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EQUITY INCOME FUND UPDATE, NOVEMBER 2017

Mitchell Fraser-Jones, 21 December 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.

November saw a modest decline in the UK stock market amid slightly higher levels of volatility than we have seen of late. A strong pound, which greeted the steady progress that Theresa May appeared to be making towards an agreement with the EU on Brexit, saw some weakness in the share prices of global-facing businesses. But this failed to meaningfully change the momentum grip on markets that has been in place for much of the last two years now. The valuation stretch in markets is now close to breaking point, in our view, as we explained in our recent article.

The fund also declined in value during the month, with US biotechnology company, Prothena, the largest detractor. Its shares weakened after a Research & Development (R&D) day, in which investors were given an update on the company's pipeline progress. Despite a lot of positive reassuring information across a range of the company's late-stage and earlier-stage assets, the market appears to have focused on a delay in its Vital phase III trial for NEOD001, the company's potential treatment for AL amyloidosis. A comprehensive explanation of our take on this update can be found here but, to summarise, we have reached a very different conclusion from the market.

The Vital study has been delayed because of the time taken for 'events', such as cardiac hospitalisation or death, to occur. There can be only two reasons for this – either the standard of care has improved or NEOD001 is working. There is nothing to suggest the former: although AL amyloidosis patients are generally living longer than they used to, that should have been captured by the dataset on which the original trial timelines were based. And on the latter, the R&D day provided new information about patient baseline characteristics in the trial, which showed that there was a higher proportion of more severely affected patients. Events in these patients would be expected to occur more rapidly, but the trial read-out has been delayed by a year because those events appear to be occurring more slowly than anticipated. Consequently, we see the delay as an encouraging indication that the drug is working, and view the market's reaction therefore as inappropriately negative.

Importantly, Prothena is fully-funded to complete the late-stage trials in NEOD001, so, although short-term share price weakness can be frustrating and may feel unsettling for some investors, it cannot change the outcome for this business now. That outcome will be formed on the basis of the clinical trial data alone and we don't have long to wait for the first data to read out – the results from the Phase IIb Pronto trial in NEOD001 are expected in Q2 2018. A very confident and reassuring meeting with Prothena's management team last week has bolstered our conviction in the long-term investment case even further, to the extent that it is as strong as it ever has been.

Babcock International also detracted from returns, as its shares declined after its interim results which were broadly in line with expectations. The bears have seized upon some cautious statements regarding the effects of the spending environment on future growth, but we would argue that the stock's valuation is already discounting a much worse outcome. Furthermore, much of the work that Babcock undertakes is maintenance-related, non-discretionary in nature and governed by long term contracts. This should insulate it to a degree from any further worsening in the spending environment, despite modestly cautious forward statements from management. Indeed, Babcock provides a clear illustration of the valuation stretch in markets currently; the company is due to be evicted from the FTSE 100, despite the fact that it has estimated annual revenues of £5.4 billion and operating profit of £584 million. It is to be replaced with Just Eat, which has forecast annual revenues of £520 million and operating profit of £132 million – so Just Eat's estimated revenues are lower than Babcock's forecast profits.

Spire Healthcare fell back over the month too, after it was announced that Mediclinic International had failed to agree terms to acquire the company. Mediclinic's improved bid still undervalued Spire and its prospects. Meanwhile, several domestically-focused businesses, such as Barratt Developments, Next, AA and Lloyds, remained heavily out of favour with investors, despite the progress being made by Davis, Barnier et al in the ongoing Brexit talks. From a fundamental perspective, these businesses and many others like them, have continued to trade well this year despite the market's preoccupation with Brexit sentiment. We expect this to continue and have positioned the portfolios to exploit this meaningful gap between perception and reality.

Turning to the positive contributors, Cityfibre Infrastructure, the UK's largest alternative provider of wholesale fibre network infrastructure, performed well in response to a new long-term strategic partnership with Vodafone. Under the terms of the agreement, Cityfibre will provide full-fibre connectivity to at least one million UK homes in 12 cities in which it already has a presence. The agreement gives Vodafone access to a superior broadband product at a lower cost, and could be extended to up to five million UK homes across 50 towns and cities by 2025. This is, in our view, a game changer for Cityfibre, because it represents a significant strategic step forward for the business in terms of scale and although execution risks remain, the economics of the deal look very attractive. Over twenty years, the deal is expected to be worth more than £500 million to Cityfibre. Despite rising 30% during the month, the shares remain slightly below the level at which the company listed in 2014. We believe substantial long-term upside exists for this share price, as the business successfully executes its ambitious growth plans and the terms of this new deal.

