

TRANSCRIPT: EPISODE 282

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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. This interview looks at current opportunities available to multi-asset managers and, most importantly, we finish with a critical issue within the investment trust industry – the inclusion of investment company costs in the reported costs of funds.

Chris Salih (CS): I am Chris Salih, and today we are joined by Richard Parfect, portfolio manager on the Elite Rated VT Momentum Diversified Income fund. Richard, once again, thank you for joining us.

Richard Parfect (RP): Thank you, Chris, you're welcome.

[INTERVIEW]

CS: Let's go straight into the fund itself, for invests in other funds and trusts amongst other things to produce an income. So, maybe let's delve into some of the largest holdings which have currently got the likes of high yield and emerging market debt sitting there. Could you maybe talk us through that? I mean, people, perhaps listeners wouldn't immediately think they are two of the more defensive areas of the market. Maybe just go into a bit more detail on those assets.

RP: Sure. I mean, you know, ultimately the fund is a multi-asset fund, and so you would ordinarily expect, you know, a broad range of asset classes in there anyway. But, at this time, with rising interest rates across the world, fixed income is an improving asset class in the competition for capital. So, the names that we have are with Royal London, are houses that we've been very familiar with they over many years and have a very high level of respect for them in terms of their ability to add alpha, to avoid the accidents that can happen in fixed income, [and] they have a very granular knowledge on the bonds that they hold. So, the Royal London Short Duration Global High Yield fund is, as the name suggests, at the short end of the yield curve, where rates are higher. And also, because it's at the shorter end, the credit quality tends to be better because credits tend to refinance and secure their financing some years ahead. So, there's no imminent likelihood of refinancing this as well because the credits are running their finances accordingly. Spreads are wider as well right now in the marketplace. So, you're getting decent reward for risk is the bottom line.

CS: And I was going to say also with defaults, obviously high yield is perhaps not the Wild West it once was a few years ago, it's a bit more mature now as well. On the emerging markets side, maybe just talk to us a little bit on that as well, please?

RP: Yeah, sure. So, we've got two holdings. A more active one you might say in the shape of Absalon [Absalon Emerging Markets Corporate Debt]. They're value investors in credit; we're value investors ourselves, so, they're sort of playing to our own bias. They're unconstrained by index, so they'll tend to buy some issues that are smaller in size, that will be below the radar of index buyers. And so, there's a price reward for that, [a] discount for that. They're very contrarian. They're not afraid to go into areas that have had macro events because there's that sort of priced reward for that. So, it's not a major part of the portfolio, it's 2.5% but we feel that again, there's a place for that. I mean, EM debt in general, you're seeing yields of about 7.2% versus a 20-year average - now you [have to] bear in mind, <laugh> there's been a lot of sort of yield movements in that time, but a 20-year average of 5.7%. So again, the pricing, the timing opportunity feels ok now.

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And we also have a more generic, cheaper fund in terms of cost: Jupiter Short Duration EM [Jupiter Global Emerging Markets Short Duration Bond]. Again, short duration, so at the shorter end where yields are sort of higher and also, credit quality [is] probably a little bit safer as it were. So, and that's 2.2%. So, in the end we've got about 4.7% across those two funds, which again feels not unreasonable, given where yields are right now.

CS: Okay. And obviously the fund has a few buckets of the likes of UK equities, overseas equities, credit. One of the others is specialist assets and you've got Doric Nimrod Air Two and [Doric Nimrod Air] Three, which are two of the special assets sitting there. A lot of our listeners might not be familiar with these. These are trusts that invest in the likes of airline leasing. Airlines have been quite a polarising thing post-Covid, in terms of the recovery and whether it's real or not. Maybe just give us a view on that and the recovery and their place in your portfolio.

RP: Well, so, both these two vehicles have a single lease counter-party in Emirates. So, they're two different portfolios of A-380 aircraft with different vintages, but the single counter-party is Emirates. And Emirates, as I'm sure many of your listeners will know, is a high quality airline. It recently announced the most profitable year in its history. I think it's only made a loss in one or two years of its history, but it's come out of the pandemic in very strong form. You know, not being able to get the aircraft back in the air post-pandemic quick enough, then their load factors are very high and the reduction in capacity in the industry has really played to their strengths. Their pricing of tickets has been strong. So, we don't have any concern about the counter-party risk of those two vehicles. They've paid their dividends, as expected on time. Emirates paid all their leases right in the pandemic, in full and on time, which could not be said for many of the airlines, which failed.

