Adrian Frost & Adrian Gosden – Income Fund

Dick Turpin

Hello and good morning. Welcome to the continuous series of Artemis Webcasts and in particular today focusing on the Artemis Income Fund with I'm delighted to say both Adrian's; Adrian Frost and Adrian Gosden. Now thank you for waiting while we connected with all the participants and I apologise if you've been waiting a little while but we're now ready to go.

Now I know that many of you have listened to us before so at the risk of sounding like an airline pilot encouraging you to listen to yet another safety brief, may I just remind you of the procedure for asking questions? Hopefully in front of you, you've got a picture of Adrian Frost and just to the right of the picture is a tab marked "questions". If you wish to ask a question just click on the tab, type the question into the box below and then click on the "send" button. Additionally the slides in front of you will, I hope change as we progress through the presentation. Now I will attempt to answer all your questions as the presentation progresses, but we have received already a lot of questions, and I'll try and focus on those that are not covered during the presentation as we proceed.

Now today I'm joined by one of the grandmasters of the income sector, Adrian Frost; Adrian good morning and the co-manager Adrian Gosden, Adrian also. It's very helpful for me, very easy for me to have Adrian's all around me. But thank you for joining us today and taking the time to address the income sector and what's going on in the Income Fund. Now, Adrian is now into his sixth year of managing the Fund, working together with Adrian Gosden, and I think we're clearly entering an interesting time at the macro level presenting possibly a challenging time for the provision of equity income, something a little bit like the English weather that they're facing at the moment.

So without further ado I'll hand over to Adrian who will take us through, or both Adrian's will take us through their thoughts. Adrian, thank you.

Adrian Frost:

Thank you very much, [Dick]. Good morning to you all. If I could start off by just drawing to your attention the fact that the annual report has just come out on the Fund and we've got a bit carried away this year and written quite a lengthy piece, which will expand some of the themes that we talk about today, and any feedback you have on that would be welcome. I'll finally say that part of the reason we write those reports is not just because it's a statutory requirement, but because the idea is they should be utilised and help you and your holders and prospective owners of the unit trust to understand what we do.

What I've actually put on the first slide is just a summary of the key points I'm going to cover today. And let's start off with the first one. I think sometimes I'm accused of being too pessimistic, which is obviously outrageous. But I did a recent round of road shows at the beginning of the year. I just question the fact that I think, whilst there was no looming disaster for income funds, I think people have become somewhat complacent because they have delivered spectacular returns in a bull market, very consistent returns and that goes against the very long term trend where income funds can be a bit volatile. So I just question their ability to keep up this impeccable near term record. And so that it might be a more challenging environment and the numbers I've seen would suggest that it is a bit more of a challenging environment for income. Purely and simply, just like anything you compare versus the rest of your return and bond yields, interest rates and inflation have risen. And so that's a bit more of a headwind for income, where income clearly benefited from a more benign environment before.

So I think the question which comes out of that is, is this set to continue. And our sort of working assumption at the moment, and if you read our report, we're somewhat sceptical about economists and forecast there. We say there are 3,000 employed in the city if any were any good there'll be far less than that. But, our working assumption is on yields and interest rates to remain in the sort of 5 to 6% range. Inflation remains a sort of live-ish threat but, it will not overwhelm us and the theme is that interest rates will remain at these levels and higher for longer than maybe people expected early in the year. So I'd say that's still a bit of a headwind for income funds but, if you like the transitional, the change has happened.

I think the other thing to point out is that it's not just for income funds but if you look at the trends in the market, which we'll come onto, we've seen a much better performance from the mega-caps which has long been predicted but absent but that started to happen. And in general unit trusts I think are much more entrepreneurial in their approach to portfolio structure. This is not just income but generally they don't closet index, they don't necessarily go overweight, underweight positions. So when the big mega-caps start performing, it means we go through a period where it is quite difficult for funds generally to beat the market. And I think you're seeing that now.

One of the things, you say: "ok maybe not quite so challenging but a challenging environment Artemis Income, what are you able to do about this?" And we continue with the assertion that if we get our stock selection right because of the way we approach income, we think we have more flexibility and that's quite simply because we are not what I call heavy metal yield investors. And the point we've made to people about being a heavy metal yield investor, on the slide I'm just putting up here, is that if you adhere to the, "I must buy something with a 10% yield premium", traditionally there's been 150 odd stocks – or 140, 150 of the 350 which have offered you that opportunity, and that universe has shrunk. Now that's more testing, less choice. For us the fact that we do provide the requisite yield and some very good dividend growth, as I'll show you in a minute, but effectively we do it through a blend. We always want things with good free cash flow but sometimes we're prepared to take something with a slightly lower yield. Plus the fact we've got about 11% or 12% of the portfolio in Europe at the moment and that's been a successful diversification for us to go and find yield elsewhere. So we feel that we've got much more flexibility to counter-act the more challenging conditions.

