Artemis Income Fund Investment Review - 30th April 2007

Welcome to the Artemis Income Fund's seventh annual report. There is a lot to talk about this year! If you are not feeling strong enough to read on, then we summarise our main points at the conclusion.

Performance

First, in time honoured fashion, some comments on this year's performance. Our return of 17.9%*, whilst less than last year, was very respectable. We allocated your capital to better effect than the market and after all fees and costs achieved a return some 5.2%* better than the FTSE All Share Index. Given that the country is now run by league tables, for the record the Fund ranked 11th out of 88 in its peer group! We are apt to be somewhat wary about some of these measures when looked at in the short term and so we would refer you to the longer term record at the end of this report.

Income and Dividends

The income performance of the Fund was very strong and the dividend rose by 20% over the year, a better performance than the market. This was exceptional as some companies rebased their dividends to a higher level and/or paid out special dividends. Some of the special dividends received were treated as capital as the accounting rules require that, if the funds to make the dividend payment had been generated from a capital event, such as the disposal of a business, then it should be treated as capital rather than income. Taking these factors into account we have our work cut out in maintaining the dividend next year. However, at the time of writing the Fund has a historic yield of 3.3% and the income from the companies in our portfolio still has good scope to grow.

What are our thoughts on the portfolio?

1. Some companies could pay out more in dividends

Seasoned readers of this report will know that normally we have a dig at private equity by about the third page. Not so this year. Partly because the debate about private equity in the FT has been so extensive that there were some days when you wondered whether anything else was happening in the world! More importantly we admire private equity in that they certainly know how to pay themselves dividends. In the period that private equity owns a company they skilfully and legitimately pay as much out in dividends as possible – the financial equivalent of an 'all you can eat buffet' if you will. Whilst we would not expect publicly quoted companies to replicate such a strategy, they have been slow to adopt even a pale form of imitation. The average UK plc pays out about 43% of its earnings in dividends, so you may well ask what happens to the remainder. Well, some of it is correctly spent on investment, but there is often cash left over, sometimes enough to fund a material uplift in the dividend. Private equity wouldn't leave this on the table. Why do quoted companies? Is it for a rainy day? Is it to provide a cushion so that dividends can always be increased thereby flattering the achievements of management? We see companies that are justifiably proud of the diversity, visibility and resilience of their profits but the amount that they pay in dividends is little different from the average. We actively encourage them to pay more of their available cash flow out to shareholders - an average payout is not good enough. Some retort that they give money back via share buybacks but to us the difference between a share buy back / special dividend versus an actual permanent increase in the dividend is the same as the difference between a Valentine's card and a marriage. The long term commitment of the latter has a much more positive impact on the share price.

The importance of regular, growing dividends to total return is still not widely understood. As Ian Marchant, the CEO, of one of our holdings, Scottish & Southern Energy, said in announcing an 18 % increase in the dividend "the fundamental reason that we exist is to provide dividend growth" Too right Ian, too right!

2. The portfolio is not unduly exposed to the economic cycle

In our reports we do not dwell on the macroeconomic background for two reasons. First there are 3,000 odd economists in the city who make a living out of commenting on this and the very fact that the profession can sustain such a population would suggest that they are not any good; if they were there would not be as many. We read a lot of their material but in truth for fund managers they are something akin to a comfort blanket.

The second reason for not dwelling on the macroeconomic background is that we are in effect looking for 'growth annuities'. Annual income or cash flow from companies that is resilient, sustainable and, if possible, will grow. Where we find such a company, by definition it tends to be less vulnerable to external forces such as the day to day fortunes of the major economies. You might then say, well surely if the stock market is efficient then it can see the value of these companies versus their competitors and price these companies accordingly i.e. expensively. Not so.

First the market tends to obsess about the next two or three years of companies' progress and therefore loses sight of the longer term strength of a company's cash flow. Second the market likes to value all companies quite similarly so no sooner does a company trade at a premium valuation to the market there is a tendency to question whether that premium is justified and at the slightest sign of weakness the stock market will pull that company back to the average. To be fair a lot of companies share similar characteristics and are average; their cash flows and dividends tend to go up and down with the economic cycle, so the market is not wrong to do this. Indeed we have a fair proportion of these average companies in the portfolio.

3. An example of what we like

We think that there is one particular theme at the moment which is throwing up some companies with good cash flows and these growth annuity characteristics. Think back to 2001 and many of us, including myself, would be embarrassed to have quoted back to them some of the assertions made in the heat of the technology boom. At home, up on a high shelf along with a CD of Tubular Bells and some photos of me when I had hair, I have a DVD of a conference speech I made around this time. Thus far I had not had the courage to watch it but I may one day soon because if my memory serves me correctly quite a bit of what was said in the frenzy of the TMT boom was not wrong, it was just overstated and way too premature. As computers, laptops and wireless broadband are more widely used in business and the home then many of the predictions made six years ago are indeed coming to pass. As we have discussed in previous reports this has positive and negative ramifications for many companies and to date we have concentrated on avoiding the companies that we think are challenged.

