RIT Capital Partner – RCP continues to deliver on its aims of long-term capital growth while preserving shareholders' capital...

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By William Heathcoat Amory

Summary

RIT Capital (RCP) aims to generate long-term capital growth and to protect shareholders' capital. The managers invest the portfolio in a broad range of asset classes – both directly and through third-party managers – which are expected to deliver differentiated returns.

RCP now has net assets north of £3.6bn (having listed in 1988 with £280m) and a senior management team that have been working together for over nine years. The team have a wide network of contacts and relationships, which provide many investment opportunities. They believe that their propriety network of contacts and their permanent capital give them a distinct edge in finding the best opportunities in any asset class on a global basis.

RCP's team have a consistent investment philosophy, aiming to identify differentiated sources of returns that, when combined, will deliver strong returns with lower volatility. Fundamentally, the managers are thematically driven, and use their world view to set risk levels as well as look for profitable investments. They balance natural caution with strong structural themes, as well as retaining the ability to be opportunistic.

2020 proved to be a good example of how this approach can work well, as shown by the strong NAV total returns RCP delivered over 2020 and, so far, this year. That said, it also illustrated the risks of investing in trusts on a large premium. Whilst the NAV per share increased by 14.4%, the share price fell by 2.4% (both excluding dividends), reflecting the premium to NAV of 5.5% at the start of the year giving way to a discount of c. 10% as at 31/12/2020.

Look-through management fees are c. 1.48% before performance fees. The most recent KID Reduction in Yield is 4.1%.

Analyst's View

RCP is a differentiated trust, and it has a strong track record of achieving its twin objectives of growing and protecting wealth. 2020's NAV performance has shown how strong the model is, with the team having started the year with net listed equity exposure in the low 40%'s, mitigating downside in Q1 2020 before delivering strong absolute returns subsequently. Over the past three years, RCP's NAV volatility was around half the volatility of its equity benchmark but delivered cumulative outperformance of c. 1.9%.

We characterize RCP as aiming for a lower beta than the equity market but harnessing alpha to generate strong risk-adjusted returns over the long term. The different drivers to returns for each of RCP's six 'cylinders' is key to how they achieve this. RCP's proprietary network is an advantage, as is the nature of their 'permanent capital', not to mention the c. £4bn of assets. Investing in private companies has always been a key part of the strategy, and the last 12 months has seen a particularly strong contribution from this part of the portfolio.

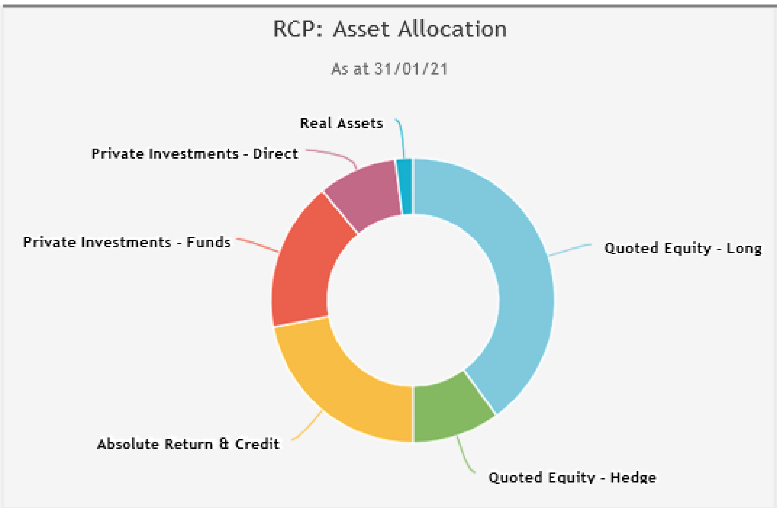
RCP publishes its NAV monthly. Notwithstanding the difficulty of accurately assessing the actual discount or premium on a specific day, RCP's shares have traded on a premium for most of the last five years. Over 2020 however, the shares derated to a discount, which seemingly persists at the time of writing (next NAV due mid-April). For long term investors, this could be an opportunity.

