

Transcript of conference call for the Rathbone Income Fund Tuesday 22nd July 2008

Carl Stick: Welcome to our regular quarterly update on the Rathbone Income Fund. We will focus on performance attribution, and our current positioning and outlook. (The performance attribution report will be forwarded after this call.)

Performance

During Q2, the fund retreated 6.57% versus the FTSE 100 at -1.34%; the FTSE All-Share at -2.44% and the FTSE Mid 250 at -8.66%. We outperformed the Mid 250, but clearly there is a gap versus the FTSE All-share and the FTSE 100. To put this into context, the performance of the All-share has been dominated by very large commodity plays. The index actually lost 65 points during the period, but the likes of BP, Royal Dutch Shell, BHP Billiton, Anglo American, Xstrata and BG Group contributed 132.14 points. If you strip that away, we are back to where we started. We hold no large mining exposure, so we are going to underperform when those stocks perform well. Conversely, we will perform better relative to the index when those stocks perform badly. When looking at relative performance, positioning with regards to large miners is therefore going to exert a massive influence on return. Furthermore, we have adopted the value mantle, so the fund will perform well when value stocks do well, and it will perform badly when value performs badly versus the wider market.

On absolute performance, the biggest positive contributors were commodity plays. Venture Production, a small business exploiting natural gas reserves in the North Sea, was our biggest contributor to performance. We have a large exposure to BP and Royal Dutch Shell also. We can never be fully weighted in large oils but have around 4% in both BP and Royal Dutch Shell, and they performed well as large oils played catch up with the large miners. If we want value in the commodity sector, then BP and Royal Dutch Shell certainly offer that. Both companies offer safe and growing dividend streams in future, and that is very important. Our fourth biggest contributor to performance was Anglo Pacific. This is a niche mining company with stakes in businesses around the globe. It yields +3% - not bad for a commodity play. We had some very positive news coming out of the Queensland State Government with regard to the coal loyalty rate. Queensland increased its tax-take, of which Anglo Pacific is a beneficiary. Our fifth biggest best performer was Titan Europe, which received a take-over approach. We have a residual holding.

As for the negatives, the biggest hit to performance was Barclays. Our banking sector exposure is now less than 8%, so we are underweight. The bulk of that exposure is held within HSBC and Standard Chartered. Both these banks have relatively strong balance sheets which will enable them to grow going forward. We exited from Royal Bank of Scotland during the period; news of the rights issue was unwelcome. We still hold Barclays as our one high beta banking play. We do believe there will continue to be a rotation away from highly-rated commodity stocks into the banking sector, and we want to be able to participate in that. However, on-going work into the sector is yet to convince us of any underlying intrinsic value, so we must be careful as to how far we let these plays go. Unsurprisingly, the other big hits to performance came from mid-cap, consumer-orientated stocks. We have three house-builders, although our house-building exposure is less than 2% of the Fund. However, we have seen Bovis, Persimmon and Bellway get marked down and are seeing stakes being built up in these businesses. We are going to maintain our exposure - longer term, we need to build houses in this country and can take the dividend cuts on the chin for now. However, you should

expect us to consolidate our construction exposure down to a few niche value plays. SIG has not performed well in the period and may well be jettisoned.

Sectorwise, commodity-related plays and the engineers continue to benefit from quality spend, and the consumer-oriented plays have done badly - it is as simple as that. We remain underweight pharmaceuticals, based on fundamental problems within the industry. One holding we do own is Dechra Pharmaceuticals which continues to perform very well. Dechra is involved in veterinary medicine, a very defensive area within the current environment.

Fund positioning and outlook

We are viewing the future with measured confidence. At the start of this year, we suggested that the market would oscillate between 5,400 and 6,000. Admittedly it has been more volatile than that at the lower end of the valuation scale, but we did add that within that volatility there would be opportunities to buy some fantastic, long-term businesses. We maintain that view.

