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Initiation | Investment Companies

4 May 2016

Henderson International Income Trust

Yield, performance and liquidity

Henderson International Income (HINT) has delivered the highest NAV growth in its peer group since launch, is on track to achieve 15% cumulative dividend growth over the past four years and offers investors a unique way of diversifying their dividend income outside the UK.

Until recently, the fund was relatively small. A £95m rollover from Henderson Global has almost doubled the size of the fund which should improve the liquidity of its shares. We think HINT should now have a broad appeal for investors, which should help it eliminate its 4% discount and allow it to expand further.

Overseas equity income diversification for UK investors

HINT aims to provide a high and rising level of dividends as well as capital appreciation over the long term, from a focused and internationally diversified portfolio of securities outside the UK.

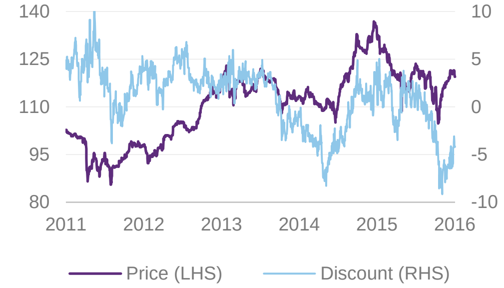
Year ended	Share price total return (%)	NAV total return (%)	MSCI World (ex UK) TR. (%)	MSCI World total return (%)	MSCI UK total return (%)
30/04/12	(2.1)	(1.2)	(2.1)	(2.0)	(1.8)
30/04/13	24.3	26.8	22.3	21.8	16.5
30/04/14	0.9	4.2	7.3	7.5	9.1
30/04/15	20.0	16.1	19.2	18.0	6.2
30/04/16	(5.1)	1.1	1.2	0.5	(7.5)

Source: Morningstar, Marten & Co

Sector	Global equity income
Ticker	HINT LN
Base currency	GBP
Price	119.5
NAV	124.7
Premium/(discount)	(4.2)
Yield %	3.8

Share price and discount

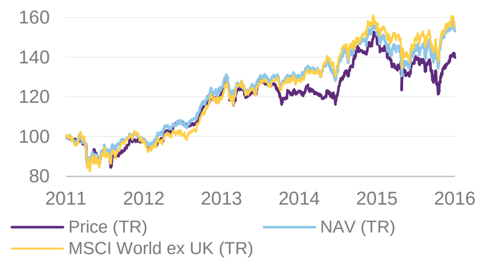
Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Performance since inception

Time period 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co

Domicile	UK
Inception date	28 April 2011
Lead manager	Ben Lofthouse
Market cap (GBP)	185.8m
Shares outstanding	155.481m
Daily vol. (1 yr avg.)	202,000 shares
Net gearing	10%

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Fund profile

HINT provides an ideal and unique way to diversify your source of dividend income outside the UK

HINT launched at the end of April 2011. At the time, many UK equity income funds were struggling to maintain their dividends, as a number of large dividend payers in the UK index had cut or passed their dividends in the wake of the global financial crisis and, in BP's case, the Deepwater Horizon drilling rig explosion. It was obvious to many that UK investors holding just UK equity income funds, had too much stock and sector specific risk. Even in 2015, just five stocks accounted for a third of dividends paid in the UK (according to Capita) and, at the end of February 2016, just 20 companies accounted for over 70% of all UK dividends. HINT, which invests globally, excluding the UK, offers a useful and practical way of diversifying investors' income and is the only UK closed-end fund with a global ex UK, income-focused mandate.

