AVI Global

AGT seeks companies with high-quality growth assets trading at a discount to fair value...

Update
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Summary

AVI Global Trust (AGT – previously British Empire Trust) seeks to generate capital growth for investors through investment in a reasonably concentrated portfolio of listed companies whose shares trade at a discount to the managers' estimate of fair value.

Under current manager Joe Bauernfreund, who took over in 2015, AGT has evolved its investment strategy, looking to increase portfolio concentration, utilise attractive borrowing rates on long-term debt, and place a greater emphasis on identifying a catalyst for value realisation (amongst other factors).

Holdings can be categorised as either: 1) closed-ended funds, 2) family-backed holding companies, or 3) asset-backed special situations, which currently consists primarily of Japanese cash-rich operating companies. The exposure to Japan has been gradually increasing in recent years, as AVI believes there is a substantial investment opportunity in their investment strategy in this area, so much so that they launched a separate investment vehicle focussing solely on this opportunity.

Whilst focussed on accessing high-quality assets, the managers of AGT are cognisant of the price they pay for these holdings and look to acquire them at substantial discounts to their assessment of fair value. Presently, the look-through double discount to 'fair value' stands at c. 50% (as at 30/04/2020); as discussed in the **Portfolio** and **Performance** sections, this is anomalously wide relative to AGT's history. Although past patterns do not always repeat, previous instances where the double discount reached this level tended to lead to periods of outperformance.

Gearing has been tactically utilised in recent months, and the team tell us the recent market sell-off has created new buying opportunities in high-quality assets.

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Analyst's View

We think the recent indiscriminate sell-off in markets should create opportunities for precisely this sort of strategy. Indeed, the move to an unprecedentedly wide double-discount within AGT would suggest to us the existing holdings themselves likely offer significant relative and absolute upside in the coming months, as discussed under **Performance**. Added to the tactical flexibility that the recent increase in **Gearing** has afforded the team, this would seem a potentially attractive entry point. This perhaps needs to be caveated; we do not know the full economic impact of the pandemic, or what form the impact will have. If the effects prove transitory, and we see a rapid return to equity markets from capital 'on the sidelines', AGT will probably not be the **immediate beneficiary in our view**, as previous winners and the largest and most liquid stocks are likely to maintain momentum. However, Joe's move to tilt the portfolio tactically towards more liquid holdings should offset this somewhat as these holdings should prove beneficiaries and afford the opportunity to build exposure to some of the strongest long-term opportunities.

Strategically, the long-term opportunity set looks attractive. The move to a more concentrated strategy, with a greater emphasis on long-term compounding opportunities, should help the managers to catalyse improvements in shareholder returns. Short-term fluctuations on unforecastable macro variables mean immediate upside from discount narrowing should not be assumed, but as an entry point the double discount suggests attractive valuations.

BULL
Very wide double discount
Relatively idiosyncratic return profile offering diversification to portfolios
Exposure to an array of otherwise hard-to-access, high-quality opportunities

BEAR
Positive sensitivity to falling sterling has been a tailwind, but could reverse
Illiquid nature of many closed-ended holdings makes discounts vulnerable to market reversals
High level of KID RIY

Portfolio

AVI Global Trust (AGT) – previously British Empire Trust (BTEM) – invests in listed equities around the globe, focussing on under-researched and overlooked companies. Managed since 2013 by Joe Bauernfreund (who was appointed sole manager in September 2015), AGT has been operating for c. 130 years.

