



Ingredients for success

We identify several less conventional trusts that offer strong sources of diversification to major indices...

Update
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This year has been full of surprises, and not many of them good ones. Inflation figures surpassing expectations and the Russian invasion of Ukraine have been key drivers of tumultuous markets. Prior to 2022 investors were well rewarded for simply following trends, and the volatility this year is perhaps a painful reminder of the necessity for good portfolio diversification. Diversification of asset classes is important, but so is diversification within asset classes. Simply buying growth or buying value is unlikely to work as it has in recent years and, in a volatile environment, finding equity investments which offset each other's risks is potentially rewarding. To that end, we have analysed the correlations of equity investment trusts versus key major indices over the past three years. Below we highlight a number of strategies with perhaps surprising diversification potential.

Global equities

Benchmark: MSCI ACWI
Chosen trust: Baillie Gifford Shin Nippon (BGS)
Three-year correlation: 0.44

Source: Morningstar, as at 14/07/2022

Baillie Gifford Shin Nippon (BGS) invests in smaller companies in Japan, aiming to identify companies with exceptional growth potential. The secular growth themes that BGS's manager, Praveen Kumar, often plays may contribute to the trust displaying a relatively low correlation to global equities (specifically the MSCI ACWI). Praveen takes an ultra-long-term approach to small-cap growth investing, trying to identify disruptive, entrepreneurial companies whose share price can ideally grow multiples over several market cycles. Praveen has already demonstrated his accomplishments in this regard, with BGS having held companies whose share price has grown 20 or 30 times over the last decade. The idiosyncratic nature of these companies' growth prospects is demonstrated by companies like Bengo4, which offers digital document signing. The company thereby offers an alternative to the uniquely Japanese habit of requiring all documents to be signed physically, which was even the case during the pandemic. Given its impressive decade-long compounding of returns, BGS has generated the highest ten-year NAV returns of any Japanese equity trust, with a c. 300% return. While BGS is clearly a useful addition to a broader global equity exposure given its return and diversification potential, we highlight that the trust's historical performance has come at the cost of high volatility, which may not make it suitable for more cautious investors.

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Global value equities

Benchmark: MSCI ACWI Value
Chosen trust: AVI Japan Opportunity (AJOT)
Three-year correlation: 0.45

Source: Morningstar, as at 14/07/2022

Like BGS, **AVI Japan Opportunity (AJOT)** benefits from the inherently low correlation of Japanese small caps to global markets. However, AJOT's strategy is very different, with its manager Joe Bauernfreund aiming to identify cheap, cash-rich companies, ideally with the potential for value to be unlocked via active engagement. Despite this leading the trust to have more of a value tilt, the portfolio has displayed relatively low correlation to the MSCI ACWI Value Index over the past three years. Currency may have an effect, as may the idiosyncratic nature of the returns from engagement strategies, which are uncorrelated to the returns of the style indices. Joe's approach is to take substantial positions in small Japanese companies whose low valuations inherently allow AJOT to own a larger amount of the outstanding shares. Joe will then resolve ongoing



governance issues through the use of active engagement campaigns. These campaigns have in the past led to results ranging from greater shareholder disclosure to buyouts by parent companies. It is important to note that the AJOT team also ensure that all their investments have inherently high-quality business models, meaning that even in the absence of governance reforms their businesses are still able to grow, thus helping the team to avoid 'value traps'. This combination of lower valuations, high-quality businesses and the powerful tailwinds that active engagement can generate has meant that, at the time of writing, AJOT is the only Japanese small-cap trust to generate a positive NAV return over the last three years. It is also one of only two Japanese equity trusts to generate a positive one-year NAV return.