Portfolio

RIT Capital (RCP) has twin objectives: to generate long-term capital growth and to protect shareholders' capital. To this end, the portfolio is invested in a broad range of asset classes – both directly and through third-party managers – which are expected to deliver differentiated returns. This, along with judicious management of risk (including currency exposure), is how the trust aims to grow capital but also to shield investors from the worst of market falls.

RCP now has net assets north of £3.6bn (having listed in 1988 with £280m) and a senior management team that have been working together for over nine years. RIT Capital was set up by Lord Rothschild, whose family owns 21% of the trust, but who was succeeded as Chairman in 2019 by James Leigh-Pemberton. The team have a wide network of contacts and relationships, which provide ideas as well as investment opportunities that are likely beyond the grasp of ordinary investors. The team believe that their propriety network of contacts and their permanent capital give them a distinct edge in finding the best opportunities in any asset class on a global basis. The most recent breakdown of the portfolio can be seen in the chart below.

Fig.1: Asset Allocation



Source: RIT Capital Partners

RCP's team have a consistent investment philosophy that shapes how they invest. They identify six 'cylinders' or differentiated sources of returns that they aim to grow and protect capital through. The team recognize that at any one time, not all cylinders will be firing, but with each cylinder having different drivers, over the cycle the combined portfolio should be able to deliver returns with lower volatility.

Fundamentally, the managers are thematically driven and use their world view to set risk levels as well as look for profitable investments. They balance natural caution with strong structural themes, as well as retaining the ability to be opportunistic. 2020 illustrates the process well, with the team having started the year with net equity exposure at the low 40% mark. The team were opportunistic in investing directly in equities when markets fell but also invested in credits at knockdown prices as spreads widened in what was a dislocated market. After the summer, the team rotated into value and cyclical stocks, which the team saw as unjustifiably cheap both on an absolute basis and relative to 'growthier' parts of the market.

Once the macro direction has been set, the team implement their investments through a variety of different approaches – either directly, using in-house expertise, or alongside or through third-party managers. In the case of third-party managers, the team only invest with those who have they deem to have specialist expertise and who invest with high conviction. We understand that all of RCP's top ten current third-party managers are closed to new money. During 2020, RCP saw a very strong performance from managers focused on core structural themes, in particular Asia, biotechnology, and clean energy. Two value managers detracted from returns, although value holdings did contribute strongly in Q4 2020.

RCP also invests directly into single stocks, either as ideas from the in-house team or as co-investments with third parties. These are typically large-cap, quality names such as IQVIA and Alphabet. However, over the year, the team added to names with greater cyclicality (Disney), and we understand they are currently reviewing potential opportunities in stable, quality, companies that they believe have become underappreciated in today's market, which either focuses on high growth technology names or value/recovery stories. Overall, the managers have been cautious on the outlook for equity markets for more than three years, with an average net equity exposure of 44% since 2018. Prior to this, exposure was significantly higher (the five-year range has been roughly 35% - 70%).

Another tool that the team use to manage risks, and hopefully contribute to returns, is active currency management. This is managed on a look-through basis, with overall exposures adjusted and managed through the derivatives market. The trust has historically been highly active on this front. The impact of currency on returns to sterling investors weighs heavily on the managers and board. To that end and given the global remit of the trust (which implies a built-in 'short' on sterling), the relative benchmark for the trust is the MSCI AC World index calculated with 50% in sterling. This effectively reduces the otherwise implicit sterling short, given the UK only makes up c. 4% of the MSCI AC World. During 2020, the team actively increased GBP exposure, ending the year with around 80% exposure to sterling, which will have contributed to returns. The team have been buying USD since the year-end (almost zero exposure at the end of December 2020, to c. 30% currently), noting its useful diversification role in volatile markets.

