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INVESTOR

Henderson High Income

Investment companies | Annual overview | 26 April 2022

Last man standing

Henderson High Income (HHI) has enjoyed something of a UK revival for a year now, boosted by a recovery from the pandemic and a game of catch-up among dividend-paying companies, which manager David Smith says still have further to go. Concerns around inflation, and now the Russo-Ukrainian conflict, linger – but the trust's focus on high quality companies and its ability to invest across both equities and bonds means that it has more scope to prepare for any uncertainty on the horizon. Following the liquidation of Acorn Income in Q4 2021, HHI is now the only trust in the UK equity and bond income sector.

Sector	UK Equity and Bond Income
Ticker	HHI LN
Base currency	GBP
Price	177.00p
NAV	176.23p
Premium/(discount)	0.4%
Yield	5.7%

High income from a diverse UK equity income portfolio

HHI invests in a prudently diversified selection of both well-known and smaller companies to provide investors with a high income stream while also maintaining the prospect of capital growth. Gearing (borrowing) is used to enhance income returns, and also to achieve capital growth over time. A portion of gearing is usually invested in fixed-interest securities, which helps dampen the overall volatility of the trust.

HHI performed strongly over 2021, achieving an NAV return of 19.8%, outperforming its blended benchmark's rise of 14.1%.

HHI received just over £900,000 in special dividends during 2021

As at the end of March 2022, gearing was 22.3%, while equity exposure was 111.4% and bonds 10.9%.

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Domicile	England and Wales
Inception date	November 1989
Manager	David Smith
Market cap	228.19m
Shares outstanding (exc. treasury shares)	128.9m
Daily vol. (1-yr. avg.)	18.8k
Net gearing	24%

Click for our most recent HHI update note

Click for an updated HHI factsheet

Click here for HHI's peer group analysis

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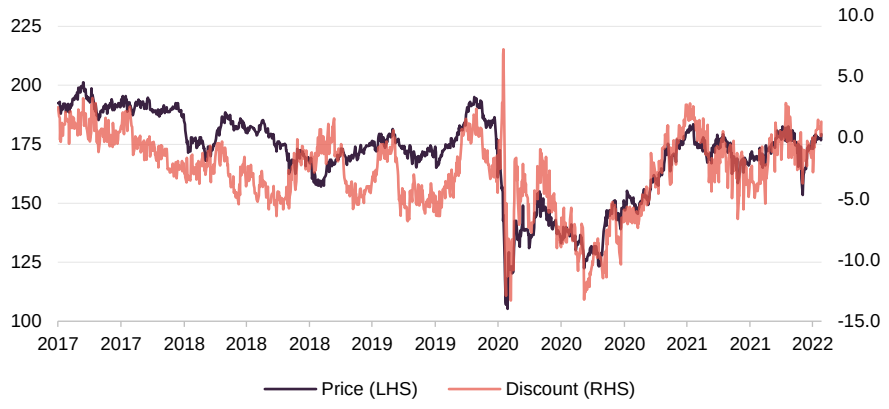
At a glance

Share price and discount

Over the past 12 months, HHI has traded between a discount of 6.7% and a premium of 2.8%. The median discount for the period is 1.0% while the average discount is 1.2%. As at 25 April 2022, HHI was trading on a premium of 0.40%. The trust issued 325,000 shares at the beginning of February to satisfy investor demand at the time.

Time period 31/03/2017 to 25/04/2022

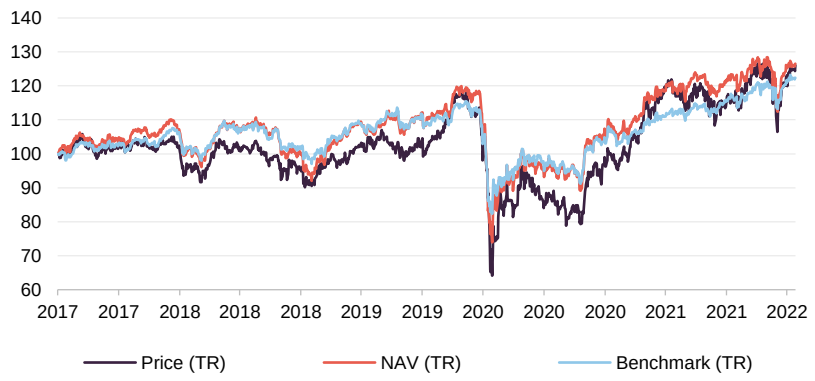


Source: Morningstar, Marten & Co

Performance over five years

HHI performed strongly over 2021, achieving an NAV return of 19.8% on a total return basis, outperforming its blended benchmark's rise of 14.1%. More recently, the trust has delivered a 1.2% NAV return from the start of the year to 31 March 2022, slightly behind its benchmark return of 2.6%.

Time period 31/03/2017 to 25/04/2022



Source: Morningstar, Marten & Co

Year ended	Share price total return (%)	NAV total return (%)	Benchmark[1] total return (%)	MSCI UK total return (%)	ICE BofAML SN-G[2] (%)
30/03/2018	(5.1)	(1.5)	0.1	(0.2)	1.3
29/03/2019	3.6	8.1	6.8	7.6	3.7
30/03/2020	(24.4)	(20.7)	(16.2)	(20.6)	1.6
31/03/2021	42.7	31.6	18.7	22.3	7.0
31/03/2022	16.1	12.7	13.9	19.1	(5.1)

Source: Morningstar, Marten & Co. Note 1) see note on page 4. Note 2) The ICE Bank of America Merrill Lynch Sterling Non-Gilts Index

Fund profile

Diversification, high income and the prospect of capital growth

Henderson High Income Trust (HHI) invests in a prudently diversified selection of both well-known and smaller companies, to provide investors with a high-income stream, while also maintaining the prospect of capital growth.

The majority of HHI's assets are invested in the ordinary shares of listed companies with the balance in listed fixed interest stocks (no unquoted investments). Investee companies should have strong balance sheets that are capable of paying dividends. There is a focus on well-managed companies whose qualities may have been temporarily overlooked by investors and which offer the potential for capital appreciation over the medium term. A maximum of 20% of gross assets may be invested outside of the UK.

A portion of gearing is invested in fixed interest securities

Gearing is used to enhance income returns, and to help achieve capital growth over time. A portion of gearing is usually invested in fixed interest securities.

Henderson Investment Funds Limited is the company's alternative investment fund manager (AIFM) and it delegates investment management services to Henderson Global Investors (both are subsidiaries of Janus Henderson Group Plc). The lead fund manager assigned to the trust is David Smith. He was made co-manager of the trust in 2014 and has been sole manager since 2015.

Blended benchmark

HHI benchmarks itself, for performance measurement purposes, against a blend of 80% of the FTSE All-Share Index return and 20% of the ICE Bank of America Merrill Lynch Sterling Non-Gilts Index. For the purposes of this note, we have replaced the All-Share with the MSCI UK Index. Note that the two indices' performance can differ over certain time periods.