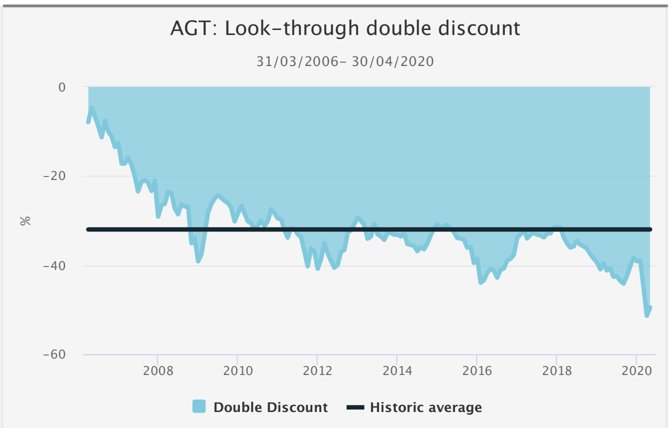
Joe seeks to build a concentrated portfolio of companies. He aims to identify and hold those which own high-quality assets, and trade at a discount to their intrinsic value. In recent years AGT has gradually moved to reduce the number of holdings (from c. 40 in 2015 to 30 as of 30/04/2020, if the Japanese basket is treated as one position), and to transition the investment process to place a greater focus on identifying a catalysing agent to drive value realisation. Thus, the trust will not be a black box of 'cheap' assets, but of high-quality assets which the market has materially undervalued and where there is an identifiable catalyst to drive a move towards fair-value pricing. Increasingly often, potential catalysts identified by the team include internal activity and corporate-governance reforms. Joe and the team are increasingly active in engaging with the company managements and boards of many holdings to try to instigate policies which should drive positive shareholder outcomes. **We have covered the investment process in greater detail in our previous research here**.

The manager notes that the current bout of market volatility is unsurprisingly giving rise to multiple opportunities, and Joe and the team have been actively rotating the portfolio to increase exposure to high-quality assets which offer strong long-term growth potential and which are trading at significant discounts to their intrinsic fair value.

A wider derating of existing assets has seen the 'look-through double-discount' widen to extreme levels such as those last seen in the financial crisis or the Eurozone crisis of 2011; this double discount is now well in excess of the long-term average level. This accounts for the discount on AGT, and for the discount of the underlying companies to AVI's fair-value estimate. This likely underemphasises the extreme nature of the discount seen presently, as the trust has moved away from what was a 'purer' value/discount targeting approach at the time of comparable instances towards placing a greater emphasis on underlying operating resilience and exposure to high-quality assets; thus, if anything, a narrower level of double discount might reasonably have been expected in response. We have discussed this further in the **Discount** and **Performance** sections.

In particular, the recent sell-off has presented the team with attractive opportunities to enter and/or expand holdings in four new positions. These positions are high-quality assets that they had been monitoring for some time, looking for a more attractive entry price: SoftBank, Christian Dior/LVMH, KKR and The Howard Hughes Corporation.

Fig.1: Look-Through Double Discount



Source: AVI

The SoftBank position is now roughly in line with what the team would deem to be its appropriate weighting. More so than the other new positions, the introduction of this holding was driven by the arrival of a tangible route to value realisation. Having been aware of the stock for a number of years, the team had observed the stock trading at an increasingly attractive valuation relative to the tangible value of the underlying holdings.

Media headlines around the travails of the Softbank 'Vision' fund (of several issues that arose amongst the fund's holdings, significant write-downs in their stake in WeWork attracted the most attention) had, in the team's view, caused the market to overstate the relative importance of the Vision fund as a proportion of Softbank's assets, with holdings in Alibaba, Softbank Corp, ARM Holdings, and T-Mobile much more significant. When accounting for these and other assets, and for cash and debt on the balance sheet, Joe and the team noted that the stock trades on a c. 58% discount to the sum of its parts.

Having decided on the hidden value in SoftBank, the team decided to introduce the stock when the activist investor Elliott Management started to push for shareholder-friendly activity, seeing this as a likely catalyst to ultimate value realisation. Expectations of potential changes to improve corporate governance and add shareholder value have been vindicated, with the announcement of significant planned asset disposals of JPY4.3tn (AVI believes a partial sale of the stake in Alibaba will most likely form the majority of these sales) to both pay down debt and fund extensive, NAV-accretive share buybacks.

