WISE FUNDS

TB Wise Multi-Asset Income
Investment Review – Annual report
April 2020

Market background

This annual report covers the year ending the 29th February 2020. Since then the impact of Covid-19 has altered our lives in ways unimaginable two months earlier. The global nature of the pandemic and the social distancing measures taken to mitigate its spread have had a dramatic impact on the operating outlook for businesses across all sectors of the economy. The response of central bankers and governments to support jobs through this crisis has been unprecedented in both size and speed, yet at this point in time it remains unclear how long the present global lockdown will persist and the economic damage that it will cause. The period under review does not capture the magnitude of recent market moves and in many ways this commentary has been superseded by current events. We have, therefore, added to this report comments covering Covid-19, its impact on the dividend prospects for the fund and how we have been repositioning the portfolio in response.

Entering the year, markets were focussed on the outlook for economic growth and the ability of central bankers to steer a path for interest rates that kept inflation under control but was not too tight as to choke global growth. At 10 years, the US economic cycle represented the longest expansion in history and the sell-off at the end of 2018 reflected concerns that the US Federal Reserve looked set to tighten monetary policy too far and thereby would tip the economy into recession. Initially this period under review enjoyed the tail-end of a market rally as investors responded to the Fed commentary that it was ready to respond to market conditions and would keep interest rates on hold. In addition, there was optimism that trade talks between China and the US would be resolved in advance of the US election this year.

The period from May 2019 to the end of August 2019, however, saw a distinct reversal in investor sentiment as global economic data deteriorated, especially in manufacturing sectors of the economy, and it became clear that the absence of inflationary pressures that had previously comforted investors was in fact a sign that economic activity had slowed. The yield curve (a line that plots interest rates of bonds, usually US Treasuries, with equal credit quality but differing maturity dates and which is normally upward sloping) inverted and became downward sloping - historically a reliable warning that a recession lies ahead as investors are expecting interest rates to decrease - and a mood of caution descended on markets. The US economy, stimulated by tax cuts, had performed well but was showing signs of slowing whilst the Chinese economy suffered as it became clear that industrial demand was being impacted by increased trade tariffs. European manufacturing surveys came in well below expectations, with new orders falling at the fastest rate for 7 years.

Against this weaker economic backdrop, the political climate also soured, particularly for domestic UK investors where Brexit negotiations and the prospect of any parliamentary consensus seemed to have reached a state of paralysis. Investor concern at the prospect of a disorderly exit from the EU increased with the election of Boris Johnson as leader of the Conservative party and fears mounted of an anti no deal Corbyn-led coalition with a policy agenda to nationalise certain sectors of the economy. Sterling fell to levels not seen since the Brexit vote in 2016.

On the global front, any hope that a US-China trade deal might be agreed unravelled in early August as President Trump imposed 10% tariffs on a further $300bn of Chinese imports, which compounded already febrile investor sentiment.

Against this backdrop there was an abrupt reversal of the direction of global monetary policy. The US had been on a tightening cycle since 2016. However, the Federal reserve cut interest rates three times, by 0.75%, in response to the weakness of the global economy. All other major economies have followed a similar path to looser monetary policy. However, these cuts were accompanied by statements from Jerome Powell and Mario Draghi, highlighting that there was a limit to what central bankers could achieve and that a more effective way to stimulate the economy would be to loosen fiscal policy. The effectiveness of QE and zero-interest rate policy was increasingly debated and signs grew that governments were moving away from a decade of austerity and looking to take advantage of historically low interest rates to jump start economic growth.

From a market standpoint, August 2019 marked a turning point. The extent of negative investor sentiment at that point was best reflected in the US 10-year government bond yield which fell to levels not seen since the Financial crisis of 2008. Whilst the published economic data continued to remain weak throughout the course of 2019, investors were cheered by the response of central bankers and there was a marked improvement politically in the second half of the period. Domestically, the election of Boris Johnson heralded a marked shift in fiscal policy with the era of austerity consigned to history and increased commitments to government spending presaging an upcoming general election. Furthermore, the political stalemate regarding Brexit was broken as unexpectedly the government agreed a Brexit deal that satisfied both the European Research Group Brexiteer wing of the Conservative party and the EU. Fears receded, therefore, that a disorderly Brexit outcome was unavoidable. The landslide Conservative party majority in December's General Election further buoyed a strong recovery in domestic equities, which had languished at extremely low valuations since the announcement of the referendum result in 2016. Internationally, the political clouds also lifted with the US and China. On the same day as the UK election the US agreed to a limited tariff rollback, reducing the tariffs on $120bn of goods from 15% to 7.5%. In return, China agreed to increase purchases of US agricultural products by $32bn over two years, and other US goods and services by at least $200 billion over the same timeframe. China also agreed to implement greater intellectual property protections and end the practice of forced technology transfer. This helped justify the strength in cyclical shares which were further boosted by corporate commentary suggesting that earnings weakness had troughed.