Absolute return and credit include fixed-income investments as well as absolute return funds or hedge funds that aim to protect capital, in particular when equities underperform. This exposure is designed to deliver consistent returns with low correlation to equities or bonds. The strategies the team invest in are credit, macro, and market neutral. When equity markets sell-off sharply, this potentially provides a stable pool of capital from which the managers have the option of rebalancing into newly derated equities.

RCP has long been an example of how investment trusts can profitably invest in private, unlisted companies on a minority basis. This is now becoming much more popular in the closed-end fund space, but we would note that RCP has been in the advance guard within the investment trust world. These investments are made through traditional private equity funds but also in individual companies or co-investments made by the in-house management team. RCP's network of contacts and relationships remains very important in generating ideas and opportunities. The team invest with those they regard as 'niche' managers, rather than 'generic' private equity managers, and those that fit within their top-down thematic views. Technology, healthcare, and China are significantly represented in this part of the portfolio, with a number of strong realisations driving returns for the trust during 2020, as well as more latterly in the case of Coupang's IPO (although the trust has not exited this investment).

Gearing

RCP largely uses gearing opportunistically but does have an element of structural gearing. At the date of the latest factsheet (28/02/2021), RCP had a net gearing of 1.6%. This level of gearing is relatively low in comparison with history and relative to potential gearing. We note that at the beginning of 2020, RCP was 7.2% geared. The managers are flexible in their approach to using gearing and have short term facilities as well as hold cash against the structural borrowings to reduce gearing levels as they see fit.

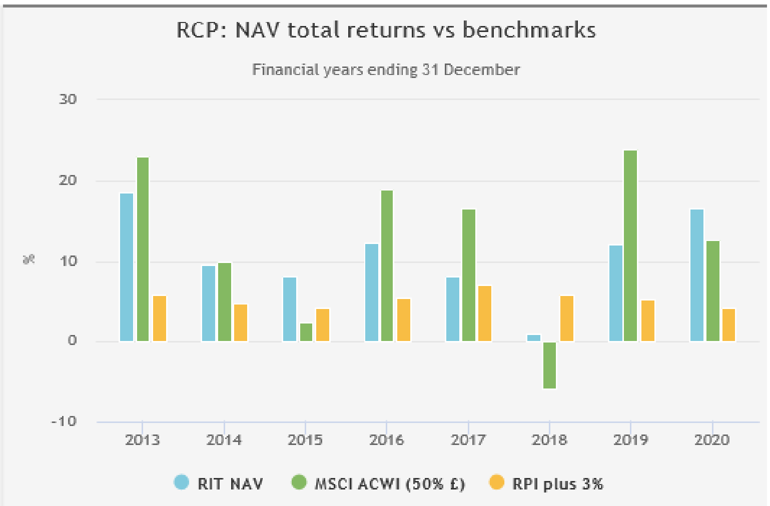
In 2015, the board chose to lock in some long-term borrowing by issuing £151m worth of fixed-rate loan notes. These will be repaid between 10 and 20 years and pay coupons from 3.00% to 3.56%. In addition to the structural gearing, RCP has short term credit facilities totalling £385m. The overall weighted average interest rate on RCP's total borrowings at 31/12/2020 was 2.49% (2019: 3.17%).

Returns

RCP's formal objective is "to deliver long-term capital growth, while preserving shareholders' capital; to invest without the constraints of a formal benchmark, but to deliver for shareholders increases in capital value in excess of the relevant indices over time". In looking to achieve this objective, the team aim to participate in rising markets but protect capital (on a relative basis) on the downside. This is not an absolute return strategy, but one that might characterise RCP as aiming for a beta lower than the equity market, whilst harnessing alpha to generate stronger risk-adjusted returns over the long term. Since its inception in 1988, RCP claims to have participated in 73% of market up moves, but only 38% of market down moves. This has resulted in an annualised return from inception to 31/12/2020 of 11.7% per annum, which compares to 7.3% p.a. for the MSCI ACWI (with 50% in £) (Source: RIT Capital Partners).