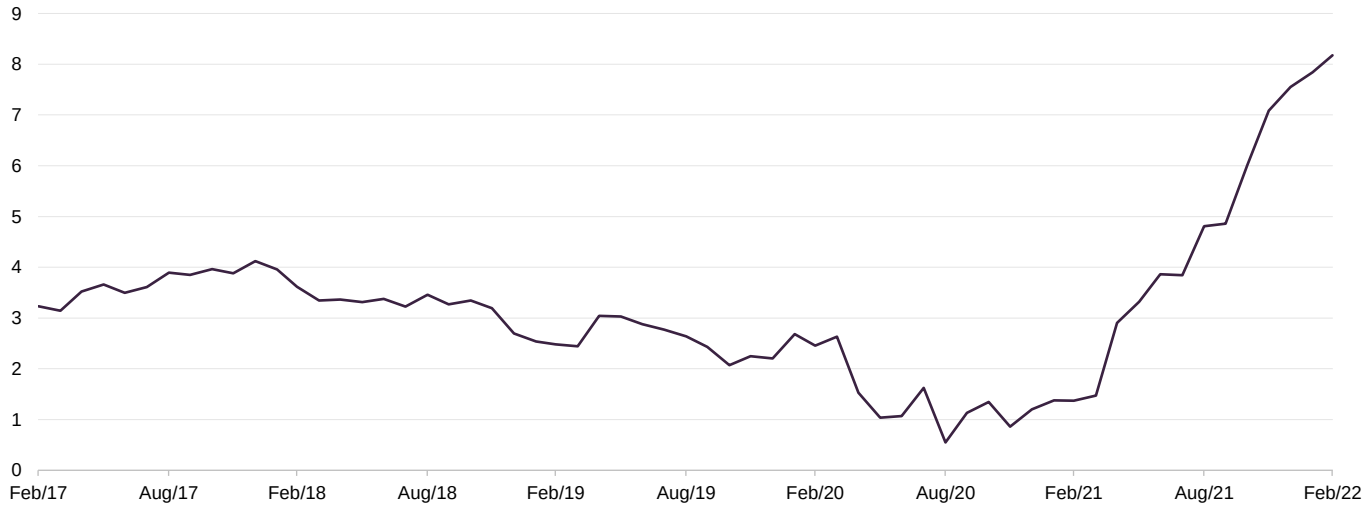
Market outlook

You can read our last update note on HHI here

A lot has happened to markets across the globe since our last note, *A taste of more to come*, was published on 25 August 2021. As we approached the end of the year, investors grew increasingly concerned about inflation and began to anticipate interest rate rises.

Following a significant increase in energy costs and household expenses more generally, the Bank of England's monetary policy committee (MPC) has now raised its key rate to 0.75% with 0.25% jumps in February and March. The February move was shortly followed by an announcement from the European Central Bank (ECB) of a sharp turnaround in its policy that would see its deposit rate raised to -0.25%, from -0.5% (a record low) by the end of 2022 (the ECB having previously said there would not be a rate rise until at least 2023).

Figure 1: UK inflation rate – 12-month percentage change in the retail prices index (RPI) over five years to 31 March 2022



Source: Morningstar, Marten & Co

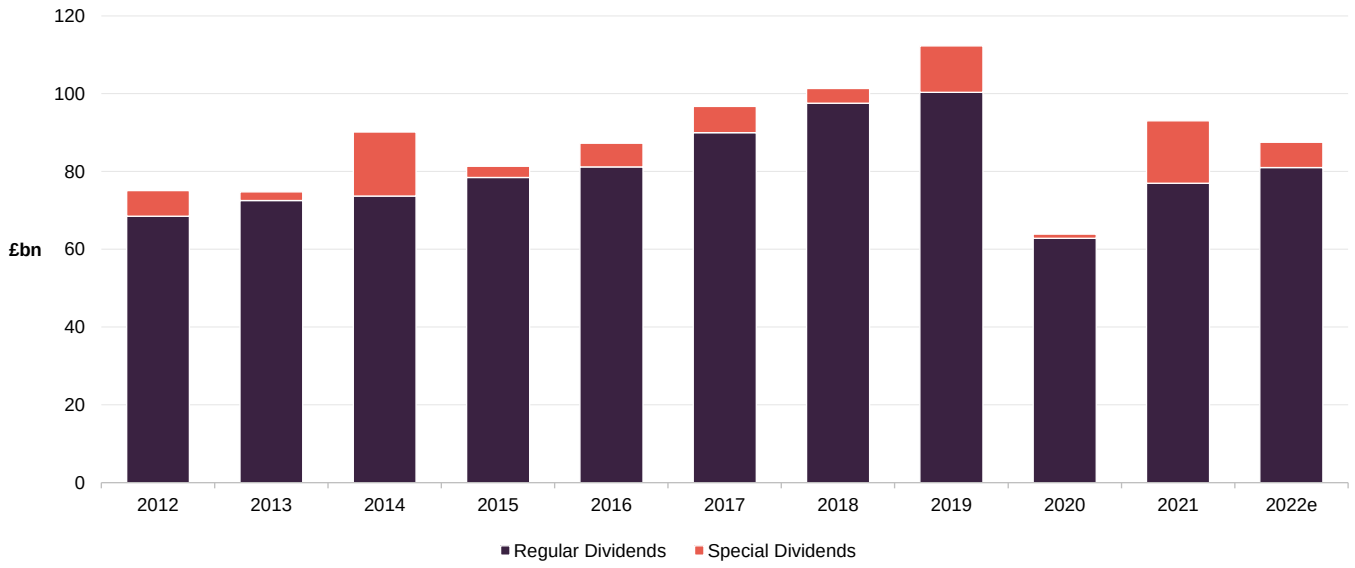
Meanwhile, the Russian invasion of Ukraine, which started at the end of February of this year, has made investors more risk-averse and exacerbated the inflation problem. While both countries' economies are small in terms of their contribution to global gross domestic product (GDP), the ramifications of Russia's shocking actions and the sanctions applied have already been felt in commodity markets and could weaken the outlook for the global economy and sentiment more generally.

> The UK market looks attractive in absolute terms and relative to global indices

Although increased geopolitical tensions have created new uncertainties, the starting valuation of the UK market is attractive both in absolute terms and relative to global indices. HHI's portfolio is focused on good-quality businesses, that are in strong financial health and can pay and grow an attractive dividend.

After the significant fall in market dividends in 2020 due to the pandemic, we highlighted the improving outlook for income in our last note, which has continued. There has been a strong recovery in market income with previously suspended dividends in the banking sector returning and strong growth in dividends from the mining sector (we talk more about this in the context of HHI's portfolio under the manager's view section of this note). According to the Link UK Dividend Monitor (see Figure 2), market dividends in aggregate in the UK rose by 21.9% last year on an underlying basis (excluding special dividends), recovering to 2015 levels. They remained, however, 23.0% below the levels of 2019, before the pandemic struck.

