



Adrian Frost

Not just a yield addict

Manager of Artemis Income, Adrian Frost, talks about the difficulty of managing a £2.4bn fund, the changes he anticipates in the market and what impact recent volatility has had on his approach to investing

What first attracted you to income fund management?

Over 25 years in the business I have done all sorts of fund management. At Deutsche 20 years ago, I was given an income fund to run and I learnt from that. It is a simple, effective discipline. A lot of investment processes are complex but with income funds you have a yield or cashflow to focus on, and that is a good guiding tool.

Tell us about your investment process

We go about our business trying to make an equity look like a bond, spotting companies with a good free cashflow yield after capital expenditure, tax and interest. We don't start with the dividend yield; we end with it. That is the easy part. The second part is making judgments about where the cashflow is going – how sustainable it is and how good the management are at deploying it. We want robust and preferably growing cashflow and managers who will spend it wisely and make it grow.

To help with our process we use SmartGARP, Artemis' proprietary quantitative resource. There is only myself and Adrian Gosden running the fund, which is in stark contrast to the research team of 40 I had at Deutsche. But a lot of managers have a process that struggles to get to grips with mountains of information. That's why I keep it simple.

Do you have any benchmark constraints?

We are completely unconstrained versus the index; we don't look at it much. But there are constraints we

apply to the portfolio: we will have no more than 5% of the fund in any stock, and no more than 15% in any industry subsector. The reason for that is we look for economic diversification, rather than looking at a benchmark. If we buy a stock at 4.5% of the fund it might creep over 5%, but our starting point is not to position ourselves *vis-à-vis* the index. I did that for 15 years with pension funds and I don't want to do it again.

One of the reasons I came to Artemis six years ago is that it struck me as a culture where none of that sort of thing goes on. I had done it a bit myself and you need someone to help you kick the habit.

Where are you finding the best opportunities at present?

We don't think in terms of countries and rarely in terms of sectors – it's stocks, stocks, stocks. It goes back to sustainable cashflow – in the last six months the portfolio has remained unmoved by what has been going on in the markets.

A lot of cyclical stocks have done very badly – we're looking at them but not yet buying. I think we are still in the early stages of a period of volatility and instability. The portfolio remains pretty anti-cyclical stocks and we haven't done a lot to change it. We did sell a couple of banking stocks a couple of months ago and bought some telcos with the proceeds.

I tend to buy stocks and see themes in retrospect. The only theme I can think of in the last 12 months is bus and rail transport, and before that

companies with private finance initiative exposure. But we are not one of these fund management teams with an overbearing vision. We focus on stocks first and from there a picture of the portfolio emerges.

You are biased quite heavily to large-caps. Is the long-awaited shift to large-cap outperformance finally taking place?

At one stage large-caps as a group were hobbled by underperforming oil shares; now it is bank shares. You can't escape the fact that when making large-cap allocations you are taking some industry decisions. But we buy a stock for the cashflow and don't really care if it is a FTSE 100 stock or a mid-cap.

We've got to a larger weighting in large-caps because free cashflow yields are looking better in large-caps. In general there is better value in large-caps now than there was, and they come up on our screens more often than they did. But I would say we have found better cashflows and valuations and stock ideas in European large-caps than in the UK – we have about 14% of the fund in European equities at the moment.

Is it more difficult to manage the fund at £2.4bn than when you took it over?

It is more difficult, but that's a fact of life. As you move up in size there are areas of the market you can't go as you would be buying too large a percentage of a company. When I took over the fund it was £80m, though it got bigger when it merged with ABN Amro.

When you manage a small fund, there is a tendency to be a bit complacent, as you can get out of positions quickly. With a big fund you have to be more thorough and disciplined, and more realistic about your entry and exit points. At the same time as thinking about entering a position, you have to think about how you will get out, but that means you end up with a better portfolio as a result.

Ironically, when I was managing at £80m, I don't think I made the most of it. I had been running £6bn at Deutsche and I was still thinking like the manager of a big fund when I had a small fund.

Do all your stocks have to conform to a particular yield requirement or do you use a barbell-type strategy?

First off, every stock has to have a specific free-cashflow yield – I don't buy sub-market cashflows. But I'm happy to buy one stock where an 8% free-cashflow yield turns into a 4% dividend yield and another with the same free-cashflow yield and a dividend yield of 2%. We see the free-cashflow yield as the thing.

Some people pursue a barbell strategy where at one end there is loads of yield and at the other, a load of biotech companies. All of our companies, if push came to shove, could pay out above-market dividends.

Secondly, we look at the overall yield of the portfolio, to make sure it is always in excess of the yield requirement for the sector. So if I wanted to buy something with a high free-cashflow yield but a low dividend yield, and the overall yield on the portfolio was looking a bit thin, I might not do it.

How has the recent volatility affected you?

One of the beauties of running an income fund is there is always a part of the market that is being kicked, and that gives us scope to find our next opportunity. We have scope to buy more banks and have little exposure to retailers; we haven't done anything yet but we are watching, and have remained pretty cautious. We can see where the problems are coming from and our judgment is that it is still early days.

The way we run our portfolio, our best stocks are what we call growth annuities – companies that can meet our criteria and be as unexposed to what is going on outside as possible.

There are 3,000 economists in London trying to tell us what is going to happen next – if any of them were any good there would only be one of them. We don't gamble on cycles.

How much overseas exposure do you have and how significant has it been in performance terms?

When I started here six years ago, I was cautious about investing overseas. I realised there was an opportunity there, but I didn't push it too hard. Originally I had an internally set limit of 5% outside the UK; that rose to 10% and the limit is now 20%. At 13-15% overseas at present, the exposure is not far off the highest it has ever been.

It's not the case that Europe is more attractive than the UK. But I tend to look at the big stocks and sectors – banks, oils, pharmaceuticals – and if the companies

in Europe look better than those in the UK, I will buy in Europe. We fully hedge all the exposure back into sterling – that is a matter of preference for us.

Do you aim to be fully invested at all times or do you raise your cash weighting in difficult markets?

We have tended to find we work best with a relatively modest cash position – the fund is about making choices between stocks. Generally our cash balances are 0-5%, with an average of 2-3%. We see ourselves as stockpickers rather than asset allocators – you won't find us saying "I don't fancy the market, let's raise a heap of cash".

How do you see the near future developing for the fund, for income stocks and for markets in general?

In the last 12 months I have been quite negative about income funds. Income had been a fantastic performer in the last five years and people should have been easing off – opportunities were looking stretched, the risk-free return had gone up and the yield from equities was less attractive. Income funds

have had pressure points this year and there have been big adjustments in the market.

There are plenty of high-yielding stocks about, although they have risks. We are more into traditional income fund territory, and the risk-free return has stopped rising, so I am more positive on the outlook for income funds.

As for the markets, a lot of people are rushing out and saying "we still love the market". There are changes afoot that will have a real effect on the economy, but markets are still not far off all-time highs and I don't like that. I am defensive for the time-being and will stay like that. There is too much leverage both from the consumer and the financial community, and it won't wash out just like that in a couple of months, hence I am retaining a bit of caution.

