

Why FGIT's Portfolio May Be Cheap

Introduction

FGIT's NAV underperformed its FT All-Share benchmark in calendar 2008. The NAV, with dividend reinvested, declined a sobering 31.3%, while the benchmark lost 29.9%. It is noteworthy that in the second half of the year FGIT outperformed by some margin, "only" losing 12.5%, compared to the 21.1% drop for the FT All-Share. This divergence of relative return between the first and second six months of the year can be largely explained by the Company's nil exposure to shares in the Commodity/Mining sectors. FGIT lagged badly as the bull market in such companies went "exponential" through H1 2008, but rebounded after the eventual derailing of the boom. It is important shareholders know that we still have no intention of buying Mining shares today – although this stance is informed by investment principle, rather than any view as to how the sector will perform in 2009.

It is trite for us to say it, but nonetheless true, that we are very sorry about the loss of value suffered by shareholders in 2008 and earnestly hope we can reclaim the losses in coming years.

Shareholders may also regard it as trite to learn that their Investment Manager is bullish at the start of a new calendar period, as he was at the commencement of 2008. However, at the very least, there have been significant changes in the valuation of financial assets over the course of the last twelve months meaning, in our opinion, that 2009 is unlikely to play out as a carbon-copy replay of last year's debacle. We highlight below the factors that seem to us to promise well for the Company's investment strategy.

Capital Market Backdrop

The price of the 2.5% Consolidated Loan Stock rose sharply in the second half of 2008, hitting 62.3p by year-end. At this level the instrument offers a gross annual yield of 4.0%, or a feeble 2.4% after tax for a high rate payer - every year out to infinity or the bankruptcy of the British state, whichever comes first. Its income stream is fixed, meaning there is no protection against any future acceleration in inflation.

The gilt is almost certainly over-priced on a 10 year view, although we understand why it remains well-bid. In the circumstances of the UK being gripped by a Japanese-style deflation/recession, its yield could even fall further, as investors rush to lock into any cast-iron source of income.

But what interests us about the Consol - and its relevance for FGIT's investment portfolio - are the implications it has for the valuation of "sound common stocks" – to use Sir John Templeton's terminology. As in – "The best time to buy sound common stocks is when economic conditions are most uncertain."

Today, indeed, it's hard to recall a time when conditions have been more uncertain.

Templeton's advice accords with something one of our most thoughtful clients put to us recently – "High quality companies offer protection against both deflation and inflation". Sound companies may negotiate a recession relatively unscathed, coming out the other side stronger, while their pricing power offers significant comfort against the (surely inevitable) coming monetary inflation.

We submit that FGIT's largest holding, Diageo, is a sound common stock. We also argue that on the same 10 year view its earnings are likely to perform as well as, or more likely better than, the coupon on the 2.5% Loan Stock. And here is why the recent appreciation of the gilt is important, because, following this argument, we believe Diageo shares ought to be worth at least as much as the

gilt to a long term investor. But they are not; not by a yard of Guinness.

Diageo is forecast to earn £0.67 in 2009. If that 67p was valued as investors today value the gilt's 2.5p "earnings", Diageo shares would trade on an earnings yield of 4.0%, giving a warranted share price of £16.75, compared to today's £9.75 ($67p/4.0\% = £16.75$).

We are not so naïve as to expect Diageo's price to approach £17.0 forthwith – although in our opinion this is a genuine value gap which corroborates Lindsell Train's longstanding working hypothesis that investors persistently undervalue great companies. But we do have two related observations.

First, recently I asked Mike Lindsell – veteran of a two decade deflationary bear market in Japan - how Diageo shares might have performed from 1990 if the quote had been on the Tokyo exchange and had offered a dividend yield of 3.5%. His opinion? They would have gone up a lot.

Next, we hear that Neil Woodford believes that investors will be amazed by the valuations attained by true growth companies in 2009 and beyond. We are sure he is right.

In conclusion, deflation gets a bad press from financial commentators (a deflationary slump is another matter). Falling prices benefit cash-rich or cash generative companies and consumers, because the spending power of their cash increases. There is no reason why the shares of such advantaged companies should not go up. And in an environment where income returns from competing asset classes, like the 2.5% Consolidated Loan Stock, have been driven to multi-decade lows, those companies capable of delivering cash-generative growth are extraordinarily attractive.

