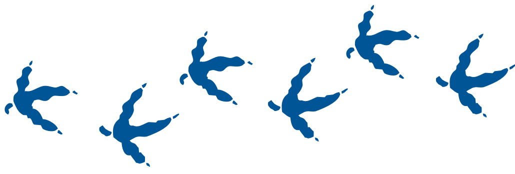

ARTEMIS
The PROFIT Hunter

Adrian Frost & Adrian Gosden – High Income Fund

Dick Turpin: Thank you very much. Ladies and Gentlemen good morning, welcome to the continuing series of Artemis webcasts and may I thank you for waiting while we've got all the participants hooked into the conference call. As you know, today we are focusing on the Artemis High Income Fund and with me today, I am fortunate to have both Adrian Frost and Adrian Gosden who are the co-managers to the Funds, not only the High Income Fund, but also as I am sure you are well aware, the Artemis (Equity) Income Fund. Now, interestingly this is in fact the first webcast we have conducted on the High Income Fund although Adrian Frost has been managing it for now over five years and so Adrian is going to take the opportunity, in his introduction, to spend a little bit of time on the background of the Fund and give you a positioning statement, before we go through the rest of the detail. Just before we start, if I could remind you of the procedure for asking questions, and apologies to those of you who have listened in before. Hopefully in front of you, you currently have a picture of Adrian Frost. To the right of that picture there is a small tab marked Questions. If you would like to send us a question, please click on the tab, and below that you will see a box where you can type the question in, and then below that again if you press the Submit button we will get the question received on line. We'll make every effort to answer all the questions today as we go through the conference call, but apologies if any of you get a question that we fail to answer, but we will follow up once the conference call is finished. So without further ado I am going to hand over to Adrian who is going to take us through his thoughts on the High Income Fund. Adrian.

Adrian Frost: Thank you Dick. Good morning everyone. What I propose to do is actually spend a little bit of time on the background, because as some of you may be aware it sits in the UK Other Bond Sector. It's a sort of different fund, if I might say so, and we don't get out much to talk about it, so I think it's helpful if you understand where we come from on this Fund and then you would either say "well yes that's exactly as we anticipate it" or you can say "my goodness me I didn't realise it was like that". Hopefully it will be the former rather than the latter but we will see. On the introductory slide I just put a quote there "be careful what you wish for" because when I arrived at Artemis one thing we put in place in the Income Fund was to actually exploit some anomalies in the bond market and do bonds in a small way. So when we did the merger with the ABN Unit Trusts, people like Dick and Mark Tyndall said "Ah, you've always wanted to do bonds, here's your great opportunity" and naturally at the age of 64 I was actually looking for a new avenue in life so, but more seriously, it was an opportunity to exploit what I think was some disconnect between the equity and bond markets. So, what started in a small way has now become very much, if you like, a way of life for us in managing this Fund, but I think the important thing which we always emphasise is that please do not regard us as bond managers, I mean there is nothing wrong with bond managers, don't get me wrong, but you know the way we look at things is primarily from an equity perspective and indeed that is entirely the inheritance of the Fund in the sense that, what we do on the Fund is not materially different from its founder manager, George Luckraft in the way it is structured and the way it goes about its business. So I have set out a short agenda there which I will touch on, some background objectives, how we approach it, some examples of portfolio structure and perhaps of most interest, current strategy and the like.

When I say they are inherited objectives, I mean let's not say, perfectly happy with them. The way I look at this Fund is it sits in a sector with a lot of funds that have the bond tag on them, but many of them are going about their business in different ways. This is there to provide an above average yield for investors from a diversified set of investments, but because it is an above average yield it should actually give you a reward better than gilts over time. You know as we constantly outline in the report and accounts, if we are not doing that then it is not worth taking the risk because inherently in taking anything on which is high yielding the market is telling you that there could be some higher risks afoot. Obviously it is and always has been a distribution fund, which I think conveys some other advantages. And just to remind you that the IMA asks that the funds in this sector have at least 80% in bonds. Now for us that has meant that we have always had something of the order of 20% in equities which is something you should take into consideration when you look at the performance record both short and longer term, and also the sector asks you to have 20% in sub investments. So it is making quite a strong statement there, about what it wants the characteristics of these sorts of funds to be. When you wrap that all together and look at what we do, we think about this Fund as something in terms of its investment characteristics lies between equity and bonds in terms of its returns potential and its volatility. The way we interpret this is to say, 'okay we want to deliver to you at this above average yield'. If we do so then there should be some capital gain that goes with that, so in other words, if we have actually spotted some under valued yield, but we want to do that, we are investing in riskier assets but we want to construct the portfolio to try and actually minimise that risk. Okay, so that is how we think about the Fund on a day by day basis.

