Quality will out

Alternative income trusts offer diversification, but stick to high quality...

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Experience counts. That's how jaded old dogs try to reassure ourselves. At times, having experience on your side doesn't pay. And there are also times when it does. With all the gyrations in markets over the last few years and the recent rush for AI and 'Trump-bump' stocks, it feels like this could be the moment to look back and draw on the memories of those with experience. History doesn't repeat, but it often rhymes.

In the context of 2024 so far, the head tells us to forget all of those investments that offer specialist exposure in niche but interesting areas of the market, and stick everything in a US tracker. What is the point of trying to fight the heart, which keeps faith in active management, stock picking and asset allocation? The head says generating performance through passives is so simple and so cheap nowadays. And investment trusts have hampered everything anyway, with those pesky discounts widening out. After such a bruising year for active management, there is little Christmas cheer left in many portfolios.

Unfortunately, the coming year is fraught with much greater uncertainty than most. Aside from heightened tensions politically, the economics don't look much better either. In the UK and Europe, growth is stuttering and government finances are stretched. In Asia, a big question remains over China. And the huge rock that will be thrown into the water will be President Trump, whose potential tariffs will spread unpredictable ripples into different parts of the global economy at different times and in different ways. Where to turn?

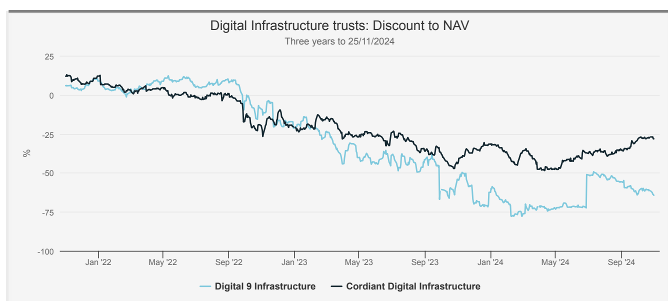
We have no answers, other than to turn back to portfolio construction 1.0: diversification. Experience tells us that the elastic can stretch for what seems like forever. But 2022 is a very recent reminder that when it snaps back, it can do so very quickly. Last time, traditional value stocks were the biggest beneficiaries of the market tide turning. There are an ever-dwindling group of trusts that plough Value's lonely furrow. Those that jump out include **Aberforth Smaller Companies (ASL)**, and its more highly geared sister, **Aberforth Geared Value & Income (AGVI)**. For a larger-cap value exposure **Temple Bar (TMPL)** has performed well since the current managers took over in 2020.

Looking outside of equities, one area of the market that could offer a lot of value and potentially lower beta, is the alternative income trust universe. There continues to be a marked disconnect in most real asset classes between pricing in public and private markets. In public markets, discounts have yawned wider, in our view a direct result of bond yields remaining high. Importantly, with no real expectation that inflation has been conquered, bond yields may stay higher for much longer. Yet, in private markets, investors are still committing increasing amounts of capital towards new funds and single assets, the latter evidenced by realisations from listed funds being made at premiums to carrying values (admittedly with low deal volumes).

With the whole alternative income sector looking bombed-out, a promising diversification strategy could be to look for quality alternative income trusts that have been unfairly derated with their lower quality peer group. Many of these trusts are offering chunky yields, meaning investors will be paid to wait for a turnaround in fortunes. The theory goes that over time, as corporate activity winnows the wheat from the chaff, capital will be returned to shareholders of the also-rans, leaving only the strongest offerings, and discounts should narrow as the cycle turns. In the meantime, accretive buybacks will deliver an added leg to returns.

The risks to this strategy are that these may prove a value trap – exemplified by the two-horse race that is the digital infrastructure subgroup of trusts. Both constituents seemed equal peers three years ago, but as time has gone on, it has become increasingly clear that this was an unfounded assumption, and investors looking to 'bottom fish' Digital 9 (DGI9) on a very wide discount have seen the wide discount narrow sharply for the wrong reason – a significant write-down in the NAV. These two trusts have had very different trajectories, as we show in the graph below. For much of 2023 DGI9's discount has been wider than its peer, indicating that 'the market' had an inkling that these two portfolios had different properties, and perhaps that **Cordiant Digital Infrastructure (CORD)** was of a higher quality. CORD recently announced a confident-sounding interim results statement, accompanied by NAV growth and the discount on a narrowing trajectory. CORD has a highly concentrated portfolio, but this time, it turns out the market was correct to assign it a narrower discount. As we all know, the market is not always right .

