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2016: THE YEAR IN REVIEW

Mitchell Fraser-Jones, 11 January 2017

This time last year we took a look in the rear view mirror to analyse the performance of the CF Woodford Equity Income Fund and the UK stock market as a whole over the course of 2015. Here, we do the same for 2016.

The fund delivered a modestly positive total return in 2016, but fell short of our aspiration to deliver high single digit annualised returns to investors. Clearly, that is a long-term aspiration and this was just one year in a multi-year investment strategy, but nevertheless, for a variety of reasons which we aim to explain below, the fund's performance in 2016 was disappointing.

Importantly, however, we have seen considerable fundamental progress made across much of the portfolio which, given the prevailing market conditions, has not yet been reflected in share prices. You can hear more on this subject in our video of Neil below.

Neil Woodford on 2016 and his 2017 outlook

Neil reflects on why 2016 reminded him of the challenges he faced at the height of the technology bubble as momentum, not valuations, drove share prices – a reason he enters 2017 in a confident and optimistic mood. He also explains how momentum-driven markets test the resolve of active fund managers and their investors but why they always represent the best opportunity to add long-term value.

We have always been clear that the fund is very actively managed and at times, will not look or behave like the broader UK stock market – since launch, investors have seen the benefit of such an active approach but 2016 saw some of the fund's prior outperformance unwind. That said, it's worth spending some time looking at why the fund underperformed the broader FTSE All Share index in 2016.

Much of what we saw in 2016 does not appear to be grounded in fundamentals. In the long run, fundamentals are all that matter for share prices, but over shorter periods, they can be overtaken by other drivers, such as sentiment and momentum. That appears to have been the case in 2016 – as the chart below demonstrates, market leadership has become increasingly concentrated in a handful of stocks, most of them commodity-related.

Now you could argue that the performance of the oil & gas and mining sectors has been justified by fundamentals, given the increase that we have seen in commodity prices over the last twelve months. We are not convinced by that argument, however. Perhaps these sectors (and the commodity prices upon which they depend) fell further than they needed to in 2015 but the recovery since then, in our view, goes way beyond what fundamentals would justify, particularly when you consider that many key commodities remain structurally oversupplied and the global demand outlook is still very poor.

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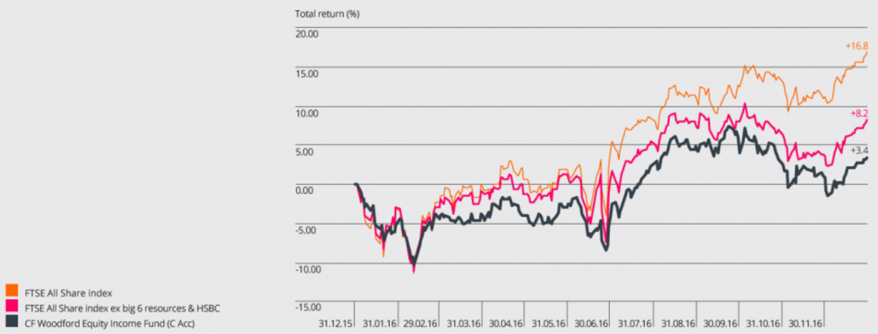
Let's take Royal Dutch Shell, as an example – in sterling terms, the price of its B shares rose by more than 50% in 2016, presumably in response to the recovery in the oil price. However, despite the higher oil price, consensus forecasts for its earnings per share in 2016 declined by 34% as the year progressed. The market clearly chose to ignore these downgrades, but the combination of a higher share price and lower earnings forecasts has led to a more than doubling in its PE ratio, from 12x earnings to 27x earnings in the process (source: Bloomberg on a capital return basis).

This is an extreme example and, obviously, Shell's share price may have responded to many other things besides the outlook for earnings in 2016. Nevertheless, a similar pattern is evident across many other commodity-related stocks and, in aggregate, given the fund's continued absence from these parts of the market, this has been the source of a significant part of the fund's underperformance.

UK stock market leadership was increasingly narrow in 2016
Excluding the big six resource companies and HSBC, the market return was +8.2%, not 16.8%
Source: Bloomberg, Morningstar Direct, Woodford



As the chart above demonstrates, however, the fund did not keep pace with the broader market, even if we strip out the impact of these index heavyweights. The fund's performance has also been impacted by adverse share price performance from some parts of the portfolio – some of this is linked to negative fundamental developments but, importantly, much of it is not.