Emerging markets

Benchmark: MSCI Emerging Markets
Chosen trust: Middlefield Canadian Income (MCT)
Three-year correlation: 0.53

Source: Morningstar, as at 14/07/2022

Once upon a time investors may have thought of emerging markets as being dominated by energy, materials and lower-end industrials supplying inputs for developed market economies. Yet that cannot be farther from today's emerging market companies. Thanks to the rapid growth of the emerging market consumer and the desire for emerging markets to be equal players on the economic stage, the MSCI Emerging Markets Index is now dominated by technology and consumer discretionary stocks, as well as financials, with very little exposure to materials and energy. This means that the often overlooked Canadian equity market offers investors substantial diversification potential, as outside of its large weighting to financial stocks, the two regions have little in common. **Middlefield Canadian Income (MCT)**, under the management of Dean Orrico and Rob Lauzon, invests in a portfolio of financials, real estate and energy companies. We believe a large part of MCT's diversification benefit is due to its strong exposure to energy, where many of its holdings are net beneficiaries of rising energy costs. MCT's holdings in financials and real estate are also potential sources of diversification, and its real estate holdings are heavily domestic, reflecting the economic and demographic trends in Canada. Meanwhile, its financials are large, stable institutions which not only provide services for Canadians but also have a strong presence in the US and Europe, with Canada's largest banks often being regional leaders in other markets. Importantly, because of their strong exposure to the US market, Canadian banks can be net beneficiaries of rising US interest rates, something which is notoriously detrimental to emerging markets. Thanks to

its ability to benefit from rising interest rates and energy prices, MCT is also one of the best-performing listed equity trusts over the last 12 months, generating an NAV return of 12%: an impressive figure in the face of today's painful bear market.

US equities

Benchmark: S&P 500
Chosen trust: International Biotechnology (IBT)
Three-year correlation: 0.33

Source: Morningstar, as at 14/07/2022

The healthcare sector is the second-largest component of the S&P 500, currently making up 15% of the index. Yet **International Biotechnology's (IBT)** focus on biotechnology has allowed it to generate one of the lowest correlations to US equities of any listed equity trust. This low correlation is not merely the result of the inherently low correlation of biotechnology, where the fortunes of companies are determined more by the success of their R&D endeavours than they are by economic activity, but is also due to the IBT team's investment philosophy. The team's approach is backed by their years of biotech-investing experience, and they believe that the larger companies which dominate the specialist NASDAQ Biotechnology Index (as well as being present in the S&P 500) are likely to have stalling revenue growth over the next few years. Therefore they believe the best opportunities within the space are in the small- and mid-cap companies, which are still able to achieve growth via innovations as well as benefitting from the waves of M&A. This leads IBT to reflect a subsector of the specialist industry, which inherently leads to lower correlation. Another factor behind IBT's low correlation is the team's approach to diversification, and specifically how they approach the binary outcomes of biotech firms by managing the trust's exposure to stocks ahead of their clinical and regulatory outcomes. This serves to limit IBT's exposure to one of the sector's major risks: failed research projects. The final component of IBT's low correlation is its c. 9% exposure to unquoted investments, which inherently reduces its correlation to listed equities. We note that because IBT has such a low correlation to US equities, by extension it also has a low correlation to global equities, given the US's dominance of global equity indices. We remind investors that, given the growth-focussed nature of biotechnology investing, IBT does come with inherently high volatility.



UK equities

Benchmark: FTSE All-Share

Chosen trust: JPMorgan China Growth & Income (JCGI)

Three-year correlation: 0.01

Source: Morningstar, as at 14/07/2022

China's equity market is dominated by consumer discretionary and communication stocks, which make up nearly half the MSCI China Index and not only service China's rapidly growing consumer but also are becoming increasingly prominent within global consumer and technology industries. This is in stark contrast to the UK, which has a more diverse range of sectors and has its largest weighting in financials and consumer staples. These differences have in part led to **JPMorgan China Growth & Income (JCGI)** having an essentially uncorrelated return profile to UK equities. Yet JCGI's diversification potential is not solely due to the inherent differences in the regions' respective equity markets, nor to their vastly different economic profiles; it is also thanks to the team's focus on 'new China'. Managers Howard Wang, Rebecca Jiang and Shumin Huang primarily focus on areas of the Chinese equity market which are facilitating its transition to a new, consumer-led economy. This focus on China's 'new economy' biases the trust towards the region's growth stocks, be they in sophisticated manufacturing, healthcare or the region's cutting-edge technology firms. These companies exemplify the potential of China's economy, capitalising on both its domestic and overseas growth potential while reflecting the innovation which is simply not found in the UK. Examples include Country Garden Services, which services China's vast property market, and LONGi Green Energy Technology, a solar panel manufacturer and developer which represents China's increasing dominance in renewable energy.

