There were once good reasons for this trust's 34pc discount – but not any more

Questor
Trust Bargains
Richard Evans

Things have changed drastically at Tetragon Financial. It's simply mispriced

A RECURRING theme in this column involves trusts that trade at a discount because of perceptions formed in investors' minds many years ago – perceptions that no longer reflect reality.

This week's tip, Tetragon Financial, which yields a generous 5.5pc, trades at a discount of 34pc and there are several reasons to expect that discount to narrow.

First is that the portfolio owns a diversified range of assets that should move independently of the stock market. It has 21pc of its money in hedge funds, 8pc in property funds, 8pc in direct investments, 23pc in cash awaiting investment opportunities and 19pc in various asset management firms involved in running some of Tetragon's own portfolio. The remaining 21pc is in highly esoteric assets called "CLO equity".

Some investors will associate the abbreviation CLO (collateralised loan obligation) with the excesses seen before the financial crisis, although Questor understands that these particular assets performed well during and after the crisis.

Tetragon Financial
Buy
Diversified portfolio, lack of correlation with stock market, 5.6pc yield

When Tetragon floated (in Amsterdam) in 2007 the fund was much less diversified, with a much larger holding in this CLO equity. In the years that followed there were a couple of developments that left a bad taste in investors' mouths, the memory of which probably weighs on the shares today, even though things have now changed for the better.

The first was a write-down in the value of CLOs at the time of the crisis, followed by a strong recovery over the following years. This in itself was unexceptional, but the upwards revaluation triggered the payment of a large performance fee to the managers. Performance fees are often structured to avoid this kind of seemingly undeserved payment but in this case the fee was contractually due.

The second controversial aspect of Tetragon's history was its purchase, in 2012, of Polygon, the firm from which Tetragon originated. Polygon was owned by Reade Griffith and Paddy Dear, the managers of Tetragon, and shareholders in the trust could not vote on the deal as their shares were (and are) non-voting.

Tom Treanor of Asset Value Investors, which runs the British Empire investment trust, a shareholder in Tetragon, said: "As a 'related-party' transaction on which shareholders could not vote, and with payment made in deeply discounted shares in Tetragon, suspicions were understandably heightened."

But he added: "Subsequent growth makes the transaction price appear reasonable today, if not obviously cheap. More importantly, the deal sowed the seeds of Tetragon as it stands today, leading to a more diversified investment portfolio, an asset management platform and – crucially – a much greater alignment of interest given management's greatly increased stake in Tetragon."

That stake arose because Griffith and Dear were paid for their Polygon holdings in Tetragon shares.

The pair, and other members of the management team, now own about 25pc of the trust between them.

"Their increasing stake has been accompanied by a perhaps unsurprising new interest in tackling the company's wide discount," Treanor added. "Management has appointed two new specialist investment trust brokers and joined the Association of Investment Companies.

"They have marketed the company much more extensively and, in late 2015, added a secondary listing in London.

"More tangibly, excess capital has been returned to shareholders via five separate tender offers over the past five years, and the dividend has grown by 52pc over that period."

Treanor concluded: "While the lack of voting rights and fee structure mean that Tetragon should trade on a discount, we contend that the current level is too wide and reflects the market's perception, having failed to keep pace with the changes in alignment of interest and management behaviour. While today's discount of 34pc is materially less than the near-50pc of mid-2016, it is significantly wider than the five-year low of 20pc.

"Tetragon offers low correlation to elevated equity markets and a strong track record, while investors are being paid to wait (via the 5.5pc yield) for a re-rating which should be helped over the long term by a flotation of the asset management business."

Questor says: buy
Ticker: TFG
Share price at close: 12.75p

Key numbers

- **Market value: £1.2bn**
- **Year of listing (London): 2015**
- **Discount: 34pc**
- **Ave discount over past year: 35pc**
- **Yield: 5.5pc**
- **Most recent year's dividend: 67 US cents**
- **Gearing: nil**
- **Annual charge: 1.64pc**