

Henderson Opportunities Trust ^(LSE:HOT)

Positive

Price / NAV (cum-fair)	1017.5p / 1203.1p
Discount (-) / Premium (+)	-15.4%
Yield	2.0%
Market cap	£81m
Net gearing (30 Sep 18)	8% (max 25% NAV)

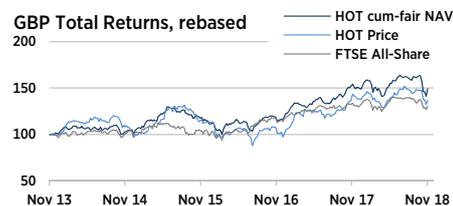
Objective

To achieve capital growth in excess of the FTSE All-Share index from a portfolio of UK investments

www.hendersoninvestmenttrusts.com

Benchmark	FTSE All-Share
Listing / Domicile	Main Market / UK
Managers	James Henderson, Laura Foll
Discount control	Continuation vote every 3y
Dividend policy	Progressive, semiannual
Annual mgmt. fee	0.55% of net assets
Performance fee	15% of outperformance vs benchmark, subject to higher price and NAV than prev. year end
Fee cap	1.5% of average net assets
Ongoing charges (YE 31 Oct 2017)	0.89%

GBP total return (%)	6m	1yr	3yr	5yr
HOT NAV	-3.7	-3.4	25.7	48.6
HOT Price	-1.6	-4.9	19.3	35.7
FTSE All-Share	-4.4	-2.5	25.1	30.2



Source: Morningstar, Bloomberg. Data as of 06/11/2018.

Multi-cap growth investing

Henderson Opportunities Trust (HOT LN) has been managed in the same style since 2007: an unconstrained multi-cap approach to UK equities driven by stock selection with ideas generated via company meetings. Small and mid-cap growth stocks form the core of the portfolio which differentiates HOT from other strategies managed by the team and closed-end fund peers. A substantial exposure to AIM listed stocks (c. 60% as at 30 April 2018) is another distinguishing factor in our view and results from where the team are seeing opportunities in today's markets. The flexibility to transition between market-cap segments is another key feature that sets HOT apart from the competition, in our view. Finally, we believe the current discount presents an attractive entry point for a differentiated, long-term buy-and-hold UK equity fund.

Key points:

- A growth oriented portfolio of 70 to 100 stocks across the UK equity market cap spectrum from micro to mega-caps, including AIM listed companies
- A low turnover approach allows the identified growth theses to play out, with stocks initiated and trimmed gradually to control portfolio sizing
- Macro considerations are only involved at the individual stock analysis level, with six classification buckets used to ensure portfolio diversification (see p.5)
- The current discount presents an attractive entry point for a differentiated, long-term buy-and-hold UK equity fund, in our view

HOT highly differentiated from other funds managed by the team

James Henderson and Laura Foll are also responsible for Lowland IC, the investment portfolio of The Law Debenture Corporation, and the open-ended Henderson UK Equity Income & Growth Fund. HOT is the only fund to not have an income focus, and has a much larger small and micro-cap exposure than the others (see p.11).

Significantly wider discount than peers and other strategies managed by the team

HOT's discount of c. -15.4% is the widest of the closed-end funds managed by the team (see p.11) and the second widest of the comparable closed-end fund peer group (see p.13) which, excluding HOT, averages c. -5.4%. This is despite HOT's impressive track record against its benchmark and peers (see p.14), and we believe presents an attractive entry point for a strategy well suited to long-term investors.

Progressive dividend policy with robust reserves supports

Unlike the other strategies managed by the team HOT is not targeting an income mandate. However, HOT follows a progressive dividend policy and pays a non-negligible trailing yield of c. 2.0%. Further, revenue reserves equivalent to 1.0x total distributions made in FY2017 as at 31 August 2018 give us confidence in the dividend's sustainability (see p.6).

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Company details

The Company was incorporated and listed in 1985 as Strata Investments plc which subsequently changed name to Henderson Strata Investments in 1992 and was run as a global smaller companies mandate until 2005, when the focus changed to UK micro-caps. In January 2007 the mandate changed to the current unconstrained approach to UK equities with the appointment of James Henderson and the name changed once more to Henderson Opportunities Trust plc.

Investment objective and policy

The Company aims to achieve capital growth in excess of the FTSE All-Share index from a portfolio of UK investments. The strategy is to invest in a concentrated portfolio of shares on an unconstrained basis across the whole range of market capitalisations. Formal investment restrictions include:

- Equities are to represent 70% to 100% of assets, with fixed income and cash allowed to vary from 0% to 30%.
- There are no limits on investment relative to the FTSE All-Share index by sector or market capitalisation, with the Company investing in a portfolio of 70 to 100 investments on an unconstrained basis
- Investments in investment companies can represent up to 15% of gross assets (though the Company will not normally do this)
- Unlisted securities may represent up to 10% of gross assets at the time of investment, but at the time of writing only one was held (Oxford Sciences Innovation – which represented less than 0.4% of the portfolio as at 30th April 2018).

Investment philosophy

A flexible approach to growth investing focused on earnings

The team typically focus on earnings growth and cash generation. However unlike the team's other strategies HOT's emphasis is much more weighted towards earnings growth, which they believe creates long-term investor value (albeit with a lower yield and higher risk profile). This naturally favours the smaller, higher growth companies further down the market cap scale, but the team believe it is important to have the flexibility to vary exposure to small-caps when markets are overly bearish or exuberant, and hence prefer to manage to an all-cap mandate.

Low turnover approach, trim winners as growth thesis plays out

The team typically take a long-term view on stocks held, particularly within the smaller-cap area of the market. New ideas are built gradually as their comfort with the investment case rises and to minimise price impact, and strongly performing stocks are gradually trimmed to crystallise profits and control portfolio sizing.