When we look at the approach, let's just remember unlike equities which can record some staggering gains and in theory, can go on and on growing. Bonds are limited up side, you get power back plus your coupon and indeed one of the ways we think about bonds, and it may come up later in some questions, regardless of what the short term volatility is in terms of pricing, what we always have in our mind is does the issuer have the ability to service the coupon and pay back the money? And that's the things we are principally interested in.

The other thing is that returns can be much more limited by the drumbeat of what the macro is doing and what the actual underlying risk free return is. Whereas in equity markets, equity managers generally don't have a clue what bond markets are doing. Maybe they should pay more attention to it, but they don't and equities and equity markets can wend their sort of happy way and can disconnect with risk free returns and to some extent with the macro, less so in a fund such as this. I have put a point there which says Extract; we actually put in our annual reports and we write very extensively on this Fund because we think it's something which constantly needs to be explained, so please do go on line or ask us for copies of past reports and accounts because I hope you will find them useful in not only understanding what we are

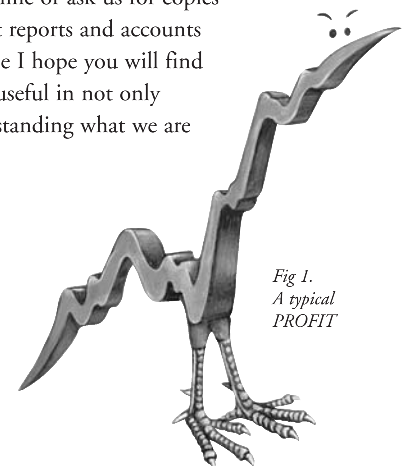

Fig 1. A typical PROFIT

doing but actually what the Fund is all about. A conventional bond manager is largely driven by what the credit rating agents say and to some extent you are just trying to actually out-guess the credit rating agencies in terms of whether they will upgrade or downgrade etc. Obviously we have an awareness of that but it doesn't actually dictate our every waking hour. We are thinking about it, as I say, like an equity investor in saying, 'what is the industry, what do we understand about the underlying company, what do we understand about the cash flow and how does that relate to the serviceability of the debt?' In the main we think that is an advantage because we can incorporate some of the things we learn from our following the equity markets. We can incorporate the softer things such as management change and what we think of the management, where there is good information. We can actually do things like saying 'this company is actually increasing the dividend by 20%.' That just shows in what a good state of health it is, whereas traditionally that sends some bond investors running for cover and saying, 'my goodness they are giving all the money to equity investors they must be mad'. So we sit in the middle and we have a different way of viewing these things, which on balance we think is an advantage. So we are all about the solvency, the industry background, forward looking about the management, dividends can be a strength, not a weakness. We are not following the every step of the credit rating agencies, we are trying to exploit some, what we think is an information gap between bond investors and how equity investors look at life. There are some disadvantages in where we look and what we do and again I look at this in a pretty objective manner. When you look at equities you pick up a page in the FT and there are all the prices and there is all the liquidity displayed, likewise there is the real drill down on information from analysts etc, about industry, company prospects, etc.

One thing that has fascinated me over the last five years is in the world of bonds there are plenty of issuers that are not quoted for one reason or another, whether it be private equities, whether it be international companies, government agencies, or quasi government agencies. So actually you don't have extensive brokers research reports with cash flows etc. and you have to work on the fact that there are opportunities there which are both illiquid and have limited information flows, but that's not to say that they shouldn't play a part in the fund, but what we quite simply do is we actually own a weight in proportion to our confidence in our knowledge and information flows, so it's about the landscape of issuance and the amount of information that is out there, and you know that is an opportunity, but you do not always have ready access to information. Sometimes on some of our issuance we can go a year without really actually having much detailed information about how life is progressing so we have to rely on what we think of the industry and what we hear from competitors etc. So I see that as an opportunity but there can be times particularly when markets are tight that it could be a little bit more difficult.