You can access the company's website at : www.hendersoninternationalincometrust.com

HINT's goals are to grow investors' income in real terms and to also grow their capital. HINT pays quarterly dividends. As the fund was set up in response to the problems created by a swathe of dividend cuts in the UK market, the manager places an emphasis on ensuring that HINT has a secure flow of income. The fund has been managed since launch by Ben Lofthouse. He joined Henderson in 2004 and has managed global equity income funds there since 2006. In addition to managing HINT, he also co-manages two open-ended funds – Henderson Global Equity Fund and Henderson Horizon Global Equity Fund. There is some crossover in holdings between the funds but they do not share HINT's global ex UK mandate. Henderson's, 12-strong, global equity income desk (headed up by Alex Crooke) has assets under management of about £12bn. Half this sum is invested in global funds (including funds such as Bankers Investment Trust) and the rest is in regional funds such as City of London and Lowland.

HINT is benchmarked against the MSCI World ex UK Index for performance measurement purposes but the composition of the Index does not influence stock selection decisions.

Rollover beneficiary

Doubled in size following rollover of funds from Henderson Global Trust

HINT started with assets of just £41.5m. 2011 was a difficult time to raise money for closed-end funds and equity funds in particular. Since then, however, HINT has expanded significantly, aided by last year's successful exercise of its subscription shares. It has now undergone transformational change as it was selected as one of two rollover vehicles (the other being its "stablemate", Bankers Investment Trust) for Henderson Global Trust. 61.4% of Henderson Global's shareholders have rolled their investment in that fund into HINT, resulting in the issue of an additional 75.2m shares and adding £95m to HINT's assets. This should have a beneficial impact on the liquidity of HINT's shares.

Falling ongoing charges ratio

As the fund expands, so its ongoing charges ratio is falling – from 1.39% to 1.11% in its last accounting year and, we believe, to around 0.83% after the Henderson Global deal (see page 11).

Manager's view

Uncertain markets create investment opportunities

The manager acknowledges the challenges faced by the global economy but he is not expecting a recession. He says markets are "walking a tightrope" and, in such an environment, certainty is prized. In his view, investors are not willing to pay up for what might happen in the future and, whilst this is not necessarily irrational behaviour, it does create some opportunities.

Generally solid, dependable income stocks and, within this group, some sectors such as consumer staples are seen by the manager as expensive. However, there are some attractively valued sectors – pharmaceuticals, for example, which currently seem to be out of favour. He thinks the same is true of telecoms, although these are now getting more expensive.

Equities are not particularly expensive, especially relative to other asset classes

Globally, stocks are trading at a small premium to their 10-year average (15.0x 12-month forward P/E on the MSCI World, compared to a 10-year average of 13.5x at the end of February 2016, with a range of 16.0x for the US, down to 11.1x for emerging markets). The manager says that it is hard to argue that equities are much out of line with historical levels, on valuation grounds. However, prices across a number of other asset classes are at peaks. For example, equity yields are much higher than government bond yields in most major markets and more than 60% of European companies have a dividend yield higher than their corporate bond yield. This is one of the drivers of companies issuing debt to repurchase shares and could also encourage M&A activity.

To sum up, the manager believes that this is a market where caution needs to be exercised. He says you have to be careful what you buy because you are not going to be bailed out by economic growth.

Investment process

Focus on yield

Dividend seeking, valuation focused investors

The global equity income team at Henderson are dividend-seeking, valuation-focused investors and this is at the core of their approach to managing HINT. Lead manager, Ben Lofthouse, thinks it is important that HINT achieves capital growth as well as paying an attractive yield. The flow of dividends to the fund also needs to be secure.

Most holdings in the portfolio have yields between 2% and 6%

The first criterion the team examines when selecting stocks is dividend yield. Every holding in the portfolio must make a contribution to the income account of the fund and so a stock must have a yield of at least 2% when it is added to the portfolio. Very high yielding stocks are generally avoided, as these have a greater propensity to cut their dividends. Most portfolio holdings will have a yield between 2% and 6%.

Lower yielding stocks need to exhibit higher-than-average dividend growth. The prospect of dividend growth is assessed by looking at forecast cash flow growth, dividend pay-out ratios, balance sheet strength, capital expenditure (capex.) requirements and trends in margins. A strong emphasis is placed on diversifying the sources of income by geography and sector.

