

TRANSCRIPT: EPISODE 237
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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Today we're looking at the UK equity income sector and discussing the advantages of investing in small and medium-sized companies as well as large ones – both in terms of potential profit growth and dividend growth.

Juliet Schooling Latter (JSL): I am Juliet Schooling Latter, and today I'm joined by Sid Chand Lall, the manager of [IFSL] Marlborough Multi Cap Income. Hi Sid.

Sid Chand Lall (SCL): Good afternoon, Juliet.

[INTERVIEW]

JSL: This fund has managed to produce a better dividend yield than the FTSE All Share each year since it was launched well over a decade ago. How have you achieved this?

SCL: The starting point really is having a very clear respect for what is known as the Investment Association yield test. To be an equity income fund in the UK, you have to beat the [FTSE] All Share index, in simple terms. So, in terms of the dividend yield, historically tested and published in the Financial Times, you must be able to outperform that. And that's my starting point.

Now, in some cases you know, it maybe that investors feel it's actually all right to sell a bit of capital and make up any distributions. What we've done is taken a very disciplined approach, [that] said, actually that decision is not ours; our remit is very clear: it is to deliver the dividend and do so in that format. Not to sort of say, well, we had a bad year, so you know, could you sell some of the capital instead? And therefore, it was really with that design in mind that, that when we construct a portfolio, every single stock in the fund must pay a dividend. So, that's the backdrop.

The second important pillar I think, in terms of achieving this target, is that you've got to look for profitable companies, and that's what we've done. Just because you've got smaller companies, it doesn't mean that they're unprofitable [or] necessarily the riskiest. So, we will go for the profitable companies where there is growth and, with the quantitative overlay, to have free cash flow that supports that dividend and can cover it. And again, then you have a balance sheet to support it. So, you've got low gearing or net cash, especially in this environment, that makes that dividend sustainable.

So, in a high interest rate environment, if you've got a lot of debt, what tends to happen is paying a dividend is less of a priority – you've got to service your interest costs instead - and we don't want to be

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in that situation where businesses are over-levered and struggling. Instead, it should be that actually it's not a burden. It's fairly straightforward to pay the dividend because you've got the earnings coming through and with the earnings, the good cash flow that supports the dividend payment quite comfortably.

JSL: Great, thank you. And why do you think dividends are more important in this environment when inflation and interest rates are now higher?

SCL: Well, at a very basic level, when you get inflation - and let's say it's 10% at the moment, give or take - what it does, is it erodes your buying power. So, whether it's capital or income, you're still depleting wealth as a result of that inflation. When you have income and in the form of dividends, you are able to essentially offset that erosion. So, income comes in to play actually very nicely in the form of equity income, because you don't just go back to par as you would with the bond. You can have the ability to recover beyond that, quite significant[ly]. So, you have both the capital growth side and you have the dividend, while that happens. So, you get paid to wait essentially.

Now, in terms of a total return, a dividend contribution is quite significant. So, if you go back and look at the long-term returns, you'll see that actually across most geographies, it is really the dividend contribution that has been reinvested and compounded to give you a much more significant total return, had it just been looking at capital contributions. So, the bulk of total returns come from income, is what I'm saying. And therefore, not just in the short term, but also in the medium and long term, you will find that the power of dividends is actually incredibly useful for the overall return from an investment.

So yeah, I think if you look at the bank rate, you might get 3 or 4% in terms of dividend. If you look at the UK 10-year gilt, again, you're looking at sort of three and a half percent or so. But what's happened is, if the 2022 year is anything to go by, that was one of the worst years for index-linked gilts. It was down over 30%. So, this is why, actually, UK equity income may well be a much more interesting place to be now, especially as valuations have come down significantly, the number of stocks and trading on single digit price earnings ratio. And you get offered the potential for not just upside in terms of capital, but also the income while you wait.

JSL: Right. And your fund, it tends to be overweight small and medium-sized companies, doesn't it? Why is this?

SCL: Well, we start with the premise that smaller companies have the ability to grow their earnings quicker than larger companies, or their larger counterparts. And if you believe that, then other things being equal, the dividend should also follow in the same magnitude. So, if you have a constant dividend policy and your earnings have grown 10%, you should be able to grow your dividend 10% as well, just as an automatic output. And it tends to be the case that actually it's easier for a smaller company to potentially double its profits, and therefore, over time, potentially double its dividend as well. And certainly, we've seen that over time, that actually the dividend growth has been superior from smaller / mid-cap companies. That's the first point.