We are hearing advisors suggest that the income sector is dead, but we contend that this could be the time of greatest opportunity. This depends on us adhering to very strict 'value' rules. We are analysing asset values; looking at businesses with strong, conservative balance sheets; we want predictable cashflows and high cashflow returns on invested capital. Ultimately, we are looking at future dividends and the sustainability of those dividends. Despite dividend cuts across sectors, our view of dividend flow for this year and next remains very healthy. Looking forward into 2009, we are confident that we will distribute a real increase. Forgive the marketing speak, but do compare the Rathbone Income Fund to our peers and their historic inability to raise their distribution - compare this to what we have done and what we continue to do. That is our differentiating factor. We invest in companies with the cash to pay out an increase in dividend stream; eventually the share price will follow suit

We are looking to consolidate our holdings into a focused group of larger businesses that are going to benefit from ongoing organic growth. More specifically, we have identified pockets of the market that are going to engineer that growth - businesses like Diageo, Tesco and Unilever. We are seeing higher inflation but do not believe it is going to have a massive impact on this emerging middle class. To take this theme further; we have talked in the past about the need for energy generation, hence our exposure to International Power and Aggreko; and the need for emerging market finance, hence our holdings in HSBC and Standard Chartered. We must keep an eye on valuations, but the likes of Fenner and Weir Group are engineers that benefit from global demand for all types of products. And although construction is a dirty word, why not look at businesses like Keller and Carillion that are also involved in the construction of infrastructure in emerging markets, especially the Middle East?

The credit crunch was an almighty shock to the global economy, and we cannot underestimate its impact. However, the fear has generated opportunities. The most fundamental tenet in all of this is our sell discipline. We have always said that we would hold onto a business across the cycle, and that we are tolerant of adjustments in ratings. In hindsight, this statement was misguided. If we look at the way share prices have reacted to the current downturn, we do not believe that our unit-holders can tolerate shares that fall back 60% or 70%. If we buy a stock because it represents value, we should sell it when that is no longer the case. In other words, if Mr Market offers us a silly price to buy our stake we should accept that. Secondly, we must ruthlessly assess the downside. Very volatile markets remind investors how much money they can lose in equities. It is interesting that over the long term, the best hedge fund strategies focus on mitigating losses rather than maximising gains. This is something which we have to take on board. If we get that right over the longer term, we will make you a lot of money.

When markets are weak, there is a real danger that their weakness is such that it takes a long time to recover and an awful long time for investors/client confidence to recover as well. We believe if we can invest in businesses that can organically grow their earnings and their dividends, and thus maintain our rated dividend growth, your clients should be indifferent as to the level of the FTSE, because the share prices will recover to reflect that dividend growth. In other words, if we can nail the sustainability of distributions, we will nail shareholder return for your clients.

Finally, we do not expect an immediate recovery of equity markets, nor overwhelming inflows into the equity income sector. In 2000, equity and income were dirty words; arguably they are just as filthy now. However, we believe that by investing in a core list of stocks with a growing and sustainable dividend flow, and by doing so now while optimism is so very low, we can create a clear path through the current environment.

Should you have any questions, please contact your representative at Rathbones. We look forward to seeing you or hearing from many of you in the future.

Carl Stick
Investment manager

The value of investments and the income from them may go down as well as up and you may not get back your original investment. Past performance should not be seen as an indication of future performance.

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Transcript of the conference call for the Rathbone Income Fund, continued

Questions and Answers

Alan Harris (Harris Investment): Can you give any examples of areas where your criteria require you to be overweight at this point in time; and secondly, whilst completely agreeing with your confidence in the future, by looking for the type of companies that you're talking about, isn't it the case that everybody is looking for companies with strong balance sheets, cash flow sustainable dividends etc? And doesn't that increase the price of such stocks?

Carl Stick: Yes, that's very fair point. In terms of weights, we are underweight banks and pharmaceuticals. On housebuilders, arguably we're overweight because any exposure to housebuilders, in any sort of way, is likely to put us overweight. **Our** biggest overweights are unsurprisingly the electricity sector, utilities, general financials. We have large stakes in Intermediate Capital and Man Group; we have a much smaller stake in Paragon. We are overweight aerospace and defence where we've got earnings visibility; we do like BAE Systems and BT Group where there's security of income. We are overweight industrial engineers - Fenner and Weir Group. It's a small sector, and the fact that we have decent holdings there puts us in an overweight position. So those are the principle overweight positions. Just looking at the list, travel and leisure are just under 4%, and that's relatively overweight; fixed line telecoms is an overweight as well. We are underweight large miners, where we are obliged to have only 4% in a stock.

