-3.8	4.69	-4.32
Gearing	0.66	0.05	-0.32	0.61	0.47	-0.61	-2.40	2.50	1.53	1.13
Expenses	-0.43	-0.42	-0.42	-0.42	-0.41	-0.39	-0.36	-0.40	-0.37	-0.37
Share issuance	0.19	0.13	0.11	0.07	0.09	0.11	0.26	0.30	0.04	0.18
TOTAL	1.56	3.84	0.91	-3.58	-2.74	2.10	-1.60	-1.40	5.89	-3.38

Source: Janus Henderson Investors
Past performance is not a reliable indicator of future results

regard. Job's stock selection has been strong over the past decade, making positive contributions in six out of the last ten financial years. At the same time, gearing has also contributed to returns more years than not. We also note that share issuance has contributed consistent and significant value to shareholders, in some years making a considerable dent in offsetting the trust's already low ongoing charges (see **Charges section**).

We show the graph below because we think it interesting to highlight, that despite employing gearing and having a truly active manager, CTY's NAV volatility, whilst marginally higher than an ETF of the benchmark, is not significantly higher on a consistent basis. This will reassure investors that, in CTY, they have all the benefits of Job's experience and ability to deliver a progressive dividend, without taking significantly more risk than the index. We would note that share price volatility is likely to be higher than that of the NAV.

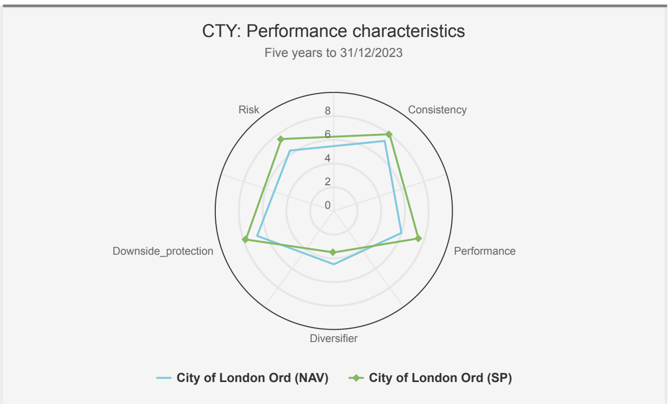
Fig.5: NAV Volatility



Source: Morningstar
Past performance is not a reliable indicator of future results.

Our KTI spider chart below shows how CTY's NAV has performed versus the peer group of UK equity income trusts over the past five years, in some key categories. Each category is scored out of ten, based on returns over the last five years, and scores are normalised to the peer group, with a higher score indicating superior characteristics. CTY ranks well for performance and

Fig.6: KTI Spider Chart



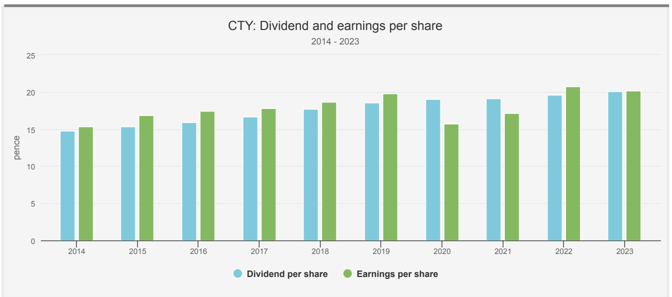
Source: Morningstar, Kepler Partners
Past performance is not a reliable indicator of future results.

consistency. It also scores well on risk and downside protection, in our view, likely reflecting the risk-averse manner in which Job and David manage the portfolio. It is likely that this fact is also responsible for the relatively low score which CTY attracts as a diversifier, given the managers do not tend to take particularly strong sector views against the benchmark. In the graph below we have also included the share price in our analysis. Because of the relatively tight control exercised by the board on the discount (see **Discount section**) relative to its peers which have more volatile discounts, CTY's relative performance measures are enhanced when seen on a share price basis.