As we discuss in the Portfolio section, RCP has a broadly spread and diversified portfolio, aiming for a number of independent drivers of returns. At any one point, the managers hope that one or more of these 'cylinders' is firing, making returns more consistent than the equity markets, but delivering strong returns overall. As an example, RCP provides a statistic that over the three years to 31/12/20, the NAV volatility was 8.5%, against the MSCI ACWI (50% £) of 15.3%. Therefore, with around half the volatility of equity markets, RCP has delivered cumulative outperformance over the same equity index of 1.9%, which in our view is an impressive feat. We show the discrete NAV total return performance over a longer period, broken down into calendar / financial years in the graph below. What is immediately obvious is the consistency of delivering positive absolute returns in each year (which may not necessarily be repeated), but also how the diversified approach has provided good returns in strong years for equity markets whilst shielding investors from lower returning years. Compounding the numbers in the graph below shows that NAV total returns from 1st Jan 2013 to 31/12/2020 were 107%, against 152% for MSCI ACWI (50% £) and 51% from RPI +3%.

Fig.2: Financial Year NAV Total Returns



Source: RIT Capital Partners

Having recently published their annual report, we note that RCP again delivered a strong performance during 2020. The results show that the biggest contributor to returns was the private investments 'cylinder', which fired very strongly during the year, with the focus for several years having been on technology, healthcare, and China within this bracket. Around a quarter of the portfolio is invested in private companies, but they contributed half the returns over 2020. As we discuss in the Discount section, one of the private companies IPO'd recently (Coupang) which has driven the valuation even higher, and at the time of writing has added significantly to the last published NAV (as at 28/02/2021).

The graph below shows the NAV performance against the MSCI World ETF (note, this is not the trust's benchmark) and peers in the AIC Flexible Investment sector. We note the fact that equities have at times raced ahead, but the lower volatility trajectory and ability to capture some of the upside from equity markets means that RCP has performed well on a risk-adjusted basis – especially over the last year or so. Over this period, it is noteworthy that RCP's net public equity exposure has been roughly between a third and two thirds – and over the last three years has averaged 44%.

Fig.3: Five Year Performance Relative To Index & Peers

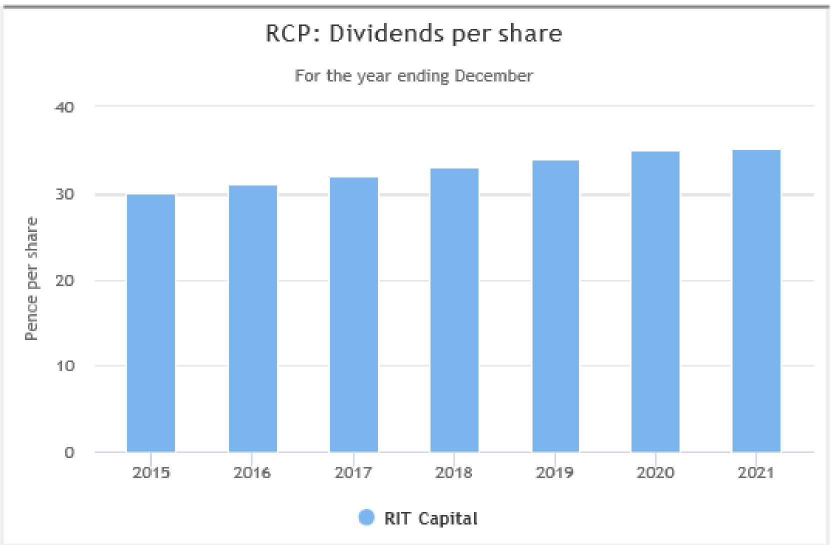
Source: Morningstar

Dividend

RCP's portfolio generates relatively little natural income, and the trust's expenses - ongoing costs, interest payments etc - outweigh any income that the portfolio generates. However, the board has paid progressive dividends over the past few years, drawn from capital - for which the company has authority to do from shareholders.

