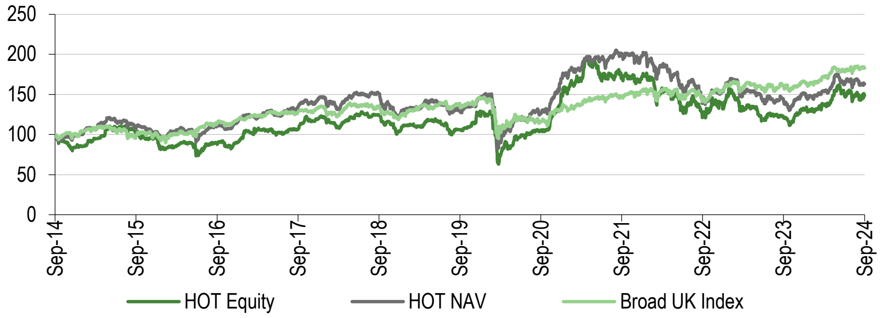
Henderson Opportunities Trust

Taking AIM at the opportunity

Investment trusts
UK all-cap equities

With a focus on long-term growth, Henderson Opportunities Trust (HOT) seeks investment opportunities across the breadth of the UK market. This includes a strong bias towards smaller and earlier-stage companies with significant potential to become tomorrow's leading British businesses. HOT's managers, James Henderson and Laura Foll, from Janus Henderson Investors, note that these smaller companies are under-owned, under-researched and lowly valued, and that their extended period of underperformance relative to larger peers should be seen as a pent-up opportunity. With interest rates on a downward path and the UK economy performing better than had been expected, mid- and small-cap company relative performance has begun to improve, and that of HOT as well.

Seeking tomorrow's leaders



Source: Janus Henderson Investors

Smaller companies have begun to outperform

While HOT seeks to balance smaller company volatility with a high level of diversification and a meaningful exposure to growing larger companies, this has not offset the three-year performance drag of smaller company underperformance. However, there are early indications that the tide may be turning, with lowly valued smaller companies likely to benefit more from lower interest rates and a robust UK economy. Since HOT's FY23 year-end (in October 2023), small- and mid-cap stocks have risen strongly and have outperformed their larger peers. This is reflected in HOT's performance, even as AIM-listed stocks (c 40% of the portfolio) have continued to lag. In the 11 months to end-September HOT's NAV total return was 20%, around two percentage points ahead of its broad UK market benchmark, despite September being a noticeably weaker month for the AIM market.

Speculation that inheritance tax (IHT) relief on AIM stocks may be removed in the October UK budget is weighing on the market, although this is far from certain and would run counter to the government's desire to foster innovation, investment and growth in the UK economy. The managers argue that whatever the outcome, they are invested in well-managed, growing companies, which are not reliant on IHT exemption for their future success, and that this will drive medium-term performance. As we discuss in this note, the managers argue that IHT concerns, having further depressed valuations in an unloved area of the market, should be seen as an opportunity.

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3 October 2024

Price		**215p**
Market cap		**£85m**
AUM		**£108m**
NAV*		239.1p
Discount to NAV		10.1%
*Including income. As at 2 Oct 2024.		
Yield		3.3%
Ordinary shares in issue		39.5m
Code/ISIN		HOT/GB0008536574
Primary exchange		LSE
AIC sector		UK All Companies
52-week high/low	236.0p	171.4p
NAV* high/low	260.0p	205.1p
*Including income.		
Net gearing*		8%
*As at 31 August 2024.		

Fund objective

Henderson Opportunities Trust aims to achieve capital growth in excess of the broad UK stock market from a portfolio of UK investments. Stock selection is not constrained by the benchmark and there are no limits by sector or market capitalisation. Therefore, the portfolio will differ materially from the index.

Bull points

- Opportunities across all market segments and market capitalisations.
- Disciplined approach to stock selection, valuation and portfolio diversification.
- Experienced and stable management team with consistent long-term strategy.

