Value investing benefits enormously from corporate events

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Joe Bauernfreund, manager of the British Empire Trust

The high level of corporate activity is an attractive feature of the current market environment for value investing. An environment in which assets are being sold, or where value is being squeezed from a business via active ownership, is one in which discounts can narrow. Corporate events, such as trade sales, IPOs and restructurings of underlying portfolio companies, allow for the true value of these businesses to become more fully reflected in the market.

British Empire Trust (BTEM) is an actively managed investment trust investing in a global portfolio of equities. BTEM has followed a distinctive value philosophy for over 30 years that focuses on investing in companies trading at discounts to net asset value (NAV). This focus leads us to invest in three main areas: family-controlled holding companies, closed-end funds and asset-backed special situations. All these companies own diversified portfolios of assets and businesses – both listed and unlisted – the net asset value of which exceeds the current share price.

However, merely trading at a discount is not enough (many unattractive businesses achieve this feat!). Rather, we seek to invest in quality companies trading at discounts, whose asset value is likely to appreciate in the coming years.

> **"We seek quality companies trading at a discount"**

Pushing for corporate action to help unlock value

We try and identify catalysts, or events, that can help reduce the level of discount and unlock value, such as IPOs of unlisted assets, or changes to ownership structures, as well as potential for us to engage with Boards in a constructive manner to help narrow discounts. Since I became sole manager in 2015, the Trust has placed an increased emphasis on activism, engaging with management to bring about value-enhancing change where necessary.

As an investor in a family-controlled holding company, such as the Wallenberg-controlled Investor AB in Sweden, we are aligned with prudent long term capital allocators, who actively manage a portfolio of high quality businesses and who have delivered strong returns for all shareholders over a long period. Many family-controlled holding companies around the world have long-term track records of NAV growth that far exceed global markets.

Similarly with closed-end funds, we look to invest in portfolios of companies trading at discounts to NAV and often seek to be a large shareholder in the fund so that we can lead discussion with the Board. Whereas with family-controlled holding companies the families themselves are the active owners, when it comes to closed-end funds, we typically take a larger constructive activist position. In recent years, the listed private equity space has been particularly fruitful for us, using our experience to help unlock value for all shareholders. In the case of Aberdeen Private Equity, we engaged with the board after establishing a 25% stake - the outcome was a sale of the portfolio above NAV and the return of the proceeds to shareholders, thus eliminating the persistent discount at which the shares had traded for years.

Japan – the home of cheap quality companies

Over the last year, our focus on undervalued asset-backed quality companies, has led us to the purest asset: cash, and the home of cheap quality companies: Japan – which now accounts for nearly 20% of the portfolio.

Japan remains the one global stock market with quality businesses trading at cheap valuations. Corporate governance reform – a central tenet of President Abe's economic reforms – is also starting to deliver tangible changes in corporate behaviour. This latter point is important, given the incredible amount of value that is hidden away on Japan Inc.'s bountiful balance sheets. To capitalise on both of these factors, the Trust has built a basket of 20 heavily over-capitalised small cap Japanese stocks, averaging 57% of their market cap in cash. The trend toward improved balance sheet efficiency, and shareholder-friendly policies, gives this basket considerable upside.

Cynics argue that that this value is entrapped by a complex web of cross shareholdings and

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inert boards. However, things are, albeit slowly, really starting to change. 2017 saw record high buybacks, an increased presence of independent directors, and examples, such as with Toshiba Plant, of shareholders' rights being legally upheld, and management to account.

Therefore, in light of these ongoing changes, in addition to the basket, we are also taking a more proactive approach in communicating directly with management of Japanese companies ourselves. We believe that constructive engagement has the potential to yield positive results for all shareholders.

30+% discounts in holding companies and closed end funds

One family-controlled holding company that we find particularly attractive is Pargesa, the Swiss-listed holding company whose sole asset is another holding company, Groupe Bruxelles Lambert (GBL). GBL, in turn, own a portfolio of stakes in high quality European equities, such as Pernod-Ricard, Adidas and Burberry.

Historically we have invested in GBL, who have a strong record of NAV growth, especially in recent years, as their strategy has evolved to make larger investments and play a more active role as shareholder. However, in 2015, we sold our position and reinvested the proceeds in Pargesa, whose discount, both absolute and relative, reached rarely seen levels.

With identical look-through exposure, Pargesa and GBL had historically traded in lock-step; with then long term average discounts of 25% and 26% respectively, and an average discount spread of just 1%. However, making a mockery of the idea that financial markets are efficient, a discount spread of over 10% has opened up and persisted, with Pargesa now trading at an anomalously wide 31% discount.