I would just point out that this UK yield drought, like the weather; you know they'll think there's some around. So there's some sectors like retail, financials which are not doing very well, which will progressively increase the size of that universe back up again. And it's just the wonderful thing about income, there's always a part of the market that's out of the favour which will then provide the next set of opportunities for an income fund manager.

So I think what you see in our portfolio, and it's nothing new, but it's of more emphasis that we, with a great

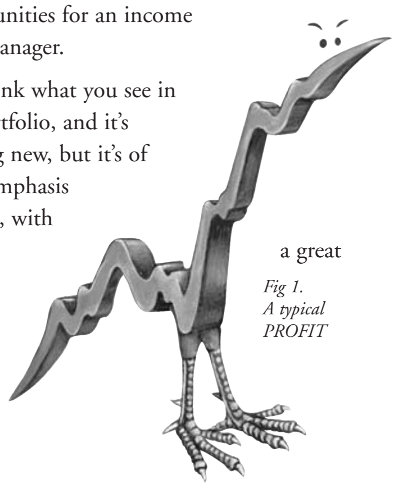

Fig 1.
A typical
PROFIT

preparedness to have good cash flow and for the sake of a label, a bit more sort of income growth and growth stocks incorporated into the mix. Perhaps this is reflected in the fact that, as well as meeting the yield criteria, we've had some pretty good dividend growth out of the portfolio. So to summarise, rather than have something on a 4% yield or a 3.5% yield, we're quite happy to have something on a, slightly sub-3% yield with some good dividend growth. We think that at this juncture given the market conditions that's a more profitable place to be in terms of total return. So that's what we're looking for.

Just moving off from there and this is a theme which we expand on in the annual report.
I think it's as well to emphasis exactly what it is we're looking for long term in the portfolio. And I'll come up with a sort of new way of expressing this. The perfect stock, the perfect equity is essentially a growth annuity and that's something which, as well as being attractively valued, it has visible sustainable long term cash flow and if you can get that at the right price, you really are in business. And sometimes when companies come in I say, "well, the more you can convince the equity market that you have those characteristics than the higher valuation that will accrue". Incidentally you know that's the "Eldorado". I'm not saying there's loads of stocks out there, that's the aspiration for a company to be able to provide that.

What we feel at the moment is that, because of the way the market has moved over the last five years there's been a great compression of valuations. I think the way I described it in the annual report is that high up on a shelf at home I have three things. I think one was a CD of Tubular Bells, which nobody will ever admit to owning. Two is a photo album which has got pictures of me when I had hair, which you wouldn't want to look at. And a third thing is some speeches I made in 2002 at a Technology conference; where like everyone else I probably said some completely outrageous things.
Now I'm getting, plucking up the courage to get one of those things down and actually it's the speech one, none of the others. And really what that would tell me is that some of the things we talked about in the TMT boom are actually coming to pass. We were just way over sated at the time, and way too premature in their timing. And some of these companies are not materially differently valued than the market but they do represent growth annuities.

The other way I look at it and I'll come onto an example in a moment. Is traditionally in income investing, you get some things that have a yield at 2%, no interest to an income manager that have the things which yield 5%? Whereas today the broad yield spread is 2.5, 3 on a vast range of stocks. Likewise PEs sometimes have ranged from 10 to 30 for the sake of argument and today they seem to be 12 to 16. So we expand on example in the annual report of the company, Reed International, some people might say, "oh it's a bit expensive it's on PE 16". But relative to history we don't think that's too expensive and the yield is about 3%. And I won't go into the detail here but effectively what they're doing is, they are profiting from the internet in two ways, by being able to sell more but also having a greater persistency and pricing power with their customers. Whether it be in services to lawyers, services to science and education and services to the medical world. So in our view represents an opportunity for an income fund to access a quality growth annuity, whereas in pass cycles it's been quite difficult to get on board.

Dick Turpin:

Adrian, you mentioned in passing cycles, if I might just interrupt a second. There's a question here from Adam Hughes at Rowan. Just saying: with your long experience do you see any periods looking back that resemble the current environment, any sort of signposts that would remind you of past times?