Meanwhile, shares in Imperial Brands enjoyed a brief bounce after it announced robust annual results. As we noted last month, its shares have been out of favour for some time, as the bubble in markets has inflated, but we expect it to continue to deliver strong and dependable growth in cash flow, earnings and dividend. It has been, however, quite out of tune with the current mood music in the market. The small bounce in its share price of late is, in our view, a precursor to a more meaningfully positive contribution to performance on a longer-term view, as market behaviour corrects, and fundamentals reassert themselves.

Alkermes also performed well after releasing very positive news about its potential therapy for multiple sclerosis, ALKS 8700. The company has reached an agreement with Biogen, which will commercialise the drug, providing upfront and milestone payments to Alkermes, along with a royalty stream. This is a clever and attractive deal on an asset to which most analysts attributed no value in their models and which is not part of Alkermes' core franchise.

In terms of portfolio activity, we added a further UK housebuilder to the portfolio during the month. A trading update from Crest Nicholson in the middle of the month, led to some near-term share price weakness due to a slight shortfall in revenue compared to what was expected. This was the result of the business refusing to sacrifice margin in the pursuit of revenue, which highlights a degree of discipline from management which we view as a positive rather than a negative. We initiated the position with the shares trading below £5 for the first time since January, and with the shares offering an attractive starting yield of more than 7%.

Meanwhile, we participated in a fundraising by Thin Film Electronics. Its shares have been weak recently with this fundraising hanging over the stock, but we maintain significant confidence in the company's technology and its long-term prospects. This latest fundraising provides it with the capital it needs to reach profitability based on its current development plans. During the month, IP Group also completed its merger with Touchstone Innovations. This resulted in an increase in the portfolio's position in the former and the exit of the latter.

To conclude, it is clear that our investment strategy has not played out in the way we would have hoped and expected in 2017. As we examine in our 'Year in review' article also published today, we understand the reasons why and have continuously reassessed our strategy in the light of what we've seen unfold in markets, and have consistently returned to the same conclusions. Risk is now very evident in the parts of the market which have performed well over the last eighteen months, but pockets of extreme undervaluation also exist. The portfolio is exposed to those areas of undervaluation and continues to avoid the sectors and stocks in which valuation risk is now extreme.

We believe we are close now to an inflexion point in markets, which will see the valuation stretch in markets start to reverse.

As the era of easy money draws to a close, with the Federal Reserve intent on steadily shrinking the size of its substantial balance sheet, the implications for global liquidity and the US dollar pose a hazard for financial markets that have been paying too little attention to risk.

Meanwhile, the winds of change in China also threaten the consensus view that the outlook for global growth is benign and almost trouble free. There is growing evidence to suggest that, with Xi Xinping having consolidated his power base at the communist party congress a few weeks ago, the priorities of the Chinese authorities going forward will be very different to the 'growth at all costs' mantra of the last decade.

For example, there was a conspicuous absence of an economic growth target in Xi Xinping's opening congress address and the remarks made by China's central bank governor about an approaching 'Minsky moment' for a Chinese banking system that has been creating credit at an alarming and increasingly ineffective rate for years are also important. Meanwhile, a number of billion-dollar infrastructure projects have been cancelled and initiatives to tighten Chinese financial regulation have been introduced. All of this points to the inevitability of slower growth from the Chinese economy as it faces up to its massive bad debt problem and exports deflation to the rest of the world via its currency.

This may sound like a very bleak assessment of the global growth outlook but it should only be disturbing for those who are not prepared for it. The stock market consensus does not appear to be prepared for this outcome but we are. We continue to believe that the fund is appropriately positioned for the prevailing economic and market environment. In turn, we are very confident that the fund will deliver attractive, positive long-term returns to its patient investors.

Fund name change: CF to LF

Some of you may have noticed that the fund has had a slight name change and is now called the LF Woodford Equity Income Fund (rather than CF). This change, which came into effect in December, reflects the acquisition of our Authorised Corporate Director (ACD) Capita Asset Services by Link Group in November.

For investors, nothing has changed besides one letter and by way of background, many fund firms outsource their ACD, which is the legal owner and administrator of a fund.

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 ongoing charges figure 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 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
- The fund may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value

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