woodford

EXPLORING RISK AND RETURN

Mitchell Fraser-Jones, 13 March 2017

We asked for your help in shaping our content for the launch of the CF Woodford Income Focus Fund and, in response, we've received hundreds of questions and comments. Thank you for sharing these thoughts – they are really helpful and we will be using them in our communications over the next few weeks.

Many of you asked about the anticipated risk characteristics of the new fund and whether this a good time to be launching the fund given market levels. This article looks to address these questions and concerns.

An enduring relationship

The strong link between risk and return is one of the very few enduring relationships in the investment world. Investors that have been prepared to take more risk have ultimately been rewarded with superior long-term returns. This is clearly illustrated by the data below, from the Credit Suisse Global Investment Returns Yearbook 2017, which shows that, since 1900, UK equities have delivered a better annualised return than other asset classes such as Gilts or cash. This excess return from equities has, however, come at the expense of greater volatility.

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	UK equities	UK Gilts	UK cash
Annualised total return	9.2%	5.5%	4.7%
Volatility (standard deviation)	19.6%	13.7%	6.3%

Source: Credit Suisse

Different views on risk

Is it right to think of risk in terms of volatility though? The fund management industry has certainly done so over the years, but we would argue that there is a compelling alternative. As long-term investors, we define risk in absolute terms – as the potential for a permanent loss of capital.

In essence, volatility represents a temporary loss of capital, but we would argue that what should really matter to investors is the concept of a permanent loss of capital – the prospect of crystallising a loss at the point of exiting an investment. This is why we consistently advocate taking a long-term view.

We do not wish to dismiss the concept of volatility completely because the questions we have received show that it is clearly important to many investors, particularly those with a shorter-term investment horizon. The point at which a temporary loss of capital becomes a permanent one will vary from investor to investor but we thought that it would be interesting to see how the prospect of loss changes as an investment horizon extends.

Time in the market

The data below demonstrates that the longer an investor can leave his or her capital invested in the stock market, the lower the risk of a permanent loss of capital becomes. At the same time, the potential for attractive positive returns improves considerably.

Why time matters in the stock market

Time period	Probability of loss	Best performance	Average performance	Worst performance
1 day	44.6%	£10,921	£10,004	£8,891
1 week	43.1%	£11,292	£10,020	£7,817
1 month	37.1%	£11,396	£10,087	£7,354
1 quarter	31.1%	£12,238	£10,261	£7,003
1 year	23.6%	£16,265	£11,073	£6,564
3 years	17.5%	£20,294	£13,327	£6,065
5 years	11.5%	£25,522	£15,931	£7,116
10 years	1.2%	£48,095	£24,438	£9,342

Source: Morningstar Direct using total return data from 31.12.85 to 31.12.16.

Please note: Probability of loss and historic performance ranges for other markets, individual securities or funds will be different. Past performance cannot be relied upon as a guide to future performance.

On any given trading day on the stock market, the risk of loss is not far from 50% – investors might as well be tossing a coin. Extending the investment horizon out to a week, or a month and we can see that the prospect of a loss from UK equities reduces slightly, but is still rather substantial. This is why having a short-term investment horizon makes equities a riskier investment proposition – in the near term, volatility matters.

We have consistently said that investing in equities requires a minimum time horizon of three-to-five years but, realistically, the longer the better. On a 10-year view, for instance, the probability of loss is negligible while the potential returns are significant for those willing to tolerate the volatility. Time is on your side when you take a long-term view.

Why now?

Many investors also appear to be concerned about the timing of the new fund launch, given the elevated level of equity markets at present. We have recently explored the long-term returns that can be delivered by the equity asset class, which will hopefully assuage some of these concerns. However, we believe it is also important to look at the attraction of UK equities relative to other asset classes.

