

Key notes



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HIDDEN ALPHA

Schroder Income Fund, Nick Kirrage – July 2010

Uses value investor approach, valuation is crucial

- Look to see if stock is cheap and then if it has high yield, not the other way around
- Vital to do own in-depth research on stocks, eg look back at 10 years' report and accounts
- Look for stocks with depressed profits with future potential, higher dividends likely
- Does not just look at potential rewards, have to factor in risk against this

Does not believe UK equity income is becoming a high risk sector

- Income concentration is higher than ever
- Danger of managers using biggest stocks to generate yield – big is not safe, eg BP
- Real risk is that of losing clients money. If you focus on this equity income is not high risk
- Invest to protect capital, don't buy stocks at wrong price, avoid value traps

Positive on the banking sector

- Banks yield little today but in future will pay big dividends vs today's share price
- Important to think about future dividend requirements of fund, not just today's
- Banks had 20 year bull run followed by a dreadful 18 months, neither a normalised environment for the sector
- Mid 1980s last time banks in normal environment, compare what they did then to how they are priced today, suggests c100% upside in domestic banks is possible
- In medium to long term there is a chance banks are actually overcapitalised

Income fund has more healthcare and fewer industrials than Recovery fund Kirrage runs

- He likes healthcare stocks: lots of cash, dividends well-covered, have learned not to make poor acquisitions
- Healthcare ideal for income fund as businesses are cheap and have an attractive yield
- Recovery has higher risk tolerance, so focus on stocks with little yield but much greater potential upside, healthcare does not provide these
- Industrial stocks got badly hit in last couple of years and cut dividends
- Tough to buy for Income Fund (they are low liquidity, higher risk, little yield), easier to buy for Recovery for the long-term potential

It is important to balance yield and future growth on an income fund

- If you buy yield alone you will get found out over time
- High income beats the market by about 2%pa over the long term
- 1% of that comes from income, 1% from better capital growth (ie buy the cheap company)

BP has fallen almost 50% from April peak, bought it for Income but not for Recovery

- BP not necessarily really cheap. In last decade has had high Capex spend (to replace existing reserves) vs its free cashflow (which looks good as oil price has been high)
- Recovery Fund looks for stocks with depressed profits and valuations for those profits
- Income Fund has yield requirement and BP can pay its dividend with cashflows it has
- Has BP in Income Fund but does not think it is as attractive as some pharma or telco stocks

2009 Income Fund cut dividend to protect capital value and drive total return

- New environment today with stocks able to improve dividends
- Portfolio includes stocks with no yield that can pay out over 3-4 years
- Stocks that have cut dividends in the past have better profitability, can pay out in future