Update | Investment companies

10 May 2016

Strategic Equity Capital

Cashing up!

Strategic Equity Capital's managers believe that we are now in a late-mid-stage bull market. As a result, they are maintaining a preference for companies exposed to structural growth and are aiming to operate with higher levels of cash in the portfolio (10-15% up from 5-10%). Highly rated growth stocks are being avoided and the focus is on "reasonably priced growth" and "self-help" opportunities. Tribal Group and Goals Soccer were significant detractors during 2015, eclipsing otherwise decent portfolio performance. However, Tribal is recovering strongly (up 169.1% year to date) and Goals is also starting to take remedial action. The rest of the portfolio continues to perform well.

Concentrated UK small-cap equity exposure with absolute return focus and PE style approach

Strategic Equity Capital (SEC) invests in a relatively concentrated portfolio of quoted UK equities, primarily small caps, with the aim of generating an IRR of 15% per annum across an economic cycle. Stocks are evaluated using private equity techniques and the investment manager operates a policy of constructive engagement with companies in the portfolio, where appropriate.

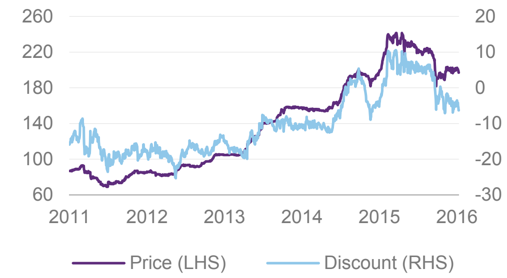
Year ended	Share price total return (%)	NAV total return (%)	FTSE Small Cap ex IT TR (%)	FTSE All-Share ex IT TR (%)	IA UK Small Cap TR (%)
30/04/12	(1.1)	2.4	(2.5)	(1.9)	(0.8)
30/04/13	24.9	18.9	28.2	17.8	17.9
30/04/14	51.8	44.6	31.8	10.7	27.4
30/04/15	27.5	17.5	3.8	7.3	3.1
30/04/16	1.1	2.5	3.8	(5.9)	5.8

Source: Bloomberg, Morningstar, Marten & Co.

Sector	UK Smaller Cos
Ticker	SEC LN
Base currency	GBP
Price	197.00
NAV	210.25
Premium/(discount)	(6.3%)
Yield	0.4%

Share price and discount

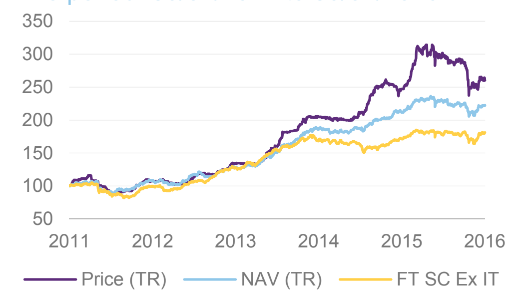
Time period: 01/04/2011 to 06/05/2016



Source: Morningstar, Marten & Co.

Performance over five years

Time period: 30/04/2011 to 30/04/2016



Source: Morningstar, Marten & Co.

Domicile	United Kingdom
Inception date	13 July 2005
Manager	Stuart Widdowson
Market cap (m)	137.6
Shares outstanding	69.9m
Daily vol. (1-yr. avg.)	162k shares
Net cash (31/3/16)	13.5%

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Macro outlook

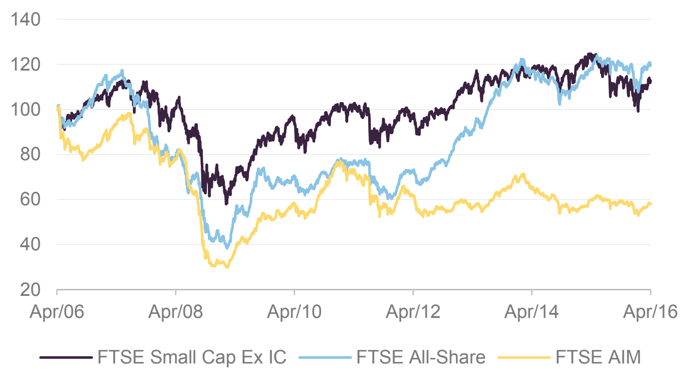
Markets are characterised by uncertainty and valuations remain elevated.

As evidenced by recent volatility, global markets are characterised by uncertainty, with varying views on the direction of travel of the global economy (ranging from recession, to stagflation through to hyperinflation). There is little in the way of broad consensus, other than that further periods of volatility are likely to prevail. As illustrated in Figures 1 and 2, UK equities have, in common with global markets as a whole, had a good run and, despite recent setbacks, continue to trade valuations above their longer-term averages (see Figure 2 below). This may sound a note of caution for some.

An underresearched universe and volatility are potential sources of opportunities.

