Athelney Trust plc

Yield attractions with small caps out of favour

25 November 2024

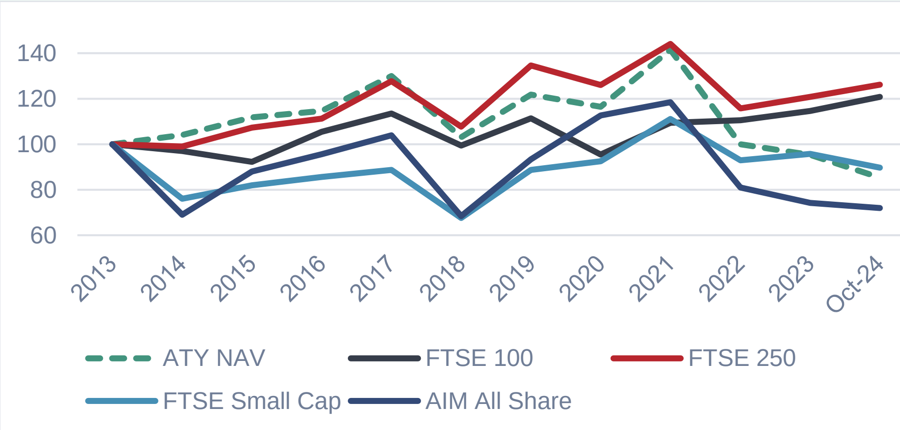
ATY should be of interest to investors tracking the relative undervaluation of UK small caps vs their international equivalents, and indeed the segment's underperformance generally.

Over the longer term a small cap weighting would be regarded as a core component of a diversified portfolio. It has, however, materially lagged mid and large caps in recent years. Those who see this differential as cyclical and temporary, rather than structural, will see potential for resumption of long-term outperformance. On that basis, the current valuations of both ATY and UK small cap sector generally represent an increasingly interesting complement to both larger scale UK and international equities.

Revised asset allocation would be a positive

Even a modest reallocation from the latter into small, microcap and AIM stocks has potential to generate a significant positive adjustment in investment returns. Although ATY has positioned its portfolio to benefit primarily from underlying economic and business trends, it would be well placed to see material upside from any small cap rerating.

UK indices and ATY NAV performance



Source: LSE data

Recent share decline means yield attractions

UK small caps weighting has rewarded patient investors over the longer-term. ATY holds a diversified portfolio of established, cash generative businesses, with proven management and competitive advantages in their specific industry niches. The core investment focus is listed UK smaller (£50-230m market cap) companies, all at a stage of their lifecycle where they pay regular dividends. This support ATY's own distributions and core commitment to maintain **progressive distributions.**

At today's share price ATY is underpinned by its 5.5% yield (historic), backed by a 21-year history of distribution growth and commitment to maintaining membership of a small group of 'dividend heroes'.

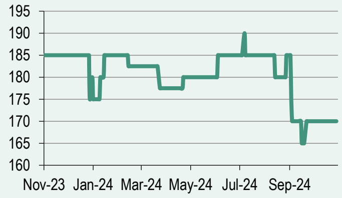
Recent performance by ATY shares reflects general malaise affecting UK small caps, with the shares broadly in line with where they were four years ago, although over that period shareholders would have received cumulative distributions of 38.3p/share.

The shares' mid-price is also at a 9% discount to end October NAV/share. That compares with the AIC UK Smaller Companies investment trust sector discount average of 10%.

Company Data

EPIC	ATY
Price (last close)	170p
52 weeks Hi/Lo	190p/162p
Market cap	£3.7m
NAV/share end Oct	187.2p
Discount to NAV	9.2%

Share Price, p



Source: ADVFN

Description

Athelney Trust is a UK listed investment trust. Its objective is to provide its shareholders with long term capital and dividend growth from a diversified portfolio of UK listed small cap companies, industries, and sectors.

The strategy is focused on total return, although the Asset Manager is committed to maintaining its 21-year progressive dividend record.

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UK small cap specialist, well placed for sector rerating

We set out brief arguments for a UK small caps rerating after an extended period of underperformance. There is inevitably noise and a lack of clear consensus, so readers must as ever draw their own conclusions.

