

TRANSCRIPT: EPISODE 302

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. We're focusing on the UK market today emphasising the current generational opportunity in the UK and overall optimism despite recent challenges.

Darius McDermott (DM): Hello, I'm Darius McDermott from FundCalibre. Today I'm delighted to be joined by Simon Murphy, who is the fund manager on the [VT] Tyndall Unconstrained UK Income. Simon, good morning.

Simon Murphy (SM): Morning Darius. How are you?

DM: I'm very well, thank you. Yeah, surviving the February chills, but yes, we are good and ready to go.

[INTERVIEW]

DM: So, we noticed that the fund has recently changed the name from the [VT] Tyndall Real Income fund to [VT] Tyndall Unconstrained UK Income. Can you give us a couple of thoughts on why that decision was made and has it actually changed anything in the fund or is this just a name change to greater encapsulate what you do?

SM: Yeah, sure. I mean, the primary reason for the name change is because the new one rolls off the tongue so easily — obviously!

No, no, in all seriousness, the short answer is it doesn't change anything that I do but it does more accurately, we feel, reflect what we're trying to do with this portfolio. Since I've been running it for the last four years now, it's a genuinely unconstrained portfolio, by which we mean we have the ability to invest anywhere across the the UK market cap spectrum. We tend to focus more - I'm sure we'll come onto this - into the mid market, but we can go anywhere with it, with no sector constraints, no market cap weighting constraints, anything like that. So, it is a genuinely unconstrained approach, and that's why we changed the name really, to make sure that people would be more readily informed.

DM: Yeah, maybe that's a good segue - and we'll come and talk about the UK market maybe in a little bit and Covid and all the things that happened - but you talked about the mid-cap: what sort of percentage do you typically hold in mid-caps? Is that particularly high at the moment, given the valuation opportunity? And then maybe that might lead us into an example or two.

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SM: Yeah, sure. So, the mid market in the UK is the primary focus of the portfolio. And by primary, I mean typically around about 75% of the fund. So, we'll have some exposure to some of the big companies and we do have a little bit of exposure down in the smaller cap end of the market as well, but they're small exposures really. The vast majority is in that mid market. Partly because it's an area I've always invested in and enjoyed investing in, but partly, and more importantly is, because we just think we can find some fantastic really interesting businesses in that part of the market: you know, very diverse in terms of sectors, geographic exposures even - it's not all about just the UK domestic economy; different stages in development of the business in terms of maturity and so forth. And I just think it's a really fascinating, interesting area in the market where there's just really amazing opportunities.

DM: And look, I'm privileged enough to get to see lots of managers, UK and overseas, but the one thing I hear fairly consistently is about the valuation opportunity within that mid-cap sector of the market - and small-cap as well, but maybe we'll just focus on the mid-cap today. I mean, is that something you are seeing at company levels, you know, decent companies that are doing well and got enough cash flow to pay you a nice income and potentially a growing income as well as being really cheap?

SM: Yeah, absolutely. Obviously you'd expect me to say that, wouldn't you?! But, I think - and I choose these words very carefully - I think we've got a generational opportunity in the UK today, in particular in the mid, and probably also in the small-cap area of the market as well, in terms of valuation. I can go into the reasons or my thoughts on it if you'd like, but you know, all the reasons that you and the listeners would know; we've been out of favour for many years post the Brexit vote; we've had huge outflows from retail funds, and institutional investors and overseas investors are all record underweight and all that sort of stuff. And all of that negativity has, I think, created a wonderful valuation opportunity, literally a once in a generation opportunity in my view. And you know, I'll probably come back to this in a minute, but a lot of that negativity, I genuinely believe is perception versus reality and that's what's creating the opportunity.

DM: I will ask you just to pick on a few, maybe one or two examples and they can be mid- or large-cap or whatever you prefer. But just so our listeners — because this is the first time we've done this since the fund's got the Elite Radar rating — you said typically 70% mid-cap; is that because of the valuation opportunity slightly higher today, or it's always going to be around that mark?

SM: Yeah, I'd imagine broadly around that mark. I mean, again, given the unconstrained nature of the fund, it can go anywhere. So, if for some reason we decided there was no longer any massive amounts of value in the mid-cap space because it had outperformed tremendously for a decade or something, then we'd probably have more exposure to some of the larger companies. So never say never, but, you know, as I've been running the fund for four years now, it's been around that 75% mark. Certainly for the foreseeable future, I'd imagine that to be the case as well. And what I like about it, there are just loads and loads of really good fundamentally sound franchises that are just on crazy - well, I think, crazily attractive valuations.