Entering the new year, the prospects for growth appeared to be improving. Whilst backward-looking economic data remained relatively weak and cautious comments from the Governor of the Bank of England increased the likelihood of a cut in interest rates, there was mounting evidence that the market's optimism following the UK election result was translating into a tangible 'Boris Bounce' economically, particularly in the housing market. The appearance of Coronavirus in China, however, impacted Emerging Market shares and cyclical businesses, particularly those with manufacturing supply chains that were affected by cities being quarantined or where changes in consumer behaviour impacted demand. Initial hopes that Covid-19 would follow the same trajectory as the SARS epidemic proved wrong and the sharp sell-off in risk assets in February set the tone for the current market volatility and steep falls witnessed in all risk assets.

Performance

The performance of the fund can best be separated into three distinct periods. The first six months of the year the performance of the fund was disappointing with the fund generating a total return of -3.1% (B Income Shares). Over this time, the fund underperformed both target benchmarks, the CBOE UK All-Companies Index, which rose 3.8%, and the Consumer Price Index, up 1.5%. The fund also underperformed the comparator benchmark, the IA Flexible Investment Sector, up 6.4%. As described above, the economic weakness and political backdrop drove investors to a position of extreme risk aversion. Relative to our peer group, our lack of exposure to US equities, bonds and gold proved costly. We were unwilling to relinquish the clear value process that underpins the portfolio and consequently we have avoided the former two areas on valuation grounds whilst gold, as a non-yielding asset acts as significant headwind to our performance objective to deliver a yield for the fund in excess of the CBOE UK All-Companies Index. In an environment of economic uncertainty investors were primarily attracted by growth and predictability of earnings whilst valuation was a secondary consideration, which left them vulnerable should any improvement in pessimistic forecasts for global growth materialise. Our underweight exposure to these highly rated, defensive sectors, such as beverages, healthcare, pharmaceuticals, personal goods and food producers, negatively impacted performance. Conversely, performance was further hurt by our overweight exposure to property and financials, particularly life insurance, where Brexit related concerns and low bond yields left sectors trading on exceptionally low valuations. Finally, some stock specific disappointments (McColls, Lookers, Kier and ShoeZone) compounded what was a difficult market backdrop. The extent of risk aversion at this point was particularly evident in global bond markets, a large proportion of which were priced at levels that guaranteed investors would lose money should they hold those bonds to maturity.

TB Wise Multi-Asset Income has a wide and flexible remit allowing us to invest across the broadest range of assets, in whatever proportions we believe is appropriate. Given the extreme valuation opportunity available in a relatively narrow set of assets (broadly cyclical and domestic equities as well as property) and the unattractiveness of safer assets such as bonds, portfolio positioning provided limited downside protection during this period. We highlighted at that time that we felt there were significant opportunities to invest in attractive higher yielding assets where those yields could grow but the trade-off was a willingness to embrace risk, whether that was Brexit-related risk or by investing in more cyclical, international businesses being hit by the US-China trade impasse. We wrote at the time that, whilst sticking to our valuation discipline had been painful, we remained confident that there was a high level of value inherent in the portfolio and that a number of catalysts existed to reverse the underperformance. In particular, we cited the significant value that we felt existed in domestic UK equities, where uncertainty over the terms and timing of our departure from the EU has seen these companies trade at an obvious valuation discount since 2016.

This conviction positioned the portfolio well during the second phase of market performance, driven by the political developments around Brexit, the General Election and the softening of global trade tensions. From the end of August to the end of December 2019 the fund generated a total return of 16.7% (B Income Shares) significantly outperforming the CBOE UK All Companies Index, up 7.6%, the Consumer Price Index, up 0.1%, and the comparator benchmark, the IA Flexible Investment Sector which rose 3.5%. Financial holdings, such as Legal & General, Royal Bank of Scotland, Numis, Chesnara and Aviva all made significant contributions to fund performance. Construction exposed stocks, such as Henry Boot, Galliford Try, Morgan Sindall and Polypipe all rose strongly as expectations of increased activity grew. Property stocks, such as British Land, NewRiver REIT, Palace Capital and U&I, which had been under pressure given the weakness in domestic consumer spending and lack of investment activity, also performed well.

