



Keystone

Now paying a quarterly dividend, KIT is a long-established trust with a valuation-focussed, bottom-up approach and a keen focus on governance...

Update
06 May 2020

Summary

Keystone (KIT) aims to generate long-term total returns through investment in primarily UK equities. Managed since April 2017 by James Goldstone, KIT typically invests on an all-cap basis. The manager seeks to identify companies where investor sentiment is unjustly negative and there exists a catalyst to a valuation re-rating.

KIT typically offers a greater yield than much of its peer group. Dividend generation is considered important by the manager because he views this as evidence of alignment of management and shareholder interests, as well as capital discipline. Presently KIT yields c. 4.7% on a historic dividend basis. **The board moved in 2019 to introduce a quarterly dividend.** The current environment may present challenges to maintaining this level of dividend, but revenue reserves remain in place to potentially help mitigate any shortfall in portfolio revenue.

Currently trading on a **discount** of c. 12.7% (as of 20/04/2020), KIT is trading at a wider discount to both its own historic average and the wider sector. The board has been supportive, with significant buybacks earlier in 2020 and capacity for further buybacks.

Presently the **portfolio** remains overweight UK domestic earners, but the manager has consciously adopted a 'barbell' approach to relative risk positioning with regards to potential environments, with different positions that should benefit in either inflationary or deflationary environments including a significant allocation to gold mining companies. He believes he has identified stocks which are attractive on their own merits, but particularly so in a divergent range of economic results. On balance, however, the portfolio remains tilted slightly towards an inflationary environment, with the manager believing extraordinary policy stimulus measures will ultimately have this result.

Analyst's View

To our misfortune, we live in interesting times. In this context, the barbell risk approach currently employed within KIT offers some reassurance in an environment where the ultimate macroeconomic outcomes from an unprecedented economic lockdown (and the unprecedented scale of stimulus from governments and central banks) remain uncertain. We believe the overweight positioning in gold miners could offer significant relative upside, with this sector extremely cheap on most valuation metrics. On the other hand, if increased awareness of supply-chain fragility results in onshoring, the UK could well see repatriated capital flows and the outperformance of domestic assets.

Should the current macro environment metastasise into a broader credit crisis, KIT's SMID market-cap overweight will likely weigh on relative returns, as it did in the sell-off earlier in 2020. We note that recent portfolio activity should mitigate this somewhat, with additions to utilities likely to provide ballast. The board has proven supportive, and we think acted sensibly, in expanding the level of gearing permissible in the event of an NAV drawdown, while any further buybacks could offer the potential that the discount narrow further. In the near term, even if revenues are impaired, there could be some support from revenue reserves to ensure dividends do not suffer too great an impairment.

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BULL

A discounted portfolio of out-of-favour stocks

Board has mooted buybacks to narrow the relatively wide discount

Macro risks to relative performance reasonably balanced

BEAR

Whilst the board is acting (via buybacks), discount has been persistently wide

Gearing can exacerbate the downside (as well as amplify the upside)

Short-term political and economic noise could remain a headwind to UK domestic assets in particular



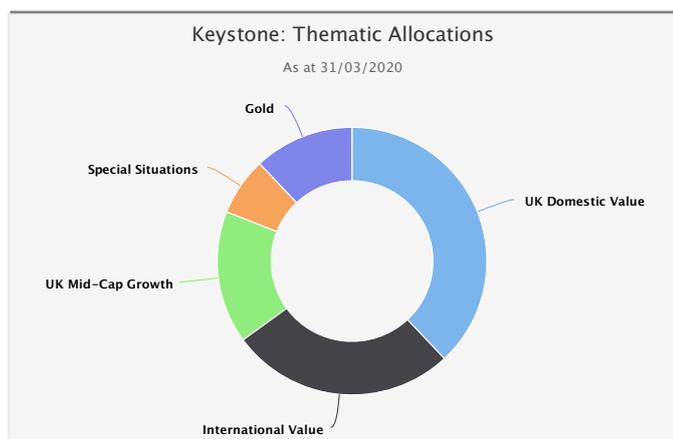
Portfolio

Keystone (KIT) is managed by James Goldstone, who aims to generate long-term total returns through an all-cap portfolio of predominantly UK equities, though he is able to invest up to 20% of the portfolio overseas. James primarily aims to identify companies which are undervalued due to investor sentiment or past troubles, and hold them while their valuations revert to fairer levels. The manager is prepared to actively manage core weightings depending on near-term market activity.