Figure 2: Link Q4 2021 dividend monitor - Growth from a lower more sustainable base (£bn)



Source: Janus Henderson Investors. Analysis, as at 30 June 2021. e = estimate.

Manager's view

Manager, David Smith, has enjoyed something of a UK revival for the past year now. Some investors feared that the economic recovery had peaked when lockdowns and restrictions were eased last year but the manager says that despite strong performance following the pandemic lows, valuations are attractive and there are still opportunities within the market.

Inflation frustration

The manager says inflation is likely to remain elevated, at least in the first half of 2022

Despite the good news in terms of dividend recovery and the economy appearing to have reopened for good, the after-effects of the pandemic also include higher inflation. David says inflation is likely to remain elevated, at least in the first half of the year, caused by surging oil, gas and wheat prices associated with the Russo-Ukrainian conflict. This is likely to put further pressure on consumers and corporate profits, and slow the economic recovery from the pandemic, perhaps even tipping it into recession. However, central banks may now apply caution to the further tightening of monetary policy. It may also help that for the consumer, wages are generally rising in nominal if not real terms, debt levels are relatively low, and some savings have been built up during the pandemic.

Another risk that the manager is keeping an eye on is a potential spike in bond yields. They have been rising gradually, which has meant that areas of the equity market that were considered expensive – notably speculative growth stocks – are starting to come under significant pressure. David says if we see a further move

higher in a short time frame, this could have a wider impact across the rest of the market.

Nonetheless, the manager expects to see positive returns from equity markets this year – though likely lower than last year. He admits there will be volatility, but he remains cautiously optimistic about equities making continued gains, underpinned by the UK market's dividend yield and expected dividend growth.

Income recovery

There are three companies in HHI's portfolio that have yet to restart their dividend payouts

As already mentioned, there has been some healthy bounce-back in dividends but David says this is only back to 2015 levels so there is still a further leg of recovery, and potentially some expansion, yet to come.

There are two companies in the portfolio that have yet to return to the dividend register, which the manager says were 'in the eye of the storm' during the pandemic. This includes hospitality business Whitbread, which owns hotel and restaurant brands such as Premier Inn and Beefeater and coach operator National Express. David says assuming another lockdown isn't imposed, he believes these names should return to full profitability in short order which means dividends can resume, though this is more likely to be next year. As an income fund, HHI does not tend to own zero-yielders but in the case of these companies, David says the potential share price recovery offsets a lack of yield in the short term.

Meanwhile, banks are just one of the types of businesses moving at a much higher and faster rate towards returning to 'normal' pay-outs. Lloyds, NatWest and Paragon paid dividends in 2021. Retail brands Burberry and Next also returned to paying dividends during the year and there was good underlying dividend growth from some of the company's longer-term holdings such as Hilton Food (+22%), Cranswick (+16%) and Intermediate Capital (+10%).

HHI benefitted from its mining companies paying special dividends in 2021

HHI benefitted from its holdings in miners Rio Tinto and Anglo American, both significantly increasing their ordinary dividends last year and are also paying special dividends, given the strong underlying commodity environment. David says it is unlikely that the magnitude of these payments will be sustained going forward given that any fall in commodity prices will reduce the companies' abilities to pay dividends due to their set dividend payout ratios. In total, HHI earned just over £900,000 in special dividends over 2021 with payments received from Volvo, PageGroup, B&M European Value Retail and Sabre Insurance.

Investment process

David is responsible for stock selection in the equity portfolio, asset allocating between bonds and equities and setting the day-to-day level of gearing. The split between bonds and equities in the portfolio varies but is typically 20:80. The bond portfolio will usually be funded in whole or in part by gearing, which is limited to a maximum of 40% of gross assets. The margin achieved on the bond portfolio (HHI's cost of borrowing is about 2.4% and the yield on the bond portfolio is about 4.9%) supplements the income account and allows HHI to hold some lower-yielding and higher-dividend growth equities, without compromising the trust's dividend paying ability.

The margin achieved on the bond portfolio allows HHI to hold lower yielding, and higher dividend growth equities

The bond portfolio is managed by John Pattullo and Jenna Barnard, part of a five-strong strategic fixed-income team. They are supported by Janus Henderson's wider fixed-income team. John and Jenna's approach to managing bond portfolios, and their views on the fixed interest market, have been explored in depth in our notes on Henderson Diversified Income Trust, one of the other funds that they manage.

Within the global equity income team, which David is a part of, each manager has a good deal of autonomy and is accountable for the performance of their funds. The managers on the team are generalists and get to know investee companies directly rather than relying on analysts' views. That said, there is considerable collaboration across the team and wider investment floor and significant proprietary research is available to David – regular meetings and a centralised system enable the sharing of research across the whole group, including the analysts based in the US.

Fundamentals, financials and valuation

For inclusion within HHI's portfolio, each stock has to pass muster on each of three criteria – fundamentals, financials and valuation. If a stock fails on one criterion, it will be excluded from the portfolio.

- Fundamentals: the process places strong emphasis on companies that display market leadership, good visibility of earnings, strong franchises, proven management and robust defensible business models with high barriers to entry that cannot be disintermediated.
- Financials: companies with the fundamental characteristics outlined above should also demonstrate sustainable returns. David is also looking for cash-generative companies with robust balance sheets, which have invested in their businesses, have a sustainable dividend policy – the payment of dividends should not compromise investment in the business, and where management are aligned with shareholders.
- Valuation: companies should be paying dividends and offer the prospect of dividend growth. They should be valued at a discount to David's estimation of their fair value (offering upside in absolute terms) and attractively valued relative to their peers. The valuation should also be underpinned in some way (for example, by realisable assets) so that the downside is limited. David aims to own companies for the long term. He looks two to three years out when valuing businesses.

Sweet spot between yields of 2% and 6%

David believes that there is a sweet spot for equity income investors of companies offering yields between about 2% and 6%. Within this range, companies tend to offer a good combination of yield and dividend growth. Above this level, it is more common to see dividend cuts/omissions and stocks that fall into value traps. Those very high-yielding companies that HHI does hold have strong cash-generative business models.

Stable growth, high yielders and quality cyclicals

To achieve a balanced portfolio, David focuses on three types of stock: stable growth companies that can provide good dividend growth through a cycle; high yielders that provide a good base level of stable, predictable income; and quality cyclicals that provide strong dividend growth during economic upswings but, given their quality nature, can still pay and perhaps grow their dividend in more challenging times. Utilising gearing and owning bonds to boost income means HHI

can own lower yielding companies that offer more dividend growth, typically stable growth companies and quality cyclicals. He likens his portfolio construction to putting together a well-balanced football team.

Responsible investment

Environmental, social and corporate governance (ESG) factors are taken into consideration when evaluating a company's business model and prospects and in the ongoing monitoring of the portfolio. Janus Henderson uses a variety of sources to help identify and monitor material ESG risks, including fund manager research and input from the independent Janus Henderson Governance and Responsible Investment Team and third-party data providers, such as Sustainalytics, RepRisk, Climetrics and ISS.

