

TRANSCRIPT: EPISODE 336

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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're looking at a newly Elite Rated fund - a fund designed to offer diversified monthly income with lower volatility, making it suitable for both retirees and growth investors.

Chris Salih (CS): I am Chris Salih, and today we are joined by Craig Rippe and Jordan Sriharan and co-managers of the Elite Rated Canada Life Diversified Monthly Income fund. First of all, thank you both for joining us today.

Craig Rippe (CR): Thanks, Chris.

Jordan Sriharan (JS): Thank you, good afternoon.

[INTERVIEW]

CS: Obviously this fund has recently been Rated, so for some of the listeners that may not know as much about the fund as we'd like, so let's perhaps start with a bit of an intro into the fund. Obviously you two are managing it, but there's a wider team involved in it. And also maybe just in terms of the remit in terms of what you're looking for, how you go about delivering monthly income to clients.

CR: Thanks Chris. Yeah, I'll start off with the fund and then we'll touch on the people second if you like. So this fund was designed for retirement. Although we have found it works really well for growth investors as well. And given it was designed for retirement we wanted it to have a lower unit price volatility and a smoother monthly income. We thought these were good characteristics for that type of investor. And so we're seeking to preserve and grow that monthly income in inflation adjusted terms as well as to provide lower kind of capital volatility. And so we've done that in a number of ways.

We're firstly trying to reduce the expected volatility of the fund by investing in a very diversified range of asset classes and instruments with very different return profiles. And we felt that putting it into the 20-60% shares sector was the best place for that because that's the right amount of volatility that we thought would suit this type of investment.

And we wanted to invest across as many asset classes as we could while still maximising expected total return. So we're investing not only in sort of the more vanilla equities and investment grade fixed income bonds, but we've also got some allocation to alternatives and real estate investment trusts. We've also got a little bit invested in high yield bonds, but not too much because I want to keep it diversified. And we've even had some interesting things such as mandatory convertible shares, which sit within the equity portfolio,

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which are essentially equities which have boosted their dividends at the expense of a little bit of capital. But it allows us to access perhaps some interesting growth names that otherwise we couldn't do while still maintaining an income, a high income from those within those portfolios.

The sub buckets, if you want, the equity portfolio, we want to keep diversification across lots of sectors and styles without being benchmark or benchmark obsessed. So we're always making sure we don't get too focused in one particular part or another.

And within the fixed income portfolio, we're trying to be diversified as well across different sectors and also across different durations and potentially even across different currencies and different parts of the credit spectrum. And then finally, it's just worth noting to get that smooth monthly income. We do invest directly into securities and we're not a fund of funds because this allows us to accrue income daily and monthly. And so we do have to be a little bit thoughtful sometimes about which equities will provide income more smoothly across the year rather than big lumpy payments on the last day, which is not so useful.

CS: Just to interrupt there before we go on to the sort of power of the team behind it, obviously you aim for a yield of at least 4% while targeting that minimum monthly income. How did you come to that number? Has that number always been the same? Is that just what you feel was the right number for the type of companies you're looking at?

CR: Well, we launched this fund, I designed this fund in 2018, before Jordan joined, and we were asked to provide a yield that was meaningful, but also achievable. And at the time, of course gilts were yielding, it seems like a long time ago, gilts were yielding 1% and investment grade spreads above that were 1%. So you could get a high quality bond for 2% yield. I felt at the time that was not gonna be a structural low yielding world, so I wanted it to be a bit more than that and we decided 4% would be achievable, which in those days it was a bit more of a stretch than it is today. But still kind of credible and a bit of a stretch, but not too much of a stretch.

Now the world has moved on and you can get a bond, a government bond in the UK for 4% and a credit spread above that for another 1%. And if we live in a world where yields stay very high for a long time, I think we would review that 4%. But for the time being, my plan or our plan now is to try and grow that yield in inflation adjusted terms and I think that's a reasonable yield to do so from if it feels like we're behind the curve at some point we'll review it then. But for now, I think keep it at at least 4% but do try and grow with inflation, which we have done so far.

CS: And just briefly before we go into the sub-sector buckets that you mentioned there, just talk about the wider power of Canada Life. I mean, it's not just you two in the room, there's a whole team of analysts, but also you tap into the global team and fixed income team. Just give us a bit of an idea of what is behind the fund in terms of the research and the power behind the asset manager.

