Witan investment trust

Witan performance in 2020

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Witan's performance in 2020

Towards the end of 2019, investors began to factor in a 2020 revival in global cyclical prospects and, following the clear-cut General Election outcome, an improvement in the UK market's performance. These expectations were turned on their head by the spreading COVID-19 epidemic in February, which caused a dramatic fall in global equity markets. Our portfolio fell steeply in this changed environment, so 2020 has been a disappointing time for our shareholders, with our -17% total return to the end of May trailing that of our benchmark (which has fallen 5%). Although our recent investor updates and factsheets have referred to some of the contributory causes, this report gives additional details of what has driven this very poor performance and what we have, and have not, done in response.

In broad terms, our 12% underperformance has been due mainly to the underperformance of our underlying portfolio (9%), exacerbated by being geared into a market fall (2%), with an additional 1% being the cost of the early repayment of our 2025 6.125% Secured Bonds.

Portfolio performance

Turning first to the portfolio, the causes of underperformance have been various. We adopted a new and simpler benchmark from the start of 2020, with a lower UK content (19%, down from 30%) and a higher weighting in the US (46%, up from 25%). As a legacy from our previous benchmark, our portfolio was heavily represented in the UK and Europe and underrepresented in the US. In view of the reduced political uncertainty in the UK and improving expectations for economic growth outside the US, we decided, wrongly as it turned out, to move only gradually to align our manager allocations to reflect the more global structure of the new benchmark. This proved costly, with the UK (-19% to the end of May) and Europe (-7%) performing much worse than the US (+2%), which was boosted by its high weighting in technology stocks, whose prospects were enhanced by increased internet use during the COVID-19 lockdown.

Aside from this, our global managers, in the round, were themselves underweight in the US, preferring the valuations on offer elsewhere. Our managers had reduced their technology exposure before 2020 on stock-specific and valuation grounds and were more highly weighted in the stocks that had been expected to benefit from 2020 being a better year for economic growth. These expectations, as referred to earlier, were confounded by the lockdown measures adopted to contain the COVID-19 epidemic. Although technology stocks have understandably performed strongly recently, it seems reasonable to expect a broader base of sectors to participate in the stock market's recovery once the economies that they depend on show clearer signs of pulling out of the recent dive in activity.

Two of our global managers (Lansdowne and Pzena) were particularly hard hit, having portfolios with significant cyclical exposure. Our two UK managers (Artemis and Heronbridge) also suffered from their exposure to domestic stocks and the poor performance of the UK market. The portfolio of direct holdings in investment companies was affected by specific concerns about a minority of holdings allied to a general widening of investment company discounts. Good relative performance by our other two global managers (Lindsell Train and Veritas) and by GQG Partners in Emerging markets was insufficient to offset the drag from the rest of the portfolio, hence the lamentable overall portfolio result.

Gearing

The reason we were geared in January, ahead of the COVID-19 crisis, was a belief that our managers had in aggregate a lowly valued portfolio that stood to benefit from economic conditions that (at the time) were widely expected to improve. When COVID-19 spread beyond China expectations changed dramatically, which turned our gearing from a potential benefit to a burden on performance. We reduced gearing from mid-February onwards but not as rapidly as, with the benefit of hindsight, we should have. Being geared into the rapid market fall cost us around 3% in performance, while being geared into the subsequent market recovery has recouped 1% of this.

We have used a lower average level of gearing since the crisis, reflecting the less predictable economic outlook. As previously announced, we decided to repay our 2025 6.125% Secured Bonds early, in order to reduce interest charges and take advantage of the greater flexibility offered by short term borrowings. The cost of the early redemption was £23m (which equated to just over 1% of our end 2019 NAV). Most of this will be recouped in the years to 2025 by the lower rates of interest (which are expected to persist) for short-term borrowing and the ability to repay borrowings when not used.

Our current level of gearing (7.9% at the end of May) will be subject to adjustment according to our confidence in the economic outlook and the value on offer in global stock markets. The selective use of gearing has been a significant source of added value for Witan over the years, notwithstanding occasions such as early 2020 when it has amplified losses.

Our response
Just as it is important not to become complacent when investments do well, one should avoid reacting to misfortune by automatically selling what you wish you had sold earlier. Nevertheless, after this period of unusually poor performance, the Board has carefully examined the drivers of Witan's performance in 2020 and considered what changes arising from the COVID-19 lockdown may be transitory and which may be permanent. A number of changes have been made.

The manager structure has changed to reflect the more global nature of our benchmark, with reduced use of regional managers and a greater proportion of the portfolio in global mandates. As at the end of May, we are still underweight in the US (with 38%) and overweight in the UK (with 27%) but this is principally driven by stock-specific decisions by our external managers.

We terminated the two Europe ex-UK mandates, in favour of making greater use of unconstrained global managers able to choose between European stocks and those in other regions. We have sold the global systematic value portfolio managed by Pzena, with the majority of the proceeds being held in a US equity index ETF, pending the conclusion of a search for an additional more stylistically neutral global manager.

The discounts of investment trusts, including our own, have been unusually volatile in recent months. We have stepped up our level of share buybacks, particularly during periods of wide discounts such as March and May. This is accretive to NAV as well as contributing to our objective of a sustained low discount or a premium, which is in shareholders' interests.

There have been widely-publicised cuts in dividends by many companies, including those held within Witan's portfolio. Growth in our portfolio's income over time is a confirmation of its cash generation and the progress made by the individual businesses, although clearly the circumstances in 2020 are exceptional. Although we are total return investors we recognise the importance of income to many of our investors. Witan's revenue reserves at the end of 2019 were equivalent to over 1.5 times the annual dividend and the Company has announced that is prepared to draw on these reserves if necessary in order to extend its record of 45 consecutive years of dividend rises.

Conclusion
Shareholders could be forgiven for thinking that Witan and its managers had been afflicted with a reverse Midas touch - everything we touch having seemingly turned to lead earlier in the year. The impact is all the greater coming after a strong year in 2019. I apologise to our shareholders for the poor performance experienced so far this year. Rest assured that the Board and everyone at Witan take the delivery of value for shareholders very seriously and this year's setback is felt keenly, not least because we are shareholders ourselves.

Witan's business model has delivered good returns for shareholders in most years over the past decade and the Board is confident that, following a poor showing during this especially turbulent time, our managers will return to form, enhanced by the changes made and the broader range of opportunities offered by the benchmark adopted at the turn of the year.

Andrew Bell
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