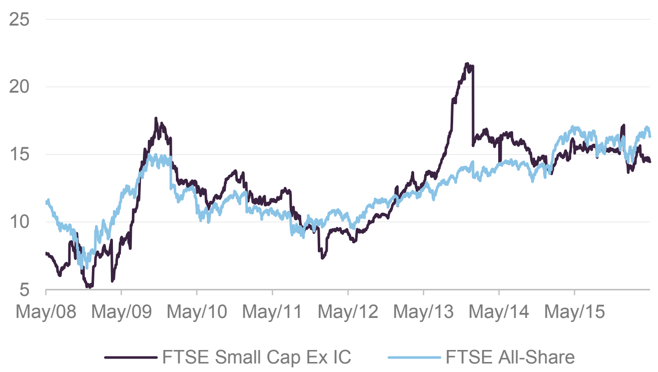
However, the smaller companies sector, in which Strategic Equity Capital tends to be invested, is a less well-researched part of the market and so there is a greater likelihood of finding a mispriced security. Small caps tend to be more volatile than mid-and-large-cap stocks and, whilst heightened volatility may not be to everybody's taste, it is likely to create opportunities for some. These opportunities may be superior to those that might otherwise be available in less volatile markets, particularly for those who have the resources and expertise needed to identify them, and are able to take a longer-term investment horizon to allow such ideas to come to fruition. In terms of valuations, the FTSE All-Share Index is trading at a F12m P/E of 16.3x versus a five-year average of 13.1x, whilst the FTSE Small Cap Ex Investment Companies (IC) Index is trading at 14.5x versus a five-year average of 13.6x.

Figure 1:Market indices – 10-year performance rebased



Source: Bloomberg, Marten & Co.

Figure 2: Market indices - F12m P/E ratios



Source: Bloomberg, Marten & Co.

Manager's view

SEC's managers believe that we are in a late-mid-stage bull market. Growth and momentum stocks have performed well. Valuations have been rising on moderate volumes.

SEC's managers believe that we are in a late-mid-stage bull market - an environment in which they would expect growth and momentum stocks generally to perform well, while value stocks and quality stocks with strong balance sheets and cash flows would be less prized. As such, they maintain a preference for companies exposed to structural growth, rather than cyclical growth opportunities, and have also opted to maintain a higher level of cash in the portfolio. Having typically run cash balances of between 5% and 10%, the managers are aiming to run between 10% and 15%, with

12.5% being the average level, unless they come across exceptional investment opportunities.

On a short-to-medium-term view, the managers consider that markets are relatively expensive: this was particularly apparent towards the end of 2015, when the managers were selling down growth stocks that they considered had become highly rated. This was less of an issue after January's correction and the managers added to some reasonably priced growth opportunities, but markets have now recovered significantly and so the managers are exercising caution. On a more positive note, the managers believe that whilst mid-and-large-cap stocks look to be fully priced for modest growth, small-caps stock look more attractively valued.

Liquidity is a key concern.

The managers say that liquidity is a key concern: it remains challenged in both the UK and overseas equity markets, particularly for small-cap stocks. They do acknowledge that, over the longer term, this could support their investment style (lower liquidity typically leads to less research and less active broking of small-cap stocks and greater opportunities for mispricing coupled with less competition from other managers who shun the space over liquidity concerns). However, the downside is that this tends to give rise to higher volatility and, more worryingly, small-cap holdings need to be increasingly treated as a semi-private investments, as exiting a position is less easy. This is exacerbated in instances where something goes wrong. Investors need to be able to take a long-term view and be prepared to ride out the storm.

Markets are potentially exposed to sharper falls in the event of bad news.

SEC's managers are concerned that prices have been moving up on moderate volumes, which they see as evidence that the market is not being driven by conviction buying, which leaves the market potentially exposed to sharper falls in the event of bad news. The managers have noted that the main global macro risks remain unresolved (eurozone concerns; Chinese shadow banking and the equity bubble; public sector debt; and persistent budget deficits) and various geopolitical risks remain, such as troubles in the Middle East and Brexit concerns closer to home. The US has been one of the brighter spots in the global economy, but the managers sound a note of caution following the Federal Reserve's about-turn in rate guidance. However, they also see a positive earnings tailwind through to 2020 from declining corporation tax and think that new IPOs should broaden the investment universe.

In this environment, the managers are employing six key investment strategies in managing the portfolio: 1) focus on above average quality companies, 2) look for companies with strong balance sheets and strengthen where appropriate with equity, 3) look for margin upside and self-help opportunities to drive profit growth, 4) selective corporate engagement,5) exercise strong sell discipline where shares trade above the managers' estimates of fair value, and 6) avoid companies with poison pills that could hamper M&A activity.

SEC's portfolio has aggregate net cash. SEC's portfolio has a higher F12m P/E ratio than most of the indices, but has strong EPS growth as well.

