Strategic Equity Capital

Different, in a good way

The trouble with choosing between UK equity funds is the similarity of their investment styles. Strategic Equity Capital's approach, looking at companies the same way that a private equity investor would and engaging with them, is refreshingly different. What's more, it seems to work, making investors three times their money over the past five years, well ahead of its nearest rival. This has attracted the attention of Lord Rothschild's RIT Capital Partners, which has just acquired the management company and taken a substantial stake in SEC.

Objective

Strategic Equity Capital ("SEC") invests in a relatively concentrated portfolio of quoted UK equities with the aim of generating an internal rate of return 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 (explained later).

Year Ended	Share Price Total Return (%)	NAV Total Return (%)	FTSE Small Cap ex IT TR. (%)	FTSE All-Share ex IT TR (%)	MSCI World ex UK TR (%)
31/12/10	35.1	37.5	16.9	14.5	12.1
31/12/11	9.5	3.2	-15.2	-3.5	-5.9
31/12/12	25.6	21.0	36.3	12.3	15.9
31/12/13	61.5	46.5	43.9	20.8	27.3
31/12/14	32.7	18.2	-2.7	1.2	5.9

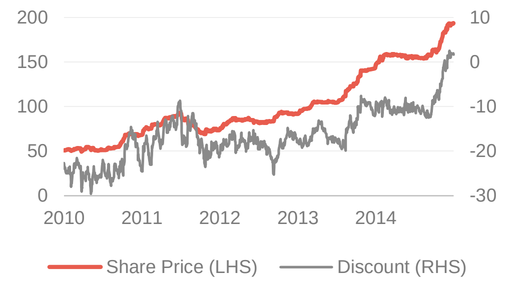
Source: Marten & Co., Bloomberg, Morningstar

SEC is an unconstrained portfolio and has no formal benchmark. Throughout this report we have compared the performance of the fund with the FTSE Small Cap. ex Investment Trusts Index. This is the index that SEC uses to calculate its performance fee and is used as a reference for performance comparison purposes.

Sector	UK Small Co.s
Ticker	SEC LN
Base Currency	GBP
Price	197.375
NAV	192.38
Premium (Discount)	2.6%
Yield %	0.4%

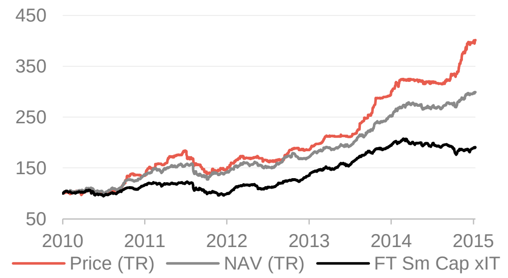
Share price and discount

Time period 1/1/2010 to 31/12/2014



Performance over 5 years

Time period 1/1/2010 to 31/12/2014



Domicile	United Kingdom
Inception Date	13 July 2005
Manager	Stuart Widdowson
Market Cap (mlns)	113.3m
Shares Outstanding	57.4m
Trading Volume	86,000 shs
Net Gearing	Nil

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GVOIM’s reasons to invest in SEC?

We asked SEC’s investment manager, GVO Investment Management (or GVOIM for short) what differentiates SEC from its peer group and why investors might think about buying its shares.

- SEC has a distinct investment approach, applying private equity techniques to investing in publicly traded companies that are typically too small for inclusion in the FTSE 250 Index.
- It operates with an unconstrained mandate and is a concentrated portfolio of stocks that the manager believes are high quality.
- Before any investment is made, GVOIM carry out significant in-house research, aided by a panel of industrial advisers.
- Each investment should have the ability to provide four potential drivers of investment return over the long term: earnings growth, re-rating potential, cash flow and corporate activity.
- SEC has an enviable performance record over the past five years, well ahead of its peer group in absolute terms but with lower volatility.
- The managers are clearly aligned with the shareholders as they have substantial “skin in the game”. GVOIM employees own over 1% of the fund and RIT Capital, the new owner of GVOIM, has a 17% stake in SEC.

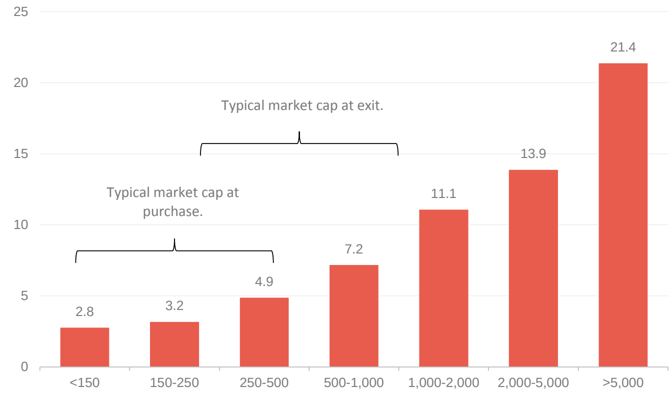
Investment Strategy

Distinct investment strategy - Private equity in public markets

SEC’s investment approach, which could be summed up as employing private equity techniques to investing in public markets, results in a portfolio that is clearly differentiated from any competing UK smaller companies investment company.

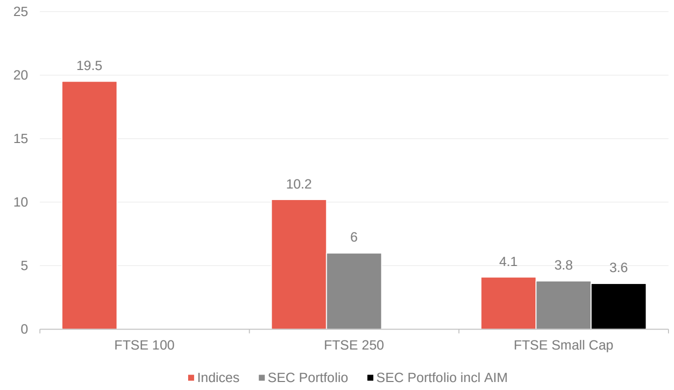
The portfolio is a fairly concentrated one with typically fifteen to twenty small cap listed equities (currently 20) spread across a range of industries. There is a maximum of 15% in any one investment and holdings will typically have a market capitalisation that is too small for inclusion in the FTSE 250 Index (at the time of investment). This segment of the market is less well researched (see Figures 1 and 2 below) creating greater opportunities to identify mispriced securities. The portfolio will see between two and five new investments made each year. At any one time, the managers will have five to six prospects that they are actively considering for inclusion. The managers invest with a rolling three year time horizon and turnover is typically 25-30%. They target an internal rate of return (“IRR”) of 15% over the economic cycle. As discussed below, GVOIM develop entry and exit strategies, and a clearly defined route to value creation, prior to initiating an investment.

