EQUITY INCOME FUND UPDATE, JANUARY 2017

Mitchell Fraser-Jones, 16 February 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. The contents of this article are not intended as investment advice and will not be updated after publication unless otherwise stated.

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

The fund may invest in overseas securities and be exposed to currencies other than pound sterling

The fund may invest in unquoted securities, which may be less liquid and more difficult to realise than publicly traded securities

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.

The turning of a calendar year is an important cultural event but it rarely carries such significance for financial markets. Thus, the first few weeks of 2017 saw a continuation of the trends that we saw building in intensity during 2016. The 'reflation trade' remained in full swing in January, thanks to continued (and in our view, misplaced) optimism around President Trump's pro-growth agenda and expectations of another year of resilient growth from China. Against this background, the fund delivered a negative return in January and trailed the broader UK stock market, which was led by parts of the market to which the portfolio has no exposure, such as banks and mining stocks. Within the fund, AstraZeneca was the largest detractor from performance. There were no untoward developments at the company itself. However, rival Bristol-Myers Squibb announced that it would not be seeking accelerated approval for an immuno-oncology combination asset as a new therapy for lung cancer. This has led some analysts to become more concerned about AstraZeneca's Mystic trial, which is investigating the efficacy of a similar asset in the same condition. Whilst this is understandable to an extent, we think the reaction is wrong. Indeed, Bristol-Myers Squibb's problems in this setting may well turn out to be positive for AstraZeneca. As with any ongoing clinical trial, there is a degree of uncertainty about how the Mystic trial will conclude. Arguably, the market has become overly-infatuated with the importance of Mystic to the AstraZeneca investment case. We believe the company is on the right path for a return to growth regardless of the outcome of Mystic. That said, we remain very confident in the potential that exists within AstraZeneca's immuno-oncology pipeline, and are optimistic that Mystic will deliver hard evidence of that when it reads out in the middle of this year. Next also performed poorly after the company issued a profit warning during the month. We have been anticipating a tough trading environment for the company and indeed for all UK retailers, with cost inflation (partly because of sterling's recent devaluation) and the growing threat from online rivals clearly having an impact. These challenges have been causing more of a problem for Next than we had expected, however, but it is important to remember why we own the shares in the portfolio. It is an extremely well-managed, disciplined company with a well-invested asset base and healthy cash generation. Moreover, it returns the vast majority of its free cash flow to its shareholders. These attractions remain in place despite the recent profit warning. The company will be paying a series of special dividends this year and its shares continue to look attractively valued. On a brighter note, the largest positive contribution to returns came from the portfolio's tobacco holdings, with industry consolidation a key theme. British American Tobacco is moving towards crystallising its takeover of Reynolds American, prompting the market to look for the next consolidation target. Imperial Brands is seen as a possible bid candidate, in what will perhaps be the last big deal for an industry that is already highly consolidated. We can see the rationale for such a move but we don't see it as something that is likely to happen imminently. In the meantime, Imperial Brands looks very attractively valued and capable of delivering consistent and sustainable growth. While those attractions remain, it deserves its place as a core holding within the portfolio. Elsewhere, there were notable contributions from Purplebricks and Burford Capital. These are both young, dynamic businesses that are proving highly disruptive in their respective industries. There was no particular news from litigation finance company Burford over the month, but its share price continued to benefit from some of the strategic announcements made in late 2016. Purplebricks, meanwhile, is seeing strong growth in the UK and is ahead of plan in Australia. The market continues to warm to its future growth prospects, with the growing viability of its business model in other territories adding to the company's already significant long-term potential. In terms of portfolio activity, we took advantage of recent share price weakness to increase the positions in Next and AstraZeneca. Additionally, we added to Horizon Discovery, Paypoint and Idex. During the month we also introduced a new, albeit small position in Honeycomb Investment Trust, a UK-based specialist lender focused on consumer and small-to-medium enterprises sectors, both of which continue to be underserved by mainstream lenders. Looking forward, we remain cautious on the outlook for the global economy. We remain sceptical about the notion of imminent 'reflation' which has gripped financial markets in recent months and dominated market behaviour. Previously, we have set out why we are not convinced about the impact that President Trump will have on growth, but we are also concerned about the market's apparent optimism on China. The Chinese economy is slowing, and this is causing problems for the country's authorities. Policymakers are doing what they can to maintain annual GDP growth at around the targeted 6.5% level but, in doing so, the economy has become increasingly dependent on debt. This, we have long believed, has created a credit bubble, which policymakers appear keen to keep going, with various forms of debt repackaging programmes being implemented to disguise the extent of non-performing loans and avoid confronting the issue directly. Last year, this kicking of the can down the road provided enough fuel to ignite market optimism on China's near-term growth prospects but it cannot continue forever. Ultimately, economic fundamentals will have to assert themselves. As long-term investors, we remain concerned about the deflationary consequences of that eventuality. Consequently, we remain focused on businesses that are more in control of their own destiny and capable of delivering growth in the challenging economic environment that we continue to foresee. As such, we are confident that the fund remains well-positioned to deliver attractive long-term returns.