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EQUITY INCOME FUND UPDATE, APRIL 2017

Mitchell Fraser-Jones, 12 May 2017

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It's been an active few weeks here in terms of strategy evolution. Neil has been keen to take advantage of what he sees as a compelling, contrarian opportunity in domestic stocks, which have become too cheap to ignore in the wake of the Brexit vote last year. In this video, he explains the background to this activity with more details of what's been bought and sold for the fund further down in our April fund roundup.

Political events continued to dominate UK equity market movements in April. A key feature was Emmanuel Macron's victory in the first round of the French presidential election which, although this outcome had been accurately forecast by the polls, was seen as a positive development by financial markets following the political shocks of 2016. Macron has since secured the French presidency, comfortably defeating Marine Le Pen in the final round. Although this result removes some of Europe's political risk in the near term, we do not believe that the structural issues that have led to the rise of populism and anti-establishment sentiment in France, and indeed elsewhere, will dissipate. Without the backing of a conventional political power base, Macron will find it hard to implement meaningful policy changes. Consequently, we expect the challenges of high unemployment, high public debt and an inflexible, uncompetitive labour market, to continue to impede the French economy.

Meanwhile, in the UK, Theresa May called a snap general election for June 2017, a move which is widely expected to secure the Conservative party a substantial parliamentary majority. This caused an immediate strengthening in sterling and, in turn, a decline in the UK stock market which is, of course, dominated by global-facing companies with substantial overseas revenues. More domestically-focused stocks tended to fare much better, however, suggesting that some of the foreign exchange market's enthusiasm for this political development has filtered through to the equity market.

The news has also fortified our growing conviction in an increasingly positive outlook for the UK economy, which now looks set to benefit from a prolonged period of economic and political stability. You can watch Neil talking about the reasons for his relatively upbeat view on the UK outlook and its implications for the portfolio's investment strategy in the video below.

Against this backdrop, the fund delivered a positive return in April, outperforming its benchmark which declined. The strongest contributors to performance included a number of financial holdings. The most prominent of these was Provident Financial. During the month, the company held a capital markets day, which allowed it to provide a detailed update on the progress of its operations. The company is seeing good momentum and delivering strong growth, and this has led to some upgrades to earnings forecasts for the years ahead. Redde also performed well after a positive trading update, and Legal & General made a strong contribution too, although there was no specific news to drive this.

Another positive performer was BTG, whose shares climbed higher following a reassuring trading update. We have been investors in the company for many years, and have seen it progress a number of key products across its interventional medicines pipeline. As so often happens with early-stage companies, the development process has taken longer than initially expected, as has the process of market penetration once products have made it to market. Following a period of slower-than-anticipated growth, however, a trading update in early April provided evidence that business momentum has started to pick up.

Hostelworld also performed well following the announcement of solid full year results at the end of March. The company reported growth in booking volumes and announced it would be paying a special dividend this year. Hostelworld is clearly making solid progress and appears to have put last year's trading disappointment behind it. At the time, we were confident that the decline in bookings volume was transitory and this now appears increasingly evident – Hostelworld's shares moved to new all-time highs during the month.

In terms of detractors from performance, shares in Allied Minds performed poorly, following the announcement of its decision to halt funding to seven subsidiaries. As we stated in the March update, we have built the investment case in Allied Minds around its more promising subsidiaries in which we have substantial confidence. These include Federated Wireless, Precision Biopsy and Spin Transfer Technologies – we have co-invested directly in each of these businesses and several others, all of which are, in our view, significantly undervalued and offer tremendous growth potential. For example, the opportunity that lies ahead for Federated Wireless, which is developing a mobile telecommunications spectrum sharing technology, could justify a higher valuation than that of its parent on its own. We expect positive news from Allied Minds and the subsidiary companies it is now concentrating its attention towards, in the months ahead as it accelerates the process of commercialisation.

Elsewhere, 4D Pharma, AstraZeneca and Prothena also underperformed during the month, although there were no fundamental developments to justify the declines.

Turning to portfolio activity, we have been busy in recent weeks, as Neil explains in our new video. As a result of our growing confidence in the long-term outlook for the UK economy, we have been selectively building a greater exposure to domestic cyclical businesses.

New holdings that have resulted from this strategic shift include Lloyds Banking Group. I have often heard Neil say that banks should be viewed as warrants on economic growth. In a modern 'fiat money' system, banks play a pivotal role in the economy through the creation of credit. When a banking system is functioning normally, credit creation fuels economic growth and the central bank monitors and influences the quantity of credit being created by adjusting base interest rates, as a tool for managing the economic cycle. In a benign economic environment, banks therefore offer leveraged exposure to economic growth.

For much of the post-financial crisis period, the UK banking system hasn't been functioning normally because it has been in a prolonged process of rehabilitation – rebuilding capital and slowly recognising losses that were incurred during the crisis. Importantly, that process now appears to be largely complete in the UK, as evidenced by the recent pick-up in bank lending activity and, although the banks will likely continue to rebuild capital, the domestic banking sector looks more attractive as an investment proposition than it has in many years.

Specifically, we view Lloyds as a well-managed bank with a conservative approach to its balance sheet. Its valuation looks very attractive in our view, and it has the ability to pay a very healthy and growing level of dividend.

Another new holding is Forterra, a UK brick manufacturer. The UK brick industry has been structurally challenged for many years, with surplus capacity. As a result, the domestic industry has consolidated and Forterra is one of the last remaining players with a solid market position and a low cost base. The weakness in sterling since last summer has meant that importing bricks from Europe is no longer as economic and the long-term prospects for Forterra now look very attractive. We believe the company is well-positioned to benefit from steady growth in the UK construction industry in the years ahead and took the opportunity to buy a meaningful stake in the business at what we consider to be a very appealing valuation.

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Other new additions to the portfolio in recent weeks include housebuilders Barratt Developments, Taylor Wimpey and student accommodation developer, Watkin Jones, construction materials businesses Eurocell and Topps Tiles, real estate businesses British Land, Hansteen, Londonmetric and Sirius Real Estate, technology service companies Softcat and Micro Focus and retailer Card Factory. We also participated in the IPO of Eddie Stobart Logistics, a business we know well as long-term investors in its parent group, Stobart. The IPO underscores how active and creative Stobart's management team is in realising shareholder value from its collection of assets.

We have funded these new additions through a combination of inflows, a slight reduction in the holding in British American Tobacco and the complete disposal of the fund's position in GlaxoSmithKline, where this evolution of strategy has catalysed a change of investment view. You can read Neil's explanation of this investment decision here.

In conclusion, clearly, it's been an active few weeks here in terms of portfolio activity. We have been keen to take advantage of what we see as a compelling, contrarian opportunity in domestic stocks and the portfolio is now poised to capture that opportunity. Looking ahead, we remain very confident that the fund is well-positioned to deliver attractive long-term returns to investors.

What are the risks?

The value of the fund and any income from it may go down as well as up, so you may get back less than you invested

Past performance cannot be relied upon as a guide to future performance

The annual management charge is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded

The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits

The fund may invest in overseas securities and be exposed to currencies other than pound sterling

The fund may invest in unquoted securities, which may be less liquid and more difficult to realise than publicly traded securities