

Transcript of conference call for the Rathbone Income Fund Wednesday 25th March 2009

Carl Stick: We would like to update you on where we are now and the ideas we're considering over the next six months or so. We spent a lot of time at the back end of 2008 reviewing the errors that we made. Today, we're going to focus on some of the positives too.

Risk

When we talk about risk, we're talking about value that can be lost. We're talking about valuation risk, business risk and financial risk, and what they mean for performance. We've always spoken about holding businesses for the longer term – that's fine to a degree. But when markets are volatile, that can add volatility to performance. We've now rid ourselves of our own 'toxic assets', so we're happy with our starting point.

Valuation risk: Our example is Greene King. In 2000, the shares were cheap, and we were right to buy them. In 2007, they rose aggressively, and we should have sold then. The shares have since come back, with some recovery this year, but the valuation was too expensive: there was a valuation risk. Capital value was lost, albeit temporarily, and still affected performance.

Business risk and financial risk: Business risk and financial risk are very worrisome because they represent permanent losses of capital - that's what we must avoid. Assessing business risk is about asking what is there around the corner, be it a competitor, economic risk or a change in the business model? Assessing financial risk is all about asking if there's something about the way a company is financed that may erode the value of its equity. If we examine the last 18 months where investors have done badly, it is down to these permanent losses of value. What hit our performance most were stocks like Paragon, Intermediate Capital Group, Cattles, and a relatively small exposure to the banks, where business models were no longer valid.

Investment process

We are investing in businesses where we see the long-term merit of ownership, and where cash is being generated and paid as a dividend *and* reinvested in the business. We are talking about equity and cash, not businesses that rely on debt to grow. It is basic, not rocket science.

Fund positioning

Eighteen months ago, investors were asking if equity income was dead. Well, it's very much alive, and there's a very good reason to be looking at income funds now. Our mandate offers a straightforward method of investing in the equity market. If – and it's a big if – investors can capture growing dividends, that's a good hedge against inflation. We've got a very loose monetary policy, and inflation will come back. In simple terms, about 30% of the Fund is exposed to the big income gorillas within the FTSE All-Share. The top 10 companies in the FTSE All-Share - businesses like BP, Vodafone, Royal Dutch Shell - pay out 60% of the dividends, and offer a relatively secure dividend stream. In many cases, these dividends are paid in Dollars, and we've benefited from Dollar strength. We're still avoiding pharmas and are not going to buy them for the sake of the dividend. The second 30% of the fund is within core stocks, good long-term holdings. Again, we're talking about FTSE 100 players here like Diageo, Unilever, Scottish and Southern, all of which have made explicit their intentions to grow their dividends over time. The final 40% goes into our mid to small cap arena where we've always done well. We believe businesses like Greene King and Severfield Rowen will be left standing once we get through the downturn. Venture

Production, Dechra Pharmaceuticals, Cineworld and Halfords, these are all non-FTSE 100 names that make up a very important part of the portfolio. Our top 20 names constitute about 72% of the Fund; overall, we have a more concentrated list of stocks (53 at March-end).

Ultimately, for all of the companies we're looking at, it's about the *compounding of earnings*. If a company can generate, year in, year out, 15-20% return on capital, and can reinvest money back into the business at that return, investors will make money. Over the short term, share prices may be volatile, but in the longer term, it's that compounding that's important. That's our buy story.

Dividends

Over the last 14 years, we have posted a real increase in our payout, year-on-year. Had you asked two months ago whether we would post an increase this year, we'd have said yes. Now, we're not so sure. Realistically, the interim dividend of 9p will remain just that. The final dividend will be reduced, and we're expecting to reduce the overall dividend for the year by 10-15%. It's disappointing, but in the context of a market forecasting 15-20% falls in dividend, it is satisfactory. We could increase the dividend, but that would involve sacrificing our process just to contrive an increased payment. There's no point fighting the tide of massive dividend cuts coming through. If you can buy this Fund, yielding + 6%, it's not a bad return when deposit accounts are yielding next to nothing. That cash return is very important.

Performance

Over the last 10 years, we have outperformed the FTSE All-Share by 5%, year-on-year – we're very proud of that. However, over the last 18 months, there has been a deterioration in the value of the Fund. We maintained patience with stocks whose business models were breaking, and we didn't realise it. We don't want that happening again. Finally - and this is the real advert for the Fund and the sector - total return for the Fund over 10 years is 51.25%; the unit price of the Fund has gone up 1.79%. The vast majority of our performance has been driven by the dividends that we've produced and the reinvestment of those distributions into the Fund. It's that compounding of returns that creates value for shareholders and your investors. Nobody wants to buy the market at the moment. Back in 1999, the yield on the All-Share was about 2.4%. That 2.4% reinvested would give you a return of about 26-27% over a 10-year period. Therefore, from the inflated levels of 1999, that's a 73-74% return from dividend and capital appreciation from an expensive market. Where we are now? An income fund yielding about 6.5%, reinvested in the market, means 90% of your original return back in dividends, without any growth at all. Our argument is it doesn't matter whether you think the market is falling in the short term, put money in the market now, put money in this Fund now, and you only need the market, or the dividends, to close by 10% to supplement that 90% on the reinvestment of dividends. We accept that those dividends are vulnerable to falls, but it's just an interesting insight into investor psychology that when the market is expensive, investors plough in; the market is relatively cheap today, but nobody is interested. An income product will provide you with a decent return and some capital appreciation over the next 10 years. That is the bull story behind this Fund and the income sector.

