# City of London

**A strong year for CTY highlights its attractions...**

Update
**02 October 2024**

## Overview

City of London Investment Trust (CTY) can claim many superlatives: the biggest – in the UK Equity Income sector, the cheapest – in its sector, and the best – at paying increased dividends for the longest consecutive period of any trust across the wider sector. Job Curtis has been the trust's manager for over 33 years, and his style of management has clearly been key to achieving strong results for shareholders over this period. The last financial year to 30/06/2024 saw CTY outperform, having now delivered outperformance of the benchmark over one, three, five and ten years.

Job brings a conservative and cautious approach to the mandate, which is to deliver capital and income growth. As we highlight in the **Portfolio section**, Job aims to maintain a broad spread of exposures and to invest based on fundamentals. The portfolio has a mix of higher yielding stocks as well as lower yielders that have higher growth potential. Job remains convinced that takeovers of UK companies is recognition of the quality and value of those UK companies, and as such is optimistic. In the meantime, with the dividend yield from UK equities attractive, Job believes investors continue to be 'paid to hold on' to UK equities.

CTY's board locked in long-term gearing, at what now look like highly attractive interest rates. This should confer a steady advantage to the trust over many years to come, and the weighted average cost of borrowings is 3.35%. Over the long term, given long-run expectations for returns from equities is well ahead of this, this should contribute positively to long-term returns. As we illustrate in the **Gearing section**, having gearing hasn't meant CTY's NAV volatility is significantly higher than the wider market. During 2024 CTY's shares have traded at a small discount in absolute terms, a symptom of market sentiment against the UK.


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## Analyst's View

CTY occupies an enviable spot within the UK Equity Income sector, which is reflected in its share price rating that has seen it trade on a consistently narrower discount than peers. Over time, the board has a relatively tight policy of ensuring the company's share price reflects closely its underlying net asset value. Aside from allowing the trust to build a loyal following and therefore be in a position to issue shares and grow, our analysis in the **Performance section** shows that on a number of metrics, having a tight discount through the cycle improves many risk metrics relative to peers who typically don't have such a tight control over their discount.

Job Curtis has managed the trust for 33 years, and his philosophy has clearly been critical to CTY's success. So too is the ability to tuck away surplus income into a reserve, and thereby smooth dividend payouts to shareholders (see **Dividend section**). 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. In our view, CTY is a high-quality proposition to invest in the underappreciated UK market for capital and income. If the shares slip to a discount to NAV, this could be considered an attractive entry point.

| 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 |
| Track record of 58 years of progressive dividend increases |

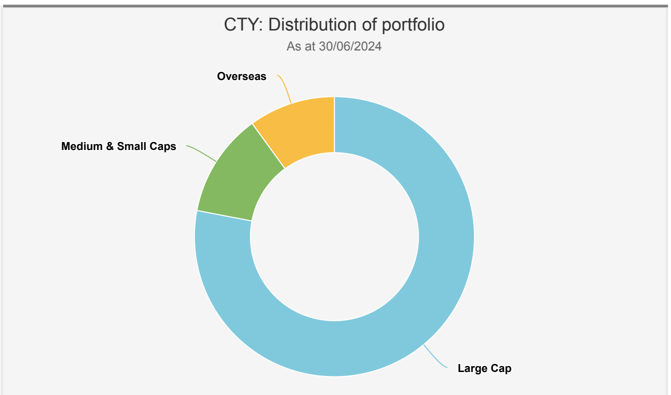
| BEAR |
| --- |
| Cautious approach means that NAV performance can underperform in some market conditions |
| Income track record highly attractive, so manager might risk long-term capital growth in trying to maintain it |
| Structural gearing can exacerbate the downside |

# Portfolio

City of London Investment Trust (CTY) dominates the UK Equity Income sector on a number of superlative fronts, being the biggest, cheapest and having paid the longest consecutive years of dividend increases of any trust. Key to CTY's success is the fact that it is actively managed, but in a cautious manner. Job Curtis has been the trust's manager for over 33 years, and his style of management has clearly been key to achieving strong results for shareholders over this period.