Adrian Frost: Well for income, no. I mean I think we've been through, a slightly exceptional period for income which as we all know was the bounce back from the major disruption of the TMT boom, where things got so out of kilter. And today we've just compressed back into a more normal situation, we witnessed the fact that the income sectors responded poorly to rising interest rates and bond yields etc. That to me strikes me as entirely normal behaviour and if in 18 months time interest rates are coming down and inflation is subdued etcetera, etc the income sector will respond accordingly. So we're kind of back in sort of normal conditions.

Dick Turpin:

Oh, picking up on that, if I may. I mean with interest rate futures pointing to sort of 6, 6.25 do you see that as being potentially the sort of top of the cycle in terms of rising rates?

Adrian Frost:

Yes I think so; in order to discourage some brokers with some of the wilder ideas. I tell them my central assumption on base rates is 9% and that leads to a very short phone call. But that is a deterrent and nothing else.
Yes I mean, we're not macro economists but we look at some of the signs coming through at the stock level and clearly weather aside, there's some signs of stress in the UK economy and indeed in the US as well. So I think that we're in the region where if nothing else, central banks will sit back and observe the effects of what has been quite a prolonged period of tightening. And I think it's only in New Zealand at the moment where their enthusiasm for tightening is really getting, you know, they're not even waiting to see what's happening. They seem to put interest rates up every week. We've got a very leveraged situation out there and I think that will be quite dangerous. So I think that's probably right to do.

Just moving onto the next slide, one of the things that we are keen to talk about when we see companies at the moment is learning some lessons from private equity. I'm not their greatest fan, in terms of what they do, but I would acknowledge that there's some things which they're pretty smart at. And one of the things they don't do is they don't leave any cash on the table. I mean, they don't leave anything on the table at all really. In fact they don't even leave the table. They're rapacious in what they do and it's all legal etc. But when we look at publicly quoted companies, there are, we see some very good companies with very sustainable cash flows. And they tell us how good they are but when you look at their dividend payout ratios they're average. And you say: well why; why don't you pay out more of your cash flows because you know they're steady and sustainable? Now I'm thinking about Cobham and Bunzel, the people we talked to in this regard. And private equity would not leave any of that cash on the table and would not be imprudent at the same time.

More controversial is how much debt companies should carry, and I've used the word selected companies here, because there are plenty of companies that are too cyclical and too risky to carry a lot of debt. But by the same token some of those companies could be of more interest on their balance sheet. I just think that when you get something like private equity, public equity has to learn from it. And we're also encouraging companies, as we would because we're income managers, to favour permanent dividends over buybacks and special dividends. And I think with the way we describe it is that it's a difference between a Valentine's card and a marriage, in that the dividends are obviously the more permanent and hopefully like marriage more permanent as well.

So that's another theme we've been putting through. Just turning to the portfolio, we've been tightening it up a bit and learning some lessons from our reading elsewhere. We've reduced the number of holdings; we're broadly 75 to 80 holdings, at one stage, 18 months or a few years ago we had over 100. We've been running lower working cash balances. We think introducing capital discipline into the portfolio is helpful to us; a sharper focus in terms of actually putting more into the things where we are more committed. And I couldn't naturally have a presentation without talking about this, but we do have a higher large cap weighting. And yes, that's been doing better and if you look at the way the Fund has moved in recent years on this slide, we've gone from sort of mid-40s to about 70% in large cap.

Now I want to be clear on this. We don't sit there and say: oh gosh large cap sort of, set to out perform why don't we make an allocation there. We do it on a stock by stock basis. I don't know whether you, Adrian, want to pick up any of that, about what we've done in large cap and otherwise.

Adrian Gosden:

Yes sure, we screen by, as Adrian mentioned kind of cash flow and a propensity to pay dividends and that has just led us up the size scale. It's nothing that we've really particularly searched for, we are size agnostic. But those screens when we do them, have taken us up the size scale and the type of shares we've been buying, haven't naturally been financial companies as you might have seen. For the financials we've done quite badly, obviously with interest rates rising, they also yield a lot. But actually we're finding some of the very strongest cash flows have come from sectors such as the oil sector, as Adrian mentioned; a couple of media companies we've bought. As an amalgam the Fund has now nearly 75% of its assets in the FTSE 100 or 100 equivalents.

