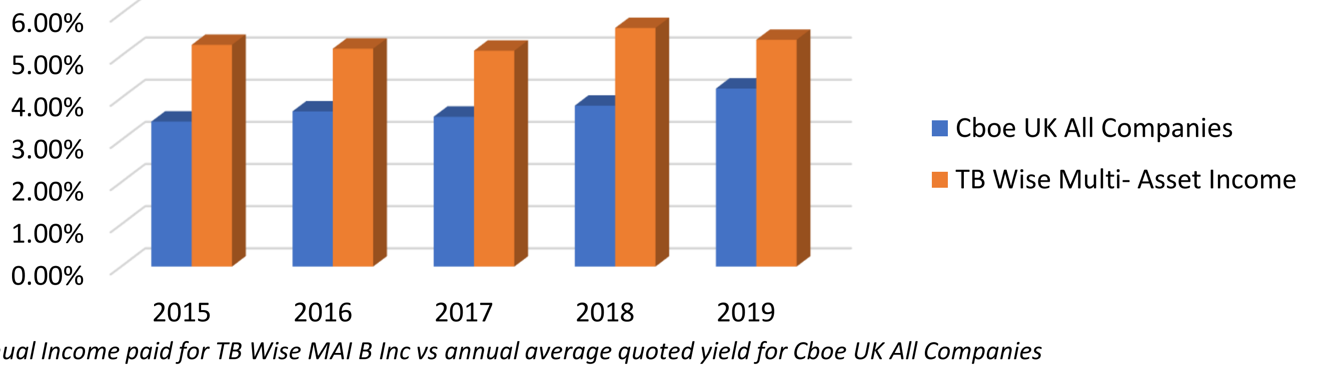
WISE FUNDS

Our approach to dividend income in the aftermath of the Covid-19 crisis

Tony Yarrow – June 2020

TB Wise Multi-Asset Income (MAI) was launched in October 2005. Fifteen years after its launch, the fund retains its three original objectives. These are:

- To pay a yield in excess of the target benchmark, the Cboe UK All Companies Index.
- To increase the fund's income payments in line with or better than the rate of inflation (CPI) over the medium to long term (rolling 5 year periods).
- To increase the fund's capital value in line with or better than the rate of inflation (CPI) over the medium to long term (rolling 5 year periods).



Annual Income paid for TB Wise MAI B Inc vs annual average quoted yield for Cboe UK All Companies
Source: Factset 31 May 2020

At the beginning of February this year, fourteen and a half years into the project, we had consistently succeeded in the first of these objectives, and despite a considerable setback in the 2007-9 crisis, were ahead of the second one. We were behind our capital return objective, owing to the number and size of financial crises which have afflicted the financial markets during this period. The compensating factor was that the assets in which the fund was invested were unusually cheap and it appeared that, following the General Election, we had entered a period of strong price recovery.

Covid-19 presented the managers of MAI with a double challenge – as the crisis developed, we saw an unprecedented collapse in asset prices, followed by an equally unprecedented cutting of dividend payments, the majority of which were removed entirely until further notice, rather than partially reduced. The situation was like a re-run of the Global crisis of 2007-9 but this time telescoped into a period of three weeks rather than 21 months, at a time when our visibility on how events might unfold was as limited as it had ever been.

The fund's value was down by almost 40% and its income yield by more than half. It would have been tempting to restore the fund's payments by disposing of all the newly non-dividend-paying holdings and replacing them with assets which continued to pay income. In doing so, we would have boosted the fund's first aim, while permanently impairing the other two. Most high-yielding assets in the current environment will not increase their payments over time, nor do they offer any meaningful potential for capital gain. Also, there was a palpable air of panic in the market during March and early April, and we were reluctant to sell what we knew were good assets at distressed prices.

It is important to stress the extraordinary nature of these dividend cuts. Three months ago, the fund lost more dividend income in the space of three weeks than in the whole of the 2007-9 crisis. Companies take pride in holding their dividends through difficult times. Funds and companies with long histories of held or increased dividends are quite rightly revered.

Suddenly these values were turned upside down, and the payment of dividends came to be seen as somehow reckless and irresponsible. The FCA placed a veto on dividend payments by the banks, and warned insurance companies to think long and hard about their responsibilities to the community before paying dividends to their shareholders. In this environment, passing dividends becomes the default option, whether to do so is necessary or not.