At its own modest scale, ATY is not a UK small cap proxy. Its investment strategy seeks to accentuate outperformance across the cycle. It focuses on companies characterised by strong business models which is regards as positioned to capitalise on the medium-term outlook for UK corporates. Interim update: NAV decline, distribution ticks up again

ATY reported NAV/share at 188.1p for the six-month period to end June 2024, a 10% decline vs end 2023. As at the period end its shares stood at a 1.7% discount to NAV vs 11.5% at 31 December 2023 and a sub-sector average of 10% (AIC UK Smaller Companies sector) at end June 2024. The figure as at 31 October 2024 was 187.2p and 9.2% discount.

The first half total return was negative 6.4%, a combination of dividends paid net of change in NAV. Gross revenue fell 23% to £0.095m (H1 23: £0.12m), revenue return per share 3.0p (H123: 4.9p, FY23: 7.7p). The interim dividend was 2.3p (H123: 2.2p).

The trust is on a shortlist of UK Smaller Companies investment trusts with a 20 year plus record of consecutive dividend increases:

'Dividend Heroes' - UK Smaller Companies

Company	No. of consecutive years dividend increase
Athelney Trust	21
BlackRock Smaller Companies	21
Henderson Smaller Companies	21
Aberforth	13

Source: The Association of Investment Companies

Two issues were behind a disappointing first half performance, both in absolute terms and relative to the AIC UK Smaller Companies investment trusts segment. These were the loss incurred on exiting its holding in Close Brothers, and weak performances by Impax AM and YouGov. Close Brothers' decision not to pay dividends for the current financial year directly affected ATY's revenues - an equivalent 23% fall in H1 revenue to £94,816 (30 Jun 2023: £122,408).

This was frustrating for ATY, but against trend; dividend yields for UK small and mid-cap companies are expected to outperform the FTSE 100 by 2025 (Octopus Investments Dividend Barometer, April 2024).

ATY's manager sees less market uncertainty ahead, post the conclusion of elections in both the UK and the US. As these administrations' intentions become clearer it should enable it to position its portfolio relative to expectations on interest rates and inflation, as well as the UK government's impact on the private sector and small businesses generally.

Strategy: progressive dividend yield from UK small caps

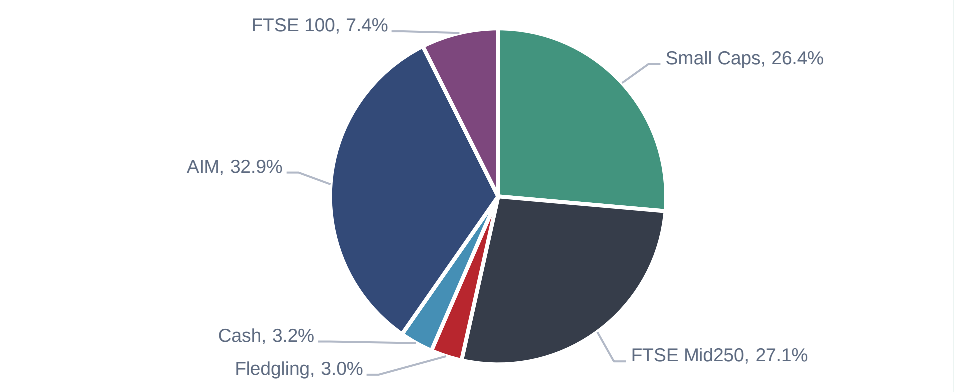
ATY's investment case combines: (a) portfolio weighting in UK small caps ahead of an anticipated rerating and (b) a 5.5% yield underpinned by a 21-year record of dividend growth and commitment to maintain a progressive dividend policy.

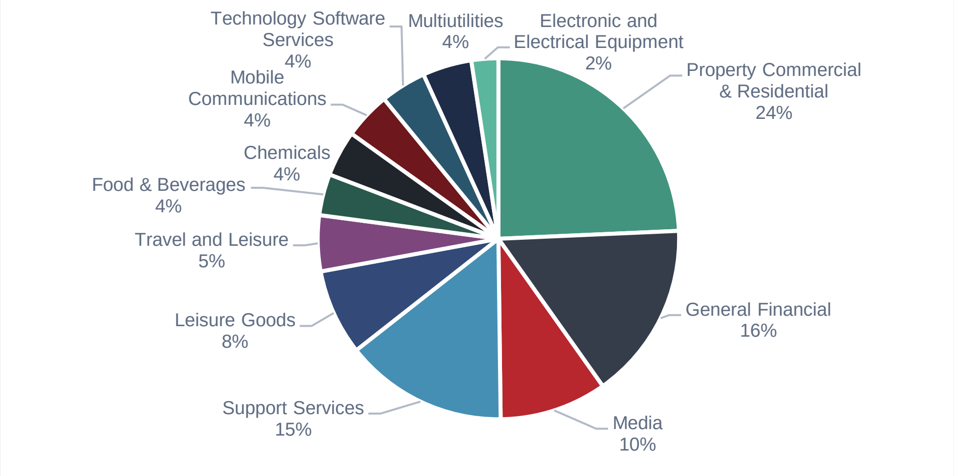
The portfolio distribution charts below illustrate that the trust is not a UK Small Cap proxy. It manages a portfolio consisting of c. 25 UK listed companies which it believes exemplify the attributes necessary to perform across the economic cycle and respond positively to challenges that it anticipates they will face over the next 18-months and beyond.