Free-cash-flow yield is the primary indicator of value

Free-cash-flow yield is used as the primary indicator of value for a stock (except in the case of financials where they use price/book) but the manager will also look at measures such as EV/Sales and CFROI (using the HOLT system). Valuations are assessed relative to history and the wider market. The manager will not set a hard price target for a stock. Instead he will have in mind a relative and absolute valuation level based on his measures of value which, if achieved, is likely to result in the sale of a holding.

Attractive valuations available in out-of-favour companies

Unloved, undervalued, underappreciated earnings

The sorts of companies that Ben likes tend to be strong and growing cash flow generative businesses, with barriers to entry and historical evidence that returns are sustainable. Sustainability is aided by the presence of licences, intellectual property, brands and economies of scale. Ben believes that he can buy companies at attractive valuations by targeting those that are unloved, undervalued and/or have underappreciated earnings. Companies that he believes can improve through "self-help" are favoured as are companies with relatively high Returns on Equity (ROE) but low valuation.

The manager needs to be able to trust that the management of each company is competent and that its interests are aligned with shareholders. Face-to-face meetings with managers are an important part of the investment process.

Portfolio divided along regional lines

Ideas are shared between and challenged by the members of the global equity income team. The portfolio is divided into a series of geographic "buckets" or "sleeves" comprising Europe (ex UK) plus EMEA, Asia and the Americas. Ben can invest between 0% and 50% in each of these three buckets. In addition, he can choose to allocate up to 25% of the portfolio to an investment in bonds. He can draw on the expertise of Henderson's regional fund managers to help him with stock selection decisions. For example, in Asia, stock ideas are suggested by Mike Kerley, manager of Henderson Far East Income.

The portfolio will normally be made up of interests in 40-60 companies. No single investment will exceed 5% of net assets at the time they make the investment. Generally though new holdings in the portfolio begin as 1.5% to 2.5% positions. Sector weights are generally less than 20% of the portfolio.

Gearing up to 25% of net assets

The board allows the manager to use gearing in the portfolio up to a maximum level of 25% of net assets. Reflecting the emphasis on stock selection, higher levels of gearing are an indicator that the manager is finding more attractively valued stocks to invest in rather than being influenced by any particular macroeconomic story. Although currency hedging is permitted, it does not tend to feature within the portfolio.

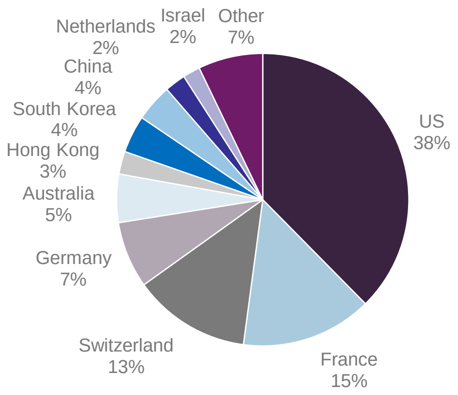
Sales triggered if yield drops too far, dividend looks insecure or if valuation criteria achieved

Sales are triggered if the yield drops too far, the dividend looks insecure or if the valuation criteria have been achieved. For example, the manager recently sold out of, tobacco company, Reynolds American, which HINT had held since launch and was for some time the fund's largest holding. While he still likes the company, the manager felt that at 22x earnings the stock's upside is more limited.