The glaring irony in all this is that the group of people most damaged by the suspension of dividends is the very same group of often vulnerable older people that government policy is intended to shield.

We wonder how this will all look in six months' time. Already, the market has begun to reward those companies which have bravely held their dividends and can be seen to afford them. Perhaps these companies will regain the moral high ground, and pressure will grow for the me-too dividend-cutters to do the right thing by their long-suffering shareholders. Like much else, this remains to be seen, but we wonder whether in its guidance on dividends, as well as in its encouragement of tenants not to pay their rent, the Government's thinking will turn out to have been as muddled as it has been in other aspects of the crisis.

It rapidly became clear that there were differing motives behind the wave of dividend cuts. Some companies cut dividends because they were no longer able to pay them. Others did so because, though they were able to pay, there was so little clarity on the outlook for their businesses that it felt prudent to conserve cash in all possible ways. Banks cut dividends because their regulator required them to do so, and insurance companies because their regulator strongly advised them to.

We have been greatly helped by the fact that the majority of the funds in which we invest carry dividend reserves for precisely such an eventuality as this crisis and are willing to use them. We are encouraged by the high priority these managers give to maintaining their dividends and to re-positioning their portfolios accordingly. We could see that among the dividend-cutters, some would return soon, while others would take longer, and others again might not return at all.

It soon became clear that the crisis would hit some sectors of the economy particularly hard, while bypassing others and positively benefitting yet others. We could see that certain holdings in areas such as leisure and hospitality were unlikely to be able to pay dividends again in the foreseeable future and would have to be sold.
The fund has always had an unofficial policy not to hold an asset in the portfolio unless it paid a meaningful dividend. However, it feels right to suspend this approach for the duration of the current crisis, as not to do so would limit the potential for price normalisation in mispriced assets.

The Covid-19 crisis is unusual in many ways. The current recession has not been provoked by financial excesses as so often in the past, but by an entirely exogenous, non-economic development. The speed of the recession and its extent are unparalleled, as has been the response by governments and central banks around the world. We are only in the very early stages of understanding what is happening around us. We are learning all the time.

In the midst of this crisis, we see several positive signs.

- The willingness of monetary authorities to do 'all it takes' and the ability of governments to borrow unlimited sums and be paid to do so, add to the credibility of the response.
- The fact that companies have been dealt such a sudden and painful blow has caused them to take drastic action which suggests that the survivors will emerge from the crisis leaner, more productive, and most likely, more profitable than before.
- Despite the high level of concern in this country over the timing and extent of the unwind, there has not been a significant 'second wave' anywhere else, not even in countries that are many weeks ahead of the UK in the unwind process.

The crisis has not ended the tendency of expensive assets to become more expensive, and cheap ones cheaper. The result is that the opportunity set for value managers such as us has rarely been more appealing.

We look at our dividend benchmark index as a reference point rather than as an anchor. In the past, the fund's yield has been as much as 50% higher than that of its benchmark. The benchmark yield has been substantially reduced by the withdrawal of the banks together with such dividend stalwarts as BT and Shell, while the dividends of others such as BP look vulnerable. Our aim as managers remains to maximise the fund's dividend income without sacrificing the quality that produces the income growth and capital growth that remain our core aims.

The rest of this blog will explain the changes we have made to the portfolio since the onset of the crisis in March, and the fund's current positioning.

Portfolio changes since the start of March

We have reduced our exposure in the consumer facing sector from 11% of the fund to 5%, reflecting the companies' lowered ability to pay future dividends. We exited all of our below positions:

Photo-Me

The company's business model is to earn revenue from machines installed in high-footfall areas, such as railway stations and supermarket car parks. The original division, still the largest, is photo-booths. The company has diversified into laundries, printing, and recently fruit-juice machines. We were attracted by the company's strong balance sheet, experienced management and high levels of cash generation. Photo-me will be affected by the reduction in footfall everywhere, together with a drop-off in passport applications as fewer people travel abroad. Longer-term, we had become concerned about the potential threat to the company should other governments follow the UK's example and allow applicants to use selfies in their passport applications.

PZ Cussons

The global washing & beauty products business had been overshadowed by issues in Nigeria. These have proved intractable and have been exacerbated by government policy. PZ Cussons make Carex and other cleansing products, which boosted the share price in March and gave us an opportunity to sell into share price strength in the early part of the crisis.