In terms of SEC's current portfolio, the managers say that they are happy with its composition and that, on aggregate, it has a net cash balance sheet, as illustrated in Figure 3 overleaf. Looking at one of the measures the managers publish, the combination of F12m EPS growth and F12m dividend yield (see the growth and yield column in Figure 3 overleaf) as an estimate of return over the next 12 months, SEC's portfolio looks attractive relative to the FTSE 100, FTSE 250 and, to a lesser extent, the FTSE Small Cap Index. The figures for the FTSE AIM and FTSE Fledgling indices look superior to SEC's, but the managers think that these tend to be over-optimistic. They also highlight that SEC's growth compares favourably with the wider market despite having much lower financial leverage.

Figure 3: Valuation and growth metrics of SEC's portfolio versus broader market as at 31 March 2016

Heading	Average market cap	12m forward P/E	12m forward EPS growth	12m forward dividend yield	Growth & yield	PEG ratio	PE/(growth & yield)	Net debt/EBITDA
SEC Portfolio	£342m	17.0x	13.9%	2.2%	16.1%	1.2x	1.1x	(0.2x)
FTSE 100	£15.8bn	15.0x	5.2%	3.9%	9.1%	2.9x	1.6x	1.7x
FTSE 250	£1.6bn	15.4x	6.0%	3.2%	9.2%	2.6x	1.7x	1.6x
FTSE Small Cap	£304m	12.2x	8.3%	3.6%	11.9%	1.5x	1.0x	2.0x
FTSE Fledgling	£43m	13.3x	14.4%	3.8%	18.2%	0.9x	0.7x	1.2x
FTSE AIM	£87m	15.8x	15.0%	2.4%	17.4%	1.0x	0.9x	1.2x

Source: Strategic Equity Capital, Peel Hunt, Capita, Factset, GVQ Investment Management.

Brexit

The managers expect that a sterling depreciation from a Brexit would likely create a tailwind to sterling profitability, within SEC's portfolio, with limited real impact on underlying companies trading.

The managers say that, looking at the underlying revenues of their portfolio companies, approximately 60% of these come from the UK and 40% come from outside the UK. The vast majority of revenue from outside the UK comes from the US. The managers are of the view that, should sterling come under pressure in relation to a Brexit, this would, on average, create a good tailwind to the portfolio's performance. In the managers' view, sterling costs would largely remain the same, but a sterling depreciation would lead to a real boost to overseas revenues. Overall, the managers are of the view that, whilst portfolio companies' share prices would not be immune to the impact of a Brexit, the impact on their trading would be limited.

Interest rates

Rising interest rates are normally assumed to be negative for equities. However, the managers believe that as SEC's portfolio has, in aggregate, net cash, it should be relatively insensitive to rising interest rates. They also consider that approximately 14% of the portfolio's stocks would be net beneficiaries from rising interest rates. These include companies such as IFG Group and Brooks Macdonald, which hold significant client cash balances and have historically captured the first 50 basis points (bps) of rising interest rates (a phenomenon which has been absent for the last five years).

Asset allocation

The portfolio has more cash and concentration has reduced.

SEC continues to maintain a portfolio of between 15 and 20 holdings. However, reflecting the managers' outlook on the market (see pages 2, 3 and 4) the portfolio's net cash has increased from 9.1% as at 31 March 2015 to 13.5% as at 31 March 2016. As illustrated in Figure 4, the portfolio's concentration has also been modestly reduced during the last 12 months, with the top 10 holdings accounting for 75.1% of SEC's NAV at 31 March 2016, down from 76.9% at 31 March 2015.

The managers describe the portfolio's structure as a "barbell" of reasonably priced growth and self-help opportunities. Beyond this, approximately two thirds of the portfolio falls into one of the six key themes illustrated in Figure 5 overleaf.

Figure 4: Top 10 holdings as at 31 March 2015

Holding	Sector	Geography	Allocation 31 March 2016 (%)	Allocation 31 March 2015 (%)	Percentage point change
Servelec Group	Technology	UK	15.6	10.4	5.2
e2v technologies	Electronics	UK	9.7	10.1	(0.4)
Wilmington Group	Media	UK	8.3	9.0	(0.7)
EMIS Group	Technology	UK	7.1	8.7	(1.6)
Clinigen Group	Healthcare	UK	6.8	3.0	3.8
4imprint Group	Support services	UK	6.8	8.1	(1.3)
IFG Group	Financials	UK	6.1	0.0	6.1
Gooch & Housego	Electronics	UK	5.8	5.5	0.3
Tyman	Industrials	UK	5.7	8.7	(3.0)
Tribal Group	Technology	UK	3.2	4.0	(0.8)
Total top 10 holdings			75.1	76.9	(7.0)

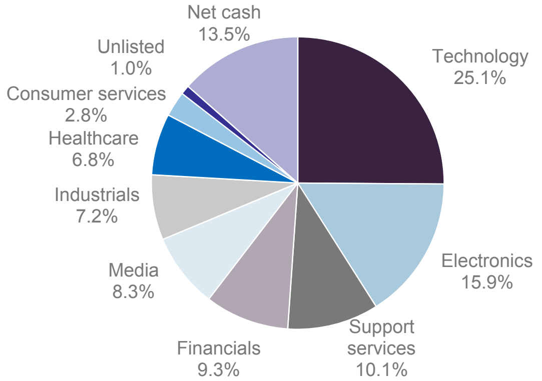
Source: GVQ Investment Management, Marten & Co.

