LF WOODFORD EQUITY INCOME: A PORTFOLIO UPDATE

Neil Woodford, 3 May 2019

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.

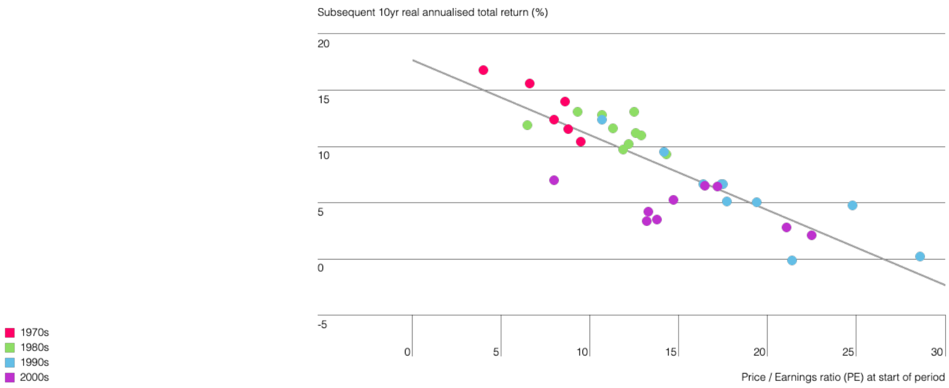
In recent months there has been considerable commentary about the shape of the portfolios Neil manages, in particular, the LF Woodford Equity Income Fund (WEIF). In light of this, Neil explains why the fund is positioned as it is today and what this means for investors in the months ahead.

You may have heard me talk about my investment process in the past and despite its fundamental importance in guiding everything I do with the funds, it often gets overlooked and ignored. Because it is the thing that drives the strategy, what I own in the funds and what I don't, I want to spend a little time explaining the key elements of that process.

Everything in my investment world begins and ends with valuation. It sounds simple and, in some ways it is, but before answering the question, "what is the right valuation for a business?", I will explain why valuation is so important and why in the long term it is the most reliable predictor of future investment return.

On the basis that a picture paints a thousand words, let me start with one. The chart below shows the starting valuation of the UK stock market, in terms of its price / earnings ratio (PE), at the end of every year since 1974. This valuation is plotted against the real annualised total return that investors would have received over the subsequent 10 years if they had invested at that point.

UK equities: starting valuation has a strong influence on long-term returns
Source: Lazarus Economics, Woodford, based on FTSE All Share (excluding investment trusts) total return data in UK sterling, adjusted for CPI inflation; R^2 = 0.6972



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Nothing in investment comes close to the predictive power of valuation with respect to future returns. This is profoundly intuitive, even common sense, and all of us use valuation principles in everyday life. But, in the investment world, valuation principles don't always guide investor behaviour. When financial markets lose touch with valuation principles, accidents always happen and crowded trades always blow up. This has happened throughout financial market history and has affected many different assets as diverse as tulip bulbs, property and of course most frequently, equities. Ultimately, the inevitability of a correction in overvaluation is certain. The timing of that correction, unfortunately, is not.

That is why investors get sucked into asset bubbles. Investors lose their perspective on valuation (the fear of missing out), crowd-like behaviour subjugates normal valuation discipline and momentum takes over. Investors rush into stocks that have risen in price and, typically out of those that have fallen, insensitive to valuation. Investors feel safe following these trends and, in the short term, that is likely to be a successful strategy because, by definition, it is being followed by the majority and to stand back from it invites opprobrium. But, in following a valuation insensitive strategy, momentum investors contradict the experience of history and the predictive power of valuation. Chasing over valuation because the majority of investors are doing the same thing condemns that majority to a rude awakening and, more importantly, poor future returns.

It is for this reason that I stick religiously to valuation discipline. It is the only way, in the long term, to insulate investors from permanent capital loss and importantly, to position them to benefit from attractive long-term returns. If you accept, as I do, that valuation discipline should be the foundation of a long-term investment strategy, it is incumbent on a fund manager that pursues such a strategy to explain clearly how valuation is judged. In this, again, I follow what I believe to be a common-sense approach.