So that's a huge move over the last three years. We used to be about 45% but it hasn't been necessarily all into financials. It's been a broad spread, an economic diversified portfolio. And the yield on the Fund is about 3.3%, 3.4% so quite materially above the yield on the stock market which we think is around 2.8%, that sort of area. So we are gaining good yield and good cash flow. And if you take a company like Reed which is a company we do have in the Fund. It's grown its dividend above inflation for twenty years in a row. So you know these are serious companies that take their dividend policy very seriously. And if we get our timing right, the dividend that we're going to get from them and the belief we have in that dividend is going to be stronger than say a mid-cap company that's currently under speculation and is paying very low dividends out at the moment. So we have some degree of security in that.

Dick Turpin:

Thank you, Adrian. I have just got to pick up on one question here a, question from Charlie Newsome reflecting the fact that, and this is very much a generic question across the income fund sector, that a lot of income funds have quite a higher weighting to the financial sector due to income requirements. And I wondered if either of you pick up on that whether there is a need to be concerned in that weighting.

Adrian Frost:

I think there is a need to be concerned in certain areas. Clearly it's an area that hasn't done well of late and I think the area of concern for us is that you know we keep reminding ourselves that in as much as we can as generalists, we like to actually understand the mechanisms in a company as to how it makes its money. And you know sometimes when you sit in front of us and ask us questions, you judge us on our ability to expand as to why a company and how a company makes its money. We do, as we always have, had a bit of a problem with what can be sold, the capital markets or investment banking side. Where, quite frankly, some pretty numbers fall out at the bottom and there's some very complex transactions which produce that profit. But really we can't understand it and if you go back to my point you're going to say: Are they growth annuities, certainly not. We do hold them from time to time and you know we do, still have got some positions in Barclays and Royal Bank of Scotland. But we did have a position in Deutsche Bank which we sold quite recently, because we couldn't put our hand on our hearts and say really what's going to happen next. And you know in two years time we might look back and they would have emerged completely unscathed from what is undoubtedly a difficult period. But at three minutes past one this afternoon they might make an announcement on the screen and say that they've actually taken a hit of, I don't know a billion dollars in sub prime; got no idea. So that's not a comfortable situation for us.

In terms of where we stand on that we have about 12% in banks at the moment. We have this rule that we run the portfolio on an economically rational basis. We limit ourselves to no more than 15% to only one sector roughly and that's absolutely explicit in saying: look it's very important that you get your yield from a diversified base. And I think some income funds because of the yield requirement will go to 20% or 30% in financials. And in these particular times I think that can represent an above average risk because you're geared into one industry or one set of circumstances.

Dick Turpin:

Thank you Adrian.

Adrian Frost:

We set out on the final, second to last slide, the sort of things that we have been doing. The big move this year has been from 8% to 12% in oils. I think we're a portfolio that, you know, we're not big macro callers and I think we tend to have lower than average economic sensitivity, as a matter of course, but that is pretty low at the moment. Again going back to this growth annuity, the visibility, the sustainability of the cash flow is very important to us. These are the sorts of things that we've been buying and selling. Some of them have more cyclicality than the others.

We've bought Yell after the profit's warning. We're by no means out of the woods yet but long term we're think that's a decent source of growing cash flow.

British Energy we bought in a government placing. ENI, there's a shortage of generation capacity in the UK and I don't see many local communities sticking their hands up, asking for a new nuclear facility to be built by their leisure centre. So that would argue for existing nuclear sites, we miss out on new build.

We took some of Cineworld which is doing very well because it's the only place you can keep dry at the moment, and cinema attendances is, well we'll obviously have comparisons versus the World Cup last year. And cinemas are very full at the moment so that's going well for us.

And on the sell side, you know it's largely taken profits in situations where we think valuation is full. In one or two cases Rexam, I think we, Adrian, we decided that they didn't like dividends. No.

Adrian Gosden:

No, it was extraordinary. We do actually meet companies and we met them and we kind of sat in horror as we saw this lovely cash flow, which we're expecting to come back in streams of dividends, as they suddenly decided actually they wanted to be a growth company and they're off and here are a series of activities they would like to do. And at that point in time we left the meeting and I was just slightly faster than Adrian back to the desk to get the order on to sell the shares.

Dick Turpin:

Quite a lot of questions on air before we sort of draw it to a close. You mentioned that the drought of income, Adrian and clearly what we hear, that you've been using European companies to help support dividend stream. The question is here from Connor Dempsey at Gerrard's about your limit to exposure in Europe which is clearly a sort of statutory limit. But also do you have any thoughts about the positive aspects of using that limit in the sort of European arena?