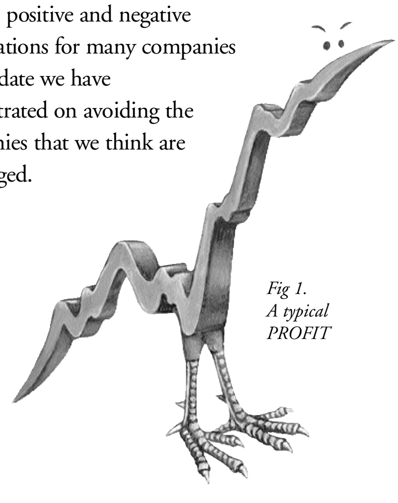

Fig 1.
A typical PROFIT

Latterly we have bought one or two companies where we think the advent of broadband usage will materially improve the magnitude and longevity of their profits and dividends, yet the stock market attributes no value for this.

The best example is that of Reed Elsevier. Post the sale of a major division, the remainder of the company will substantially be providing information to lawyers, scientists, the medical profession and in its commercial division publications such as Farmer's Weekly and the Estates Gazette. In all of these cases the users themselves are increasingly keen to access this information online. This has a material benefit to Reed in that the cost of delivering this information is, over time, reduced relative to physical publishing. Furthermore the ability to interact with a customer online means that the selling opportunity is greater than that which is conveyed by a weekly, monthly or quarterly journal. Where customers have gone online, notwithstanding 5% price increases over the last 3 years, renewal subscriptions were steady at 97% and opposed to 88% in the old traditional paper based form. If we are right, what Reed Elsevier has here is market leading information services, which are increasingly critical to the recipients' ability to fulfil their job together with an enhanced ease of use. Provided Reed Elsevier is managed appropriately and does not get complacent then an investor has a highly visible, growing, long term, stream of profits and cash flows, priced at little more than the market average.

4. Things we have learnt

Worthy of mention since our last report is our approach to the structure of the portfolio. As you will recall we have a preference for restricting individual stock positions to less than 5% of the portfolio and owning not much more than 15% of the portfolio in any one sector. We call this economic diversification and, as a result, it means that we have no desire to, and cannot, mimic the structure of the FTSE All Share Index. However, we always recognise that there are aspects where we can improve or change and over the last 18 months we have "sharpened up" the focus of the portfolio by taking slightly bigger positions where we feel most positive about a company's prospects. I would love to tell you that the notion for doing this came from a flash of inspiration on the train back to Cambridge but, in effect, it did so because of spending time reading how others do things. From this you can concur that we absolutely have no problem in adopting a good idea from somewhere else. In this case I would commend the letters to shareholders on the website of Lindsell – Train, who are highly regarded specialist investors; Nick Train is both a good investor and writes about investment in a simple yet compelling fashion. In one of his pieces he talks about rules of investment management which he learnt from a mentor. One of the rules was, in constructing a portfolio, to buy a position that you are comfortable with and then double it! The thinking being that if you are comfortable in a position you are not really living on the edge and engaged enough in the prospects of the position to worry enough about it. So armed with a few packs of anti-hypertensive remedies we have indeed taken this advice on board and have begun to adapt the portfolio accordingly.

5. Strong appetite for European Companies

We continue to find good dividends and dividend growth in European companies (we always hedge the currency back into Sterling) and genuinely believe that European companies, having not been the greatest dividend payers, have now got the message that higher 'rent' in the form of dividends leads to better longer term share values. We have a particular focus on Germany in two respects. First, some of the companies we found attractive just happen to have been German such as Bayer, a very undervalued pharmaceutical company with a crop science and material science business to boot. Another is Deutsche Post a very lowly priced company which has historically allocated capital poorly, been averagely managed and faces the threat of postal liberalisation in Germany. This might not sound very appealing but even if management where to begin to scratch the surface of managing the assets appropriately they would be able to improve their already strong cash flows and pay out some monster dividends. However, at present, the company is genuinely trapped in the past and listening to a recent conference call it was difficult to discern whether the company was participating in a capitalist or communist society. Management has historically set targets that have not been achieved and as I said to a colleague the other day, at present if Deutsche Post management asserted that the world was round we would certainly seek a second opinion. However, joking aside there are some clear signs of change in the company and I think they are genuinely trying to forge a change in fortune but time will tell.

More specific to the improving economy in Germany, we have 2% of the portfolio in companies that invest in German property. Our initial reason for investing was attractive resilient yields the thought being that if the underlying property remained static (as indeed it has done for some 10 years) then we would still make a 7% or 8% per annum return. As it happens the economy is proving to be quite vibrant and there are signs of improvement in the underlying property market and thus far we have made more money than we anticipated, but think there is much further to go with this story.

6. Increase in exposure to larger companies

Larger companies are cheaper and often have greater resilience and stronger balance sheets. They have performed poorly in this bull market because they have grown slower than their smaller relations. In addition, the wave of takeovers has not reached these companies because they are deemed to be too big to be taken over…watch this space. We do not allocate capital according to size but as the attractions have become more evident we have increased our exposure here. Crucially, they are very strong financially and offer substantially higher yields than the rest of the market – it is the business of an income fund to be exposed here. Inevitably this means that the names in the portfolio have a familiar ring and some investors might think that this is a boring strategy. Although we like to own some of the exciting and exotic, we think that larger companies will produce the better returns for the time being.