So, in terms of credit quality, it's good. The underlying assets, as I said, are [Airbus] A-380 aircraft. The Emirates business model relies completely on the A-380 in terms of its capacity. They do have future plans for having other aircraft types such as the Boeing Triple Seven [Boeing 777] X, the largest version, the newest, largest version of Triple Seven. But that's stuck in [a] licensing and authorisation nightmare with the FAA [Federal Aviation Administration]. So, the Emirates has a big problem in terms of being able to meet its likely future demand with capacity, and so it's going to need these aircraft for longer, materially longer, than was originally expected. So, these are income vehicles for us and the residual value risk we see where current pricing of where the shares are [is] not zero, but minimal.

CS: Okay. We talked about a few of the buckets there. I mentioned earlier the likes of UK equities, overseas credit and specialist assets. The other area is defensive assets. Now in that portfolio, you've got in that subset, you've got the likes of UK Gilts, you've also got a couple of gold holdings in there, in particular Ninety One Global Gold [fund], which perhaps people who look at that sort of desire for income, etc. perhaps wouldn't immediately associate that with the portfolio. Could you maybe explain the role? Is it purely as a defensive ballast? Is there more to it? Just give us a bit of insight into that as well, please.

RP: Yeah, sure. Yes, it's to provide defensive ballast alongside our physical gold exposure that we have, but with a little bit more alpha opportunity, it's probably fair to say. So, that Ninety One [Global] Gold miners fund is invested in gold mining companies and that sector in recent years has really sort of tightened up its act in terms of capital allocation, capital discipline. So, the cash generation that they've started to see is being returned to shareholders as it happens. And so actually starting to get a level of income out of that sector, which wouldn't have been the case some years ago. So, this is a, you know, a defensive play in terms of it's gold, but it's got active alpha through gold mining companies [which] are sort of undervalued and turning their act around, and we can get an income out of it, which is helpful when you're running an income fund, basically.

CS: Does gold typically have a position in the portfolio, or does it depend on the point in the cycle?

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RP: Well, yes, it would always have an element of, you know, a presence in it; how much we have, would be flexed given on how defensive we want to be, how gold has performed in the shorter term. But over the long term, then gold is there as a quasi sort of inflation hedge. Short term performance is affected by various other factors, but over time, it should provide an element of protection. But we're certainly not betting the house on expecting gold to double overnight sort of thing. It's just there as an extra string to the bow.

CS: I'm going to move to inflation - a word that's dominated markets in the last 18 months or so. Obviously, this fund has an inflation target, I believe it's inflation, CPI+5%. Obviously, that, 10 years previously to the last 18 months, although not easy, was more achievable. Things have changed dramatically now. I mean, if 5% +, if you look at the UK, that takes you into double digits for the UK, maybe just talk me through how you manage that, because I'm not assuming that you just immediately go, well, we can beat that in this sort of extreme scenario. Maybe just talk us through how you manage that, how you go about that? Do you just look at it and go, right, let's beat what we think inflation will be over a 5-year timeframe? Do you make any changes? Is that why high yield and emerging market debt's in there at the moment?

RP: Yeah, sure. I mean, when that objective was set, it was, you know, some years ago and pre-pandemic and pre-the current world order. And so, it was probably fair to say that the degree and pace of inflation rediscovery, shall we say, was not anticipated. Perhaps it should have been! But I think it still has a value as a handle because essentially, no investor can realistically pretend to say that they can achieve a given - whatever investment objective it is, whether it be an absolute return or a relative return over a short timeframe.