Figure 1: Average number of analysts by mkt cap.



Source: GVO Investment Management, figs as at 30 June 2014

Figure 2: Average number of analysts, SEC's portfolio



Source: GVO Investment Management, figs as at 30 June 2014

GVOIM searches for companies that can perform well regardless of wider market moves

GVOIM uses a research driven 'private equity style' approach to assess the merits of portfolio candidates, seeking to identify companies that are undervalued but might benefit from strategic, operational or management initiatives. A key feature of this approach is that the managers do not rely solely on the re-rating of a stock or on the success of "value" or "growth" styles of investing which can fall out of favour. Instead they are looking for companies that offer a number of routes to value creation (that are not market related) and, in the manager's view, this will typically lead to generation of more consistent returns over different market conditions.

GVOIM look for 15% IRR across the cycle from a combination of growth, rating change, free cash flow after dividend payments and dividends. The managers focus their efforts on four key potential drivers for value creation within a company:

- **Growth prospects.** GVOIM say they like companies that are exposed to growing markets but will invest in low growth and cyclical companies, where they believe these should be capable of earning more and generating strong cash flow. GVOIM prefer businesses with the ability to defend their profitability (those with intellectual property, high barriers to entry, etc.), even when markets are falling.
- **Corporate activity.** GVOIM conduct an analysis of a company's surrounding market forming an opinion on the potential value of a company to a trade buyer or private equity house. All portfolio candidates are valued using an in-house leveraged buyout model (in other words, assuming a buyer could borrow money to buy the company and then use the cash generated by the business to pay back the interest and debt). Ideally, GVOIM are looking for companies trading at a discount to recent IPO's/trade sales in their sector.
- **Cash flow.** GVOIM favour cash generative businesses. This may be a consequence of the company's operating model, high margins, efficient working capital and / or low capital expenditure requirement. Such businesses can deliver investors returns from the transfer of value from debt to equity, either through reducing the amount of debt used to fund the company, dividends or enhanced returns (buy-backs, special dividends etc.).
- **Valuation.** Returns are a function of choosing appropriate entry and exit points and, reflecting this, GVOIM say they maintain strong pricing discipline based on the appropriateness of the valuation a company is trading at. They frequently identify strong candidates for the portfolio but will wait until they're trading at appropriate valuations before buying any shares. Similarly, whilst GVOIM are

happy to run their winners where the valuation remains compelling, they will reduce and ultimately sell out of businesses where the shares have re-rated to GVOIM's target exit level.

Focus on cash flow

A key feature of this, private equity style, appraisal is an analysis of a company's cash flows – post maintenance capital expenditure (the money it needs to reinvest in the business to keep it running at the same level). The managers highlight that, whilst earnings are important, they can be more readily manipulated and that a focus on understanding a company's cash flow and its sources of cash leakage are key to evaluating its ongoing profitability. For example, they are cautious on companies with significant commitments to defined benefit pension schemes. They also highlight that, whilst important, focusing purely on free cash flow is problematic as this can be boosted short term by cutting back on investment, etc. which can not only undermine a company's future profitability but can lead to investments in companies that appear to be generating higher margins and trading at cheaper valuations than is actually the case. The managers say that by focusing on cash flows post maintenance cap-ex gives a fairer indication of a company's ongoing profitability.

The focus on decent quality companies that can generate strong cash flow has the effect of excluding investment in some areas of the market. The managers avoid businesses that are inherently low margin (e.g. housebuilding, construction, etc.), and businesses where the primary driver of profitability cannot be influenced by management (e.g. resource companies and commodity prices). They avoid businesses in structurally declining markets and those that overly reliant on a single product, customer, supplier or distributor. Poor accounting systems and deteriorating governance standards are also significant black flags, as are weak cash flows and excessive levels of gearing. GVOIM will not invest in companies that it does not have the expertise to analyse. As such they will avoid blue sky investments, those that are at an early stage in their life and are yet to generate positive cash flows.

The ideal investment is one with one with predictable growth and strong cash flow, trading at a reasonable price. This is the favoured hunting ground for many other managers however so the "reasonable price" element is not often available. GVOIM have a list of companies they'd like to own, at the "right" price, that they monitor closely in case the opportunity presents itself.

GVOIM say they consider IPOs but aren't usually given sufficient notice to evaluate these properly and so rarely invest in them.

All investments must go before GVOIM's Industry Advisory Panel. The panel was formed in 2003 and meets monthly to discuss investment candidates in detail. They give consideration to the quality of a business, its board, its accounts, whether it is operating at full potential, the strategic and structural challenges it faces, as well as the factors that could cause earnings to collapse and lead to a de-rating. The panel is made up of an experienced team (see page 15) and, whilst the managers are not bound to follow its recommendation, they consider the Industry Advisory Panel to be very valuable resource that helps them to challenge and further develop investment rationales. They believe this ultimately contributes to superior performance.

A feature of GVOIM's private equity style approach is that this will typically lead to the identification of companies that, whilst operating in a growth segment, may be trading at depressed valuations reflecting specific strategic issues within a business. This could be something as simple as a young company that needs help in developing is investor relations and communications strategy so that investors are better aware of it. Other examples include management that is pursuing a sub-optimal acquisition strategy or unprofitable R&D. GVOIM's approach informs the manager of the challenges within the business of a portfolio candidate, and a key part of GVOIM's due diligence is to establish whether management is open to engagement with GVOIM to bring about these value creating changes.