MARSTON'S

Marstons is fundamentally a well-run company, with a market-leading brewing business, but carries a high level of debt incurred in constructing its portfolio of 1500 UK pubs. The company has experienced a number of headwinds in recent years – sterling weakness, high business rates, the National Living Wage and increased competition in the casual dining market. Lockdown hits pubs and restaurants especially hard, and we were unable to see Marstons returning to the dividend list in the foreseeable future. Following our sale, the share price has recovered when the company merged its brewing business with Carlsberg's. We are pleased that the company has done that deal, but feel the decision to sell was still the right one - the company was too risky to merit a place in the portfolio in today's harsher climate.

Lookers plc

We held the company's shares for its assets, which are worth several times more than the company's market value, and for the prospect of recovery in the UK car market after the election, following several years of weakness. However, on top of an ongoing FCA investigation into the company's selling practices, an accounting fraud was discovered, which made the shares un-investable. Following our full disposal, the company has announced that it is unlikely to be able to publish its accounts by the deadline at the end of this month, at which point the shares will be suspended, and the company's auditors have announced their resignation.

We have also exited our positions in the following companies.

Morgan Sindall is an excellent company, in which we expect to re-invest in due course. We sold the holding to raise cash following a good run – we had re-bought the shares well on weakness before the Election. We are a bit concerned about the company's positioning in the construction market coming out of the crisis. Recovery in the sector is likely to be led by government spending, whereas Morgan Sindall's main customers are companies, which may prefer to conserve capital than invest it in construction projects.

The crisis has hit BT in several ways. The company's decision to withdraw its engineers from the field is both caring and responsible but is impairing revenues in Openreach. BT loses from the absence of Premier League football. Perhaps most damaging of all, lower-for-longer interest rates will weigh on the discount rate used to calculate the balance between BT's pension fund's assets and liabilities, causing the pension deficit to spike, and more cash to be diverted into the pension fund and away from productive investment.

BT has capable management now and is a solid business at its core. However, for inclusion in the MAI portfolio today an asset has to fall into one of three categories, and BT doesn't quite fit into any of them. The categories are:

- it pays an attractive dividend which we believe can be sustained and in due course grown
- it doesn't pay a dividend at the moment but is likely to do so in the near future or
- it is so completely mispriced that there is a strong chance of an early re-rating.
- These categories will be examined in more detail in the next section.

New holdings

The fund’s two new holdings offer us high initial income yields with the prospect of capital growth.

Twenty-four Income fund**.** An investment trust investing in asset-backed loans in the UK and continental Europe, managed by a specialist boutique, and with an impressively low rate of defaults in the 2007-9 financial crisis. This trust, which had been on our ‘watch list’, sold off with other ‘risk assets’ in March, and we were able to buy it on a dividend yield above 7.0% and at a discount to its net asset value which itself had fallen substantially from pre-Covid 19 levels.

Provident Financial is known as a Home Collected Credit (HCC) company which has branched into consumer credit through Vanquis Bank and car loans via Moneybarn. Several years ago an attempt to digitalise the doorstep-lending transaction process, while at the same time moving the agents from self-employment to a salaried basis was badly mishandled, resulting in a mass of exodus of (mainly) the highest -paid agents and a mountain of uncollectable debt. At the same time the company experienced several regulatory issues. The share price collapsed. This debacle was one factor in the downfall of some of the best known UK Equity Income managers, whose funds were among the largest investors, and were forced to sell the shares to meet ongoing redemptions.

Under new management, the IT issues have been fixed, the HCC division re-launched, and the regulatory issues worked through to the FCA’s satisfaction. 2020 is the year in which HCC was forecast to return to profit, while the other divisions were trading strongly, and costs had been cut throughout the business.

Then Covid-19 emerged, and the shares collapsed again, on the basis that home collection becomes impossible during lockdown, and the debt built up soon becomes uncollectable. Covid-19 has created major challenges for Provident Financial but the company has reported that they have been able to collect a remarkable 80% of their HCC payments remotely, that defaults in their other divisions have remained at low levels, and that they have around £600m of financial headroom. The shares have already recovered by over 50% from their early April low point.

The work we have done on Provident Financial over the last two years supports the business case for the corporate bond, which we acquired on a yield of 8.1% per annum. If Provident Financial, a regulated bank with a high level of regulatory capital, remains in business for another three years, the company will redeem the loan at a price 21% higher than what we paid for it.