.Asset allocation

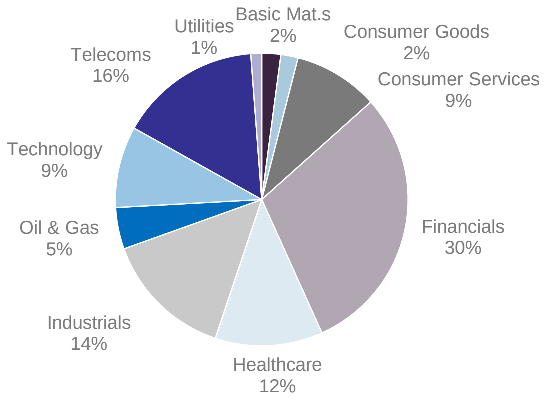
HINT's geographic asset allocation as it stood at the end of March 2016 is shown in Figure 1. As you can see, the largest weighting is to the US, driven by the breadth of opportunities available in that market although, collectively, there is a larger allocation to the European bucket. There is no exposure to South American stocks at the moment, reflecting Ben's view that these markets face a number of political and economic challenges. Similarly, within the European/EMEA portfolio, there is nothing invested in African or Middle Eastern markets at present. There is also very little invested in Japan despite that being a large part of the benchmark index. Generally, the manager struggles to find sufficient higher yielding, attractively valued companies in this market. The manager keeps this situation under close review, however, and does think the range of potential opportunities in Japan is increasing as stronger corporate governance standards create an increased emphasis on improving returns to shareholders.

Figure 1: Geographic split of the portfolio at 31/03/16



Source: Henderson International Income, Marten & Co

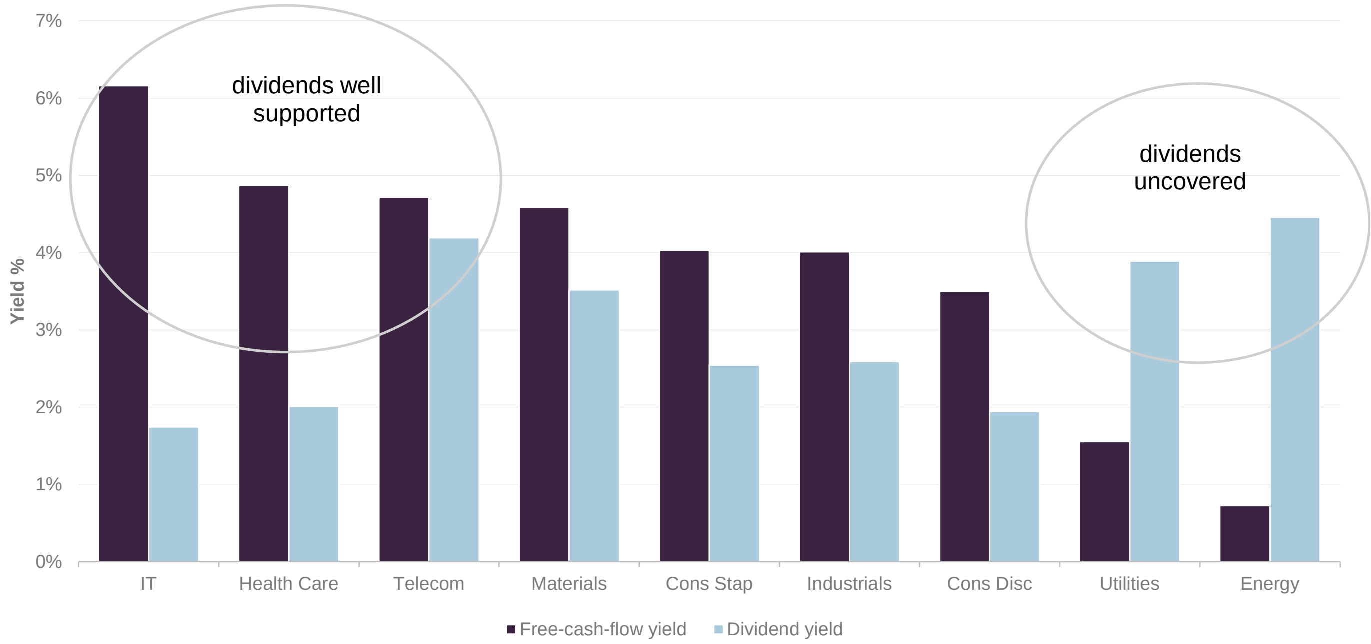
Figure 2: Industry sector split of the portfolio at 31/03/16



Source: Henderson International Income, Marten & Co

Ben is not a thematic investor but acknowledges that sectors go in and out of fashion, which creates more stock-specific opportunities in some sectors than others. To some extent therefore the sector weights shown in Figure 2 reflect sector-wide themes. The low weights in energy (oil & gas), utilities and consumer goods tally with those sectors being some of the most expensive. Corresponding allocations to technology, telecoms and healthcare reflect the relatively low valuations available in those sectors. This is illustrated further in Figure 3.

