DMS Charteris Premium Income Fund update

Ian Williams, Fund Manager
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Consistent with the management of all of the Charteris funds, there is a strongly held macroeconomic view that drives the strategy of the Charteris Premium Income Fund. This top-down driven strategy is embedded in a genuinely active management approach with the sector and stock selection decisions based on identifying which businesses are best placed to benefit from the global macro trends the manager has researched.

Complementing this macro-driven strategy are some clear bottom-up disciplines, which drive the Fund's stock selection process. These are focused on fundamental stock characteristics and include, for example, geographic preferences in the resources sector and dividend sustainability alongside a clear view of the potential return of each investment. Liquidity considerations also have an important bearing on stock selection.

The long-term macroeconomic view drives the strategy of the Fund, but this is complemented with a shorter-term tactical discipline which the manager deploys to finesse timing decisions on sector and individual stock positions.

As with our Gold & Precious Metals Fund, one of the over-arching views that drives our medium and longer-term thinking is our perspective on inflation. We have long believed that eventually the cumulative expansion of global money supply we have seen since the financial crisis will eventually lead to higher inflation.

Most investors accept that Quantitative Easing (QE) is fundamentally inflationary however its impact on prices was masked in the aftermath of the Global Financial Crisis (GFC) by a very significant reduction in the velocity of circulation of money. This was constrained by a combination of demographic factors (ageing populations in the developed world and retiring baby boomers) and weak credit growth – a product of regulatory pressure on banks to build capital combined with huge reparation costs throughout the ten years of the post-crisis period. Absent these factors QE would have led to higher inflation despite other disinflationary factors driving prices down such as globalisation.

The Covid-19 pandemic has delivered the biggest global economic shock since the Second World War and is being met with a fiscal and monetary stimulus the likes of which the world has never before seen. As a consequence, central bank balance sheets are increasing at a rate unprecedented in modern economic history as governments everywhere seek to offset the worst effects of the lockdown and social distancing measures.

To put the scale of this stimulus in context it may help to compare what is happening now with the period that followed the financial crisis. During the six years of QE 1, 2 and 3 the FED's balance sheet grew by $4trn. So far during this crisis, the Federal Reserve's (FED) balance sheet has expanded by $2trn over the past four weeks and is forecast to expand by another $2trn throughout the rest of the summer. This vast and rapid expansion in the monetary base, we believe, will reinforce the move to higher inflation and this time the mitigating influences that dampened the inflationary impacts of QE will be relatively muted. It is conceivable that governments and central banks everywhere will quietly welcome this outcome and will tolerate higher inflation at levels above explicit targets for a period.

Our confidence in this somewhat non-consensual view is increased because it appears that some of the powerful disinflationary forces that we have witnessed play out over the past 20 years are likely to go into reverse in the wake of the pandemic crisis.

Shorter supply chains and a move to self-sufficiency in food production, vaccine production and other strategically important products could all lead to higher prices – in other words, a partial reversal of the last two decades of globalisation. It is likely that key public sector workers throughout the developed world could potentially see inflationary wage increases in the aftermath of the crisis. This, of course, will add a more inflationary economic environment. All of this upward pressure on prices will be bullish for all real asset inflation hedges but especially so for gold and other precious metals and of course for equities exposed to these assets.

For our Income Fund, this view is played out most obviously in the significant exposure to gold and precious metals miners and indeed to the wider commodity complex, but importantly, excluding oil. Other factors also influence our preference for these stocks – and these tend to be driven by our bullish views on growth in demand for all metals including zinc, nickel and copper. This longer-term view is in part a product of the growth in demand we see for these metals as the world switches to electric vehicles. We can only see these trends accelerating in the aftermath of the Covid-19 crisis.

This long-term inflation view does not drive all of the sector and stock decisions albeit that they are consistent with it. Within the Fund, other sector preferences that are a focus include the house building sector where we believe demand, prices, mortgage availability and land costs are all fundamentally supportive and where valuations are way too low.

In the utility sector where regulation in real terms protects the businesses from inflation and where dividend resilience is appealing, we have a number of holdings. In the financials' sector our exposure is focused on insurance where we also see attractive value in part because we believe the market underestimates dividend sustainability here. This is also a factor that influences our preference for Glaxo and Astra Zeneca, and BAT and Imperial Brands in the tobacco sector.

While the Fund has seen a few holdings announce dividend suspensions as a result of the Covid-19 crisis, the majority of the portfolio should either maintain or even continue to grow dividends and, as a result, we are hopeful that the Fund can achieve its distribution targets in 2020 and in 2021.

The Covid-19 crisis is clearly an economic and societal shock the like of which we have not seen before in modern economic history. Some commentators are forecasting unprecedented falls in GDP across the world and especially here in the UK that dwarf what was seen in the aftermath of the financial crisis. For example, the Office for Budget Responsibility (OBR) has talked about a potential 35 per cent fall in GDP in the second quarter and a reduction of more than 13 per cent for the year. In this scenario, the economy bounces back strongly in 2021 but the magnitude of these falls is more than twice as bad as we those experienced during the GFC.

Irrespective of the actual outcome, it is likely that the UK economy will suffer a sharp fall in GDP – however, the pain will not be evenly distributed. Certain parts of the UK economy will prove to be more resilient than others. Airlines, retail, hotels and restaurants are likely to be among the hardest hit but other sectors such as healthcare, tobacco and insurance should be largely unaffected. In respect of the gold and base metal miners, they may actually benefit from the fall in oil prices. Sector allocation is going to be an important driver of returns going forward and as an active manager, we are keen to focus on the likely winners and avoid the potential losers.

Some mitigating factors could also soften the lessen the impact on the economy. They include a public sector that has been working through the lockdown period and a construction sector that has continued to work throughout the past six weeks – albeit at a reduced level of capacity. It is also a recognition that the government's many initiatives to support the incomes of furloughed workers will stand the economy in good stead as it begins to open up.

The Fund has performed well during this Covid-19 crisis sell-off and has protected investors capital during an especially torrid period for the UK equity market. We also expect the Fund's income distribution to be reasonably resilient at a time when many companies have cancelled dividend distributions and funds abandon income targets. Indeed, we expect the Fund to meet its income target for 2020 and for 2021. This is especially important in the light of the announcement that Shell, the largest dividend payer in the world, was cutting its distribution by two thirds. Our Fund does not have a holding in Shell.

Because the Fund has the regulatory permission to write covered call options, this gives the Fund added confidence that it will be able to maintain and even grow the Fund's dividend, although, based on what we see in the portfolio at the moment, there will be no need to use this flexibility now or in the foreseeable future.

In conclusion, this is a Fund that could be well-positioned to benefit from domestic and global trends that we confidently expect will play out over the months and years ahead.

Ian Williams, Fund Manager, DMS Charteris Premium Income Fund

Important information
Past performance should not be as guide to future performance. All performance information is based on the Institutional Accumulation class unless stated otherwise. The value of this investment and the income from it can go down as well as up, it may be affected by exchange rate variations, and you may not get back the amount invested.

The views expressed in this document represent the views of the author at the time of preparation and should not be interpreted as investment advice.

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