The board has stated that it aims to increase dividends above inflation, or at the very least maintain them. In the latest annual report, the board announced that the dividend target for the year ending December 2021 will be 35.25p a share, up 0.7% from 2020. The dividend will be paid in two equal instalments in April and October. The 35.25p dividend for the current financial year equates to a prospective yield of 1.5%. It is worth noting that there can be no guarantees that the final dividend for the year will meet this target, even though it is paid from capital.

Fig.4: Dividends Per Share



Source: RIT Capital Partners

Management

RIT Capital is internally managed. The day-to-day functions as well as investment functions of the trust are managed by J. Rothschild Capital Management's Executive Committee. Investment is led day-to-day by CIO Ron Tabbouche (ex GAM) and CEO Francesco Goedhuis (who has worked with Lord Rothschild since 2010. Andrew Jones (CFO) and Jonathan Kestenbaum (COO) also sit on the committee. They have been together as the management team for nine years.

Lord Rothschild and his family/trusts continue to own a very significant stake in the company, amounting to c. 21%. Recognising that investors value the Rothschild family's involvement and the long-term perspective it brings, the appointment of Lord Rothschild's daughter Hannah to the board in 2013 was intended to highlight the family's continued commitment.

The investment team have a variety of incentive plans, linked to NAV performance relative to the relative and absolute benchmarks over one and three years, which aligns them to shareholder's interests. The scheme is capped at 0.75% of NAV in an up-year and 0.25% in a down year. There is also a longer-term incentive plan measured over periods up to 10 years.

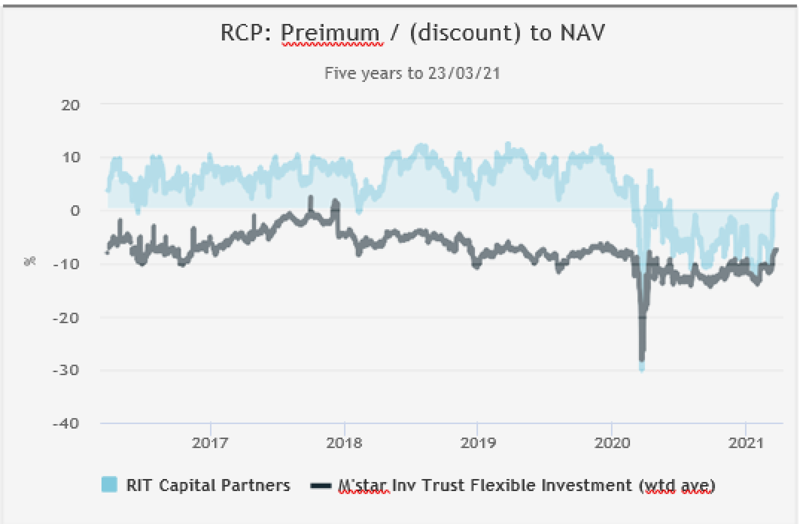
Discount

As the graph below shows, RCP's shares have traded on a premium for a significant part of the last five years. RCP initially moved to a discount in the turbulent market conditions of Q1 2020, which saw indiscriminate selling pressure. Given the defensive investment strategy, we attribute part of the reason for the discount has subsequently persisted as a reflection of animal spirits stalking markets, with high growth strategies (rather than the patient, long term growth of RCP) being the flavour of the month with retail investors.