Figure 5: Current investment themes

Theme	NAV (%)	Portfolio companies	SEC's managers' view
Electronic records – healthcare and students	20%	Emis Group, Servelec Group, Tribal Group	The sector is characterised by structural growth, significant demand for systems upgrades and 'sticky customers'. There is scope for sector consolidation.
Niche electronics – for existing and new aerospace, defence, space and life science applications	15%	e2v, Gooch & Housego	Around 20% of sales is exposed to more cyclical microelectronics. A move up the value chain is a structural trend (components to subsystems). There are also self-help opportunities.
Growth of defined contribution (DC) pensions and self-managed investments	9%	Brooks Macdonald, IFG Group	Multi-year tailwinds from structural changes and potential margin upside.
Ethical unlicensed drug supply/sourcing – salvage medicines and outsourced sourcing of comparator drugs for trials	7%	Clinigen Group	A niche provider in a structural growth market. The IDIS acquisition provides some strong market shares and the acquisition of healthcare company, Link, expands the company's footprint.
Automation, telemetry and SCADA* products and systems	6%	Servelec	Structural growth area, nice operator with few competitors
Continued recovery in US residential construction	6%	Tyman	New housing starts materially below average. Medium term outlook remains good.

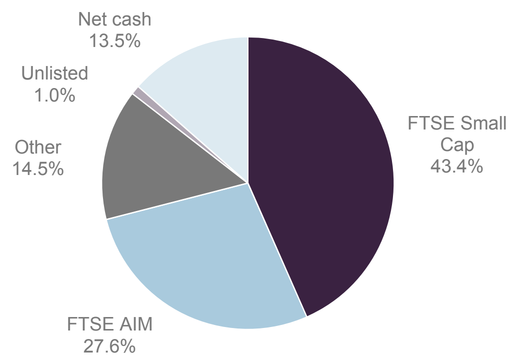
Source: GVQ Investment Management *Note: SCADA (Supervisory Control and Data Acquisition) is a system for remote monitoring and control that operates with coded signals over communication channels that is primarily used in industrial automation.

Figure 6: Sectoral allocation as at 31 March 2016



Source: GVQ Investment Management

Figure 7: Index allocation as at 31 March 2016



Source: GVQ Investment Management

Q3 2015 was an active period for investment: Q4 2015 was more focused on realisations. The managers have been selling down growth stocks that they believe have become highly rated.

Portfolio activity in the fourth quarter of 2015 was focused towards realisations, particularly during December, when markets were more buoyant and valuations elevated. At this time, SEC's managers held the view that the scope for disappointments had increased and were actively selling down growth stocks that, in their view, had become highly rated, such Brooks Macdonald, Clinigen Group, Gooch & Housego, Idox and Wilimington Group. However, following the market retrenchment in January, the managers have been able to invest in more reasonably priced growth opportunities again. They say that they are actively building a new position in a quality non-cyclical business, at an entry P/E of around 10x, with anticipated earnings growth of over 10% per annum, for the next five years, and intrinsic values twice the current share price.

With the exception of Tribal, which we discuss below, there has been limited change in the trust's major holdings and the managers are largely happy with their trading performance. We discuss some of the more interesting examples below.

Servelec Group

Servelec is SEC's largest holding and the managers would add to the position if it were not already the trust's largest. SEC's managers believe that Servelec's balance sheet will allow it to invest in its new acquisitions to drive profitability.

The managers continue to be positive about the outlook for SEC's largest holding, Servelec Group (Servelec), which accounted for 15.6% of the portfolio at the end of March 2016. The managers are aware that this is a significant allocation, but consider that there are a number of mitigating considerations which mean that this is not necessarily the concentration risk that it might first appear to be. First, the company comprises three distinct business units (health & social care, technology and controls) with different risk profiles and revenue streams. SEC's managers consider that all of these business areas benefit from structural growth as well as a "sticky" customer base from which there is significant demand for systems upgrades.

Moreover, the company is ungeared and, in SEC's managers' view, has a very strong board and management team in place to deliver on the plans for growing the business. SEC's managers think that current market forecasts for the company's growth are very achievable and, with good earnings visibility over the next two to three years, they believe that the risk is primarily to the upside despite Servelec's strong performance year to date (13.1%). SEC's managers say that there is still plenty of headroom at the current price in comparison with their own estimate of intrinsic value for the company.