Let's go onto your second point which is very valid, but to be honest with you we're not necessarily seeing that. Using Diageo as an example, its shares have been weak recently owing to concerns over its exposure to the US market. That's why the shares have come under pressure and that's why they've moved below £9. Our bullish view, however, has been based on their exposure to emerging markets. When we did a series of presentations in the spring on value-investing Alan, we highlighted that our average holding period is five years, but the average holding period of stock in a mutual fund is now down to nine months. And investors are using day-to-day news flow as a basis to make a decision. So if there is bad news with regard to the US on Diageo, they sell Diageo and ignore the long-term point. So, ultimately yes, everybody is looking at strong balance sheets etc - it's not rocket science - but not all investors do that.

Allan Harris: How big an affect will recession in the US have on your fund?

Carl Stick: A recession will have an impact on most equity funds, and to that extent it will have an effect on us. You can't argue globalisation in one breath and then say there is a disconnect between the two; the global economy will be affected if the US economy slows down. We are aiming to look for businesses which can exploit other positive factors around the world as well, like BAE systems and BT Group.

The reason why I emphasise the middle class coming out of emerging market is we can try and benefit from that very strong driver. Unilever is a good example. We are seeing more people around the world with disposable incomes where they do choose to buy deodorants or toothpaste or washing powder. These are basic products, and basic brands that people are looking to exploit, and Unilever with their 40% exposure to emerging markets is one way of doing it.

Bob Donaldson (AG Financial): There has been a lot of criticism of funds that are purely looking at yield, and purely at returning growth by way of dividend. What is your view on total return over purely focusing on the dividend?

Carl Stick: Ultimately, we are looking to maximise total return, but by identifying companies with strength in dividend flow. If we start using a barbell type approach or being aggressively growth-oriented, it is fine when you get it right, and you lose focus when you get it wrong. We do make mistakes; clearly looking back to any period of time even when we were performing very well, we were still making mistakes; they just weren't quite as obvious. We are setting ourselves a series of rules, and thinking about the dividend side. We've adopted a longer-term view to investment, which isn't necessarily helpful when you are running an open-ended fund, but it is what we choose to do. And I do make that point that we hold a stock for five years.

Over a one-year period, the tangible return from the stock in terms of dividend and dividend growth only makes up about 35-40% of the return. The bulk of return on average comes from how the market feels. If the market likes the stock and it gets re-rated you do very well. If there are problems with the de-rating, you can do badly, but over a five-year period, you dampen that market view. In other words, you dampen the switches and sentiment to the extent that dividend and dividend growth make up 80% of the return you get from a stock across the wide market. Ultimately, that is what we say we are trying to do.

In the context of the last 18 months, we have performed in a mediocre fashion versus the income sector, and the income sector has underperformed the wider market. But the wider market has gone through its own gyrations, and we have had this split between a narrow range of stocks that have done very well, and the rest of the market which has done poorly. Now, we choose to invest in certain areas and not in others, our focus is on value, which historically has produced very, very strong returns.

Bob Donaldson: I'd like to thank you for your honesty and it is always nice to know where the fund is coming from, but if I could just follow up with a second question. If we live in a changing marketplace, is it sometimes the case that people have got to change their attitude towards investment and also change their methods?

Carl Stick: We could have had the same conversation in 2000, but it is very dangerous for me to say this is exactly the same as 2000 because it may be and may not be. There are two points. As far as equity investment is concerned, if you look at the FTSE All Share and the AIM market, the stocks that have powered ahead have been miners. Mining stocks are cyclical businesses, although they are not being viewed as such that at the moment. So we are in a market where investors feel they have to buy certain stocks because they act as a hedge against inflation, or because the dollar is going to continue weaken. We understand the short-term argument, but we have got to look at the valuations being attributed.

The second point is very relevant, and this has a greater impact on us. Quite clearly, investors are looking at alternative products. In terms of your asset allocation, there are a lot more tools at your disposal, and equities are likely to form a smaller part. That is a bigger issue for us than any argument about equity income or value is dying. We don't personally believe it is; but then we wouldn't, would we?