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TRANSCRIPT: EPISODE 223
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**Chris Salih (CS):**
Hello, I'm Chris Salih, Investment Research Analyst at FundCalibre, and today I'm delighted to be joined by Kevin Murphy, co-manager of the Elite Rated Schroder Income fund. Thank you for joining us today, Kevin.

**Kevin Murphy (KM):**
No problem, Chris.

**(CS):**

So, Kevin, let's get straight into it. The fund has a slight behavioural aspect, in that it's your view that stock markets are inefficient because people make irrational decisions based on emotions and inherent biases. Given what's been happening in the markets, has that been something you've seen quite a lot of recently and how do investors keep their head in such uncertain times?

**(KM):**

[00:36] Absolutely. It happens every day in financial markets, and in particular investors have a tendency to extrapolate what has happened in the recent past and forecast it to continue. The most recent example of that extrapolation is the performance of growth stocks. So, these are a cohort of stocks or ideas which prioritise growth in revenue or sales, rather than making money. So, companies like WeWork or Peloton would be good examples of that, or ideas like Bitcoin or takeaway delivery companies. Recent revenue growths were extrapolated, and investors thought that nothing could go wrong, as the company was growing. But unfortunately, just like in the year 2000, these stocks simply became too expensive and gravity has started to constrain their share price. It turns out that profits are quite important after all. So, WeWork has gone bust, Peloton is down 93% from its pandemic peak, and we've all seen the headlines around Bitcoin's collapse.

The only way to keep your head when companies like that are on their way up, and the inevitable way down, is to focus on the numbers. The stories behind every stock are always compelling, but they're like the sirens dragging you onto the rocks. A focus on the numbers allows you to steer a course between the rocks of greed, and ensures we can deliver strong, long-term returns for our clients, but it is not straightforward.

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**(CS):**

If interest rates continue to rise, will dividend incomes still be attractive to investors? I mean, say for example, someone's got a savings account that pays 5% with a building society, how do dividends compare with this? Maybe give the viewers a sort of scope on that and explain that to us?

**(KM):**

[02:12] So, it's a good question, but a slightly complicated one to answer, so bear with me. We're going to start with a simplified example. Let's say you invest £100 in your building society account earning 5%, you'll gain £5 a year interest; so far, pretty straightforward. Stocks today yield just less than 3.5%. So, if you invest £100 in a stock, your dividend return will be £3.50, which is clearly less than the £5 interest.

But when you invest in a share, you get something that you can't get when you put money into a bank account, and that's capital growth. You do take risk to achieve it - money on deposit with a well-capitalised bank is pretty low risk, and money invested in the stock market is clearly a slightly different risk profile. But let's use an example of what growth can deliver, can achieve over time. So, when the Schroder Income fund was launched in 1988, it's yield was about 3.5% and, 34 years later, its yield is still about 3.5%, but because of the growth in capital, it's 3.5% of a very much larger number. So, if you invested £100 at the dawn of the fund, your dividend would've been £3.50 a year, but because of the growth in the capital part, that £100 invested, will now be delivering £18 worth of dividends each year because the £100 has grown and the income has grown alongside it.

**(CS):**

It's a double whammy is essentially what we're saying.

**(KM):**

[03:40] Exactly. And that's something that simply can't happen for money on deposit, but it's very difficult to compare interest rates and dividend yields. They're fundamentally different things, with different risk profiles and what is right for you depends entirely on your own personal circumstances.

**(CS):**

And maybe just talk about your outlook for the UK market. Obviously, it's done well this year compared to other markets, there's been reasons for that. Can that continue and will the value style continue to do well?

**(KM):**

[04:09] That's a very tough question to answer, but the academic evidence suggests that the best predictor of future returns is the price you pay. If you buy things that are cheap, you're more likely to get a good return, than if you buy things that are expensive. And, after a succession of issues from political concerns around the potential for a Corbyn government, to Brexit, to a tough COVID, the UK started the year as one of the cheapest markets in the world. So, it should come as no surprise that it performed well compared to some of the other markets that are out there. The UK does remain cheap compared to international competitors and, if history is a guide, from that starting point, it can continue to do well, but it's unlikely the level of performance differential will be as marked as it has been because the valuation gap simply isn't as wide as it was.

And the same argument goes to the performance of valuation-based strategies. They started 2021 with a generational opportunity, as the valuation gap was as large as it has ever been, but value stocks have performed well since, and the valuation gap does remain wide in the context of history. So, if history is a guide, the outlook remains bright, but it's certainly not quite as strong as it would've been, if we were having this conversation in January of 2021.

**(CS):**

Finally, let's go to your portfolio in a bit more detail. So, you've moved out or cut some exposure to a quartet of sectors: miners, oil, gas and banks, into consumer stocks - probably something that's been in the eye of the storm at the moment. Could you give us your explanation and reasoning behind those moves?

**(KM):**

[05:51] Of course. So, we built our positions in the miners when commodity prices were depressed and people thought the outlook was bleak. We built our positions in the oil and gas companies in the height of COVID when the oil price was negative. And we built our positions in the bank shares following the great financial crash, when people were scared about the outlook and the regulatory environment. Each one of these investments were made at the time when the outlook was challenged and people were fearful, but each of those investments have turned out to be very profitable, as those sectors have been amongst the best performing shares in the entire market this year.

But rather than resting our laurels, and crow about past performance, our job as investors is to try and find the next opportunity, and the best place to find a bargain is to look at shares where others are scared or where competition as a buyer is limited, but where there are lots of sellers. And there's no sector more in the spotlight today than the consumer-facing shares. The average retail shares have fallen by 40% so far this year. So, we're buying shares that aren't priced for perfection. We're selectively picking those where the balance sheet is strong enough to withstand tougher times, but where we think the upside, in due course, is conservatively in hundreds of percents.

We haven't sold all of our banks, or all of our miners, or all of our gas companies in full - they remain significant parts of the portfolio - but we are slowly and prudently rotating the portfolio, selling shares which have done very well for us, and buying into the stocks which can be the foundations of performance over the next 3-5 years.

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**(CS):**

Is it a bit of both? Do you have price targets for each of the companies in those sectors? Or is it more, you're looking over there and thinking, look how cheap they are! Is it a balance of that? Or how does that work essentially?

**(KM):**

[07:33] It's a total mix. There are some shares that are hitting price targets, so they're being sold from the portfolio, but there's also a relative argument where you might be selling something that's cheap, to buy something that's much cheaper. And when we're doing that, it's a much more difficult conversation because you're selling something that you've invested in for a long time, that you like, where you know and you trust the management team, where the balance sheet is strong and you think there's still upside to their value, but you're comparing it against something where the upside is much greater.

Now, because we haven't owned it for a while - the retailer, for example - and because we don't know the management team potentially as well, then the upside that you must be compensated with, to take that decision to jump out of one share and into another that's cheaper, we have to be compensated with much greater upside. And when we are doing that, we do so on a prudent and sensible basis, making sure we understand or try to understand all the risks that are involved. And that is why that rotation in the portfolio happens slowly and gradually, to ensure that we lay those foundations for the next 3-5 years.

**(CS):**

Thank you, Kevin, really appreciate your time today.

**(KM):**

Not at all.

**(CS):**

And for more information on the Schroder Income fund, please visit fundcalibre.com

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