Figure 3: A comparison of free-cash-flow yield and dividend yield for industry sectors of the MSCI World Index at 29 February 2016.



Source: Citigroup, Henderson International Income

The largest sector weighting is to the financials sector. Within this, though, the allocation to banks is relatively small. REITs make up around a third of the financials weighting – Ben thinks these are still attractively valued against bond yields. Within the rest of the sector, the focus is on business models generating high and sustainable returns, stocks such as Deutsche Börse, JP Morgan and Cembra Money Bank (a Swiss car and consumer credit business that is generating a 16% ROE).

Technology is an area that Ben thinks is more defensive than many investors perceive. Telecoms benefits from having earnings with relatively low levels of cyclicality. It is also a good example of a sector where HINT can achieve much greater diversification than a UK fund could, by choosing to own firms that are regulated in many different jurisdictions. Many mobile telephone networks are benefiting from the take-up of 4G services which help promote increased data usage. There are even signs of life in overall telecoms pricing in Europe, which has recently turned mildly positive for the first time since 2009, according to data from Credit Suisse and Thomson Reuters.

The 10 largest holdings

Two Swiss pharmaceutical stocks, Novartis and Roche, occupy the number one and number three positions in the fund. The sector has been out of favour since the turn of the year due to worries that a new Democrat president in the US would crack down on drug pricing but Ben sees an increasing rate of drug approvals and the opportunity presented by novel ways of treating disease as reasons to back the sector. Ben has taken advantage of the weakness in the sector to add to these positions.

Six Flags Entertainment is a stock the manager has held for a few years. It owns and operates a number of theme parks across the US. These benefit from having low levels of local competition (and therefore pricing power) and, after a high initial capital outlay, relatively low levels of maintenance capex. Previous management had loaded the company up with too much debt and, in 2009, it was forced into Chapter 11. HINT acquired its stake about a year after Six Flags emerged from bankruptcy. The new management is running the company to maximise cash generation and returns to shareholders.

Figure 4: 10 largest holdings at 31/03/16

Stock	% of total assets 31/03/16	% of total assets 31/08/15	% Change	Sector	Business focus	Country
Novartis	3.2	2.7	0.5	Healthcare	Pharmaceuticals	Switzerland
Microsoft	3.1	2.6	0.5	Technology	Software	US
Roche	2.8	2.5	0.3	Healthcare	Pharmaceuticals	Switzerland
Verizon Comms.	2.6	2.4	0.2	Telecoms	Mobile phones	US
Six Flags Entertainment	2.5	2.2	0.3	Consumer services	Theme parks	US
Lockheed Martin	2.4	2.7	(0.3)	Industrials	Defence/aerospace	US
Nielsen	2.3	2.1	0.2	Consumer services	Market research	US
Eurocommercial Properties	2.3	2.1	0.2	Financials	Property	
Chevron	2.3	2.0	0.3	Oil & gas	Oil major	US
Cisco Systems	2.2	1.8	0.4	Technology	Software	US
Total	25.7	23.1	2.6			