Bear points

- Relatively small size means HOT could be overlooked by some investors.
- High portfolio weighting in smaller and earlier-stage companies, where liquidity can be thin and returns can be volatile.
- Investor appetite for UK smaller companies remains subdued.

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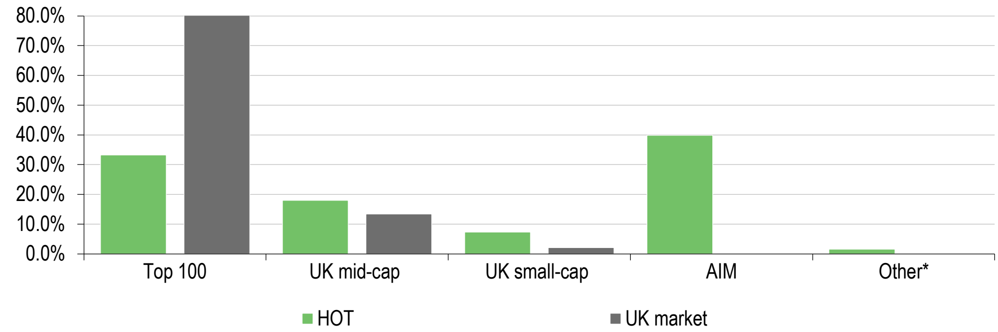
Targeting growth with stability

HOT is focused on providing long-term growth, in excess of the broad UK market, with a secondary objective to grow dividends over time. The trust's all-cap focus gives it the flexibility to seek growth opportunities from across the market, including companies listed on AIM, underpinned by a value-driven style that invests in out-of-favour or under-researched companies. At its core, the HOT portfolio is a blend of what could be tomorrow's leading British companies, across a wide range of activities and market caps, at different stages of their lifecycle, from promising early-stage businesses to established businesses reinventing themselves.

HOT's truly all-of-market investment approach is complementary to a wider range of more mainstream offerings, seeking to provide long-term growth, mainly from smaller and mid-sized (SME) companies, while balancing the risks, through a high level of stock diversification (c 90 holdings) and the 'ballast' of meaningful exposure to larger, more established businesses. For many investors, this would be difficult to replicate, and HOT's permanent capital base is ideally suited to the long-term, patient approach required.

Exhibit 1: HOT versus the broad UK equity market by segment



Source: Henderson Opportunities Trust, 30 April 2024. Note: *Other includes unlisted equities.

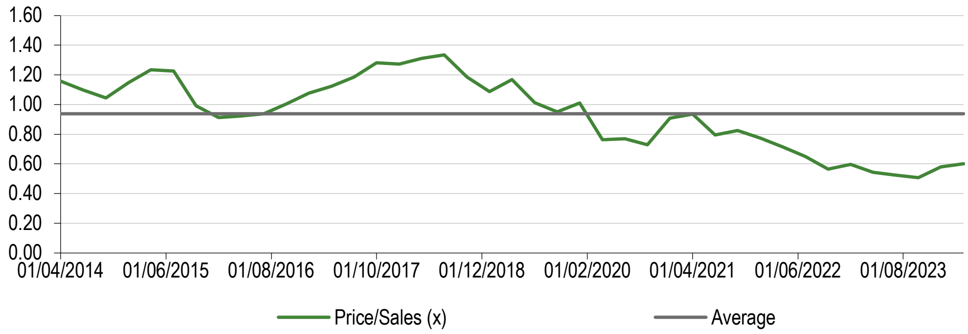
The trust has been managed consistently for many years by two experienced investment managers, James Henderson (since 2007) and Laura Foll (since 2018) of Janus Henderson Investors (JHI). In turn, they are supported by the broader resources of the JHI equity team.

The investment opportunity

The investment managers believe the recent relative outperformance of SME companies does not reflect their potential, following a period of sustained underperformance. In particular they highlight:

- **The valuation of UK equities is low** in historical and relative terms, and for smaller companies even more so. On a price to sales (P/sales) ratio (our preferred method) smaller companies are trading at the very low end of their range in absolute terms and versus their larger peers. The HOT portfolio P/sales ratio of c 0.6x is well below its 10-year average of over 0.9x.

