

Summary of conference call for the Rathbone Income Fund Tuesday 20th October 2009

Carl Stick: I want to spend some time talking about performance of the last quarter and a little bit of time talking about the markets, and then finally, I will be looking ahead as far as this fund is concerned.

Performance

The problem with looking at short term performance is that things short term can be quite volatile and can be quite misleading. The convention that we use is that we do first of the month to first of the month, so on that basis, from the 1st of July to the 1st of October, the fund has grown 16.7%, I'm pleased with that, versus a market that's returned 17.1%, just a little behind the market. Considering the drivers that have pushed the market forward, people buying risk - and we've specifically avoided more risky areas of the market; I think that's a very good performance indeed. Now, the big caveat though. If you go back a day and look at the 30th of June to 30th of September, the market did have a very strong bounce at the start and the end of both those two days that we've included, and if you look to the performance of the fund then, we'd have actually underperformed by 4%. The 1st of October saw the market fall back, and we did not fall back by quite as much, hence we're actually much more in line with the market.

Stock selection

Stock-wise, we know banks have performed very well this quarter and this year. We remain substantially underweight the banks (and any analysis should take this into account) and we think that they represent a risk not really worth taking. Ironically our holding in HSBC contributed a large part of our performance. It makes up 7.9% of the FTSE All-Share index; it makes up 3.5% of the fund. Standard Chartered is 0.9% of the fund, which went up also.

We've had strong news flow from a lot of our small and mid-cap names, and again we've very much focused on the value end. We have avoided or sold out of those stocks when we felt there might be dangers to the strength of the balance sheet, and where we've been reassured, we've maintained positions. So it's definitely very encouraging to see strong performances and strong news flow out of the likes of Senior and Restaurant Group, Fenner, Weir, four businesses that have come up with good data. We have actually taken profit from all of those four because we felt that the ratings have started to move away, they're no longer value oriented stocks.

On the other hand during the quarter, we have seen defensive names lag behind the more cyclical names, the more risky names, and also in the case of BAE Systems, we haven't seen the greatest news flow coming through. Certainly the laggards to performance have been the likes of Scottish and Southern, BAE, Diageo, and National Grid, relative to the market,. Another relative laggard versus the market has been GlaxoSmithKline. We have for years said we're not buying the pharmaceutical sector because we've worried about top line growth or the lack of it, and I remind you the four p's; pipeline, patent expiry, political pressure, and a lack of pricing power. Our view has changed slightly with regard to Glaxo with the entrance of new management. They're focusing on the repeatable revenues that consumables might give them, they've been buying assets within the generic space, and on a risk/return basis, looking at our exposure to the likes of the utilities and thinking there's a lot of debt on those balance sheets. We've slowly reduced that utility exposure and put that money into Glaxo, just on the view that the dividend from that stock is very safe. So our exposure to Glaxo through the quarter has been risen up to 2%. Mentioning dividend there, I should point out that on 16th October, so after the period end, we went 'ex' our final dividend. It's estimated to be 17.71 pence, which corresponds to a fall, across the year, of about 14% in our distribution, (I've been predicting that for most of the last three or four months). Versus the market, that's a good result. More importantly as we stand now, and I've been consistent in this over the last six months, that this is a

level from which we can grow the distribution, and certainly as things stand at the moment, we have a very good chance of growing it next year.

Market outlook

It is so very difficult to predict where this market is going. There are a lot of 'doomsayers' in the market, very clever individuals who are saying that the market's due for a considerable fall-back. There are a lot of other very clever people who are saying that if the market's going up, it's going to keep on going up; and you can see why people get scared because if you're not in the market, you're worried. We are in the market because we need to provide you with a dividend stream. My gut feel is that the equity market or large parts of it have overshot the economic reality.

