Charifund
Sterling Class A – Accumulation shares

Quarterly Fund Review as at 30 September 2019

Fund manager – Michael Stiasny

For investment professionals only

Highlights

- Charifund has made solid progress so far this year, both in terms of its capital performance and income generation. The main performance drivers have been stock selection within mid-caps and at a sector level within miners, housebuilders, media, travel & leisure, banks, fixed line telecoms and the water companies. In addition, the fund's overseas exposure added value, assisted by a weak pound.
- Longer term, the fund is ahead of the index over one, seven and 10 years, and broadly in line over three and five years. Against the IA peer group, Charifund is top quartile over the year to date and one, three, five, seven and 10 years.
- Charifund's turnover remains fairly low, with the focus on managing the income generation.
- The third interim distribution, amounting to 19.50p per Income unit, was paid at the end of August, bringing the total for the year to date to 52.50p. This represents an increase of 5.0% compared with the corresponding period in 2018. The fund's yield on 30 September 2019 stood at 5.12% (net of income tax and fees). This represents a meaningful 22% premium over the average yield of the FTSE All-Share Index of 4.21%.

The main risks associated with this fund

For any past performance shown, please note that past performance is not a guide to future performance.
There can be no assurance that any investments held will appreciate in value or that the investment objective will be achieved.
The value of investments, and the income from them, will fluctuate. This will cause the fund unit price to fall as well as rise and the charity may not get back the amount it originally invested.

Fund performance

	3 months (%)	YTD (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Since launch (%) p.a.
Sterling A Accumulation	1.3%	15.4%	5.4%	6.6%	7.1%	-
FTSE All-Share Index	1.3%	14.4%	2.7%	6.8%	6.8%	-
IA UK Equity Income sector	1.1%	12.1%	-0.1%	4.6%	5.7%	-

Single year performance (5 years)

	2018	2017	2016	2015	2014
Sterling A Accumulation	-8.9%	12.1%	12.4%	4.5%	4.7%
FTSE All-Share Index	-9.5%	13.1%	16.8%	1.0%	1.2%
IA UK Equity Income sector	-10.5%	11.5%	8.9%	6.1%	3.2%

Past performance is not a guide to future performance.

Source: Morningstar, Inc and M&G, as at 30 September 2019. Returns are calculated on a price to price basis with income reinvested.
Benchmark returns stated in GBP terms.

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Largest positive contributors 3 months %

	Relative weight	Absolute return	Contribution
Royal Dutch Shell	-4.6	-6.0	0.4
Prudential	-1.8	-13.0	0.3
Vodafone	1.2	25.3	0.2

Largest negative contributors 3 months %

	Relative weight	Absolute return	Contribution
Micro Focus	0.8	-42.9	-0.4
London Stock Exchange	-0.9	33.6	-0.2
British American Tobacco	-3.0	9.4	-0.2

Source: Aladdin, preliminary data. Performance contribution includes both stocks held and not held relative to the fund's comparative index.

Largest positive contributors YTD %

	Relative weight	Absolute return	Contribution
KCOM	1.0	64.8	0.6
Glencore	-1.4	-11.0	0.4
Informa	1.7	39.0	0.4

Largest negative contributors YTD %

	Relative weight	Absolute return	Contribution
London Stock Exchange	-0.8	82.0	-0.4
Kier	0.3	-70.9	-0.4
Micro Focus	0.4	-39.1	-0.4

Industry breakdown (%)

	Fund (Start)	Fund (End)	Change	Index	Relative weight
Financials	34.8	34.9	0.1	25.6	9.2
Oil & gas	12.9	12.2	-0.7	13.2	-1.0
Health care	9.9	11.2	1.3	9.4	1.9
Consumer services	10.2	10.5	0.3	11.9	-1.5
Utilities	7.1	7.6	0.5	2.7	4.9
Industrials	7.1	6.7	-0.4	11.7	-5.0
Basic materials	5.8	5.1	-0.7	7.4	-2.3
Communication services	0.0	5.0	5.0	2.8	2.2
Consumer goods	4.3	4.6	0.3	14.3	-9.7
Technology	1.2	1.1	-0.1	1.0	0.1
Other	0.2	0.5	0.3	0.0	0.5
Cash and near cash	0.6	0.7	0.1	0.0	0.7