This is likely to be a shorter-term holding, Joe tells us, with a clear path and view to value realisation of the position as the return of capital to shareholders provides an uplift. The other new holdings are considered to represent longer-term compounding opportunities in the team's view, with the recent market sell-off giving the team the ability to access very high-quality businesses at discounted valuation levels. Christian Dior/LVMH, for example, is one of the world's leading luxury-goods brands that the team believe offers a structural growth opportunity. AGT has invested in both Christian Dior, a mono-holding company through which the trust gains exposure to LVMH, and in LVMH directly. The perceived structural growth opportunity may have been largely appreciated by the market and reflected in the valuation; however, the recent sell-off created the opportunity to build exposure to this high-quality business at a wide relative discount.

Similarly, Joe believes The Howard Hughes Corporation (also a significant holding in Pershing Square Holdings, one of AGT's largest holdings) is a very high-quality property owner and land developer which had seen drastic falls in its share price, enabling the team to build exposure at a wide discount. KKR, while still thought of as solely a private-equity manager, is today a much broader and more diversified alternative-asset-management business. The company has significant balance-sheet investments and a still-growing asset-management business. AVI believe the market fails to fully appreciate the resilience and visibility of KKR's revenues from long-duration contractual-management fees, and the scope for margin increases as newer strategies reach scale.

The investment process specifically targets under-researched companies with low or no broker coverage, as market misperceptions about companies such as KKR are seen as driving the opportunity to take on exposure to high-quality assets at discounted valuations.

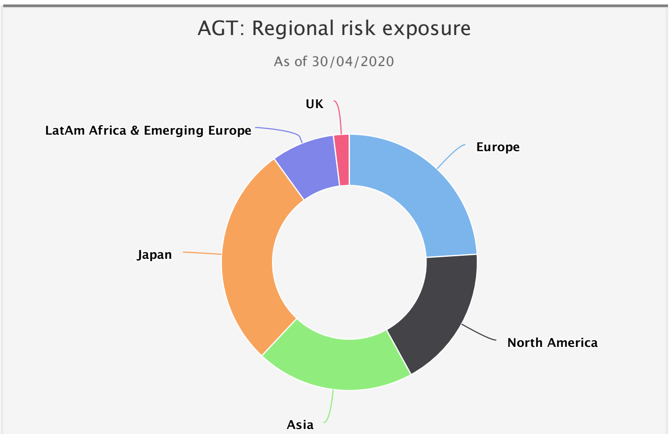
Holdings remain predominantly split amongst three categorisations: 1) closed-ended investment funds, 2) family-backed holdings companies, and 3) asset-backed special situations (primarily Japanese cash-rich operating companies, but also includes real-estate plays such as The Howard Hughes Corporation).

Asset-backed special situations continue to primarily consist of cash- and asset-rich Japanese operating companies. These are viewed collectively, and as such are considered the largest holding at present. Joe and the team have been steadily increasing the weighting to these companies in recent years, viewing this as an outstanding opportunity to access very high-quality businesses at very low valuations with a visible catalyst for rerating in place. In this instance, the team are actively engaging with company managements to themselves catalyse value realisation, launching public campaigns designed to return capital to shareholders, improve corporate governance and increase balance-sheet efficiency. The team also run a separate strategy designed to target the opportunity set they see in Japanese companies, the **AVI Japan Opportunity Trust (AJOT)**; **full details on the strategy can be found in this research note**.

The ongoing COVID-19 shutdown could offer a significant challenge to the investment thesis if it were to encourage recalcitrant company CEOs to retrench and claim the sudden economic shutdown justifies the massive capital buffers held and discourage company managements from engaging with shareholders and increasing balance-sheet efficiency. However, AVI contend that there is a happy medium between the 'ultra-lean balance sheets' and 'excessive buybacks' of many US companies, and the 'ludicrously' high cash balances and cross-shareholdings of their target Japanese companies. They also highlight the modest nature of their buyback/special dividend proposals to date. Furthermore, we note the much broader focus on operational and strategic concerns in the trust's latest campaign (unveiled earlier this week), which targets elevator manufacturer Fujitec. More details can be found at **www.takingfujitectothenextlevel.com**. They continue to monitor the ongoing efficacy of engagement with different management teams, and 'score' the opportunities on an ongoing basis to try and identify holding companies where they no longer see a path to value realisation is being followed. There is significant crossover of AGT's holdings in the Japanese market and AJOT's holdings, but AGT will invest directly in these companies and tends to have a greater weighting towards larger companies as a result of the greater level of assets under management.

