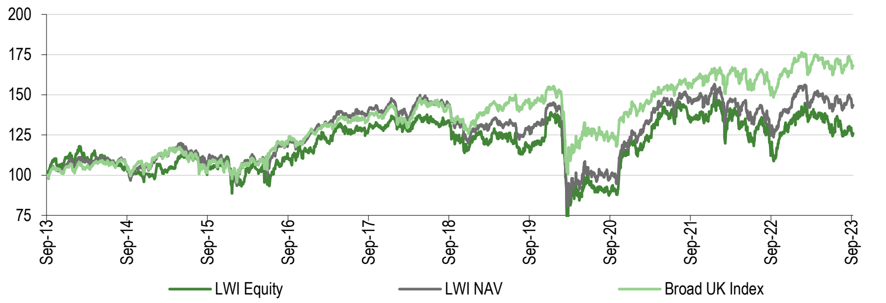
Lowland Investment Company

Dividend growth and NAV outperformance

Since we published our detailed review of Lowland Investment Company (LWI) in August, quarterly DPS has been increased 4.9% to 1.6p, continuing a long track record of progressive dividends, and maintaining the trust's position as one of the highest yielding in the UK Equity Income sector. In the financial year to 30 September 2023 (FY23), its NAV total return of 17.2% was 3.4 percentage points ahead of the benchmark, despite larger-cap stocks continuing to lead market performance, a strong headwind to the trust's multi-cap approach in the previous year. Although market uncertainties prevail, the managers continue to identify opportunities in market leading, well managed businesses with growth potential.

Recent market focus on large caps has created a multi-cap headwind



Source: Refinitiv, Edison Investment Research

Anticipating a re-rating of domestic SME companies

Across most sectors and company sizes, UK equities trade at a significant valuation discount to history and compared with global markets. The investment managers note that, in many cases, valuations already discount a severe recession. Amid continuing economic uncertainty, this alone should mitigate further weakness and may well attract further takeover activity, which had a positive impact on LWI's FY23 performance.

LWI's flexible, bottom-up, multi-cap approach differentiates it from most peers and its portfolio comprises a highly diversified blend of exposures to companies ranging from constituents of the top 100 companies right down to smaller companies, including those listed on AIM. Although underweight its broad market benchmark, LWI's large-cap exposure is c 50%, typically providing more immediate income and, in an uncertain market, opportunities for growth in more liquid stocks from within more defensive sectors. However, the managers increasingly see the most attractive opportunities in mid- and small-cap (SME) companies and domestic earners and are selectively and slowly rebalancing the portfolio in this direction. With investor confidence weak, these have significantly trailed the broader market; their valuations are particularly low, and they typically have the potential to grow faster, increasing the capital base of the portfolio and distributable income over time. LWI's broad opportunity pool and risk-return spectrum make LWI an interesting complement to more mainstream trusts. Narrowing of the 13% discount to NAV offers additional potential to enhance shareholder returns.

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Investment trusts
UK Equity Income

10 October 2023

Price		**110p**
Market cap		**£297m**
Total assets		**£382m**

NAV*		126.5p
Discount to NAV		13.0%

*At fair value including income, as at 9 October 2023.

Yield		5.2%
Shares in issue		270.2m
Code/ISIN		LWI/GB00BNXGHS27
Primary exchange		LSE
AIC sector		UK Equity Income
Financial year-end		30 September
52-week high/low	144.5p	100.0p
NAV* high/low	150.1p	114.3p

*Including income

Net gearing*	12%

*As at 30 September 2023.

Fund objective

Lowland Investment Company (LWI) aims to give investors a higher-than-average return with growth in both capital and income over the medium to long term by investing in a broad spread of predominantly UK companies. LWI measures its performance against the total return of the broad UK stock market, although its portfolio is markedly different from that of its benchmark index.

Bull points

- Strong recovery in portfolio revenue.
- One of the higher yielding funds among peers.
- Portfolio trades on a historically low valuation.

Bear points

- The UK remains unloved by investors.
- Multi-cap investment strategy can be volatile.
- Value style can be out of favour.