Diversification key to small-cap investing

Although the team have a high level of conviction that growth in smaller companies will deliver significant long-term returns, they prefer to take a diversified approach to portfolio construction. This helps shield the portfolio from the high number of variables present for each stock, especially given the increasing rate of disruption taking place in markets. Thus, maintaining diversification is key for the portfolio and is broadly monitored via the six classification buckets shown on p.5.

Small-cap research ensures broad awareness of opportunities available

Being able to invest across the entire market cap spectrum in HOT ensures that the team's research coverage is broad and raises their awareness of the potential opportunities available across the UK equity market.

Janus Henderson
GROUP PLC

www.janushenderson.com

The Investment Manager

Janus Henderson Group plc

Janus Henderson Group plc was formed following the merger of Henderson Group plc and Janus Capital Group, Inc. on 30 May 2017. The combined entity now has a wide reaching investment management platform spanning equities, fixed income, alternatives, and multi-asset, with a combined AuM of c. £280bn as at 30 June 2018.

For AIFMD regulation purposes, the Board have appointed Henderson Investment Funds Limited as the AIFM, which in turn delegates investment management services to Henderson Global Investors Limited, both of which are subsidiaries of Janus Henderson Group plc.

Investment Manager: key personnel

James Henderson and Laura Foll are the key individuals responsible for managing HOT, alongside three other UK equity mandates. They are supported by one analyst, Charlotte Greville, alongside the Janus Henderson's wider global equity resource. James and Laura split research by sector and will thoroughly discuss ideas with each other before acting on the portfolios. They now manage a combined c. £1.6bn of assets across four strategies as at 30 September 2018.



James Henderson, Fund Manager and Director of UK Investment Trusts

James Henderson has been Director of UK Investment Trusts since 2003, having joined Henderson in 1983 as a trainee fund manager and, during his tenure with the firm, having been successfully managing a number of investment trusts since 1990. Prior to joining Henderson he was an accountant trainee at Binder Hamlyn. James graduated with an MA (Hons) in economics from Cambridge University and has 35 years of financial industry experience. James was appointed as manager of HOT in 2007.

James has been manager to HOT since 2007, having also managed Lowland Investment Company (LWI), the investment portfolio of The Law Debenture Corporation (LWDB), and the open-ended Janus Henderson UK Equity Income & Growth Fund since 1990, 2003, and 2005 respectively.



Laura Foll, Fund Manager

Laura Foll has been a Fund Manager since 2014, having joined Henderson in 2009 as part of the graduate scheme. She was subsequently named a global analyst on the value and income team and later an assistant fund manager for the Global Equity Income Team. Laura graduated from the London School of Economics with an honours degree in economic history with economics. She holds the Chartered Financial Analyst designation and has 9 years of financial industry experience.

Laura already has a number of years' experience running UK equity investment trust mandates, having been appointed as Deputy then Joint Fund Manager for Lowland Investment Company (LWI) in 2013 and 2016 respectively. She was also appointed as co-manager of the open-ended Janus Henderson UK Equity Income & Growth Fund in 2014. Following the retirement of previous co-manager Colin Hughes on 30 June 2018, Laura was also appointed as joint manager of HOT with James, having worked alongside James since joining Henderson in 2009.



Charlotte Greville, Analyst

Charlotte Greville has been an analyst within the Global Equity Income team since 2016, having joined Henderson in 2011 as part of the graduate scheme. Charlotte graduate from the University of St Andrews with a Bachelor of Science in Psychology. She holds the Chartered Financial Analyst designation and has five years of financial industry experience.

Investment strategy and process

Face-to-face meetings with companies forms the core of the research

The team do not use any formal screening process and instead spend a lot of time meeting companies and researching individual stocks from across the market capitalisation spectrum. This typically results in c. 400 face-to-face company meetings each year, and all contributes towards their goal of finding companies that have strong earnings growth potential whilst also exhibiting quality characteristics. A typical time horizon for their investment analysis is from three to five years, which reflects a sufficient period for the identified growth opportunity to play out, whilst looking past shorter time market noise.

Six classification buckets ensures a broad spread of ideas

Although stock selection is the team's focus, they also monitor the portfolio's broader shape. Stocks are classified into six buckets, each with different characteristics and purposes within the portfolio. Importantly, the resulting diversity ensures that the team are monitoring all sections of the market to help prevent missed opportunities.

Portfolio classification buckets

Classification	Description	Typical allocation (actual as at 31 Aug)
Small and mid-cap compounders	Quality companies with strong management where long-term returns can be compounded as the company grows substantially in size. Tend to be established companies with longer track records.	20% - 40% (24%)
Growth small-cap	Also quality companies, however tend to be at an earlier stage in their life cycle with a correspondingly higher growth rate and shorter track record than the compounders.	20% - 40% (34%)
Early stage/University spin-outs	Companies that are earlier in their life and have prospects largely uncorrelated to wider market moves, with the potential for significant gains	0% - 20% (8%)
Natural resources	These offer exposure to cyclical stocks that can add diversity alongside timing opportunities depending on the position in the commodity's cycle	5% - 15% (12%)
Recovery	Stocks that are working through difficulties and may be seen as a contrarian value opportunity, as opposed to the above 'core' of growth stocks	0% - 20% (6%)
Special situations	These are one off investment opportunities often driven by a catalyst for change that the team will monitor the evolution of closely following investment	0% - 10% (2%)

Source: Company data, CFE Research

Small and mid-cap growth stocks form the core of the portfolio

Small and mid-cap compounders, and growth small-cap stocks form the core relative high growth portion of the portfolio. Three of the remaining buckets (natural resources, recovery, special situations) are typically allocated to when the team see value opportunities.