Economic data have been good, but there are concerns, and there are a lot of them to list; unemployment levels, where they're going to go in the US and in the UK; the sheer scale of fiscal deficits and how governments are going to pay back the sheer weight of borrowing that they're taking on their balance sheets. How profitable are the banks really? They haven't been hit by the economic downturn. What happens if businesses start to go bust, or people start to fail to repay their mortgages? The mortgage data in the States, in terms of failure to repay, are getting worse. What happens if China overheats? China is the saviour of the global economy alongside Brazil, Russia and India, but what happens if the sheer liquidity that's been generated produces overcapacity and there's a bubble there that bursts? These are big questions for which we can't possibly know the answer. Let's look on the positive side. Certainly in the last quarter the data that's come through has in general been better than expected. Unemployment data in the UK last week [w/c 12/10] was better than expected. The Rightmove analysis came out yesterday and was better than expected. We don't want to get too negative.

I go back though to what we've always said this fund should be. In the last 12 months, the fund has had a very difficult patch - we have spent the period re-emphasising the value focus of this fund, and all I can say is what we cannot do is buy stocks that are assuming a very strong rebound in the economy. We cannot buy stocks where the rating is assuming a return to the levels of profitability of one or two years ago, I don't think we should be doing that with a value fund. Other funds will play that game, but all along we have said to you, this is a value-oriented fund and our aim is to provide you with that increasing level of dividends. I am very aware that people do look at short term performance, but the reality is if we're focusing on that dividend, what happens in the short term is not our problem. What we are keen to do is focus on the longer term and to do that we buy stocks that we think represent very good value, and above all - and this is taking on the lessons from the last couple of years - we buy those businesses where we think there is limited downside.

Positive positioning – looking forward

Now, the final part of the presentation. Limiting downside is the focus of the fund and that is why I'm so positive about where we are positioned now. We are in a sector that is very diverse. It is quite extraordinary to see the spread of performance between the best performing income funds and the worst performing income funds so far this year. At the top of the tree, we see funds that made, in hindsight, the very sensible gamble to buy the banking sector. The likes of Barclays and Lloyds have gone up several fold this year. Managers of those funds took the decision to do that and it has paid off for them. We specifically did not make that gamble because we were not being paid to do so through a dividend stream, and in our minds, there was too strong a risk that we might lose all our capital and we weren't willing to take that risk with your clients' money. Also, there are funds higher up the list that have performed very well because they've taken on additional risk. They own businesses that have moved ahead have been under financial stress, their balance sheets have needed shoring up through rights issues and those stocks have moved ahead when that has happened.

The lower half of the sector (below us) contains very defensive funds, funds that are focused on balance sheets, funds that are focused on cash flow and dividend, but they have performed badly this year, because they have not chased that risk. We've achieved our position through not taking risks and also from gaining exposure away from the FTSE 100 index - by buying deep value stocks with strong balance sheets, with strong competitive positions, with strong cash flow in the mid and small cap arena - I've mentioned four of those stocks already to you - but we could include Halfords and Dechra Pharmaceuticals. We could include Severfield-Rowen in this list. Now some of them have performed well this year, some of them have performed badly this year, but all of them are good businesses with strong market positions and strong defensive qualities and that mix away from the FTSE 100 index has certainly helped us.

Where do we stand now? This 'middle' position we have attained, has been achieved despite taking a very defensive stance. I'm not sure how many of you would have seen this but on the final day of our annual accounting year (15th October), an article appeared in Citywire, and it had a wonderful headline for income managers; "how the market is punishing income investors", and it highlighted six funds, and it highlighted their position on stocks that occupy the bottom half of the FTSE 100. I looked down this list and I realised that a large number of our top ten holdings are in the bottom half of the FTSE 100 year-to-date. The likes of National Grid, BAE, Scottish and Southern, Reed, Royal Dutch Shell, Vodafone, BP are involved. These are not bad businesses, these are very good private client stocks, these are very good providers of income, but the market does not like them this year. However, where we're positioned now, in that middle point of the sector, we've done relatively well in a strong market driven ahead by risk. Also, we are in a very good position to do very well in a market that broadens out and looks for more defensive areas.

