ARTEMIS
The PROFIT Hunter

Adrian Frost & Adrian Gosden - Income Fund

Dick Turpin: Good morning ladies and gentlemen, thank you very much for joining us today for a continuing series of our fund webcasts.

Today as you know we're joined by Adrian Frost and Adrian Gosden, Managers of the Artemis Income Fund, and we're very fortunate to have you both here – welcome; thank you very much for joining us today.

Now Adrian last time you did this webcast, I was just looking back and it was back in July of 2007 and at the time no one could have imagined what the global economies and markets would experience over the following 12 months. Now you have both navigated your way through those incredibly well and have continued to maintain your first quartile stance with the Fund. We're delighted to have you both here this morning and take the opportunity for you to give us your thoughts and views going forward on both the Income Sector and Income Fund. Thank you, and if I can take the opportunity now to pass over to you Adrian.

Adrian Frost: Thanks Dick, good morning everyone; I think what Dick meant to say there was that actually over the last 12 months we've actually got less bad news to tell than some but it's bad news in any way because of the negative return on the Fund. But more seriously, and we would like to draw your attention to, we think some of that has come about as a result not of stock picking per se but because of the principles we put in place and we've had in place for 7 years.

If you step back and think about the problems that income funds in particular have encountered over the last 12 months, it's to do with what I call an over-dependence and blind faith on the published yield. It's been to do with, in some cases, too much in small- and mid-cap. It's been to do with an overweighting in financials and it's been to do with an absence of mining. We don't have answers to all of those, but what I would suggest is first off, because we actually do have this heavy dependence on identifying the cash flow first and foremost and trying to think about where the cash flow is going, the dividend is then a result of that and I think people do forget that dividends are a discretionary decision and we've seen much of that, we've seen some companies who have turned tail on their dividends within a space of 6 months, such has been the severity of what's going on.

I think it's helpful to concentrate on that cash flow rather than say it's on a yield premium of 10% of the market, therefore it must be a valid candidate for the Fund. So that's been helpful to us and I think has meant that on balance, thus far, we've been less affected by those companies that have been unable to sustain their dividends and we put up there a reminder of what our definition is of the free cash flow.

I think the other fact I would draw your attention to is important, is really our portfolio of construction rules; because I'd love to tell you that we had no banks at all over the last 12 months, but we've had anywhere between 8 and 12% or thereabouts. And we have this rule of no more than 15% in any one sector, and I fear that what has happened for some participants is what I call this benchmark tyranny - or benchmark complacency is another way of putting it - which says, if in the summer of last year you had 22 – 23% in banks: it didn't seem all that risky purely and simply because it was only 5% overweight the index. Ignoring the fact that you actually had over 20% of your capital in one fairly homogenous sector; and part of the reason for funds finding themselves in that situation, was a chart which we showed at our roadshow at the beginning of '07, which was looking at the number of shares of the index that were yielding 10% more than the market; and there was something of a yield drought; yield had been a good performer and we slightly cautioned on people's enthusiasm for income and I think that drove people more and more into the banks area. But back to us: the most we could have and the most we will have owned in banks is 15% of the portfolio. And this very much ensures that if our job is to deliver an income stream to you as investors, it actually comes from an economically diversified portfolio rather than one that is actually dictated by the benchmark. So we think that was an advantage in the portfolio construction.

Turning to the mid- and large-cap issue, which I don't think was a big issue for the Fund, but just to emphasise that; much of our work in previous years had been moving out of mid-cap into the large-cap and there were plenty of times when we really chastised ourselves for being far too early in our selling, but today it's not a move that one could undertake easily, so it's better to be early rather than late. So that's been something which I think has been helpful.

So these are kind of embedded rules in the portfolio. It hasn't made us immune from exposures which we wish we didn't have or things that have gone wrong in the portfolio, but on balance it has put us the right side of the line rather than the wrong side.

I think the other issue which has been difficult - not just for us, but for all Income Funds - has been the rise and rise of the Resources Sector and we've got some charts here on that, I don't know whether Adrian, I'll just pass over to you on that…

Adrian Gosden: Just on the Resources Sector, for the Artemis Income Fund we weren't holding resources for the last couple of years and not dissimilar from other Income Funds, they didn't really offer us the income opportunity. That was a tremendous headwind: in 2007, it would have cost us about 4% of relative performance and halfway through 2008, another 3%. Things are clearly changing in that area now and you can see from that graph how the equity prices came detached from the commodity prices due to M&A and various other reasons. We didn't sign up for decoupling, we were slightly wary of some of the commodity prices and how they got to where they were, so we just didn't play in that area; we were using the money elsewhere in the portfolio. But just to communicate that we do think that that headwind is over now and as a consequence July and August you've seen the Fund gaining some very strong relative performance. That's just because this area is quite big now in the London market, due to all the Kazakhstan companies and the various Mexican silver companies that have joined our exchange. This is about 12% of the London index. As it comes off (and we're thinking it's going to continue) that will just be helpful for the Fund. So, an alleviation of a headwind for all income funds but for ours as well and it becomes maybe something of a tail wind, better news for income funds.