Outlook

Turning to the future, when we look at the portfolio and its running yield, the following thoughts occur to us. First, we expect the yield to grow and it comes from a collection of companies who are not overly indebted, financially strong and, insofar as we can see, have good long term prospects. However, set against that, interest rates and bond yields have risen since our last report and the yield on the portfolio and the market looks less attractive than that which can be achieved on risk free assets, namely 10 year bonds. So it is just as well that the dividend is growing because without that the portfolio would look decidedly dull if not over priced.

To the extent that it has a bearing on the portfolio we are somewhat worried about the economic prospects, purely and simply because we do not see any early end to this period of higher interest rates. Indeed, for the time being, there are some significant distortions in the world economy that will yet fan the flames of inflation. As many of you will have read, there is a real appetite for the development of biofuels, and increasingly the economics of growing crops for fuel rather than for food is influencing the planting and pricing of crops. If you look at basic food prices over the last 12 months there have been some astonishing rises. In fact there are moments when you feel that it can only be a matter of time before all available land is being devoted to producing crops for biofuels all except essential areas such as the Lord's Cricket Ground. (However, in the light of recent performances it might be tempting for the committee at Lords to try a crop of rapeseed in the outfield.) The super inflation in soft commodity prices obviously has implications for the price of finished food and this places some upward pressure on UK inflation, but it has to be said that food probably only accounts for about 10% of household expenditure, so the impact is limited. More pertinently, economies such as the UK have benefited enormously from the imported goods from low cost economies and to date the costs of these goods have been falling, therefore helping inflation to remain subdued. It is in these 'low cost' countries that the proportion of household expenditure accounted for by food is significantly higher. For example some estimate that in China food accounts for 40% of a typical household budget. Naturally this will lead to wage inflation in these economies and the knock on effect is to, at the very least, remove the goods deflation which we have been accustomed to and more probably lead to some inflation in the cost of these goods. This means that it would be complacent to think that inflation and interest rates will come down anytime soon, in fact the reverse may be true.

In part the market is aware of these negatives but, for the time being, the tidal wave of merger and acquisition activity (M&A) means that it is being largely ignored. However if the cost of money rises to stem inflation then the ability to finance this M&A becomes more difficult and the underlying profits of companies will fall, making valuations more expensive. So under the surface the tide is turning against M&A but for now it will continue at a hearty pace. Much of what is being done here is difficult to justify in economic terms…we know this because of the increasing use of the word 'strategic' in the justification for making these moves. Roughly translated this means that it doesn't stack up in economic terms but if you share our vision it is a fantastic thing to do. Past experience would suggest that 'sharing a vision' entails having a good set of windscreen wipers and a good few spare sets of wiper blades because the folly of these strategic moves can become evident very quickly. If nothing else many companies fail to appreciate that a consequence of getting bigger is that it is more difficult to grow and be fleet of foot- 'size creates its own anchor' as the saying goes. One cannot help thinking that some recent moves have a 'king of the golf club' feel about them and aim to satisfy the egos of chief executives rather than the savings of shareholders. But there are plenty of animal spirits to be worked off. Particular mention must go to our Spanish friends who have thus far consumed Abbey National, British Airports Authority and Scottish Power and we wouldn't bet against further moves. We are tempted to brush up our Spanish so that we can engage more effectively with our new friends.

"Hola y bienvenidos. Siéntense por favor. Muchas gracias por su generosa oferta de comprar nuestras acciones. Aquí las tienen. Muchísimas gracias y suerte en el futuro." (Hello. Please have a seat. Thank you for your generous offer. Here are our shares. We wish you well in the future.) In part we regret the removal of these companies from the portfolio because it is not always easy to find replacements. But given the appetite, particularly in the Utilities sector, we may need to learn the same in French, German and Russian.

The message is that there is more M&A to come as companies sieze the opportunity to get bigger. In particular we expect there to be more interest in UK companies from overseas entities ranging from Continental companies to Middle Eastern and Chinese state funds anxious to deploy their surplus funds.

To summarise

1. Recent performance has been strong contributing to a good longer term record.

2. The increase in the dividend was very strong but benefitted from exceptional conditions. We will have our work cut out to maintain the dividend this year. However, there are certain companies that could learn from private equity and be more generous with their dividend payments.

3.We are looking to populate as much as the portfolio as possible with attractively priced 'growth annuities'. As a result the sensitivity to the economic cycle is reduced.

4. We have sharpened up the structure of the portfolio carrying fewer holdings and larger positions.

5. We continue to see good opportunities in European companies but hedge our currency exposure back into Sterling.

6. We feel that inflationary pressures are strong and enduring, meaning that interest rates will remain at current levels or higher for some time.

7. The higher cost of money will, in time, curb the appetite for mergers and acquisitions. In the short term we will see plenty of 'strategic' moves from an eclectic mix of 'investors'.

Adrian Frost and Adrian Gosden

Fund Managers

Risk Warning