Turning to the following slide about the structure of the Fund, as I say we are very diversified; sort of critical and well, the whole thing is a bit dispersed. But we are concentrating on getting that yield from a raft of opportunities. And I often think that sometimes the simple reason why somebody has 5% of their fund in one holding because they really fancy it, is not necessarily an economically driven one – it is because they would like to be number one in the peer group. And if it works they are number one. And if it does not they are kind of number 100. That actually is not related to income generation, this is about actually getting the right balance between getting some capital growth and getting some income generation. A moment on the equity weightings. This is a very absolute approach. This whole Fund is a yield hunter and we invented that term before and Dick's saying well that is - thanks for the Artemis advertising. This was invented before the advertising campaign. We are a yield hunter. We will go anywhere and look at yield side by side. So I do not really care whether the yield comes from an equity or bond within the constraints we have to work in with the IMA. I do not care where it comes from. What I care about is the integrity of that yield and whether it is overall undervalued. So we are very absolute with the equity weighting. We do not run sector targets. We say here is something on a six percent yield that is interesting. I will put 0.7% of the Fund into it. We have about 7% or 8% of Fund in Preference shares. This is very valuable to us. It is an area we have been putting more money in because for us they actually give us very good net yields. And we would have to buy bond yields of about 8%/8.5% to get to the equivalent Preference shares so we see some good quality names such as Standard Chartered. If I was offered a Standard Chartered bond rate of 8.5% I would leap at it. So only a Preference share on 6%-7% is a no brainer for us.

Let us come on to recent strategy. Three or four months ago we had a very defensive position with lots of cash and quite a big weighting in short gilts. It is always a moot point for this Fund on how defensive you can go because on the one hand the audience of investors out there wants its yield and do not want the yield diluted, but on the other hand they would like capital preserved or grown. So we walk a bit of a tightrope there as unlike our colleagues on the Strategic Bond Fund, who do not have a dividend or distribution remit they have a total return remit and they can go for lots of cash and lots of defences if they need it. It is a little more compromised for us but we will go there if need be. So we have been more defensive but let us not beat around the bush here in as much as this Fund in terms of actually going for high risk and high yield has done extremely well in the bull markets of bonds. And by the very nature of its structure it will be surprising if it were top of the pops in a more difficult period for bonds unless we completely uprooted the whole portfolio and got rid of some long valuable imbedded positions just to actually get some short term performance.

Other things we have looked at is limiting our exposure to private equity. We have had about 10% exposure to private equity issues which we think we understand why we are there and we are very happy with that. We have, not so relevant today, sought protection from private equity targets because of the implications of what happens to yields if a company is swallowed by private equity, and I think we have had a competitive advantage there with our equity hat on. And latterly we have been for yes above average yield - but we have been going for a better quality yield rather than the best yield. There have been moments over the last six months where we could have supported some really very, very attractive yields in absolute terms but the capital consequence would have been a less spectacular turnover in the last six months. But it would have been a lot worse if we had just gone for a very mechanistic heavy metal yield approach. Now we have actually been selling some of those gilts and investing some of that money. And I am just going to hand you over to Adrian who is going to tell you the sorts of things we have been investing in.

Dick Turpin: Just before you do hand over if I could ask - accepting that you are looking for yield and hunting yield as you so eloquently put it, there is a question that has come through about what sectors would you be, have you been evaluating and are there any sort of particular themes coming out of the sectoral bias that you favour at the moment?

Adrian Gosden: I am happy to answer that question because that plays into the way that we have been investing the money. So as Adrian said, we kind of started this year with 15% in short dated gilts and 10% in cash. We were kind of struggling about where the capital upside for the Fund was coming. The coupon looked good. It was well covered and we were definitely going to get that. It is just where we were going to make capital with quite a number of the bonds trading above par. What happened is that as we went through the year we had some sort of emergence of the sub prime problems in April time, as clarified by HSBC, but these really came to a head in August when we had a bit of a wipe out in the high yield

market and consequently in the equity market. This actually presented the opportunity for Adrian and I to start to deploy particularly the short dated gilts. Those are sold and are now all gone from the Fund. So we have 15% to invest. And the sectors where we originally started were ones that you will be familiar with in terms of cash generative ability, some resilience of the franchise where we could be certain we were going to get the coupon. And where these bonds were being battered by the market as some people were forced to sell due to various reasons we were able to deploy our cash into that. So in what I will describe is like Phase 1 where we initially put the money was the telephone sector which received our attentions. Names such as Aircom, Tele Denmark, Cell C which is the third operator of mobile in South Africa, Cable & Wireless has been in the Fund for a while and we have just added another one. So about four different names there being deployed. And we are talking yields here of about 9%. These are cash generative companies and certainly in two of those situations there is a reasonably good upside in a capital term if there is a corporate event. Here I am talking about what might happen to Aircom when they split their business and also Cable & Wireless if they were to do the same with theirs. So good capital potential but a good solid 9% yield which is something that the Fund could benefit from.