So, if I gave you an example of something like a WHSmith, you know, which most people think of WHSmith's as obviously as a high street business, but actually it's really a travel retail business. So, 85% of WHSmith's profits now come from travel retail, so predominantly airports, but also rail and so forth. And this business obviously had a torrid, torrid time through Covid when travel was shut down and so forth, but the company have continued throughout this period, investing in new stores, not just in the UK but more

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globally, particularly in American airports and so forth. And they've got this huge pipeline now of redevelopment opportunities that will play out now over the next four or five years, and will see this business grow very, very strongly both from the expansion of the store estate, but also from continuing recovery in travel. And it's now valued on about 13 times earnings. Historically, it's been valued on sort of 18 times plus. We're getting them back on the dividend list and so the dividend is going to grow quite quickly over the next few years. It's run by, I think, a really, really strong management team. And it just looks an outstanding opportunity for the next few years. You know, I'm not making a call on whether it'll outperform in the next week or the next month, but as I see the development of the business over the next few years, it just looks a wonderful investment opportunity.

DM: Are there any larger cap companies you'd like to highlight on that are generating lots of cash flow and again, potentially cheap?

SM: Yeah, I mean, I think my comment about generational value, I think applies to the UK market broadly.

DM: Full stop, yeah.

SM: Full stop, because of those big sort of trends of negativity. It just happens, I think, particularly over the last couple of years to be more exasperated in the mid- and small-cap space because people have been very worried, I think, haven't they, about the outlook for the economy and whether we were going to have this famous recession and how bad it would be and all that sort of stuff. So, I think the large cap area of the market, the FTSE 100, looks pretty good value as well. And I do own some FTSE 100 companies, so I own companies like Prudential, the Asian insurance company you know, which again, I think looks incredibly good value. I own Entain, the online gambling business, which again, I think, it's had a few troubles over the last few years, but I think is in incredibly attractively valued. One business that I've owned for quite a long time now, which has done amazingly well in the larger-cap space, is Rolls-Royce over the last year, 18 months.

DM: It was a stock in the FTSE last year, wasn't it?

SM: Yeah, exactly right. And yeah, and now it's sort of getting there, I think. I don't think there's so much value on offer and I've been reducing my position. But yeah, so we definitely own larger companies, but as I say, I'm just seeing, and I do think the FTSE 100 is good value, but I'm just seeing even more value available further down the market cap spectrum.

DM: And as we're introducing this fund to our listeners, sort of for the first time — it's the first time you've done our podcast — what might they expect from a yield point of view? Is this, you know, some funds we see a higher yield, no dividend growth, some are lower yield, high dividend growth. Is this a combination of the two? Or, I mean, I guess we should expect a premium to the [FTSE] All Share. What's your income positioning?

SM: It's a great question, thank you. So, my broad philosophy here is to offer a reasonable yield premium to the FTSE All Share. And I sort of think about that in the sort of 10 -15% type premium range, but with a conscious focus on looking for really good capital and dividend growth opportunities as well. So, it is a

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genuine blend. Being mid-market focused, it does tend to lean itself more towards capital growth and dividend growth opportunities.

DM: There's nothing wrong with some capital growth if we can have that as well, right?

SM: Exactly right. We certainly could do with some of that, couldn't we? And I think it is a perfect balance. So right now, for example, the yield on the portfolio is about 4.2%. [**DM:** Okay.] That has been growing quite nicely in the last couple of years as the dividends of rebounding more broadly, post the pandemic. But I still see really good opportunities for good dividend growth in the portfolio as well. There's still quite a few companies on my portfolio list that are only really sort of rebuilding their dividend profiles, post the pandemic and so forth, and still have plenty of runway to see good dividend growth. So I think it's a decent starting yield. I think the broader market is roughly about 3.8% dividend yield, something like that.

DM: It's a nice number. You know, we happen to be looking at the five and 10 year gilts yesterday and five year gilts now are nicely below that, and if - and I use the word *if* - rates are coming down, then that sort of differential between UK equity and maybe the UK gilt yield starts to look actually quite attractive just from a yield perspective, if no reference to potential for capital gain as well.

So, given that you took over this fund just before Covid, and that was a very difficult period for lots of listed companies, but also for lots of dividend stocks, maybe we could talk about what you did in the fund at that time, and whether you learned anything. Obviously you and I have known each other, well, let's not say for how long, but you know, best part of 20 years, you've been at a few different houses - what did you learn at that period, particularly challenging as it was for all equity managers?