The focus is on companies which demonstrate the dynamism associated with small caps. It seeks to capture broader segment and market trends and accentuate capital growth and income.

The UK Small Caps segment, despite a prolonged period of underperformance, has typically outperformed mid and large caps over the longer term. This makes ATY particularly interesting if investors see prospects for revival in UK small caps in the relatively short term.

ATY Portfolio distribution – 31 October 2024





Source: ATY documents

The largest stock positions at 31 October were AEW UK REIT (14.2%), Games Workshop (7.5%), Tritax Big Box (7.0%), Impax Asset Management (5.8%) and Paypoint (5.7%): companies with market values ranging between £150m and £4bn and dividend yields from 3.4% to 8.4%.

UK Small Caps

Rationale for end to unprecedented period of underperformance

It may appear counter intuitive to use data which confirms prolonged underperformance to support the case for revival in sector fortunes. However, the longer-term investment case is supported by the performance of UK funds with smaller company investment focus. These on average have outperformed UK All Companies in twelve of the past 20 years, cumulatively equivalent to 73% above the returns from large cap over that period (*source: London Stock Exchange Group: article 'UK Small Caps: It's the Hope that Kills You' 6 March 2024*).

Data below illustrates the underperformance by UK Smaller Caps relative to their peers internationally, notably over the last two to three years. The UK small cap sector returned just 0.19% last year after a 25.77% decline in 2022, and underperformed **UK All Companies** in both years.

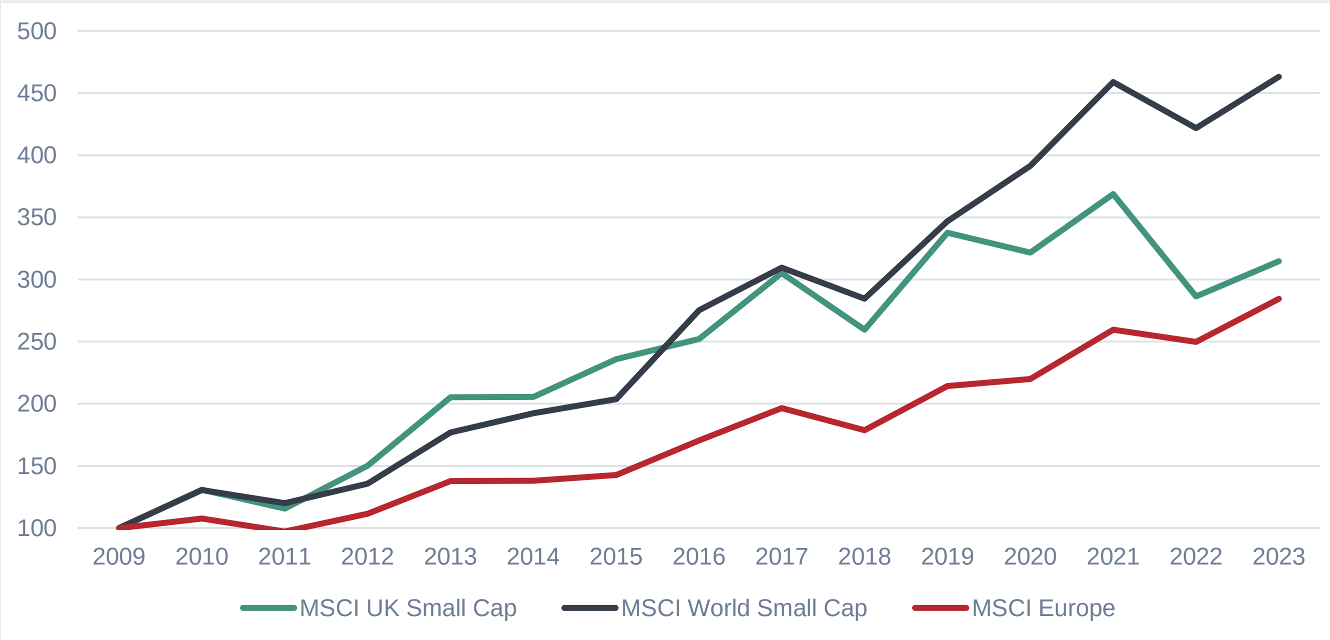
Index Performance - Gross Returns (%) - 31 October 2024									Fundamentals			
	1 Mth	3 Mth	1 Year	YTD	3 Yr	5 Yr	10 Yr	Since 29 Dec 2000	Div Yld (%)	P/E	P/E Fwd	P/BV
MSCI UK Small Cap	-3.5	-4.5	23.9	6.5	-2.7	1.7	5.5	7.5	3.6	14.0	12.0	1.6
MSCI World Small Cap	1.5	-0.4	22.8	7.5	2.7	8.4	10.4	9.7	2.1	23.9	16.4	1.8
MSCI Europe	-1.8	-1.9	16.3	5.9	5.9	7.7	8.2	5.8	3.3	14.7	13.3	2.0