While HHI is not an ESG-focused trust, ESG factors are an important consideration when it comes to determining whether a company's business model is sustainable. The manager believes that those companies with good processes for managing ESG risk factors generally outperform.

The following four steps are integrated into HHI's investment process:

- Identifying risks – determining the underlying ESG risks of a company
- Analysing the controls and actions – gaining insight into the controls and actions a company performs to mitigate those risks
- Assessing sustainability targets – this helps determine a company's ability and willingness to adapt to ESG risks and a framework to hold management accountable
- Engaging with management – having regular and ad hoc meetings with senior management teams on a variety of topics

HHI does not exclude any companies solely on ESG grounds

No company will be specifically excluded from investment on ESG grounds. However, the manager will actively engage with companies and their management teams and, if the manager believes that material ESG policies and processes are not sufficient or improving, or that change is not being embraced, the position in the company will be sold or no investment will be made.

Asset allocation

As highlighted in our update note, David had been reducing HHI's bond exposure over the first half of 2021 – given that bond yields and credit spreads had fallen to very low levels – while upping equities, particularly within the banking sector, and increasing the trust's gearing.

However, since March of this year, the manager has reduced some of the cyclical exposure of the equity portfolio by selling Metso Outotec, a Finnish industrial, and Ashmore, an emerging markets asset manager. The decision was made in response to the volatility and uncertainty around the Russo-Ukrainian conflict. In total, equities were reduced by £9m (approximately 4% of the trust), the bond allocation was upped by around 2%, and gearing was reduced by 2%. As at the end of March 2022, gearing was 22.3%, while equity exposure was 111.4% and bonds 10.9%.

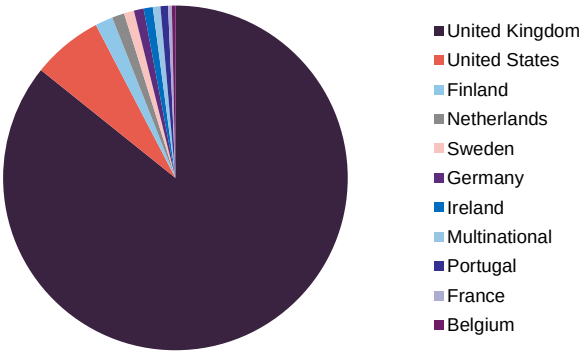
As at 31 March 2022, HHI was 22.3% geared

Other sales since our last note include Lancashire Group and abrdn, while new purchases include recruitment consultant Page Group and value retailer B&M. We talk about these portfolio changes in more detail on pages 11-12.

Portfolio breakdown

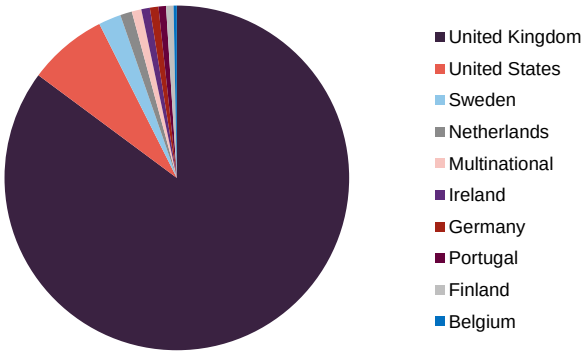
Since our last note, which looked at data for HHI as at 31 July 2021, there has been little change within the geographic distribution of the portfolio. Exposure to Sweden has increased from 0.9% to 2.1% as a result of the new investment in Nordea Bank, which we talk more about on page 12.

Figure 3: HHI geographic distribution as at 31 July 2021



Source: Janus Henderson Investors

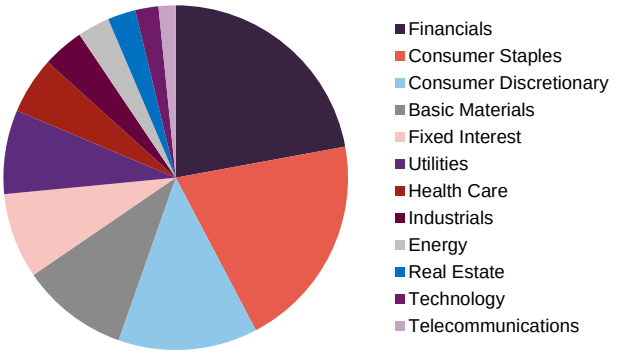
Figure 4: HHI geographic distribution as at 31 March 2022



Source: Janus Henderson Investors

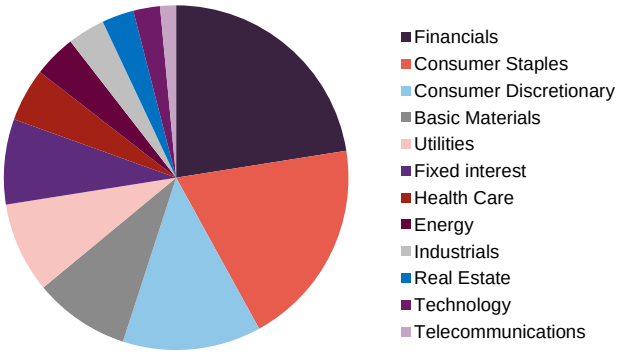
Meanwhile, change within HHI's sector distribution has also been minimal. Financials remain the biggest weighting followed by consumer staples and consumer discretionary. Exposure to consumer staples and basic materials has reduced slightly, while the allocation towards utilities has increased, but only marginally.

Figure 5: HHI sector distribution as at 31 July 2021



Source: Janus Henderson Investors

Figure 6: HHI sector distribution as at 31 March 2022



Source: Janus Henderson Investors

Top 10 holdings

Turnover within the portfolio is low, reflecting the manager's long-term approach. 3i Group is the only new entry to HHI's top 10 holdings when compared with the data as at 31 July 2021, replacing Tesco. The biggest weighting changes are an increase in the trust's biggest holding, British American Tobacco, and a 0.8% decrease in the allocation to Rio Tinto, which had previously stood at 3.4%. HHI's top 10 accounts for 29.5% of the portfolio, an increase of 0.6% since 31 July 2021.

Figure 7: 10 largest holdings as at 31 March 2022

Stock	Sector	Portfolio weight 31 March 22 (%)	Portfolio weight 31 July 21 (%)	Percentage point change
British American Tobacco	Consumer goods	4.4	3.6	0.8
Anglo American	Basic materials	3.3	2.9	0.4
Diageo	Consumer goods	3.3	3.3	0
AstraZeneca	Healthcare	3.2	2.7	0.5
Unilever	Consumer goods	3.0	3.5	(0.5)
RELX	Consumer services	3.0	2.7	0.3
Rio Tinto	Basic materials	2.6	3.4	(0.8)
National Grid	Utilities	2.4	2.1	0.3
GlaxoSmithKline	Healthcare	2.2	2.6	(0.4)
3i Group	Financials	2.1	-	-
Total of top 10		29.5	28.9	0.6

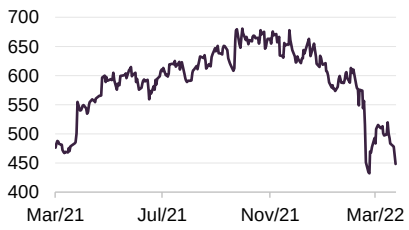
Source: Janus Henderson Investors, Marten & Co.