We believe that these two new holdings will help to plug the fund’s income gap while other sources of income are recovering. In addition, we do not sacrifice the prospect of capital returns in the process.

We have also made a some changes to some of the positions in the portfolio. These are highlighted below

European Assets Trust **-** This trust invests in the shares of high-quality companies in continental Europe and is a useful diversifier for MAI. Each year's dividend is a pre-announced percentage of the fund's net asset value at the end of the previous year. The board has reiterated its commitment to pay the current year's dividend, which equates to 7.2% of the current share price.

Princess Private Equity **-** The Princess trust invests in private equity, primarily in continental Europe, but also in the Americas. It has been in MAI for over a decade and has been a rich source of dividend income and capital returns.

Like EAT, PEY pays a dividend which is based on a proportion of its net assets, which is paid twice a year. The company has passed 2020's first dividend but has stated that during the year it will pay a dividend at least equal to the second dividend, indicating that the missed dividend may have been a one-off. Meanwhile, the trust is trading at a discount of 24% to a net asset value which was significantly written down at the end of March to reflect current economic and market conditions.

Property Sector **-** This crisis has created a harsh environment for landlords, particularly in the retail sector. MAI holds three REITs, British Land and the much smaller Ediston Property and Palace Capital. All three companies have reported independently that they have been collecting around 70% of due rents, and that they view the bulk of the un-collected rent as deferred rather than lost. Ediston has reduced its dividend payment to reflect the rent collected, while the other two have passed dividends. However, their REIT status obliges them to pay out 90% of income collected, so they must return to the dividend list soon, and we added to **British Land around its low point in early April.**

Ecofin Global Utilities & Infrastructure Trust **-** We added to this holding for its defensiveness and reliable dividends.

Trifast - A small top-up in a holding which has significant growth opportunities in interesting niches, and appears to be substantially mispriced.

MAI Portfolio Dividends

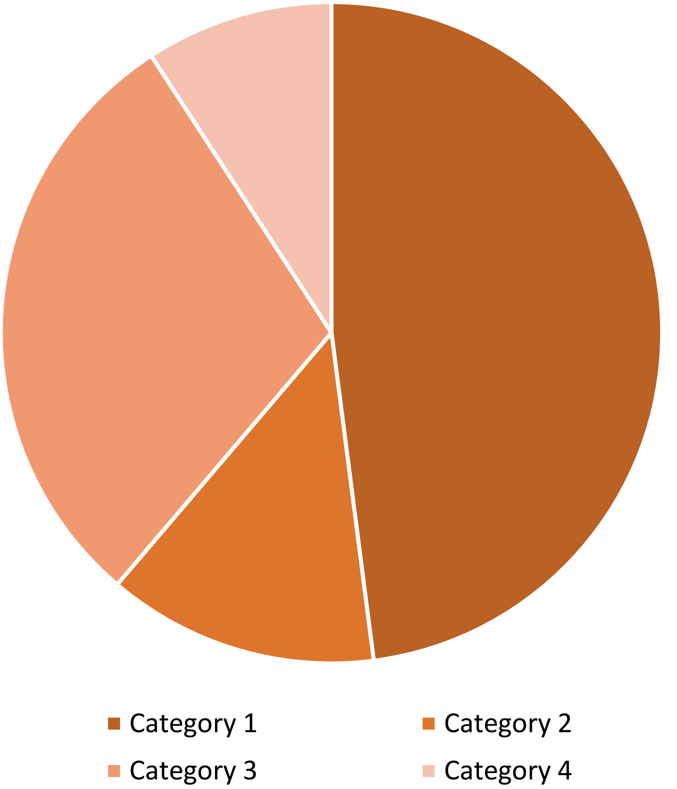
The situation is highly fluid and is evolving continually. We aim to be responsive to every opportunity to rebuild the fund's income payments from their current level.

We sub-divide the fund into four categories

1. **Holdings paying an unchanged or increasing dividend (47%)**
   Aberdeen Asian Income, European Assets, 24 Income, Provident Financial 7.0% 2023, Murray International, Middlefield Canadian Trust, Blackrock World Mining, Rio Tinto, Ecofin Global, Legal & General, Numis, Chesnara, Randall & Quilter (current dividend being paid in bonus shares, cash thereafter).