Conclusion

The fund is doing what we have always told you we shall try and do. We are trying to mitigate downside risk. We're focusing on income, and delivering on that. I want you to view this fund as a diversification tool, because I know a lot of people have been buying emerging market stocks, have been buying commodity ETFs, have been buying more high beta funds, but that's putting all your eggs in one basket. I think we offer something different. We're not looking to beat the market, month in, month out; we're looking to beat the market over ten years by focusing on dividend growth and we are doing that right now. This time last year I quoted Seth Klarman who runs a hedge fund in the States called Baupost, he's a very famous value investor. I'm going to quote him from a letter than he wrote in 2004, and he says: "*by holding expensive securities with low prospective returns, people choose to risk actual loss, we prefer the risk of lost opportunity to that of lost capital...*" That is all we're trying to do with this fund; we do not want to lose your client's money, we want to be in a position to feed and grow their dividends going forward and we are in that position.

Questions

James Maguire: Just a question on the financials, the general financials. We've had a good run on the likes of Aviva, Prudential, and so forth. Can you give us a view on that sector?

Carl Stick: We took a calculated risk to increase our exposure to Aviva back in February and March. When they came out with their results and the analysts focused on one specific line in the note and the shares got marked down horrifically, I think they got down to about £1.60 at one point. We took the view that that was overdone and we quite aggressively purchased more shares then, and clearly that's been the right thing to do because the shares have recovered very strongly. It is hard, the life assurers certainly fit in the category of - could there be something that comes out and bites us? Well yes there could, so we've been taking some money out very recently from that sector, from that particular stock. The interesting point, that the bull case for the wider sector, is based upon, if you look at demographics and the fact that we are all getting older, the life assurance sector and their knowledge, or in theory their expertise in understanding, not so much the risk of people dying, but what are the risks of people staying alive

and living to 90, how do you finance that, that type of product that needs to be generated for that sector of society - that is the long term dynamic that might benefit these stocks. So, it's interesting that as an alternative to the banking sector, I'm more happy investing in something like an Aviva. Secondly, you look at the risks taken on their balance sheets, the amount of new equity that had to be issued by the banking sector - I don't know the number exactly, but it's about 40 to 50% of existing 'old equity', has had to be issued in addition over the last year and a half. If you look at the life assurance sector, it's about 1 or 2%, so they have not got themselves into the same amount of trouble that the banking sector has, although the shares have been marked down in a comparable way. So I'm reasonably positive with our exposure to Aviva but I'm not positive enough to go out and buy more, because realistically I still understand there are things around the corner that could come and bite us, but as an alternative to the banking sector, Aviva has been good for us.

David Drewett: You mentioned BAE Systems; obviously BAE is suffering a bit at this moment for bad news flow. Do you not feel this is going to have a detriment so far as the share price is concerned?

Carl Stick: Yes I do, but my belief is that this has already happened. It's an interesting point. The news flow, when OshKosh was recently awarded a large ground-force contract, the shares were marked down. The value of that contract was similar to the value of the contract that BAE had won in the previous two weeks, but nobody focused on what they won, they focused on the bad news. The shares recovered, and obviously we've got the SFO enquiry, which has also been dragging on for many years and that's brought the shares back down.

Your question is a very interesting one. I suppose ultimately major shares just drift nowhere potentially, but buying BAE where we are now, you're buying a business on eight times earnings, 10.5% earnings yield, yielding 4.5%; and I suppose I'm arguing that I would rather buy that franchise, that business, which may ultimately attract the attention of a Lockheed Martin, or any American player if the shares stay so low. For your clients, and to try and achieve my dividend focus, I would rather buy that share at that price than pay 17 or 18 times for a company that is being bought by the market because it's a recovery stock into next year, and it's that difference in risk, that difference in valuation, in my mind BAE on eight times, we're limiting the downside risk. Buying something on 17 or 18 times next year, if the earnings don't come through that share price could halve. So it's a very valid point, but a company of the stature of BAE, I personally think that a deal will ultimately be done with the SFO, and when it is done the shares will move higher because that uncertainty will be out the way. Right now, paying that price, I think is a sensible price to pay for the future dividend flow we're going to get.

For those of you wishing to review this conference, the replay facility can be accessed (for a limited time) by dialling within the UK on 0845 245 5205, or alternatively on country code +44 1452 55 00 00. The reservation number for this call is 77160694#.

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