We believe two buckets stand out: the first is natural resources - these typically cyclical stocks are often considered to be the remit of 'value' investors, however the team believe a small allocation at all times is warranted for diversification purposes. The second is recovery - this also does not fit the typical 'growth' investment style, however it gives the team flexibility to add stocks that are suffering from negative momentum whilst also not being forced sellers if an existing holding is to show signs of weakness.

Initiations are gradual with strongly performing stocks trimmed to recycle capital

Attractive opportunities are then initiated in a staggered approach as the team become more comfortable with the company and investment case, with organic growth often being the main reason for a stock's weight in the portfolio rising. The recycling of capital is done in a similar fashion: should valuations rise beyond a level the team are comfortable with or a more attractive opportunity presents itself, a holding will gradually be reduced. Nonetheless, should an investment thesis be violated the team can be quick to act in exiting a position, with no restrictions on having to meet management before doing so.

Risk management

Risk is primarily controlled through individual stock selection and the classification buckets which ensure a spread of company types and economic sensitivities, alongside the diversification that comes with holding 70 to 100 stocks.

Management and performance fees

The manager is entitled to a management fee of 0.55% of net assets, alongside a performance fee calculated as 15% of any outperformance over the FTSE All-Share index benchmark.

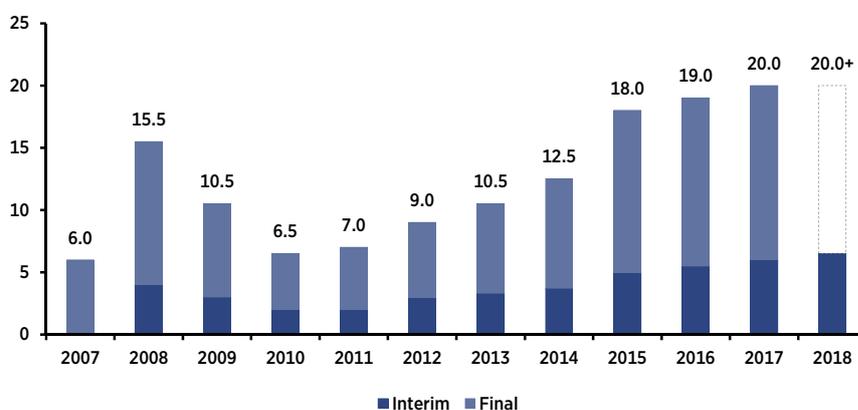
Total management and performance fees payable in any one year are capped at 1.5% of the average net assets (calculated quarterly) during the year. Further, the share price and NAV per share must not be lower than the previous accounting year end's share price if a performance fee is to be paid. Any underperformance and unrewarded outperformance (due to the cap) are carried forward to subsequent years.

The management agreement is terminable on six months' notice and is reviewed annually by the Board.

Dividend policy

Although HOT's focus is not on dividend paying companies, the preference for growing businesses with strong cash flow profiles often leads to companies with good dividend prospects. As a result of this the Board has been following a progressive dividend policy in recent years and are optimistic that this can be maintained. This takes the form of a semi-annual dividend, where the majority is back-loaded in the final dividend:

Dividend history shows progressive growth since 2010



Source: Company data, Bloomberg, CFE Research. Total dividend for FY2018 assumes that at least the same level of dividend as FY2017 is maintained, as the Board are following a progressive dividend policy in recent years.

Additionally, HOT had revenue reserves of c. 20.0p as at 31 August 2018, which represents 1.0x the total distributions made in FY17, giving us confidence that the Board's ability to at least maintain the dividend is robust looking forward.

Gearing

Gearing is provided via an unsecured loan facility of £20m, and amounts drawn are limited to a maximum of 25% of net assets, and the team are given the freedom to vary the level of gearing for tactical purposes, which is typically determined by the opportunity set and market valuations.

Discount management

Although the Board seek authority to buy back shares at each AGM, there have been no buybacks since December 2012. This is due to concerns that reducing the size of HOT via buybacks would only reduce long-term demand for the shares. It is intended that superior long-term returns will encourage investor interest and over time help to narrow the discount.

A continuation vote is held every three years, with the next in March 2020 after the one held on 16 March 2017 passed by a vote in favour of 99.3%.

Capital structure

8,000,858 ordinary shares as at 30 September 2018, of which none were held in treasury.

The Board

Peter Jones (Non-executive Chairman)

Peter Jones was chief executive of Associated British Ports for six years up to March 2013. He is a non-executive director of Hargreaves Services plc, and was formerly chairman of Port of Milford Haven, and a non-executive director of Mercantile Ports & Logistics Ltd.

Malcolm King (Non-executive Director)

Malcolm King has over 30 years' experience in fund management including investment in UK smaller companies and is a Chartered Accountant (ACA). He is also a director of Ecofin Global Utilities & Infrastructure Trust, having retired from Investec Asset Management in 2016.

Chris Hills (Non-executive Director)

Chris Hills is CIO of Investec Wealth and Investment Limited, a position he has held (originally with Carr Sheppards) for 20 years. He was formerly a director of Baring Fund Management, and was appointed to the board of the AIC in January 2015. He is also a member of the investments committee of University College London.

Frances Daley (Non-executive Director)

Frances Daley is a Chartered Accountant (FCA) with significant financial and commercial experience having held several senior finance and general management positions in accountancy, investment banking, and corporate sector companies over the last 29 years. She is also the chairman of Baring Emerging Europe PLC.

Wendy Colquhoun (Non-executive Director)

Wendy Colquhoun is a partner at international law firm CMS Cameron McKenna Nabarro Olswang LLP. She has advised investment trust boards for over 25 years on advisory and transactional matters. Wendy has previously held positions at Dickson Minto and Linklaters. She is a Trustee of the Stewart Ivory Financial Education Trust and a nonexecutive director of, and Chairman of the Risk and Governance Committee for, Scottish Financial Enterprise.