Source: Henderson International Income, Marten & Co

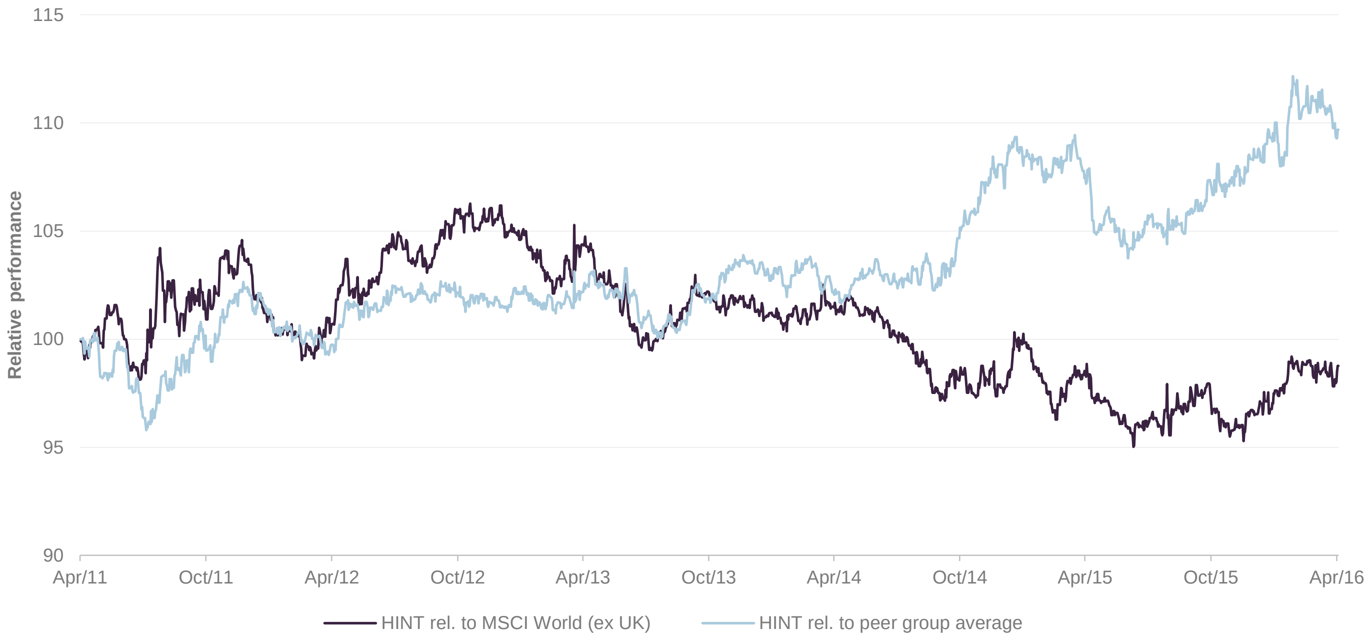
Ben has also been adding to package delivery company, UPS, Synchrony Financial (the largest provider of private-label credit cards in the US) and has made new investments in, pharmaceutical company, Sanofi and Deutsche Telekom.

Performance

Figure 5 shows HINT's performance relative to both its benchmark index and to the average of its peer group (more information about the peer group is given in the next section). Figure 5 shows that, after a good initial run, HINT underperformed the MSCI World (ex UK) Index over the course of 2013 and 2014. In recent times, though, its relative performance has been improving.

Against the peer group average, the past couple of years have seen HINT outperform its rivals by a considerable margin.

Figure 5: HINT total return performance relative to benchmark and peer group since launch



Source: Morningstar, Marten & Co

After Reynolds American, which we discussed on page 5, one of HINT's best performing stocks of the past few years has been Hong Kong-based telecoms company, HKT Trust & HKT, a stock that Ben has been trimming. HINT has also seen positive contributions from Microsoft, General Electric, Six Flags (which we talked about above) and Lockheed Martin.

Seagate Technology was an investment that did not work out as expected. It is a manufacturer of solid state drives for data storage. In the past, this was a highly competitive business but the number of players in the market has been consolidating. Seagate's ROE numbers were quite good and it was posting reasonable dividend growth. However the revenue growth that the manager anticipated from the expansion of the data centre market in the US did not materialise. HINT no longer holds this stock.