Dividend

CTY has an unmatched record of delivering consecutive years of dividend growth, now having reached 57 years. This is the longest continuous period of any investment trust and means CTY is top of the **AIC's 'Dividend Heroes'** list. As the graph below shows, this is not to say that underlying earnings have increased each and every year. Investment trusts have the ability to retain up to 15% of each year's income in reserve and use this reserve in future years to smooth dividends if revenues subsequently fall. One such year was 2020, with many portfolio holdings cutting or passing on dividend payments in the face of the economic shock brought on by the COVID-19 pandemic. CTY was able to continue to pay an ever-increased level of dividends through the crisis, allowing earnings to catch back up again with the dividend by 2022 when the dividend was once again covered. CTY's dividend was marginally covered in 2023. Total revenues over the first half of the current financial year, which ends in June 2024 were up, but earnings per share only increased marginally thanks to the short-term dilutive effect of share issuance so far this year. We understand that income generation is in any event biassed towards the second half of CTY's financial year, when many of the big income stocks pay their final dividends. The board has stated that it is confident that it will be able to continue to increase the annual dividend this year.

Fig.7: Financial Year Dividends And Earnings

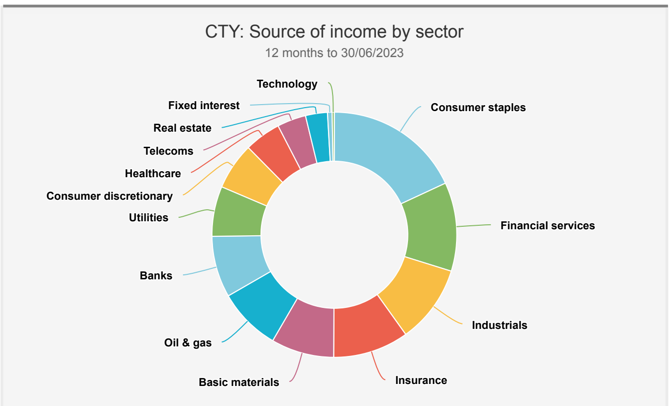


Source: Janus Henderson Investors

Aside from being able to use reserves, the key to CTY's long-term success in raising the dividend every year has been Job's stewardship of the portfolio over many years. As we highlight in the **Portfolio section**, Job's inherent conservatism and wish to spread risks means that the portfolio has been able to withstand shocks, but his stock picking has also allowed CTY to perform well in income and capital terms when the conditions are more favourable. CTY provides the spread of the trust's income sources by sector, which we reproduce below for the year ending 30/06/2023, illustrating the point that CTY remains diversified both in terms of its capital base and revenues.

The 2023 dividend equates to a high dividend yield of 5.2% at the current share price (as of 22/02/2024), significantly higher than the AIC UK equity income peer group weighted average of 4.4% and the FTSE All-Share yield of 3.9%. Revenue reserves stand at 8.9p, equivalent to 0.44x the annual dividend. Whilst not the highest in the AIC sector by any means, we think the board's determination to continue to pay higher dividends on a yearly basis going forward is clear. In extremis, the board has stated that capital reserves could also be used to support dividends.

Fig.8: Source Of Income By Sector



Source: Janus Henderson Investors, by ICB Industry except Financials, which is split out by ICB Sectors

Management

CTY has been managed by Job Curtis since July 1991, representing a length of tenure rarely seen elsewhere. His experience of managing the trust through many market cycles, and his cautious valuation-driven approach to investment, have clearly been critical to maintaining CTY's record of continuous dividend increases year on year.

Job works alongside a wider team of 15 at Janus Henderson's global equity team, who generate suggestions and lead company meetings. David Smith was promoted as CTY's deputy fund manager in September 2021. David also manages Henderson High Income and the UK portfolio of The Bankers Investment Trust. David and Job work closely together, but we understand that Job still holds the ultimate responsibility for any holding within the portfolio.

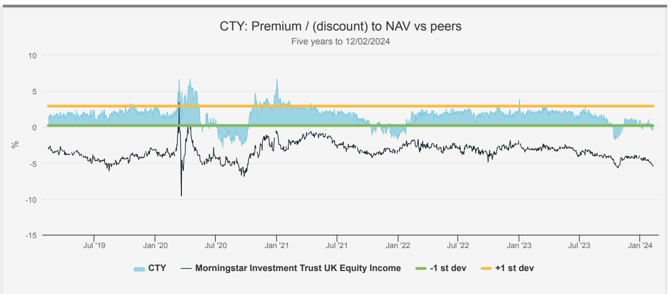
The investment strategy—which tends to focus mainly on constituents of the FTSE 100 index—suits a trust with scale. CTY is the one of larger and more liquid investment trusts listed on the London Stock Exchange, with a market capitalisation of c. £2bn. It is the largest trust in the AIC equity income sector, and as we illustrate in the **Charges section**, is amongst the lowest cost of those across the wider investment trust sector as well as being the lowest cost within its own sector.