2. **Holdings paying a reduced dividend (13%)**
   Ediston Property, Henry Boot, Polar Capital, Princess Private Equity

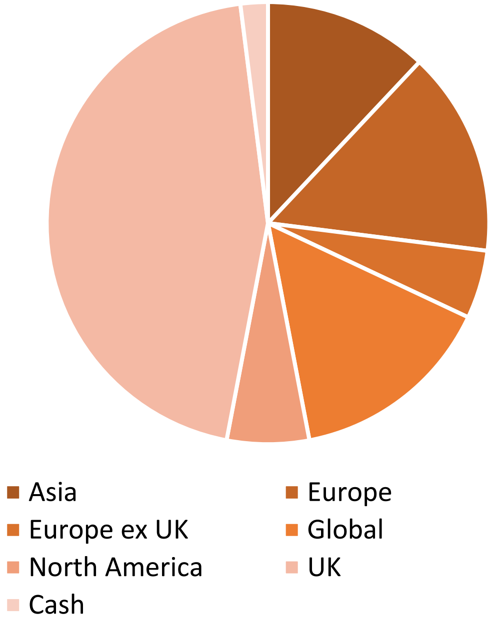
3. **Holdings where we expect an early return to dividend payments, though possibly/probably not at their original level (29%)**
   Sthree, Page Group, Alliance Pharma, Palace Capital, British Land, Taylor Wimpey, Watkin Jones, Aviva, Paragon, XP Power, Volution, Bakkavor, New River REIT, Standard Chartered, Royal Bank of Scotland.



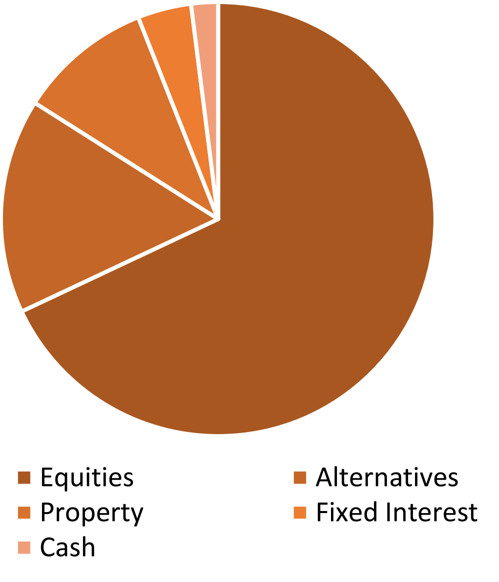
4. **Holdings where we don't expect an early return to dividends but which we believe to be significantly undervalued and are holding for recovery (9%)**
   Easy Jet, Provident Financial, Ricardo, RPS, Shoe Zone, U & I, Morses Club, Elementis, Trifast

Current Asset Allocation breakdown as of the 31st May 2020.

Geographical Breakdown



Asset Type



Source: Wise Funds 31 May 2020

The Dash to trash

Investors may remember the ‘dash to trash’ of March to September 2009. This was a violent re-rating in the shares of companies which experts had predicted would not survive the recession, and was so named by journalists and those fund managers (the majority) who were not participating in it.

We are witnessing a similar re-rating today. Markets have moved on from the blind panic of late March. Companies have made necessary adjustments to their finances and cost bases and many now appear well placed to survive. The mortal danger is passing, and markets have begun to adjust. In many cases, this adjustment could involve a re-rating of 50-200%. If this appears over-optimistic, it is worth bearing in mind that the price of shares in portfolio holding Elementis has already risen by 335% from the low point on March 15th.

We continually examine the MAI portfolio in the light of market changes. We are value investors, and it is not our custom to hang on to assets once they have reached a full valuation. At the time of writing, we consider that 5% of the portfolio is around fair value. The other 95% remains undervalued.

Summary

TB Wise Multi-Asset Income exists to pay dividends to its investors. This has been our focus throughout the crisis-strewn period of 15 years since the fund was launched, and it remains our priority today. As the situation evolves, we continue working towards a portfolio of fully dividend-paying funds and companies, managed by teams who are as committed to the generation and payment of dividends as we are ourselves. We acknowledge that the last three years, and particularly the last one, have been extremely disappointing, and we thank our loyal investors for your continuing support.

Tony Yarrow

June 11th 2020

Please note – this blog is not intended as financial or investment advice and is not an inducement to buy or sell financial assets.

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