

Rathbone Income Fund Conference call update, March 2008

Introduction

I will be talking about the Rathbone Income Fund and reflecting on 2007. I will also give a view on our current positioning and our remit for the future. It's difficult and unusual to be bullish in the current market. Investors oscillate between depression and over-optimism. However, despite its difficulties, this year could provide great opportunities.

The fund

The Rathbone Income Fund aims to provide a distribution stream that will increase by a real amount, year-on-year. We achieve that by investing in companies that are able to provide us with that growing dividend stream. It means buying quality businesses - not sectors or indices – and holding them over the longer term. There is a slight change in our strategy this year, but this remains our basic philosophy. Our growing distribution stream is what differentiates us from our peers within the sector – our ability to pay out a real increase in distribution every year since 1994. This demonstrates the health of the fund as well as the health of the underlying businesses. In some cases, this is not reflected in the share prices, but it highlights the strength of the business models, the stability of those businesses, as well as the cash they generate. That cash is paid out in a dividend; we pay it out in a distribution. In 2007, we pushed forward an increase in distribution of around 13%.

Performance

We've been first quartile every year for seven years since 2000; our long-term record is very strong. However, although we only slightly underperformed the sector last year, we showed a negative return, whilst the FTSE All-Share index rose. If you return to 1999 - the last time that we underperformed - it was less of an issue because we still made money for our clients. This time we didn't. So despite the underlying strength of our businesses, and the fact we pushed through a dividend increase, the net result was actually a small loss. To put this into a wider context, by September-end, we were about 2.7% away from being first quartile for the year. The final three months of 2007 were problematic for the businesses in which we invest but not in an operational sense, more in terms of how the market treated the shares.

Value versus momentum

Last year was a difficult one for the equity income sector in general. 'Value' underperformed; 'momentum' did well. It's too simplistic to argue that the market moved on a very narrow band of

stocks and industries, but if you stripped out the large miners in the FTSE 100, the index would have been down last year. On the other hand, if you stripped away the banks, you'd have been up further.

It's interesting to hear comments suggesting that 'equity income' is a dying breed of fund. I'm sure most of you would agree that's ridiculous. We heard that comment back in the late 1990s, at a time when the market was again being driven by a relatively narrow list of stocks. We are using last year as an opportunity to re-examine what it is that we do this year. We're certainly not changing our strategy to any drastic extent, but we're re-emphasising the importance of value within our investment process. That re-emphasis clearly has an impact on the buy-side, but has a greater impact upon when we sell a stock.

Ultimately, this fund and the other funds that I manage, including the Rathbone Special Situations Fund, are value-oriented. We would like you to understand what we are trying to achieve in order to make a sensible asset allocation decision. If you believe the market's going to move ahead, driven by momentum stocks, then you can understand why we might lag behind that market. However, if you decide to allocate more money to value-oriented plays and believe that certain areas of the market have gone too far, then you should consider what we're doing.

I'm sure you have heard of Benjamin Graham who wrote 'The Intelligent Investor' in the 1930s – another time when investors were wary about equity markets. I love his idea of "Mr Market". The point is that businesses have a worth, but on a daily basis the market tries to buy or sell that stock on a price. We don't have to take those prices, we have a choice. The key is to identify the right price, and if the market's getting it wrong, that is our big opportunity.

Positioning for value in 2008

We're going back to our roots in 2008. That's not to say we have ignored value over the last few years, but we're now firmly positioning ourselves on that side of the market. Reflecting on 2007, a value-oriented fund is most likely to underperform towards the end of a 'bull' market. It might be contentious, but if the end of a bull run is nigh, it's sensible for us to re-state our value credentials. Focusing on value last year, however, would have made little difference in terms of our relative performance.

So what do we mean by 'value'? We use a classic definition: businesses where the current share price is low versus the net asset value. We're also looking at high free cashflow. In other words, how cash-generative is a business, and how is it reinvesting that cash? We're also looking at high dividend yields. Those simple ideas are going to provide the focal points of our investment

philosophy. Ultimately, however, we want good businesses. We're not just buying cheap businesses for the sake of it: we want good businesses because the market's failing to value them correctly. Also, if the market is valuing them correctly, then we'll hold fire. So we're going to use short-term volatility to our advantage and differentiate fact from noise. There's a lot of noise right now, and we're ignoring calls from brokers who are scrabbling around for deals and simply reacting to news flow.

Sell discipline is crucial. We have always said we would hold a business across the cycle. We will buy it when it's cheap, and we might take profits when it's expensive, but we intend to hold it for the longer term. However, realistically – and reflecting on last year - when markets are very volatile, when the market de-rates that stock, that hit can be unbearable. For example, we first invested in Greene King in 2000 when the market was failing to recognise its strong growth because it wasn't a 'tech' company. The stock was trading on a price/earnings ratio of around six to seven times and a yield of 5-6%. Over the last five years, the shares performed very well. The business also performed in an exemplary fashion, with decent acquisitions, and rising earnings and dividends. However, the rating also rose. At the high point last year, it would have been on a price/earnings ratio in excess of 19x, and in hindsight, we should have sold at that level. We should have recognised that there were better places to put the money. That would not have been a reflection on the quality of the underlying business, it would have been a reflection on the stretched valuation. It's easy to say it in hindsight, but our value principle must impact the sell discipline in the same way that it impacts our buy discipline.