Job's conservative and cautious approach sees CTY exposed to 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, stock selection will deliver outperformance whilst at the same time not expose investors to undue risks. The portfolio is expected to constitute between 80 and 90 stocks (currently 82, as at 31/08/2024). Job tends to see the portfolio as mainly consisting of large, liquid companies listed on the London Stock Exchange, although as the chart below illustrates, he can and does invest outside of the FTSE 100. Job has latitude to invest up to 20% overseas, but given the value on offer in the UK, this exposure has been coming down and now represents only 10% of the portfolio.

## Fig.1: Distribution Of Portfolio




Source: Janus Henderson

Given the mandate is to deliver capital and income growth and build on the trust's unrivalled 58-year track record of consecutive dividend increases, it is perhaps not surprising that Job favours companies with strong balance sheets that can offer resilience. This is especially important when he is considering companies in cyclical sectors, which need to be able to demonstrate the potential for sustainable cash generation that will support dividends and capital expenditure for future growth. Balance sheet strength is therefore an important consideration for Job, and he prefers companies that are not in need of a turnaround. Instead, companies must have a degree of predictability, and therefore are likely to be able to pay a dividend for the foreseeable future. As we note in the **Dividend section**, Job reports that he is seeing increased use of buybacks amongst UK-listed companies, such that in aggregate this year buybacks as a proportion of market capitalisation is in excess of that seen in the S&P 500 this year. Job sees this as a positive from these holdings, showing that companies are recognising their own stock is undervalued, but it also mechanically contributes to earnings per share progression.

As we show below, the portfolio is well diversified, with the top ten holdings representing around one-third of the portfolio, with no holding of greater than 4.2%. As can be readily appreciated by scanning the list of companies below, a significant proportion of CTY's look-through revenues originate overseas. As such, CTY is benefitting from cut-price exposure to similar end markets as more globally exposed portfolios.

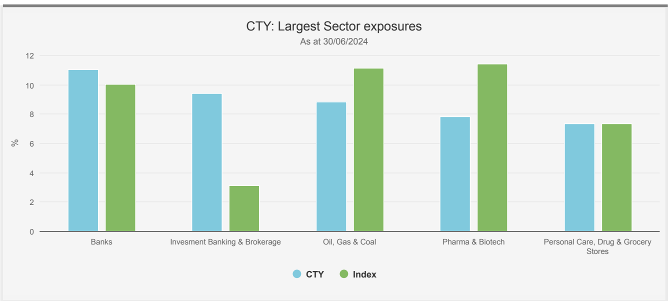
## Top Ten Holdings As At 30/08/2024

| COMPANY | % OF PORTFOLIO |
|---|---|
| BAE Systems | 4.2 |
| Shell | 4.0 |
| Unilever | 4.0 |
| RELX | 3.9 |
| HSBC | 3.8 |
| AstraZeneca | 3.5 |
| British American Tobacco | 3.2 |
| Tesco | 3.0 |
| Imperial Brands | 2.7 |
| NatWest | 2.6 |
| **Total** | **34.9** |

Source: Janus Henderson

We show below CTY sector breakdown as at 30/06/2024, which illustrates that the largest exposure in absolute and relative terms is to financials. These companies that Job holds for CTY are relatively diverse, with banks, life insurance groups and financial services. Banks continue to profit from higher interest rates but, mindful that they can be exposed to economic shocks, Job remains confident that their capital bases remain significantly stronger than at any point in the last 15 years. NatWest in particular has been a strong performer for the trust. Also technically a financial, 3i is another top contributor to CTY's outperformance in the last financial year, with European discount retailer Action group continuing to power ahead. Job is underweight relative to the benchmark in energy but remains happy with his holdings in Shell and BP, both of which are showing good capital discipline and growing dividends, but also buying considerable numbers of shares back. During the last financial year, a new holding was bought in Eni (headquartered in Italy but with global operations), which was added for its good prospects for oil production growth.