Also within this kind of first phase electricity and some other natural gas and oil players are also present. First Hydro is a name we have known for a while. We added also Current Energy and Chesapeake. Here the yields are a bit lower but the franchise is certainly better understood by the market and consequently we are talking about 6.5%/7% yields. And the kind of third editions within this first phase are what we would describe as quality service companies or service companies where the cash flow is considerably better than it has been over the last 12 months. Companies such as Rentokil which has certainly improved its business model; there again a yield. You can value these bonds below par on a yield of about 6.5%. So that is what we were doing.

So once we had done the initial deployment of money, the next question was really what are we going to do in financials? Because these were the things that were really flying around as people decided what to do with their own positioning within that sector. For us the more understandable part of the financial sector is insurance. Much easier to understand and less chance of unforeseen write offs. The write offs are pretty much explained by natural disasters. So here RSA yielding 6.8% was a purchase for the Fund, an increase in the holding and the only kind of real additions in the banking sector at this point in time was to buy a new issue in Rabo Bank which is a AA rated European bank, Netherland bank, at a yield of 7% and the only Northern Rock purchase we made in the Fund is the very senior dated Northern Rock Short dated paper which matures next year in March and September. You get a yield of 8% on that and that is backed by the government. So just to summarise what we went about doing is good cash generators where we know the businesses and know the franchises, quite defensive assets. That is the first thing to go for in the market sell off, user sell off for better pricing and then in the second phase where the financials all fall about, we go for what we understand not for what would probably give the best return if we had a good outcome. It is simply those where we know we are going to get the coupon and now we can buy them below par and we will get that return when the time comes.

Dick Turpin: Interesting Adrian. We have got a question here about the financial weighting and I think you partly answered that in terms of the positioning and the sort of bonds you have chosen. But do you feel sufficiently shielded from the sort of significance of some of the non-converted collateralised debt obligations that are hanging around on banks' balance sheets?

Adrian Gosden: Yes it is pretty hard to know where all these are for certain but our banks weighting is low, it is only 11% and so as a consequence to that we think we have done what we can do to reduce, as I say using things like the insurance names etc etc. We have done our bit. So it will always look like funds are exposed to finance because finance is a 'catch all' group for a large number of different bonds. It is actually those that are exposed to kind of CDO's and the collateralised debt market you talk about is actually quite small.

Adrian Frost: Let's just make a further distinction there. When you say shielded, my interpretation of that is to come back to the original point. Are we going to get a coupon and are we going to get our money back on these things and the answer is yes we feel adequately shielded. Does that mean that through the events of maybe the next 12 or 18 months, a bond which is trading at 95 might hit 85 on the fact of how investors feel about the world etc.? Well that may well be the case so we are not, I mean I don't think we can shield against that, all we can do is say to ourself well look, if we are not going to get paid on this bond then the equities or the equity value of Barclays has to experience some major problems before we actually don't get our money back on the bonds. So that is the way we look at it and I just want that distinction because I think there still will be some short term volatility in those names.

Dick Turpin: Interesting. We have had another question along those lines of the impact of the credit crisis on the high quality end of the bond market, clearly we have seen that and do you think there is more to come or do you think we see an element of stability creeping in now?

Adrian Gosden: No, we are working on the slight minor defaults because we have had the effect on the financial sector, clearly we have got some, the next order of effects is on the underlying economy and companies that have constructed their balance sheets for a particular set of economic circumstances. The corporate finances call this an efficient balance sheet. There must be some companies sitting there saying, 'but they told us we have got an efficient balance sheet and actually it's a balance sheet that stinks in a different environment.' There will be some problems there and our job in the Fund is to actually try and steer our way through so that yes, there will be some short term volatility in price movements but to steer away from the reality of actually having a default in the Fund. I can't give you a guarantee we are going to have a spotless record on that but that is what we are about. So stock selection in portfolio structure is imperative and again it comes back to the fact that let's just say we do get a default it shouldn't be 1 or 2 or 3 percent of the Fund, it should be half or three quarters of a percent of the Fund. I am not being complacent about it at all but that is part of the job of structuring the portfolio correctly so you recognise the risks of what you are owning and making sure you are getting a decent reward for it.