Largest holdings (%)

	Fund	Index	Relative weight
Royal Dutch Shell	5.4	8.3	-2.9
BP	5.0	4.4	0.6
Astrazeneca	4.8	4.1	0.6
HSBC	4.6	5.5	-0.9
Glaxosmithkline	3.8	3.7	0.1
Rio Tinto	3.2	2.0	1.2
Vodafone Group	3.1	1.9	1.2
Informa	2.2	0.5	1.7
National Grid	2.2	1.3	0.8
Aviva	2.1	0.7	1.5

Quarterly income (%)

	Rate	Payment dates
Final	19.50p	8/31/2019
Interim	19.50p	5/31/2019
Interim	13.50p	28/02/2019
Interim	29.00p	14/12/2018

Largest overweights (%)

	Fund	Index	Relative weight
General Accident	1.8	0.0	1.8
Informa	2.2	0.5	1.7
Pennon Group	1.7	0.2	1.6
Aviva	2.1	0.7	1.5
United Utilities Group	1.6	0.2	1.3
Legal & General	1.9	0.6	1.2
Vodafone Group	3.1	1.9	1.2
Rio Tinto	3.2	2.0	1.2
SSE	1.6	0.6	1.1
Micro Focus International	1.1	0.2	1.0

Largest underweights (%)

	Fund	Index	Relative weight
Diageo	0.0	3.4	-3.4
BAT	0.0	3.0	-3.0
Royal Dutch Shell	5.4	8.3	-2.9
Reckitt Benckiser	0.0	1.7	-1.7
Prudential	0.0	1.7	-1.7
Relx	0.0	1.6	-1.6
Glencore	0.0	1.2	-1.2
Barclays	0.0	1.1	-1.1
Experian	0.0	1.0	-1.0
Anglo American	0.0	1.0	-1.0

Capitalisation breakdown (%)

	Fund (Start)	Fund (End)	Change	Index	Relative weight
Large	54.2	53.5	-0.7	80.6	-27.0
Medium	18.1	20.2	2.1	16.0	4.3
Small	10.1	8.0	-2.1	3.4	4.5
Preference shares	4.2	5.0	0.8	0.0	5.0
Non-FTSE All-Share	12.8	12.6	-0.2	0.0	12.6
Cash and near cash	0.6	0.7	0.1	0.0	0.7

Fund commentary

Charifund has made solid progress so far this year with respect to both its capital performance and income generation. The main performance drivers have been stock selection within mid-caps and at a sector level within miners, housebuilders, media, travel & leisure, banks, fixed line telecoms and the water companies. In addition, the fund's overseas exposure (approximately 9% of the portfolio) made a positive contribution, assisted by a weak pound.

In the third quarter once again stock selection within mid-caps added value, partly reflecting bid activity, along with a positive contribution from the overseas segment aided by currency factors. In addition, sector allocation benefited performance through overweight positions in utilities, mobile telecoms and pharmaceuticals, and an underweight in the miners, emphasising the market's defensive tilt. Conversely, the fund's tobacco restriction detracted value, as did a zero exposure to healthcare equipment and defence companies. Amongst the main contributors at the stock level was Greene King; the brewer's share price rose by more than 50% in August following a £4.6 billion cash offer from CKA Group, a Hong-Kong-listed investor – Marston's shares rallied on the back of this news. Sentiment improved towards Vodafone following the announcement that it was planning to monetise its tower assets. Falling bond yields along with fading concerns about the prospect of a Labour majority government provided support to the water utilities.