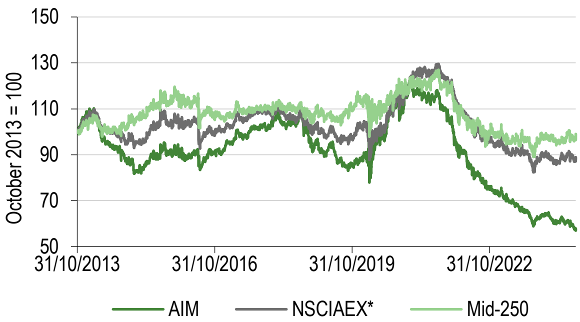
Exhibit 2: HOT portfolio price to sales ratio



Source: Henderson Opportunities Trust

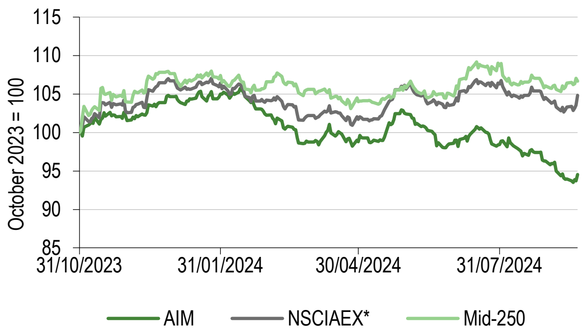
- **There are signs that the divergent share price performances of large versus smaller companies may have come to an end.** Leaving aside the 2020 recovery from COVID-19 lockdowns, the market trend since around 2016 has seen the very largest companies significantly outperform smaller companies, especially those with more cyclical exposure to the UK economy. There are now increasing signs of a recovery in the absolute and relative performance of mid-cap companies and many smaller companies, although the gains in AIM-listed stocks have continued to lag.

Exhibit 3: Indices' performance relative to broad market over 10 years



Source: LSEG Data & Analytics. Note: *Numis Smaller Companies Index plus AIM and excluding investment trusts.

Exhibit 4: Indices' performance relative to broad market since October 2023



Source: LSEG Data & Analytics. Note: *Numis Smaller Companies Index plus AIM and excluding investment trusts.

- **Increasing takeover activity underpins valuations.** While the valuation opportunity in smaller companies has not yet been widely recognised in the market, low valuations are being increasingly underpinned by takeover activity. For HOT in particular, this included the yet-to-complete cash bids for IDS, owner of Royal Mail, and for the software company IQGeo, both at very significant premiums to the prevailing share prices. The agreed acquisition of IDS is at a 70% premium to the pre-bid price. IQGeo was acquired at a 48% premium to average price over the preceding 12-months and a 19% premium to the price immediately before the bid.
- **The UK economy is performing better than had been expected.** Smaller companies are typically more exposed to the UK economy than larger companies. GDP has recovered well from the short technical recession (two consecutive quarters of negative GDP growth) at the end of 2023. Preliminary data show 0.6% growth in the three months to June following 0.7% in the three months to March. Although the Bank of England expects growth to slow in the second half of the year, growth is overall stronger than many had expected. Market consensus is that interest rates (cut by 25bp to 5.0% in August) will be cut by a further 50bp by year end.

- **Progressive dividend policy.** While HOT is primarily focused on growth, the trust does seek to grow dividends over time. Over the past five years, DPS has increased by an average 11% pa. In FY23, DPS increased 4.4% to 7.1p (35.5p prior to a 5:1 stock split that was effective in March 2024), and aggregate dividends for the first three quarters of FY24 of 4.5p are in line with same period of FY23. HOT's 3.3% yield is above the average of its peer group.