Source: MSCI

The **MSCI UK Small Cap Index** has specifically **been** designed to measure the performance of the small cap segment of the UK equity market. It has 226 constituents and represents approximately 14% of the UK's free float-adjusted market capitalisation.

The table above illustrates current negativity towards UK small caps, both in terms of recent performance and inferior valuation metrics which reveal investor appetites. A modest readjustment which moved them into alignment would translate into a significant uplift in equity prices.

Cumulative Index Performance – Gross Returns (GBP) – October 2009 rebased



Source: MSCI

We have not undertaken a comprehensive analysis of the arguments in favour of increased weighting in UK small caps and, by definition, many of the reviews published post the UK Budget and US election will have been written by fund managers and prominent investors with a specific interest in the sector.

Allowing for the inevitable confirmation bias, the key points we have identified include:

- Research (*from Abrdn*) assesses the UK smaller companies' market as the cheapest globally. UK and Europe are the two regions where valuations are lowest vs their historical averages. Attractive returns could flow from simple reversion to the mean alone, with valuations at exceptionally low levels.

- There is therefore real potential for significant upwards adjustment if prevailing investor views on the UK outlook prove overly pessimistic. Much of the worst-case scenario already appears priced into historically low ratings. Abrdn's data suggests that UK small caps are projected to see earnings growth of 16.4% this year and 9.9% in 2025. Its projections for larger caps are more modest at respectively, 5.9% and 5.7%.

- Historical data suggests that UK small caps outperform larger peers during a period of declining interest rates.

- Established businesses in capital intensive industries may be particularly well placed to leverage competitive positioning, while a shortage of new investment restricts new entrants into established and profitable markets.

- Although the UK Budget reduced IHT relief on AIM investments to 20%, it still left a material advantage relative to pension funds which were subject to harsher changes. Some commentators have expressed the view that over the next few years this should encourage revived interest in AIM market investment. It is apparent that even a modest diversion driven say by profit taking in large cap to diversify into smaller caps could trigger a significant rerating.

  It would also represent a source of new flows of cash into AIM listed companies. If that were combined with other measures under consideration to help underpin the competitive positioning of the UK equity market, it could revive its appeal as a destination for small company IPOs and fund raisings, rebuild its profile and add liquidity.

- Any new source of buyers for small-cap shares may reverse recent selling pressure and combine with regular buybacks to spur higher valuations.

- The last year has seen significantly more M&A activity in the UK, with acquirers coming from both sector peers and private equity firms. Smaller companies, with their low ratings, are particularly being regarded as bargains.

A balancing view concedes that there are material risks in the UK associated with measures such as the increases in National Insurance rates and the minimum wage in the recent budget. That is compounded by the potential for further increments, conceivably justified by additional unexpected budgetary shortfalls identified by the UK government.

Both the recent UK Budget and the new US administration's investment plans are also seen as possible contributors to higher inflation.

