HARGREAVEHALE

# INVESTMENT BULLETIN

## Marlborough Extra Income Fund

2nd July 2010

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Registered and settlement office: 9-11 Neptune Court, Hallam Way, Blackpool FY4 5LZ
Telephone: +44 (0) 1253 754700, www.hargreave-hale.co.uk
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The emergency Budget that took place on 21st June will produce one of the largest contractions in public sector spending in recent memory. One result of this is that interest rates are going to stay at low levels for longer than initially thought.

For income investors, this environment is forcing a reassessment as to how much risk they are prepared to take in order to achieve a realistic level of income. A year ago it was possible to achieve nearly 4.5% before tax on 2 year fixed rate bank or building society deposits. Today, savers are faced with rates of around 3% for a similar product; a reduction in income of over 30%. Worse still, if inflation is taken into account – 5.1% over the last twelve months as measured by the Retail Price Index – the real value of capital on deposit is being rapidly eroded.

Traditionally, those income investors prepared to take a small amount of risk would move to the bond market, buying Government stock or good quality corporate bonds. This avenue, however, is not of much help at the moment. Treasury 2.75% 2015, for example, trades above its final maturity value and offers a gross yield to maturity of just 1.9%. An A rated corporate bond, BOC 6.5% 2016, trades at 113 and offers a redemption yield of 3.7%. An investor buying the BOC bond would thus face a guaranteed capital loss of over 10% in order to secure an income of 5.7% gross.

It is against this background that we have seen substantial new monies being invested in the Marlborough Extra Income Fund, which we last wrote about in August 2009. Since then, the fund has grown from £4.1m to over £6.3m.

As a brief recap, the Extra Income Fund is a *mixed asset* fund, viz. it invests in different asset classes – fixed interest bonds, preference shares and equities, both UK and overseas. This makes the investment riskier than holdings in bonds alone. The objective is to provide investors with a good level of income combined with the possibility of growth both in income and capital in the long term. The fixed interest corporate bonds and preference shares should provide the fund with a high, stable income and low volatility, whilst the equity element is designed to provide both income and capital growth. Our original target mix was 50/50 fixed interest/equity and we have stayed with this for much of the last year. It has meant that we have underperformed during times of strong equity markets, but outperformed when equities have been weak. At the time of writing, the historic dividend yield on the fund is 5.6% net of tax.

Current Fund Structure

As of 22nd June, the fund had 109 holdings, none of which account for more than 2% of the fund by value. This maximises the level of diversification, something that investors will have to pay increasing attention to in the light of the BP situation. Many equity-only UK income funds have, in the past, held over 6% in BP shares and with the BP dividend now being passed until at least 2011, some funds will be struggling to maintain their yields.

The Extra Income Fund is part of the Equity and Bond IMA sector, which means that it must always have at least 20% in fixed interest bonds. Currently we have a

23% weighting. Most of the bonds we buy are short dated and purchased with the intention of holding them to maturity. Our largest holding is Close Brothers 6.5% 2017 bond, which was purchased as a new issue at par in February 2010. Close Brothers is a FTSE 250 company with a market capitalisation of over £1 billion. The bond is rated at A3 by Moody's, one of the highest bond ratings available.

We do not see bonds as being especially attractive at the moment because of the low level of gross yields, but we will continue to take advantage of any opportunities, such as the Close Brothers issue, as and when they arise.

In order to maintain a high level of income for the fund, we also have approximately 20% in preference shares and PIBS (Permanent Interest Bearing Shares, issued by Building Societies). Exposure to PIBS has been reduced over the last year, despite the high yields on offer, because of concerns over the finances of a number of these institutions. Unlike quoted banks, UK Building Societies cannot raise equity to bolster their balance sheets, which means that they are vulnerable to property related right-offs. Our PIB exposure (3% of the fund) is limited to those Societies which have the strongest balance sheets and our largest position is in the Coventry Building Society PIBS. The Coventry has assets of £18 billion, a Core Tier One capital ratio of 27%, the highest of all the leading societies, and 99% of loans are secured on property or land, with an average Loan-To-Value of 51% (source: Evolution).

Our preference share holdings are spread among 19 companies. Most are *cumulative* which means that if a dividend is suspended, all arrears must be paid before any future payments are made. We have also invested in two Lloyds Banking Group preference shares, the 9.75% and 9.25% issues. These are not currently paying any income as dividends were suspended due to the agreement with the EU on state aid for banks. However, Lloyds can restart payments on these preference shares after February 2012 and assuming these take place, then they will provide a yield for the fund of over 10% based on current share prices. We would anticipate that should dividends be restored, these preference shares will also be trading at significantly higher prices.