Analyst

Martyn King +44 (0)798 626 8072
investmenttrusts@edisongroup.com
Edison profile page

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Multi-cap growth and income

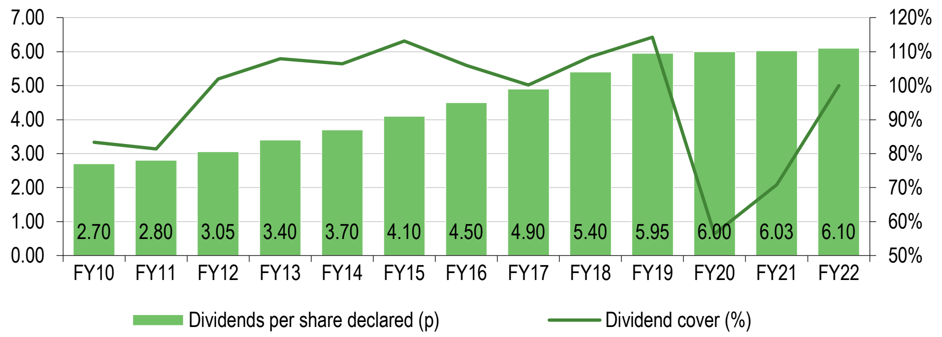
Q323 DPS was increased in line with progressive policy

LWI aims to provide shareholders with a higher-than-average return derived from growth in both dividends and capital over the medium term. To this end, it has successfully maintained a progressive dividend policy since its inception more than 50 years ago, but is differentiated from many income trusts LWI by investing more widely than just the traditional 'income' areas of the market, to include companies that can also grow, increasing the capital base of the portfolio and distributable income over time.

Having maintained distributions during the pandemic and its aftermath, using the flexibility provided by the trust's revenue reserves to smooth out the impact of market-wide dividend cuts, full cover was again achieved during FY22. The 4.9% increase in the Q3 distribution[1] (to 1.60p from 1.525p) follows modest dividend growth in the market, with LWI additionally benefiting from the special dividends received from its holdings in Irish insurance company FBD Holdings and foundry business Castings.

Over the 25 years to end-FY22, DPS has grown by an average 6.8% pa. Ten-year growth, shown in Exhibit 1, is 7.2% pa and, despite the pandemic, DPS has increased by an average 4.5% pa over the past five years.

Exhibit 1: Revenue smoothing supports stable, progressive dividends



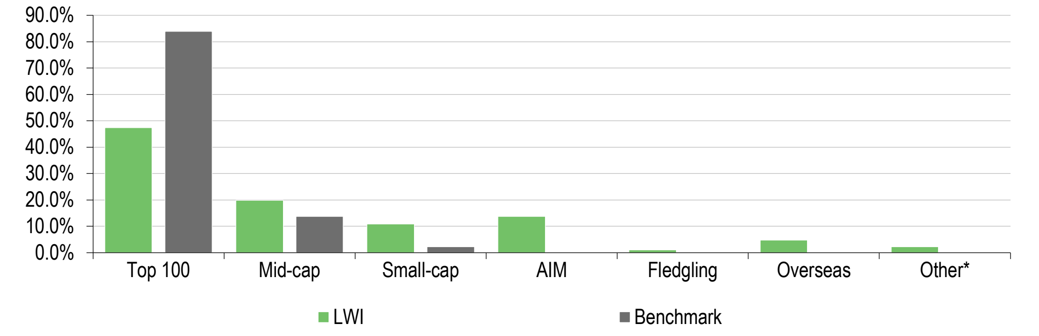
Source: LWI data, Edison Investment Research

FY23 outperformance despite being underweight large cap

LWI's investment approach generates material diverges in portfolio positioning versus its chosen broad market benchmark. The data shown in Exhibit 2 are as at 31 March 2023, as disclosed in the interim report, but we do not believe the position has changed materially since. Although the managers have been selectively and carefully recycling capital into mid- and smaller-cap stocks, this in part reflects the continued appreciation of large caps. The trust's largest exposure is to the top 100 UK listed companies, which at c 50% is around the top of the range that the managers would normally expect and above its medium-term level of c 30–35%. The weighting is nonetheless well below the c 84% weighting of its broad UK market benchmark. Conversely, broadly half the portfolio is invested in mid- and small-cap stocks, well ahead of the benchmark weight.