### Fig.2: Largest Sector Exposures




Source: Janus Henderson

Job has seen a number of stock market cycles over the 33 years he has managed CTY. Informed by his long experience, he aims to maintain a broad spread of exposures and invest based on fundamentals. The portfolio has a mix of higher yielding stocks as well as lower yielders that have higher growth potential. Job remains convinced that the continuing spate of takeovers for UK companies is recognition of the quality and value of those UK companies, and as such is optimistic on the future returns from the portfolio. At the same time, Job notes that there have been satisfactory dividend increases announced during the recent half-year results season, and as such with the dividend yield from UK equities attractive, investors continue to be 'paid to hold on' to UK equities.

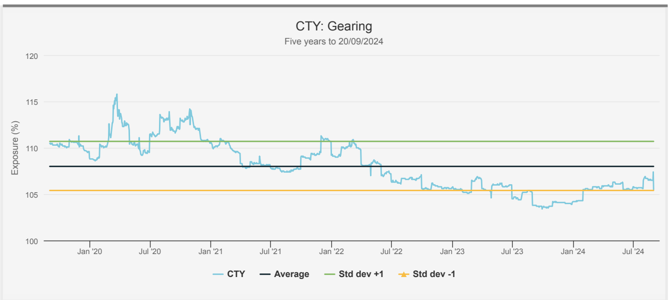
## Gearing

One of the advantages of investment trusts, in our view, is their ability to borrow money to enhance long-term returns. Clearly gearing does add to volatility, and can exacerbate the downside. However, the fact of the matter is, if long-term returns from CTY's portfolio outpace the costs of borrowing, then returns will have been boosted. An added boost comes from the effect of inflation, which eats away at the real value of the principal of the loan, but over the long-term equities should deliver positive real returns.

The board of CTY took advantage of the previous era of low interest rates by locking in long-term gearing at what now look like highly attractive interest rates. This should confer a steady advantage to the trust over many years to come. With a weighted average cost of borrowings of 3.35%, it is not hard to imagine that CTY's long-term returns could be considerably in excess of this. In addition to the £115m of long-term structural gearing (equating to c. 5% of NAV as at 31/08/2024), 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.

Currently, CTY is c. 7% geared (as at 31/08/2024), meaning that short-term gearing of c. 2% of NAV is employed. This is broadly in line with the long-term average level of gearing, reflecting Job's cautiously optimistic outlook.

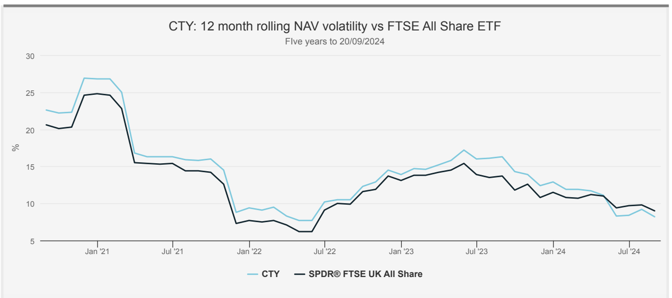
### Fig.3: Net Gearing




Source: Morningstar

Job believes that CTY's portfolio beta will, typically, be around 0.9 to 0.95, so he reasons that CTY's NAV beta (which reflects the effect of gearing) should not necessarily be significantly higher than the wider market. The graph below shows CTY's rolling NAV volatility compared to an ETF of the benchmark. We think it interesting to note that, whilst CTY's NAV volatility is higher, it is not significantly higher on a consistent basis. Indeed, it is interesting that lately CTY is actually less volatile than the benchmark despite gearing having been increased over 2024.

### Fig.4: NAV Volatility




Source: Morningstar

***Past performance is not a reliable indicator of future results.***

## Performance

CTY is managed in a cautious manner. That said, Job is an out-and-out stock picker, investing in companies based on his research and evaluation of the fundamentals. As such, whilst the pattern of returns is unlikely to deviate wildly from the benchmark index, performance is expected to be driven by stock selection. Over time, Job hopes to deliver meaningful increases in the dividend as well as outperformance of the benchmark. As at 30/06/2024 CTY had outperformed the benchmark over one, three, five and ten years, which we show in the table below. Whilst Job has not outperformed every year by any means, this does show that his approach of investing cautiously for the long term does add value. As we show below, Job's stock selection has been the main driver of outperformance, which is what one might expect from an actively managed portfolio.