CR: Yeah. Well, we sit in a team of experts and although we're the multi-asset team, we're not really experts in any one asset class because that's a very detailed and time consuming knowledge. So we are reliant on the team around us. There's a large team of credit analysts, 10 locally and 20 globally. There's a team of fixed income fund managers, one of which is KJ Sinha who helps us on a fortnightly basis at our meetings. And it helps us with security selection on the fixed income side. We also sat in the middle of a team of global equity fund managers. So one of those is called Bimal Patel. He sits and helps us choose our stocks from the global equity side, but he sits within a global team as well, so he's not just on his own.

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And finally, although I used to be head of UK equities and so I used to manage a UK equity income fund we do now increasingly rely on the the UK equity income fund manager who's called Stuart Taylor. And I suppose what I'm trying to say is we've got a very broad team of individuals that sit around us. We speak to them daily, we meet with some of them fortnightly on a more rigorous basis. And indeed the normal quarterly and annual kind of reviews go on as well. But we certainly do rely on those three individuals, especially for security ideas. And then Jordan and I kind of put them together, shape manage the portfolio from a top down approach to make sure it's meeting all the needs of our investors and so on.

CS: I want to cover a few of the asset classes that go into the portfolio in terms just sort of gauge where your sort of view on the market. I think it makes sense to start with bonds given what's gone on in there in the last couple of years. So it's sort of at this interesting point now where we've moved to rate cutting cycle potentially. Could you maybe just explain where you guys are as a team in terms of evaluating the bond market? I mean, there's quite a bit of dispersion. Are you in the moving away from credit duration? If so, why? If not, why not? Just give us a sort of insight into how you are tackling the bond market at the moment.

JS: Yeah, thanks Chris. I mean, we have a natural investment grade (IG) focus and the portfolio that's relatively natural given, you know, our parent company, we've got a strong skill set in asset liability management through the life insurance arm. And our credit exposure predominantly has a focus on what we call big bonds, which is typically BBB space. Where today we think that's where the best opportunity or the best risk reward opportunities are. And that focus on IG has a kind of secondary order effect as well, which is that it allows a bond allocation to work quite effectively as downside protection to the wider portfolio. And that's why at this point in the evolution of the strategy that the IG focuses is important part of the way we think about the bond market when we come onto the rates discussion it is interesting.

I mean you mentioned it the question earlier. We're in a period of loose and monetary policy. The Fed, the Bank of England, the ECB, have all begun that process. I think what's more interesting is that a lot of those central banks, or those three central banks at least, are facing more different growth environments than each other. I mean the EU looks a bit weaker, inflation is lower, but the broader economy picture in Europe is weaker.

The UK is more stable perhaps from a place of previous weakness and the US where growth is strong, even if that pace has slightly slowed, they all three of them have got sort of different growth environments to tackle. So whilst as a team we weren't surprised to see the ECB and the Bank of England lower rates before the Fed, personally I was a bit surprised that the Fed cut as much as 50 basis points at the last meeting.

And I guess to have a high conviction view on where rates go from here is difficult because it's quite data dependent and particularly for the US where the volatility of that data seems to be heightened. Clearly unemployment is now the most important data set for the US and for the Fed, I should say. But that's somewhat distorted a little bit by, you know, the hurricane season we just had will impact jobless claims or will impact non farm payroll numbers. So to put that into context of where we are on credit versus duration, I think, just come back to the point about income being a principal driver, which Craig mentioned earlier, the investment grade spread is important. A large majority of the names of the credit names and the portfolio are those that we hold on balance sheet portfolios.

So there is a low default probability attached to them. And so that credit portfolio is relatively stable. I don't think we'd be free to miss, you know, we don't look to make big alpha or generate significant alpha from the big macro calls to rotate materially out of investment grade credit into duration. Now we do own duration in the portfolio and by that we mean government bonds. So there is a five year treasury in there. There's a 2042

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Tip, a treasury inflation protected security, but crucially both of those were bought when yields were at significant premiums to their competing sub-asset classes within fixed income.

We bought the five year treasury at 4%, 4.4% in May of this year early in the summer. We bought the 2042 Tip inflation protected security in October 2022 after trust genomics. And so both those decisions to buy those bonds were driven by our focus on what is the opportunity in year, where's a relative value opportunity for yield. And so I think it's important to bring it back to that is what drives the decision making as much as anything else rather than the I guess trying to predict for the macro and then position accordingly because the yield environment is important helping us to think about the balance of the portfolio.

CS: Okay. I want to move on to equities because obviously there's a couple of elements here that are quite interesting. Could we maybe just start with some of the themes that run through the equities segment? I mean tech has been one of them. Maybe just talk through a couple of others. I mean tech's one that people don't immediately look at and think income, for example. Just give us an example of what you are looking for and some of the themes that are coming principally out of the equities bucket of the portfolio.