SEC has the flexibility to invest up to 20% of its portfolio in overseas stocks but to date this has not been utilised and GVOIM suggest this would only be utilised in exceptional circumstances. SEC also has the power to invest up to 20% in unquoted stocks, mainly to enable the trust to maintain a holding in a portfolio company that is being taken private at a value which GVOIM feels materially undervalues its prospects. It has been used opportunistically in the past to acquire stakes in limited partnership vehicles where the assets are well known to or managed by GVOIM and very attractively priced.

Engagement

SEC is not an activist fund but takes a closer interest in the companies it buys than many other investors.

GVOIM are keen to stress that SEC is not an activist fund. However, they feel that shareholders should not be passive investors but should engage with the management and directors of the companies that they invest in, on matters of corporate governance and corporate strategy. GVOIM take a holistic approach to this and their focus is on creating shareholder value.

Even before they make an investment they think about any message they might want to convey to the company. They want to do that from a position of understanding which is one reason why they put so much emphasis on in-depth research, including conversations with key stakeholders; management, chairmen, senior non-executive directors, brokers, other shareholders and, sometimes, suppliers and customers. Before they make an investment, GVOIM think it is important to establish a good dialogue with the people running the company and other stakeholders to understand their views.

GVOIM conduct their own appraisal of companies and present these back to management, directors and other shareholders, to use as a basis for discussion. If GVOIM believe change is needed, they want to create consensus among key stakeholders and they are happy to play a supporting role to another shareholder with the same aims.

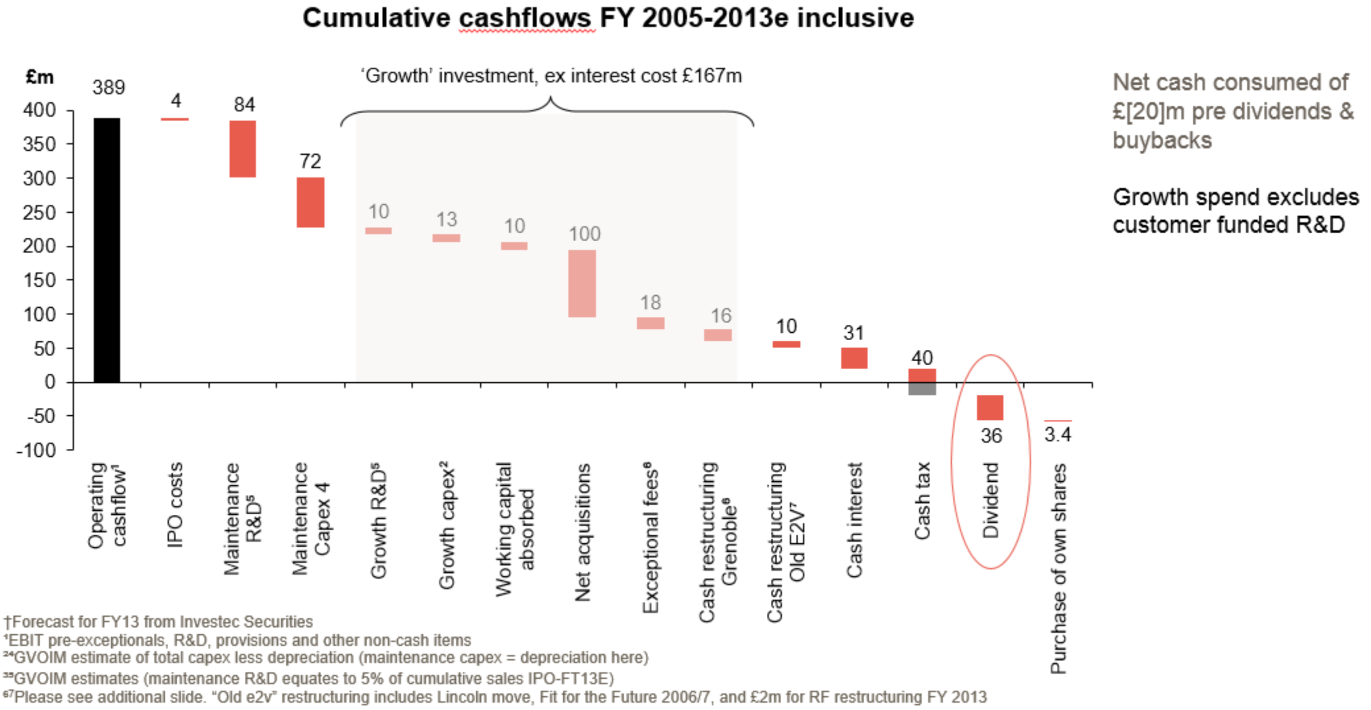
We asked them to provide a case study to illustrate how this works in practice and GVOIM suggested e2v Technologies.

e2v Technologies

SEC first invested in e2v in 2009, when the company conducted an equity fund raising to repair its balance sheet and GVOIM has supported the company as it sought to restructure its business to focus on higher return activities. This seemed to meet with some initial success but gradually GVOIM became concerned that e2v might be reverting to its old practice of making significant investment, including acquisitions, without getting much of a return on this investment – as was perhaps suggested by analyst's downgrades to earnings expectations in 2013.

In 2013, GVOIM undertook, at some effort, an analysis of all the investment – R&D, capital expenditure and acquisitions – made by e2v since its IPO in 2004. Part of the output from this analysis is reproduced in Figure 3 below. This analysis suggested that, while the underlying business was sound, in aggregate e2v had made no additional return on growth capex and acquisitions, while spending significant amounts on advisors' fees and integrating its acquisitions. GVOIM presented this analysis to the company and asked them to double check it and consider the implications. GVOIM did not mandate change or make specific suggestions about the best way forward. The company elected to appoint a new chief executive (Steve Blair, ex Spectris) in March 2014. He seems to have taken GVOIM's points on board and says he is working to double the company's EBIT. GVOIM think this is achievable yet, at the moment, the valuation does not reflect this, hence e2v is SEC's largest shareholding.