Dick Turpin: Just going back to yields if I may. I think both of you have mentioned that there are some attractive yields out there and that you have been picking up on those and with the gross running yield of around 6.3% do you feel that the yield situation is relatively stable looking forward?

Adrian Frost: We have got 8 or 9% cash and we have some sort of cash or near cash in other things of maybe another 3 or 4% so if I were to tell you that we thought the outlook was stable and completely rosy then you would say, 'why have you nearly got 12% near cash because you should be fully invested?' So we have done our first move which was short gilts into some bonds that we liked in some of the previous hiatus and we have got some resource for a second move into the defaults and into a more turbulent environment. And let's look at it this way, let's assume that that doesn't happen, well, we have missed out on a bit of opportunity but actually we have not lost money, and that's the pragmatic way we tend to look at it. One of the other things to bear in mind is that, and I am not, I can't be different as to how this would play out, but I suspect yes we do think things are going to get worse in underlying economic terms and there is going to be real pressure on central banks to cut rates. And they do so against a background that feels quite inflationary. And so your Mervyn King, there is 65 million people in the country who are getting toasted and you are actually holding to an inflation target which you know somebody sort of suggested was a really a bright idea. What are you going to do? You are human and at some stage, in a sly sort of way, you might try and bin the inflation target and actually

provide stimulus to the economy. Call me cynical but that is what I think will happen. Of course that is not great news for underlying government bonds and government bonds will be sceptical about that so I think you will see a situation where interest rates are coming down but you won't necessarily get the follow through in terms of the underlying government bond returns because they will still be worried about that inflation outlook. So I don't think we have got an environment where we have got a tail wind and in all honesty I think we have still got a mild head wind to go into which is why we have got the resource to take opportunities from that.

Dick Turpin: Let's move on….there is a quick question from Mick Gilligan on duration which is always a subject that gives me heart flutters but really whether it plays a part in your positioning of the bond element of the Fund and indeed over the last couple of years, whether you have seen the shifts in duration.

Adrian Frost: No it doesn't. I go back to my earlier slide just as case for the defence. We do not get caught up in things such as following the credit rating agencies, trying to actually ship the duration around because quite simply in doing that we move more onto the territory of our colleagues in the Strategic Bond Fund where effectively you can up sticks and move the tent and change the duration materially. Say for example we have got 8 or 9% in preference and things like that and some bonds which we think are ultimately very valuable. If I start actually being pushed around, it is a bit like in the equity fund, you start to be pushed around by tracking error then effectively you say, 'well, what is driving this, is it the economic views you hold or is it this particular measure?' The fact is that this Fund actually will always be, even if we made some adjustments to the margin, will always be more aggressive in that respect.

Adrian Frost: Can you remember what our duration number is at the moment?

Adrian Gosden: It is about 5.5.

Adrian Frost: Yes it is shorter…..

Dick Turpin: Well thank you for that. Interestingly one other question has come through on real estate which clearly has been very high in investor's minds over the last couple of years. Is it looking more attractive on a yield basis now because clearly it wasn't very attractive, over the last year or so?

Adrian Gosden: Real estate is a genuinely interesting question. We only own 3% of real estate exposure in the Fund through the bonds and one of them is say a bond like SEGRO high quality industrial, you are earning about 6.5 but this is where it becomes interesting as equity investors as well as bond managers. On the equity side those shares are being absolutely hammered at the moment so something like SEGRO is nearly half this year alone and is now yielding over 5% as an equity so the equity and the bond market are at slight odds there, the coupon on the bond is absolutely without question. The actual equity is trading at a 40% discount to its assets and yielding almost well 5 against 6.5 as much as the bond. So for us looking at it, we are actually looking at the equities there at the moment and doing what work we can to see what is going on. But, it is a secondary market and not the listed shares that are the problem because there is a lot of leverage in there and these things get rolled over on a three monthly basis so we are going to probably see some forced selling into the beginning of New Year. That will probably be the buying time. I am just not sure that the bonds are reflecting the sort of turmoil that people expect there. The equities certainly are; they have really fallen quite hard and so we are looking at the equities. The bonds seem to be taking it all in their stride which is, if that is the right way then you want to own the equities, because they are going to re-bound strongly. If the bond market has got that one wrong then there is going to be some widening there and we will use that advantage; there is nothing wrong with some of these property companies it's just they got too tight against the government tenure, implying no risk and as we will see if there is any economic slow down, you do get risk in property companies. So the opportunity if it exists is actually in the equity market and not the bond market at the moment.