Another detractor from returns was Och Ziff, a hedge fund manager. This company cut its dividend with the aim of reinvesting in its business and buying back shares. This course of action was not received well by investors, however. Och Ziff's core products are low-beta S&P products. It is hard for them to earn decent performance fees in weak markets.

Peer group comparison

HINT is the best performing fund in its peer group since launch

We have used HINT's AIC Global Equity Income peer group for comparison in this report. We have excluded Blue Planet Investment Trust from this list, however, given its small size. Figure 6 shows how HINT compares with the rest of the peer group. In market cap terms it is, following the Henderson Global deal, the third largest in the peer group. HINT's discount is the third widest within its peer group after Securities Trust of Scotland and London & St Lawrence. This seems anomalous given that HINT is the best performing fund in the peer group over the period since it was launched and ranks second over three years and one year. HINT's yield is at the lower end of the peer group. This might reflect HINT's focus on security of income and dividend growth over investing in the highest yielding stocks. We expect that the yield will be boosted as the ongoing charges ratio drops following the Henderson Global deal – see page 11 for an analysis of this point.

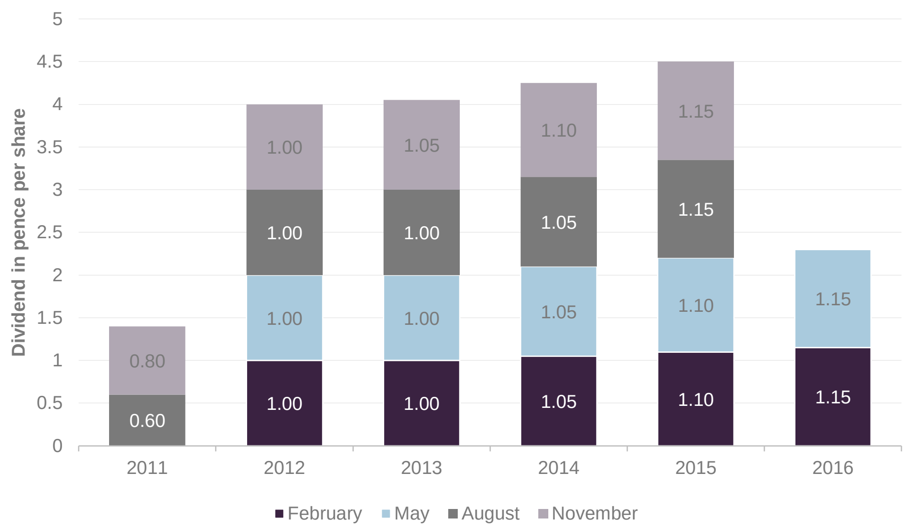
Figure 6: Global equity income subsector comparison table (data as at 30/04/16)

	Market cap GBPm	Discount (%)	Yield (%)	Ongoing charge (%)	NAV total return performance to 30/04/16 1 year (%)	3 years (%)	Since 28/04/11 (%)
Henderson International Income	186	(4.2)	3.8	1.11	1.1	22.4	53.3
F&C Managed Portfolio Income	48	(1.7)	4.6	1.16	(2.8)	12.9	39.8
Invesco Perp Select Global Eq.	52	0.3	3.8	0.97	(1.2)	26.9	51.7
London & St Lawrence	99	(5.3)	4.2	0.73	(0.5)	19.1	49.0
Murray International	1,198	1.1	5.0	0.75	(3.3)	(3.5)	27.5
Scottish American	364	6.1	3.9	0.93	2.4	20.1	30.1
Securities Trust of Scotland	150	(7.4)	3.8	0.93	(1.9)	11.0	40.0
Seneca Global Income & Growth	59	1.5	4.0	1.52	(0.2)	17.4	40.3

Source: Morningstar, Marten & Co

Dividend

Figure 7: Quarterly dividend history since inception



Source: Henderson International Income Trust

15% dividend growth over the past four years

Figure 7 shows the steady progression of the quarterly dividends paid by HINT since inception. At the current rate (i.e. assuming the next two dividends are also 1.15p), the dividend will have grown by 15% over the past four years – well ahead of the rate of inflation in the UK. It has achieved this growth at the same time as building a healthy revenue reserve: this stood at £2.4m at the end of August 2015.