Figure 3: e2v cumulative cash flows 2005-2013e inclusive

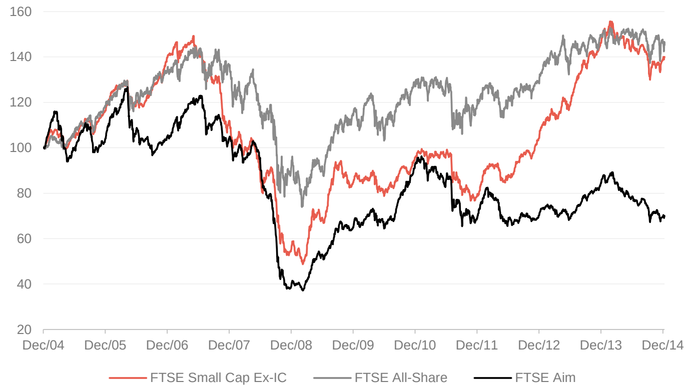


Source: GVO Investment Management

Outlook, market - unsettled / SEC - fair to good

Background: There are plenty of reasons to be negative about the outlook for equities. On a global level, worries about Chinese demand persist, linked to fears that they have created their own mini credit crisis. There are signs of growth in the US but economic data is inconsistent, government debt is still far too high and the Federal Reserve is becoming taking a tougher line. In the EU, deflation has resurfaced and the sanctions imposed on Russia are taking their toll on Europe as well. Against this, both Japan and the EU are still trying to stimulate growth. Weak oil prices should also have a beneficial effect on many economies. In the UK, there is real concern that the result of the election in May could have adverse consequences for markets. GVOIM are also unsure how sustainable the UK consumer recovery will be, especially if house prices stabilise. However, the measures adopted in the budget to increase the size of ISAs and freedom from compulsory annuity purchases could help equities.

Figure 4: Market indices – 10year performance rebased



Source: Bloomberg, Marten & Co.

Figure 5: Price to book ratio

Source: Bloomberg, Marten & Co.

The chart in Figure 4 above shows the strong performance of the FTSE Small Cap. Index relative to the FTSE All-Share Index from January 2012 to February 2014. In the Spring of 2014 however sentiment towards smaller capitalisation stocks shifted adversely. The move seems to have triggered significant outflows from open-ended UK smaller companies funds and this is compounding the problem.

As the price to book graph in Figure 5 shows, smaller companies have got relatively cheaper over the past nine months. GVOIM suggest that much of the move in markets has been indiscriminate but, while there are still pockets of the small cap. market where companies are overvalued, the market falls are uncovering some bargains.

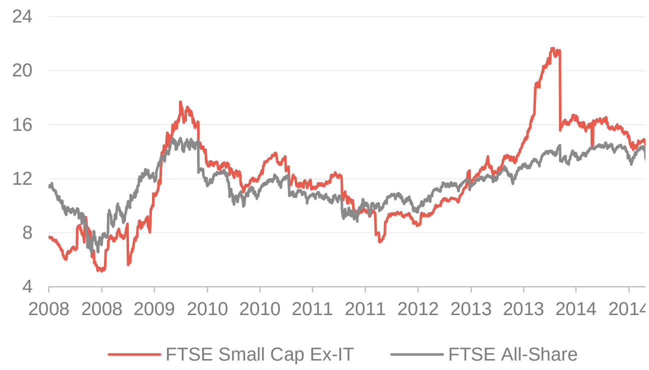
GVOIM think we are in a mid-cycle phase in the UK economy. This environment is unlikely to throw up opportunities to get involved with recovery finance for companies. GVOIM say the focus for new acquisitions will probably be companies in need of some operational improvement, those with inefficient balance sheets and those where the market has been unnerved by a pause in revenue / earnings growth. They also believe, as the economy improves, we are likely to see more companies coming to the market looking for growth capital.

Figure 6: Valuation metrics for UK indices

Index	5yr Avg. F12m P/E	Current F12m P/E	Premium over 5yr Avg. (%)
FTSE Sm Cap Ex-IT	12.9	13.5	5.0
FTSE All-Share	11.9	14.1	18.0
FTSE 100	11.7	13.9	18.5
FTSE 250	13.7	15.5	13.3
FTSE Fledgling	19.0	19.2	1.4

Source: Bloomberg, Marten & Co

Figure 7: Forward 12m P/E ratios



Source: Bloomberg, Marten & Co

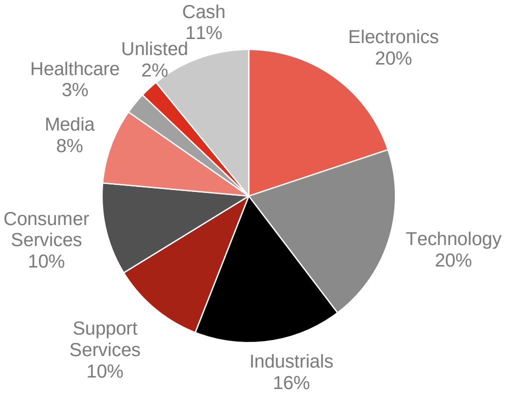
M&A uptick could be very good news

Figure 6 suggests that stocks in the FTSE Small cap. ex Investment Trust Index are very modestly higher rated, on a price / earnings ("p/e") basis, than they have been over the past five years. Only the stocks in the Fledgling Index (which contains even smaller stocks than the FTSE Small Cap. Index) look more attractive on this view. GVOIM believe analysts' estimates are becoming more realistic, as is evidenced by the fall in forward 12m p/e ratios in Figure 7; this is good news in their view. The strengthening US dollar is having a positive impact on the portfolio and this is evident in performance of stocks like Tyman and 4imprint. Signs are that Merger and Acquisition ("M&A") activity is picking up. This could have a disproportionate effect on SEC's portfolio given GVOIM's effort in identifying the companies that a private equity firm would be happy to buy. This has been evident recently in the bid for Allocate Software and a bid for a competitor of EMIS. GVOIM believe the earnings (sales and margins) of their companies remain below peak / full potential, and are undervalued.