The company acquired software company, Synergy, from Tribal at the beginning of March 2016, which follows the acquisition of Aura Healthcare in May 2015 and social care software company, Corelogic, in December 2014. In the managers' view, Servelec has a strong balance sheet and this will allow it to invest in these businesses and drive profitability. The managers are also encouraged by the rate of healthcare contract wins and believe the controls division is regaining traction.

Tribal

Tribal suffered from difficult trading during the second half of 2015, and issued two profit warnings in Q4.

As discussed in the performance section on pages 8 and 9, Tribal was by far the largest detractor from SEC's NAV performance during the final quarter of 2015 (it detracted 4.82% from SEC's NAV in Q4), with the market providing strongly negative reactions to trading updates issued on 19 October and 14 December. In the managers' view, a lower sales win rate, project delays, an inflexible cost base (not helped by a rather long search to replace the CEO) as well as a balance sheet that was weaker than the market had believed, contributed to disappointing trading for Tribal in the second half of 2015.

SEC's managers reviewed the investment case following the profit warnings. They concluded that the investment thesis remained intact and that the outlook for Tribal is now very positive. The market seems to have shared this sentiment. The 1-for-1 rights issue saw a 94% take-up by existing shareholders and the company's share price has returned 169.1% year to date. The rump placing (for the remaining 6%) completed on 19 April 2015 and, despite Tribal's recent strong share price performance, SEC's managers believe that it continues to offer the prospect of very good returns over the next three to five years.

Tribal has a new chairman, non-exec director and CEO.

As part of Tribal's remedial action, a new senior non-executive director (Roger McDowell) and new chairman (Richard Last) were appointed in November 2015. Both directors are already well known to SEC's managers, as they hold the same positions at Servelec. Mr. McDowell is also a non-executive director of Intec Telecom Systems, a SEC holding between 2006 and 2010. SEC's managers welcome these appointments as they believe the directors have highly relevant experience and should be able to effect more focused international growth, reduce the complexity of the business and drive a stronger focus on existing customers, all of which should propel the company's profitability upwards.

Both have also made significant personal investments, since joining the board, which should align their interests with shareholders. In addition, the company appointed a new CEO, Ian Bowles, in February 2016. As a former CEO of Allocate Software, a SEC holding between 2009 and 2014, Ian is also well known to SEC's managers and they are encouraged by his appointment. SEC's managers also welcome the appointment of new CFO, Mark Pickett, from 4 July 2016 (announced on 25 April 2016. SEC's managers believe that Tribal now has a management team in place that can drive the company's performance to achieve its potential.

Tribal is now focused on the electronic student records sector, where it has a very high market share.

Following the disposal of a number of non core assets, the bulk of Tribal's business is now focused on providing electronic student records. This is a segment in which Tribal enjoys a very high market share: it has an installed base in excess of 50% of the market in its core UK and Australian markets. GVQ Investment Management's (GVQ's) research indicates that Tribal's products continue to be viewed favourably by their customers, which are traditionally sticky, and there is ongoing upgrade potential within this installed base (as well as ongoing support and maintenance).

Successful rights issue has recapitalised the balance sheet. This has reduced risk and will allowing the company to focus on developing the business.

Tribal's rights issue raised an additional £21m. SEC's managers believe that the recapitalised balance sheet reduces risk and has increased the company's flexibility to focus on developing its business. They also think that, as the only listed company in its sector, Tribal could benefit from global consolidation in its sector.

Idox

Idox, an opportunistic investment.

The manager describes SEC's brief holding in Idox as an opportunistic investment. The company is a software provider that primarily serves the UK public sector and is now the only listed provider in its sector. The managers' model suggested that the company should be trading at 9.0x to 10.0x EBITDA but, at the time of purchase in Q3, was trading at 7.0x to 7.5x EBITDA. However, following a rerating by the market, to 9.5x to 10x EBITDA, the manager has exited the position.

IFG Group

The manager considers that IFG Group, which is listed in London and Dublin, is a position that, on a sum-of-the-parts basis, is trading at a significant discount to its intrinsic value. The group comprises two businesses (The James Hay Partnership and Saunderson House), both of which are focused on the UK wealth market and SEC's managers believe that it will benefit from a structural tailwind, over the next decade, from the move to self-managed pensions. The James Hay Partnership is a leading platform provider in the UK's retirement and wealth planning market (c £20bn of assets under administration (AUA) and Saunderson House is a City of London based financial adviser (c £4bn of assets under advice).