Some performance was lost as a result of a 45 basis points negative price swing. Stock selection also detracted value modestly within software, industrials and financial services. Micro Focus, having run up strongly over the past 12 months, consolidated after issuing a profit warning following a drop in half-year licence sales. Having previously realised some profits, we took the opportunity to increase the fund's holding on a more attractive yield. In the industrial transportation sector, Wincanton's share price was affected by problems at Eddie Stobart. The fund does not hold the London Stock Exchange, a low yielder, which was bid for by the Hong Kong Exchange – although this was abandoned subsequently. Elsewhere, increased iron ore supply, as Brazil's Vale returned to production, weighed on Rio Tinto; however, the Anglo-Australian miner is another attractive yielder and has raised its dividend substantially in the past 12 months, paying out a special in the process.

Distribution

In terms of income generation, in the first nine months of the year Charifund has distributed 52.5p, representing an increase of 5.0% over the corresponding period in 2018. For the year as a whole, we are currently aiming to distribute at least 82.00p, barring any unexpected events, representing a 3.8% increase compared with last year and RPI inflation in August, which was 2.6%. This should provide some comfort for charities facing the prospect of another year of low interest rates and rising costs.

Market background

The UK equity market registered a modest gain in the quarter in total return terms, supported by the outperformance of medium-sized companies, which mainly reflected a pick-up in takeover activity. Despite a weaker trend in sterling that could normally be expected to provide a boost to larger companies, these were held back by the underperformance of higher yielding sectors such as miners, energy companies and financials. Notwithstanding the mid-month uptick in oil prices following attacks on Saudi oil facilities, commodity prices ended the quarter lower amidst concerns about the impact of trade wars on a slowing global economy. Financials, meanwhile, were affected by falling bond yields on the back of interest cuts by the Federal Reserve and the ECB. Smaller companies underperformed as the domestic economy shrank in the second quarter, although there were signs of an improvement in output in the third quarter. Also, Brexit increasingly dominated the UK market as the prospects of a disorderly departure from the EU increased under new prime minister Boris Johnson. The immediate impact was felt by sterling, which fell to a 34-year low against the US dollar at one stage. In this environment, more defensive areas of the market such as pharmaceuticals, mobile telecoms, utilities and tobacco tended to outperform. Notably, there was a sharp snapback from oversold levels by value stocks in September as the decade-old growth/momentum trade has looked increasingly stretched. However, this trend has not been sustained subsequently.

Portfolio activity

Charifund's turnover remains fairly low and the emphasis of activity continues to be on enhancing the portfolio's income generation. To this end, Cineworld was the one new holding during the quarter. The FTSE 250 company became the second-largest cinema chain in the world by screens last year when it took over US rival Regal Entertainment. Cineworld's shares were acquired on a high yield as the market has been concerned about next year's film line-up and capital investment requirements to compete with their theatrical peers and the likes of Netflix and Amazon Prime. However, we believe that audience numbers will stay firm.

Two stocks exited the portfolio: Kcom and Nordea Bank. The Hull-based telecoms operator was taken over by a division of Australian banking group Macquarie, some 25% above the initial bid level, following a bidding war involving several interested parties. Nordea was sold because we had lost confidence in the investment case. The biggest bank in the Nordic region, originally added to the portfolio in 2017 for its yield and diversification reasons, Nordea has been a disappointing performer. The bank announced a fall in profits in the first quarter, which led to uncertainty over the dividend; it has also been experiencing some compliance issues with its regulator.

Elsewhere, positions were trimmed in holdings that had outperformed, causing yields to decline; these included Greene King post the bid, as well as Ashmore, Assura, BBA Aviation, Compass Group, Electrocomponents, Informa, Marshalls, Segro, United Utilities and WH Smith.

Conversely, some of the fund's more recently established positions were increased, such as NewRiver REIT, Regional REIT and Warehouse REIT, along with AbbVie, Hastings, ITV, Paypoint, Reach, Standard Life Aberdeen and St James's Place Capital. We also added to Micro Focus after the shares fell back, and increased the fund's position in Marston's to replace the departing Greene King. The REITs were acquired earlier in the year as part of a reorganisation of the fund's real estate portfolio in order to improve its yield in this market segment, and which was also reflected in the reduction to Segro.