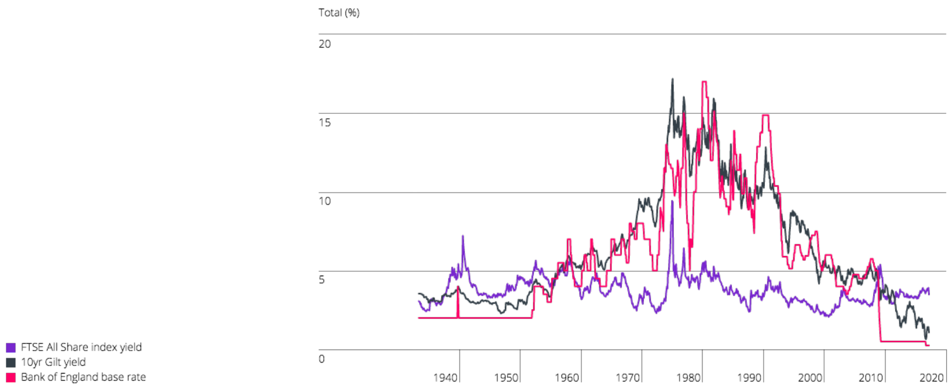
The simplest way to do this is to focus on a critical part of any investment's total return – its yield. Traditionally, investors haven't had to look much further than the banks or building societies for a decent income stream through deposit interest. Those days are over, however, possibly for several years to come. Meanwhile, Gilts (or sovereign bonds more generally) have been another favoured asset class for income investors, but here too, yields have been steadily decreasing for years and, since the financial crisis, have contracted still further, even turning negative in some countries. Yes, that means that investors are effectively paying for the privilege of lending money to their governments!

The 'go-to' asset class

For most of modern history, these other asset classes have been the primary domain of income investors because of the attractive yields they were able to offer. Equities, meanwhile, have tended to have a much lower yield, relying on dividend growth for a greater part of their superior return. In recent years, however, all of that has been turned on its head. The equity market has become, in our view, the go-to asset class for income investors.

As the chart below illustrates, at the end of February 2017, the yield you would have received from UK equities was 3.9% compared to 1.1% from Gilts and a mere 0.25% from depositing cash. From an income perspective, UK equities clearly look the most attractive, especially when you take into account that, at current valuations, holding Gilts to maturity will undoubtedly lead to a permanent loss of capital and, with interest rates likely to remain ultra-low, any return on cash deposits will remain negligible.

Yield from primary UK asset classes over time (%)
Source: Morgan Stanley



As a result of this, many investors have turned to equities for an attractive and sustainable source of income, a trend that we expect to continue. And although this trend has, on the face of it, helped drive equity markets to all-time highs, this clearly has not come at the expense of yield!

Not all dividends were created equal

Some parts of the market have, however, benefited more from this trend than others. And, as a result, there are parts of the market where valuations do look very stretched. This is why it is important to be selective and our focus won't just be on yield. It will be on identifying the most attractively-valued businesses that can sustain their dividends while avoiding those that cannot. By being selective, the CF Woodford Income Focus Fund is looking to deliver an even more attractive income stream than the UK market as whole.

A word on suitability

We believe that the equity market is an appropriate home for income investors – arguably now more than ever before. But that doesn't mean it's an appropriate home for *all* income investors. If investors are concerned about volatility, or have a short-term investment horizon (which we would define as less than three-to-five years), the equity market probably isn't the right answer – and nor is our new fund. But, for those that can tolerate volatility and are prepared to take a long-term view, equities should be a very rewarding investment. With these aspects in mind, our new fund has to be worth a look.

What are the risks?

- The value of investments and any income from them 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 funds may be higher but capital growth may be restricted or capital may be eroded
- The funds may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits – some of these security types could increase the funds' volatility and increase the level of indirect charges to which the funds are exposed
- The funds and trust 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 these investments and the income from them, to fluctuate

- The LF Woodford Income Focus 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 LF Woodford Equity Income Fund and the Woodford Patient Capital Trust 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
- The price of shares in the Woodford Patient Capital Trust is determined by market supply and demand, and this may be different to the net asset value of the trust. This means the price may be volatile in response to changes in demand
- Long-term outcomes are more binary – extremely attractive rewards for success but some businesses will inevitably fail to fulfil their potential and this may expose investors to the risk of capital losses
- Young businesses have a different risk profile to mature blue-chip companies – risks are much more stock-specific, which implies a lower correlation with equity markets and the wider economy – it can take years for young businesses to fulfil their potential, this investment requires patience

Important information

Before investing, you should read the Key Investor Information Document (KIID) for the fund – or Key Information Document (KID) for the trust – 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 Woodford Patient Capital Trust currently intends to conduct its affairs so that its securities can be recommended by IFAs to ordinary retail investors in accordance with the FCA's rules in relation to non-mainstream investment products and intends to continue to do so for the foreseeable future. The securities are excluded from the FCA's restrictions which apply to non-mainstream investment products because they are shares in an investment trust.

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.

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