Looking at similar businesses, Curtis Banks Group is listed on the London Stock Exchange (CBP) and has AUA of approximately £18bn and an enterprise value of more than £200m. Taking Curtis Banks as a comparison, SEC's managers say that James Hay alone, with its higher AUA and stronger growth prospects (SEC's managers are expecting mid-teens earnings growth) could justify an enterprise value of at least as much as Curtis Banks. However IFG Group, with c £35m of cash on its balance sheet, has a market cap of just over £176m. IFG Group's primary listing is in Dublin; however despite its operations primarily being in the UK, it is largely uncovered by the London market and SEC's managers believe it has been largely overlooked as a result. They believe that moving the primary listing to London could catalyse a rerating of the stock.

Goals Soccer

Goals Soccer has suffered from difficult trading but SEC managers expect the new chairman will have a credible plan to rejuvenate the business.

Goals Soccer operates five-a-side football centres. It has 46 centres in the UK and one in Los Angeles. The company has suffered from difficult trading, which is particularly apparent in the company's results for the second half of 2015, and in SEC's managers' view, the company has been undermanaged. However, it now has a new chairman, Nick Basing, and other "new blood" is coming through. The new chairman is yet to set out a plan for tackling the problems but SEC's managers consider that he has a credible track record in being able to rejuvenate a business, based on his experience at Essenden (the tenpin bowling alley company). They believe he was instrumental in improving its performance and turning the business around.

Arguably reflecting its difficult results for the second half of last year, Goal's share price performance has been disappointing (a fall of 38.8% YTD) and it is now trading at a discount to book value. SEC's managers think that it should trade at a premium and that the current discount provides an indication of the strong recovery potential that Goals Soccer should provide.

Performance

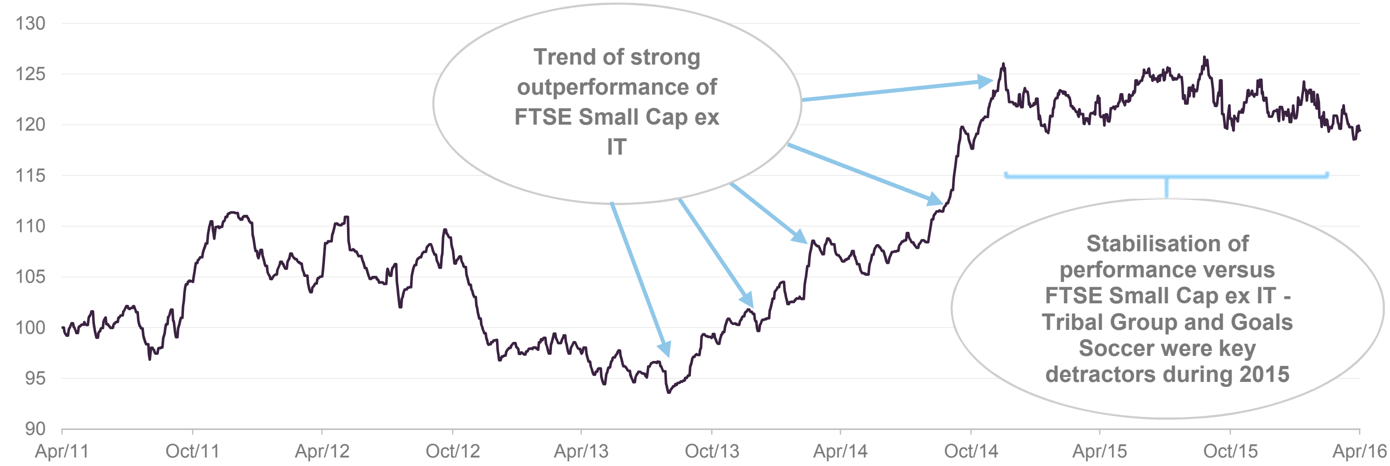
A period of stable performance following a period of strong outperformance.

As illustrated in Figures 8 and 9 (overleaf), SEC's NAV has, following an extended period of very strong outperformance of the FTSE Small Cap Ex Investment Companies Index, been relatively stable over the last 15 months. The performance of SEC's concentrated portfolio is driven by stock-specific events (in particular Tribal in the second half of last year and more recently Goals Soccer). However, more recently, it may also reflect the managers' strategic view that we are in a late-mid-stage bull market, which has led to a decision to reduce growth/momentum stocks and hold higher levels of cash. This decision could prove to be an aid to relative performance in the event that markets were to experience an aggressive derating.

Tribal was a significant detractor during Q4, but it is now trading significantly above its January low. SEC's managers expect to make strong returns from this investment.

The Tribal holding had a negative impact on performance during Q4 2015, as discussed above. Tribal cost SEC 482 basis points (bps) of relative performance during Q4, which dwarfed all other movements and masked generally good performance elsewhere in the portfolio. However, following the completion of its rights issue, Tribal is currently trading at 46.5p, 200.4% above its January low of 15.48p. Reflecting this, Tribal was the single largest contributor to performance in Q1 contributing 262 bps to SEC's return during the period. It would also appear to be on track to be a significant positive contributor to performance in the current quarter, as its share price has returned 27.3% since 31 March.