Fig.1: Digital Infrastructure

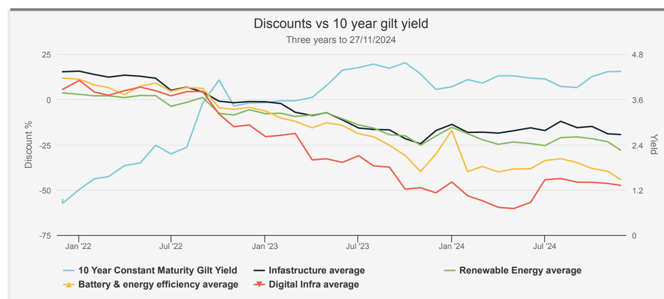


Source: Morningstar

Past performance is not a reliable indicator of future results.

A compelling reason for wide discounts across the alternative income sector is that government bond yields have risen dramatically, and now represent a compelling alternative to the alternative income sector on a risk-adjusted basis. The graph below shows that once gilt yields hit 4%, discounts started to widen dramatically. Since then, when gilt yields have fallen, this has seen tightening of discounts, and vice versa. Fundamentally, the rise in yields has led to a big mismatch of supply and demand for shares, likely exacerbated by the specialist nature of underlying portfolios in alternative income sectors, which for most investors are hard to properly analyse. This has perhaps created something of a crisis of confidence in what 'real NAVs' might be, exacerbated in our view by the significant variation in quality within peer groups. As with the digital infrastructure peer group, in the good times, peers can look very much the same. Now the tide has gone out in terms of investor confidence, they are clearly worried that some trusts are not wearing their swimmers.

Fig.2: Ten Year Gilt Yield Vs. Alternative Income Discounts



Source: Federal Reserve Bank of St. Louis, Morningstar, Kepler Partners

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In fact, for those who can remember past cycles of premiums and discounts, this is history repeating itself. Those in the market before the GFC may remember the burst of enthusiasm in the early 2000s for listed hedge funds. Premiums gave way to wide discounts, and the sector gradually wound itself up. With Boussard & Gavaudan having recently returned capital to investors, **BH Macro (BHMG)** remains the last listed hedge fund in existence. In our view, BHMG's high quality cannot be denied, evidenced by the consistency of returns over more than a decade and a half. As such, in our view it is very much proof that Darwinian forces exist in listed fund world, and the fittest has survived. We note that a hefty premium at the start of 2023 has given way to a discount that persists and remains relatively wide at c. 11%. With economic uncertainty higher than it has been for a while, BHMG's NAV has staged an impressive burst of performance recently (+ 7% during November), which may provide a catalyst for the discount to start to narrow.

In the alternative income sector, we believe quality offerings have been dragged down by lower quality 'me-too's. In our view, the experience of the digital infrastructure peer group means that it will pay to stay as close to the piste as possible, and avoid the risk that a crevasse may open up underneath those who have taken more of a risk.

Looking at the infrastructure sector, we observe that **BBGI Global Infrastructure (BBGI)** has maintained its premium rating relative to the peer group (see graph below), justified by the simplicity of its offering, which focusses entirely on the lowest risk availability-based infrastructure assets, which are broadly diversified. BBGI pays a progressive annual dividend, which currently yields 6.7% on a historic basis and trades on a discount of 16%. On the other hand, one trust that appears to have been derated relative to peers is **HICL Infrastructure (HICL)**, which has had a number of historic issues with Affinity Water (its largest asset), as well as some of its demand-based investments. As a result, dividend cover has eroded, and

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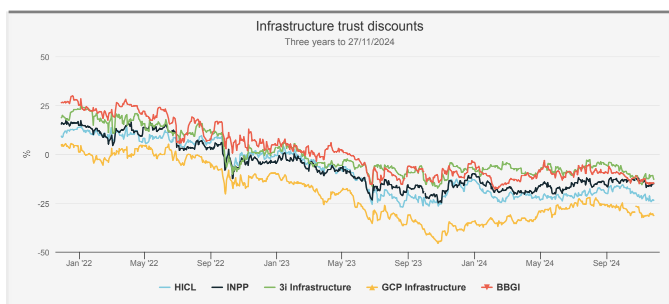
the dividend has not been raised for the past few years. Despite the discount being wider than the peer group average, the recent interim results gave cause for optimism that dividend cover is now on an improving trend, with the team optimistic on the ability of Affinity Water to resume dividend payments. Elsewhere, the growth assets that HICL has invested in over latter years are generally delivering in line with or ahead of expectations, such that dividend cover is expected to recover to 1.1× by FY 2026. HICL has a high-quality portfolio, managed by a specialist team with long expertise in the sector, and having repaid its short-term borrowing facility, surplus cash flows can be used to buy shares back on a highly accretive basis at current levels. On a significant discount to peers and yielding a historic 6.9%, one might argue that it offers good share total return prospects for a recovery.