Portfolio

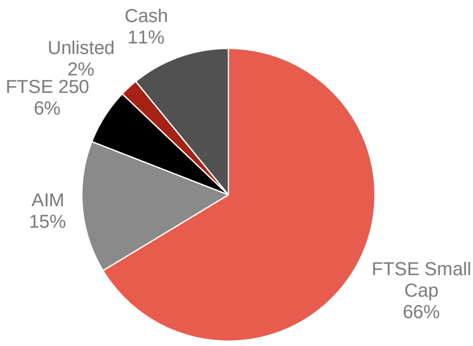
There were 20 holdings in the portfolio at the end of December, two more than at the end of September. SEC has not yet disclosed the names of the new additions. GVOIM say turnover (purchases and sales in the portfolio) is running at about 30%, elevated by M&A activity.

Figure 8: Portfolio split by sector



Source: GVO Investment Management

Figure 9: Portfolio split by index



Source: GVO Investment Management

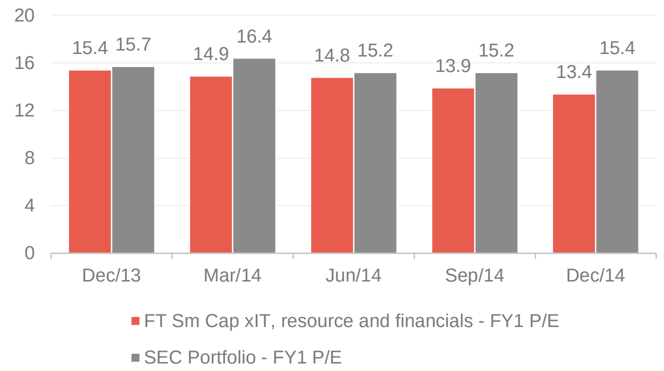
Figures 8 and 9 show the distribution of the portfolio at the end of December 2014. As we explained in the investment strategy section, there are industries that do not suit this investment approach. This means that, on a sector basis, the portfolio is materially different to the split of the FTSE Small Cap. Index. The cash balance rose to 10.9% by the end of December due to the bid for Allocate Software by Hg Capital. SEC bought into the company in 2009 to support an acquisition the company was making and topped up their investment over time, taking its stake to 9% of the company. GVOIM say that, although Allocate's recurring revenue climbed significantly, its share price did not keep pace. Hg's bid came at a 35% premium to the prevailing market price, crystallising a 150%+ profit for SEC, equivalent to a 25.6% IRR.

The unlisted exposure is to Vintage One. This is a fund of private equity funds managed by 3i which they bought in 2007 and is now effectively in run-off mode and so will turn into cash over time. It is very diversified, around 33 underlying funds.

SEC's portfolio has faster earnings growth than the market

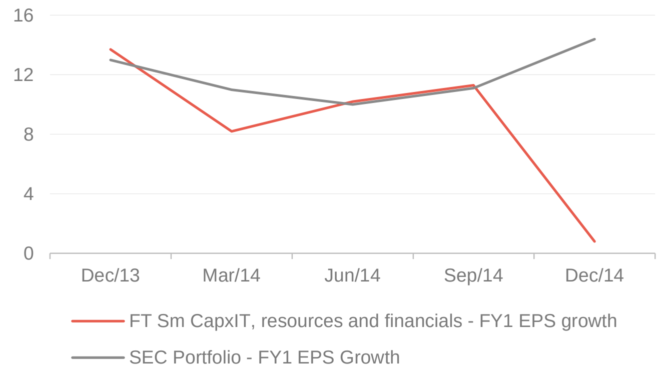
It is interesting to see that the forecast earnings growth for companies in SEC's portfolio is much higher than for the small cap. market as a whole – see Figures 10 and 11 overleaf. This is, in part, a reflection of the absence of oil and mining stocks in SEC's portfolio, which have been hit as commodity prices have fallen, but it might also suggest the portfolio is relatively resilient in the current market environment. Not to say that the portfolio is completely unresponsive to moves in the oil price, in recent months the prices of Northbridge and Lavendon both seem to have come off in response to the oil price fall.

Figure 10: Forecast P/E – SEC vs. market



Source: GVO Investment Management

Figure 11: Forecast earnings – SEC vs. market



Source: GVO Investment Management

The top ten holdings

Figure 12: Holdings at 31 December 2014

Stock	% of Portfolio	Sector	When bought	GVOIM FCF Yield
Tyman	11.6	Industrials	2009	9.3%
Servelec	10.7	Technology	2013	8.9%
e2v technologies	10.6	Electronics	2009	11.1%
EMIS	8.8	Technology	2014	8.0%
4imprint	8.6	Support Services	2006	8.6%
Wilmington	8.3	Media	2010	10.4%
Goals Soccer	6.9	Consumer	2012	10.1%
Gooch & Housego	5.3	Electronics	2011	10.2%
XP Power	3.9	Electronics	2012	11.0%
RPC	3.2	Industrials	2007	12.7%

Source: GVO Investment Management

Looking at a few of the key holdings,

Tyman, formerly Lupus Capital, (11.6% of the portfolio at the end of December 2014) is a leading supplier of door and window fittings to the new build and renovations markets with operations across Europe, the Americas, Australasia and Asia. In 2013 it strengthened its US presence with the acquisition of a competitor, Truth. A trading statement in November described growth in revenues and orders in the US market. Also the strengthening US dollar is boosting revenues in sterling terms from this business. They have been extracting cost synergies from the deal and say a further $8m of cost savings have been identified for 2015. GVOIM believe Tyman's capacity utilisation is still well below what it could be (in other words, they have the ability to make a lot more money given the investment that has gone into the business).

Servelec (10.7% of the portfolio at the end of December 2014) was IPO'd in 2013. It provides software, hardware and services predominantly to the UK healthcare, oil & gas, nuclear, power, utilities and broadcast sectors. In December it acquired Corelogic, a company providing software to manage social care. Servelec have hopes of growing this business organically. GVOIM see upside from the integration of this business and from the renewal of some of Servelec's existing software licences. The company has made cash flow returns on invested capital ("CFROI") of over 40% in the past but, on HOLT Lens analysis (a research service used by many investmentmanagers, including GVOIM), this is currently 22%. GVOIM thinks Servelec's profits could be at a trough.

We covered e2v technologies in the engagement section on page 5.