[1] The Q3 dividend will be paid on 31 October 2023.

Exhibit 2: LWI versus market by segments



Source: LWI. Note: At 31 March 2023 (last full data published). *Other includes unlisted.

FY23 outperformance of the benchmark is despite the trust being strategically underweight in the large-cap segment of the market. The large-cap segment continued to lead market performance during the year but by less of a margin compared with the prior year, a challenging period for the trust.

Exhibit 3: Index performance matched to the LWI fiscal year

Total return, October to September	FY23	FY22
Boad market benchmark	13.8%	-4.0%
Top 100	14.7%	0.9%
Mid-cap	9.9%	-23.6%
Small cap	7.5%	-18.7%
AIM	-8.3%	-34.3%

Source: Refinitiv

The trust is managed bottom up and is highly diversified (107 holdings at end-August 2023).[2] With detailed data as yet unavailable, there is no stand-out driver of the outperformance, although the managers have previously highlighted the positive contribution of holdings in Rolls-Royce and Marks & Spencer, both of which have benefited from a range of self-help measures implemented to revitalise performance, and selected industrials such as Hill & Smith, an industrial conglomerate that is performing well and has significant exposure to US infrastructure investment. A key disappointment during the year was Direct Line Insurance where the underwriting performance fell well short of the managers' expectations. Several of the trust's holdings were on the receiving end of takeover approaches, at significant premiums to prevailing market prices and provides. These included the acquisitions of/offers for Devro, K3 Capital, Numis, DWF and Finsbury Food. The managers note that while the takeover activity has boosted performance and provides confirmation that valuations are attractive, in many cases the transaction prices were too low, did little more than make up for recent weakness and fell well short of what they believe to be a true fair value.

The opportunity in mid and smaller caps, particularly domestic earnings

While the UK market as a whole is trading at a historically low level, this is particularly the case for SME stocks. In characteristic contrarian fashion, driven by their long-term, company-focused investment approach, which is underpinned by a strong valuation discipline, the investment managers believe this represents a very strong opportunity for investors, especially so for investment in domestically facing businesses. The timing of an SME share price recovery is difficult to predict, and patience may be needed, but, with valuations so undemanding, investor sentiment

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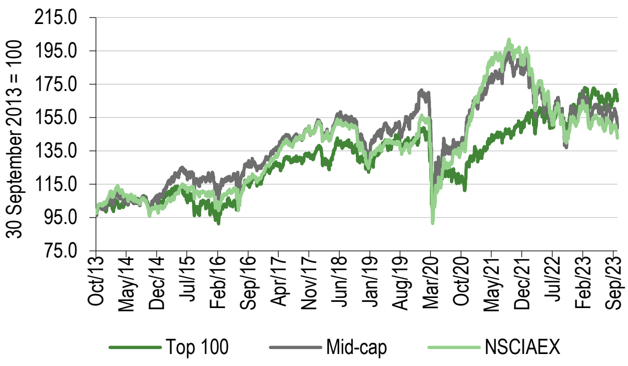
2 Given the trust's diversified stock-driven approach, we have not shown the top 10 holdings and sector weightings in this note, but they can be found at https://www.janushenderson.com/en-gb/investor/product/lowland-investment-company-plc/

weak and trading liquidity at times tight, it may well be better to be a little early than late. The key elements of the managers' positive outlook include:

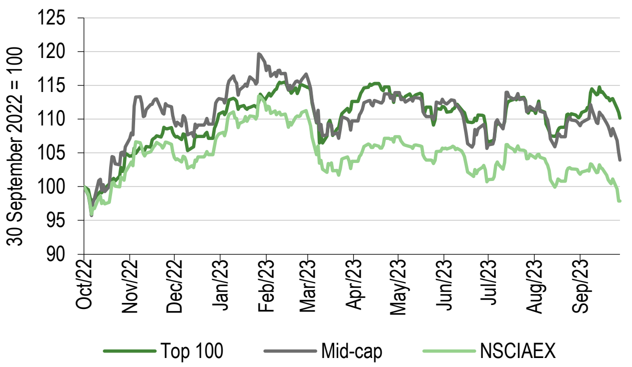
- While it is not unusual for investors to favour larger, more liquid and more defensive stocks in times of uncertainty, the sell-off of mid- and small-cap stocks has been acute. SME stocks have generally outperformed over the long term, and for much of the past 10 years, but following a strong rally from the initial pandemic sell-off, they have significantly underperformed as inflation and interest rates spiked, heightening investor concerns about the domestic UK economy, to which SMEs are more exposed.
- Weakness outside of the largest companies has been broadly based. Nonetheless, the earnings performance of many economically sensitive companies continues to outstrip low expectations, there are many SMEs that are global leaders in their industries with less reliance on the domestic economy, and for others, growth is driven by capturing market share within large end-markets or creating new markets, mitigating any impact from general economic conditions. The managers speak of investing in companies and not the economy.
- In general, analyst expectations for SME stocks, and for economically sensitive, domestic facing businesses in particular, have been significantly pared back, but even though UK economic data have been stronger than feared, the market is yet to respond. Many companies have responded to inflationary pressure by paring back costs to support margins, leaving them in a strong position to benefit from increased activity.

Exhibit 4: Mid- and small-cap stocks have given up outperformance… (10-year data)



Source: Refinitiv. Note: The NSCIAEX is the Numis Smaller Companies Index, including AIM but excluding investment companies.

Exhibit 5: …and this has continued over the past year



Source: Refinitiv. Note: The NSCIAEX is the Numis Smaller Companies Index, including AIM but excluding investment companies.

Large-cap outperformance still weighs on medium-term performance

Given LWI's multi-cap approach, marked divergence in the trust's net asset value (NAV) total return performance compared with the chosen broad market benchmark is inevitable over shorter time periods and this can be clearly seen in Exhibit 6.

Exhibit 6: Performance on a financial year basis (October to September)

	FY23	FY22	FY21	FY20	FY19	FY18	FY17	FY16	FY15	FY14	FY13
NAV total return	17.2%	-14.8%	51.0%	-24.8%	-9.6%	2.7%	17.0%	12.2%	0.8%	5.7%	20.1%
Benchmark total return	13.8%	-4.0%	27.9%	-16.6%	2.7%	5.9%	11.9%	16.8%	-2.3%	6.1%	17.3%
Versus benchmark	3.4%	-10.8%	23.1%	-8.2%	-12.3%	-3.2%	5.1%	-4.6%	3.1%	-0.4%	2.8%

Source: LWI NAV data, Refinitiv

The FY23 outperformance and a very strong FY21 more than offset the weak FY22, such that on a cumulative basis, LWI's performance is strongly ahead of the benchmark over three years.

Nonetheless, over five years, the outperformance of large caps versus SMEs still weighs on the five-year performance and this is likewise reflected in the 10-year data.

Exhibit 7: Cumulative 10-year performance to 30 September 2023

%	1 month	3 months	6 months	1 year	3 years	5 years	10 years
LWI share price total return	1.4	1.0	-6.5	13.9	46.0	-3.0	29.5
LWI NAV total return	2.3	3.1	0.9	17.2	50.9	2.5	47.6
Broad UK index	1.8	1.9	1.4	13.8	39.6	19.5	71.2
NSCIAEX*	-1.6	-1.3	-2.9	3.3	9.9	-1.0	48.5

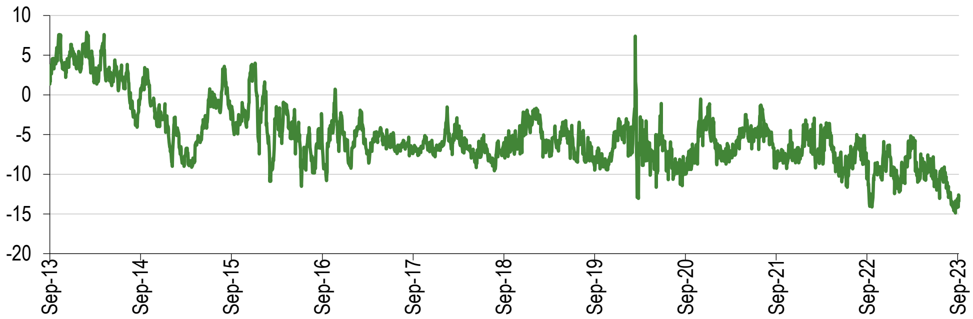
Source: Refinitiv. Note: *Numis Smaller Companies Index including AIM and excluding investment companies.

