Feather your nest with ugly ducklings

Alasdair McKinnon has turned around the Scottish Investment trust by buying up unfashionable stocks, he tells Merryn Somerset Webb

This is an interesting time for the investment trust industry. With fees coming down across the board, passive funds taking market share, wealth managers demanding they achieve greater size before they are considered investible and ordinary investors becoming increasingly savvy, they are all having to up their game. Those that don't do this for themselves run the risk of going the way of Alliance Trust: attracting activist investors who will force them to do it (see page 30). Enter the Scottish Investment Trust (SIT). By the end of 2015, it was underperforming the market over one, three and five years (over five years it was up 36% but the FTSE World index was up 54%). Not good.

So the trust got a new chairman and changed its manager. So far so good. Results to the end of October last year showed a 30% total return (much better than the 12.3% from the MSCI UK All Cap) and a total dividend rise of over 40% (an 8% rise in the regular dividend plus a special dividend of 9p a share). Finally it managed to cut its total expense ratio from 0.69% in 2014 (already reasonable) to a mere 0.49% in 2016. Not bad going. SIT is also self-managed (the company doesn't contract out the actual fund management to anyone else) and has a stellar board keeping an eye on things (it includes one of our favourite investment strategists, Russell Napier). It's all interesting. So I went to see them in the (slightly too big) house in Edinburgh's New Town the then managers bought as their head office in 1889, two years after the trust's incorporation.

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Everything is cyclical

The money is managed by Alasdair McKinnon who was appointed in early 2015. Since then he has made some changes. It is now a "global high-conviction contrarian" trust. The core idea here is that everything is cyclical: "fashionable companies become overvalued" and "unfashionable companies eventually become undervalued". That sounds obvious, but that doesn't mean it doesn't work. People get carried away with ideas. It's easy for investors to convince themselves that the high prices they are paying for the past earnings of top stocks are worth it – that they will just keep going up. But the truth is that what goes up must come down. It might not look like it when everyone's excited about a story, but in the end, "believe me", everything is. Likewise, at the bottom, once a business has done badly for a few years, "people get depressed, they give up, and the valuation becomes compelling... that's when to buy". This sounds to me like a way of taking advantage of the fact that most other investors are idiots. Is that it? "I wouldn't say that at all," says McKinnon. But it is true that "there is a lot of pressure on investors… as humans we are all sociable creatures... we all have groups we like to be part of". And when prices are rising and other investors are excited, it's really hard not to join in. But of course when prices are rising fastest is precisely when more capacity will be coming on in whatever the product in question is – quietly laying the groundwork for prices to come down again.

Marks & Spencer: one of the most interesting inves

How is this different to value investing, I ask. Aren't we just talking here about buying stuff on the cheap? It's not that simple, says McKinnon. His contrarianism comes in three categories. The first is "ugly ducklings" – firms that have a "chequered operational history" and are properly disliked but have a reasonable yield, are cheap, and have room for improvement. The best example of the last year for SIT has been Treasury Wine Estates, an Australian wine firm that has a long history of profit warnings and oversupply to the extent that they had to destroy stock. A new management team changed the strategy, from treating the products like a commodity to treating them like quality consumer goods, and everything changed. So SIT bought, with the safety net of a 4% dividend just in case. All went as planned and Treasury Wine Estates is still the top holding in the portfolio.

investment opportunities out there, says McKinnon

Next up is the "change is afoot category". These are companies that have already changed but are still suffering from negative perceptions among investors: no one likes to be burnt twice. The classic example is Rentokil, which was regularly voted Britain's most admired company in the 1990s thanks to its 20% a year growth. When much of that growth turned out to be entirely unsustainable, the shares collapsed and the early 2000s were all about profit warnings. Even after a new management took it back to focusing on pest control ("one of the most attractive businesses there is out there"), the market continued to hate it. SIT bought – it is the fourth largest holding and is up about 45% in the last 12 months.

On to the third category, called "more to come". These are companies that other investors are on to as well, but in which McKinnon's team sees "something extra". Take Microsoft, which three or four years ago everyone thought was in "terminal decline". It turns out that "all businesses have to use Microsoft products" and that Microsoft figured out how to change their business into an annuity stream by getting people to pay annual subscriptions for software. The power of that has yet to be recognised by the market. And that, says McKinnon, is what makes his style different to value investing.

I wonder about that last category. Given that all fund managers must surely think there is more to come in every stock they buy or they wouldn't buy them, couldn't you shovel pretty much every listed stock out there into this group? Not so, says McKinnon. He is also always checking for safety in the valuations and the dividend yield – and focusing on the odds of long-term returns and on making actual money rather than just doing a bit better than his competitors. This leads us on to just how global the fund is. We've talked about some major non-UK holdings, but the fund is 30% in UK listed firms. Is that intentional? It isn't – it just reflects the fact that much of the UK looked "extremely undervalued". Everyone was anti resources, pro mid caps and anti big caps, but "we saw huge dividend yields on these stocks" and knew that the commodity cycle would turn. Then after Brexit the shift to favouring mega caps was immediate – there was an "overnight shift" into the companies SIT had considered undervalued.

Get ready for a retail recovery

So what is the trust buying now? UK retail, says McKinnon. "We've bought some Tesco recently, we bought some M&S in the summer and some Kingfisher". Brexit and Trump are a cry of rage from those who haven't participated in globalisation. Those people are now being promised more via deficit spending: there is a "widespread recognition that politicians have to improve the lot of the left out… otherwise the whole system doesn't work". That should mean a "shift into people's pockets of disposable income and a pick up in inflation".

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One of the most interesting opportunities is Marks & Spencer. It was a top-performing business. Then it spent ten years in decline – despite "a succession of grand plans". Now they have in place at the top a proper retailer and things are turning around. I don't buy this. I've had an M&S voucher in my wallet for a year now and still haven't managed to spend it. But McKinnon still reckons the food department is fabulous and the clothing changes "encouraging". He also points to a cheap valuation and a "very sustainable 5.5% dividend" with a special dividend this year taking that up to around 7%.

Another is the financial sector in Japan, where after 20 years of work the banks are not just solvent but "some of the cheapest in the world" (think 0.6 times book value and decent yields). Take the Bank of Kyoto, which owns stakes in lots of tech companies left over from the days when it used to take equity in the firms it lent to. "The value of these stakes is greater than the value of the bank."

We ended our talk there. But before I left, I nipped down to the basement for a look at the company safe – one of the oldest and the "most secure in Edinburgh", says MacKinnon. Let's hope the same is true of the trust – it is already one of the oldest.

Fact file: Alasdair McKinnon

Alasdair McKinnon graduated from Edinburgh with a degree in economics and social history in 1997, followed by a masters in investment analysis from Stirling in 2001. He joined the Scottish Investment Trust in 2003, initially on the Americas team, then later covering the UK, Australia, New Zealand and South Africa. He was appointed as assistant manager in 2011, acting manager in 2014 and lead manager in 2015.