One of the more recent additions to the portfolio, EMIS (8.8% of the portfolio at the end of December 2014) is another healthcare software business, specialising in patient records, and is the market-leader in record management for GP practices and pharmacies in the UK. EMIS has a high degree of recurring revenue and this was one factor that attracted GVOIM. GVOIM bought in at a relatively low valuation whilst markets were unsettled prior to a contract renewal in March 2014. GVOIM was attracted to the strong cash flows, long term growth track record and prospects, the then all-time low rating and the attractiveness of the asset to trade and private equity acquirers. Although EMIS has re-rated since the investment, there has been significant M&A activity in the sector at valuations which might imply that significant upside remains.

Performance

SEC is the best performing UK smaller capitalisation investment company and it is less volatile than its peer group over five years.

SEC's performance record over the past five years is second to none within its peer group, as is illustrated in Figure 13 below. Furthermore SEC has outpaced the FTSE Small Cap. ex Investment Trusts Index by a considerable margin. This has been achieved over a period when, for the most part, smaller companies have been outperforming large capitalisation companies, as is evidenced by the FTSE Small Cap. ex Investment Trusts' performance relative to both the FTSE All-Share Index (which covers most of the UK market and is dominated by larger companies) and the MSCI World ex UK Index.

Figure 13: NAV total return performance vs. indices and peers, periods to end December 2014

	1 month	3 months	1 year	3 years	5 years	Volatility (5 yrs)	Sharpe Ratio (5 yrs)	% up months
Strategic Equity Capital	0.9	7.4	18.2	109.5	197.2	13.3	1.67	73%
FTSE Small Cap ex IT *	1.2	-0.9	-2.7	90.8	89.2	13.2	0.99	65%
FTSE All-Share	-1.6	0.6	1.2	37.3	51.8	12.4	0.69	55%
MSCI World ex UK	-1.5	1.5	5.9	56.3	64.9	14.2	0.95	63%
Peer Group Average	**1.9**	**1.7**	**-2.8**	**75.2**	**128.9**	**13.8**	**1.19**	**65%**
Aberforth Smaller	0.7	-1.9	-1.0	100.9	119.8	17.2	0.97	60%
BlackRock Smaller	1.9	2.2	-1.4	78.2	161.6	15.8	1.27	68%
BlackRock Throgmorton	2.6	2.6	-2.4	70.5	144.8	14.8	1.26	67%
Dunedin Smaller	2.7	0.1	-5.0	72.9	116.5	12.4	1.27	65%
Henderson Smaller	2.8	4.7	1.4	99.7	164.8	15.9	1.28	63%
Invesco Perpetual UK	2.0	3.5	2.8	75.1	107.4	12.2	1.22	63%
Montanaro UK Smaller	3.8	2.0	-6.0	44.2	98.5	12.1	1.15	68%
JPMorgan Smaller	0.5	0.4	-5.7	75.5	113.9	16.1	0.99	63%
Standard Life UK Sm	0.1	1.8	-7.7	59.6	132.4	13.3	1.31	67%

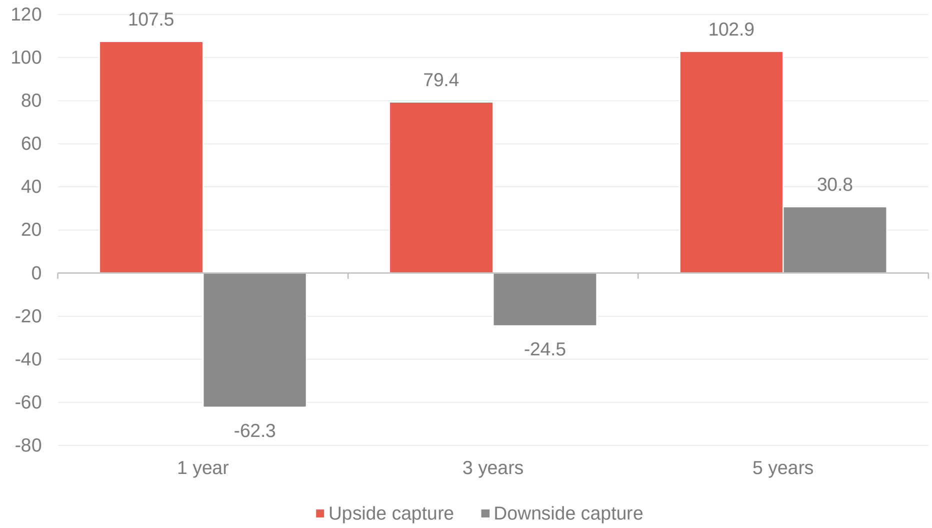
Source: Morningstar, Bloomberg

SEC's performance has been achieved without the benefit of borrowing money (net cash levels have averaged around 7% of the portfolio over the last five years). SEC's returns are also less volatile than the average for its peer group and are only very marginally more volatile than the FTSE Small Cap. ex Investment Trusts Index. The strong performance with lower volatility is clear in SEC's Sharpe ratio (a measure of how good a manager is at outperforming a benchmark without taking too much risk), the highest in the table by some distance. SEC has also delivered more consistent positive performance than its peer and comparative indices with a higher percentage of up months.

Morningstar publishes a measure, the upside / downside capture ratio, that tries to demonstrate how well a fund has done relative to a comparable index in periods of rising and falling markets. An upside capture ratio over 100 indicates a fund has generally outperformed the index during periods of positive returns for the index. Meanwhile, a downside capture ratio of less than 100 indicates that a fund has lost less than the index in periods when the index has been in the red. If a fund generates positive returns, however, while the index declines, the fund's downside capture ratio will be negative (meaning it has moved in the opposite direction to the index). As you can see from Figure 14, which uses data for periods ending on 31 December 2014, SEC has done a good job of capturing the market upside but not falling as fast as the index in negative periods.

GVOIM believe SEC has generated a lot its outperformance at times when the market has been falling or drifting sideways, sometimes generating positive performance in falling markets. They believe that their focus on higher quality, cash generative companies, avoiding overpaying when they invest and avoiding resources and "blue sky" stocks is the driver of this. This does mean though that the NAV may lag in fast-rising "risk-on" markets (markets where investors seem happier to consider riskier investments, as was the case in Q4 2012) or if certain sectors that SEC has little exposure to, such as oil & gas and resources, lead the market.