We hope that much of FGIT's portfolio will turn out to comprise of such companies – we certainly intend it to.

The Portfolio

The core of FGIT's strategy is its commitment to consumer branded goods companies, amounting to 58% of gross assets. The individual names, in descending position size, are Diageo, Unilever, Barr, Cadbury, Marston, Dr Pepper, Youngs, Fullers and Burberry. We include regional brewers here as well as fashion marque Burberry, because we think customer loyalty to their products and their inherent profitability is similar to that of, say, IRN-BRU or Johnnie Walker Green label. We don't pretend any of these companies is exempt the effects of recession, but we believe the likelihood of them not only surviving the episode, but delivering cash flows higher in real terms than today's, at some not so distant point in the future, is good. That prospect of real growth already makes these shares highly competitive relative to what a long-dated gilt can offer - before you even begin to compare their dividend yields to the pittance available from Sterling cash deposit rates.

Another significant portfolio allocation is to Business-to-Business Media and Software companies, 26% of total assets - Pearson, Reed, Sage, Fidessa, Thomson Reuters and Euromoney. To a meaningful extent, the customers of these companies cannot remain in business without access to their products or services. Meantime, the provision of these services is already highly profitable and becoming increasingly so, because increasingly delivered in electronic format. We expect a number of the above companies to grow their earnings every year for the foreseeable future. Pearson outperformed the FT All-Share by 20% in 2008, by dint of only falling 10%, while the European Media sector as a whole outperformed the broad market, for the first time since 2000. We hope "growth" companies in this part of the market will earn absolute returns in 2009.

The final meaningful industry bloc in FGIT is its financials, in all 21.5% of the gross portfolio. Here we must make a distinction.

Just over half of this exposure, 11.0%, is to "stock market proxies", primarily the fund management companies Rathbone and Schroders, but also the LSE. With short term interest rates so low, we expect savers to be forced out along the yield curve in search of income. This should benefit trusted retail financial savings brands. Meanwhile, quoted companies will need to refinance maturing bank debt somehow, probably by rights and, particularly, convertible bond issues. Any upsurge in new issuance would benefit the LSE.

The other half of the financials exposure, 10.5% of the total portfolio, is to banks. Here we hold 3.4% in what will shortly become Lloyds Group ordinary shares and a further 6.7% in its preference shares. Finally we retain 0.4% in Nat West pref.

These bank assets have been and continue to be, a cause of worry and disappointment for us, although the preference shares have proven relatively resilient, continuing to pay their generous dividends. Our thinking on them all is as follows.

We are not convinced that Royal Bank of Scotland is a viable commercial entity, albeit in no immediate risk of collapse after the injection of taxpayer capital. We have, therefore, been reducing our holding in the Natwest pref, whenever the market bids us. Recently we have switched the proceeds from these periodic sales into a cocktail of Burberry and Marston ordinary shares, allowing us to replace the "lost" preference dividends - because, at recent lows, the yields on those two common stocks were so high. Of course, there are risks to Marston's dividend and perhaps even Burberry's, but these are tolerable compared to the threat of outright nationalization, which will be RBS' fate if it stumbles again.

The correct course of action for the investment in Lloyds Group is less clear. Here we can see a clear rationale for the existence of the bank - to be the dominant force in UK retail banking, in theory still an attractive business activity. We think if the UK economy muddles through Lloyds Group should be the cheapest share in FGIT's portfolio. Meanwhile, its preference shares would be very attractive, assuming confidence about the sustainability of the dividends improves - because they yield nearly 14%, or a clear 10% more than the 2.5% Loan Stock.

On the other hand, the bear case is that HBOS' loan book is so compromised it will bring the whole combination down, into state control - at which point our equity would be worthless.

On balance, given the entrenched pessimism afflicting the bank sector - meaning the shares could go up a lot if the news just turns out to be less awful than feared - we are content to hold the Lloyd's Group positions, but will alert FGIT shareholders if our thinking changes on what, clearly, remains a significant allocation of their capital.

Risk Warning

This document is intended for use by investment professionals only and should not be relied upon by private investors.

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