Our equity investments account for approximately 58% of the fund and we have over 50 holdings here, in order to diversify the income stream. Although we hold shares in BP, it accounts for just over 1% of the fund by value and we expect to make up the loss of income from this investment elsewhere in the portfolio.

The philosophy underlying the equity portfolio is important. Income investors do not just need a good level of income, they also require some income growth in the long run to counter the effects of inflation. We have shaped the portfolio so that this is achievable. Approximately one third of the equity portfolio yields less than 4.5% and is invested in companies such as Unilever or Diageo, which we feel have the potential to deliver good levels of dividend growth over the medium term. A typical holding in this section would be Halma, a leading UK engineering company and a component of the FTSE 250. Halma is a specialist engineering company with businesses in 20 countries – most of its sales are generated outside the UK - so that it has been a beneficiary of the fall in Sterling. Many of its products are based on hazard detection and are therefore driven by changes in legislation. It is, for example, one the largest manufacturers of smoke alarms worldwide. There is net cash on the balance sheet and the company has, for 31

consecutive years, delivered dividend growth of over 5% per year (source: company). Although the current yield on the shares is not high – just over 3% - we are confident that this type of holding will contribute to a rising income stream for the fund in future years.

We have also recently raised our weightings in the Water industry, following the 2010 – 2015 pricing review by the regulator OFWAT. Although the outcome of the review was tough, most companies believe they can provide continued dividend growth over the review period. The sector is also useful as an inflation hedge, since revenues are agreed with the Regulator through a formula which links prices to changes in the Retail Price Index (RPI). Our largest holding is Northumbrian Water, which has recently indicated that it expects to deliver dividend growth of 3% per annum above the RPI over the next five years. Although the share price has risen and is currently being buoyed by bid speculation, we continue to hold the stock as we like the longer term fundamentals.

In summary, we hope that the fund continues to find favour as a halfway house between cash deposits and equity investments. Our mix remains cautious but the balance held in equities should be sufficient to provide holders with longer term income growth and some capital appreciation, without exposing investors to too much volatility. That said, investors need to be aware of the differing risks relating to our holdings in fixed income securities (issuer default, rising base rates, market liquidity, etc) as well as the risks of investing in equities where returns are heavily influenced by market sentiment and corporate profitability.

We have shaped the portfolio so that the emphasis has been on the quality of holdings and sustainability of returns. This is very important given the current economic and investment environment. If you are interested in investing in the fund, or would like further information, please contact your usual Adviser.

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| Performance of a Lump Sum Investment, % Change, Bid-Bid prices, GBP, for a Basic Rate Tax Payer | | | | | |
|---|---|---|---|---|---|
| UK Registered Investment Funds | 01/07/2009 | 01/07/2008 | 02/07/2007 | 03/07/2006 | 01/07/2005 |
| | 01/07/2010 | 01/07/2009 | 01/07/2008 | 02/07/2007 | 03/07/2006 |
| Marlborough Extra Income | 16.88 | -14.04 | -15.62 | 11.68 | 10.27 |

**Nigel Beidas**
**Investment Manager July 2010**

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# Office Network


**Registered Office:** 9-11 Neptune Court,
Hallam Way,
Blackpool FY5 4LZ
Tel: 01253 754700

**London:** Accurist House,
44 Baker Street,
London W1U 7AL
Tel: 020 7009 4900

**Blackpool:** Marsden House,
4-10 Springfield Road,
Blackpool FY1 1QW
Tel: 01253 621575

**Lancaster:** 25 Brock Street
Lancaster LA1 1UR
Tel: 01524 541560

**Bangor:** 2nd Floor,
30 Dean Street, Bangor
Gwynedd LL57 1UR
Tel: 01248 353242

**Worcester:** Virginia House,
The Butts,
Worcester,
Worcestershire, WR1 3PL
Tel: 01905 723551

**Carlisle**: 10b Clifford Court
Cooper Way
Parkhouse, Carlisle
Cumbria CA3 0JG
Tel: 01228 515224

**Direct Deal:** Virginia House,
The Butts,
Worcester, Worcestershire,
WR1 3PL
Tel: 08457 423325

**Email**: bulletin@hargreave-hale.co.uk


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