Portfolio changes

Despite little movement in the HHI's top 10 holdings, there have been a fair number of new purchases and disposals within the wider portfolio relative to history over the past year. As at 31 March 2022, there were 95 positions held in the trust.

PageGroup

Figure 8: PageGroup



Source: Bloomberg

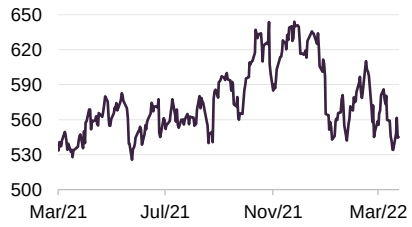
HHI initiated a position in PageGroup (www.page.com), a recruitment business, in August 2021. The company provides mostly permanent recruitment services for executives, qualified professionals and clerical professionals across a broad range of industries and geographies. David says the main thinking behind buying PageGroup was that the recruitment sector is one of the few which benefits from rising inflation, which he adds is clearly here to stay. With labour markets tight globally, solid wage growth inflation is likely to translate into higher margins for the company in this cycle. He adds that PageGroup enjoyed strong margins during the last period of high wage inflation in the mid-noughties, significantly above current margins. The company is capital light, has an attractive, cash generative business model and a strong balance sheet and during good times, they can pay a special

dividend. According to Bloomberg, PageGroup last paid a special dividend in October 2021 of 26.71p.

B&M European Value Retail

Another new purchase HHI made in 2021 (December) was of UK value retailer B&M (www.bmstores.co.uk). B&M is the UK's leading discount retailer with approximately 700 stores in the UK and an increasing presence in France. David says its low-cost, limited assortment and direct sourcing business model leads to very competitive pricing within value retail, an already attractive market segment. With consumers' disposable income likely to come under pressure this year from rising inflation, there could be an accelerated shift toward value retail, supporting higher profits, while the company's strong cash-generative and robust balance sheet could result in further special dividend payments to shareholders. The manager notes that the company has performed well during previous recessions which he expects could happen again as the consumer comes under pressure this year. He adds that there is further growth potential for rolling out new stores, particularly in southern parts of the UK.

Figure 9: B&M

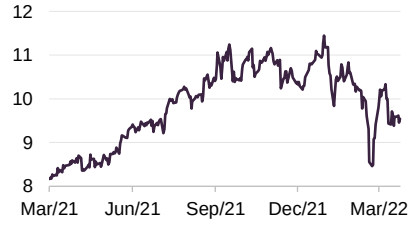


Source: Bloomberg

Nordea

HHI bought Scandinavian banking group Nordea (www.nordea.com) in September 2021. It is a leading bank in each of the four Nordic markets offering retail, business and wholesale banking along with asset and wealth management. The company operates in attractive markets, with strong loan growth and margins expected in Sweden and Norway. It already pays an attractive dividend, with future growth supported by further management action on cost and an improvement in returns. Nordea has a 12-month trailing dividend yield of 7.2%.

Figure 10: Nordea (EUR)



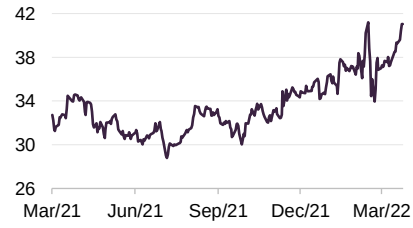
Source: Bloomberg

Disposals

Meanwhile, over the past 12 months, the manager exited positions in financial companies Lancashire Group (www.lancashiregroup.com) and abrdn (www.abrdn.com). David explains that his decision to sell the Lloyds insurer, which underwrites insurance against extreme weather and major loss events, was due to concerns that climate change means we are seeing more events like this. He adds that profits were significantly impacted by the high-loss events of Hurricane Ida and European floods. He exited the company in December 2021.

Meanwhile, abrdn was looking less attractive due to its new strategy and accompanying execution risk, and so the company was removed from the portfolio in May 2021. David says that while the strategy includes very ambitious long-term targets in terms of revenue growth and the cost to income ratio, this would require a significant improvement in growth compared to what the company has achieved historically. Meanwhile, an increased focus on growing areas that are not considered the company's core competencies adds to concerns.

Figure 11: RWE (EUR)



Source: Bloomberg

As already highlighted in our last note, David exited his position in German utility RWE, which is exposed to the development of renewable power generation. With large oil companies now bidding for seabed rights to develop their own offshore wind farms, David believes that returns for new projects are likely to come down in the long term.

More recently, HHI sold its positions in Finnish industrial Metso Outotec, and Ashmore, an emerging markets asset manager. The manager said Metso Outotec's

shares had performed very strongly since the initial investment in 2020, and the valuation had reached a level where risks to slowing global economic growth were not being discounted. Meanwhile, he sold Ashmore on fears that the fallout of the Russian and Ukraine conflict on emerging market debt markets may impact the performance of the company's underlying funds given it is a specialist emerging market debt manager.

Performance

HHI performed strongly over 2021, achieving an NAV return of 19.8% on a total return basis, outperforming its blended benchmark's rise of 14.1%. The overweight position in equities relative to bonds versus the benchmark contributed to performance, while gearing further enhanced returns given the strong market backdrop.

HHI has benefitted from strong performance from Tesco, NatWest and Anglo American

Holdings in wealth manager St. James's Place, self-storage company Big Yellow and software provider Sage were particularly positive for performance while holdings in Tesco, NatWest and Anglo American were also beneficial. We discuss performance attribution, including both positive and negative detractors on page 14.

More recently, the trust has delivered a 1.2% NAV return from the start of the year to 31 March 2022, slightly behind its benchmark return of 2.6%. Figure 12, which looks at HHI's NAV total return relative to its benchmark over five years, shows the point at which the first pandemic-induced lockdown was implemented in March 2020. The trust has since exceeded the levels immediately prior to this, but has more recently been hit by volatility, likely from the repercussions of the Russo-Ukrainian conflict.

Figure 12: HHI NAV total return relative to benchmark over five years ended 31 March 2022

Source: Morningstar, Marten & Co

Meanwhile, as shown in Figure 13, over the longer term, both HHI's NAV and share price have outperformed its benchmark as well as the wider MSCI UK and ICE

BofAML Sterling Non-Gilts indices. Over six months and one year, its NAV has slightly lagged the benchmark, though HHI's share price has outperformed.