Top shareholders, Board and manager holdings

The majority of HOT's shareholder base is comprised of retail investors, which collectively represented over 75% of HOT's issued share capital as at 30 September 2018 (source: company data).

Top 10 shareholders as at 31 August 2018

Name	Holding (%)
Halifax Share Dealing	15.0
Hargreaves Lansdown	9.6
Janus Henderson Investors	7.5
Alliance Trust Savings	7.3
Cazenove Capital Management	5.9
Investec Wealth & Investment	5.3
M&G Investment Management	4.4
Miton Asset Management	3.8
Interactive Investor	3.7
Quilter Cheviot Investment Management	2.2

Source: Company data

Board and manager holdings as at 31 October 2017

Name	Holding (shares)
Peter Jones (Chairman)	12,000
Malcolm King	3,200
Chris Hills	2,000
Frances Daley	2,000
James Henderson (Fund Manager)*	361,179

Source: Company data. *Composed of a beneficial interest of 80,950 shares, and a non-beneficial interest of 280,229 shares

Portfolio analysis

When considering a multi-cap strategy like HOT, we think it is first useful to remind ourselves of what the different market indices represent when breaking down the UK equity market:

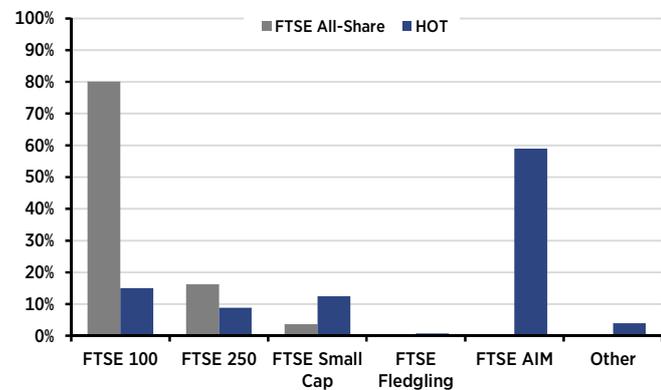
Index name	Description
FTSE All-Share	Aims to represent at least 98% of the full capital value of UK companies on the LSE’s Main Market that are eligible* for inclusion
FTSE 100	The largest 100 UK companies by full market capitalisation
FTSE 250	The next 250 largest UK companies, again by full market capitalisation
FTSE 350	The FTSE 100 + FTSE 250
FTSE Small Cap	UK companies within the FTSE All-Share not in the FTSE 350
FTSE Fledgling	All eligible companies too small for the FTSE All-Share (without liquidity requirement since not designed to be investible)
FTSE All-Small	The FTSE Small Cap + FTSE Fledgling
FTSE AIM	Shares quoted on the LSE’s Alternative Investment Market, subject to meeting eligibility criteria. Splits into the FTSE AIM All-Share (all stocks meeting free float and liquidity criteria), FTSE AIM UK 50 (the largest 50), and FTSE AIM 100 (the largest 100).
Numis Smaller Companies (NSCI)	Covers the bottom 10% of UK equities by value. The widely used NSCI ex-Investment Companies simply excludes investment companies from the universe.
NSCI +AIM	Also includes AIM stocks that meet the NSCI size limit
NSCI 1000	Covers the bottom 2% of UK equities by value
Numis Mid Cap	Covers the bottom 20% of UK equities by value, excluding the bottom 5%

Source: FTSE, Numis, CFE Research. *criteria include liquidity, free float, structure, nationality.

A point to consider here is that the AIM market, which HOT has a substantial weighting towards (illustrated in the LHS chart below), is merely a market listing classification and does not necessarily reflect the average size of companies in the index. Indeed, as of 28 September 2018 the FTSE AIM 100 index had 9 constituents with market caps over £1bn, three of which were over £3bn, whilst the median size for the FTSE All-Share was c. £670m. This highlights the overlap by market cap between the FTSE All-Share and AIM indices, and is due to a number of large, high profile companies (e.g. Fevertree Drinks and ASOS) remaining on AIM, where benefits such as taxation, lower regulatory burden and lower costs remain attractive.

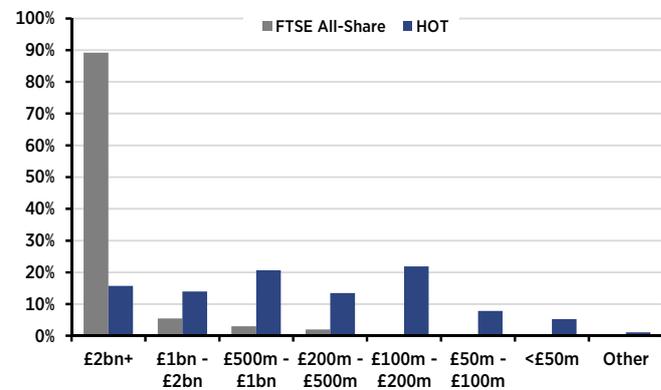
If we instead look at market cap distribution itself (rather than by index) we see that HOT’s profile has a significantly lower exposure to the mid-cap and above section of the market than the FTSE All-Share, with a smoother distribution across the small and micro-cap section of the market.

Distribution by index can skew portfolio’s market cap ...