Just on the next slide we've done about a month ago, it just shows you how strong this theme has been within the London market with this area of very, very strong outperformance and it really has been the only story in town for making capital over the last 18 months. As I say, we think that's probably behind us now so we don't need to worry about it anymore. We'll be vigilant on the sector, we've actually got a meeting after this to talk about mining shares, but I would just ascertain at this point in time, it's too early for us to get involved. The dividends aren't apparent to us and as a consequence probably no mining shares from the latter part of 2008 so far.

Into what we are looking at, is slide 10. When we spoke at the beginning of the year, we thought we'd probably be buying much more Cyclical companies than we actually have been

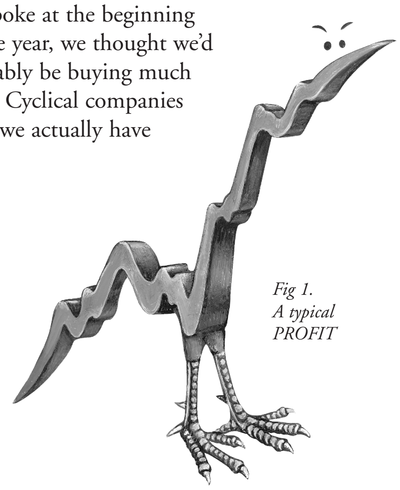

Fig 1. A typical PROFIT

buying. Our meetings with companies and our meetings with analysts have actually led to us buying more defensive shares, so a lot of the companies we bought tend to be more international in their focus; the balance sheet is absolutely critical to us. We don't want to get into a debate with the bank about whether the dividend can or cannot be paid. Similarly on pension funds the business has to be of a stable franchise to be able to service that pension fund. The pension fund numbers are moving around quite a lot due to movement in equity markets or assumptions on people's longevity. These can present real problems and if the pension fund and the banking debt comes before the dividends as Adrian said, this is a discretionary item. We need to pay a good dividend and a progressive dividend, so we need to be careful with the share companies that we should look at.

At the moment, ideas that have come into the portfolio in the last six months have been things like Centrica, AstraZeneca, First Group, BA Systems. We have put a couple of cyclical shares in; it's fairly early days and they amount to no more than 3 or 4% of the portfolio. I'm happy to go through that if anyone has any questions on those, but it's very much early days; we can actually see some companies that look really quite fragile and we'd be very, very wary about going near any of them.

Dick Turpin: Now picking up on that Adrian, we've had a couple of questions very much to do with the earning cycle with Ian Reece at Premier and also Linda Desforges. I'm talking about expectations for dividend growth or indeed dividend decline. Where you see the earnings cycle, in terms of the companies you've been meeting and the feedback you've been getting, how do you see that panning out?

Adrian Gosden: We've got a real cycle going on here now and dividend cuts after the 4th, so we're seeing dividend cuts: these aren't shares that we own, but just to communicate them in the pub sector, we're seeing it in the retail sector, we're seeing it in the property sector and we've most clearly seen it in the bank sector, with people issuing script dividends which is useless, you can't distribute it to your unit holders that's just capital and they probably shouldn't even bother with that, they should firm up their balance sheet. So real dividend cuts going on in the market. The market as a whole has dividend growth forecast of about 4% this year, which is down some 10% they were forecasting a year ago.

When we look at our portfolio, as Adrian said, we're looking at franchises, defensive, cash flow where we can see it paying a dividend, we just had a lot of results from companies in the portfolio, over 30 of the 72 shares in the portfolio told us what their dividend progress was in July and August and from that we are quite confident about the dividend growth that we have in the portfolio being in the areas of about 6% and the range of companies, if I'd just mention the sort of companies that we have a report: The Pearson's dividend is up 6%, Aviva - 10%, Glaxo 8%, BP 30% - slightly exceptional maybe. National Express 10%, Centric 15%, Bat 19%. Astra 10%, BA Systems16%, Cobham 10%, RSA 10%, Hayes – becoming a bit boring; but I'm trying to give you an impression that actually there is some quite good dividend growth in the portfolio, so we are hoping after five years of growing the dividend 10% or better, to produce a 6th year which will look pretty respectable against the market.

