A UK EQUITY INCOME FUND WITH THE FREEDOM TO INVEST ACROSS THE MARKET CAP SPECTRUM

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Siddarth Chand Lall

Siddarth Chand Lall, Manager of the Marlborough Multi Cap Income Fund, explains why UK small caps have outperformed large caps since the EU referendum, why he's seeing opportunities in utilities and why the environment for UK equities is benign.

A distinctive feature of the fund is its bias to smaller companies and they've outperformed their larger counterparts since the Brexit vote. What has driven this?

"The outperformance of UK small caps since the Brexit vote demonstrates the diversity of the companies operating at this end of the market cap spectrum.

"There's a stereotype about small caps being dependent on the domestic economy. In reality though many have an international focus and have been benefiting from stronger global growth or tapping into new and fast-growing markets, so they're performing well despite the shadow Brexit uncertainty is casting over the UK economy.

"A good example is hotel company PPHE, which operates the Park Plaza chain. Some might take the view that it's a consumer-facing business, with a lot of hotels in the UK, and so is reliant on the domestic economy, and, indeed, it was hit after the referendum vote.

"It has rebounded strongly though, with the share price doubling over the past two years to £14.60 at the time of writing. Many of its UK hotels are trophy assets in London, so it benefited when weaker sterling increased the number of visiting tourists. It also has a growing portfolio of hotels in continental Europe.

"Another example is Midwich, which is a distributor of leading audio-visual equipment brands in markets including the UK, Germany and France. It combines technical expertise with strong long-term customer relationships and represents a number of high-end brands, including Harman Kardon, which provides audio equipment for car manufacturers including Mercedes-Benz. It has achieved strong growth in profits and the share price has risen from £2.45 at the time of the referendum to

more than £6.50 at the time of writing."

Are there are any particular sectors where you're seeing opportunities at the moment?

"We believe there are a number of good utility companies that have been unfairly punished or ignored. There was a sharp sell-off of the sector in the first quarter, prompted by political criticism and concern about the impact of tighter regulation.

"Labour also continues to talk about renationalisation - despite an estimated price tag of up to £90 billion, which in the eyes of many commentators makes that a highly unlikely scenario.

"Most companies have now seen their share price regain some of the ground lost, but generally they still remain at a discount of around 15 per cent to the sector average for global utilities.

"We take the view that many utility companies are steadily delivering for their customers, at the expense of booking larger profits, while also investing heavily each year in the UK's infrastructure.

"We hold Severn Trent, which is a strong and profitable business, but also one that has been rewarded by the regulator, Ofwat, for meeting or exceeding targets for service delivery. In May the company reported annual profits up 4% and announced a 6.2% increase in dividends for the year. The forecast dividend yield is now 4.7% (at the time of writing).

"We also like Pennon Group, owner of regulated utility business South West Water. It's another utility business generating attractive profits, but also delivering for its customers. The forecast yield is 5.5%.

"Electricity and gas supplier SSE has complex challenges to manage. It plans to split off its household energy business and also faces pressure from government plans to cap standard variable tariffs, possibly as early as this winter.

"We believe though that SSE is a well-run business, which is increasingly doing the right thing for customers, and that it has significant growth potential. The forecast yield is 7.1%.

"Overall, our view is that sentiment will eventually turn positive on the utility sector as understanding grows that broad generalisations about inefficiency do not hold true for every company."

Have you identified any new investment themes emerging?

"A number of companies we hold are benefiting from the growth of electric vehicle technology. These are businesses where we've already identified a strong investment case and the electric vehicle technology is an additional bonus.

"For example, engineering consultancy Ricardo has been at the forefont of engine design for over 100 years, but given the move away from the internal combustion engine, it could have found itself trapped in a dying industry.

"Instead Ricardo's order book hit a record £302 million in the half year to the end of last December, with work on electric and hybrid vehicles growing rapidly and now accounting for 24 per cent of business. The forecast yield is a relatively modest 2.2%, but we think this is a company with great intellectual property and strong growth prospects.

"Mining company Central Asia Metals, which has the capacity to produce up to 14,000 tonnes of copper a year, is also well placed to benefit from significantly increasing global demand for electric vehicles - a single electric car can have up to six kilometres of copper wiring.

"We like the focus on low-cost production of high-quality base metals and the company's commitment to paying attractive dividends. The forecast yield is 6.1%.

"Mining royalties business Anglo Pacific Group is another business repositioning itself to benefit from the growing number of electric vehicles. Part of its strategy is to focus on commodities such as nickel, which is used to lengthen battery life in electric cars. The stock's forecast yield is 4.9%."

How would you summarise the outlook for equities?

"There's uncertainty about Brexit and where Donald Trump's trade tariffs will lead us, of course, but overall I'd characterise the environment for UK equities as benign.

"Depending on the economic data that emerges, we may see two interest rates rises over the next 12 months to combat inflationary pressures. But any increases are likely to be modest and we'll still be in a low interest rate environment. That benefits companies borrowing to invest in growth and also supports consumer spending.

"In terms of tax on profits, companies in the UK are paying 19% Corporation Tax, compared with 28% in 2010, and the Government has announced that this will be cut by a further two percentage points to 17% in April 2020. So, again, that's supportive for businesses.

"In currency terms, sterling remains weaker against the US dollar as a result of the Brexit vote and that's helping exporters by making their prices more competitive for overseas buyers. At the same time, the pound has regained some of the lost ground, which means we're not feeling the squeeze on import costs to the same extent that we were.

"So, overall, I'm positive about the outlook. We're continuing to identify attractive opportunities at company level, while at the macro level I'm reassured that we have able policymakers in the Bank of England and that they'll do what's right for the economy."

Siddarth Chand Lall is Manager of the Marlborough Multi Cap Income Fund, which holds some or all of the stocks mentioned. The views expressed are his own and should not be taken as investment advice.

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