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INCOME FOCUS FUND UPDATE, AUGUST 2017

Mitchell Fraser-Jones, 15 September 2017

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.

August is typically a quiet month for the UK equity market but, as many of our investors are acutely aware, the relative calm of the holiday season was disrupted by a significant profit warning from Provident Financial and a general mood of market antipathy towards much of the rest of the portfolio.

The profit warning from Provident Financial, which came hard on the heels of its warning in June, has been an obvious headwind to performance. This arose from continued and worsening problems for its home credit division, which Neil has comprehensively explained in his blog post and our recent video, which also provides some context about what's been happening in markets recently more broadly. More than half of the portfolio's underperformance in August came from Provident Financial – much of the rest, in our view, is the result of the stock market's current preferences, which have become extreme.

As the summer has progressed, global stock markets have become increasingly narrowly focused, returning to the themes that drove behaviour in the second half of 2016. Markets have appeared singularly fixated on stocks that are seen as proxies for Chinese credit growth – in the UK that basically means mining companies, Asian exposed banks and some consumer staple businesses – with the rest of the market languishing behind. We do not believe this behaviour is fully justified by what is really happening in the economy, as we explain below – nor do we believe it is sustainable. Nevertheless, it has been a considerable further headwind to performance in recent weeks.

Furthermore, we would argue that this behaviour has introduced more risk to certain parts of the market. To demonstrate this, let's look at what has happened in the UK mining sector – a sector to which the fund is not exposed – over the last eighteen months. The sector had a great run in 2016 and has enjoyed another strong rally over the summer months. For example, Rio Tinto's[1] share price started 2016 at £19.80. Since then it has risen almost 90% to end August at £37.47. Mining companies like Rio Tinto have benefited from a significant increase in the price of the commodities that they produce. We have missed out on those gains, in part because we did not anticipate the rally in commodity prices, but primarily because we do not believe the increase in commodity prices that we have seen is fundamentally justified.

On the face of it, mining company shares may not look expensively valued, because earnings, dividend and cash flow forecasts have all increased broadly in tandem with share prices. But the question we always return to is, "what if those commodity price increases are not sustainable?". We have written before about the amount of financial speculation that currently takes place in commodity markets in China – the scale is enormous and alarming. For example, the amount of iron ore volume that is traded in China every day now regularly exceeds the country's entire annual output of that commodity. Meanwhile, global supply growth has continued to outstrip global demand growth across many commodities, including iron ore and copper. This fundamental dynamic is naturally more likely to result in commodity price declines, rather than increases, which suggests that something other than fundamentals has been driving price behaviour across the commodity spectrum.

Obviously, the China growth story has been central to the investment case for commodities and commodity producers for a long time. Growth has slowed in recent years but policymakers have prioritised economic stability, with annual growth of 6.5% currently targeted, seemingly at any cost. Growth has become increasingly dependent on credit, with the IMF estimating that the credit intensity of the Chinese economy is now close to 5x – in other words, for every 1 unit of incremental output, the Chinese economy now needs nearly 5 units of debt. This worries us – Chinese credit growth far outstrips that of the US and other western economies in the build-up to the global financial crisis. Indeed, it is widely acknowledged that China already has a substantial bad debt problem and policymakers have been increasingly innovative in their attempts to stave off their own banking crisis. They have so far managed to delay that conclusion but are running out of options to continue to do so. There is growing evidence too, that policymakers are becoming more interested in the quality of growth rather than the quantity of it – all of this points to a very different Chinese economic performance in the years ahead, than the one that financial markets have become accustomed to.

Joining all the dots here, we are concerned that rampant Chinese credit growth has leaked into commodity markets through some inappropriate infrastructure investment and unprecedented amounts of financial speculation. This has inflated commodity prices to levels that are not justified by fundamentals. This represents a gigantic misallocation of capital and we know from centuries of economic history that episodes like this do not end well. This is why we say that the Chinese credit growth theme that has played out in markets carries considerable risk. We are not prepared to take these risks with our investors' capital – nor do we believe that we need to in order to deliver attractive long-term returns.

