Q&A: Hunting across the market cap spectrum for attractive and sustainable dividends

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"The UK small and mid-cap space is undervalued, but we've also seen opportunities among large caps."

Siddarth Chand Lall

The Marlborough Multi Cap Income Cell offers access to the Master onshore Marlborough Multi Cap Income Fund managed by Siddarth Chand Lall who explains that while this year has started on a positive note for UK equities, Brexit uncertainty means interesting opportunities are still to be found, particularly among undervalued UK small and mid-cap stocks.

The fund has made a strong start to 2019, what has driven that?

"The year started well for us, with the fund up 10.54%* in the first two months. This shows just how oversold the market was in the final quarter of last year, although we did outperform as well. I think there was an element of panic selling and UK small and mid-caps were hit particularly hard with stocks de-rating significantly in anticipation of a raft of profit warnings that didn't always materialise.

"So, this year we've seen a recovery in certain stocks, which has benefited the fund. Where stocks have rebounded it has almost always been led by good earnings reports and business performance. There is also an element of relief when companies don't downgrade earnings.

"What's been interesting is that many of the stocks that have been our strongest performers so far this year have been UK-headquartered small cap companies focused primarily on the domestic market. These include **Churchill China**, **Macfarlane**, **Solid State**, **Softcat** and **Dairy Crest**, which has also recently been the subject of a takeover bid from Canadian rivals **Saputo**. The doom and gloom we read about in the financial press just doesn't seem to have affected these companies.

"We have a well-balanced portfolio, with c. 58% of the revenues of our underlying holdings coming from the UK and the remaining 42% generated overseas. That may be surprising to some who still think that UK small and mid-caps are almost exclusively focused on domestic markets. Such diversification provides a number of benefits, including a degree of protection in the event of currency volatility."

**P class, accumulation shares, 01/01/19 to 02/03/19. Morningstar data, bid to bid, net income reinvested. Net of fees.*

With financial and mining companies playing such a big role in the record dividends paid by UK companies in 2018*, were you tempted to alter your investment process and increase exposure to them?

"We want to avoid the blanket approach of buying into cyclical sectors. We're bottom-up stock-pickers and we have a proven investment process. While we do hold financial companies and miners, that's as a result of our filtering for individual companies paying attractive and sustainable dividends. That may or may not include large cap miners. On the financials side, we have companies like **Phoenix Group**, which has a good record of progressive dividends, and **Intermediate Capital**, which is a top ten holding with a good steady income story. On the mining side, we have stocks like **Central Asia Metals** and **Anglo Pacific**, which, as a royalties business, tends to pay out a high proportion of its earnings in dividends.

"All these companies have earned their place in the portfolio on their individual merits. We look for companies with strong earnings that will allow them to sustain and grow their dividends across a cycle. We strive to achieve dividend growth for our investors every year.

"Dividends can be a powerful driver of your total return, particularly when you take into account the power of compounding when income is reinvested. If you can, for example, generate a total return averaging around 9% per year (with roughly half of that coming from dividends) then over eight years you should approximately double your investment. In our case, we launched the fund in July 2011 with the shares priced at £1 and nearly eight years later the accumulation shares are over £2, so the proof is in the pudding."

**Source: Link Asset Services UK Dividend Monitor Q4 2018*

What changes have you been making to the portfolio?

"We've added to our position in **Zegona Communications**. It's listed in the UK, but is essentially a shell with a 14.9% stake in Spanish telecoms provider **Euskatel**. For us, it's another way to get into the **Euskatel** stock but at a 20% discount.

"The key point is that **Zegona's** management team have valuable experience and expertise they can share with **Euskatel** to help them grow market share and profits. The reaction from **Euskatel** has been encouraging too, they seem to welcome **Zegona's** support.

"As well as the discount to the Euskatel share price, we like the dividend yield, which is currently 3.7%*.

"We've also increased our holding in **P2P Global Investments**. This is an investment trust which, despite the name, is moving away from peer-to-peer lending and becoming more of a specialist lender.