ATY - 20 Largest Holdings as at 31-Oct-24	
Company	**% of fund**
AEW UK REIT	14.2
Games Workshop	7.5
Tritax Big Box	7.0
Impax Aset Management	5.8
Paypoint	5.7
Cake Box Holdings	5.5
NWF Group	4.5
National Grid	4.4
Treatt	4.4
Gamma Communications	4.3
Alpha Group International	4.2
Liontrust Asset Management	3.6
Cerillion	3.5
Begbies Traynor	3.2
4Imprint	3.2
Fevertree Drinks	3.1
Autotrader	2.9
Rightmove	2.6
S&U	2.4
Wise	2.0
Top 20 total %	**94.0**
Other four holdings	4.1
Cash	1.9
Total %	**100.0**

Source: Company

Manager

The fund manager is Dr Manny Pohl. Dr Pohl founded EC Pohl & Co. in 2012 and has since built one of Australia's leading fund managers with AUD2.5bn of AUM.

As an active manager it bases stock selection on forensic research and a detailed understanding of each business' performance and potential.

Portfolios are built without reference to index weightings, and instead focuses on the conviction and prospects of the individual investments. Companies are assessed over a five-year horizon, a genuine long-term approach that ignores temporary themes.

FINANCIALS

Income Statement

Six months ended 30 June, £		Unaudited			Unaudited		Audited
		2024			2023		FY 23
	Revenue	Capital	Total	Revenue	Capital	Total	Total
Losses on investments held at fair value		(111,919)	(111,919)		12,885	12,885	(57,725)
Income from investments	94,816		94,816	122,634		122,634	219,366
Investment management expenses	(1,594)	(14,469)	(16,063)	(1,781)	(16,141)	(17,922)	(34,438)
Other expenses	(27,520)	(51,031)	(78,551)	(15,728)	(38,500)	(54,228)	(139,858)
Net return on ordinary activities before tax	65,702	(177,419)	(111,717)	105,125	(41,756)	63,369	
Tax	(317)		(317)			0	
Net return on ordinary activities before taxation	65,385	(177,419)	(112,034)	105,125	(41,756)	63,369	
Dividends paid:							
Dividend	(163,999)		(163,999)	(161,841)		(161,841)	(209,314)
Net return per ordinary share	3.0p	(8.2p)	(5.2p)	4.9p	(1.9p)	3.0p	(0.6p)

Source: ATY Interims

Statement of Financial Position

As at 30 June 2024, £	Unaudited	Unaudited	Audited
	30 Jun 2024	30 Jun 2023	31 Dec 2023
Fixed assets			
Investments held at fair value through P&L	**3,969,785**	**4,318,342**	**4,374,302**
Current assets			
Debtors	105,297	135,114	137,709
Cash and bank and in hand	14,721	74,366	40,347
	120,018	**209,480**	**178,056**
Creditors falling due within one year	(31,734)	(22,383)	(40,388)
Net current assets	88,284	187,097	137,668
Total assets less current liabilities	4,058,069	4,505,439	4,511,970
Net assets	**4,058,069**	**4,505,439**	**4,511,970**
Capital and reserves			
Called up share capital	539,470	539,470	539,470
Share premium account	881,087	881,087	881,087
Other reserves (non-distributable)			
Capital reserve - realised	2,290,205	2,497,638	2,467,624
Capital reserve - unrealised	275,338	431,133	453,206
Revenue reserve (distributable)	71,969	156,111	170,583
Shareholders' funds - all equity	4,058,069	4,505,439	4,511,970
Net Asset Value per share	**188.1p**	**208.8p**	**209.1p**

Source: ATY Interims

Statement of Cash Flows

£	Unaudited 6 months ended 30 June 2024	Unaudited 6 months ended 30 June 2023	Audited Year ended 31 Dec 2023
Cash flows used in operating activities			
Net revenue return	65,385	105,125	167,070
Adjustment for:			
Expenses charged to capital	(65,500)	(54,641)	(122,623)
Increase/(decrease) in creditors	(8,654)	5,298	23,303
Decrease/(increase) in debtors	32,412	408,186	405,592
Cash received/(used) in operations	23,643	463,968	473,342
Cash flows from investing activities			
Purchase of investments	(376,627)	(669,737)	(906,775)
Proceeds from sales of investments	491,357	414,615	655,733
Net cash (used)/received from investing activities	114,730	(255,122)	(251,042)
Equity dividends paid	(163,999)	(161,841)	(209,314)
Net increase/(decrease) in cash	**(25,626)**	**47,005**	**12,986**
Cash at the beginning of the year	40,347	27,361	27,361
Cash at the end of the year	**14,721**	**74,366**	**40,347**

Source: ATY Interims

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