Portfolio construction combines both bottom-up stock selection with a more top-down macro input. However, the primary focus is on company specifics, seeking to understand the fundamental operational position of a company. The valuation of a stock is considered with this understanding of the company’s position relative to industry peers and on its own absolute terms. James also looks to try and identify potential catalysts (and their likelihood) which could drive a valuation re-rating, with ongoing monitoring of the potential upside to fair valuation levels each stock offers. These factors are evaluated in the context of James’s broader macroeconomic outlook.

With a top-down macro framework informing position sizing and stock-specific considerations, a thematic framework results within the portfolio. Presently, there are five key themes: UK Domestic Value, International Value, UK Mid Cap Growth, Special Situations and Gold. Whilst the current market volatility means there is likely to be ongoing fluidity to the thematic exposure, varying as opportunities arise from market short-termism, the current positioning is broadly similar to that seen at the end of March.

Fig.1: Thematic Breakdown



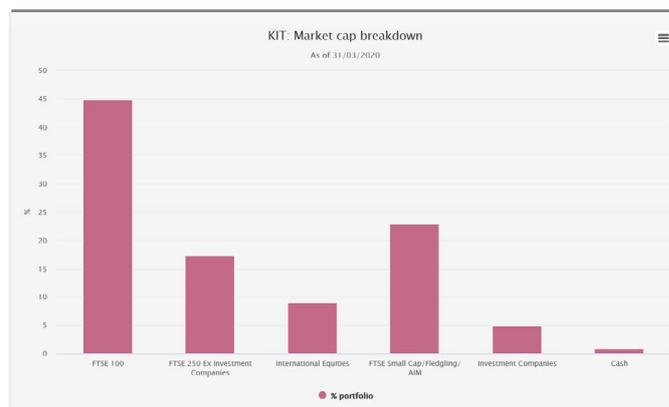
Source: Invesco

Relative to most peers, KIT has displayed a tendency to tilt towards companies with discounted valuations and the potential for a re-rating. KIT has typically offered a higher yield than most peers. The concern for dividend

income is reflective of the manager’s desire to hold shares in companies where governance is undertaken in the interests of shareholders, as well as the importance placed upon capital discipline and cash generation.

James has an all-cap approach, and he tends to overweight small and mid-cap stocks relative to the benchmark FTSE All-Share Index. As the graph below shows, KIT is currently overweight small and mid caps relative to the index. It is worth noting that he has a flexible mandate, and allocations will depend entirely on the range of opportunities identified.

Fig.2: Market Cap Breakdown



Source: Invesco

Ultimately James views free cash flow as the key determinant of a company’s outlook, and valuation assessments will consider the free-cash-flow yield looking forward two to three years, amongst other metrics as appropriate to the industry. This forward-looking framework aims to give a reasonable holding period for the stock to re-rate towards fair value.

With the emphasis on free-cash-flow generation, good capital allocation is a key qualitative assessment in the investment process. James prefers companies where management have demonstrated good returns on capital and retained balance-sheet strength; with quality of management a key consideration here, he will accordingly always look to meet with company management prior to investment (and twice p.a. thereafter).

Ongoing company meetings help James to qualitatively assess ongoing operational risks to the companies he holds. Prior to every investment, and on an ongoing basis, James is looking to understand what the downside risks are to any business held. This often feeds back into considerations of likely returns on invested capital; businesses in sectors or industries with high barriers to entry should offer downside protection from an operational standpoint, whilst likely being more easily able to ensure invested capital generates an adequate return.