Over the very short term, investors should be aware that published discounts are often not at all accurate. This is because of RCP's policy of only publishing monthly NAVs at the end of each month. Even then, the NAV is usually only published around ten working days after the month- end. We can see the impact of this over 2020 in the graph below, with RCP seemingly moving to a significant discount in March 2020. However, as the NAV was subsequently published, it transpired that share price movements had not adequately accounted for NAV drawdown, and the reduction in reported NAV moved the trust to a premium. This can give rise to some sharp moves in the share price, depending on how markets have evolved since the previously published NAV, and in our experience can often offer an opportunity for canny investors. That said, as we discuss in the Portfolio section, RCP's portfolio has a large number of relatively idiosyncratic investments and so trying to second guess portfolio valuation movements is hard.

The graph below is a case in point. Morningstar faithfully reproduces published NAVs, and so RCP's shares currently look like they are trading on a premium to NAV. However, at the time of writing, the last NAV date is 28/02/2021. Since then, one of the largest holdings in the portfolio (Coupang) has IPO'd at a significantly higher valuation than in the February NAV. At the closing price on the first day of Coupang's trading, this on its own would add approximately 195p (or 8.4%) to the RCP NAV. Coupang's share price has retreated from day one, but we also need to consider the rest of the portfolio, and so it is not surprising that calculating a precise discount implied by the price today is rather hard. That said, we believe it likely that rather than trading on a premium of 2.5% as indicated by the graph, RCP shares are likely trading on a small discount (although it is impossible to say with any strong conviction).

Fig.5: Premium / (Discount) To NAV



Source: Morningstar

RIT Capital has no formal discount control policy and does not issue shares to control the premium. During the last financial year, RCP's board bought back approximately 116,000 shares at a discount to NAV, which was accretive to shareholders. The Company has also continued to buy shares back more recently, with 30,000 shares purchased on 15 March. In uncertain or more risk-averse environments, RCP's premium (caveated by the above) has reached almost 10% and reflects the attraction of a vehicle that aims to protect capital in difficult times but grow capital in better times. In absolute terms, we always find it difficult to countenance paying a premium above 1 or 2%. However, the draw and attractions of RIT Capital clearly prove irresistible for many, but the risks are illustrated by the diverging performances of the share price and NAV during the 2020 financial year. Whilst the NAV per share increased by 14.4%, the share price fell by 2.4%. As we warned in our last note on RCP in 2019, any sudden shock either to the trust itself or to global markets could see the premium rating evaporate overnight.

Charges

RCP's published OCF for 2020 was 0.66%, compared to a weighted average of 0.82% for the flexible investment trust sector (Source: JPM Cazenove). However, RIT estimates that shareholders are also paying external managers an additional 0.89% (excluding performance fees). Total look-through management fees are therefore c. 1.48% before performance fees, so the trust cannot be described as cheap. Internal performance and incentive fees are capped at 0.75% of NAV, or 0.25% if the NAV has declined in any year. The KID Reduction in Yield number is 4.1%. It is worth noting that the KID costs include interest on borrowings (which the managers point out were taken out at historically low rates) as well as performance fees paid for outperformance above a hurdle. We also note that calculation methodologies do vary.

ESG

RCP's managers are signatories to the UN's Principles for Responsible Investment. In the latest annual report, the board state that they are looking at how to develop and refine the trust's approach to responsible investing and other ESG matters. That said, the board believes a focus on sustainability is a natural component of how the trust has approached its long-term objectives. For example, for some time now the team have more explicitly incorporated ESG into their fundamental assessment of investments. The team observed that climate risk, and the ongoing development of the ESG movement, is becoming a key influencer of shareholder behaviour, corporate activity, and governmental response. In this regard, clean energy is one of the themes that the portfolio has been exposed to. One of the key ESG exposures, Lansdowne New Energy, benefited from the strong tailwinds in this area during 2020, contributing materially to performance.

Given the nature of the underlying portfolio, Morningstar are unable to provide an ESG sustainability rating. We believe that RCP is unlikely to suit investors who require a specific ESG angle from their investments. Whilst we don't doubt the manager's integration of ESG, it is more the lack of reporting that we think will count against RCP in this respect.