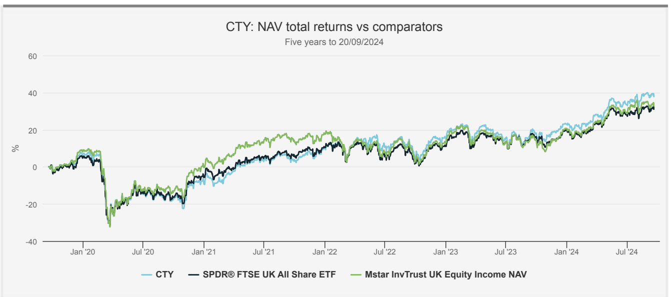
## NAV Performance

| CUMULATIVE PERFORMANCE (%) | 1 YEAR | 3 YEARS | 5 YEARS | 10 YEARS |
|---|---|---|---|---|
| CTY NAV | 15.6 | 29.9 | 33.1 | 83.0 |
| FTSE All-Share Index | 13.0 | 23.9 | 30.9 | 77.8 |

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

As we show below, over the five years to 20/09/2024, CTY's total return NAV has outperformed a representative FTSE All-Share ETF. At the time of writing, outperformance of this ETF was 6.8% over the five-year period, showing a good degree of value added from the manager, net of fees. As is discernible from the graph below, returns were behind the benchmark during 2021, a result of CTY being underweight exposure to growth stocks. Job attempts to spread risks across the portfolio at all times, so that over the long term the benefit of his stock picking should come through, and hopefully deliver long-term outperformance. Last financial year, stock selection added 2.6%, thanks to some strong performance from stocks Job was overweight in, such as 3i, BAE and NatWest. Two takeovers contributed significantly too: Wincanton, the logistics company, and Round Hill Music Royalty Fund.

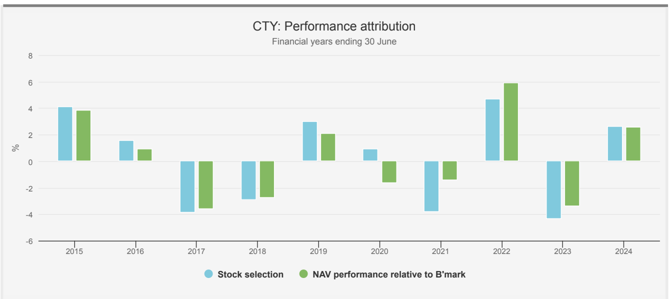
## Fig.5: Five-Year Performance




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. We show below the contribution from stock selection in each financial year, as well as the overall relative return. This illustrates that, as one might expect from a stock-picking strategy, Job's stock selection has been the key driver of returns. As it is, stock selection has been strong over the past decade, making positive contributions in five out of the last ten financial years. We note that gearing has also contributed to returns more years than not, and over time CTY's low fees also give it an advantage relative to peers (see **Charges section**).

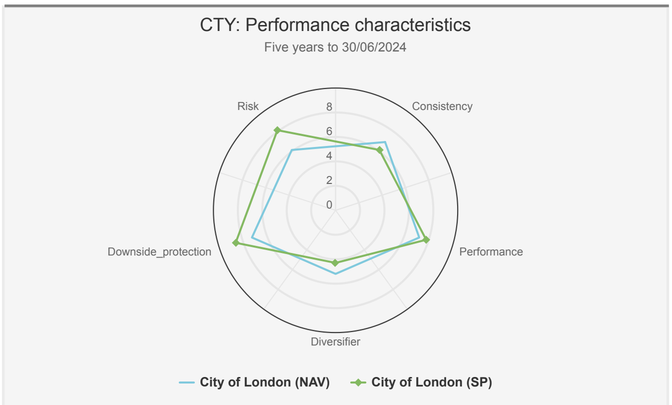
## Fig.6: Stock Selection Attribution (Relative To Ftse All-Share Index)




Source: Janus Henderson Investors
***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 almost across the board, as one might expect from a trust that is managed in a risk-averse manner. As we have highlighted before, CTY's lowest score is for the diversifier category, which is to be expected given that 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. We continue to observe that because of the relatively tight control exercised by the board on the discount (see **Discount section**) relative to its peers - which tend to have more volatile discounts. As such, CTY's relative performance measures are enhanced when seen on a share price basis.