Questions and Answers

Kay Burt (Kay Burt Investments): What percentage of the fund do you have in mid, small caps and AIM?

Carl Stick: AIM exposure is negligible. We are about 38% away from the FTSE100.

Kay Burt: What do you feel about feeding money into AIM?

Carl Stick: Too many stocks in AIM are illiquid. They must be well financed. We've always looked at businesses on a case-by-case basis rather than where they're listed, but there must be a view as to where the shares are progressing to and an exit strategy if we need one. We're in no hurry to rush into small caps or very small caps - we've got to maintain a balance. We have got rid of most of our problem assets, and that's why we're more comfortable talking about the Fund.

Kay Burt: I'm not suggesting that you should move there; I hold your Fund knowing you have mid caps and want to get some bounce from them.

Carl Stick: Yes, that's the point. Investors must understand what we do and make an asset allocation decision based upon that. The worst thing we can do is say, "sorry, it's just tobacco and utilities now," because that's not what investors buy us for. That doesn't mean we hold things for the sake of it and ignore if a company is broken. That's why we've sold stocks like Paragon.

Kay Burt: You've tried to get some exposure to companies that were/are going to benefit from emerging market growth in Asia. Is that still where you see an uplift?

Carl Stick: It's difficult. People are still underestimating the impact of the slowdown in China and India, so we've been circumspect. Aggreko has performed very well and that has an emerging markets' side, but we've been taking profits - the yield is not there. We might look at some of the more distressed engineering assets because valuations are pricing in a total collapse in emerging market demand. There is an imbalance between stocks where people are not pricing in a slowdown and others where people are envisaging a complete breakdown in demand. It's about striking a balance between the two. We think media is a good area; we've been building up our exposure. This sector has been damaged since 2000; the ratings were already low, even before the current market turmoil. United Business Media and ITE have strong balance sheets and emerging market exposure. We've got to make sure the valuations we're paying reflect the fact that we're going to see a slowdown in emerging markets before we see them recover.

Kay Burt: Are cyclicals looking more interesting?

Carl Stick: Our mid cap exposure is more cyclical, but we're keeping a balance. They've been hit but they're recovering now.

Alan S Harris (Harris Investment Management): Regarding capital performance and income performance, what is your priority? Are you looking for total return? Are you looking primarily to maintain the dividend? What is the driver for you?

Carl Stick: The focus is the dividend. If we can buy businesses that generate enough cash to grow their dividends organically but also grow the business, that's a good starting point. On top of that, that dividend growth will mean you should get two types of compounding - the compounding of returns within the company, and the compounding of returns within the Fund, and that will lead to a maximum total return.

Alan S Harris: So you subscribe to the theory that income growth will drive capital growth?

Carl Stick: Yes.

Alan S Harris: So where has it gone wrong in the last couple of years?

Carl Stick: We've always wanted to maintain a long-term view with regard to an investment. Some advice given to me recently sums it up - 'love your fund, but not the stocks inside it'. There were certain businesses, using Paragon as the example, which we knew very well. It occupied a dominant position within a niche market. Northern Rock collapses and the wholesale lending market collapses too. Our mistake was not realising the dramatic impact it was going to have on Paragon. In hindsight that was foolish - we failed to recognise that the story had changed forever.

Alan S Harris: In July last year, you had measured confidence in the future and felt there were opportunities to pick up stocks at good value. Did you manage to pick any stocks that are now in the portfolio and that you feel are going to perform in the future?

Carl Stick: Yes. I am mindful that I could end up being the boy who cried wolf with my confidence. We have, over the last 12 months, consolidated this list. We know the businesses where we think, long term, they are very good value. This has started to come through, although last July, August, was a better time.

The period that really hit the Fund last year was a ten-day period from mid-October through to October-end, when the market got absolutely pummelled. The FTSE recovered, but our 250 exposure remained down, and that's where the big hits were taken. Over the last nine months, we have trimmed those non-performing stocks and focused on those businesses that offer great value, and that has started to come through. Recent company announcements have been very good for us, whether it's smaller businesses like Severfield Rowen or Venture Production. Mistakes have been made, and we can't look backwards.

Alan S Harris: Can you give me an example of a stock that you've purchased over the last nine months that you're confident about for the future?

Carl Stick: We've increased our media exposure through ITE Group, United Business Media and Tarsus. Another new holding this year is Domino Printing. Again, we have been taking our time to build up these exposures and buying on weakness.

Closing

Carl Stick: The last two years have been difficult. We are starting to see a nice recovery coming through. The short-term numbers are looking better, but the dividend is the key – if we can pay out 27p as dividend this year, it will be a nice 6.5% yield, which is not a bad place to be. Thank you once for your support and we look forward to speaking to you soon.

Carl Stick
Investment manager

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