Stock risks continue to be managed through an internal 6% no-buy limit for any individual stock. The board has recently approved an increase in the limit to permissible overseas exposure from 15% to 20% of gross assets. This was essentially to allow James to ‘run’ his gold-mining positions going forward, after strong outperformance from these holdings saw them take on an increased portfolio weighting. Portfolio management will see positions sized on conviction, but with tactical adjustments around a core position size to reflect short-term valuation fluctuations and increased or decreased mean-reversion potential.

Top Ten Holdings

HOLDING	POSITION WEIGHTING
Barrick Gold Corp	5.3
BP	4.9
British American Tobacco	4.7
Tesco	4.5
SSE	4.1
Barclays	4.0
Newmont	3.6
Next	3.5
Babcock International Group	3.1
JD Sports Fashion	2.6
TOTAL	40.3

Source: Invesco, as at 31/03/2020

External broker research is used for idea generation and for qualitative reassessments of current or prospective positions. Where possible, James will look to read both bullish and bearish forecasts for stocks held within the portfolio to more fully appreciate both downside risks and upside potential, as well as providing insight into broader market assumptions about stocks. Updates to company projections are maintained in a stock model for ongoing monitoring of positions.

Often a bearish broker outlook will give rise to an attractive opportunity to access a mispriced stock. Such is the case for KIT’s holding in Next plc. The consensus outlook remains negative, with the company trading at a valuation which, in his view, suggests the primary concern of the market is its status as a member of the beleaguered high-street retail sector. This has become especially acute in the ongoing COVID-19-related lockdown. However, James believes this understates Next’s strong position within the sector; the company was probably the best-placed high-street retailer to deal with the rise of internet shopping, having built up a strong legacy catalogue business.

James believes that even before the rise of online retailing, Next was increasingly in a position to use its domestic stores as a hub for collections and deliveries of orders from its catalogue business. Management have been able

to carry much of this legacy across to a growing online business, but remain very focussed on costs and will not pay, for example, for Google clicks to drive traffic to the website. This latter point means that the increasingly strong internet traffic seen is very much organic to the business, which retains a robust balance sheet to help carry it through the ongoing environment.

The holding in Next is itself reflective of a general overweight to UK domestic earners relative to the benchmark, informed by the manager’s top-down macroeconomic overview. James believes that the market has undervalued UK domestic earners for a considerable period, with political uncertainties deterring many investors from paying attention to the actual performance of many UK domestic companies. Clearly the ongoing COVID-19-related economic lockdown has negative implications for domestic-earnings companies, but he thinks valuations in sectors such as utilities continue to be unreflective of the robustness of many businesses.

Although the majority of the portfolio will focus on companies with significant upside to reach perceived fair valuation, James also holds exposure to more ‘growth’-oriented names displaying rapid expansion and significant scalable potential. This includes companies such as PureTech, a biotechnology company which looks to discover and develop new medicines for a variety of serious diseases. James believes that the structural-growth opportunities should remain strong in this area, and the associated intellectual property is not easily replicable and represents a significant barrier to entry.

More recently, James had been building his exposure to utilities as political risks receded following the December 2019 General Election, and he has continued to increase exposure during the current market turbulence. The new (undisclosed) positions have been added at discounted valuations, offering what he thinks should remain robust cash flows. Dividends face some political risk, but he believes this is likely to be one of the less affected sectors.

Similarly, the position in gold mining companies has been increased. With major economies across the world all sharing a desire to devalue, gold bullion remains the one currency unable to do so. This has been reflected in the strength in the gold price in the current environment. James believes companies such as Barrick Gold are in any event primarily driven by their internally generated free cash flow, with all new projects assessed against a 15% return-on-capital hurdle with the assumption of a spot gold price of \$1,200 an ounce. James believes these already robust cash flows should receive a boost from a higher spot price and lower energy costs (following the collapse in the oil price); he has priced Barrick using an extremely negative free-cash-flow outlook, and still finds the valuation to be compelling.