Turning back to the portfolio, the corollary to the market's current obsession with China proxies, is that much of the rest of the market is out of favour and disappointing news in particular is being punished. Recent events at the AA can illustrate this. Its share price fell by 35% during the month. To warrant such a share price decline, one would perhaps have expected a pretty serious profit warning from the company. The trading update which prompted that share price fall, however, resulted in a 6% downgrade to this year's earnings – disappointing therefore, but hardly catastrophic. Admittedly, there has been a series of earnings downgrades from AA since its IPO in 2014 and the news of the dismissal of its executive chairman, Bob Mackenzie, that accompanied the trading update won't have helped, even though the dismissal does not disrupt the investment case. Indeed, some aspects of the trading update, such as membership numbers and cash generation, were encouraging. The shares' disproportionate reaction just underscore how warped the market's behaviour has become in recent weeks. From our perspective, the logical thing to do when shares are under pressure for non-fundamental reasons, is to add to the position, which is exactly what we have done with the AA.

Other UK-focused businesses such as Babcock International and Forterra also performed poorly in share price terms in August but it is difficult to explain why, other than that they do not fit with the current market zeitgeist. Indeed, domestically-focused stocks have remained deeply out-of-favour with the market over the course of the summer, which is one of the reasons we have become increasingly interested in them. If readers wish to remind themselves of our current relative optimism about the outlook for the UK economy, we would recommend reading our series of articles on the subject. This is obviously a non-consensual view – that is amply demonstrated by the market's behaviour – but it is one that we are convinced will be very rewarding in the long-term.

Some holdings in the portfolio did do well in August. A positive trading update helped shares in Morses Club to rise during the month. The company operates in the same financial niche as Provident Financial, making short-term loans to UK households. The recent fortunes of the two businesses could not be more different, however, and in some respects Morses Club (and for that matter, another portfolio holding, Non-Standard Finance) is seen as a beneficiary of Provident's recent self-inflicted problems. Towards the end of the month, Morses Club reported a solid increase in customer numbers and an improvement in credit quality.

Meanwhile, Hostelworld also posted a decent set of interim results, with strong growth in bookings across its online travel booking platform. Across the Atlantic, US biopharmaceutical business Gilead also performed well, following the announcement of its acquisition of Kite Pharma – a pharmaceutical business that develops novel immuno-oncology products, focusing primarily on T-cell therapies.

In terms of portfolio activity, as well as adding to the position in AA, we increased the portfolio's holdings in Crest Nicholson, Imperial Brands and Morses Club. Elsewhere, we participated in the initial public offering (IPO) of Strix, a manufacturer of kettle safety control products, which has come to the market at a very attractive price.

We also added a small position in Drax to the portfolio during the month. Drax is a UK energy business which we know well. Recent strategic developments – such as converting three of its six power plants to be fuelled by biomass instead of coal and the acquisition of business-to-business energy supplier Opus Energy – have diversified and improved the quality of Drax's earnings streams and have allowed the company to introduce a progressive dividend policy. These positive developments are not yet adequately captured by the Drax share price, in our view.

Although the portfolio's performance has been disappointing in recent weeks, we retain absolute conviction in the investment strategy. We remain on track to deliver 5p per share in income next year, as outlined during the fund's launch. As Neil mentioned in the video, short-term underperformance is painful to endure, but our response to it is to continuously retest our investment hypothesis. In doing so, we conclude that our strategy is very appropriate for the current investment context. We do not believe that the rate of credit growth that we have recently seen in the Chinese economy is healthy or sustainable – neither, therefore, is the market's response to it. It has taken the valuation stretch in markets to dangerous levels, and we believe that the portfolio is well placed to benefit when conditions begin to normalise. Undoubtedly, there will be further individual stock disappointments along the way, and it is likely that these will continue to attract more attention than the successes. But we are very confident that the successes will continue to outweigh the disappointments, allowing us to continue to deliver the excellent long-term performance that investors have come to expect from Neil Woodford over a very long period of time.

Footnotes

1. We don't mean to pick-on Rio Tinto here – there are many other mining companies which we could have used to effectively demonstrate the same phenomenon. We've also taken a look at consumer goods company Diageo in the Woodford Equity Income Fund update. Share price data is sourced from Bloomberg.

What are the risks?

- The value of the fund and any income from it may go down as well as up, so you may get back less than you invested
- Past performance cannot be relied upon as a guide to future performance
- The annual management charge is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded
- The fund will be invested in a concentrated portfolio of securities – the fund is not restricted by reference to any geographical region, sector or market capitalisation
- The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits – some of these security types could increase the fund's volatility and increase the level of indirect charges to which the fund is exposed
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling – as a result, exchange rate movements may cause the sterling value of investments to decrease or increase

Important information

Before investing, you should read the Key Investor Information Document (KIID) for the fund, and the Prospectus which, along with our terms and conditions, can be obtained from the downloads page or from our registered office. If you have a financial adviser, you should seek their advice before investing. Woodford Investment Management Ltd is not authorised to provide investment advice.

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