Adrian Frost:

Yes, the limit is 20%, you know you shouldn't be surprised and no guarantee, but you shouldn't be surprised if you know you might find us at 16, 17, 18%. I would remind you it's all fully hedged back into Sterling; we're not taking a view on the currency and never would. Don't know the answer to that. And broadly speaking, we do find better value there. And if you hop back to our comments of a couple of years ago, there's always a bit of a caution because there's no doubt that European companies have been slow to recognise the power of dividend in increasing the value of the share price. And a lot more of them seem to be getting it. I mean German companies in particular, who were not the greatest of consistent dividend payers, seem to be embracing that with a high degree of enthusiasm which gives us comfort as well. So there's still a catch up story to be had there. So I would argue that you should see it go higher at the expense at the UK.

Dick Turpin:

Just following on from that if I may, Adrian, and Stewart Knight just asked a question: do you see the development of the Fund moving in any particular directions over the next 12, 18 months or presumably this junction is a bit early days to decide which sectors might be becoming increasingly attractive.

Adrian Frost:

We don't really kind of do sectors and do sector strategy. I mean oils is an exception because it's clearly one overriding factor there. But then again it was a valuation that took us there as we look at the sorts of metrics that are important to us and the stocks take us there. We, don't say never but we very rarely sit down and say: gosh I think that sector looks interesting let's put some money into it. You know it's a very stock specific approach. So can't say, it really depends what comes up.

Dick Turpin:

Yes exactly, a bottom-up point of view. Maybe passing one over to Adrian Gosden merely a bit of foreboding around in the stock market generally speaking, are the any measures that you're taking in portfolio construction at the moment that you might define as being a little defensive.

Adrian Gosden:

Just to be absolutely clear on that the Fund is an equity fund and Adrian I like to keep capital tension in the funds. We don't run around with cash in that, so that's not a defensive item for us. The Fund isn't any more defensive than the market in just pure technical terms, it has a lower beta than the market. But the way we would think about it is whenever we look at things we look at margin and safety when we're investing. We're looking at the dividend, the ability to pay that dividend and that gives us some degree of confidence. If the market was to fall, the Fund would fall, we would hope by less than the market because of the shares we got in there on slightly lower valuations with more dependability of that cash flow. But we haven't really kind of signed up to that kind of wipe out scenario at the moment. But the shares that we have in it are robust and good cash generators.

Dick Turpin:

Thank you. Well look ladies and gentlemen I'm very conscious of the time. So maybe we could just move onto the last slide. Both the Adrian's are very modest in looking at what they've achieved and they don't like to talk about performance. But being an old salesperson I think I'm allowed to blow the trumpet occasionally, or maybe it was a heavier salesperson I'm not sure.

Adrian Frost:

Or both.

Dick Turpin:

Or both, but if you could just look at the last slide. It's a very enviable track record and I'm certainly very proud to be associated. And I think it reflects everything that's been achieved over the years that both the Adrian's have run the Fund and hopefully you'll agree with me.

So I think we'll bring it to a close now ladies and gentlemen. Thank you very much for the time you've given us. If you do have any further questions, or indeed those that we haven't had time to answer, we'll certainly try and get back to you. Please if there is something that you like to follow up on, just give us a ring on our broker line which is 0800 092 2090 or pass us an email at brokersupport@artemisfunds.com. So finally if I could just say thank you to both the Adrian's for the time they've taken with us. And thank you for listening.

One final word we have recorded the presentation today and, the transcript of that, will be on our website within the next 24 hours. So if there's anything you would like to revisit, as Jeremy Paxman says, please visit the website. So ladies and gentlemen, thank you very much indeed and I wish you a very good day. Thank you.

Risk Warning

Issued by Artemis Fund Managers Limited, which is authorised and regulated by the Financial Services Authority and is a member of the IMA. Artemis Fund Managers Limited is a member of the Artemis Marketing Group. We only market our own unit trusts. Please remember that past performance is not a guide to future performance. The value of an investment, and any income from it, can fall as well as rise as result of market and currency fluctuations and you may not get back the amount originally invested. In the interests of providing a level of income consistent with the aims of the Artemis Income Fund the periodic management charges are taken from capital. The effect of this will be to constrain ultimate capital growth over time and may lead to capital erosion.

Any research or analysis contained herewith has been procured by Artemis for its own use and may be acted on in that connection. Sources of information believed to be reliable; however, save to the extent required by applicable law or regulations, no guarantee, warranty or representation is given as to its accuracy or completeness. Forward-looking statements are based on Artemis' current opinions, expectations and projections. It is provided to you only incidentally, and any opinions expressed are subject to change without notice. Artemis and the Artemis Coin are trademarks of Artemis Investment Management Limited.