So, you're right, over the medium to longer term, given the nature of the underlying assets within the portfolio, there should be a degree of inflation linkage to those returns, either implicitly or explicitly. And so, the risk is the reputational risk, as it were to the fund, that when you have short term periods like this, that you will have dislocation of pricing and value as we've seen. That sort of pricing should normalise over the longer term. And so, for example, investment trust companies which have blown out to very wide discounts to net asset value - sort of 30%, [or even] 40% in some cases - have had a significant short-term pricing event, but the underlying net asset values have not moved by anything like that. And, as yields fall, as we would hope, then those net asset values should start to recover. And then, pricing... share prices would recover and discounts narrow and maybe get to net asset value or even at premium once again.

And so, you're kind of seeing a backended recovery of performance as it were, relative to that inflation. It's a bit like the triple lock; you've got inflation straight away and then the earnings, so statistics then catch up in subsequent years, as inflation itself abates and the earnings grow. And it's the same with investments.

CS: Okay. Clearly you would manage the portfolio for the long term. If inflation was, say, 3 or 4% rather than 2%, say 3.5, 4%, would you make a call on something like that in terms of the underlying assets within the portfolio? Does what you feel inflation will be in the long term make any sort of impact on that?

RP: You mean if there's a permanence of higher level of inflation ...?

CS: ... do you make a call on whether you felt there'd be a permanence or would you sort roll with the punches if people were saying it might fall to 2%, it might be 3% or 4%?

RP: Yeah, I mean probably we'll roll with the punches. It's hard. I think where we are right now, it's hard to call it. Personally, I think we need to expect the 2% handle of inflation is probably a bit obsolete. I think we can expect - for various structural reasons - a higher level of inflation going forwards, of, let's say, 3%. And what does that do to underlying investments in the portfolio? Well, it should still be okay because the assets that we hold are inherently inflation-linked by whatever activity they're doing, whether it be a wind farm that's earning its revenues to inflation-linked subsidy plus wholesale power prices, which would appear to be likely to be materially higher than was expected three years ago. So, the return should catch up with - or at least reflect that higher level of inflation that is to be expected going forward.

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CS: I wanted to finish by sort of winding out to the broader investment trust argument. I believe Momentum's been quite vocal in the press recently, along with the likes of Baroness Ros Altman and Baroness Bowles of Berkhamsted - apologies if I butchered that - criticising the government and the FCA about synthetic costs on investment trusts and how they are stifling wider investment into these vehicles. Could you maybe just explain to the listeners what's happening and why you are specifically concerned about this?

RP: Yeah, this is a really, really important thing that people really do need to understand. And I apologise if I try and make something that is a little bit complicated into sort of simpler terms.

If you look at the income fund as an example, okay, we're reporting an ongoing cost number of around 1.54%, okay. So, within that number, that's comprised of say Momentum's own fee of 75 basis points [0.75%] in the B shares. And then on top of that, there's maybe 25-30 basis points [0.25-0.30%] of cost from Valu-Trac [VT] as the ACD [Authorised Corporate Directors], auditors' costs, you know, legals, all that sort of stuff. But then on top of that, there's about 49 basis points [0.49%], about half a percent, of look through costs on investment companies. Now, it is only recently that that half a percent of fee from investment companies has come into scope and has been shown into our cost.

Now, the problem is that investment companies, when we buy those, we pay the share price. We don't pay their NAV [net asset value] - it may be that the share price happens to be the NAV, but that's purely temporary coincidence. We buy the share price. In a share price of any company, whether it be Marks & Spencer's or HSBC or an investment company / investment trust, such as Greencoat UK Wind [Plc] ok, that share price is a reflection of various factors, multiple factors, one of which would be its cost of operation.

So, if all things were equal, you would expect that if Marks & Spencer became suddenly highly inefficient and doubled its cost and its margins fell and the share price would fall, [it] would respond to that. So, you are paying a price that reflects those inherent costs. Previously, those costs were not included. But they've now - [and] for reasons which are understandable, to be open and to have disclosure, it's been that, but those disclosed costs are being included, but they're not actually being paid by investors; they've already been paid through the share price.

So, including them in the reported cost of our fund of 1.54% in total, half percent of which is through investment companies, has not been paid. It's a purely optical number, ok? Otherwise, you're double counting to include them, it's implying a double counting effect.