Source: Company data as at 30 April 2018. Analysis excludes cash

Looking at distribution by market cap itself shows more balance

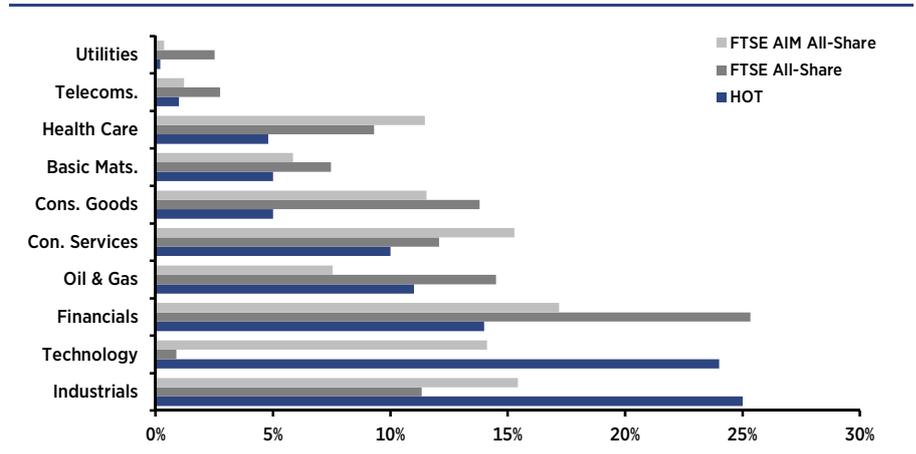


Source: Company data as at 30 April 2018. Analysis excludes cash

The team see the large-caps held in HOT as providing a risk dampening effect alongside liquidity should a portfolio shift be desirable in a short period of time. Nonetheless, the main focus is on small and mid-cap stocks, where the team seek to exploit the lack of research coverage to uncover compelling growth opportunities at relatively cheap valuations.

The focus on growth and stock picking within HOT will naturally lead to a differentiated portfolio from the market average. It is therefore of little surprise to see that HOT has an active share of 88.3% and 86.7% against the FTSE All-Share and FTSE AIM All-Share indices respectively (as at 30 September 2018). This also manifests itself in the sector breakdown, with HOT having a substantial overweight to both the industrials and technology sectors and underweight to financials, consumer goods, and health care.

HOT portfolio highly differentiated from both FTSE's All-Share and AIM All-Share indices



Source: FTSE and Company data as of 30/09/2018, CFE Research

A quick glance at HOT's top 10 holdings helps to illustrate the global nature of many of the companies, alongside the diverse niches that each are operating within.

Top 10 portfolio holdings

Holding	Weight (%)	Mkt cap (£m)	Sector	Description
Blue Prism	6.0	1,157	Technology	Global provider of application software including automation solutions
RWS	4.0	1,338	Industrials	Global provider of translation and other language support services
Serica Energy	3.3	348	Oil & Gas	Independent upstream oil and gas company mainly operating on the UK North Sea
Learning Technologies	3.2	769	Technology	Global provider of e-learning services and software licenses
Keyword Studios	3.2	867	Industrials	Global service provider to the video gaming and publishing industries
LoopUp	3.0	209	Technology	Global provider of conferencing software using data centres across the world
Tracsis	2.9	168	Technology	UK based resource allocation and scheduling software provider for projects across Europe
Johnson Matthey	2.5	5,825	Basic Mats.	Global emission control technology provider alongside chemical and precious metal divisions
HSBC	2.4	127,399	Financials	One of the world's largest global banking and financial services companies
Faroe Petroleum	2.3	553	Oil & Gas	Independent co. focusing on exploration, appraisal, and production in Norway and the UK
Total	32.8			

Source: Company data as at 30 September 2018, Bloomberg, CFE Research

Macro? What macro?

The team do not involve macroeconomic concerns in portfolio construction, only when analysing an individual company's market and backdrop. Even for stocks within the natural resources bucket, the team do not try to forecast the direction of commodity prices, instead trying to find undervalued companies with robust fundamental characteristics.

One headline that seems to be unavoidable is Brexit, and although the team have not repositioned the portfolio for any particular outcome, they maintain a watch list of stocks that have either already been impacted by the market's expectations, or those they believe will be unfairly punished if negotiations deteriorate, and should be available to purchase on a discount.

Peer group comparison

Firstly, we think it is useful to look at how HOT differs from the other strategies managed by the team, namely Lowland Investment Company (LWI), the investment portfolio of The Law Debenture Corporation (LWDB), and the open-ended Janus Henderson UK Equity Income & Growth Fund ("OEF"). There was a time where the team used to spread ideas a lot more across the different strategies, however in recent years HOT has become much more focused on growth stocks with a higher active share against the FTSE All-Share index and the larger-cap strategies as a result.

Key stats for strategies managed by the team

Ticker	HOT	LWI	LWDB	OEF
Structure	Closed-end	Closed-end	Closed-end	Open-ended
Objective	Capital growth	Capital and income	Capital and income	Income and capital
Market cap. (£m)	81	378	687	298
Discount (%)	-15.4	-4.2	-6.7	N/a
Dividend approach	Progressive	Progressive	Progressive	N/a
Yield (T12M)	2.0	3.8	3.1	4.1
Typical no. holdings	70 - 100	80 - 120	Max. 150	80 - 120
Mkt. cap bias	Small & Micro	All-Cap	All-Cap	All-Cap
Active share vs FTSE All-Share	88.3%	68.5%	64.5%	71.8%
Management fee	0.55% NAV	0.50% NAV up to £375m, 0.40% above this	0.30% NAV	0.75% NAV
Performance fee	Yes	Yes	No	No
Total fee cap	Yes - 1.5% NAV	Yes - 0.75% NAV	N/a	N/a

Source: Morningstar, Company data, CFE Research. Active share data is as at 30/09/2018.