Figure 13: Cumulative total return performance over periods ending 31 March 2022

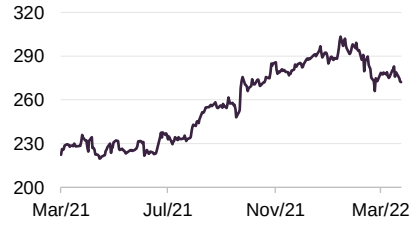
	3 months	6 months	1 year	3 years	5 years
HHI Share price	0.0	9.8	16.1	25.2	23.1
HHI NAV	1.2	6.1	12.7	17.6	25.2
Benchmark	2.6	7.7	13.9	13.2	21.0
MSCI UK	4.7	11.3	19.1	15.7	24.1
ICE BAML	(6.2)	(6.1)	(5.1)	3.2	8.5

Source: Morningstar, Marten & Co

Figure 14: BAT

Source: Bloomberg

Figure 15: Tesco



Source: Bloomberg

Positive contributors

Over 2021, sectors that traditionally benefit in a rising inflation and interest rate environment – such as oil & gas – mining and banks all performed strongly, while more defensive sectors – such as tobacco, telecoms and food producers – underperformed.

However, more recently, David says one of the best performing stocks has been HHI's biggest holding, British American Tobacco (www.bat.com). He says it has been a deeply unliked share for some time but has benefited from a value rotation. Its shift towards 'reduced-risk products' has also gained more interest, while the announcement at the end of 2021 to buy back shares has helped performance.

Fellow top 10 constituent Tesco (www.tesco.com) has also been a strong performer as of late, having reported its full year profits ahead of expectations and stated its intention to start returning excess cashflow to shareholders via share buybacks which was supportive for the share price.

The recovering economy has been good for banks with NatWest reporting significantly lower impairments than expected. Furthermore, a rising interest rate environment has helped improve sentiment for the sector which should translate into higher profits thanks to higher net interest margins. Meanwhile, another top 10 holding, Anglo American benefitted from the strong commodity price environment, especially iron ore and copper, which led to a significant increase in dividend payouts to shareholders.

The utility names in the portfolio, such as National Grid (www.nationalgrid.com) and Severn Trent Water (www.stwater.co.uk) have performed well which David says is due to being regulated and also linked to inflation. Energy company SSE has also benefitted from high power prices coming through.

Detractors of performance

One of the biggest detractors of performance for HHI has been chemicals company Johnson Matthey (www.matthey.com). The company had been developing materials for electric vehicle batteries, but abandoned plans in November 2021 after deciding its rivals were too far ahead in the technological race. The firm said its battery chemicals arm would go up for sale, which saw shares tumble by 20%.

However, David says the valuation has fallen to level that doesn't properly reflect the value of its remaining businesses such as its emission controls, precision metals or high-growth Hydrogen divisions.

Not all financial holdings did well in 2021 despite banks outperforming

Although the banking sector outperformed in 2021, other financial holdings fared worse, with some detracting from returns. Weak pricing and lower volumes impacted Sabre Insurance's profits, given the delayed recovery in the auto insurance market from the pandemic. Intermediate Capital saw good underlying dividend growth but was hit by the sell-off at the turn of the year, while emerging debt specialist Ashmore – which has now been sold – suffered from volatility in the emerging market space.

Fixed-income portfolio

The fixed-income portfolio performed well over 2021 returning 4.4% on a total return basis, outperforming the 3.0% fall in the ICE BofAML Sterling Non-Gilts Index. Government bond yields rose during the year, with the UK 10-year gilt yield reaching 1.0% as at the end of December from 0.2% a year earlier.

Bonds issued by financials performed particularly well

Despite this rise in gilt yields, high yield bonds produced a positive return, benefiting the fixed-income portfolio as credit spreads compressed due to economic data showing a stronger than expected recovery from the pandemic. Bonds issued by financials performed particularly well, especially Nationwide, Barclays and Direct Line. Nationwide and Barclays reported lower impairments and better capital ratios while Direct Line was supported by the release of the final FCA General Insurance Review which was in line with expectations. The bond portfolio represented 8.8% and 11.0% of gross and net assets respectively as at the end of 2021.

Peer group

HHI sits within the AIC's UK equity & bond income sector. Until last year, there was only one other constituent in the sector, Acorn Income. However, the trust announced a scheme of reconstruction in September 2021 which saw investors offered a choice of cash or a rollover into an open-ended fund managed by Unicorn Asset Management. In this section, we have therefore compared HHI to the UK equity income sector, which has 22 constituents.

Over one, three and five years, HHI is consistently in the top half of the table in NAV total return terms and also ranks in at fourth place over six months to 31 March 2022. It is also one of the more competitive offerings, ranking 14th for its 0.84% ongoing charge, as at 31 December 2021. While it may be one of the smaller trusts with a market cap of £228.19m as at 25 April 2022, HHI offers a yield of 5.75%, the fifth highest in its peer group.

Figure 16: UK equity income subsector comparison table, as at 25 April 2022

	Market cap	Premium/ discount	Yield	Ongoing charge	NAV total return performance over periods ending 31 March 2022			
	(GBPm)	(%)	(%)	(%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
Henderson High Income	228	0.4	5.7	0.84	6.1	12.7	17.6	25.2
abrdn Equity Income	179	(1.9)	5.9	0.87	3.8	11.3	2.3	8.0
BlackRock Income and Growth	40	(9.6)	3.9	1.22	5.1	11.4	16.2	21.8
BMO Capital & Income	344	0.2	3.6	0.59	(0.8)	8.4	15.1	27.8
BMO UK High Income	76	(5.5)	6.1	1.04	(2.3)	1.9	11.7	12.8
British & American	7	70.9	13.5	10.42	(39.6)	(41.9)	(25.7)	(17.0)
Chelverton UK Dividend Trust	40	(6.7)	5.8	2.46	(10.3)	2.7	22.2	16.7
Diverse Income Trust	394	(2.8)	3.5	1.06	(5.5)	1.4	31.8	37.9
Dunedin Income Growth	440	(0.6)	4.3	0.56	(4.8)	2.9	19.8	30.6
Edinburgh Investment	1,091	(7.3)	3.8	0.44	4.4	14.0	12.7	9.8
Finsbury Growth & Income	1,840	(6.7)	2.1	0.62	(1.7)	5.8	13.9	41.5
Invesco Select - UK Equity	132	(9.5)	3.8	0.91	3.6	18.9	29.4	30.4
JPMorgan Claverhouse	436	0.0	4.2	0.67	0.3	10.0	15.6	24.5
JPMorgan Elect – Managed Income	78	(3.2)	4.5	0.8	2.0	12.0	15.4	18.7
Law Debenture	1,006	1.9	3.6	0.5	4.9	15.5	42.6	55.6
Lowland	354	(5.1)	4.6	0.59	0.2	(89.0)	(88.6)	(88.9)
Murray Income	1,023	(5.7)	3.9	0.46	1.0	11.3	24.6	35.0
Schroder Income Growth	212	(2.3)	4.2	0.79	7.4	13.6	20.2	26.6
Shires Income	84	(0.6)	5.1	1	(1.0)	11.1	22.1	31.1
Temple Bar	753	(4.8)	3.5	0.48	3.1	6.3	0.5	10.0
City of London	1,890	1.7	4.7	0.38	10.0	16.3	17.2	25.6
Merchants Trust	743	0.1	4.8	0.55	7.8	19.9	39.7	49.5
Troy Income & Growth	228	(1.7)	2.6	0.92	1.4	9.4	8.6	16.1
Peer group median	344	(2.32)	4.2	0.79	1.0	10.0	16.2	25.6
HHI rank	13/23	4/23	5/23	14/23	4/23	7/23	10/23	12/23