Performance appears to be turning a corner

We reported on HOT's outperformance of its benchmark in the six months to 30 April (H124) in our last note, and this has continued since. HOT's H124 NAV total return was 18.6% compared with 14.2% for the benchmark, while the share price total return was 25.5%. For the 10 months to end-August 2024, HOT's NAV total return is 28.0% compared with the benchmark 19.7%, and its share price total return is 33.0%. Stock selection has had a positive impact on performance in the current financial year (FY24), including strong performances from larger companies (the banks, Rolls-Royce, Marks & Spencer). Some of the key detractors of performance have been the North Sea oil and gas exploration companies, Serica Energy and Jersey Oil & Gas. On top of an extension of the 'windfall' tax, the feared removal of capital allowances in the October budget would be a significant headwind to their operations.

Portfolio positioning by market cap segment has been mixed, with mid-cap stocks and selected smaller companies outperforming but the AIM index lagging.

Exhibit 5: HOT's performance versus indices to 30 September 2024

Cumulative returns	3m	6m	YTD**	1y	2y	3y	5y	10y
Share price total return	(2.0%)	5.5%	29.0%	17.5%	19.7%	(15.6%)	36.4%	45.0%
NAV total return	0.6%	3.3%	20.3%	9.6%	11.6%	(20.4%)	20.9%	59.3%
Benchmark total return	2.3%	6.1%	18.2%	13.4%	29.1%	23.9%	32.2%	83.6%
NSCIAEX*	3.3%	8.5%	24.2%	15.0%	18.7%	-13.2%	22.9%	65.0%
AIM	(2.7%)	0.6%	11.0%	3.9%	(4.7%)	(37.4%)	(9.1%)	13.4%

Source: LSEG Data & Analytics, Morningstar, Edison Investment Research. Note: *Numis Smaller Companies Index plus AIM and excluding investment trusts. **The 11-month period from the end of the FY23 financial year at 31 October 2023 to 30 September 2024.

The impact of the relative weakness of SME companies, particularly those listed on AIM, still weighs heavily on HOT's otherwise strong performance record. Although not apparent in standard performance data shown in Exhibit 5, as we showed in our May 2024 review, looking closely at the 10-year period to April 2024 (H124), performance for the first seven years was very strong, compared with an even more significant period of underperformance over the more recent years. During the first seven-year period, HOT's NAV total return of 97% was more than twice that of the 42% delivered by its benchmark. Smaller companies were outperforming during the period, but HOT's performance was still well ahead of the Numis Smaller Companies Index including AIM but excluding investment trusts (NSCIAEX)[1] return of 76%. Throughout the 10-year period there was no material change in HOT's strategy and aims, or in the consistent approach applied by the managers, which includes running a diversified portfolio to manage risk. The overriding factor in the underperformance of recent years has been weakness of SME stocks and AIM-listed stocks in particular. Stock selection had a modest positive impact in the period.

[1] The Numis Smaller Companies Index (NSCI) is the main index used as a smaller company benchmark. It targets the bottom 10% of the main UK market by value. The NSCAIEX includes all the constituents of the NSCI and all companies listed on AIM that fall below the NSCI size cut-off.

Exhibit 6: Relative performance changed in 2021

Cumulative total returns	Three years to H124	Seven years to H121
HOT share price	-17.1%	103.2%
HOT NAV	-20.8%	96.8%
Benchmark	17.5%	41.5%
NSCIAEX	-17.9%	75.5%
AIM	-35.2%	70.8%

Source: LSEG Data & Analytics, Edison Investment Research

IHT concerns weigh on AIM in the near term

In our May review, we discussed the relative weakness of the AIM market in recent years but that the market continues to be home for many success stories. Over the past five years, the top performers within the portfolio were all AIM-listed stocks (Ceres Power, IQGeo, Learning Technologies and Vertu Motors).

The inheritance tax break on qualifying AIM shares means that these can be passed on, tax free, if held for at least two years before an individual dies. There is no doubt that it has attracted funds into the AIM market and that its removal would likely create near-term weakness in certain shares or, at the very least, market volatility. A number of investment funds exist specifically to benefit from the inheritance tax breaks on AIM, alongside direct equity investments from founders, families and individual investors. Ironically, if IHT relief were abolished and significant divestments were made, potential share price declines would substantially limit the amount of tax revenue that may otherwise have been expected. More fundamentally, the removal of IHT relief risks reduces access to growth capital for smaller, entrepreneurial companies and undermines the government's aim to reinvigorate the economy.