Figure 14: SEC NAV Upside / Downside Capture ratio from Morningstar



Source: Morningstar

Given the nature of SEC's investment style, its strong performance can only really be attributed to stock picking. Many individual stocks within the portfolio have performed well over the past five years but GVOIM reckon half of SEC's return for 2014 came from its holdings in three healthcare software companies. One of these is Allocate Software, which added 2.5% to the value of the fund over the final quarter of 2014 after it received a bid from Hg Capital (more detail in the portfolio section), and Tyman, which started off the year well but is sensitive to the US dollar (a problem in the middle of the year when the dollar was weak that reversed sharply in Q4). It released a well-received trading statement in November and recovered all the ground it had lost to finish the year just shy of its 2014 high, adding 2.2% to SEC's NAV over Q4.

Discount

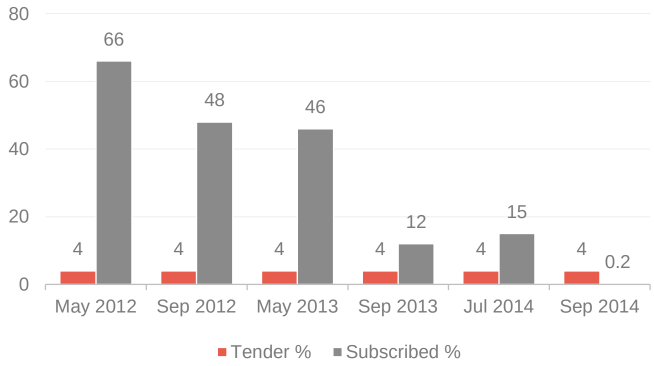
Optional four per cent. tender at 10% discount, semi-annually

SEC operates a discount control mechanism ("DCM") 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 they feel it is unwarranted. The tender planned for May 2014 was delayed until July 2014 in response to management changes at GVOIM. 18% of SEC's share capital has been repurchased under the DCM.

Figure 15: SEC's % discount (based on cum fair NAV)

Source: Marten & Co, Morningstar

Figure 16: Discount control – % tender offer sizes



Source: Marten & Co

The announcement of the introduction of the DCM in 2012 triggered some discount narrowing but the shift to trading around a 10% discount only occurred in Q4 2013, once some of the larger sellers of stock had been cleared out. Today GVOIM believe the opportunistic investors who bought SEC purely because it was trading at a wide discount have, largely, sold their stakes on to investors who are buying on the back of the fund's strong track record and unique investment proposition. Hardly any shares were tendered to the last tender offer in September 2014 (just 0.19% of the company). The move over the past few weeks has been particularly dramatic, allowed SEC to trade at a premium, to reissue all 109,772 shares it had held in Treasury and to start issuing new shares.

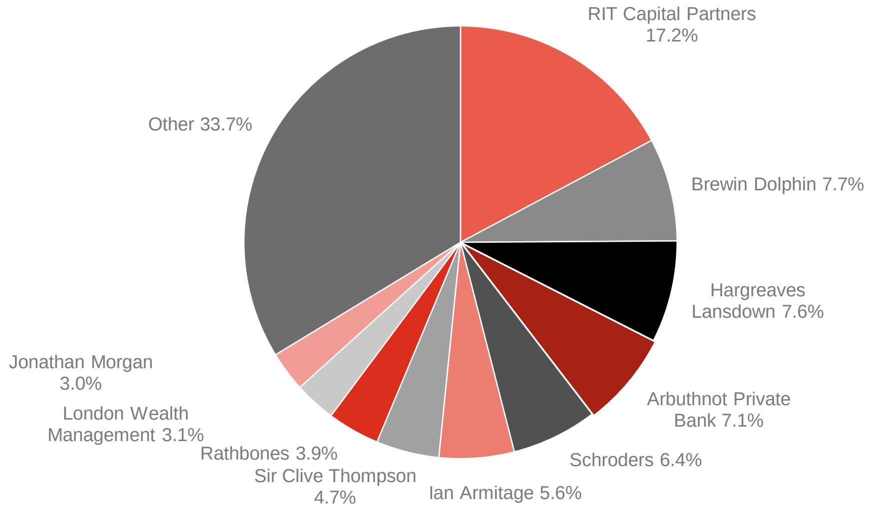
Capital Structure

SEC's capital structure is straightforward – just ordinary shares and no gearing. There are 57,426,013 of these in issue and no shares are now held in Treasury. Their articles permit them to borrow up to 25% of the NAV but GVOIM say they have no intention of gearing the fund and SEC hasn't had a borrowing facility since July 2012.

Significant shareholders

Figure 17, overleaf, shows SEC's largest shareholders, those holding more than 3% of its issued share capital. The list of shareholders incorporates a broad mix of institutions, private wealth managers and individual investors, including Sir Clive Thompson, a director.

Figure 17: Shareholders holding more than 3%



Source: GVO Investment Management

Management Fees

The management agreement was revised in July 2014. GVOIM get the lower of 1% of the market capitalisation of the fund and the net asset value (which gives them an incentive to work to drive the discount down but does not reward them if the fund goes to an excessive premium). GVOIM also get a performance fee of 15% of the excess return over the FTSE Small Cap ex Investment Companies Index over rolling three year periods (or 2% per annum when the return on the Index is lower than this). They can't take more than 1.75% of the NAV in any one year – excess amounts are carried forward to future periods. There is a high watermark. 12 months' notice is needed to dismiss GVOIM but no notice need be given if the shareholders vote against the continuation of the company. SEC's ongoing charges ratio is 1.27% (based on the year to end June 2014) – slightly up on the level for the year to end June 2013 which was 1.16%.

Management Team

GVOIM bought by RIT Capital Partners

GVOIM was founded in 2002. It specialises in using the techniques employed by the private equity industry to investing in quoted companies and they believe they are one of the leading firms doing this in Europe. They do the bulk of their own research, aided by an extensive network of industrialists and private equity professionals. Their fund managers have extensive private and public equity experience, and invest in GVOIM's products.