"we believe Pargesa discount will come on I think that's all on this spread"

Whilst we are surprised how long the market is taking to wake up to this, we believe the discount spread will close back in, and Pargesa's discount will revert to more typical levels. In the meantime however, Pargesa provides the cheapest possible exposure to high quality European companies, in dominant market positions, and with significant emerging market exposure. The combination of returns from discount contraction, the continued growth of the underlying holdings, and GBL's active management, make Pargesa a highly attractive investment.

In our third area of focus, closed end funds, one investment we are currently excited about is Tetragon Financial, the owners of a diverse portfolio of financial assets, as well as partial

Finsbury Growth & Income Trust

Finsbury Growth & Income Trust (FGT) is managed by Nick Train, who runs a concentrated portfolio of primarily UK equities, aiming to generate long-term capital and income growth. A key feature is the trust's low portfolio turnover – initiating a new holding or a complete disposal of a position happens very infrequently. FGT is invested in just four out of 10 sectors of its benchmark FTSE All-Share index. Shareholders have benefited from the manager's focused, long-term investment approach, with the trust having significantly outperformed its benchmark over the last one, three, five and 10 years. Train remains optimistic on the outlook for FGT's portfolio companies and has been taking advantage of individual share price pullbacks, adding to some of his largest positions, such as Burberry.

Price		784.0p
Market cap		£1,309m
AUM		£1,340m
NAV*		779.8p
Premium to NAV		0.5%
NAV**		780.8p
Premium to NAV		0.4%

*Excluding income. **Including income.

Yield		1.9%
Ordinary shares in issue		167.0m
Code		FGT
Primary exchange		LSE
AIC sector		UK Equity Income
Benchmark		FTSE All-Share
Share price/discount performance		
52-week high/low	784.0p	710.5p
NAV** high/low	780.8p	706.4p
Gearing		
Gross*		2.0%
Net*		2.0%

As at 8 May 2018

Investment strategy: Very stock-specific approach

Train employs a bottom-up approach to stock selection, seeking companies that can grow over the long term, with low capital intensity, that generate high returns and cash flow. He rarely initiates new positions, but does so when he is able to identify attractive companies that are trading below their estimated intrinsic worth. Essentially, the manager aims to buy quality companies that he can "hold forever". FGT's portfolio is made up of companies producing branded consumer goods; own media/software intellectual property; or provide retail financial services. At end-March 2018, there was a modest 2.0% level of gearing.

Market outlook: More focus on stock selection

Both UK and overseas equities have rallied strongly over the last two years, supported by improving corporate earnings, but also due to higher equity valuations. On a forward P/E multiple basis, UK shares are now trading at more than a 10% premium to their 10-year average. Against this backdrop and with higher levels of stock market volatility compared to the subdued levels in 2017, investors may be rewarded by considering a fund with a concentrated, high-conviction approach that has a strong performance track record.

Valuation: Trading close to NAV

FGT's current 0.4% share price premium to cum-income NAV is broadly in line with the average premiums of the last one, three and five years (range of 0.5% to 0.6%). The board actively manages the premium, regularly issuing shares to satisfy unfulfilled buy orders in the market. FGT has a progressive dividend policy, aiming to grow annual dividends at a rate higher than UK inflation. Based on its current share price, the trust has a dividend yield of 1.9%.

12 months ending	Share price	NAV	FTSE All-Share	FTSE 350	MSCI World
30/04/14	12.6	12.7	10.5	10.3	8.1
30/04/15	19.6	18.7	7.5	7.5	18.7
30/04/16	2.2	2.4	(5.7)	(5.9)	1.1
30/04/17	22.1	21.9	20.1	20.0	30.6
30/04/18	11.1	12.6	8.2	8.1	6.9

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

Mel Jenner, analyst at Edison Research. www.edisongroup.com

and whole stakes in asset management companies. Tetragon currently trades at a discount of 36%, in part reflecting their historically less-than-saintly corporate governance record.

However, akin to how we think about family-controlled holding companies, the board and management now own a 26% stake (vs. 1.2% in 2011), creating an alignment of interest with shareholders. In tandem with increased insider ownership, marketing efforts have improved and pro-shareholder policies, such as tender offers and dividend increases, have been enacted. As investor perception catches up with these changes, we are likely to see discount contraction.

Like with many of our investments, the listing of currently privately-held assets is another key potential catalyst for reducing the discount. In Tetragon's case, this means a potential listing of their asset management business which is implicitly being assigned no value by the market. Whilst there is no concrete timeline for such a move, Tetragon provides idiosyncratic exposure, largely uncorrelated with equity markets, as well as an attractive 5.5% yield, whilst you wait.

Overall, whilst varied in nature, the Trust's investments in family-controlled holding companies, closed-end funds and asset-backed special situations are united by their focus on high quality companies that trade at discounts to their net asset value, run by manager-owners with skin in the game, or where we ourselves can be a driver of change.