Whilst both gold miners and utilities have remained operationally robust in the current environment, on a forward-looking risk basis they might be reasonably expected to benefit from different macro drivers. On balance, we think there is a slight skew at present towards KIT benefitting on a relative basis from a more inflationary environment. However, the presence of both utilities and gold miners is a deliberate acknowledgement of the fact that they will likely benefit in the short term from different macro environments, with James adopting a barbell approach to macro risks in an incredibly uncertain environment.

Gearing

KIT currently has net gearing of c. 12% in place. The gearing policy has recently been amended, giving more flexibility. Going forward, the manager will be unable to make net purchases at times when the net gearing level is greater than 15% of net assets. If movements in the NAV cause this ratio to exceed 20%, the manager will now be obliged to reduce the gearing ratio; previously, sales had to be made if the gearing ratio exceeded 15% of net assets. With this change of policy having been announced on 27/03/2020, it seems to have been undertaken in recognition that extraordinary market conditions and volatility could otherwise compel the manager to liquidate positions at a disadvantageous time and to the ultimate detriment of shareholders.

Previously, there were two outstanding long-term debentures worth c. £32m. The board recently redeemed the outstanding 2020 debenture stock and 2023 bonds, and this should provide a significant reduction in interest costs, which had previously amounted to c. £2.2m p.a. for these instruments.

Gearing has been applied tactically in recent months, with James having taken net gearing down from c. 8% to c. 0% ahead of the December 2019 General Election. Subsequently gearing was reintroduced as political risk dissipated, being used to introduce exposure to utilities and housebuilders, amongst other transactions.

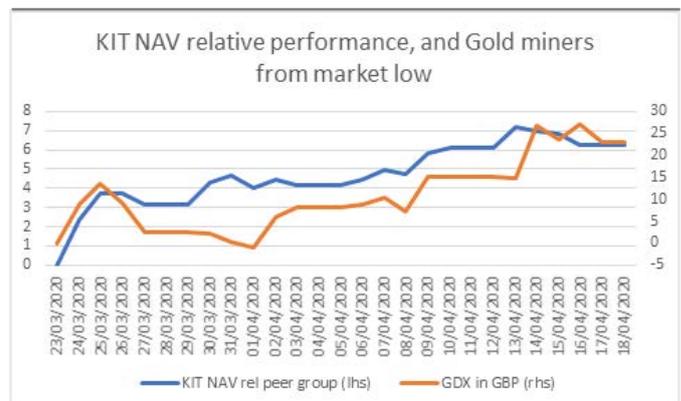
Performance

In line with the rest of the UK market, KIT has struggled year-to-date in the wake of the COVID-19 pandemic and the accompanying economic shutdown. KIT NAV returns YTD in 2020 (as of 20/04/2020) are c. -32.2%, against a sector-average NAV return of c. -30.8%. Returns from the benchmark FTSE All-Share over the same period, as represented by a passive index tracker, have been c. -23.1%, with the FTSE 250 Index down by c. -27.8% and

Small caps down by c. -30%. As we note in the **Gearing section**, some of the trust's underperformance in this environment is attributable to gearing, with KIT's gearing currently c. 13% (as of 27/04/2020).

More encouragingly, KIT has bounced back stronger than both its peers and the wider market, with the NAV rising c. 26.9% between 23/03/2020 (when the FTSE All-Share bottomed) and 20/04/2020. Over this same period, the wider peer group made gains of c. 20.6%, whilst the FTSE All-Share, FTSE 250 and FTSE SmallCap indices gained c. 17.2%, c. 20.9% and c. 20.4% respectively. Again, relative to wider market indices, gearing will have helped, but our analysis suggests that even full use of the gearing facility would not have accounted for the degree of outperformance. Stock specifics appear to have driven much of the outperformance from the lows. The exposure to gold miners will have proven beneficial in the rebound on both an absolute and relative basis. **As we discuss in the Portfolio section**, James retains conviction in these holdings, and these positions could remain important for relative returns going forward.