CR: I suppose I'd like to just preamble that Chris with kind of how do we set the scene for the equity portfolio and when bond yield are very high, it allows us to hold more growth within the equity portfolio and still meet our needs. And when bond yields are very low, it's the opposite.

Now, bond yields certainly in this fund are quite high. And so we've been able to increase our growth allocation within the equity portfolio. And tech is just a part of that theme, although it's quite a big part. And of course, given the success of tech over the last two or three years in particular with the AI kind of space pushing it this year, it's been an interesting place to be.

Now we haven't played Nvidia and I'll say that now because the yield I checked today is 1 cent a quarter on \$136 share price. So it yields three basis points I think. But and also I found it personally extremely hard to value. But we've played really across the space, we've played in a series of what we deem to be high quality names from Microsoft which you'll know in Amazon at one end down to TSMC, which you'll know, but Cadence Design, which is a software design company that's a bit more mid-cap in the US but all very high quality, all having fairly similar kind of share price charts if you want to call it that over the last 12 months. And they add up to around 10% of the fund, which is probably our biggest allocation at the moment. And given that most of them now yield less than 2% that is a theme that's still running.

We did trim it earlier in the summer when we felt it got ahead of itself. And I suppose to that theme, I find it quite interesting. It's the only theme in the world that's really worked for fund managers for the last two years. And if you weren't in it, then you were feeling a bit sorry for yourself and if you're in it, you were feeling a bit too clever for yourself. And so I've always been very kind of keen that we keep it at a very sensible level in the portfolio, particularly for an income fund.

And so although tech has gone up and down and, you know, we took it down by a percent in the summer, it's still only 10% of the whole portfolio even now, even though some of those names have gone up several hundred percent since we first held them. Microsoft in particular is the same weight now as it was approximately the same weight as it was when we launched in 2019, even though it's probably doubled and then doubled again in that period because we are quite disciplined about keeping the weight down. If you're gonna ask me when the tech bubble or the tech rally is going to end, I haven't really got any more idea than you have I'm afraid. But I can see the dynamics for it's continue are still in place.

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It doesn't look like we're going to get a hard landing. A lot of people don't think we're gonna get a soft landing. We're still seeing plenty of optimism around the space. I know that Nvidia said there was, I think they used the word insane demand for their chips at their most recent presentation in the last couple of weeks and we're still seeing a lot of demand across the entire space. So for the time being, we're happy to keep running it, but we have got a very broad exposure across the whole space rather than trying to play one specific sub theme of it.

CS: Is it possible to even begin to value big tech in terms of whether you think it's expensive versus history given what's going on in that market at the moment?

CR: I suppose when people say well it's trading on these ridiculous multiples of revenue, you know 5 or 10 times revenue, but if you've got 70% margins then it's not quite the same as it normally would be because your margins are therefore kind of very high. And to my mind, the PEs - the price to earnings ratios - look a bit extended, but they're coming down very sharply. So if you even went to the most expensive and you know, forgive me, if I'm there with Nvidia, I think it's on 30 times, but it'll be on 23 times earnings in not many years time. It's not the same as buying it on a hundred times earnings back in the tech bubble. Okay.

And as long as these revenues turn out to be not too illusory, I don't think that these valuations are looking to extended. So you're having to say, these companies lying to us or they're lying to themselves more likely and thereby to us about how they think the future's going to look. I think probably they're gonna keep going. They may not keep going quite as much as they think they are but I don't think we're gonna get a great big tech crash like we had in the early nought.

CS: And just in terms of equities in general, I mean, you said you managed the fund since 2018. We've had that sort of move where you can, back then there was a death of yield. Now that's not the case, but if rates start to cut and things fall again, I dunno pick, say they end up 3- 4% in the UK, does that affect the equities bucket in terms of how you build it with regards to targeting that 4% income? I will, you have to start looking at some of those names and go this, although offering a strong growth story does not offer enough of an income story for us to hold it. Or is that something that literally just has to be tweaked at the margins to make the fund work?

JS: I guess Chris, we talk about this idea of whether relative value and yield opportunity is across all asset classes. So we end up constructing a portfolio that has a natural contrarianism to it, if that's a fair thing to say. And that's to say that when markets are risk on i.e. equities are outperforming bonds, and in this context we typically see dividend yields falling and bond yields rising.

The portfolio's approach very broadly speaking is to seek the high yielding opportunity in bonds whilst moving away from the lower dividend opportunity inequities, all things considered equal. And conversely the opposite happens in the portfolio during risk off periods. That is to say the portfolio's approach is to seek potentially higher dividend yielding equity names whilst moving away from lower yielding bonds, which is what happens in those risk off moments. So in focusing on that relative value in yields, the portfolio is able to protect the income streams from equities and bonds because there is a valuation sensitivity built into the process and that evolves through time.