Adrian Frost: Can we just illustrate that from the slide we have here. Adrian works with numbers and words, I have to work with pictures. I've devised this chart called the Equity Wheels of Debt which is obviously an understatement. What I've tried to demonstrate is that this is really how a company might feel when it's actually making its dividend decision. Some of the companies you talked about with a dividend cut are usually in, using a technical term, they're in the debt spot. Which means that they have cyclicality, they manage to convince themselves over the last ten years because of the boom that they weren't cyclical - but they are. For that reason, sometimes persuaded by us collectively as a city of shareholders, they have taken on too much debt, too much share buy back, so they were debt burden and this issue of pension liabilities, is very important as well.

When they actually sit round the boardroom table and come to take a decision on the dividend, it is not just the fact that the business is cyclical, in fact quite a number of cyclical companies without debt and without pension fund liabilities, are in a position to actually maintain a dividend record if they so choose, but if you've got the other two wheels of debt coming your way, then I'd suggest it goes out of your hands. Some of these dividend cuts are not being made by the Board; they're being made after pressure from bondholders, bankers or the trustees of the pension funds. Those problems aren't going to go away any time soon. I think this is something which has been in our minds not just during the last year, it's been something that we keep thinking about; and there are still one or two situations in the portfolio that are on the fringes of that debt spot which we have to deal with.

Dick Turpin: And do you see a growing number of companies potentially or actually entering that so-called debt spot?

Adrian Frost: From the point of view of the pension side of things, I think what we have to do is work out how big the numbers are and then accept the fact the numbers could move around and that's the key. Taylor Wimpey is widely reported, that here we have a house builder with a market cap of about £500 - £600 million. Widely reported of having debt I think something in the order of £1.7 billion; but the other thing which was not so widely reported was the pension deficit went up from £215 to £377 million, that's the deficit! It's not the liabilities. I'd suggest that actually by the time the bankers and the Pension Fund trustees have passed through the self service canteen, the amount which shareholders can load up on their trays is going to be pretty meagre.

Dick Turpin: If I can pick up on that talking about pension fund debt, we've been sent a question in here about the recent move of Cable & Wireless passing on their pension fund to the Pru, and he just wonders whether that sort of thing is going to become a trend and whether it's positive for companies to be able to bundle it up and pass it on..

Adrian: Problem trend but the bits that get passed on are generally the less painful and the easy bits. It's a market: the more tricky the liabilities you're handing over the more costly it will be to get the third party to provide those guarantees. So, yes, it's a good thing and it takes volatility out of the equation, but there generally is a cost associated with it and in the case of Cable & Wireless, let's not forget that they have actually put quite a lot of money into the pension scheme over the last few years to get it into the position where it can now be taken off the books because they have an agenda to do so. You know what the cost is, I suggest if you look back the last years as to how much they've put in, which allows them to be in this position.

So Taylor Wimpey yes, conceivably somebody could take on their pension liabilities, but there is probably a cost associated with it which they just can't afford at the moment. I don't know that for certain, but I'm surmising that that's the case.

Dick Turpin: One other question that's coming from Ian Reece about pub companies that you mentioned having dividend cuts and he quoted Greene King as one company that is consistently growing its dividend and wonders whether that's an exception to the rule? I don't know whether you're in any position to follow…?

Adrian Gosden: We had a meeting yesterday on pub companies so we're not experts; we've met Greene King and it's a very good company, good set of assets. It is carrying quite a lot of debt and I would surmise that that record might come unhinged. Management might try and keep it going for another year just to say that they did it. But this debt burden is significant and the like-for-like, that is how much beer is being sold relative to last year's is going down. The consequence of that - tough times - but no way as tough as the likes of Punch and Enterprise which have eight times debt to their EBITDA, whereas I think Greene King is around six, high five/six; so not quite the same burden, probably a better company.

I would caution you about expecting too much cash flow to be paid back as dividends from these companies because they are in a strap and when they go to the bank and ask for a bit more money, the banks are decidedly uninterested in them at the moment. I would say that has been a fantastic record, I'm not too certain it will continue in the next couple of years.

Adrian Frost: I'd be interested to ask the analysts: Greene King was one of his recommendations and we said fine, but how does Greene King ever pay this debt back? it's not impossible but it would be a very slow process. I don't think it's too much of an exaggeration to say that part of the corporate sector has engaged in the equivalent of an interest-only mortgage on the basis that it can always be refinanced, rolled over and the value of their assets would keep on going up. Effectively that would always underpin their ability to refinance et cetera. Certainly interesting and rather old fashioned question to say to a company "okay, you've got this much debt, over time, how do you propose to get it lower or pay some of it back?"