I think the second thing really is to do with diversification. If you had bought three or four UK equity income funds, chances are that the majority of them would've had the same or very similar stock names in

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the top 10, top 20. So, from our perspective, having a multi-cap approach, having a much more diverse set of companies in there, you tend to have a very different set of companies effectively contributing to that same dividend.

The third thing probably is to say that when you look at the UK stock market, approximately 15 companies make up pretty much 60% of all dividends paid. And again, what you're doing is you're reducing the stock concentration from which you get your dividend source. So, rather than choosing from let's say, 90 companies in the FTSE 100, what we're doing is choosing from something like 700 companies.

And again, we stick to our process. We're not just picking companies because they're smaller, we're picking them because we think they can pay a dividend in a sustainable fashion and they will have good balance sheets and good cash flow and be profitable. So, it's also having a hundred and say 15 companies in the portfolio, a very different approach to a number of peers who may have fewer stocks in their portfolio. So, we're not totally reliant from a portfolio construction, you know, on just a handful of businesses either. It also manages liquidity risk because smaller companies can be volatile and what this does is it just ensures that you're not too wedded to one or two companies, you know, to pay that overall dividend.

JSL: Yes, I mean I'm a great believer in small and mid-caps over the long term as well, but they did have a bad year last year, didn't they? How are they looking for this year, in 2023?

SCL: Well, we're more optimistic about the small/mid-cap space now. Part of that reason is that actually when you look at what happened in 2022, there was dollar strength, there was a big boom for commodities. Those were areas that actually this fund was relatively underweight on. But also the dollar strength doesn't help the domestic stocks in the UK, it's actually dollar weakness that helps. So, if you take the view that actually this year there will be some reversal in that, even if it is just mean reversion going back to the norm - not suggesting there's a huge crash in the dollar - but anything in terms of the more sort of historic norm in terms of the ratios versus the pound, I think that will stand to be received very well, because what happens is the FTSE 250 tends to outperform. Certainly this year, what we've seen so far is that there's a bit more stabilisation; the currency rate [GBP vs USD] is closer to sort of 1.20 rather than the 1.03 that we saw versus the dollar when we had the UK mini budget under the previous Prime Minister and Chancellor. So, it is looking a little bit more stable. And also there is an element of deflation beginning to come through in the numbers. So, perhaps you could argue the large caps have had their run, they've had that in the year that's just preceded. And this year there will be a slight rotation. That said, there's also a valuation gap. I do think that actually some of the yields that are on offer now - with the valuations - and the combination make it very attractive to small / midcap investors.

JSL: Well, let's hope this year is the year for small caps! What sort of opportunities are you finding at the moment? Perhaps you've got a couple of examples that you could give to us?

SCL: Yes, absolutely. One example would be Paragon Banking Group, which is a financier of buy-to-let mortgages. Now, if you look at that business going back to the last financial crisis - the Global Financial Crisis - they had a very high proportion of their loan book in what we would describe as 'high loan to value'. So, they would've been as high as 80% loan to value, with a big bulk of their book making up that segment; so, 60% or so of that book would've been in what you could describe as higher risk mortgages.

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Today that mix is completely different. It's something like 1.5% now, being over 80% loan to value. So, really a higher interest rate environment is, even if it does hurt the property market, it just leaves this [business] back in a much stronger position, able to cope and absorb with any variations.

The other aspect of this is that they have a large clientele in what you might describe as professional landlords. So, they don't have the same constraints if you like; they've already refinanced, they've already got a different outlook as opposed to maybe what you would see in terms of the data coming out for mortgage availability. And they have planned it much better.

So, you do have to take a stance on what you think is going to happen to the property market in the UK; if you think it's going to be a 20-30% crash, then of course that's going to hurt. But if it's more like a seven to 9% correction, then this bank's in a much better place, as I said, because of its mix.