Whilst AGT operates a global mandate, it is benchmarked against a global index that excludes the US. This is because the greater efficiency of US markets leads to fewer investment opportunities matching the manager's investment approach. Although the team are increasingly finding more companies of interest there, the geographic distribution on a look-through risk basis is likely to remain underweight to the North American region on a structural basis.

Fig.2: Look-Through Regional Risk Exposure



Source: AVI

Although AGT is generally underweight the US relative to a typical global product, Joe and the team access select opportunities in this country as and when they arise. This includes a significant holding in Pershing Square

Holdings (PSH), a concentrated closed-ended fund currently invested wholly in high-quality US equities. The manager of PSH, Bill Ackman, recently undertook very significant portfolio protection through credit-default swaps on US and European credit instruments; as we discuss in the **Performance section**, this proved highly beneficial to PSH on an NAV basis even as its equity holdings underperformed, providing significant upside as global financial 'risk' markets saw sharp declines through February and March.

These protective positions have since been realised, providing the manager of PSH with a significant amount of capital to redeploy into PSH's existing positions at substantially lower prices, leaving a highly concentrated long exposure to c. 10 US stocks. Despite this, PSH remains on a discount of c. 34% as of 30/04/2020. Whilst previously this position in PSH was partially hedged within AGT, this hedge has now been unwound and the PSH position is now held long-only; unwinding this partial hedge has had the effect of increasing the net effective exposure to this position.

Illustrative of the longer-term strategic shift to generally higher-conviction positioning, Pershing Square Holdings represents a significant proportion of the portfolio. As well as increasing the **gearing** facility, Joe and the team have also been tilting the portfolio gradually towards more liquid holdings (with greater trading volumes) on the expectation that the current heightened volatility is likely to persist for some time. Combined, they believe this will give them greater ability to take tactical advantage of the opportunities likely to arise from short-term market fluctuations.

Top Ten Holdings

30-09-2015		30-04-2020	
Holding	**% of NAV**	**Holding**	**% of NAV**
Investor AB 'A'	5.8	Japan Special Situations	19.5
Sofina	4.8	Pershing Square Holdings	10
NB Private Equity	4.5	Oakley Capital Investments	7.9
HarbourVest Global Private Equity	4.3	SoftBank Group	6.6
Kinnevik 'B'	4.0	Sony	6.0
Jardine Matheson	3.9	Jardine Strategic	5.5
AP Alternative Assets	3.3	Fondul Proprietatea	5.2
Mitsui Fudosan	3.3	Third Point Offshore Investors	4.7
DWS Vietnam	3.2	EXOR	4.2
Wendel	3.2	Kinnevik 'B'	3.7
TOTAL	**40.3**	**TOTAL**	**73.3**

Source: AVI, as at 30/09/2015 and 30/04/2020

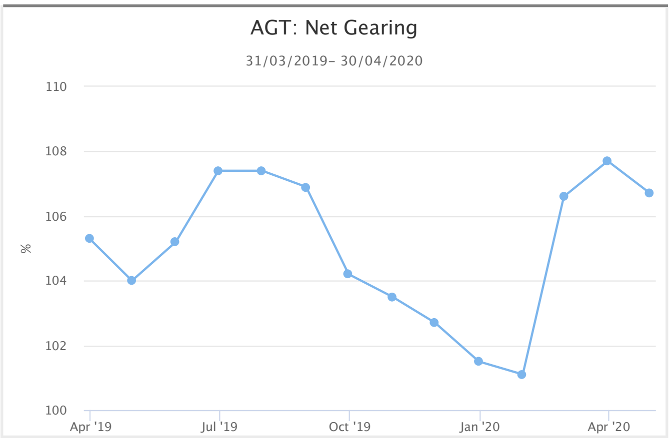
Currency exposure remains unhedged, though the managers have the option of hedging. However, gearing tends to be taken out in foreign currencies; this provides something of a hedge in the event of sterling rising, as the relative value of these borrowings falls in sterling terms in line with the underlying assets denominated in overseas currencies.