And just to give an example of how this plays out, so if I as an investor wanted to buy SSE Plc, which is an operating company - a name many people will know - which operates wind farms and power generation. It's a listed company with an internal management structure. That company reports in its Profit & Loss account in its report and accounts, £1.1bn of operating costs. Well, it would do, because it's an operating company, it has staff, employees and all the rest of it. So, £1.1bn of cost, but it's not an investment company, so it is optically free. I could buy that and there'd be no cost for me to disclose. Ok? Now, if I look at Greencoat UK Wind, which is a very similar company, in fact, it operates wind farms, some of which were bought from SSE Plc, and continue to be operated by SSE, but Greencoat Wind UK owns the wind farms - that's an investment company, an investment trust, and that has to - by regulation - disclose costs of let's say 1%, ok?

Now Greencoat Wind accounts for about 1.5% of the income fund. So, by bringing that into scope, ok, it then adds about 1.5 basis points. So, that's a member of the 49 basis points of our costs. So, that's made my fund look a little bit more expensive, despite the fact that it's not doing anything different from SSE, but it has to report a cost - SSE doesn't.

So, there's this understandable implication that cost is bad. Well, yeah, clearly if you double cost, returns have fallen, but I'm just trying to explain, it's where it's being disclosed; you don't want to have this double

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counting effect. And, as it happens, Greencoat Winds, since its inception, has outperformed SSE by 1.5% per year, in terms of shareholder return. So, investors are - under consumer duty, that's come in quite rightly, there needs to be consumer understanding on the costs - but the trouble is we've now got a situation where some funds are looking optically expensive just by the coincidence of how they happen to decide to invest in wind farms, for example, whether it be SSE or Greencoat Wind.

And these guidelines are only guidelines, they've not been adopted by everyone. So, some investors may feel, oh, it's okay, I'll avoid all this, I'll just buy an ETF. Well, the trouble is, Vanguard and BlackRock and the likes of Legal & General, they've decided not to adopt these rules. So, you could end up buying an ETF that's linked to the FTSE 250 - and the FTSE 250 has a number of investment companies in it, investment trusts - but those investment trusts 'look through' costs would not be included in the reporting costs of the ETF. And nor should it really, because for the reasons I've explained, they're not actual economic costs, they're optical costs. So, quite rightly, they've not adopted it, but we, with a third party ACD such as Valu-Trac, we don't have control over that. Valu-Trac has taken - along with other third party ACDs - has taken the decision to adopt these guidelines and to include these costs within our own costs. So we've essentially got an unlevel playing field. Unlevel insofar as, do I invest in SSE or Greencoat? Well, maybe to make myself look cheaper, I'll buy SSE but the trouble is, I'm buying something that's not going to perform as well as Greencoat Wind - or hasn't done. Or, I'm looking relatively expensive versus another product which just doesn't adopt these rules.

So, basically, the whole system's a complete mess. So, this is why we and other companies are engaging with various bodies, trade bodies and government, to try and get this sorted out because it's failing the consumer. Consumers do not understand what they're paying for, what they've got, and the differences - the important differences - between products, particularly because you've got this focus on cost and value; understandably, ok, cost is easy, it's a number. Well, how do you value value? It's an ethereal sort of concept. So, everyone's going to cost and comparing products on cost, but they're not comparable figures.

So, I apologise for the lengthy diatribe, but this is a really, really important issue that if investors are going to make investment decisions based on cost, it needs to be very clear that the number they're looking at may not actually be the fair number that they think it is.

CS: It sounds a bit like common sense needs to prevail, and that this is a case where too much transparency becomes a bad thing because that transparency is not necessarily right.

RP: Absolutely. We've got nothing against disclosure. It's great - investment trusts *should* disclose the costs that are within their business, but how is that figure then used - or abused - down the line? Because you can use that figure to compare investment company against investment company. It's probably given you a measure of indication as to how well they're running their business. But you can't compare an investment trust cost vs a fund cost - they are fundamentally different things.

CS: Well, let's hope common sense does prevail. Richard, thank you very much for joining us today once again.

RP: Thanks, Chris.

SW: The VT Momentum Diversified Income fund is a globally diversified, multi-asset fund with a straightforward investment approach centred on value investing and income generation. To learn more about the VT Momentum Diversified Income fund, visit FundCalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.