Key differences include:

- HOT is the only one to not have an income focus, and as such has the lowest yield, whilst also trading on a substantially wider discount than LWI and LWDB
- LWDB is formed of two parts: the investment portfolio alongside the independent professional services business, which as at 30 June 2018 represented c. 15% of net assets but a disproportionately higher c. 46% of the revenue return in the financial year to 31 December 2017. Additionally, LWDB is a global equity portfolio with an overweight 55-80% allocation to the UK.
- The OEF may also invest in bonds, and whilst the portfolio currently has no fixed income holdings this has been done in small size in the past and it not expected to form a material portion of the fund. The OEF portfolio is most closely related to LWI from the closed-end funds.

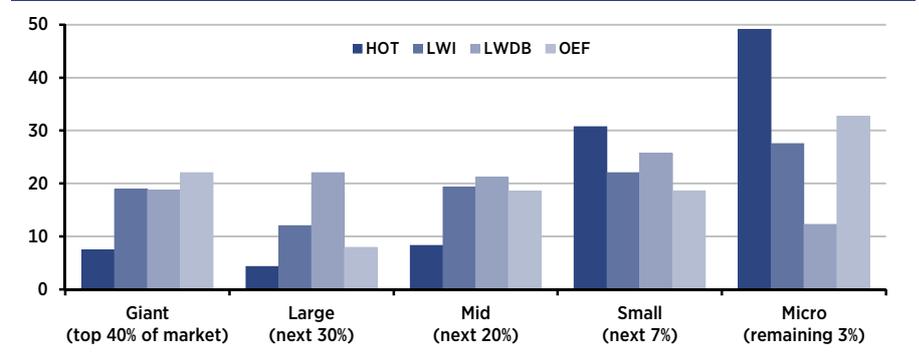
Thus, we can see that each strategy is easily differentiated by:

- Structure: OEF is the only open-ended fund, then
- Focus on UK equities: LWDB has a global equity investment portfolio alongside an independent professional services business that provides c. 40% of the income, and finally
- Market-cap bias and investment objective: HOT is mainly small and micro-cap focusing on capital growth whilst LWI is all-cap also focusing on income generation.

Looking at active share against the FTSE All-Share index, we can see that HOT is the easily the most differentiated at c. 90% active share, whilst each of the other strategies broadly sit in the 60-70% range. This cannot be simply explained away by HOT's exposure to AIM listed stocks, as we have highlighted previously HOT's c. 87% active share against the FTSE AIM All-Share index.

Notably, HOT's smaller size than all of the other strategies facilitates going further down the market-cap scale, as we can see in the chart below:

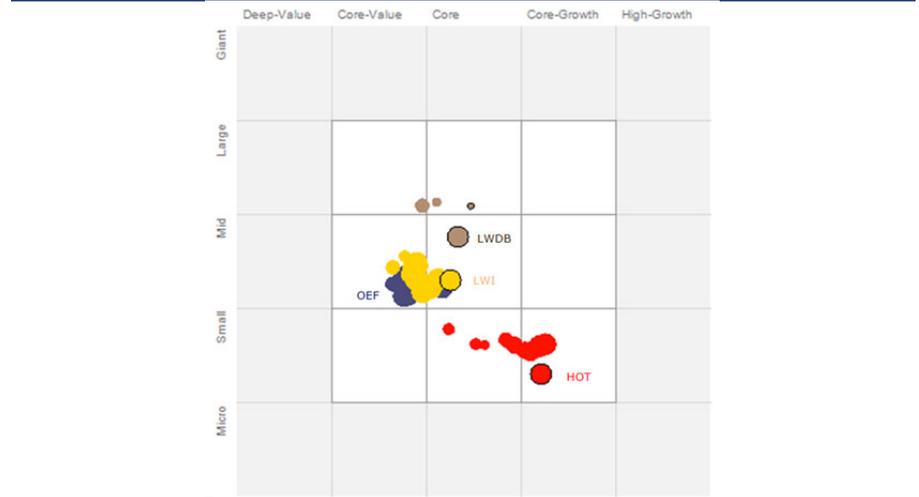
HOT stands out for small and micro allocation



Source: Morningstar, CFE Research

This can also be visualised using Morningstar's holdings-based style box tool, where we have included three years' worth of trailing data to highlight HOT's consistent differentiation in more recent periods (the larger red dots).

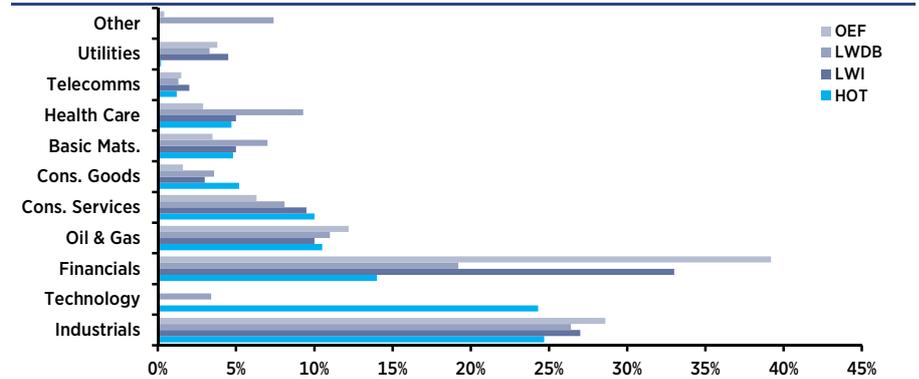
Holdings-based style trail highlights consistent differentiation of HOT vs team's other strategies



Source: Morningstar, CFE Research, covers period 07/2015 - 06/2018

Finally, looking at the sector breakdown shows a similar pattern, where HOT stands out for significant allocation to technology sector and lower financials weighting.

