LWM Consultants Ltd

Meeting the fund manager

Schroder Income Fund

In our lower risk funds we use the Schroder Income Maximiser Fund. The fund effectively sells some of the potential upside growth to provide a target income. The stocks the fund uses come from the Schroder Income Fund. So although we don't directly invest in this fund it does form part of the Maximiser Fund.

Last year we met Nick Kirrage who is co-manager of the Income Fund alongside Kevin Murphy. This year the update was with Kevin. Both managers follow very much the value investor philosophy and much of the update focused around this. The discussion opened up on how they invest as managers but also provided insights for us as individuals when it comes to investing.

Overview

Kevin started the discussion around forecasts and provided three interesting quotes:

"We have two kinds of forecasters, those who don't know, and those who don't know they don't know." – John Galbraith

In 1990 three months after the consumer led recession had started Alan Greenspan said "..the likelihood of a near-term recession seems low…"

"The US economy seems likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008" – Ben Bernanke

The point Kevin was making is that forecasting the future is very difficult because unforeseen circumstances can happen. In fact it has been proved that over 23 years economists have had trouble producing forecasts that were superior to naïve predictions. I.e. it would be as accurate to toss a coin.

When we consider this, we need to understand that as we don't know the future we shouldn't invest as though we do. We need to act prudently, limit leverage and diversify.

For Kevin one of the skills in investing is learning from the lessons of the past and one extremely loud lesson is that price is the most important determinant as to whether you will make money. It is about looking at the stock market now and seeing what the value is. In 2000 the average P /E was 31 times which is shown to provide no returns over a ten year period. In 2009 the average P /E was between 10 to 15 times.

But just because the average is 10 to 15 times there will be sectors that are overpriced and these are stocks that need to be avoided. So for example today stocks with P / E ratios of 5 to 10 times include the likes of banks and house builders whereas stocks of 30 times plus include technology and chemical companies.

Warren Buffett says “you pay a very high price in the stock market for a cheery consensus.”

The first bubble that is often quoted is the tulip bubble. In 1630 the Dutch were the richest and most successful nation in the world. They introduced the Tulip into Europe. Demand increased with limited supply so prices went up, then France got involved and the price went from 5 to 200 Dutch Guilders in the space of 3 months. The cost was more than the value of a house. Three months later the price had fallen 95%.

It is not always easy to pick stocks. In 2000 GlaxoSmithKline was the largest pharmaceutical company. Forecasts were that it would double its business over the next ten years and that it was a great business. However, the P /E was 35 times so there was a high price to pay for this consensus. During the next seven years it achieved profit forecasts but its share price halved.

Today if you look at something like BAT the dividends are around 4% but P / E ratio is 30 times on the flip side BP is paying dividends of 5% with a P / E of below 10 times. So the key is to avoid the next Glaxo.

An example of one of their holdings is WM Morrison. The reason they like the stock is that it has attractive profit margins and returns on capital. It has a low level of debt and freehold properties. Dividends are at 5% with a share buyback underway. P / E ratio is under 10 times.

For them this is one of the most attractive supermarkets in the UK and offers a good opportunity over the next 3 to 5 years. Of course there are risks including a pricing war, austerity etc but it is about looking for the opportunities going forward.

Another area is that sometimes they will hold stocks that are unloved and don’t pay dividends. This is a small part of the portfolio. Banks are an example of this. The likes of Lloyds are cheap but not paying dividends. However, it is likely in three years’ time they will start to pay dividends. They have taken profits recently to ensure it doesn’t take a dominant waiting in the portfolio.

In summary this fund is a long term play with experienced fund managers, there are times where being different means that they may underperform short term but they are always looking for long term outperformance. They have their own money invested in the fund so are careful with how they invest as their wealth is tied into the performance of the fund.

Conclusion

Although we indirectly invest in this fund it is key for us to understand how the managers approach investing as this impacts the performance of the Income Maximiser Fund. We believe both Nick and Kevin are talented fund managers and there long term performance is excellent. We always find their discussions around price and history interesting and it can be tempting to pay extra for safety and then be disappointed.