Source: Morningstar, Marten & Co

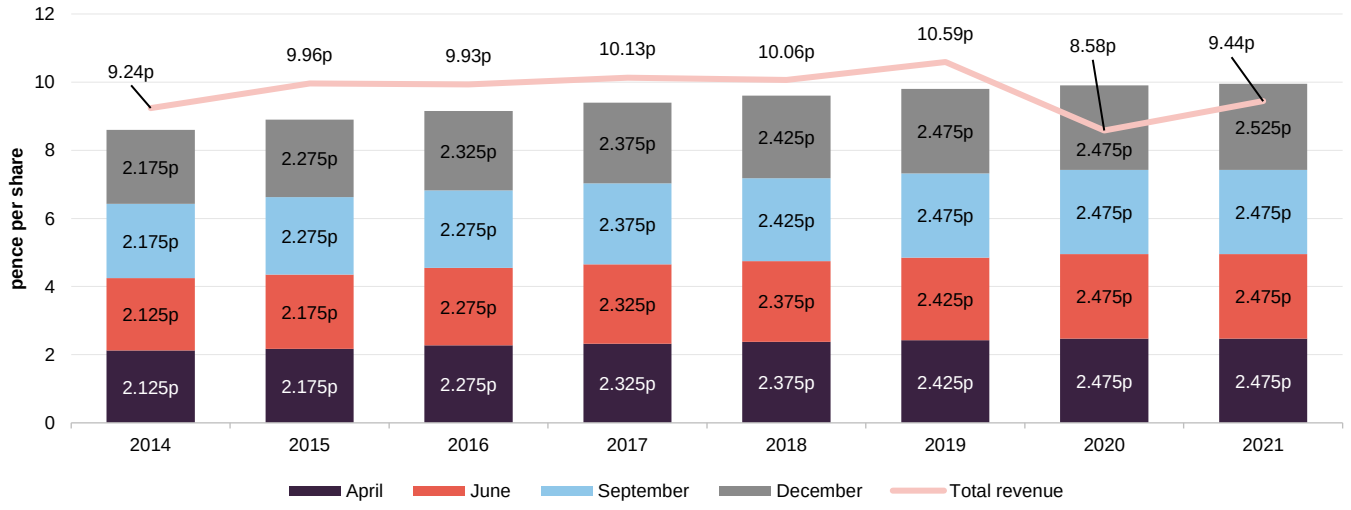
Dividend

In the face of widespread dividend cuts across the UK market in 2020, HHI used revenue reserves to maintain the quarterly dividend at 2.475p for the remainder of the financial year.

David runs frequent stress tests of HHI's revenue account under different scenarios, looking several years ahead, and over the course of 2021, he continued to monitor the level and sustainability of dividends from the trust's holdings.

Although the board says it will take time for overall income levels to return to those prevailing in 2019, the improving trend in dividends – together with HHI's current level of reserves – continues to give it confidence in its ability to continue to deliver a high level of income to shareholders.

Figure 17: HHI dividend history, accounting years ended 31 December



Source: Janus Henderson Investors, Marten & Co

At the start of 2021, HHI held almost £9m in revenue reserves and utilised a relatively modest £587,000 of those reserves to help support dividends. The first, second and third interim dividends remained at 2.475p, before increasing to 2.525p for the fourth and final interim dividend of the year.

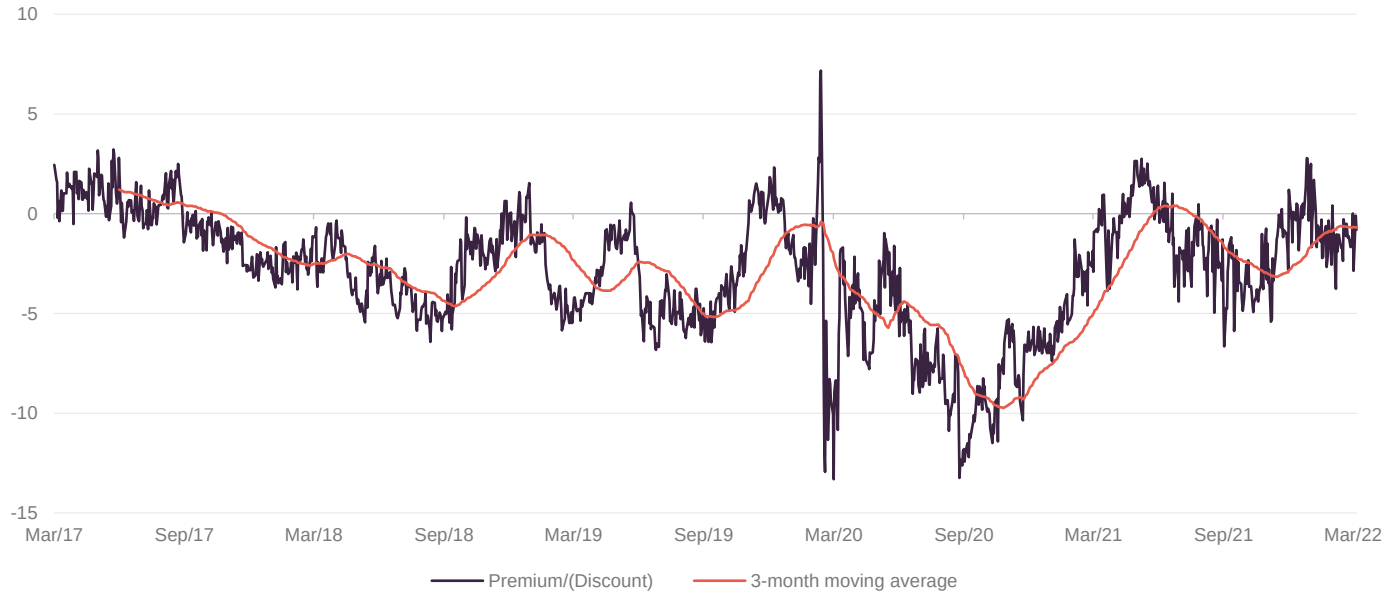
Dividends in 2021 totalled 9.95 pence per share, an increase of 0.5% over the payment in 2020. Whilst this increase was relatively modest, it does represent the ninth consecutive year of dividend growth for HHI.

At the end of 2021, HHI had revenue reserves of around £8.4m, equivalent to approximately 66% or eight months of dividend cover.

Premium/discount

Over the past 12 months, HHI has traded between a discount of 6.7% and a premium of 2.8%. The median discount for the period is 1.0% while the average discount is 1.2%. As at 25 April 2022, HHI was trading on a premium of 0.40%. The trust issued 325,000 shares at the beginning of February 2022 to satisfy investor demand at the time.