Sector breakdown for funds managed by the team



Source: Company data as at 31/08/2018, CFE Research

We can then take a wider look at establishing a peer group for HOT within the AIC's UK All Companies closed-end fund sector. Although it may be tempting to draw comparisons with HOT against funds within the AIC UK Smaller Companies sector given HOT's bias towards small and micro-caps, we believe this would be somewhat misleading. The key reason for this is that HOT has the flexibility to completely reallocate to the large and mid-cap segments of the market if the team wanted to. This is not possible for a company wishing to remain in the AIC UK Smaller Companies sector, where a minimum of 80% of assets must be in UK smaller company securities.

In order to narrow the AIC UK All Companies sector down:

- First, we start by removing those that are focused on mid-caps: JPMorgan Mid Cap IT, Schroder UK Mid Cap, and Mercantile IT.
- Then, those with non-conforming strategies: Crystal Amber Fund (activist investing), Sanditon IT (long/short with private equity stake in Sanditon AM), Manchester & London (global equity portfolio), Woodford Patient Capital Trust (focus on early-stage companies), and Aurora IT (a highly concentrated portfolio of 12-20 stocks).

This leaves just six peers: Artemis Alpha Trust (ATS), Baillie Gifford UK Growth (BGUK – previously the Schroder UK Growth Fund before July 2018), Fidelity Special Values (FSV), Invesco Perpetual Select UK Equity (IVPU), Jupiter UK Growth (JUKG), and Keystone IT (KIT).

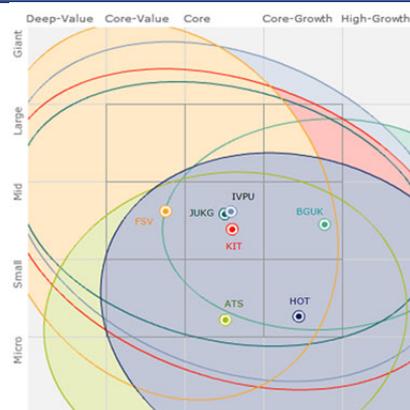
Tab 1: HOT trades on the second widest discount, closely followed by ATS

Ticker	HOT	ATS	BGUK	FSV	IVPU	JUKG	KIT
Mkt Cap (£m)	81	121	261	682	60	55	212
Discount	-15.4	-16.9	-5.0	2.8	-0.8	-1.0	-11.6
Yield (T12M)	2.0	2.2	3.5	1.8	3.9	2.4	3.8

Source: Morningstar, Bloomberg, CFE Research

Doing a similar Morningstar holding based style box for this peer group helps to highlight the diversity of strategies available. Although HOT stands out in being the only fund in the bottom right corner, we can see it is most similar to ATS in terms of market cap distribution, and BGUK in terms of growth style bias. The other peers appear relatively similar in style, with FJV's value bias being somewhat an outlier.

Holdings based style box shows HOT most similar to ATS and BGUK



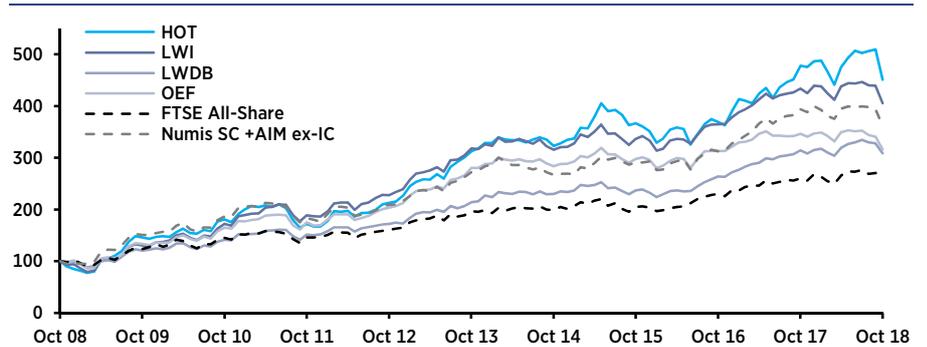
Source: Morningstar, CFE Research. Holdings range by fund between the period 30/04/2018 to 31/08/2018.

As mentioned previously, BGUK recently underwent a management change which saw the portfolio rotated away from its historical mid- to large-cap value style tilt under Schroders' management, to a small- to mid-cap and higher growth portfolio (as shown in the above chart).

Past performance

First, looking at HOT's performance against its benchmark (the FTSE All-Share index) and other strategies managed by the team shows substantial outperformance in the 10 years to 30 September 2018. We have also included the Numis Smaller Companies +AIM ex-Investment Companies index for comparison purposes, to help illustrate that HOT's outperformance cannot simply be attributed to holding smaller companies.

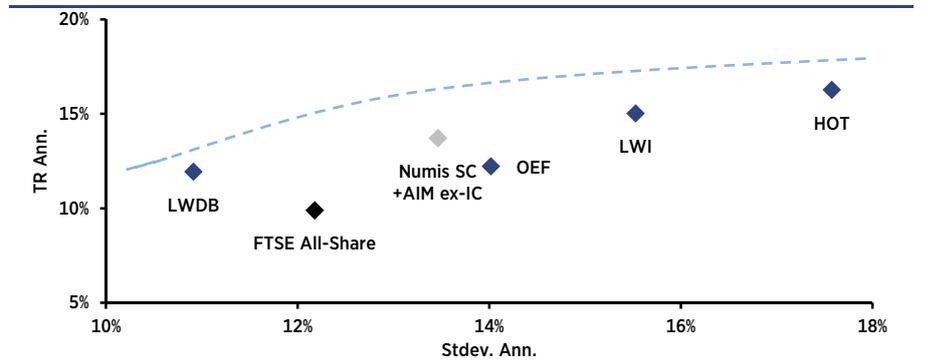
10 year returns to 31 October 2018, rebased to 100



Source: Morningstar, CFE Research. NAV total returns apart from OEF and indices where price total returns are used

However, as expected given the previous style and portfolio analysis, the higher returns achieved by HOT have come with a higher risk:

CEF strategies managed by the team form an efficient frontier around the indices



Source: Morningstar, CFE Research, calculated using monthly NAV total returns apart from OEF and indices where price total returns are used - 31/10/2008 to 31/10/2018. Efficient frontier line is for illustrative purposes only.