We note that JCGI's diversification from UK equities may be particularly interesting because of its dividend policy, with the trust paying out 4% of its NAV as a quarterly dividend each year (based on its financial year-end valuation). Given the prevalence of UK equities in income portfolios, we believe that JCGI's near-zero correlation and high yield make it an interesting diversifier for an income portfolio. It is important to note, however, that JCGI has the expected characteristics of a high-growth emerging market portfolio: specifically, a high level of volatility which cautious investors may not be able to stomach.

UK bonds

Benchmark: Bloomberg UK Government Float Adjusted Index

Chosen trust: Downing Strategic Micro-Cap (DSM)

Three-year correlation: -0.24

Source: Morningstar, as at 14/07/2022

UK small caps may not be the first port of call when one is looking to diversify away from domestic government bonds. Yet with a -0.24 correlation, **Downing Strategic Micro-Cap (DSM)** has historically been one of the best places bond investors can look to offset the pain of falling bond prices. DSM, run by Judith Mackenzie and Nick Hawthorn, has a highly concentrated portfolio (c. 12–18 stocks) of some of the UK's smallest companies. With a typical market cap of £150m or less, DSM's holdings are so small that they fly under the radar of almost all other investors, meaning the trust offers exposure to companies unlikely to be found in other funds. Due to the companies' size, the team apply private equity levels of due diligence. The nature of the team's approach means that DSM offers investors the quintessential diversification benefit of smaller companies, whose returns are typically far more idiosyncratic than those of larger companies (or bonds), and whose prospects are determined more by the decisions of their managers than by market sentiment.

Yet there is also a stylistic element to DSM's diversification potential, as the team focus on companies which trade on valuations far below their true worth, making the trust by definition a value strategy. The team estimate that DSM's portfolio trades at an aggregate 40% discount to its intrinsic value. This, coupled with the typically high exposure that small caps have to their domestic economies, also explains the negative correlation. The value and small-cap factors are associated with outperformance during periods of rising economic expansion, which often leads to rising interest rates cooling the economy and then a fall in the value of bonds. Thus, DSM's style has an innately negative correlation to domestic bonds.

Conclusion

Higher volatility and greater uncertainty are becoming a fact of life for investors, and with these increased risks comes an increased need for diversification to dampen their impact on investors' capital. We have hopefully demonstrated a range of different trusts which investors may not have immediately thought of when it comes to diversifying key equity exposures. Some, like BGS and JCGI, are based in wildly different regions to the indices to which they offer diversification, and capitalise on the unique sectoral growth trends of their respective



companies. Additionally, trusts like AJOT and DSM may appear to be surprising picks for diversifying from the indices mentioned above, as they seem to have much in common with them. However, the correlation figures show there has nonetheless been useful diversification added.

There are also a number of common factors across many of our chosen trusts. In the case of BGS, JCGI and AJOT, all three benefit from a difference in currency to their chosen index, which inherently reduces their correlation. Many of the trusts in this list also use lower gearing than their average peer, which naturally reduces their beta to equity markets, and by extension improves their ability to diversify a portfolio. However, in the case of DSM, having a geared portfolio would have only increased its negative correlation, thus improving its diversification. Regardless of the reason, we believe that each of the trusts we have highlighted here could be a useful addition to an investor's portfolio, offsetting many of the major exposures they may have today.



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