## Fig.7: KTI Spider Chart




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

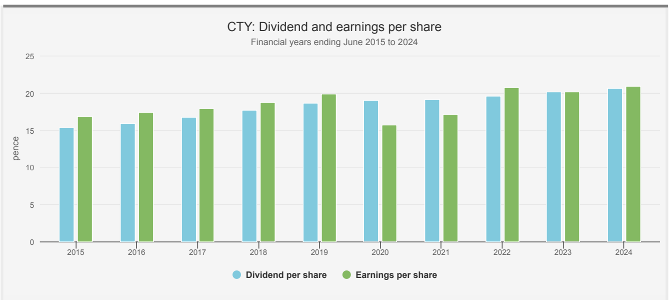
# Dividend

CTY's 2024 dividend equates to a dividend yield of 4.7% at the current share price (as of 26/09/24), significantly higher than the AIC UK Equity Income peer group weighted average of 4.2% and the FTSE All-Share yield of 3.6%. As attractive as the level of dividend, is the reassurance that comes with knowing that CTY has a 58-year track record of delivering consecutive annual dividend increases. Job believes that this record has not been surpassed by any UK-listed company, and in our view is a considerable achievement. Of course, underlying earnings have not increased each and every year, but CTY has used investment trusts' ability to retain up to 15% of each year's income in a reserve, and to use this in future years to smooth dividends if revenues subsequently fall. As the graph below illustrates, the two years following the outbreak of COVID-19 saw CTY pay an uncovered dividend, but revenues since then have exceeded dividends. For the year ending 30/06/2024 earnings per share were up 3.6%, allowing room to the board to increase the dividend by 2.5%, with the balance being transferred to reserves. This represented a higher than inflation increase, although CTY was not able to match the significant inflation spike seen in 2022. The board aims to grow the dividend ahead of inflation over longer time frames, and in this they have been successful: over the ten years to 30/06/2024, for example, CTY's dividend has grown by 39.6% compared with a cumulative increase in UK CPI inflation of 33.8%.

Key to Job's success in growing the dividend is his conservative approach to investing CTY's capital. As we outline in the **Portfolio section**, Job seeks to spread risks. For example, whilst only c. 10% of the portfolio is invested in overseas listed companies, 64% of CTY's underlying income is earned from overseas sources. By sector, revenues are also highly diversified, with the largest contributor to income being the Consumer Staples sector, at 17.9% of revenues.

The UK is a good market to invest for an income stream for a number of reasons, and dividend yield is one of the key criteria by which Job evaluates investments. At the same time, Job's mandate is to grow income and capital, and so he tends to complement high yielders with those companies that may pay a lower dividend yield, yet have strong growth prospects. Job has noticed an interesting development in the UK market in the past year, being the increased preponderance of buybacks, which in his view is supportive of future dividend growth. According to Janus Henderson calculations, the FTSE All-Share Index has seen 2.2% of the market capitalisation bought back over the past 12 months, which compares to 1.8% for the S&P 500 Index. This surprised us, given US companies are thought of as keen buyers of their own stock as a way of returning surplus cash to shareholders. Buybacks can be accretive, but also mechanistically help earnings growth, by reducing the share count. Aside from the takeovers we are seeing in the UK market, perhaps higher buybacks is yet another sign that the UK's listed companies are cheap by international standards?

### Fig.8: Financial Year Dividends And Earnings




Source:Janus Henderson Investors

Aside from Job's stewardship of the portfolio over many years, the fact that CTY is able to draw on revenue reserves to smooth the dividend should give confidence that the 58-year track record of increased dividends can continue to be extended. CTY's revenue reserve increased by £2.3m in the last financial year to £46.6m, with revenue reserves per share increasing by 5.8% to 9.43p. This equates to 0.44× the annual dividend of 20.6p. In extremis, the board has stated that capital reserves of £346.3m could also be used to support future dividend growth.