Figure 18: HHI discount over five years ending 31 March 2022



Source: Morningstar, Marten & Co

Looking over the past five years, however, as is shown in Figure 18, the range has been much wider, with HHI having traded at a premium as high as 7.2%. The median discount over the past five years is 2.4% and the average is 2.8%.

The board considers the issuance and buy-back of the company's shares where prudent, subject always to the overall impact on the portfolio, the pricing of other comparable investment companies and overall market conditions. The board believes that flexibility is important in this regard and that it is not in shareholders' interests to set specific levels of premium and discount for its issuance and buy-back policies.

Fees and costs

From 1 January 2022, HHI removed its performance fee, which the board says brings the company in line with other UK income focused trusts. It also amended the level at which the management fee falls from 0.5% to 0.45% from £250m to £325m of average adjusted gross assets. The board believes that the fee, which is payable quarterly in arrears, remains competitive.

HHI scrapped its performance fee in January 2022

Janus Henderson and its subsidiaries provide accounting, company secretarial and general administrative services to HHI, and delegate some functions to BNP Paribas Securities Services.

The company's ongoing charges ratio for the year ended 31 December 2021 was 0.84%, down from 0.93% for the previous year.

Capital structure and life

HHI's next AGM will be held in London on 24 May, 2022

At 25 April 2022, HHI had 128,921,278 ordinary shares in issue and no other classes of share capital.

The company's accounting year end is 31 December and annual general meetings (AGM) are usually held in May, in London, the next of which is scheduled for 12 noon on Tuesday, 24 May 2022.

HHI does not have a fixed life, but shareholders are asked on a five-yearly basis whether they want to approve the continuation of the trust. The last continuation vote was held at the AGM in June 2020. Shareholders voted overwhelmingly (99.8% of those voting) to support continuation. The next such vote is scheduled for 2025.

Gearing

HHI is permitted to borrow up to 40% of gross assets, but in practice, gearing will usually be lower than this, and the majority of it tends to be used to finance fixed interest investments rather than just gearing the equity portfolio. The trust should exhibit lower volatility of returns than a pure equity trust with similar levels of gearing.

In its annual report, HHI said gearing was especially beneficial during a period of positive returns for the UK equity market over 2021.

The trust has now drawn down around £37.6m of its £45m floating rate loan facility

At the end of the year, HHI had drawn down approximately £37.6m of its £45m floating rate loan facility with Scotiabank, combined with the long-term fixed rate senior unsecured note of £20m, which pays a sterling coupon of 3.67% per annum (split into two equal payments in January and July). The note will expire on 8 July 2034.

During the course of the year the total level of borrowings increased by £7.7m with the majority of the extra borrowings being allocated towards equities. As a percentage of net assets, the overall level of gearing fell a little during the year from 22.9% to 22.4% at the end of 2021 due to the increase in the net asset value of the company. At 31 March 2022, HHI's gearing was 22.3%.

Board

HHI's board consists of five directors, all of whom are independent of the manager, non-executive and who do not sit together on other boards. HHI has implemented a board succession plan over a five-year time frame (between 2016 and 2021). Five new directors have been recruited to date. The newest recruit to the board was Penny Lovell, who was appointed after the retirement of Margaret Littlejohns.

Margaret retired as chair of the company at the AGM in May 2021, after 13 years on the board. She was replaced as chair by Jeremy Rigg, who had been a director since 2018.

The board said that following Margaret's retirement in 2021, no director is expected to serve for more than nine years unless particular circumstances warrant it, for

example to facilitate effective succession planning, maintain continuity in post (particularly in regard to the chairman) or promote diversity.

Figure 19: Board member - length of service and shareholdings

Director	Position	Appointed	Length of service (years)	Annual fee (GBP)	Shareholding
Jeremy Rigg	Chair	01/04/18	3.11	36,750	20,000
Jonathan Silver	Chair of the audit committee	02/01/19	3.2	29,400	30,000
Zoe King	Senior independent director	01/04/16	5.11	24,500	9,000
Richard Cranfield	Director	01/03/20	3	24,500	30,000
Penny Lovell	Director	01/01/21	1.3	24,500	24,011

Source: Janus Henderson Investors

Jeremy Rigg

Jeremy has been chair of HHI's board since taking over from Margaret Littlejohns in May last year after her retirement. He is currently an independent investment consultant. He has over 20 years' experience within the investment management industry, having held roles at Schroder Investment Management (UK) Limited and as a senior investment manager at Investec Asset Management limited. In 2004, he was a founding partner of Origin Asset Management, a boutique equity investment manager, which grew successfully and was acquired by Principal Global Investors in 2011. Jeremy graduated from St Andrews University in 1989.

Jonathan Silver

Jonathan is the chair of HHI's audit and risk committee. He has held various senior financial positions, including 21 years as chief financial officer on the main board of Laird Plc from 1994 to 2015. He is a non-executive director and chairman of the audit committee of Spirent Communications Plc, a position he has held since 2015. Since 2017, he has been a non-executive director of East and North Hertfordshire NHS Trust. Jonathan is a member of the Institute of Chartered Accountants of Scotland.

Zoe King

Zoe is HHI's senior independent director. She is also a director of Smith & Williamson Investment Management Limited, specialising in the management of private client portfolios, and also acts as an independent director to the Dunhill Medical Trust investment committee as well as being a member of the Trinity College Oxford investment committee, the Carvetian Capital Fund investment committee and the Stramongate S.A. shareholder advisory committee. Zoe was formerly a vice president at Merrill Lynch Mercury Asset Management and a fund manager at Foreign & Colonial Investment Management. She graduated from Oxford University in 1994.

Richard Cranfield

Richard was a partner at Allen & Overy LLP, having joined them from university in 1978. He has now retired from this role but remains as a senior advisor. Richard is

global chairman of the Corporate Practice and co-head of its Financial Institutions Group. He was appointed global head of Corporate in 2000, and in 2010 took a step back from management to focus on client relationships.

In June 2019, he was appointed to the board of IntegraFin Holdings Plc, becoming chair in October 2019. IntegraFin Holdings Plc is a FTSE 250 company, the ultimate owner of the investment platform provider Transact.

Penny Lovell

Until recently, Penny was CEO of Sanlam Private Wealth, and has extensive experience in wealth management and financial advice for private investors. She has held several senior positions in sales and marketing across the investment management industry.

Previous publications

Readers interested in further information about HHI can read our previous annual overviews and update notes by clicking on the links in Figure 20 below, including our most recent update which was published in August 2021 and our initiation note published in November 2019. You can also read the notes by visiting our website.

Figure 20: QuotedData's previously published notes on HHI

Title	Note type	Publication date
The trust that delivers	Initiation	26 November 2019
Able to commit to the dividend	Update	20 May 2020
Robust high yield	Annual overview	4 December 2020
A taste of more to come	Update	25 August 2021

Source: Marten & Co

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