Performance relative to peers shows a similar pattern to that versus the benchmark. The NAV total return is ahead of peers over one and three years (fifth out of 17 trusts), with weaker five-year performance feeding through to the 10-year data. Despite this, the 20-year relative performance remains strong (third out of 14 trusts).

The discount has widened

With the share price movement lagging the change in NAV, the discount has recently widened to c 13% compared with the 5–10% range in place through much of the past five years. If NAV returns continue to increase, as expected by the managers, we would expect the discount to narrow, enhancing the share price return to investors.

Exhibit 8: The discount to NAV (%) has recently widened



Source: Refinitiv

Peer performance comparison

The AIC's UK Equity Income sector, of which LWI is a member, is one of the largest AIC peer groups and encompasses funds with a wide range of investment approaches within the overall remit of providing income and capital growth from a portfolio at least 80% made up of UK equities. LWI's multi-cap investment policy and significant exposure to mid- and small-cap stocks differentiates it from most peers. Aberdeen Standard Equity Income and The Diverse Income Trust are perhaps the closest comparators.

Exhibit 9: Selected peer group as at 6 October 2023

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	NAV TR 20 year	Ongoing charge	Discount	Net gearing	Dividend yield
Lowland	**297.2**	**10.6**	**42.4**	**1.4**	**43.6**	**369.1**	**0.62**	**(12.7)**	**114**	**5.5**
Aberdeen Standard Equity Income	145.3	(4.5)	22.6	(14.5)	25.9	221.4	0.86	1.0	111	7.5
BMO Capital & Income	296.3	6.7	25.7	11.2	67.8	268.0	0.59	(1.9)	107	4.1
BMO UK High Income Units	100.3	6.3	12.6	6.5	40.6		1.02	(4.8)	115	5.2
City of London	1,952.9	8.4	38.4	22.3	73.6	344.6	0.37	0.1	105	5.2
Diverse Income Trust (The)	248.5	(5.9)	4.4	1.1	66.3		1.09	(7.0)	93	5.2
Dunedin Income Growth	383.7	13.1	20.6	32.5	70.3	243.0	0.62	(11.1)	109	5.0
Edinburgh Investment Trust	1,048.3	18.3	54.0	21.7	86.7	332.6	0.53	(9.2)	109	4.0
Finsbury Growth & Income	1,671.7	4.2	9.2	23.5	129.4	764.9	0.60	(4.9)	101	2.3
Invesco Select UK Equity	103.2	8.4	33.0	22.1	83.9		0.81	(14.0)	108	4.6
JPMorgan Claverhouse	380.2	10.5	35.3	15.7	74.4	311.1	0.70	(6.7)	108	5.3
Law Debenture Corporation	1,013.4	11.5	59.9	43.2	125.0	651.1	0.49	0.3	113	3.9
Merchants Trust	750.2	6.2	66.3	31.9	79.9	308.3	0.56	0.8	113	5.4
Murray Income Trust	884.6	10.4	23.7	30.2	76.7	324.1	0.49	(8.6)	109	4.7
Schroder Income Growth	177.1	9.9	31.2	18.3	73.9	334.8	0.74	(10.8)	114	5.4
Temple Bar	680.8	16.5	72.5	13.0	52.2	365.2	0.53	(5.6)	111	4.0
Troy Income & Growth	161.3	4.5	4.1	6.0	61.6	197.9	0.90	(1.2)	101	3.1
Simple average (17 funds)	**605.6**	**7.9**	**32.7**	**16.8**	**72.5**	**359.7**	**0.68**	**(5.7)**	**108**	**4.7**
LWI rank in peer group	**10**	**5**	**5**	**15**	**15**	**3**	**8**	**16**	**2**	**2**

Source: Morningstar, Edison Investment Research. Note: *Latest performance data as at 6 October 2023 based on ex-par NAV. TR is total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100=ungeared).

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London | New York | Frankfurt
20 Red Lion Street
London, WC1R 4PS
United Kingdom