

Rathbone Income Fund

Conference call update, Tuesday 14 October 2008

Carl Stick: Any analysis of the last quarter stalls in the ominous shadow of what was a very difficult period for all markets and for all strategies. There is less than normal to be gained from a detailed study of what did or did not contribute to performance; however, we believe that September may prove to be a watershed. This is a very dark tunnel for equity investors, but we do believe that there is a definite chink of light in the distance.

Performance attribution

All areas of the UK equity market performed poorly during the quarter. The FTSE 100 lost 11.91%; the FTSE 250 lost 12.87%; the FTSE Small Cap lost 14.71%, whilst AIM fell back a staggering 31.82%. In relative terms, the 11.03% loss suffered by the Rathbone Income Fund is an out-performance, but that is no immediate consolation for investors who must feel as if they have no place to turn.

Despite the fact that the global credit crisis reached a crescendo in September with the collapse of Lehman Brothers, the \$85bn rescue of AIG, and the stop-start bail-out of the US banking system, it is fascinating to note that the best performers in the fund were HSBC and Barclays. This evidences the ongoing rotation away from commodity plays (especially the miners) into banking shares at distressed valuations that has gathered apace during the quarter. We have no exposure to the large miners, but our oil stocks have fallen as a counterbalance to the banks.

Elsewhere, defensive stocks such as National Grid, Tesco, and Scottish & Southern Energy held up very well. The biggest hit to performance arose from our holding in Man Group. Early in the period, we took a little profit, recognising that the company might experience a short-term impact of the unwinding of the short US Dollar/long commodity trades that had served the hedge fund community so well over the last 18 months. The shares did weaken, and we bought back the stock that we had sold. However, during the last two weeks of September, the maelstrom that has engulfed the industry dragged the company's shares down, despite a positive statement. They currently yield 7.3%, trade on a P/E of 7.6x, and are arguably at the wrong price.

As ever, a sector view reiterates all of the above. The top five performing sectors were banks, utilities, food retail, tobacco and beverages; with the exception of the banks, no real surprises there. Holding the fund back were oil & gas, general financials, and more economically-sensitive sectors such as engineers, aerospace and our support service exposure, where Aggreko saw substantial profit-taking by the market.

As far as relative performance is concerned, there are positions that are most relevant. Firstly, we were correct to pull out of our positions in BHP Billiton and Rio Tinto when we

did, at around the start of the year. Although we missed out on some of the upside, our contention that valuations had become stretched has been validated, as the shares have come tumbling back. The interesting question now is when should we revisit these businesses? To this end, we need to take a view as to the level of long-term trend earnings. At the moment, we believe that analysts are still too optimistic in their forecasts for 2009, so there will be a better opportunity to re-acquaint ourselves with these names. In the meantime, we are happier with the oil companies. Valuations are low, but expectations for next year are similarly constrained, and with BP and Royal Dutch Shell both yielding five per cent or more, we are being paid to be patient.

Secondly, we remain underweight pharmaceuticals, and our reasons are very well rehearsed. This is, arguably, the ultimate defensive sector, and therefore has performed relatively well during the quarter. However, we remind holders of the Fund of the ‘four Ps’ – pipeline, patent expiry, pricing power, and politics. All four of these are fundamental roadblocks for the industry. It would be easy for us in the current environment to park money in this sector, but in the absence of any change to long-term fundamental weakness, we remain on the sidelines. Furthermore, if our more optimistic prognosis for equity markets is correct, they may well relinquish relative performance in the future.

Future strategy – how secure are future dividends?

We think that it would be beneficial to outline at this juncture our future strategy because, as we state above, the wider macro environment swamps any review of performance. Therefore, we want to emphasise, in the strongest terms, the consistency of our process. At the start of 2008, we embarked on a campaign to remind investors of our value credentials, and we wish to repeat that clarion call now. Furthermore, we now want to remind readers that it is our focus on dividend growth that is the spine upon which the Rathbone Income Fund is supported. If we as managers get that simple yet vital aspect settled, we believe that there is a clear route to the light at the end of the tunnel. The comforting aspect to all of this is that this is what we have been doing throughout the fund’s 17-year history.

Dividend yield and dividend growth are the drivers for long-term shareholder return. However, we live in an environment when future earnings, and therefore future dividends, are uncertain. The third quarter of 2008 has seen a substantial increase in both the number of companies cutting their dividend and the cumulative value of these lost payments. Navigating this landscape is the key to our future success.

We focus on the survivors. Does the company have a business model that will survive the current downturn intact? Does its product and market position still ensure pricing power? Do the economic moats exist? We have asked these questions before, but now some others demand attention. Has the business and the management been through a recession before? Is there a scenario where this company will fail to survive?

We have always preferred businesses that could be self-funded. This prevents an over-reliance on both the debt and equity markets. We focus on companies whose dividends and

growth can be financed by internal cash-flow. This functionality often goes hand in hand with an ability to manage the cost base. So, the question of survival comes up again. Is there a scenario in the current environment where the company fails to finance its survival?

This inevitably leads us on to the banking sector. The travails of this industry are too well documented for us to add any further value here. However, an industry with challenged business models, an over-reliance on leverage, unreliable asset-backing, and a definite earnings and dividend risk does pose problems in the light of the criteria outlined above. HSBC and Standard Chartered dominate our banking exposure, on account of their stronger balance sheets, but we are wary of being too aggressive here. In our opinion, the banking sector is not the prime area of value in the current markets.

One final word. Our record on dividend growth is exemplary, because our method has always been to focus on good dividends covered by internal cash-flow. We do not buy bad value; that is cheapness for cheapness sake. We started planning for next year's dividend this summer. If there is a potential for dividend reduction, we have already factored that in to our very conservative forecasts. The confidence that we have in the long-term performance of this fund is founded upon this robust dividend performance.