Adrian Frost: I should just add that in the Income Fund we have actually been buying SEGRO or starting the holding there. We haven't done anything in High Income yet; so that shows it's an area which we are looking at and every piece of broker research we get is a downgrade or a move to neutral.

Dick Turpin: I am conscious of the time and we'll probably get to the point, we are winding up quite quickly, but there is one very interesting high level question which I am sure you have both got some thoughts on given the complexity of financial instruments nowadays. What can successful fund managers do to assuage consumer fears in terms of the security of capital and perhaps more importantly fund integrity; and I wondered if you would have any thoughts largely down to the way you are positioned or have you avoided some of these more complicated instruments?

Adrian Frost: Don't invest in anything you don't understand and you could pick up holdings where there is a bank etc and you say, 'well Adrian how much do you understand?' and the answer is up to a point; and we accept the fact that the way the banking system is nowadays there are plenty of areas where we have an understanding. But we accept that it is limited so therefore the trade off there is the size or position you have in the portfolio, point number one. Point number two is, as we actually outlined in our interim report, there is nothing like losing some money on one of these things to learn a lesson and we did have a holding, a half percent, in a thing called Calibre which offered a sparkling yield and the fact that we only had a half percent told you that we had some reservations about it but we allowed ourselves to be convinced about it and we have lost about 0.4 of performance because of that. That's just reminded us to actually say to ourselves how much do you understand about this and if you don't understand it don't go there. The number of people over the last two years coming to funds such as ourselves bearing, sporting fantastic yields that have been the creation of leverage has been phenomenal and it has been an extraordinary period and in the main probably except for Calibre we have rejected all of those. But it would have been very credible at one stage, maybe 12 months ago, to have a very high running yield on your Fund from a collection of vehicles where the conventional wisdom was that life was fine and the capital shock of owning that has been immense, absolutely immense. So avoid is the answer and sometimes we forego opportunity because we either sell something or look at one another and say no, I am sorry, I am not clever enough to understand that.

Dick Turpin: Thank you. I am going to bring it to a close now, Adrian if you would be so kind as to just look at the last slide with myself, which shows a very impressive track record over the period since launch through to the current year.

Adrian Frost: Yes but before you get carried away on that because I know you like to [Laughter] I think the important thing there to emphasise is if you look at the returns side of things, this is the nature of the asset and what its generated, you can't have it both ways as an investment manager, this is a very diverse collection of funds in the sector and people often ask us about whether we can manage something for peer group ranking and we say we don't do that in the income sector which is more homogenous. We certainly can't and don't manage for peer group ranking in this sector because it's such a diverse collection for us, we manage for a return and for protection of capital and where we end up in the peer group is a result of that work; and naturally over the last 3 - 5 years with an equity component in the Fund and with a skew towards high yield that has been beneficial and our target at the moment is holding onto that through a turbulent chapter in the market.

Dick Turpin: Brilliant. May I thank you both, I think we will bring it to a close there. Ladies and gentlemen thank you very much for giving us your time and listening this morning. I hope it has been useful and informative and we will be putting together a transcript of the presentation if any of you want to refer back to

it and that should be posted on our website within the next couple of days. Finally if you do have any questions that you haven't either sent through or we failed to answer then please get in touch with us either on our broker support line which is 0800 092 2090 or though our e-mail address brokersupport@artemisfunds.com. So if I can, both Adrians thank you very much indeed for your time, thank you for listening and we look forward to welcoming you to the next webcast in the months ahead. Thank you very much indeed.

Risk Warning

Issued by Artemis Fund Managers Ltd which is authorised and regulated by the Financial Services Authority and is a member of the IMA. Artemis Fund Managers Ltd is a member of the Artemis Marketing Group. We only market our own unit trusts. The value of an investment, and any income from it, can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. A proportion of the Fund may be invested in higher yielding bonds. This may increase the risk to your capital due to a higher likelihood of default by the bond issuer. Changes to market conditions and interest rate levels can have a larger affect on the values of higher yielding bonds than other bonds. In the interests of providing a level of income consistent with the aims of the Artemis High 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. .

3318/11/07/JL