So to answer the question, you know were bond yields to get to go higher and dividend yields to go lower i.e. because the valuation in equities has gone higher, then the portfolio naturally moves towards buying those higher yielding opportunities across all asset classes and the multi-asset nature of it is quite powerful in that respect.

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CS: Okay. I just wanted to touch briefly on alternatives before we talk about a couple of holdings. You have been adding to this bucket recently, I think particularly within real estate investment trust (REIT). Could you maybe just explain what the opportunity is there? And I believe there's also been some renewable names as well being added to that part of the portfolio?

JS: Yeah, sure. I'll pick this up quick quickly, Chris. So I mean the entire REIT and infrastructure sector, particularly when you look in the investment trust space, have derated materially for the last 18 months. You know, a lot of it, a function of higher rates, higher gilt yields and trust genomics. That period in September 2022 obviously started the downfall for some of these names or at least turbocharge their downfall, should I say. And so some of our optimism is driven by the thesis that we spoke about earlier on the start of the monetary policy loosening cycle. Some of the optimism is driven particularly for REITs on a more activity on the M&A side. And some optimism is driven by a more stable UK that's both politically and economically.

And I think REITs for the last 12 months, perhaps slightly longer, have traded a bit like long duration bonds on steroids, of course their interest rate sensitive names. But such has been the market's relief at the start of the rate loosening cycle in the UK. There are a number of names that have just performed extremely well. Now, I think it's fair to say that not all UK REITs have gone up together, and I think the universe is consolidating at the same time, which is what we should expect in a period when the competition for capital is higher.

So we've been running screens looking for REITs where the sector might be able to favour discounts remain wide, and the dividend yields not only look attractive, but but also well covered. And the shortlist of names that we come out with, which are only five or six contain some that look like possible M&A targets and others where the management remain under pressure to deliver shareholder value.

CS: With discounts on them as well?

JS: Yes, absolutely. So they would be why discounts relative to history, high dividend yields that look attractive, but also well covered dividends as well. And that's kind of a very brief screen that we've run on the REIT sector in particular. And it has come out with names that sit across a variety of sectors, industrial space, it's not just industrials but also in the residential space, the diversified space in the healthcare space. There are a couple of names as well. It's not just they've all, they're not just all fallen in the retail space or in the office space. There are a number of names across different sectors that we think might be attractive. And we're doing a lot of diligence now to work out if they might be signing in to add to the portfolio in meaningful size.

When we look at the renewable sector again, trading at a larger discount than historically and for business models that are, you know, relatively robust and well placed to capture future growth. I think many of those businesses in the renewable space have sold assets above their NAV holding value and the dividend cover again looks strong.

So we like those names and we think that the appetite might have just changed and it could possibly be a technical bounce to some of these names as the externally managed investment trust don't have to disclose costs in the KIDS in the same way as you might be familiar with. And that might make them attractive to a wider universe of names or investors. And so altogether, when you throw in that lower rate potential environment and the kind of change in regulation it could be that REITs and investment trusts have the sort of a re-rating going forward.

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CS: I wanted to just finish on a few stock examples just to highlight the active nature of the portfolio. Let's maybe start with National Grid, a lot going on there, big expansion plans tied a lot to the UK sort of energy infrastructure story. Maybe you could talk us through the rationale behind the holding as a starter point.

JS: Sure. And I think Craig alluded to earlier, Chris, but when we look at the equity portfolio, we do think about that barbell and that's sort of slightly higher dividend names with more growth, you lower dividend names. A national grid sits in the, as you expect, the sort of high dividend yield side. It has a yield there of 5.7%.

I mean, National Grid is a utility focus on the transmission of distribution of electricity and gas. It's a household name that you'll all know. Well, interestingly, despite it being this electrical motorway that powers the UK, it does generate half its revenue from the US and more particularly on the Northeastern board where Massachusetts and New York are bigger owners of the electricity transmission pipeline there. I mean, what I think what's interesting about National Grid, and it's a position we've held in the portfolio since inception, is that it's a well covered dividend from a regulated entity that is actually creating long-term value for shareholders through sensible management.

The valuation on the name is not demanding, especially when compared to its US peers or US utility peers that trade up much higher PE levels. But we're also excited as I think about the long-term opportunity for National Grid as clearly both private and state support in the ascendancy for renewable energy sources. You know, indeed the transition to a more knowledge based economy driven by tech and AI, will require more demand for power. And whether that be data centres or electric cars it feels like National Grid and its power servicing, you know, the UK economy is at the forefront, the picks and shovels shall we say in that particular the long term growth story is pretty strong multi-year, et cetera.

