

## Transcript of conference call for the Rathbone Income Fund Tuesday 2<sup>nd</sup> June 2009

**Carl Stick:** We recognise there are certain issues that are concerning investors and we want to address those. Investors are unsure where the Rathbone Income Fund fits within the wider income sector - we wish to address that today. We will re-emphasise the strength of our investment process and dividend policy, and discuss performance over the last 18 months.

### Investment process

Our investment process asks two questions of a company - is this a good business, and is this a good investment? Firstly, we look at barriers to entry and pricing power – the old Warren Buffett idea of an ‘economic moat’. In other words, what enables this particular business to defend its margins and its returns? Can this business make a return without recourse to leverage? Also, as owners of the business, will we be rewarded with a compounding of returns over many years? Secondly, does it make a good investment? In other words, is this stock cheap on a long-term view? What’s the short-term impact on how we trade in the fund? Ultimately, we are looking at earnings yield; we’ll make an assessment of how this business is funded through equity and debt, and the enterprise value and cash-flow. If it is cheap and if it is a good business, then it is a good investment as well.

My gut instinct is to buy a business because it is a good long-term investment, and historically, we have been more tolerant of holding businesses across the cycle. However, as a response to what has happened over the last couple of years, and the increased volatility, we have become more aggressive in terms of how we trade and are less tolerant of losses or expensive ratings. Finally, we are seeing a structural change in how the market views leverage. Two years ago, the investment community was far happier encouraging companies to take on debt; we called it ‘balance sheet efficiency’. That is not the case now. On personal, corporate and sovereign levels, entities are heavily indebted, and over the next few years, they will want to pay down that debt. This will have a profound impact on business strategy and how investors view a new recovery from recession. The positive side to that is we are looking at businesses with cash on the balance sheet and that do not have to worry about from where the next tranche of debt-financing is coming. From a competitive position, that’s very strong. Those entities that are going to earn a marginal dollar or a marginal pound will be able to invest for growth or buy a weaker competitor. We believe it’s a three- to five-year phenomenon, and those businesses with cash on the balance sheet will have tremendous opportunities over the next 18 months.

### Positioning

Income funds have always been a sensible method of investing in equity markets. They also provide a helpful hedge against inflation. These companies generate cash, reinvest back into their own balance sheets, and pay out a growing income - that combination provides a substantial total return. Our process focuses on value and quality, and our long-term record is ample testament to the fact that this process and this philosophy works. About 30% of the fund is trying to capture ‘easy dividends’, mega caps like Vodafone, BP and Shell, and all with relatively strong, visible dividend flow. We remain underweight large pharmas based on fundamental flaws in the sector. Another 30% of the fund is held in core FTSE 100 stocks that have consistently generated returns through their pricing power, including Diageo, Unilever and British American Tobacco (BAT). The remaining 40% of the fund is invested away from the FTSE 100 index in businesses with dominant market positions, strong balance sheets in absolute terms, but also have a tradition of generating returns relative to their competitors. These include

Severfield-Rowen, Bellway and Domino Printing. Across these three areas, we are concentrating on businesses that can compound that growth, year-in, year-out. That is what generates the long-term return.

### **Greene King**

Greene King illustrates some of the topical points that have been raised. We bought the stock in 2000 when it was cheap because nobody was interested in 'boring' beer or pub stocks. Back then, I recall it was trading on 6x and yielding around 6%. In 2007, Greene King posted its 39th consecutive year of earnings per share growth. However, this time, I recall it was trading on a P/E of 18x, yielding around just 2% because investors viewed it as a geared property business with assets which just happened to sell beer! My mistake was not selling the stock aggressively at that point because there must have been better value in the market. The shares came rattling down. At £2.50, Greene King was a better investment, and the shares have recovered because investors have become excited about cyclicals. About a month ago, it announced a £200 million rights issue which has been greeted positively by the market; however, that rights issue is being used to pay down debt. The response from most analysts has been 'fantastic, they are sorting out their balance sheet', but Greene King remains a highly indebted business. So, a good business but not a great investment.

### **Distribution**

Our distribution record has consistently been strong over the last 14 years, and we've got a good visibility going into next year. We have maintained the interim distribution at nine-tenths; we are happy to do that. At the start of the year, we were hopeful that we'd be able to grow the dividend this year, but being more pragmatic about that now. The market is forecasting a 20-25% fall-back in overall dividend this year. We're going to outperform that, but investors will see a small cut going into the final distribution. The key here is we offer a substantial return versus cash (5% yield). However, we want to re-base the dividend at a level whereby we're very confident we can grow it going forward.

### **Performance over the long term**

Our 10-year record is exemplary. Over that period, the fund has, on average, outperformed the FTSE All-Share index by 5% a year. The unit price has increased by 15%; the total return of the fund is 70%. Some 55% of that return has been generated by the dividend that we have produced and the reinvestment of that dividend. That is the ultimate proof that we achieve what we set out to achieve.

However, the fall-back from July 2007 to the start of this year is where the performance has been hit. This has affected our one and three-year numbers - that's what has concerned investors, and quite rightly so. 2008 was an exceptional year, but the fund was also heavily impacted by two or three stocks where the business model was broken. This led to substantial and permanent losses of value. The key now is, when looking at businesses, asking 'can we break this business?' Or, 'is it possible to destroy it?' We must really focus on whether there is the potential for a permanent loss of value; I think we've done that, and the fund is now clean of 'toxic' stocks. We have got over the hurdles of 2008 and are very happy with the way we are positioned. However, there are going to be times when this fund underperforms. This is a value vehicle and will not outperform a momentum market.

## Outlook

We are unconvinced about a V-shaped recovery. In fact, we believe investors are being a little bit too sanguine about where growth is coming from over the next 12 months. Ultimately, if companies are paying down debt, the shift will be away from growth, and that should affect how we value stocks.

## Summary

I have been managing this fund for almost a decade. The investment process is clear and straightforward; it is something that you can explain to your clients. We are looking for quality, based upon returns on investor capital, and making sure it's a good investment, by looking at valuation. We have always picked stocks well, and we now have a stronger sell discipline. We have always had a progressive distribution policy, and that means our return in terms of dividend is very attractive versus cash. We have seen a very good recovery and performance year-to-date which should certainly offer some comfort, and ultimately we are still the best performing income fund over the last 10 years.

**For those of you wishing to review this conference, the replay facility can be accessed by dialling within the UK on 084 524 55205, or alternatively on country code +44 1452550000. The reservation number for this call is 10466393.**

**Carl Stick**  
Investment manager

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