Outlook for 2008

Harking back to when I first started running this fund back in 2000, we had the opportunity to buy value, and it set the foundation for the next seven years of outperformance. We believe that we can do the same thing again this year. Value has been relegated over the last 18 months, and that provides us with a massive opportunity.

The market volatility that we're likely to experience over the next six months can be our friend. The one great thing we've got this year is the luxury of time. Ignore the calls in the morning - it's a case of having a shopping list of stocks, and taking the time to interrogate balance sheets and ascertaining the right price to pay for these businesses. The shares might be going up, but we don't need to buy them today. We've got plenty of opportunity over the next three to six months to pay the right price.

With reference to the current market and economic uncertainties, we are trying to spot businesses where the value of that business, based upon the value of the balance sheet, is such that we can

almost ignore the earnings' risk. If a business is trading at a sufficient discount, the true worth of that business in terms of its balance sheet – the discount to its net asset value – means we can ignore the short-term earnings' risk. That is going to be the key, and these opportunities will emerge this year. We're not going to try and 'hit sixes' straight away. To start with, we're going to look for value within the FTSE 100 index, although we don't believe that it is cheap. Some of the major defensive sectors like tobacco and utilities have had a tremendous run over the last four years and are expensive on an historical basis. We continue to ignore pharmaceutical companies where there remain long-term structural issues. As for banks – whilst cheap on an earnings' basis – it is still very difficult to establish what their net assets are worth. However, we do like food retailers and have a large exposure to Tesco. The telecoms sector is a more difficult one. It's very defensive, but if you look at the way the markets have reacted to recent news flow, there are issues. However, we believe that Vodafone is cheap, and that's one we'd be happy to buy. Beyond these areas, there are those sectors which investors are shunning including property; house-builders; leisure; retail; and media. We're not going to jump into these, but we are going to undertake extensive research into these companies and identify those businesses where, should the valuations get too low, there's substantial asset-backing. If we can find balance sheets with a low level of debt, that also supports our cause. Ultimately, if insiders are buying that industry, that's a good signal. Ignore the market chatter and look at what the insiders are doing.

Stocks

The following are examples of stocks where the market is failing to recognise intrinsic value:

Tesco: Shares rise when investors want defensive earnings and fall when they worry about the roll-out of the 'Fresh & Easy' stores in the US. There are going to be teething problems in the US, but in terms of competitive strategy and expansion into a new market, there's sense in taking that risk. The company aims to achieve +20% returns on capital. There's also growth coming through from the more defensive space within the UK. The South Korean business is performing very well, and has generated enough cash to finance the planned expenditure in the US. So if Tesco can generate this cash from South Korea, put it into the US and achieve a 20% return, from a value point of view, that's tremendous. The compounding of that investment growth should make us substantial returns. If we can buy on the day when the market's worrying about short-term issues, we will do so. Tesco is our second largest holding.

Diageo: This is another compound growth story. It is expensive from a value point of view, but is a way for us to play the emerging markets. We're not adding to it right now. If the market weakens, and if Diageo was to see some profit-taking, we would like to find the value at which we start

buying. As far as large cash stocks are concerned, this is the sort of business we're looking for - repeat brands that people buy again. The key is to pay the right price for it. We're not there yet, but it's an opportunity for us over the next three months.

Bovis Homes: We have a small exposure to the housebuilders, less than 3% of the fund. Nobody likes this sector, but there's a long-term argument to have some exposure. We will need to build houses in this country going forward, and we only have a finite amount of land. Those companies that hold land on their balance sheet have a very valuable asset. Should house prices fall, there will be an impact on land prices, but the point is you cannot recreate that land. If we can buy a business like Bovis at a 50% discount to its net asset value, that is going to provide us with a future store of wealth. If the market fails to recognise this, then a competitor, who does not want to buy land in the marketplace will.

Brixton Estates: We do not own this stock, but might buy on weakness. Brixton manages industrial and warehouse space in the UK. The key is this business owns assets that cannot be replicated. For example, they have a portfolio of assets around Heathrow Airport – strategic assets. The balance sheet is relatively under-leveraged compared to other property companies, with low levels of unsecured debt. That's important - it's not going to get itself into the difficulties that other property companies have gotten into with securitised debt. Brixton has been buying from distressed sellers. However, returning to our main point about unique assets, assets that can't be replicated, this is what we are interested in. If the stock market fails to value these correctly, then there are investors with pools of money around the world who might want to diversify by acquiring strategic assets. That would be a bonus for us, but ultimately if we can pay the right price for Brixton – say, 50% discount to net assets, for example - that would be a good long-term move.

Conclusion

We had a difficult fourth quarter of last year which followed seven-and-a-half years of very strong performance. Our underlying businesses operated very well in 2007. Notwithstanding the economic environment, they generated cash and paid out dividends. The evidence so far this year is that these same companies are continuing to operate well and are pushing through dividend increases – which is exactly why you would buy this fund.

More fundamentally, we wish to remind investors of our value philosophy. The key for us now is to ensure that at this time of greatest opportunity, we do not lose sight of this principle. To reiterate Ben Graham: “Imagine that you own a small share of a private company that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks

your interest in the business is worth, and furthermore offers either to buy you out, or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.”

The fund has delivered a compound return of 13.0% since 1996*, versus the FTSE All-Share index at 8.4%. If we can produce that kind of compound return in the years ahead, we can create tremendous value for unitholders. (*01.01.96 to 01.01.08.)

Carl Stick
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Rathbone Income Fund

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