Gearing

AGT currently has net gearing totalling c. 7% in place (as of 30/04/2020). This includes long-term debt in sterling and the euro, and a revolving credit facility in yen. Having originally entered into the latter in April 2019, AGT agreed an expansion of this facility in March 2020. Having previously been limited to ¥4bn, the borrowing-facility limit is now set at ¥9bn (c. £67m as of 30/04/2020). In addition, up to half of this facility may now be drawn in GBP, USD or EUR. The managers of AGT looked to expand this facility for increased optionality in a volatile share-price environment. With most debt denominated in non-sterling currencies, recent sterling weakness in 2020 has had the mechanical effect of slightly increasing gearing levels (as yen borrowing became greater in GBP terms).

Gearing is used variably and flexibly, depending largely on the opportunities that the team have identified on a bottom-up basis. Largely on this basis, the managers had opted to reduce gearing substantially in early 2020. This has subsequently proven beneficial to returns, as have subsequent moves to increase gearing following sharp market drawdowns.

Fig.3: Net Gearing

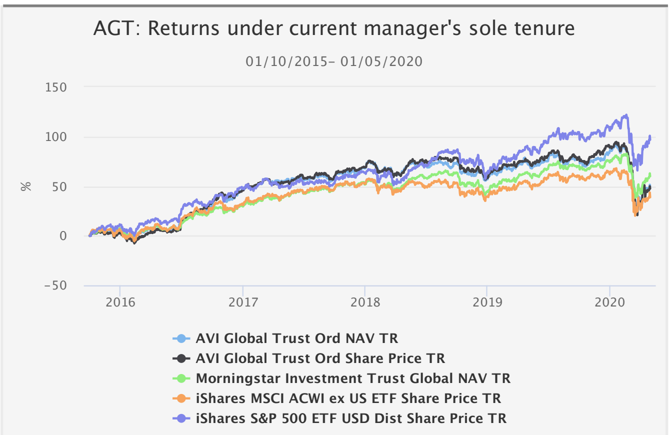


Source: AVI, 31/03/2019 - 30/04/2020

Performance

Joe took over sole management of AGT in October 2015. Over this period, AGT has outperformed the benchmark index (represented in this section by a passive strategy replicating the benchmark), but underperformed the broader peer group. Since 01/10/2015, AGT has delivered NAV and share-price returns of c. 49.3% and 47.5% respectively, against benchmark returns of c. 38.7%. Over this same period, the broader investment-trust peer group returned average NAV and share-price returns of c. 59.9% and 64.5% respectively. However, over this same period the S&P 500 ETF has returned c. 96.7%; clearly the typically ex US focus of AGT has proven a severe headwind. In this context, the US underweight, relative to global equity market weightings, would seem to account for more than the entirety of underperformance relative to peers.

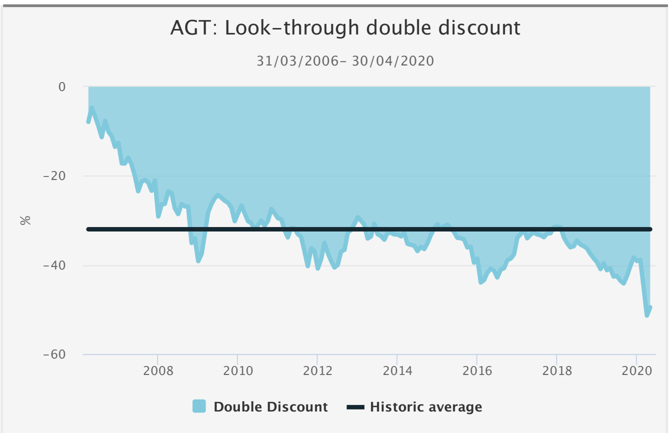
Fig.4: Relative Cumulative Returns Under Joe's Sole Tenure