GCP Infrastructure Investments (GCP) sits at a much wider discount than the peer group and as a result has a very high yield. At first glance this is counterintuitive as GCP is more focussed on debt investing rather than the equity tranches of infrastructure projects that its peers concentrate on, and because debt sits higher up the capital structure, it might be considered less risky. However, GCP is a lender to smaller more specialist projects which are clearly very different in terms of quality, having many more and smaller corporate counterparties. In our view, this highlights the quality differential between portfolios. The market has ascribed it a wider discount to NAV as rates have risen and investors looking to take advantage of this much wider discount need to be prepared to accept what is an arguably higher risk proposition.

Fig.3: Infrastructure



Source: Morningstar

Past performance is not a reliable indicator of future results.

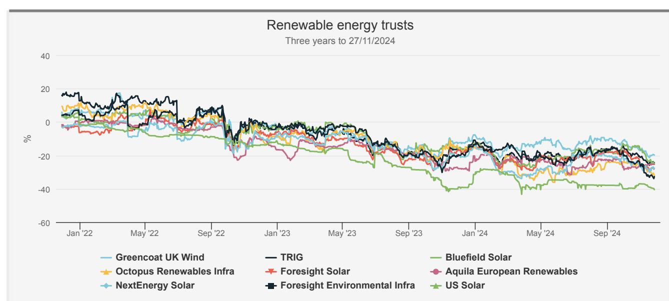
The renewable energy sector has a quite a few different strategies or subgroups within it, making high-level comparisons on discounts difficult. The first trusts that came to market have managed to gain scale, which in our view has enabled them to pick up better quality assets, and achieve critical mass. As a result, we would argue that **Greencoat UK Wind (UKW)** and **The Renewables Infrastructure Group (TRIG)**, which are both trading on wide discounts in absolute terms, justify their narrower discounts than the peer group average. These are long-term assets, and clearly a lot can change over a decade. Aside from rates rising, another reason discounts have widened across the sector is around worries on the long-term trajectory for power prices. Very recently, Bloomberg New Energy Finance (BNEF) published a report which projected long term baseload power prices that are significantly lower than those assumed by trusts in the renewable energy infrastructure sector. These are predicated on lower assumed electricity demand, and the UK not hitting net-zero by 2050.

The energy transition is certainly complicated. Over the next decades there will be many interplaying factors in politics, economics and markets which will determine the price of energy. However, if society retains a commitment to lowering carbon emissions, then absent a transformational new technology being invented and adopted at scale, then wind and solar have a key role to play. Capitalism means that if there is a need, then there will be a financial reward for those that meet that need. Whilst the future is unknowable, in our view this should provide an element of reassurance that trusts such as UKW and TRIG are unlikely to prove long-term value traps given the high quality of the underlying assets. Cash flows will continue to come through, uncorrelated to equity markets, and either investors will recognise their long-term attractions, or the trusts will continue to buy shares back at highly accretive levels. In the meantime, both offer attractive dividend yields of 7.9% and 8.1% respectively. Other trusts trade on much wider discounts, and lack critical mass. Aquila European Renewables, for example, has announced an orderly wind-down, and it will be interesting to see how easily assets are realised, and at what valuations. We suspect that read-across from these valuations may not translate directly to the likes of UKW and TRIG, given the differing quality of portfolios.

The graph below shows that, aside from US Solar, most renewable energy trusts have traded in a relatively tight pack. However, one explanation for any outliers could be that UK investors have home bias, and that trusts offering exposure outside the UK are (likely unjustly) perceived as lower quality. **Octopus Renewables Infrastructure (ORIT)**, which has a diversified portfolio exposed to different renewable technologies around Europe, could be suffering in this regard. Behind it is an experienced manager capable of developing and constructing new assets alongside its operational capabilities, and the geographic diversification gives investors more spread over counterparty risk. The UK has proved to be a reliable partner to the renewables industry, with one or two bumps along the way, but counterparty risk is one of those things that doesn't matter until it does, as we learned in the financial crisis, and of course the battery storage trusts we look at further below have suffered from their exclusive exposure to the UK. In our view, ORIT is most likely on a wider-than-average discount precisely because it is not

UK only and many investors seem happier with their home market. But therein perhaps lies the opportunity?