Fig.3: Nav Relative To Peer Group Vs Gold Miners (From Market Low)

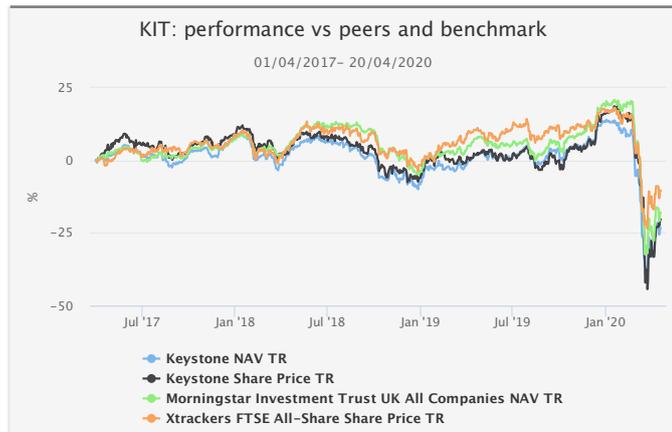


Source: Morningstar

Longer-term returns have been challenging, with KIT generating NAV and share-price returns of c. -23.3% and -20.3% respectively under James's tenure as sole manager (since 01/04/2017). This has been against a difficult market environment, but still represents underperformance of the peer group-average NAV returns of c. -18% and of the benchmark FTSE All-Share, which has seen returns of c. -10.3%. Structural gearing in a period of market decline will not have helped what has been a difficult period. We think since James took over the trust the high exposure to domestic earners (still a core tenet of his positioning) is likely to have hurt performance, with the brief rally seen post-general election falling significantly short of closing the longer-term lag.



Fig.4: Performance Under Manager’s Tenure Vs Peers & Index



Source: Morningstar

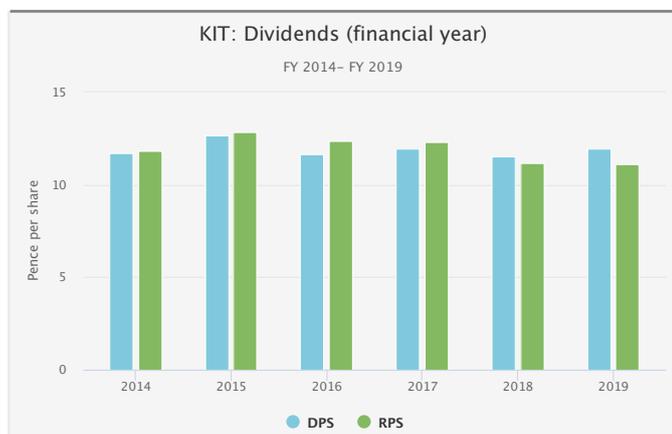
Dividend

KIT currently yields c. 4.7% (as of 19/04/2020). The trust’s objective is to maximise total return, but the board and manager consider dividends to be a crucial component of that return, with underlying dividend generation from the companies held considered a strong indication of good capital discipline and a management strategy aligned with shareholder interests.

In recognition of the importance of income to many investors, the board moved to increase dividend frequency to quarterly from the second half of the 2019 financial year.

At the last reporting period, KIT had revenue reserves of c. £7.9m after accounting for FY 2019 dividends; adjusting for the new share count following the recent subdivision of shares (**as discussed in the Discount section**), this would have equated to revenue-reserve cover of the FY 2019 dividend of c. 0.97x. Subsequently a dividend of 2.4p per share has been paid out; whether this has resulted in a depletion of the revenue reserves has not been announced.

Fig.5: Dividends Per Share



Source: AIC

However, even if this distribution were funded solely from revenue reserves, we calculate KIT should retain c. 0.8x revenue-reserve cover of the FY 2019 dividend.

As noted, following the recent subdivision of shares the share count has increased 5x. We have accordingly amended historic dividends per share and revenues per share in the graph below to reflect how these would have been (had the same share structure been in place).