Source: Morningstar

Furthermore, this underperformance is a function of recent excess drawdown, with AGT suffering to a greater degree than peers in the recent market drawdown. As discussed in the Portfolio section, underperformance in a sharp bear market such as that just witnessed is in line with what should be reasonably expected (and what the managers would anticipate) from this strategy, given the investment approach. Acute liquidity stresses in wider markets have seen the underlying holdings move out to very wide levels relative to AVI's assessment of fair value. The double discount, looking through the AGT discount and the discounts of the underlying holdings, currently stands at c. 50%.

Fig.5: Double Discount Since 31/03/2006



Source: AVI

On a monthly average basis, previous periods where the double discount has exceeded 40% have tended to subsequently see strong returns on both an absolute and relative basis. This obviously requires a caveat; even the post-financial crisis period perhaps saw less uncertainty over the operational impact on much of the economy, such is the unprecedented nature of the economic shutdown and stimulative policy measures in response to the COVID-19 pandemic.

Subsequent 12-Month Returns Depending On Double-Discount Level

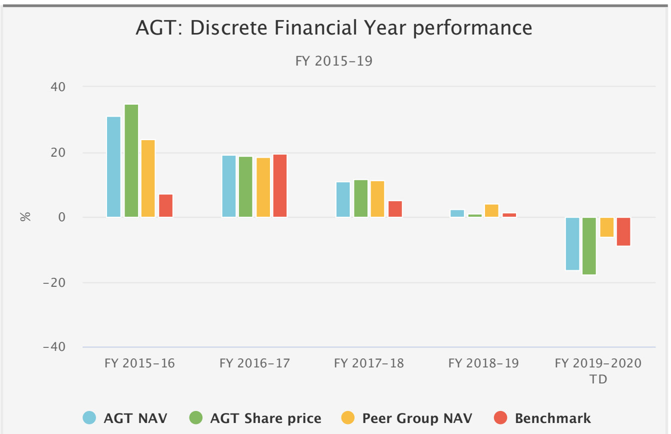
AVERAGE SUBSEQUENT 12-MONTH RETURNS	DOUBLE DISCOUNT WIDER THAN 40%	DOUBLE DISCOUNT WIDER THAN AVERAGE (-32%)	DOUBLE DISCOUNT NARROWER THAN AVERAGE (-32%)
Average (NAV absolute)	25.40%	12.80%	1.70%
Average (NAV relative to peer group)	5.40%	-1.30%	-1.70%
Average (NAV relative to benchmark)	11.20%	1.80%	2.80%

Source: Morningstar, AVI, data from 31/03/2006-30/04/2019

The table shows that returns have tended to be much better when the discount is wider than average. This is even more stark when the double discount has exceeded 40%; we have few data points, so an element of caution is required, but the evidence suggests this has proven a good guide to market sentiment and that of the underlying portfolio, although past return patterns may be completely different.

Performance over the past 12 months has been challenging, with AGT trailing and underperforming the benchmark. Over the 12 months to 30/04/2020, AGT has seen NAV and share-price returns of c. -13.6% and -15.9% respectively. This compares with a benchmark return of c.

Fig.6: Discrete Financial-Year Performance



Source: Morningstar

-9.4%, and a peer-group return of c. -1.8%. Returns thus far in the financial year have lagged, due in large part to the widening look-through discount.

This has largely been a result of underperformance in the recent period of market stress, but during the subsequent recovery in risk markets AGT has outperformed as discounts started to narrow; as we discuss in the **Portfolio section**, this is broadly in line with the manager's expectations of how this product would perform.

Many of the more illiquid names especially struggled during this period, with some closed-ended products such as **Tetragon Financial Group (TFG)** and **Oakley Capital Investments (OCI)** seeing dramatic discount widening on relatively small selling orders. However, the strong performance of **Pershing Square Holdings (PSH)** and relative resilience of holdings such as Sony proved beneficial. Holding companies tended to prove more liquid, and more resilient, in the market drawdown seen in Q1 2020, with the resilience likely reflective of the high-quality nature of many of the underlying assets.