Investors have been alert to the potential tax change since the UK general election in July and while the outcome remains uncertain, the AIM market's performance in recent weeks suggests that some investors have decided to realise profits ahead of the budget whereas others have pulled back from investment. Henderson and Foll note that they are invested in stocks where either the company's future success or HOT's long-term performance is not dependent on IHT exemption. They argue that these are good businesses in their own right and that medium-term valuations will be determined by achieving sustainable and growing profits. Where access to capital is an issue, they mostly have strong governance and reporting standards in place that would allow a transition to the main market.

Portfolio positioning

The market cap weightings shown in Exhibit 1 are the output of the investment process rather than a target in themselves. The portfolio managers are focused on long-term returns, with investment decisions driven by a selective, bottom-up approach. They are looking for the best capital growth opportunities, with no specific sector or size remits, and these are most often identified by the managers among smaller companies, particularly those at an early stage.

In monitoring the positioning of the trust, the managers look deeper than the basic distinctions of small, mid and large cap, instead grouping their holdings under one of six classifications or 'buckets'. The stocks within each of these, with the exception of resources, are expected to generate above-average earnings and capital growth over time. To clarify the process even further, the buckets are grouped under the two broad headings of 'tomorrow's leaders' and 'stabilisers'. As the name suggests, it is among 'tomorrow's leaders' that the managers expect to see the strongest growth over time. Balancing the expected returns with the risks involved, the managers select a diversified list of companies across all stages of the growth cycle. Tomorrow's leaders are complemented in the portfolio by investment in stabilisers. These are often larger, mature but still growing businesses, with more predictable cash flows, as well as natural resources companies that provide a hedge against unexpected developments in commodity markets. We provide details of each bucket in our May review.

'Tomorrow's leaders' accounted for 60% of the portfolio at the end of April (H124) when the last full breakdown was published, and the managers have indicated that this has since increased. This is the area in which they see the best opportunities, and where sentiment has been weakest and valuations are more attractive.

Exhibit 7: Portfolio positioning across buckets

	Apr-24	Oct-23	Apr-23	Oct-22	Apr-22	Oct-21
	H124	FY23	H123	H222	H122	H221
SMID compounders (20–40%)	28%	27%	26%	25%	23%	24%
Growth – small cap (20–40%)	13%	13%	16%	17%	18%	20%
Early stage (0–20%)	6%	6%	7%	7%	10%	13%
Recovery/special situations (0–30%)	13%	16%	14%	10%	11%	11%
Tomorrow's leaders	**60%**	**62%**	**63%**	**59%**	**62%**	**68%**
Growth – large cap (10–30%)	29%	25%	24%	24%	22%	21%
Natural resources (5–15%)	11%	13%	13%	17%	16%	11%
Stabilisers	**40%**	**38%**	**37%**	**41%**	**38%**	**32%**
Portfolio total	100%	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Henderson Opportunities Trust

At the end of August (the last published factsheet), four of the top 10 holdings were AIM stocks, with three banks (Barclays, Standard Chartered and HSBC), Marks & Spencer (in the 'recovery' bucket), supermarkets group, Tesco, and miner Rio Tinto accounting for the balance. In aggregate, these 10 holdings accounted for c 26% of the total portfolio, down from c 30% at the end of April (H124). The reduction in the top 10 weighting includes profit taking in strong outperformers such as Barclays and Rolls-Royce, funding the further portfolio migration towards smaller companies including, within the top 10. Rolls Royce was the second largest portfolio holding in April with a weighting of 3.4% but by August this had been reduced to less than 1%. an increased holding in Marshalls. As a measure of the diversification of smaller company holdings, the other 80 holdings were on average 0.9% of the portfolio each.