Sector allocation

Charifund's biggest overweight stance at the end of the quarter was financials; most of this position is represented by financials other than banks. The other substantial overweight position is in utilities, which is designed to compensate for the lack of tobacco stocks in the portfolio and is concentrated in the water companies, reflecting the sector's income-producing qualities and inflation-linkage. Another significant exposure is to the telecoms sector, which is dominated by BT and Vodafone; the fund's position was raised from underweight to overweight in 2017 and was increased again in early 2018 because it was offering a very attractive yield. The fund's pharmaceuticals exposure has crept up from a broadly neutral exposure at the start of 2017, as we added to AstraZeneca and GlaxoSmithKline on weakness. The stocks performed well in 2018. AstraZeneca in particular was very strong, so in 2019 we have trimmed the holding to reflect the lower yield. Similarly, a combination of the sale of some of the fund's lower yielding industrials, and underperformance of some of the holdings has left the industrial transportation sub-sector as the only notable stance.

The biggest underweight remains the consumer sector. This mainly reflects Charifund's tobacco restriction, but also the lack of yield available in the sector following strong performance. Elsewhere, the fund has a small underweight in the energy sector and a zero weighting in aerospace & defence.

Outlook

UK equity returns have been restricted by concerns around the economic and political environment as a result of Brexit uncertainty, exacerbated by the pound's weakness, which has meant the domestic market has been eschewed by overseas investors in particular. This has left UK equities offering fair value relative to other asset classes, in addition to an attractive dividend yield. The spike in takeover activity in the past 12 months, especially from foreign buyers, indicates that the corporate sector recognises the value on offer at the moment, even if investors will not take the plunge. At some point, the country will move on from the Brexit impasse and the UK equity market's strong fundamentals should begin to reassert themselves.

Data releases in the UK continue to send out mixed messages on the economy, although the overall trend is weaker. First-quarter economic growth at 0.5% was stronger than expected, assisted by companies stockpiling, but GDP contracted by 0.2% for the first time in nearly seven years in the second quarter (the weakest performance in the G20) as Brexit stockpiles were unwound and the car industry implemented shutdowns. Unexpectedly, the signs are that the economy is growing in the third quarter and will thereby avoid a recession, with a 0.3% expansion in the three months to August – driven mainly by services and despite a 0.1% contraction in August, which was largely due to weakness in manufacturing. The latest British Chambers of Commerce forecast has downgraded its growth expectations for the UK in 2019 to 1.2% (from 1.3%) and to 0.8% (from 1.0%) in 2020. Despite wage growth at its highest level since before the financial crisis and record employment, consumer confidence has deteriorated and the latest retail figures revealed that there was no growth in the year to August. Meanwhile, Brexit and political uncertainty, combined with the global economic background, loss of business and contingency planning is weighing on sentiment in the corporate sector.

In his first spending review, the chancellor, Sajid Javid, announced the end of austerity and a £13.8 billion package for health, education, policing and local government, as well as funds to pay for an "infrastructure revolution". He insisted that the increases could be achieved without breaching his predecessor's fiscal limits. The IFS pointed out that it would take £60 billion to reverse the impact of cuts since 2010.

UK inflation for August caused some surprise with CPI at 1.7%, versus consensus at 1.9%, its lowest since December 2016. Brexit is muddying the waters in the short term. In an orderly Brexit, inflation might gradually drift higher, lifted by accelerating wage growth and improvements in household demand; but a strengthening sterling in this scenario would dampen inflation. In the case of a hard Brexit, a much sharper rise is in prospect, triggered by the likely negative supply shock and any further fall in sterling. The Bank of England (BoE) is at odds with the ECB and Fed over monetary policy, and has indicated that further rate hikes are to be expected in the case of an orderly Brexit, with wage inflation likely to trend higher given the strength in the labour markets. Interestingly, the markets are predicting that the next move by the BoE will be to cut the base rate.

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