In December 2014, RIT Capital Partners, the London listed investment vehicle for Jacob Rothschild and his family, acquired GVOIM. GVOIM's managers will retain their investment autonomy under the new arrangement. There is the potential for RIT Capital's network to be a valuable source of investment ideas for GVOIM's clients, including SEC.

Stuart Widdowson is SEC's Fund Manager and has been responsible for the portfolio since mid-2009. He sits on GVOIM's Research Committee and is responsible for GVOIM's Corporate Engagement activities. Prior to joining GVOIM Stuart was Associate Director at HgCapital (2001 to 2006), responsible for originating and executing £50-£350m of leverage buyouts, including take privates, in the UK and Germany. Before working in private equity he was a Consultant at COBA Group (1998 to 2001) where he performed strategy consulting and commercial due diligence.

Jeff Harris is SEC's Assistant Fund Manager. Jeff joined GVOIM in 2012 as an Analyst and was appointed Assistant Manager of both the GVO UK Focus Fund and SEC in May 2014. Jeff is a qualified charted accountant. Prior to joining, he worked within the Transaction Services team at PricewaterhouseCoopers performing financial due diligence on private equity and corporate transactions. Following this, he worked at Macquarie as a European Banks Analyst.

Prior to May 2014, Adam Steiner had an oversight role with GVOIM with respect to SEC. Adam and Jonathan Morgan, Chairman of GVOIM, left in May 2014 and the Board cited this as the reason for the delay in implementing the May 2014 tender offer.

Board

There was quite a bit of movement in the makeup of the Board over the course of 2014. All of its members are non-executive. One, Sir Clive Thompson, also sits on SEC's Industry Advisory Panel (see below).

Richard Hills is Chairman. He has substantial investment trust board experience and is currently on the boards of two investment trusts: JP Morgan Income & Capital plc and Henderson Global Trust plc. He chairs the Aztec Group Ltd which is one of the largest Channel Islands private equity fund administrators, and is on the board of Cinven Ltd, a major European private equity house. He is also on the boards of 3Legs Resources plc and Phaunos Timber Fund Limited.

Sir Clive Thompson is Deputy Chairman. He is best known as chairman and prior to that chief executive of Rentokil Initial plc. He is a former president of the CBI, member of the Committee on Corporate Governance and deputy chairman of the Financial Reporting Council. He is also a former Director of J Sainsbury plc, Wellcome PLC, Seeboard plc, Caradon PLC and BAT Industries plc.

John Hodson, the former Chairman and former head of Singer & Friedlander will step down as a director of SEC on 10 February 2015.

Ian Dighé joined the board in November 2009. Ian was a founder and deputy chairman of Bridgewell Group plc. After successfully selling Bridgewell in 2007 he formed Matterley whose interests were acquired by The Charles Stanley Group PLC in September 2009. He is a director of a number of private companies and is also a non-executive director of Gartmore Growth Opportunities plc.

Josephine Dixon was Finance Director of Newcastle United PLC between 1995 and 1998 and thereafter served as Commercial Director, Europe and the Middle East at Serco Group PLC until 2003. She has substantial investment trust board experience and is currently on the boards of Worldwide Healthcare Trust PLC, Standard Life Equity Income Trust plc, JP Morgan European Investment Trust plc and Plutus Resources plc.

Richard Locke will be appointed as a non-executive Director with effect from 10 February 2015. Mr Locke has been a managing director of Fenchurch Advisory Partners LLP since 2007, having formerly spent nineteen years at Cazenove & Co.

Figure 18: Board statistics

Director	Appointed	Length of service (years)	Annual fee (GBP)	Shareholding
Richard Hills	05/03/2014	0.9	27,000	60,000
Sir Clive Thompson	19/07/2005	9.5	19,500	2,679,102
John Hodson	19/07/2005	9.5	19,500	50,000
Ian Dighé	13/11/2009	5.2	19,500	-
Josephine Dixon	14/07/2014	0.5	19,500	10,000

Source: Marten & Co.

Industry Advisory Panel

GVOIM consider the Industry Advisory panel plays a valuable role in GVOIM's investment research process. As well as being on the Board, Sir Clive Thompson sits on SEC's Industry Advisory Panel where he advises on business services, consumer services and FMCG companies. He is joined there by:

Stewart Binnie, formerly Chairman of Aurora Fashions. Member of the Investment Committee of the Schroder Private Equity Fund of Funds business, a member of the board of Schroder Ventures Asia Pacific Fund; and has advised Schroders plc on private equity related issues since 2005. Stewart is also a Former Partner of Permira (formerly Schroder Ventures) and Schroder Finance Partners. Stewart advises on retail, media and technology stocks

Chris Rickard, former CFO of Taylor Wimpey plc, Whatman plc, VT Group plc, Weir Group plc and Meggitt plc. Previously he was Head of Corporate Development at Morgan Crucible. Has led numerous successful financial and operational restructurings, as well as executed more than 100 acquisitions, mergers or disposals. Chris advises on industrials, business services and healthcare products.

Peter Williams, Finance Director from 1991 to 2011 of Daily Mail and General Trust plc, a worldwide media business, spanning newspapers, online consumer businesses, business information and exhibitions, with a current market capitalisation of around £2.6 billion. Peter is currently a Senior Independent Director of Perform Group plc, a FTSE 250 digital sports media business. He is also a director of Ibis Media VCT plc, a small listed VCT that specialises in early stage media investments. He specialises in the media sector.

Lindsay Dibden spent a 23 year career in private equity investment. He was a founder partner of HgCapital, establishing its Healthcare practice in 1996, which he led for 16 years. During his career he was involved in more than 30 transactions. Prior to retiring from the partnership in 2012, Lindsay served on the firm's Investment Committee and Executive Committee. He is now the owner of two healthcare businesses providing care in the home across the counties of West Sussex and Hampshire. In addition he acts as an advisor to Spring Ventures, Alvarez & Marsal and EVOCO AG and actively manages a diverse portfolio of other investments.

QuotedData

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