The AIM stocks within the top 10 holdings may be less well known and are a diverse group, by activity and size (market caps shown are as at the date of publication):

- Springfield Properties (market cap: c £125m) is a leading Scottish builder of both private and affordable housing. The company has a strong track record of growth, but its shares significantly de-rated as interest rates rose and the housing market slowed. The company is well positioned for future growth with a sizable land bank.
- Boku (market cap: c £475m) is a mobile payments company that allows its customers to charge for their services via an individual's mobile bill. The company is growing rapidly and is establishing itself globally, with Google, Meta and Amazon among its customer base.
- Cohort (market cap: c £370m) provides services to customers in defence, security and related markets. It has been held in the trust for some time but moved into the top 10 holdings as a result of its strong performance. The investment managers remain positive about the company.
- Next 15 (market cap: c £450m), is a marketing and PR company with a focus on the faster-growing technology industry. The shares weakened very significantly in September following unexpected news that the contract with its largest customer had not been renewed. The shares have positively contributed to HOT's performance over the past several years and the managers believe that despite the setback, the current share price is more than justified by the company's other business, and would particularly benefit from a pick-up in spending activity by its technology customer base.

Exhibit 8: Top 10 holdings

	Market segment/index	Main activity	Portfolio weight (%)			Change in weight since (pp)		'Bucket'
			Most recent*	H124	FY23	H124	FY23	
			Aug-24	Apr-24	Oct-23	Apr-24	Oct-23	
Springfield Properties	AIM	House building	3.4	3.1	1.9	0.3	1.5	SMID
Boku	AIM	Mobile payments	2.9	3.0	3.2	-0.1	-0.3	Growth small cap
Standard Chartered	Top 100	Banking	2.8	2.6	2.7	0.2	0.1	Large cap
HSBC	Top 100	Banking	2.7	2.9	2.8	-0.2	-0.1	Large cap
Cohort	AIM	Defence & security technology	2.6	2.2	1.7	0.4	0.9	SMID
Barclays	Top 100	Banking	2.4	4.8	3.6	-2.4	-1.2	Large cap
Marks & Spencer**	Top 100	Clothing, home & food retailer	2.3	2.0	1.9	0.3	0.4	Recovery
Tesco**	Top 100	Food retail	2.2	1.9	2.0	0.3	0.2	Large cap
Rio Tinto	Top 100	Metals & mining	2.2	2.6	2.9	-0.4	-0.7	Natural resources
Next 15	AIM	Marketing and PR	2.1	2.5	2.5	-0.4	-0.4	Growth small cap
Total top 10* **			**25.6**	**30.5**	**29.6**	**-4.9**	**-4.0**	

Source: Henderson Opportunities Trust, Edison Investment Research. Note: *Latest split available, as at 31 August 2024. **Held at 30 April 2024 but not in top 10. ***Actual top 10 weighting at 30 April 2024 and 31 October 2023, and does not equal sum of individual holdings above.

Recent portfolio investments include:

- A new position in Entain (a UK 100 stock with a market cap of c £5bn), where the managers believe the valuation does not reflect its exposure to the fast-growing US gambling market. US gaming market deregulation has been a key driver of the strong performance of Flutter Entertainment, also a HOT holding. Flutter is a much larger company with a market cap in excess of £30bn and has been part of the portfolio 'ballast' offering both liquidity and growth.
- Additions to the existing position in Oxford Nanopore, a genetic sequencing specialist with a market cap of c £1.5bn. The managers considered that the steep de-rating of the shares over the past year fails to take account of the company's increasing sales diversification, beyond the life science research tools market (where research budgets are under pressure) and towards more applied industrial, clinical and bio-pharma end-uses.
- Additions to the position in STV (Scottish version of ITV), with a market cap of c £115m, where the managers consider that the quality of the company's production business is not reflected in the valuation, while free to air advertising has been recovering this year.
- A new position in Sainsbury's, a UK 100 company with a market cap of almost £7bn, which has re-set its price competitiveness relative to the discounters and is back winning market share, at a reasonable valuation with an attractive yield.