Consumer facing companies, such as ShoeZone and Easyjet, responded well to Brexit news flow and the clear electoral result, as did BT, Ecofin Global Utilities and Infrastructure, and Pennon – given the risk of asset nationalisation had receded. Domestic stocks also helped relative performance given the strong bounce in sterling over the period. Our international, cylical and financial stocks as well as fund holdings benefitted from the improved global economic outlook that accompanied the trade deal. The strength in performance over this period meant the fund more than made up the weakness in performance in the first 6 months, with the fund delivering a total return in the 10 months to 31 December 2019 of 13.0% compared to 11.7% for the CBOE UK All Companies Index, 1.6% for the UK Consumer Price Index and 10.2% for the IA Flexible sector.

The final period of performance covers the period from the end of December 2019 and the main theme was the emerging impact of Covid-19 that drove markets down in February 2020 and which led to further falls in March and uncertainty which has continued into current months. The performance of the fund sharply reversed in February as hopes that the impact of Coronavirus might be contained to China were dashed and cases spread globally. The bear market that has spanned the fund's year end has been the fastest and broadest bear market in history as large parts of the global economy have been bought to a standstill. The full economic impact of the virus remains uncertain as long as the duration of global lockdowns and extended social distancing measures remain in place. However, these will certainly lead to a deep global recession and rising unemployment. Until a vaccine is in place or evidence that a second wave of new cases does not materialise as restrictions are relaxed, we would expect markets to remain volatile. The market reaction during this period has followed a similar pattern to other recent macro-economic shocks. Bond markets have risen, 'bond proxies', such as Infrastructure funds, have held up whilst stock markets have fallen sharply. 'Value' sectors, to which the fund was heavily exposed given our expectations of a gradual improvement in economic sentiment outlined above, have performed worse than the overall market. This is particularly disappointing as 'value' was already trading at an unprecedently wide discount to the rest of the market and had just begun a long-awaited revival before coronavirus appeared.

Performance for the fund over this period has been particularly disappointing and this has continued into the present period. From December 2019 to the end of February 2020 the fund fell 14.3% compared to a fall of 12.4% for the CBOE UK All Companies Index, a rise of 0.1% for the UK Consumer Price Index, and a fall of 5.1% for the IA Flexible sector.

The cumulative effect impact of all three distinct periods has been one of disappointing total returns for unit holders and one in which the fund underperformed both target benchmarks. Over the 12 months to the 28th February 2020 the fund delivered a total return of -3.1% compared to a fall of 2.1% for the CBOE UK All Companies Index and a rise of 1.69% for the UK Consumer Price Index. The Fund also underperformed the IA Flexible sector, which delivered a total return of 4.5% over the period. The graph on the next page illustrates the performance over a 5 year period.

Furthermore, the global pandemic is having a significant impact on the dividend prospects of the fund which we discuss below. We recognise that the events unfolding globally will take a significant economic toll and the prospects for a number of our holdings at year end have altered dramatically. We are being considered in our approach to portfolio changes, wishing to maintain our value discipline whilst scrutinising the balance-sheet strength of the portfolio holdings to understand their ability to weather the headwinds that lie ahead. We are looking to position the fund such that it is able both to capitalise on extreme market moves that the crisis throws up at the same time as seeking to replace the lost income which the unit holders have suffered in the short-term.

- A. TB Wise Multi-Asset Income B Inc
- B. IA Flexible Sector
- C. Cboe UK All Companies
- D. UK Consumer Price Index (CPI)

27/02/2015 – 28/02/2020 Data from FE FundInfo 2020

Dividends

The outlook for income has never been more challenging for investors than it is presently. The fund's aims with regards the dividend are twofold, namely to offer a dividend yield with an official target to exceed the yield of its benchmark, the CBOE UK All-Companies Index, whilst its second objective has been to increase Income payments in-line with inflation (CPI) or better over the medium to longer term (rolling 5 years).

We have included a table produced in last year's annual report showing the progression of the dividend since 2006 and comparing it to CPI inflation. It shows the dividend payments that actually have been made (column A) and compares them to what would have been paid if we had increased 2006's payments (our first full year of making dividend payments) each year since in line with consumer price inflation (column B). The table shows that over the period covered, we have paid 5.35p per share more in dividends than would have been the case if the fund's dividend had risen in line with inflation.