# Management

CTY has been managed by Job Curtis since July 1991, meaning he has recently celebrated his 33rd year at the helm of the trust. David Smith, who is also the manager of Henderson High Income, was promoted as CTY's deputy fund manager in September 2021. David and Job work closely together, but we understand that Job still holds the ultimate responsibility for any holding within the portfolio.

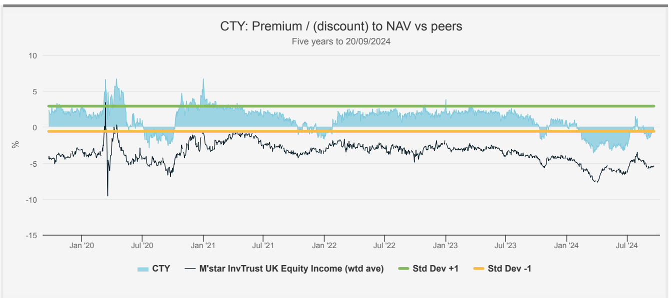
Job and David are part of Janus Henderson's 13-person global equity team, who generate suggestions and lead company meetings. Overall, the global equity team manage £13.1bn of assets (as at 30/06/2024).

# Discount

CTY occupies an enviable spot within the UK Equity Income sector, which is reflected in its share price rating. It is the largest trust (which offers institutional investors good liquidity), and the cheapest (see **Charges**), as well as having the longest continuous record of any UK listed company of raising its dividend. As a result, CTY's shares have traded at a premium rating to peers for quite some time, as we illustrate in the graph below. Trading at a premium to NAV allows CTY to issue shares, which has been additive in both capital value (c. £1.5m enhancement to NAV over the last financial year) as well reduce ongoing charges further by spreading fixed costs over a larger asset base.

During 2024 CTY's shares have traded at a small discount in absolute terms, a symptom of market sentiment against the UK, and potentially compounded by worries about the UK general election. The graph below illustrates the shares reacted positively to the UK election result. Overall, the board aims for "the company's share price to reflect closely its underlying net asset value" and states 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. Over the past five years, CTY's average premium to NAV has been 1.1%, which compares to the current slight discount to NAV of 0.6%. The shares have traded within a relatively narrow band, supported at times by the board's discount-control activities. Over the last financial year to 30/06/2024, the board bought back 8.3m shares at a discount of between 2% and 3%. By stepping up in this way, the board has been able to minimise discount volatility, which has been part of the reason that over the past ten years, CTY has been able to issue 218m shares at a premium to NAV, increasing the share count by 76% over this time.

### Fig.9: Five-Year Discount




Source: Morningstar

## Charges

From 01/01/2024, CTY's management fee reduced from 0.325% to 0.300% for up to £3bn of net assets and 0.275% above £3bn. No performance fees are applicable. These highly competitive fees mean that CTY has the lowest OCF in the sector, most recently reported at 0.37% for the financial year ending 30/06/2024. The simple average for the AIC UK Equity Income sector is significantly higher than this, at 0.86%, and 0.57% on a weighted average basis (according to JPMorgan Cazenove). Given the lower fee commenced midway through the financial year, CTY shareholders may expect the OCF to be lower next year, all things being equal.

CTY's most recent KID RIY is 0.74%, as of 29/12/2023, which compares to the sector's weighted average of 0.98%, according to JPMorgan Cazenove. In our opinion, KID RIY statistics are not especially insightful given they are backwards-looking and for example include 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, for CTY, has delivered a positive impact for shareholders.

## ESG

The fund manager and deputy fund manager, supported by specialists at Janus Henderson, give careful consideration to ESG-related risks and opportunities when selecting stocks for the portfolio. The board recognises that these risks are highly relevant to the long-term performance of CTY and of increasing concern to shareholders. An analysis by MSCI, a company widely used in the review of ESG factors, shows that City of London's portfolio as at 30/06/2024 had a lower weighted score for ESG risks than the FTSE All-Share Index.

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. They believe that governance is a key part of fundamental analysis and 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 that companies deliver. However, the team are not afraid to invest in sectors that 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 an average ESG rating, according to Morningstar (September 2024).

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