Discount

Over the last five years, CTY has traded fairly consistently at a small premium to NAV. In our view, the attractions to investors include the sector's leading track record of dividend increases (see **Dividend**) and its low cost (see **Charges**). As a result, CTY has been able to continue to issue new shares. Issuing shares at a premium to NAV is additive to NAV, but also contributes to a lower ongoing charges figure thanks to economies of scale. CTY's size, having a market capitalisation of just under £2bn, also means it remains on the radar of larger institutional investors.

Over the last five years, CTY's average premium to NAV has been 1.2%, which compares to the current slight discount to NAV of 0.6%. As we show in the graph below, by comparison, the peer group's average discount has been more volatile and significantly wider than CTY's. In our view, CTY's lower discount volatility is as much a result of the board's share issuance and buyback activity, as it is the high-quality proposition that CTY represents as a long-term investment vehicle. The board continues to highlight that it aims for "the company's share price to reflect closely its underlying net asset value" and that it intends to consider share issuances and buybacks within a relatively narrow band around the net asset value but highlights that it does not have a specific level at which share issuance and buybacks may occur. If the past is anything to go by, the opportunity to buy CTY's shares on a small discount may not prove to be around for long.

Fig.9: Five-Year Discount



Source: Morningstar

Charges

CTY has the lowest OCF in the sector, most recently reported at 0.37% for the financial year ending 30/06/2023. By comparison, the simple average for the AIC UK equity income sector is 0.84%, and 0.58% on a weighted average basis. CTY's significant size therefore puts it at an advantage. In the recent interim results, the board announced that it had negotiated the management fee lower still, reducing from a flat fee of 0.325% to 0.3%, effective 1st January 2024. No performance fees are payable. Low charges are one of the contributors to the virtuous circle that CTY finds itself in, enabling it to continue to issue shares and grow its asset base, thereby reducing the OCF over time and making CTY highly liquid in terms of secondary share trading. In the event that net assets exceed £3bn, the management fee on any excess will be reduced to 0.275%.

CTY's most recent KID RIY is 0.74%, as of 29/12/2023, which compares to the sector's weighted average of 0.97%, according to JPMorgan Cazenove. In our opinion, KID RIY statistics are not especially insightful given they are backwards-looking and are inclusive of historical loan interest costs, which contributed 0.27% to costs, according to the last KID. Clearly, this cost does not account for any benefit that a trust may have had due to being geared. Also, we note that KIDs do not account for any increase in the NAV after the issuance of shares, which, typically, has had a positive impact for shareholders.

ESG

CTY's board has published **a document** emphasising its approach to ESG considerations across its investment decisions. It is important to highlight that CTY is by no means an ESG fund, and the managers do not specifically exclude any companies based on ESG considerations. However, Job and David look to avoid companies if ESG risks are either not explained in sufficient detail or are managed poorly. The publication highlights that governance is a key part of fundamental analysis and the CTY team believe that strong corporate governance is supportive towards long-term decision-making and investment returns.

Job and David consider each ESG factor, in addition to qualitative and quantitative assessments, before concluding the suitability of a holding. They are increasingly aware of climate change and other ESG risks that pose threats to the long-term financial returns which companies deliver. However, the team are not afraid to invest in sectors which have a perceived high level of ESG risk but have attractive valuations. Where held, the team need to believe that such companies are demonstrating they are taking positive steps towards improving their products and reducing health-related risks, whilst still offering highly attractive financial returns.

Stewardship and active engagement are areas that Job and David value highly, with the view that strong ownership principles, which can include engagement with management and boards, can assist in improving long-term shareholder value. CTY's managers are assisted with this analysis by Janus Henderson's dedicated governance and responsible investing team, who take stewardship voting at shareholder meetings extremely seriously and consult the fund managers on a case-by-case basis.

In our view, CTY is unlikely to appeal to strict ESG investors, but Job's interpretation of ESG factors, and engagement with investee companies is having an impact. At the time of writing, in comparison to the UK equity large cap peer group, CTY has been designated a 'below average' ESG rating, according to Morningstar (February 2024).

Disclaimer