SM: Absolutely. And you're right, so talk about baptism of fire. So I started running the fund on the 1st of February, 2020.

DM: Literally D-Day, just as a market was about to fall!

SM: As the market was about to melt down, yeah. So what did I learn? It was an incredibly stressful period, obviously, but that was true for many people, not just in the fund management industry. I think the biggest thing I learned ... so I made a conscious decision. The market fell, particularly the mid-cap market fell so very, very sharply and in such a short period of time, I mean, the mid-caps were down about - as an index, they were down about 35% within about six weeks, which was pretty unheard of. And I made a conscious decision at that point. You know, I didn't know anything about the pandemic, obviously, I wasn't making a call on when we would discover vaccines or any of that sort of stuff. I just took a view that there were many, many franchises that were fundamentally strong, fundamentally robust, that would grow and thrive into the future, run by really good people, where their share prices in a very short space of time were down sort of 40, 50, sometimes 60% plus. And so I made a conscious decision to basically just start buying, with a view to making hopefully some very, very good returns for clients over the medium term, *not* taking any view on the very short term.

And so the biggest single thing I learned through that process was that focus on the medium-term time horizon is so important. Not trying to get too wound up about what's happening on a daily or weekly or

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monthly basis, not trying to predict what the so-called catalyst might be for performance and all that sort of stuff, but to just recognise when an investment opportunity's there and not get too worried about when it subsequently gets realised and reflected in the share price. And so through that period, and I was lucky to be supported by Tyndall and Alex Odd, our CEO, you know, absolutely backed me to continue doing that in what was a crazy volatile market, I just kept buying and buying. And in a very short term, it obviously was difficult and the fund continued to underperform because these companies kept going down on a daily basis, but very, very rapidly thereafter, we saw a good, strong recovery. And we've continued yeah ... to be pretty frank, the last four years have been sort of one sort of a difficult period after another, haven't they? Or it certainly feels that way anyway.

But the message I think, and I can't stress this enough, is to have that medium-term time horizon. And it's a really easy thing to say, but in practice, it's a really difficult thing to do.

DM: And I suppose as you've just taken over, I mean, obviously everyone's always proud of their dividend history and the ability to grow dividends, but I guess the focus on the dividend in that difficult period was probably less important to you. I mean, most income managers had to cut, didn't they?

SM: They did. And actually it is a really interesting issue, isn't it? Because, you know, when I talk about the mid market generally, people typically understand the potential for capital growth because mid-caps tend to grow more quickly than larger companies and so forth. But most people are often quite dismissive about the income capability of big caps and I think that's a real red herring.

And so, to your point, we had to cut our distribution through 2020 and into 2021 which was painful, obviously no one likes doing that, but the distribution cut on our fund - my fund is a March year-end, so, for the year to March 2021, the distribution cut was 20%. Now, for the whole UK stock market in that year, dividends were cut by 41%. So, we managed hold our cut to less than half of the overall market. And I passionately believe that's because that mid market focus meant we were much more diversified in our sources of income so we weren't overly reliant on the banks say, when the PRA [Prudential Regulation Authority] banned all the banks from paying dividends, or we weren't overly focused on BP and Shell when they both halved their dividends in that period. So that diversification, I thought, added a real defensive benefit to us in an unbelievably difficult time for dividends.

And then for the last couple of years, as dividends have recovered really quickly in the market, our distribution on our fund has more than kept up with the recovery as well. So I think that's a real advert for just actually how valuable mid market dividends can be.

DM: Well, before we wrap up and I give you a chance to summarise everything you said, let's just touch briefly on the UK market. I know some people don't like to talk about the Brexit vote, but it was a landmark time for which overseas investors particularly appeared to shun UK equities. Here we are seven, eight years on - and we've also touched briefly on the value opportunity that that long term de-equalisation of our market or de-investing into our market - are you genuinely excited about the valuation opportunity and more important, because guess what, it's easily a seven or an eight - what's the catalyst, what's the thing that kicks this market into strong positive territory?

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SM: Yeah, it's the number one question, isn't it really, for a UK fund manager? Because as you rightly point out, it is nearly eight years now since the Brexit vote, it's been a long time. So, I'd say a couple of things. First of all, I mentioned earlier the sort of narrative versus, or perception versus reality. Whether you voted to stay or leave, the facts now eight years on, in terms of economic performance, the UK is firmly basically in the pack of the G7. So, you know, we haven't done as well as the US, we've done better than Germany, Italy, you know, we're in the pack. And that's in terms of economic growth, in terms of inflation, unemployment, yeah, wage growth, all those sorts of things. So obviously we'll never know the counterfactual, we'll never know what would've been the performance had we stayed.