Whilst we have achieved our second goal of growing dividend payments in line with inflation, the outlook for growth in the dividend has suffered a significant setback as companies have moved to cut dividends in response to the Covid-19 outbreak. Whilst we describe this impact in detail in the Outlook section of this report, it is perhaps useful to look back to the experience of 2008 when it took four years for the fund to regain the level of income of 2007. It remains our strong desire to reward investors with continued dividend payments and we are endeavouring to find opportunities to replace income in a sustainable way that does not sacrifice the opportunity to grow the capital value of the fund at the same time. We intend to maintain the primary income objective of delivering an attractive income yield greater than the benchmark CBOE UK All-Companies Index through this period and as the world reverts back to normal we would hope to see strong growth in the dividend as companies return to paying dividends.

Year	Dividend declared in the year (Column A)		CPI Growth in year (%)	Wise Multi-Asset Income's CPI linked dividend (Column B)		Investors gain/ loss (A-B)
2006	4.29					
2007	5.03		+2.4	4.39		0.64
2008	4.6		+3.5	4.54		0.06
2009	4.22		+2.0	4.63		-0.41
2010	4.95		+2.5	4.75		0.20
2011	5.29		+3.8	4.93		0.36
2012	5.1		+2.6	5.06		0.04
2013	5.35		+2.3	5.18		0.17
2014	5.34		+1.5	5.26		0.08
2015	5.49		+0.4	5.28		0.21
2016	6.05		+1.0	5.33		0.72
2017	6.86		+2.6	5.47		1.39
2018	6.63		+1.8	5.57		1.06
2019	6.49		+1.7	5.66		0.83
					Total	**5.35**

All dividends are expressed in pence per share terms

On 1 July 2019 the Fund moved from paying quarterly dividends to paying dividends monthly. This will not affect the overall amount of income paid throughout the year, but the more frequent payments does mean that investors will now receive their income sooner. The fund's objective, and the way it is managed, has not changed.

Allocation changes

The period under review witnessed a period of significant risk aversion during the summer months as investor concerns grew both over the slowdown in global economic growth as well as over the prospect of a disorderly Brexit. Our belief entering the year was that the valuation of assets exposed to these areas already materially discounted the likelihood of further negative news.

As Income investors, asset allocation to bonds looked unattractive since the reference risk-free rates globally in many instances were negative. As such, our asset allocation remained heavily skewed towards domestic equities and global cyclical companies. As markets sold off over the summer we further increased our exposure to these two areas whilst reducing our holdings in the most defensive holdings we held. For example, we exited our holding in Renewables Infrastructure Group and Target Healthcare REIT whilst reducing our holding in Ecofin Global Utilities and Infrastructure Group. Around the time of the election, we also sold out of our holding in Pennon following strong performance as the threat of nationalisation receded. At that time the prospect of rising bond yields appeared reasonable given their depressed levels coupled with the possibility of higher inflation as fiscal policy looked set to become more expansionary.

Domestically, for example, we initiated positions in Bakkavor (a food producer), Morgan Sindall (construction), New River REIT (retail property), Easyjet (airlines), Polypipe and Volution (construction products), Watkin Jones (student accommodation) as well as Provident Financial and Paragon in the Financials sector. On the more cyclical side, we initiated holdings in XP Power (electronics), Polar Capital (fund management), Elementis (chemicals), Trifast (industrials) and Sthree (recruitment). We were encouraged during this period to have received two bids for Telford Homes and Tarsus at significant premiums that suggested many of the portfolio holdings represented good value. Against a backdrop of heightened uncertainty as well as significant continued structural change from the internet, we sold out of companies where we had concerns over the strength of the balance-sheet or fears that the business model was not sufficiently differentiated. We sold out of Braemar Shipping, Moss Bros, McColls, Kier and Halfords accordingly.

As we exited 2019, markets sold off aggressively with an initial focus on companies with direct exposure to Asia where the impact of Covid-19 was first felt. We tentatively increased exposure in certain Asian-exposed companies or funds, such as Aberdeen Asian Income Fund and Blackrock World Mining.