CS: Okay. maybe could we just touch on a couple more examples quickly? First would be Apollo Global Management, because that is a US asset manager, just to show the breadth of the companies that you look at and also perhaps a bit well known Broadcom as well, which both of those have made the headlines a lot recently. Maybe we could take each of those in turn as well, please.

CR: Yeah, thanks Chris. Well, I suppose I'll start with Apollo because you did and we've had a high allocation to financial throughout the life of this portfolio, but we've really not been much invested in the broad expected names. Although we've added to JPMorgan recently, our financials exposure has generally been through more interesting names and particularly higher growth names.

Apollo actually started as a mandatory convertible share. So although the normal shares have always had a fairly low yield, they did issue a mandatory convertible, which gave us access to a much higher yield for the first three years at a small capital cost. And we held that and eventually the convertible expired into the normal shares and we've carried on holding it. But really this was a play on the fact that alternative asset managers have been doing far better than listed fund managers and far better than banks.

They've had access to much faster growing customer bases and they've been providing a need for the market, which has been seeking a variety of alternatives from private equity to private credit to real estate even despite the downturn. And Apollos has been one of the high quality ways which we can access that. We've also recently added to <inaudible>, which is another alternative asset manager, and we have historically also invested in Blackstone which are all sort of plays on the same theme and although we're not getting really overweight the entire basket of them. So we've sold the Blackstone recently. I suppose these names are an

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example of how we can access a more interesting corner of the financial sector than just buying your traditional banks and life insurance names. Only the alternative asset managers are really quite a small weight in the overall index and certainly a small weight in the financials index.

CS: Do you feel the penetration of that market is still sort of fairly infant stage in terms of people looking at alternative asset managers in general?

CR: It's interesting that question, and I'm gonna take a massive step back and say that the main buyers of private assets like that are actually the really big institutional and really big pension schemes that have got very long timescales because obviously these assets are private, they can't be liquidated on a daily basis to match the retail market with daily trading.

So I suppose to answer your question in another way, you know, are those institutional buyers growing in scale or not? I think the answer is probably yes. People are saving via their pension schemes and increasingly so I think the pension schemes are adding to their weight in private assets particularly they seem to be outperforming, which I have a feeling and encourage the trustees and the consultants to continue playing that game for the foreseeable future. So I don't think we're obviously in the infancy that we were, but I think there's plenty of legs still in that market and certainly you can see the margins available to asset managers in that market is still substantial and attractive and it's a hard market to get into. So although the market is broadening out, I think there's plenty of plenty of play in that one still.

CS: And if we could just spend a moment on Broadcom, so obviously that's one that's been right in the middle of the grape of AI and all the stories that have been entailed in that. Can we just have a moment on that as well, please?

CR: Yeah, I mean, I suppose I wanted to talk about Broadcom rather than some of the more kind of specific names like ASML or TSMC because Broadcom and including the name, it's a very broad beast. It's getting towards a trillion dollars in market cap now. It's really been built through a series of acquisitions and it covers a really broad range of the tech space. It's mostly in connectivity solutions. So it does huge kind of infrastructure within network and data centres. It does connectivity within smaller scale things like modems and broadband and routers and also in your mobile phones and then connecting your car if you've got an Internet of Things car. And really it's been in the heart of all of these different plays. And so without playing directly into AI itself, it has been benefiting from the very broad kind of growth in spend in it.

And that makes it a much more, to my mind, a more kind of secure way of playing the growth in our lives collectively than perhaps a very specific name. So yeah, it's another name that started off actually as a mandatory convertible. And and so, we were able to access that when I think it had a yield of 8% in the mandatory convertible, it turned into the ordinary shares. We liked the name both before and after that. So we've continued to hold it as part of our ongoing kind of 10% weight in technology.

So I suppose what I'm trying to get across is that for this type of fund, it's a much more broad and perhaps a more safe way of play in the tech bubble or the tech rally, depending on how you wanna call it, than going into something that's gone up 400 times in 10 minutes flat and feels a bit more speculative to my mind.

CS: On that note, then, Craig and Jordan, thank you very much for your introduction to the fund and thank you for spending some time with us today.

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CR: Thank you, Chris.

JS: Thanks.

SW: A diversified portfolio of income-generating assets, including global company shares, international government and corporate bonds, as well as property. This fund aims for a yield of at least 4%, while targeting a minimum monthly income to the investor. This is a steady offering with income generation at the centre of its process. To learn more about the WS Canlife Diversified Monthly Income fund please visit fundcalibre.com