The success or failure of most businesses pivots on the things that the business can control (for example the actions of management) and the things that it cannot, for example, the behaviour of the economy in which the business operates, the regulatory landscape and the actions of competitors. It is for these reasons I believe a comprehensive view on valuation can only follow the analysis of a business alongside the economic environment in which it operates. In essence, the micro and the macro.

Taken one step further, it should then become clear why an investment process, founded on a valuation discipline and drawing on corporate and macroeconomic analysis, will drive a fund manager towards certain stocks and away from others.

For example, if a business's future success (as measured by its earnings) requires a level of economic activity that my analysis says is not going to be achieved then, by definition, its valuation is not going to look as appealing to me as it might to another investor who takes a different view. In essence, this is not a scientific process founded on absolute laws. It is a process which has subjective judgements about the future embedded within it. This is difficult, requiring extensive analysis and due diligence but there is no escape from it if one truly believes in a valuation discipline as I do.

There is one other point to make about valuation. It is not one dimensional. The chart above uses the price / earnings ratio (PE) as the proxy for valuation. This may be imperfect, but it is consistently so over time. I am content it is a good proxy for the valuation of public companies and furthermore data on PE ratios goes back a long time.

Having said that though, companies can be judged to be undervalued even when they don't have any earnings, cash flows or pay dividends. We know this from everyday life, of course, (many things have intrinsic value that don't deliver a cash return) but it requires a bit of explanation in a financial market setting. Let me give you a real-life example to illustrate the point.

Valuation case studies: Amazon and Inivata

One of the biggest companies in the world today, Amazon, grew rapidly over a twenty-year period following its IPO in 1997, but it was loss-making for several years and only modestly profitable until relatively recently. Nevertheless, it would be hard to argue that it wasn't an undervalued asset through the early part of this history.

Another example would be a company that we have owned in the Woodford Patient Capital Trust (WPCT) portfolio for about three years. It is called Inivata. It has developed a technology (called liquid biopsy) which we believe will help to transform healthcare and especially cancer treatment in the years ahead. It is a technology, like so many others, that will disrupt incumbents but will also deliver better patient outcomes via quicker, cheaper, less painful and more accurate diagnoses. It is a business we have helped to nurture through its development phase, and it is now commercialising, having recently received a positive reimbursement decision from Medicare for its initial test, a non-trivial task.

Inivata is now clearly on the road to commercialisation and we have high hopes for it. But, is it an undervalued asset, is it cheap? It has as yet, no sales, profits or earnings and it pays no dividends. In our view, however, it is profoundly undervalued. We made this judgement through our own analysis of the business's potential but, by way of proxy, we can compare it with its closest peer in the US, a company called Guardant which has also developed a liquid biopsy test.

Guardant's test was approved about nine months ago and is further ahead than Inivata's but we believe the Guardant test is less sensitive than Inivata's. Either way, it is a directly comparable business. Interestingly, Guardant has a market value of almost $6bn (it is quoted on Nasdaq). Inivata, even after a recent valuation uplift, is valued at only $170m (it is held in our unquoted portfolio). In our judgement, this business is incredibly cheap, but it doesn't fit in the conventional analytical model that looks at valuation through a PE and dividend yield lens.

In this regard, Inivata is similar to many of the smaller businesses we own in the Woodford portfolios. Businesses that we have analysed extensively and in which we have huge confidence but about which, more broadly, there is a lack of knowledge and an abundance of scepticism. I have to do a better job at explaining why these stocks are in our portfolios, how they fit our valuation criteria and why we believe they will deliver very attractive returns to our investors.

Early-stage exposure

On the subject of early-stage businesses, it is clear there is a degree of nervousness about them within our investor base. My colleagues and I need to do more to educate and inform our investors about what these businesses do, why we own them and why we think they will deliver exceptional returns (and why we think they are so undervalued).