Dick Turpin: Thank you, that was very clear. We've had several questions, I won't go into them all individually, but it's generally on banks, I think it was incredibly topical. Several people have called the bottom and found actually that the bottom is a long way further south. What are your general thoughts on where we are with the banks in certain areas?

Adrian Gosden: From my mind it is an incredibly difficult thing to try and assess, so we're going along using kind of PEs that turn out to be irrelevant. We're using dividend yields, they turn out to be irrelevant as dividend yields get cut. We tried all sorts. We're even looking at a book value and hoping that we can get some solidity there and the book values are moving around just as much.

What I would say though is the difference between now and the earlier part of the year is that we're hoping that the book value is now going to become a bit more realistic, because we are writing things down to 50p in the pound or 70p in the pound. And if you look at HBOS, which is a bank we've been looking at, it is actually trading at 0.7% of its book value. So you are starting from the right side of the book, so your question is: is the 9 billion difference between the two numbers? How is that going to be written off and how is it going to occur, through credit cards or mortgage defaults et cetera et cetera?. So we are on our way to getting to a point where these may be more interesting as investments but let's not get away from the fact that it's incredibly opaque and very difficult - Adrian and I struggle in these areas, because there just isn't any information.

We could be buying these things with little knowledge of the dividend we'll get from them over the next 12 months; but we are in a way that you know HBOS has halved since March and we find ourselves in September with some more bad news to come up in the second half for sure; but I think the market is getting itself into a position of trying to understand it, and just as you think you're understanding it Lehman Brothers goes down 45% last night, so solidity is hard to find. I think you've just got to try and find one you can understand. Try and get behind it, try and buy one below its book value and try and make some assertion about how that book value could possibly change; what's your starting point, what's the end point? And I think then you're going to get the sort of conviction that you need to actually put some capital into this area.

As Adrian said we have 8% in banks so take that as our conviction level, still remaining a little bit wobbly, but it's off the bottom of 7%, so we have bought 1% more, but really quite early days for us in that.

Adrian Frost: I think we sometimes forget that there is plenty of other things in the market that have been equally badly beaten up which arguably are easier to understand. Adrian came up with quite a good analogy the other day, that sometimes it feels with banks, if you ever go and watch one of my youngest sons plays rugby, and everybody follows the ball all over the pitch and there are vast parts of the pitch which are completely deserted and there are 30 odd people with about 10 yards from each other in one corner. It feels like that on banks sometimes. Everybody's trying to unlock, find the magic key to value on banks. The margin of safety has improved, but there are plenty of other areas to go.

A couple of charts we have here which we hope will help us on the bank side. Let me just start off with – here we go. I think that a key to a bank restoring some long-term stability is its funding and we've just about squeezed some rights issues through the equity market. This is an important area as to what bond investors are asking banks to pay on their debt. Nothing has really relented there terribly much. It's still pretty expensive, relative to risk free. It's still very expensive relative to the corporate sector. So we'll watch that closely, because I think if that starts to change somewhat, I think that would be a pretty positive sign.

That leads us to a wider issue; if banks actually… banks have had a good rally and if they consolidate from here and rally further; there is one thing we know with absolute certainty that is that they need plenty more capital. Over the next couple of years it's not going to be your last chance to buy bank XYZ because there is going to be plenty of issuance around both bond and equity.

In terms of the stock selection; we've been impressed by the fact that from the Autumn of last year, these are the credit spreads, a crude picture of the credit spreads on the various participants; so we've got HBOS, HSBC, Alliance and Leicester and Lloyds there and the credit market's been a much better differentiator of the good, the bad and the ugly in the banking sector. Again, that's something which we'll keep an eye on. It's not the be all and end all, but I think it's an interesting indicator because it's fundamental to a bank as to what their cost of funding is and where they get their capital from, because let's not forget these things are very leveraged vehicles. We talked about the pub companies and the leverage there and the debt spot and banks are, the amount of equity in the bank relative to the business it undertakes is quite small, but that's the way they work, so we're mindful of that.

Just on a couple of wider points, we said that our plan at the beginning of the year was to become more cyclical. All the indicators and the speed of deterioration in the economy put us off that plan. Plus the fact that our defensive shares actually fell very sharply in the first quarter of this year, so why buy something on a risky yield of six and a half where your safe yielding share on five has gone down in price? That's pretty much the strategy we executed.

There is all this talk at the moment. Is it the right time to buy retailers? We have to be very wary of not being caught up in what I call Hedge Fund city, which is large swathes of money moving from one sector to the other and switching their allegiance. Perhaps not with some long term fundamentals in mind. So at the moment, hedge funds are out of resources; they're turning their tables from long resources and short financials and domestic stocks and they're switching it around the other way, hence the relative performance of those two. Only follow that trend or go with that trend if you actually believe the fundamentals.