It was also a beneficiary of higher interest rates in itself. The net interest margin is expected to do much better. There is a sensitivity that they have published before, which is approximately 10 million pounds for every 1% interest rate rise. So that's on the PBG [Paragon Banking Group] bank. And then of course there is the advantage of having applied very early for what is known as the IRB [*Internal Ratings Based approach provides banks and building societies with a more risk-sensitive method of determining regulatory capital requirements for credit risk*] model. And they've done six – seven years' worth of work on that which will effectively mean that they have to hold less capital for every pound that they lend out, in simplistic terms. And that puts them on a much more level playing field. So here you have a bank, which is essentially on a single digit PE if you want to look at it that way - price/earnings ratio, -and it offers you a very handsome yield at the same time. So, that's one example. I could give you another one if you like?

JSL: Yeah, another one's great if you've got another one for us?

SCL: Yeah, I could give you one which is totally different, and it's a management story really. It's a company called Ricardo [Ricardo PLC], which has a huge British heritage, a smaller company again. And it's kind of evolved really. It used to be the go-to company when actually the British tanks in the war needed help because they were too loud. So, effectively instead of alerting the enemy, the engines were retuned so that they became [a] much quieter engine; that was [the] beginning of Ricardo really. And then today it's a very different business. What it's doing is, it's saying, okay, as the world transitions away from the internal combustion engine and moves towards electric vehicles and a much greener planet, how can we be the go-to consultant in that field?

So, that's what they've done - they've totally changed the business. There is a new CEO that's making some very good changes as well. And this one is a lower yield, sort of 2% in terms of the yield, but - going back to portfolio construction - I don't mind that, having a 2% yield, which can grow double digits in any given year, is perfectly acceptable. And in the same way, you know, [if] we had a stock level, say [a] 5% yield, 6% yield, I wouldn't expect it to grow 10-20% every year. I think there has to be a balance and therefore much healthier mix. But Ricardo is in a space where there has been consolidation in the industry already, so I would not be surprised it starts to rerate gradually as they keep delivering evidence of earnings progress.

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So, that's Ricardo, employing about 3,000 specialists. And yeah, we think it's pretty undervalued. It's on a low teen price/earnings ratio for next year, but it could easily be 16, 17 times over the next sort two or three years. That's not a forecast, that's just a blue-sky scenario where it could happen, subject to its margins improving, potentially also selling a division within its group.

And maybe a third one, which again plays into the more topical aspects. And this is me deliberately mentioning a mid-cap company, because it's very easy to forget that actually there are companies making a huge difference not just in the economy, but also general wellbeing. And how they can transform themselves. So, this is Drax [Drax Group PLC]: it's been a little bit more controversial recently, but they are a, what used to be, a coal-fired power plant company to becoming actually the UK's biggest biomass generator.

And the controversy, if you like, has really been around a Panorama documentary where there was criticism that they were accelerating deforestation and actually, if one looks into the detail, they had a very good session just two days ago in fact, with brokers Jeffries [Jefferies Group], to explain the situation and give a rebuttal to that. And what transpires, is that actually what they were doing was they had a logging license to help good forestry management. So, within a very vast acreage, if you clear one acre of land, for instance, that helps actually reduce forest fires, it helps the growth and actually certain species need more sunlight. So, if there's a very dense underlay, you are not going to be able to allow effectively a healthy forest. So, it's really removing what they described [as] round wood, hollow wood, dead wood, that would've otherwise just been left there anyway and eventually been burnt. And I am again, sort of simplifying a little bit, but it's very easy to see one side of the story. But I think this is a business that could be a very important player actually for so many companies in the UK trying to get to sort of their net zero targets on carbon emissions.

So, that's Drax in a nutshell. But yeah, I mean they've grown their dividends 10% on an annualised basis over the last five years and forecast to do it again by 12% this year.

JSL: Excellent. Well, thank you for those interesting examples. And thank you Sid, so much for your time today.

SCL: My pleasure. Thank you for having me. Really appreciate it.

[CLOSING]

SW: The IFSL Marlborough Multi Cap Income fund has a well-resourced team and offers something radically different from the majority of equity income funds investing in larger companies. This fund ventures into the small and mid-cap space where other income funds fear to tread. The team is renowned for its experience in this area of the market. To learn more about the IFSL Marlborough Multi Cap Income fund visit FundCalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.

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