The Edinburgh Investment Company (EDIN-L) - Yielding 5.5%

In early January, I highlighted the Edinburgh Investment Company (price Stg367p) as a defensively managed equity fund with a high initial dividend yield.

The Edinburgh Investment Company plc is listed on the London Stock Exchange (ticker code: EDIN-L), it invests in predominantly UK-listed companies and is managed by Invesco Perpetual. The company's assets amount to circa £1,000 million. The fund is limited to owning 5% of the ordinary shares of any one company and 10% of the combined securities of any one company. It can invest a maximum of 15% in stocks listed in overseas markets.

The fund manager, Neil Woodford, has a long established track record and is highly regarded in the UK market as a result. He avoided the tech mania in the late 1990s and protected the value of funds for clients at that time. He took over the management of the Edinburgh Investment Company in September 2008 following several years of under-performance by the fund under other fund managers. In 2009, and under his stewardship, the fund's Net Asset Value (NAV) advanced by 14% compared to a rise in the FT All-Share Index of 30%. This under-performance in 2009 was despite the fund being geared by 20% which was a benefit in a rising market.

At first glance, then, the fund is not an obvious choice. However, it is clear from the underlying portfolio that Neil Woodford has taken a very defensive stance - firstly to ensure the dividend is secure and secondly because he believes that economic recovery will be anaemic at best and quite likely to reverse. Hence, the fund is full of defensive stocks from sectors such as pharmaceuticals, telecoms, utilities and tobacco, which should prove to be relatively immune to a double dip recession (at least their profits and dividends should be).

In my initial coverage of the fund at that time, I mentioned that there were a couple of questions that I needed answers to before I would make a definite recommendation. Those questions included

- What discount the fund is at relative to its net asset value?
- Whether the fund uses borrowings (leverage)?
- Are the fund's reserves sufficient to cover the dividend for several years to come? and
- What are the annual management charges within the fund ?

The Discount

Investment companies (trusts) generally trade on discounts to their underlying assets of circa 7-9% (for reasons I have never fully rationalised but have come to accept) - with poorly performing investment companies often trading on much larger discounts. The Edinburgh investment company is currently trading at a 10% discount, although when its (high cost) debt is priced to market the discount works out at 2-3%. Not what an investor might expect given the continued under-performance.

Borrowings

The fund has a borrowing capacity of £200 million and is currently fully utilising its borrowing facilities. They are long standing facilities and the main facility, a debenture, costs 14% per annum. It matures (redeems) in 2014 after which the fund will benefit from substantially reduced interest charges. What potential investors need to understand in relation to these borrowings is that they will magnify the returns both ways i.e. should the market and the fund's holdings decline in value, that decline will be magnified somewhat due to the gearing.

Reserves & Dividend Cover

The fund has revenue reserves of £58 million that can be drawn on to support dividend payments. The annual dividend costs the fund in the order of £41 million and the fund received dividends from its stock holdings of circa £46 million in its last full year to March 2009. Hence, the reserves are not required at present to help support dividend payments.

In addition, one needs to also understand that the company can restructure its debt at any stage, swapping the expensive debt for cheaper financing. This, of course, would cost it money and that cost would reduce the net asset value in one go. However, this option to refinance provides added flexibility and should the company run low on revenue reserves for the dividend payment, rescheduling the debt would be a realistic way of improving the dividend cover. All told, the dividend looks safe to me.

Management Charges

The annual management charge is a highly competitive 0.5% per annum. The fund managers can obtain a performance fee if they out-perform the FT All-Share Index, which aligns the fund manager's goals with the investor's goals. i.e. they only earn extra fees if they out-perform. As things stand, they will have to makeup lost ground first.

Summary

Large capitalisation defensive stocks have lagged in this market recovery and many top quality stocks in this category are trading on modest p/e ratios. The Edinburgh Investment Company is full of these defensive large-cap companies. Neil Woodford has a good track record but even if his view on the outlook is incorrect, and the fund under-performs further, the fund still has considerable merit. If economic recovery falters, cyclical stocks will fall sharply and this fund will out-perform in a declining market. If large-cap defensive stocks globally are re-rated (i.e. given a higher p/e ratio), which in my view is a distinct possibility at some stage, then this fund will out-perform in a rising market. It is the classic case of ignoring the track record - i.e. past performance is no guide to future performance.

At a share price of 366p, the dividend yield is 5.5% (annual dividend 20.4p, paid quarterly) and looks sustainable and pays you to wait. In a low growth environment, income becomes even more important. Although I would prefer to see the shares trading at a wider discount to the net asset value (NAV), the high and sustainable dividend yield sways it for me and I am happy to put it on the 'BUY' list. It may not be the most exciting fund in the world but, as I say on our 1-Day Seminars, no one ever said investing is meant to be exciting.

Rory Gillen, Founder *www.investRcentre.com*
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