Figure 8: SEC NAV/FTSE Small Cap Ex Investment Trusts Index* – rebased to 100 since 30 April 2011



Source: Morningstar, Marten & Co.

Figure 9: Cumulative total return performance to 30 April 2016

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
SEC NAV TR	0.6	5.4	0.3	2.5	74.1	111.9
SEC Share price TR	0.8	5.7	(9.7)	1.1	95.6	141.6
FTSE Small Cap ex IT	1.3	6.4	1.3	3.8	42.0	77.5
FTSE All Share ex IT	0.7	3.9	0.0	(5.9)	11.8	29.1
IA UK Smaller Cos	0.6	3.6	0.5	5.8	39.0	62.6

Source: Strategic Equity Capital, Morningstar, Marten & Co.

Please click here to visit QuotedData.com for a live comparison of SEC versus its UK smaller companies peer group.

Servelec was a strong positive contributor in Q1 adding 211 bps. The market appears to have reacted positively to its full-year results and the announcement of the purchase of Synergy from Tribal. Goals Soccer and Clinigen were the two largest detractors in Q1, costing 219 bps and 148 bps respectively. In the case of Clinigen, its half-year results were in line with expectations, but it appears to have derated on concerns about the near term trading outlook (the company's new acquisitions are yet to make a meaningful contribution to returns, which have been overshadowed by a short term uplift in costs). With regard to Goals Soccer, which is discussed in greater detail on page 8, it has detracted largely because of the market's response to its difficult trading in H2 2015. However, SEC's managers believe that it now has a team in place, which can turn Goals Soccer around whilst Tribal, the other recent underperformer, already appears to have turned a corner. These holdings aside, the remainder of the portfolio appears to be performing well.

As illustrated in Figure 9, SEC's share price performance has underperformed that of its NAV over the six months and one-year periods, which reflects a widening of its discount during the period although, as the one and three-month periods illustrate, this has been more stable recently. SEC has moved from trading at a premium at the beginning of the year to trading at a mild discount (see Figure 10.) As noted below, this reflects a broader trend of derating across the investment trust sector.

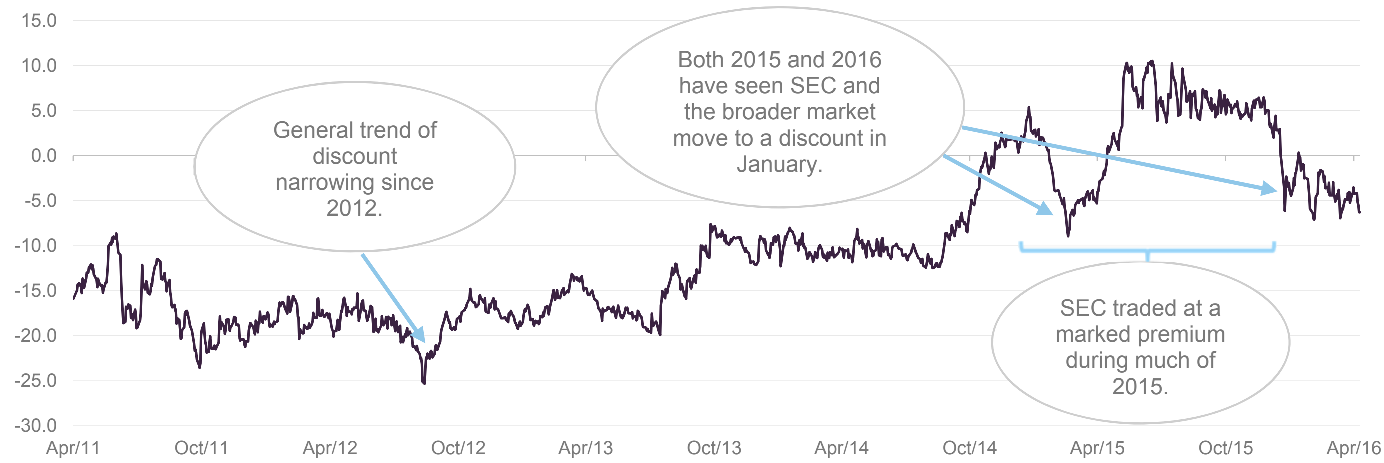
Discount

In common with the broader investment trust sector, SEC has seen its discount widen this year, so that it is now trading at a discount greater than its one-year average.

In a repeat of its 2015 performance, SEC began 2016 trading at a premium, but has seen this close and it is currently trading at a discount (see Figure 10 below.) However, similar to 2015, 2016 has seen a general widening of discounts across the investment trust sector, since the beginning of year, which has since partially reversed. Recent movements aside, the trust has been on a trend of discount narrowing since September 2012. This is arguably a reflection of both its improving performance record, during the period, as well as of the introduction of semi-annual tender offers in 2012 (see below). As such, its current discount of 6.3% is noticeably wider than its average premium during the last 12 months of 2.8% (its one-year range has been between a discount of 7.1% and a premium of 10.5%).