While the manager's emphasis on growing a secure stream of dividends makes a revenue shortfall in the future less likely, the revenue reserve would be the first line of defence if the board wanted to maintain or grow the dividend in a period where revenues fell short of expectations. Shareholders have also granted the company the right to make distributions from capital, if necessary (granted at the AGM in 2012).

Discount

Figure 8: HINT premium/(discount) to net asset value 28/04/11 to 30/04/16

Source: Morningstar, Marten & Co

Widening discount despite strong performance

The company has been in demand for some time and has tended to trend at a premium to asset value for most of its life. In recent months, however, it has moved to trade at a discount despite its strong performance relative to its peer group. While it was trading at a premium it was issuing shares (in trades that enhanced the NAV for existing shareholders). The board believes it is not in shareholders' interests to have a specific issuance or buy-back policy. It would rather retain flexibility to consider issuance and/or buy-backs within a narrow band relative to NAV where appropriate and subject to market conditions.

The discount has narrowed a little in recent weeks and now stands at 4.2%. Once things have settled down after the Henderson Global deal, we would expect the discount to narrow.

Fees and costs

Reduction in base management fee

Henderson's base management fee was reduced to 0.65% of net assets from 0.75% assets with effect from 26 April 2016. The fee covers company secretarial, accounting and administrative services in addition to managing the fund's assets. There is no performance fee. Henderson's contract can be terminated on six months' notice. For accounting purposes, the management fee is charged 75% to capital and 25% to income. Henderson also receives a payment to cover marketing costs and, in the accounting year ended August 2015, this amounted to £53,000.

The ongoing charges ratio for the accounting year ended 31 August 2015 was 1.11%. As the fund has expanded following the Henderson Global deal, we expect this number to fall, in a full accounting year, to about 0.83% (based on other administrative expenses of £350,000 and the 0.65% management fee).

Capital structure and life

HINT has one class of shares: ordinary shares with a nominal value of 1p. The company was granted permission by shareholders to issue an additional 10% of its share capital at the AGM in November 2015. Following the issue of 75.2m shares in connection with the Henderson Global deal, there are now 155.481m ordinary shares in issue.

HINT's year end is 31 August and it tends to hold its AGMs in November. HINT has an unlimited life but at every third AGM shareholders are asked to approve, by ordinary resolution, that the company continues. The next continuation vote is scheduled for the AGM in 2017.

HINT's articles of association permit borrowings up to 100% of shareholders' funds. In normal circumstances the fund manager may only use gearing up to 25% of the net assets, in accordance with the policy set by the board.

Board

Figure 9: Board member - length of service and shareholdings

Director	Position	Appointed	Length of service (yrs)	Annual Fee (GBP)	Share-holding *
Christopher Jonas CBE	Chairman	16/03/11	5	35,000	139,730
Simon Jeffreys	Chairman Audit Committee.	16/03/11	5	25,000	102,425
Peregrine Banbury CVO	Director	16/03/11	5	20,000	28,649
William (Bill) Eason	Director	16/03/11	5	20,000	125,000
Richard Hills	Director	25/04/16	0	†	†
Aidan Lisser	Director	25/04/16	0	†	†

Source: Henderson International Income Trust, Marten & Co, * as at 31 August 2015, † no data available

The board consists of six non-executive directors, all of whom are independent of the manager. Four have been in place since the launch of the fund and two, Richard Hills and Aidan Lisser, have recently joined the board following the rollover of assets from Henderson Global Trust.

Bill Eason works for Quilter Cheviot Limited, a subsidiary of Old Mutual and a substantial shareholder in the fund. The rest of the board notes that there could be circumstances where this could pose a conflict of interest but say these would be disclosed and Mr Eason would not vote on these issues.

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