Fig.4: Renewable Energy



Source: Morningstar

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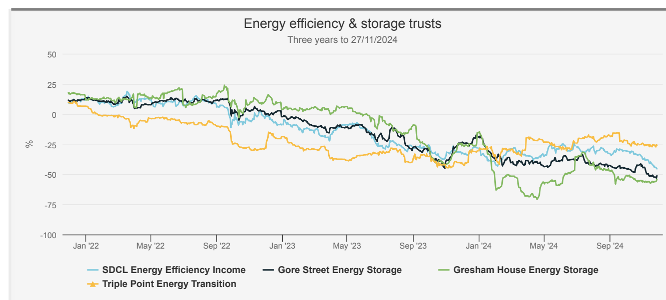
We group battery storage and energy efficiency trusts together because they have different risk and reward characteristics to trusts investing in assets that generate electricity. The two battery storage trusts currently trade on amongst the widest discounts in the entire investment trust sector. Battery assets in the UK have experienced a challenging structural backdrop for revenues thanks to grid issues, which have seen them being 'skipped' when the grid needs power, calling instead for gas-fired electricity. Both trusts have seen a significant fall in revenues, and with equity markets closed and a committed pipeline of investments, they are managing their balance sheets carefully. In our view, wide discounts are a result of the higher financial risks both trusts face, as well as the challenging environment both have faced. In this context, we think it is interesting that TRIG has started to embrace battery storage assets within its portfolio, which now has a 1GW pipeline of potential battery development assets. The TRIG team believe adding battery assets to their portfolio will improve the quality of earnings (battery assets earn the most at the same time as renewable assets are earning the least), but also attractive returns in their own right.

SDCL Energy Efficiency Income (SEIT) on the other hand, which has seen its discount widen dramatically too, owns infrastructure projects focussed on the efficient use of energy. The manager focusses on three aspects: reductions in energy consumption, connections to green energy generation and generation at the point of use to reduce transmission losses. SEIT has suffered from a change in macro-conditions rather than a fundamental change in the business model, with higher bond yields drawing investor attention away from SEIT and its peers. Wide discounts are the consequence, perhaps exacerbated by the experience investors have had with battery storage trusts. However, in contrast to these trusts, for SEIT not much has changed operationally and it has paid a covered and rising dividend for the last five years. SEIT historically traded at a justified premium to its much smaller peer Triple Point Energy Transition (TENT), which in March 2024 started an orderly realisation of assets and wind-up. Since that point, SEIT's discount has widened and it stands at a significant discount to its peer now. Meanwhile, SEIT has an existing portfolio of over £1bn and a pipeline of further opportunities, but the managers are exploring selective asset sales in order to keep its gearing levels well within limits. We think there has been a sea change in how investors perceive the energy transition, with a realisation that renewable energy assets must coexist with other technologies to make the sum of the parts equal net zero. SEIT provides investors with exposure to part of that equation and its discount of 45% and yield of 12.7% potentially offer strong returns, should the investment case play out. While SEIT offers investors diversification benefits when compared to renewables, not least that its revenues are not correlated to power prices, as well as offering exposure to assets in the US and Europe, its counterparties are corporate rather than governmental. As such, it therefore sits slightly higher up the risk curve.

Fig.5: Energy Efficiency & Battery Storage



Source: Morningstar

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Conclusion

Many alternative income trusts trade at wide discounts and high dividend yields, which are derived from assets that have little or no correlation to equity markets. As such, they could offer an important source of diversification to world equity markets, which enter 2025 at elevated valuations, increasingly concentrated in a handful of names, all exposed to the same growth drivers. Our fear is that these may in time prove to be a bubble, and equity markets are also faced with unprecedented changes to political regimes.

The GFC was all about leverage, which meant that of those companies and trusts that survived, the best performing in the rebound were those that were also the most levered (the 'dash for trash' as it became known). This time the cycle feels different, and more slow moving, founded as it is on rising interest rates and higher interest costs. In this vein, aware there is plenty that can potentially go wrong in alternative income asset classes, we advocate **'Billy, don't be a hero'**, and to seek out the high ground in terms of quality.

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