"The management of the trust has, after a merger, been taken over by Pollen Street Capital, which has a successful track record running a similar trust. The new team has changed the mix of loans and is running off the legacy loans at a rate of approximately 5% per quarter, so in around a year's time very little should be left and the portfolio will be of a significantly higher quality.

"The share price is on a discount of around 15% to net asset value and the stock has a healthy yield of 5.9%*.

"Another stock we've added to is **Manx Telecom**. They're the largest telecoms provider on the Isle of Man, which is the steady core business and effectively a cash cow, and the stock pays an attractive yield of 6.6%*. On top of that though you also have new technology they've developed called Audacious, which is installed via a SIM card, and significantly improves sound quality on a mobile phone. It could provide significant benefits for people with hearing impairments and perhaps phone users more generally. They're partnering with EE and this could provide a lucrative new revenue stream for the business. At the time of writing, **Manx Telecom** has just received a bid approach. Investment firm Basalt Infrastructure Partners has made a cash offer of 215p per share, which represents a premium to our purchase price, and the Board have recommended unanimously that shareholders vote in favour."

How would you summarise the overall investment outlook?

"There are a number of issues at a global macroeconomic level that have been making investors nervous. Slowing growth in China and India, for example, have been causing concern. Beijing is though rolling out a range of stimulus measures and India is taking action too, with financial support for struggling farmers and tax breaks aimed at the middle classes.

"US-China trade tensions have been another cause of anxiety, but there are signs of progress on that front too, with reports of positive developments in negotiations between Washington and Beijing.

"Looking at the UK specifically, there's no doubt that the uncertainty around Brexit has been affecting sentiment towards equities listed here, and the market has been at a significant discount both to historic averages and to comparable developed markets.

"Once we have more clarity about the UK's relationship with the EU though, that will mean the market will be able to reset, in effect, by pricing the new scenario into share prices. Then we can return to a more normal pattern of everyday business, where the market is responding properly to good news (instead of no news) announced by companies.

"As things stand, the Bank of England has revised down its 2019 growth forecast for the UK to 1.2%. That's still economic growth though, despite the uncertainty, and who's to say that it won't be revised up again in six months or a year's time if we get a positive Brexit outcome?

"In the meantime, foreign investors have cut their allocations to UK equities and there's a lot of domestic money sitting on the sidelines.

"As I said before, the UK small and mid-cap space is undervalued, but we've also seen opportunities among large caps and added to some of our holdings at that end of the spectrum.

"I am relatively sanguine about seeing another Brexit-related correction."

Siddarth Chand Lall
13/03/2019

Risk Warnings

The following is a summary only of some key items in the Prospectus.
Investors in Protected Cell Company (PCC) must have the financial expertise and willingness to accept the risks inherent in this investment.
Past performance is not a reliable indicator of current or future performance and should not be the sole factor considered when selecting funds.
It should be appreciated that the value of Shares is not guaranteed and may go down as well as up and that investors may not receive, on redemption of their Shares, the amount that they originally invested.
Investment in the Company should only be undertaken as part of a diversified investment portfolio.
Investment in the Shares should be viewed as a medium to long term investment.
Shares may not be redeemed otherwise than on any Dealing Day.
There will not be any secondary market in the shares of the Company.
The Master Fund invests in the UK. Therefore it may be more vulnerable to market sentiment in that country.
*Yields quoted are as at 01/03/19, subject to change and not guaranteed.

Regulatory Information

The Marlborough Multi Cap Income Cell referred to is a cell of Marlborough International Fund PCC Limited (the 'Company'), a protected cell company incorporated in Guernsey and authorised as a Class B Collective Investment Scheme under the terms of the Protection of Investors (Bailiwick of Guernsey) law, 1987, as amended. Investment may only be made on the basis of the current Prospectus.
Marlborough International Management Limited is incorporated in Guernsey. Registration No. 27895.

Regulated by the Guernsey Financial Services Commission.

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