As we said on 1 March, our long-term intention is to not have any exposure to unquoted holdings in WEIF. Instead, the fund's exposure to the unquoted asset class will come through listed investment vehicles, such as WPCT. This process is already underway and the fund's exposure to unquoted securities (including those listed on less well-known exchanges where there is little or no trading activity) will decline over the remainder of this year to below 10%.

In some respects, this will naturally decline because many of the largest, less liquid holdings in WEIF are in businesses that we have been nurturing for many years (for example, I first invested in Oxford Nanopore almost a decade ago), and some of these businesses are maturing into companies that are ready for a full stock market listing. Some others are approaching inflection points where new investors are coming onto the register (for example, large overseas institutional investors) and these afford liquidity opportunities that we will be able to take advantage of where appropriate. It is also the case that some of the smaller early-stage companies in the fund have developed so quickly that they will, over the next few months, be launching full IPO processes (typically on Nasdaq).

The combination of all these carefully managed processes will mean that beyond this immediate period, WEIF's exposure to these less liquid holdings will reduce further to significantly below 10% and, over time, to zero. Of course, my interest in these businesses will continue for as long as they remain undervalued, and WEIF investors will be able to benefit from the continued growth in many of them via their full market listings and through WEIF's direct holding in WPCT.

Outlook

Undoubtedly, the past three years have been difficult for our clients. Ultimately, the criticism I receive is driven by performance. Although I have experienced some company-specific disappointments, the fund has underperformed primarily because my valuation strategy has been completely out of step with a momentum-driven market.

As I said earlier, financial markets can for extended periods become detached from valuation fundamentals and whilst they do, fund managers like me appear incapable of delivering good outcomes. However, I hope I have demonstrated to you in this note that, in the end, valuation is what drives share prices and returns in the long run and that is why I remain resolutely focused on my strategy. I know the valuation disciplines deployed in everything I do professionally, and which guide the construction of the portfolios, will deliver the returns investors expect over the medium and long term.

To conclude this investment update, here is a brief outline of what I think will happen in markets over the immediate future and on towards the end of 2019. In the very short term, I believe there will be some important events which may catalyse a shift in broader investment behaviour not just with respect to the UK equity market but in markets across the world.

Although clarity on the interminable Brexit issue may still seem frustratingly distant, I believe that the odds of a softer Brexit have increased substantially as a result of the paralysis in Westminster. A no deal Brexit is now, in my opinion, extremely unlikely. I continue to believe that resolution will ultimately arrive through Theresa May's deal being approved by Parliament (less likely) or a softer Brexit outcome (more likely) involving some form of long-term and close relationship with the EU.

If Brexit pans out as I believe, we will see a long overdue and significant rally in sterling – and this will have a meaningful impact on the UK stock market. It should at last liberate investors to start to acknowledge the underlying robust performance of the UK economy (last month we saw yet another series of strong data from the labour market and better-than-expected strong retail sales) and the profound undervaluation of companies exposed to the UK economy. At the same time these developments will also prompt the market to start to address the significant earnings and valuation risks in parts of the index where investors have significantly increased exposure over the last two years.

As far as the rest of the world is concerned, there are some very significant issues which investors should be paying attention to but aren't, probably because the prospect of a US-China trade deal has got global investors very excited. From here, on that issue, there can only be disappointment. But, more importantly for global equities, slower growth now is the major challenge.

I have been saying for some time now that the world economy would slow and that this will be felt most acutely in Europe, emerging economies and in China. There is evidence that this slowing will continue in 2019. And because the US economy will also grow more slowly this year (under the weight of less fiscal stimulus and the lagged effects of last year's excessive monetary tightening) global growth will slow further in the months ahead.

This, in turn, will quite obviously raise earnings risk against a backdrop of excessive valuation in markets, a potentially dangerous combination. A further headwind for markets, as we approach the summer is a significant deterioration in global US dollar liquidity, which may be the catalyst for a much less benign market environment than that which we have witnessed in the first four months of the year.

In summary, the comfortable consensus view that prevails in equity markets globally is about to be challenged by the issues highlighted in this portfolio update. The rest of the year is going to be very interesting and 2020 maybe even more so.

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