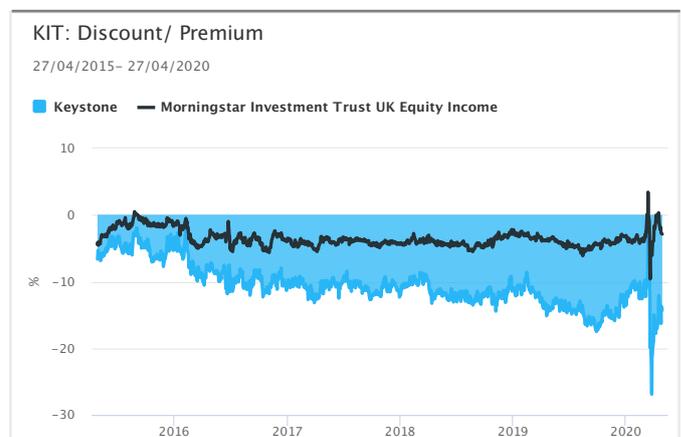
Management

James Goldstone took over KIT in April 2017 from Mark Barnett. James has slowly taken on more of Mark’s responsibilities after the latter became head of UK equities. James joined the group from the sell side in 2012, and became co-manager of the Edinburgh Investment Trust in April 2016. He took over Invesco Perpetual Select Trust’s UK equity-share portfolio in October of that year, and Keystone Investment Trust the following April. He has experience as co-manager of the Invesco Pan European Equity Fund and as head of pan-European sales at Banco Espírito Santo, which gives him relevant knowledge and experience for the non-UK stocks in this trust.

Discount

KIT currently trades on a discount of c. 13.7% (as of 27/04/2020). As can be seen in the chart below, this is a significantly greater level than has typically been the case in recent years. Even after a relatively challenging five-year period (following the start of James’s tenure as sole manager of KIT) where UK domestic stocks and the trust’s investment style have largely been out of favour, the current level is wider than the median discount level of c. 10.8%. This also represents a significantly wider discount than that seen in the wider UK sector.

Fig.6: Discount/Premium



Source: Morningstar



The board has been active in recent months, and in December it announced its intention to buy back up to 8.9% of the issued share capital. Substantial buybacks totalling c. 5.3% of the issued share capital subsequently took place over December, January and February, with the board buying back shares worth a total of c. £12.25m at an average weighted discount of c. 11.9%. Over the more recent term, buybacks have stopped – for understandable reasons, given extreme discount volatility. Once we reach a more normalised environment, we expect to see renewed buy-back activity if the discount remains significantly wider than that of the wider peer group.

The board recently undertook a five-for-one subdivision of the shares, with the intention of improving liquidity and broadening the trust's appeal to retail investors. This became effective on 13/02/2020, and as such it is too soon to make any assessment of its success. However, should both goals prove successful it is reasonable to hope that KIT could see its discount narrow towards the peer group-average level.

Charges

The trust has ongoing charges of 0.54%, making it cheaper than the 0.60% weighted sector average of the UK all-companies sector, according to JPMorgan Cazenove statistics. The management fee is just 0.45%, but the trust also has a performance fee. This is charged at 15% of the outperformance of NAV over the FTSE All-Share on a rolling three-year basis, with a 1.25% per-annum hurdle rate and a total fee cap of 1.5%. The performance fee was not charged in the financial year to September 2019. The Key Information Document Reduction in Yield (KID RIY) figure is 2.05%, compared to a sector average of 1.22%, although we caution that methodologies vary.

Management fees are charged at 75% to capital and 25% to income.

ESG

Invesco is a signatory to the United Nations' Principles for Responsible Investment. Funded by signatories and launched in 2006, these principles seek to encourage a sustainable financial system made up of responsible investors. Signing commits a manager to incorporating ESG issues within its investment decisions (the full list of principles is available at unpri.org).

KIT's investment process tends to inherently lend itself to certain ESG considerations, with James strongly preferring companies with sustainable growth and margin prospects, and superior levels of corporate governance. Invesco also has four dedicated ESG analysts in place, and is recruiting to increase the depth of resource in this area. Dedicated ESG analysts will meet companies' management teams to make qualitative assessments of various ESG considerations, and they regularly interact with KIT's manager James Goldstone about companies within his portfolio.

It should be noted, however, that the ESG-friendly characteristics of the portfolio are an output of the overall investment process, and not a targeted outcome; investment decisions are not based solely on ESG criteria.



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