Outlook

As an Income fund, it is perhaps best to frame the discussion of the outlook in the context of the dividend expectations for the year. The prospect of a sharp, global recession and uncertainty over the duration of the current lockdown measures has led the boards of most companies in the UK to the decision to stop paying dividends. In certain cases, financial regulators have forced or pressurised companies to withdraw dividends that had already been announced and many companies, which are utilising various government support schemes, have been required to cut dividends in order to do so. In many cases cyclical companies, faced with huge earnings uncertainty and balance sheets unprepared for this level of earnings shock, have been forced to cut dividends and are trading on valuations reflecting the increased likelihood of rights issues. For these types of companies, we believe historic dividends will become a permanent casualty of Covid-19 and these will be the last companies to return to paying dividends. However, there are a large number of well-capitalised, cyclical businesses where boards have taken a ‘safety first’ approach and elected to cut or defer dividends until greater clarity emerges.

We believe that the current market reaction to Covid-19 has thrown up some exceptional investment opportunities, however in the short-term most of these companies are not currently paying a dividend. It is a difficult choice to invest in a company that does not provide income to our unitholders, but we have a firm belief we will be rewarded by capital growth and a return to dividends relatively quickly. Furthermore, we believe there is a strong desire from the management of these companies to return to paying dividends as soon as possible.

As a multi-asset fund we also have the ability to invest into other asset classes where income is still available to investors. This is a fine balancing act as we recognise that many of you hold the fund because you want income today not for the prospect of capital growth and income returning tomorrow. Equally we believe it doesn’t serve investors well to crystallise recent capital falls, invest into income producing assets and, in so doing prevent you from recovering the capital losses you have recently experienced. We have, however, found certain fixed income opportunities in recent weeks that we believe bridge this gap and as a consequence we have made investments both into a fixed income fund and also directly into a corporate bond of an equity holding that we know well. Given the extreme dispersion in the market today between those assets perceived as safe and those with more inherent risk, it is likely we will continue to favour investments in equities and to a lesser extent corporate credit rather than in other areas such as government debt, infrastructure or gold, as the safe-haven nature of these asset classes has reduced their income yields to unattractive levels.

We are considering the effect of recent dividend announcements on the yield for this year under two scenarios. In the first, we assume all companies that have already announced dividend cuts pay nothing for the entirety of the fund’s 2020-2021 financial year, as well as taking a prudent view on certain cyclical companies that have not yet given guidance on dividends.

In this scenario, the reduction in income from current levels is estimated to be 52% and the estimated yield on the fund would currently stand at approximately c.3.7%. In a second, more optimistic scenario, we would anticipate a number of companies returning to paying dividends later in the year but at a reduced level compared to 2019. We would then anticipate further dividend growth into 2021. On this basis, the reduction in income from current levels is estimated to be 36% and the estimated yield on the fund would be about 4.9%.

We recognise that these cuts are highly disappointing, as has been the recent fall in the capital value in the fund. We are seeking where possible to restore the income in the fund whilst retaining the option for capital growth. We believe the current market offers investors an exceptional value opportunity, however, we remain cautious about the economic damage current events have caused.

General update

The TB Wise Multi-Asset Income fund started the interim period with £112m of assets under management and finished with £105m.

In terms of our team, we are excited to announce that Rick Ashworth has joined us as an analyst covering both funds and equities. He joins us from Citibank and complements our existing set of skills nicely.

Finally, from an operational standpoint, we are lucky enough to have a small and nimble team supported by a solid IT infrastructure. As such, as a precautionary measure, we all started working from home a week prior to the official lockdown was announced in the UK on March 23rd. All of our systems are cloud-based and we thus haven't experienced any significant issues with doing our day job, which lends itself well to remote working. Our experience is similar to what we have observed with our investee managers. Moreover, a silver lining of all of us working from home is that our research work, which is the cornerstone of our investment approach, has been made somewhat easier as phone and video calls with company and fund managers are much easier to arrange than face-to-face meetings!
As a team, we have learnt (and are still learning) how to make greater use of online chats and video calls to communicate with one another. On that front though, it is undeniable that we are all missing the social interaction with our colleagues and this is something that no technology will ever be able to replace.

From a business standpoint, although the sharp drop in assets in February and March is of course having a direct impact on our profitability, the firm has been conservatively managed since its inception; we have never borrowed any money and have a very solid balance sheet with net cash available, which is helping us weather the current storm.

All that is left is for me to thank, personally and on behalf of the Wise Funds team, all our investors for their ongoing support. There will be better times ahead, and in the meantime, we hope that you and your families are staying safe.

Please feel free to contact us if you would like a meeting or have any questions.

TO LEARN MORE ABOUT THIS FUND, PLEASE CONTACT
01608 695 180 OR EMAIL JOHN.NEWTON@WISE-FUNDS.CO.UK
WWW.WISE-FUNDS.CO.UK