Light at the end of the tunnel

In *Margin of Safety*, his book published in 1991, Seth Klarman writes:

"...securities priced as if nothing could go right stand to benefit from a change in perception. If investors re-focused on the strengths rather than the difficulties, higher securities prices would result."

No-one is arguing that the current economic environment is anything other than serious. Businesses will fail; asset values will continue to fall; funding issues will remain; unemployment will rise; private consumption and investment will fall; and economic growth will dissipate, if not decline for a short period. However, there is a danger that in all this gloom, every share will be priced for failure. There will be companies that will come through this recession as they have done previous ones, emerging as stronger beasts. During the recession of the early 1990's, value (defined here as the FTSE 350 higher yield) ultimately underperformed growth (FTSE 350 lower yield) in the three years that preceded sterling's ejection from the ERM on 16th September 1992. In 12 months after that date, those same value stocks substantially outperformed. However, more importantly, it was not until April 1993, that is seven months after 16th September that economic data came through confirming the end of the recession. The time to have invested in these stocks was at the time of the greatest economic doom, not on confirmation of the recovery.

This is our chink of light. 'Value' has endured a similar torrid time over the last three years, as momentum plays have dominated market performance. Yet that has started to unwind. We are in the depths of economic turmoil, but maybe we have had our '12th September moment'.



Q&As

Philip Lenanton (Financial Advice & Services Limited): Would you comment on the restructuring of the financial system?

Carl Stick: In the majority of the markets, this scenario needed to happen. The decision by governments to take equity stakes in the banks is the key. There must be a sense of tax-payers receiving a reward; there must also be a sense of banks feeling some pain. The next stage will be for the banks to start lending to each other; that is the acid test. We have got to see what happens to LIBOR over the next few weeks. It has edged down slightly, but it needs to come down a lot further. If that happens, we could get the feeling that the banks are secure enough to resume lending to each other, and then we can all start moving forwards. It is a bitter pill, but it had to be taken.

The week beginning 6th October represented the total disintegration of any consensus around the world or how to deal with it, and that was the really frightening for all of us. However, none of this detracts from the fact that global economic growth will stall. That it is the natural course of events: economies have a cycle. An awful lot has happened to exacerbate the problems, but realistically speaking, a period of negative growth is cathartic. Ultimately, we will come through it and move on. When it comes to the practicalities of running money, we are looking at businesses whilst recognising that growth in 2009 will not hit levels seen over the last two or three years. That may seem an obvious thing to say, but there are sectors where disaster is being priced in for 2009, and there are other sectors where people are still talking about 20% earnings growth. Those sectors worry us, because ultimately we are going to see a dramatic slowdown next year. It's possible that we'll start to see a recovery at the back end of 2009, going into 2010, and that's what we must focus on.

Philip Lenanton: I noticed that LIBOR and the iTraxx index came down, and I nearly cheered. I thought, perhaps, the system was now unblocked, but obviously you are not too sure?

Carl Stick: Yes, LIBOR has come down, but it is going to take a little while longer and more significant moves to get this system.

Philip Lenanton: It is inevitable we're going to have an economic slowdown and shrinking balance sheet structure, but on the positive side, developing countries are creating wealth and demand. They are going to be impacted by the restriction of credit through the work system, but is there not a chance that some of their momentum might lead to a more optimistic outcome than we're expecting?

Carl Stick: We would love to think so. There is a danger that everybody gets so gloomy, they miss out on anything positive. We have had a longer-term argument, which is still intact, in recognising the sheer scale of populations in China, India and Brazil and a threshold of \$5000 of earnings a year. When you get to that level, you start to consume more, and that is the long-term driver that is here to stay. Taking a three to five-year view, certain stocks will benefit from that trend - Cadbury's Unilever, Diageo, Nokia; any company producing a brand that is being sold into an emerging market and has a market share to support that. However, in the short term, there may well be a pull back in demand. It is up to us to pick the right stocks on a case-by-case basis.

Guenter Ike (Iketrade International): Which stocks are likely to be bailed by the Government?

Carl Stick: Some 7.1% of the distribution that we are receiving or expected to receive next year is from the banks, and the bulk of that is from HSBC and Standard Chartered. Neither of these two banks is expected to participate in the Government bail-out. So we feel that their dividends are relatively secure. HSBC will benefit from some of the US action, so there's a slight caveat there. The third holding that we own is Barclays (1.9% of the fund), but it represents a negligible amount of the dividend that we have got forecast for next year, because we have cut our dividend forecast for Barclays by 50%. We believe it is prudent at this stage.

Thank you very much. In difficult circumstances we are trying to present a robust and clear way forward. What is working in our favour is that investors have been disinterested in value and in income stocks, over the last few years. On that basis, over the medium to long term, this might turn out to be a very opportune time to get involved. Our method has always been to focus on good dividends covered by internal cash-flow. We do not buy bad value; that is cheapness for cheapness sake. We started planning for next year's dividend this summer. If there is potential for a dividend reduction, we have already factored that in to our very conservative forecasts. Finally, there are many harbingers of doom, but the likes of Warren Buffett and Anthony Bolton are identifying pockets of value. We are not comparing ourselves to them, but we do share their confidence. We will not pick the bottom of the market, but we do believe that we own businesses that will ride out this recession. Whilst we wait for the recovery to happen, we will continue to pay a strong and growing distribution as healthy compensation. It is that growth in distribution that sets this fund apart from others in the sector. The confidence that we have in our long-term performance is founded upon this robust dividend performance.

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