As we have previously noted, whilst it may be optically perceived as value-orientated in its approach to investment analysis, AGT is not a 'value'-factor investment product. AGT is looking for relatively idiosyncratic value-realisation opportunities, and holds exposure on a look-through basis to high-quality, cyclically resilient assets which they expect to continue to enjoy strong NAV growth. The idiosyncratic nature of many of AGT's holdings tends to lead through to a lower correlation to different factors relative to the wider peer group.

R^2 TO FACTORS

MEDIAN R^2	FIVE YEARS TO 30/04/2020	TEN YEARS TO 30/04/2020
AGT relative to growth-factor index	0.51	0.59
Sector average relative to growth-factor index	0.68	0.73
AGT relative to quality-factor index	0.48	0.62
Sector average relative to quality-factor index	0.66	0.72
AGT relative to value-factor index	0.45	0.5
Sector average relative to value-factor index	0.47	0.55

Source: Morningstar

As we can see in the table below, AGT's R^2 compared to the quality factor has been higher than to the growth and value factors over the past ten years. Furthermore, the median R^2 to ALL of these factors has been lower than that of the wider peer group; AGT has provided a less correlated return profile. This is despite the exclusion of the US market from the factor indices, which artificially decreases the peer group's correlation to these indices (as most of the constituent trusts will hold a reasonable degree of US exposure).

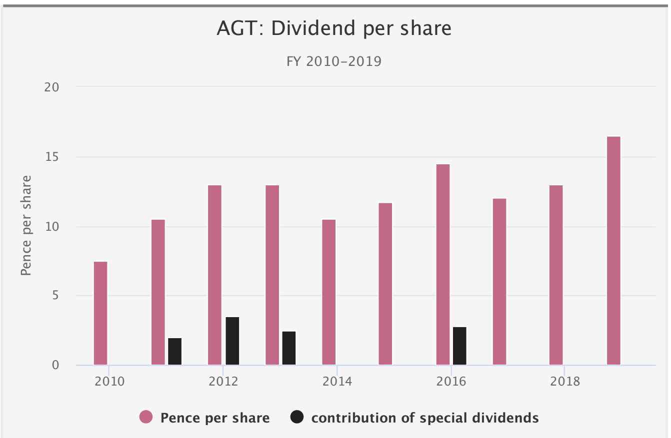
Dividend

AGT currently yields c. 2.2% (as of 30/04/2020). The trust targets capital growth, with dividends generally a secondary consideration. Nonetheless, it has a successful record of increasing dividends over the long term.

Several of the underlying strategies' increased dividends or special dividends may on occasion be a route to value realisation. Even in the current economic strictures, this remains a possibility for businesses disposing of core assets and looking to return assets to shareholders. In 2017, AGT shareholders agreed to amend the articles of association so that capital profits could be distributed as dividends. Should underlying portfolio activity result in the realisation of any investment, this may potentially be used to make additional distributions.

As noted in the **Portfolio section**, a significant component of the investment strategy involves engaging with management to reduce excess cash or assets on balance sheets, with the intention that this be returned to shareholders. If successful this will likely, in some instances, be through special, new or increased dividends. Accordingly, there is the possibility that income distributions remain variable over the near future.

Fig.7: Dividend Per Share



Source: AIC

Management

Joe Bauernfreund has been sole named manager of AGT since October 2015. Joe is CEO and CIO of Asset Value Investors (AVI), and has been with the group since 2002, starting as an analyst working on European holding companies. He became co-manager of AVI Global Trust (then British Empire Trust) in 2013 before becoming sole named manager in October 2015.

Joe is supported by Tom Treanor, head of research and an AVI director since 2017. Tom leads on closed-ended fund research and activism engagement, with significant experience in various roles covering closed-ended fund analysis.