The portfolio positioning by sector is also a by-product of stock selection rather than a target. The significant overweighting to industrials reflects the investment managers' assessment of the upside potential of more domestically focused, cyclical businesses where the valuations fail to capture the longer-term potential from operational gearing and re-rating. The recent reduction in the industrials weighting primarily reflects the profit-taking in Rolls Royce while the increase in the consumer discretionary weighting includes the investment in Entain as well strong performances from existing holdings such as Flutter and Gym Group.

Exhibit 9: Portfolio sector weightings (%)

	Most recent	H124	FY23	Index weight	Active weight	Change in portfolio weight since:	
	Aug-24	Apr-24	Oct-23	Aug-24	Aug-24	Apr-24	Oct-23
Industrials	26.2	29.4	26.6	12.1	14.1	-3.2	-0.4
Financials	19.4	20.5	20.6	24.5	-5.1	-1.1	-1.2
Consumer discretionary	17.3	14.7	19.0	11.0	6.3	2.6	-1.7
Technology	9.1	8.4	8.6	1.3	7.8	0.7	0.5
Energy	6.8	8.3	9.2	10.2	-3.4	-1.5	-2.4
Basic materials	5.8	6.6	6.9	6.3	-0.5	-0.8	-1.1
Healthcare	5.2	4.3	4.9	12.7	-7.5	0.9	0.3
Consumer staples	5.5	3.9	2.0	14.4	-8.9	1.6	3.5
Telecommunications	1.2	0.8	1.1	1.2	0.0	0.4	0.1
Real estate	3.5	3.1	1.2	2.6	0.9	0.4	2.3
Utilities	0.0	0.0	0.0	3.8	-3.8	0.0	0.0
Total	**100.0**	**100.0**	**100.0**	**100.0**			

Source: Henderson Opportunities Trust, Edison Investment Research

Peer group comparison

HOT is a member of the AIC's UK All Companies sector, comprising seven member trusts of which HOT is the smallest. Despite HOT's modest size, its ongoing charges are in line with the group average, and despite its focus on capital growth, dividend growth has been strong and HOT provides the second highest yield in the sector.

Among the sector constituents, there is undoubtedly overlap between investment strategies, although HOT is the only trust that is truly UK and truly all-cap.[2]

For the reasons discussed above, HOT's exposure to smaller companies, and AIM-listed stocks in particular, has significantly affected its short-term performance versus this diverse peer group and this has fed through to the long-term performance data. The trust's discount to NAV is nonetheless broadly in line with the simple average of the peer group.

Exhibit 10: Selected peer group*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Henderson Opportunities Trust	**84.9**	**8.5**	**(20.3)**	**19.2**	**59.2**	**1.0**	**No**	**(9.6)**	**107**	**3.3**
Artemis Alpha Trust	128.2	27.5	0.5	31.8	46.3	1.1	No	(7.4)	97	1.7
Aurora	187.6	19.2	23.9	50.5	85.8	2.0	Yes	(10.9)	88	1.4
Baillie Gifford UK Growth Trust	252.6	17.2	(6.9)	17.6	51.4	0.7	No	(14.3)	108	3.2
Fidelity Special Values	1,009.6	17.7	25.0	50.4	131.8	0.7	No	(8.1)	109	2.8
Mercantile	1,844.0	21.0	0.8	34.1	119.9	0.5	No	(11.0)	117	3.2
Schroder UK Mid Cap	211.6	16.6	(3.4)	25.9	86.6	1.0	No	(11.9)	112	3.3
Simple average	**531.2**	**18.2**	**2.8**	**32.8**	**83.0**	**1.0**	**-**	**(10.5)**	**105**	**2.7**
HOT rank in peer group	**7**	**7**	**7**	**6**	**5**	**3**	**-**	**3**	**5**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance as at 2 October 2024 based on cum-fair NAV. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

2 Schroder UK Mid Cap is a mid-cap specialist, while Mercantile invests in small- and mid-cap companies. Aurora, with a concentrated portfolio of 15–20 stocks, and Baillie Gifford UK Growth Trust both have a mid-cap bias (c 50% or over), while Artemis Alpha Trust and Fidelity Special Values both have significant (c 20–30%) non-UK holdings.

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