*R-squared is a statistical measure that represents the proportion of the variance for a dependent variable that's explained by an independent variable. In investing, R-squared is generally considered the percentage of a fund or security's movements that can be explained by movements in a benchmark index.

Source: investopedia.com

We then also look at the similarity of returns (as given by R-squared*) and see that HOT has the lowest R-squared against the FTSE All-Share index, whilst its similarity to the smaller-cap Numis SC +AIM ex-IC index is not correspondingly higher (it is in fact roughly the same as for LWI and OEF).

Looking at R-squared highlights HOT's differentiated performance profile

	HOT	LWI	LWDB	OEF	FTSE All-Share	Numis SC +AIM -IC
HOT	1.00	0.79	0.64	0.77	0.52	0.82
LWI	0.79	1.00	0.86	0.93	0.76	0.83
LWDB	0.64	0.86	1.00	0.82	0.87	0.71
OEF	0.77	0.93	0.82	1.00	0.71	0.82
FTSE All-Share	0.52	0.76	0.87	0.71	1.00	0.63
Numis SC +AIM ex-IC	0.82	0.83	0.71	0.82	0.63	1.00

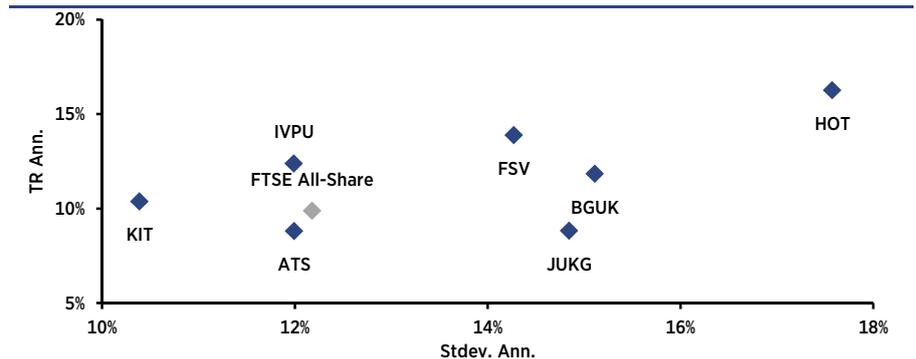
Source: Morningstar, CFE Research, calculated using monthly NAV total returns apart from OEF and indices where price total returns are used - 31/10/2008 to 31/10/2018.

Although the Numis index has a higher R-squared than the FTSE All-Share against HOT, we believe that without using a more complex composite benchmark, the FTSE All-Share better reflects HOT's unconstrained ability to invest across the market-cap spectrum, given the FTSE All-Share encompasses small to mega-cap stocks.

This may be unsatisfactory given HOT's performance fee is calculated against the FTSE All-Share despite having a lower explanatory power than the Numis index. Whilst it may be the case that a composite benchmark would better represent HOT's investible universe, the next problem would be which weightings to apply. Would a 50/50 split be appropriate? Or would a composite benchmark impose arbitrary market-cap guidelines for a strategy designed to be an unconstrained approach to UK equity investing.

Switching to comparisons against the CEF peers we identified earlier, we can see a similar profile; HOT has achieved the highest annualised NAV total return, again with a higher risk profile.

CEF peer group risk/return comparison places HOT in a similar position

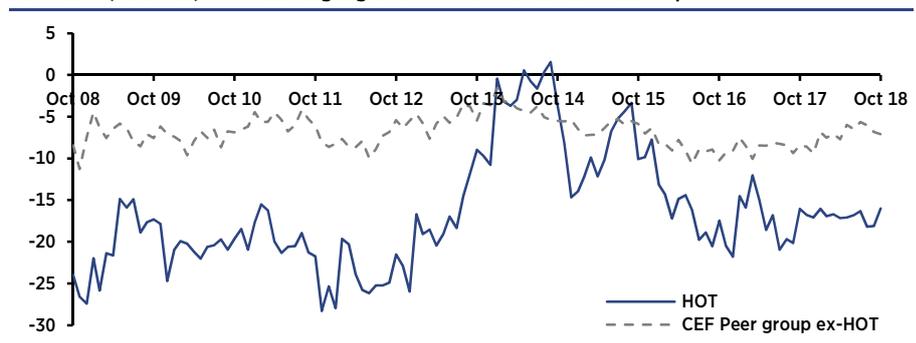


Source: Morningstar, CFE Research, calculated using monthly NAV total returns apart from OEF and indices where price total returns are used - 31/10/2008 to 31/10/2018.

A caveat here for BGUK is the recent change in management group, with Baillie Gifford having been appointed in July 2018 as highlighted previously. Although some of the other funds within the peer group may have changed named fund manager during the ten year period, these changes do not appear to have had such a step-change impact on the portfolio's style.

Then looking at discounts we can see that HOT sits on a substantial discount, being the second widest discount as highlighted on p.13, and also substantially wider than the peer average (excluding HOT) of -5.4%.

Discounts (cum-fair) over time highlight HOT's substantial discount to peers



Source: Morningstar, CFE Research. Data covers 10 years to 31/10/2018. Peer group includes ATS, BGUK, FSV, IVPU, JUKG, KIT.

Further, HOT has often traded on this notable discount to comparable peers since 2015. This is despite the strong track record we have already highlighted, and therefore we believe HOT's discount presents an attractive entry opportunity to a differentiated, closed-end UK equity fund that is well suited to long-term investors.

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Risk	Note
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Source: CFE Research

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