But the fact that we did vote to leave, I would argue the facts suggest it's not been as calamitous as most people feared. And that's not to say it's been brilliant, but it's not been as difficult from an economic point of view. And that's been a big driver, I think, that fear of economic underperformance has been a big driver of why the international investors have been so negative, while domestic investors have been shunning the UK to go global and all that sort of stuff. So, I think it is an important point. I think, you know, the perception is probably worse than the actual reality, regardless of your choice of vote at the time. So that's one thing I think is really important.

Now, to that catalyst thing, the short answer is I just don't know. I don't try and predict catalysts in my individual stock investments so I'm not going to try and predict it for the market either. I do observe that sentiment is on its knees from just about every aspect. I do observe that's created an amazing value opportunity. That's sort of good enough for me, really now without trying to predict when it will materialise.

Now, the only other thing I would say is, we are now having this discussion in public debate and policy circles and so forth. You know, there's talk about trying to do things like British ISAs in the budget that's coming up and all that sort of stuff. I don't know what the right answer is, but what I do know is that at least we are recognising there is a fundamental problem currently with UK capital markets. And recognising the problem is the first stage at least, to then eventually getting some sort of resolution. And I'm not sure what the answer will be and it'll probably be multiple different factors that coalesce together to kickstart this market.

What I also feel very passionately is a lot of people bemoan the lack of liquidity in UK equity markets, particularly at the lower end of the market spectrum at the moment. That is true that liquidity is less than it was. And at the moment it's all been negative because all we've been seeing is relentless outflows. But of course, were there to be anything more positive, god forbid, that lack of liquidity would work very powerfully, potentially on the way back up as well, because there won't be a lot of natural sellers if people do decide to be more positive and start buying again. So, I'm aware that UK fund managers like myself have been talking up the UK market for several years and it hasn't materialised yet. I don't believe for one minute that that means it won't. I just believe - as with all investment opportunities - getting the timing right and predicting catalysts is just fraught with difficulty.

DM: Yeah. And I suppose when you look relative to the US market, which apart from 2022, it's been a very, very strong market that valuations do matter to future returns, even if certain parts of the global stock market continue to get more and more expensive.

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So look, thank you very much for that. Now just to sort of close: this is a new addition to the FundCalibre stable of Elite Rated and Elite Radar funds, so maybe just I'll allow you just to finish and just say, you know, what type of investor might enjoy investing in this type of product?

SM: Thanks, Darius. Yeah, so I think what we're trying to do here is build a really interesting portfolio of UK-listed companies, predominantly mid-cap, mid market focus, which generate a real, good combination of good dividend yield with excellent dividend growth and capital growth potential alongside. It will be highly differentiated because of that mid market focus, highly differentiated from the wider stock market, but also from most of the UK equity income peer group. So, I think it offers a natural diversification to some of those more established, perhaps larger UK equity income funds. I mean, obviously I'd like it to be the bedrock of UK equity income allocation, full stop, but I can see why it would also be a useful diversification alongside perhaps some more traditional UK equity income product.

The fund pleasingly is performing well or has performed well. That's no guarantee it will continue, of course, but we are pleased with the progress we've made so far. We are growing. We are also, I won't go into the details on costs and things, but we do think we are extremely competitive on things like fees and so forth as well. So, I think the whole package ought to be very, very interesting.

And, you know, I was delighted to be, for example, the number one fund in the UK income sector performance-wise in 2023. So, all in, I think really, really exciting product. I genuinely, genuinely with all my heart, believe in the opportunity that's available in the UK today - I can't give you any guarantees as to when it comes to fruition, but that's the exciting bit really.

DM: Well, Simon, thank you very much. And as an investor as well, to have been the number one fund in 2023 with a bit of a headwind from mid-caps as an asset class, is extremely well done.

SW: As demonstrated in this interview, the VT Tyndall Unconstrained UK Income fund is a high conviction, highly differentiated mid-cap focused UK income fund. The fund received Elite Radar recognition in November 2023 and is one we will be watching closely in the future. For more information on the VT Tyndall Unconstrained UK Income fund visit fundcalibre.com – and don't forget to subscribe to the Investing on the go podcast, available wherever you get your podcasts.