One stock stands out as a poor performer and it has also been the source of a lot of questions from our investors in recent weeks. Capita was a big position in the portfolio as we entered 2016 and its share price more than halved over the course of the year. A series of disappointing trading updates in the latter part of the year have completely undermined market confidence in the business, and indeed, the credibility of management forecasts.

We have been disappointed and surprised by the apparent vulnerability of Capita to the weak trading in its more cyclical divisions (which are a small part of the overall business). The impact of this trading weakness has been exaggerated by a perception that, as profits have fallen, the company's balance sheet has become stretched.

Management has announced the disposal of its asset services division, which should help to address these balance sheet concerns. Furthermore, we believe the market has over-reacted to the series of profit warnings. In our view, the share price now profoundly undervalues the fundamental long-term attractions of this business. At times like this, it is essential that one does not compound the impact of a fundamental disappointment through an emotional reaction to a share price fall. We recognise that it will take time to rebuild credibility and value at Capita, but we are prepared to be patient.

There were some bright spots elsewhere in the portfolio. Shares in Burford Capital – a young litigation finance business and a great example of the benefits of our patient capital investment approach – more than trebled in 2016, as the market finally started to acknowledge the value that has been created by its impressively astute management team in recent years. Our tobacco holdings also delivered a positive contribution to performance for most of the year, albeit some of this was eroded in the final quarter as the momentum-driven market conditions intensified.

Regular readers of our blog have also asked why we continue to be overweight in healthcare. It's a sector that we believe offers investors an exceptional opportunity not least because of its attractive fundamentals. The industry is becoming more incentivised to bring forward innovative treatments that address the heavy burden of healthcare costs on the economy. As a result, we see a lot of value being stored up in the sector and there are some very promising drugs coming through from the pipelines of both small biotech and large pharma companies. Going forward, as a result of the market's failure to acknowledge this progress over the last eighteen months, it is plausible that value starts to be recognised in the form of more M&A activity in 2017. Consequently, we believe that there is considerable long-term value within the healthcare sector and we have positioned the portfolio to capture this opportunity. We will be writing in more detail on the attractive fundamentals of the healthcare industry in the near future.

In conclusion, despite the challenging market conditions we have witnessed and some surprising political events, nothing we saw last year persuades us that the portfolio should be positioned differently. The narrow momentum-driven rally that we have seen has added risk to certain parts of the market. In particular we continue to avoid the oil & gas and mining sectors where, despite the rally in commodity prices, dividends are still vulnerable and the fundamental backdrop for prices remains weak. This positioning was unhelpful in 2016 but we're convinced it's still appropriate to avoid them.

Instead, the portfolio remains positioned towards attractively-valued businesses with significantly more control over their destiny. This control, generally speaking, has delivered some considerable positive progress in 2016 and this progress will ultimately be reflected in share prices, when fundamentals reassert themselves as the predominant influence of share price behaviour. As such, we look forward to 2017 and the years beyond with great confidence.

	01/01/12 to 31/12/12	01/01/13 to 31/12/13	01/01/14 to 31/12/14	01/01/15 to 31/12/15	01/01/16 to 31/12/16
CF Woodford Equity Income (C Acc)	–	–	–	16.19	3.19
FTSE All Share index	12.30	20.81	1.18	0.98	16.75

Past performance cannot be relied upon as a guide to future performance.
Source: Morningstar Direct on a total return basis, with net income reinvested.

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 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

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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The Woodford Funds (Ireland) ICAV (the "Fund") has appointed as Swiss Representative Oligo Swiss Fund Services SA, Av. Villamont 17, 1005 Lausanne, Switzerland. The Fund's Swiss paying agent is Neue Helvetische Bank AG. All fund documentation including, Prospectus, Key Investor Information Documents, Instrument of Incorporation and financial reports may be obtained free of charge from the Swiss Representative in Lausanne. The place of performance and jurisdiction for all shares distributed in or from Switzerland is at the registered office of the Swiss Representative. Fund prices can be found at www.fundinfo.com.

Woodford Investment Management Ltd is authorised and regulated by the Financial Conduct Authority (firm reference number 745433). Incorporated in England and Wales, company number 10118169. Registered address 9400 Garsington Road, Oxford OX4 2HN.

Woodford Patient Capital Trust plc is incorporated in England and Wales, company number 09405653. Registered as an investment company under section 833 of the Companies Act 2006. Registered address Beaufort House, 51 New North Road, Exeter, EX4 4EP.