The trust has the authority to issue up to 10%, or repurchase up to 14.99%, of its issued share capital annually and, as discussed in our January 2015 note, the trust has a discount control mechanism in the form of a semi-annual tender for 4% of the share capital at a 10% discount. The board can opt not to hold the tender if it feels it is unwarranted and reflecting the fact that SEC experienced strong demand for its shares in 2015 (the trust issued 12.8m shares or 22.4% of opening share capital during the year) and consistently traded above a 10% discount (see Figure 10), neither of the potential semi-annual tender offers were undertaken.

Figure 10: Premium/(discount) over 5 years



Source: Morningstar, Marten & Co.

A number of catalysts could lead to a narrowing of SEC's current discount.

In addition to the general widening of the investment trust sector, mentioned above, the recent move to a discount may also be a reflection of both SEC's relative performance (versus the small-cap market) stabilising during 2015 (after a strong run of outperformance); general market nervousness in the face of recent market volatility (the sector as a whole has widened and small caps tend to suffer disproportionately during periods of market volatility); and the market digesting negative news in relation to Tribal and then Goals Soccer (see pages 6 to 8). However, it would seem reasonable to us that improvements, in any of these factors, could lead to a narrowing of SEC's discount. For example, if markets stabilise and investors' confidence improves, demand for small-cap exposure could strengthen, stimulating demand for SEC's shares. With regard to Tribal and Goals Soccer, Tribal has recovered strongly and SEC's managers believe that Goals Soccer now has a credible management team in place and that it has strong recovery potential.

Fund profile

More information can be found on the company's website: www.strategicequitycapital.com

Launched in 2005, SEC is a UK investment trust that invests in a concentrated portfolio of UK-listed equities (typically 15-20 holdings). SEC is overwhelmingly focused on small caps although this is not actually mandated by its investment objectives. The managers expect that the majority of its investments will be in the sub-£300m market-cap range as they believe this underresearched segment (those which are too small for inclusion in the FTSE 250 Index), creates greater opportunities to identify mispriced securities. The company can invest in companies listed on overseas exchanges, but this is formally limited to 20% of gross assets, at the time of investment, and the managers do not expect this to be a significant element of the portfolio. The approach is not constrained by benchmark, has an absolute return focus and does not employ leverage at the investment trust level although underlying companies may of course employ borrowings.

Private equity style valuation techniques in public markets

GVQ's private equity style is a key differentiator.

A feature of SEC, which makes it unique in the closed-end fund space, is GVQ's approach to managing its portfolio. In common with all of its mandates, GVQ uses an approach that seeks to apply private equity techniques to listed equity markets. More detail is available in our January 2015 note, but key features of the approach are a strong focus on a company's cash flows (post maintenance capital expenditure, as the managers say that this gives a fairer indication of a company's ongoing profitability); valuing companies using an in-house leveraged buyout model (and forming an opinion of the potential value to a trade buyer or private equity house); and seeking to identify companies that are undervalued but might benefit from strategic, operational or management initiatives (and then establishing, prior to investment, whether a process of constructive engagement can be undertaken to help effect the necessary changes required to unlock value).

The managers are looking for a number of sources of value creation.

It should be noted that the managers do not rely solely on the rerating of a stock. Instead they are looking for companies that offer a number of routes to value creation: earnings growth, rerating potential, cash flow and corporate activity (see our January 2015 note for more detail). In the managers' view, this will typically lead to all-weather strategies that perform in a variety of market conditions and generally outperform most other strategies over the longer term. During the five years to 30 April 2016, SEC has provided an NAV total return of 111.9%, comfortably ahead of the FTSE Small Cap Ex Investment Trusts Index and FTSE All-Share Ex Investment Trusts Index, which have returned 77.5% and 29.1% respectively (see pages 8 and 9 for further discussion on SEC's recent performance).

Well-resourced and aligned investment manager

SEC has been managed by GVQ Investment Management (GVQ) and its predecessors since launch (GVQ Investment Management was formerly GVO Investment Management and SVG Investment Managers). GVQ has assets under management of £620m and was acquired by Lord Rothschild's RIT Capital Partners in January 2015. The investment managers are well-aligned with shareholders, in our view. GVQ employees own over 1% of the trust and RIT Capital has a 14% stake in SEC.

Previous research publications

Readers interested in further information about SEC may wish to read our initiation note of January 2015 and update note of July 2015.

Figure 11: Marten & Co. previously published research on SEC

Title	Note type	Date
Different, in a good way	Initiation	27 January 2015
Measured expansion on strong performance	Update	16 July 2015

Source: Marten & Co.

Different, in a good way – 22 January 2015

Different, in a good way – 22 January 2015 - continued

Measured expansion on strong performance – 16 July 2015

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