The way we look at UK retail is that the way people are behaving is entirely logical. They're not having credit extended to them and so they're looking to actually save money and cut back because you can't just stick it on the credit card. So we think this has got, look at those saving ratios there. They've got a way to go before they even start being rebuilt.

Interestingly enough, we were looking at a chart yesterday, this is about national characteristics, but if you look at the French and German saving ratios, they're 14% and 18% respectively and they don't change much. It's just that we're actually much more akin to dipping into our savings i.e. running them down from 12 - 0. We'd rather take a rather sunnier view of life than some of our European counterparts.

The other point as well is to look at actually what the behaviour of banks is and I think this is well known to you. In this chart here, the computer says "no". Clearly this is documented good evidence that there is a real cutback going on in corporate: we're slightly positive why that lending to households line is not lower, I'm sure some economist can explain it; but it doesn't take a genius to work out where it's going. We had a company in the other day who had a bank facility which was a 364 day overdraft, and at any time during the year they could actually convert it into a four year loan. That was the optionality they had on it; and basically on day 363 because it was a fantastic loan facility, they rang the bank up and said we'd like to convert. The groans at the other end of the telephone were audible. As far as the bank was concerned, that was an unprofitable loan made in sunnier times which was using up some of their balance sheet. They were just desperate to actually stop that lending but contractually they had to carry on. That's the climate we're in and I know some share prices have fallen a lot et cetera but it's quite difficult to get enthusiastic about this when you think instinctively, this has got a way to go.

Dick Turpin: Thanks, Adrian. One question just generally, is in terms of your European exposure. The questioner is asking what's the proportion of your holdings? You've mentioned on several occasions when we've been out presenting around the country that it's an exciting opportunity to give the exposure to some sectors, where the exposure in the UK might be a little dull or uninspiring.

Adrian Gosden: So we've got about 11.5% exposure in Europe and the range in the last five years has been between 7% to 15%; but you shouldn't read too much into our views on Europe from that, it is just where we see the opportunity. The reason it's come down is the sale of Telecenera, the Swedish Finnish phone company which we sold when France Telecom was thinking about bidding for it. That was a reason, so no real material change of view on Europe as a whole; all currency is hedged back so we're getting no benefit or hit from that. As we look at our pad today, there is no reason to suggest that European weighting is going to change materially one way or the other in terms of new ideas versus the UK ideas we're looking at - it's the same sort of relationship, so I suggest as is for now, then we'll come back to you if we spot any new name that we are going to introduce to the portfolio to take it up or down.

Dick Turpin: Thank you very much. A quick question from Ian in Scotland on large-cap. You were saying that your highest would be around 75% as your large-cap exposure. One final question from Andrew Robertson on REITS. Whether you would consider the opportunity to invest in REITS or indeed whether you can or not, as an opportunity from a yield perspective; whether it's something you cast your eye over.

Adrian Frost: Every time we cast our eye over it, the yields have been very meagre and there is a whiff of some financial engineering about this in certain cases but yes, it's something we'll look at and some of the yields on that area are becoming more attractive. Adrian, you looked at…

Adrian Gosden: Technically we can; so for the Artemis Income Fund if we invest in a REIT something like one of the property companies like Seagrow formerly Slough Estates is a restructure; so are British Lambie; they've paid their dividends and the majority of their dividends will be in a 'property income dividend' format and we can take that on board because the fund has administration costs; we offset it in that tax bracket and that means we can actually distribute that dividend which is a 'property income dividend' through to unit holders. So that is good news, we can do that, up to a certain proportion. We will look at it, but if there is too much leverage against these things in the restructure it's just going to be the same reason as you would do for anything else. Restructure is just purely avoiding paying some tax that's all, so it's got to be the fundamentals of the business that will drive our investment.

Dick Turpin: Thank you. I'm conscious of the time, ladies and gentlemen, I think we've answered all the questions that you've sent through and thank you very much for sending those through, it certainly helps to bring even more colour to the webcast; but if I can take the opportunity to thank you for listening in and thank you to the two Adrians for taking us through with a thought-provoking overview of what's been going on.

If you do have any other questions please don't hesitate to either phone our broker support line on 0800 092 2090 or indeed send us an email on brokersupport@artemisfunds.com If there's anything you'd like to revisit please don't hesitate to visit it on the website.

Finally, thank you again and we look forward to getting together in the next few weeks for a further conference call. Thank you very much indeed.

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