AGT (and BTEM, as it was previously) has seen low managerial turnover, with only three portfolio managers over the previous c. 35 years. The board remains involved in oversight of the investment strategy, and whilst there is evolution of the investment process, the board has been keen to ensure that any changes are part of a natural progression. There is substantial investment-trust experience on the board.

AVI are an international equity boutique founded in 1985, which is majority-owned by employees. Part of the strategic transition they and AGT have undertaken in recent years has included partnering with Goodhart Partners, an independent multi-boutique that has helped provide resources to support the growth of AVI.

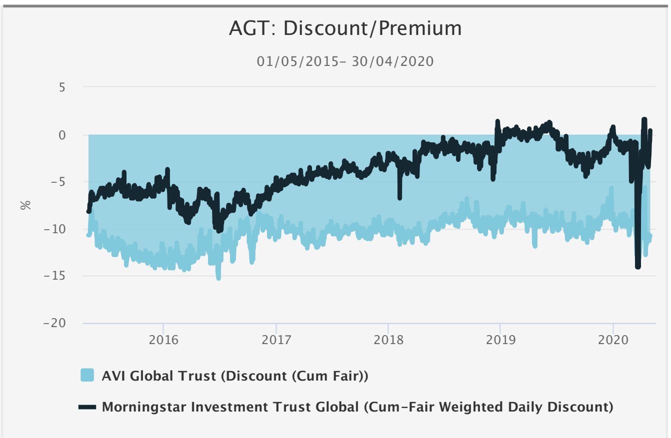
Discount

AGT currently trades on a discount of c. 10.8% (as of 30/04/2020). Whilst already wide relative to the sector, as discussed in the **Portfolio section** this does not take into account the look-through double discount when the discounts to fair value on the underlying portfolio holdings are factored in.

Whilst there is clearly a wide disparity between the discount of the trust and that of the wider AIC Global sector, it is worth highlighting that the peer-group discount level remains skewed by the sizeable (c. 14.7%) premium attached to the second-largest company in this sector, Lindsell Train.

The board has conducted extensive buybacks. In the current financial year (30/09/2019–01/05/2020) the board has bought back c. 2.1m shares at a weighted average discount of c. 10.5%. This represents c. 1.9% of the shares that were in issue (excluding shares held in treasury) as of 30/09/2019. The directors have authority to buy back up to 14.99% of ordinary shares in issue.

Fig.8: Discount



Source: Morningstar

Buybacks have been partially undertaken with the aim of reducing discount volatility, though the timing of buybacks certainly suggests the board is cognisant of intrinsic value in the portfolio, with a substantial majority of recent buybacks taking place during months where the double discount exceeded 40%.

As noted above, the investment approach highlights companies that are themselves trading at a discount to their intrinsic value; this creates a 'double discount'. Presently the double discount is c. 50% (as of 30/04/2020); this is anomalously wide, exceeding even the level of discount seen in the 2008–09 financial crisis or in early 2016 (**as discussed under Portfolio**).

Charges

AVI is paid a management fee of 0.7% of NAV per annum and no performance fee. The OCF is 0.85%, compared to a weighted average of 0.53% for the sector, which we think reflects the specialist strategy (the sector figure is also skewed by a large outlier to the downside). The KID RIY figure is 3.45%, compared to a 1.08% weighted average for the global sector, although we would caution that different managers use differing methodologies to calculate this figure. AVI notes that these charges reflect costs of gearing at investee closed-ended funds, and contend it is inappropriate to consider solely the costs of leverage without also taking into account its beneficial impact on returns. Similarly, performance fees on underlying holdings inflate these figures and are reflective of strong returns.

ESG

AGT's investment process places a premium on governance and sustainability concerns. Increasingly, as we discuss in the Portfolio section, this includes active engagement with the managements of the underlying companies to ensure strong corporate governance is in place and that company managements are cognisant of their responsibilities as shareholders.

AVI tries to understand the social system that holdings operate within, ensuring that the rights of minority stakeholders are properly respected and also finding out how employees and management are incentivised. Similarly, AVI seeks to support policies and/or actions by the companies it holds which aim to support a sustainable environment.

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