Castlefield's B.E.S.T Sustainable Income Fund:

The search for investment income in the time of Covid-19

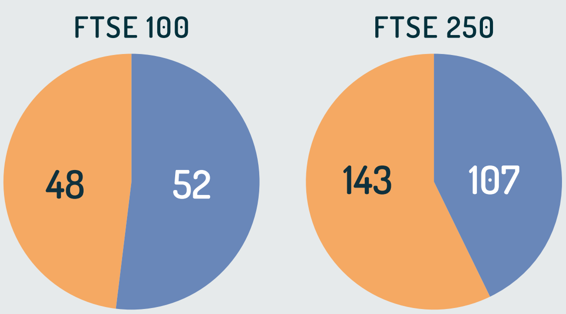
The coronavirus crisis has had a significant impact on investment values, and this is a topic that has been well covered in the media. Falls in capital values of many asset classes during March have been followed by the recovery to date as various government stimulus programmes have been announced and put into action.

What has perhaps been less well covered is the impact on investment income as a consequence of the crisis. With many companies deeply affected by the closure of large swathes of the economy for several months, firms have been under intense pressure to conserve cash. This has resulted in many businesses using a variety of means to shore up their finances, including self-imposed measures such as cutting executive pay and scrapping bonuses to reducing, postponing or cancelling dividend payments for shareholders.

For the Castlefield B.E.S.T Sustainable Income Fund, we have been actively repositioning the fund to offset some of the lost income and are hoping to provide some further clarity around the actions we have taken to date and our views on the market and anticipated levels of income.

Dividend Cuts and a Reduced Market Yield

With BP cutting its dividend in early July for the first time in a decade, this takes the tally up to 52 FTSE 100 companies which have either suspended, cut or cancelled their dividends for the current year. The FTSE 250 has seen a slightly smaller proportion of companies doing so, with the current total at 107 (as at 07/08/2020).



companies which **have** suspended, cut or cancelled dividends for the current year

companies which **have not** suspended, cut or cancelled dividends for the current year

Source: Castlefield as at 07/08/2020

We estimate that investors can expect a reduction in dividends from the wider UK market of close to 45%, after excluding any special or one-off dividends that were paid out last year.

While at the end of the second quarter, analyst consensus was forecasting a recovery to dividends in 2021, we remain cautious in our expectations as a second wave of the pandemic could dampen these hopes.

How does our Screening Policy impact the Fund?

Close to 75% of the dividend income of the FTSE100 comes from the top 20 companies in the index.[1] A large number of these companies would not form part of our investment universe due to our Screening Policy, which requires that we avoid companies involved in activities or industries that we deem to be unsustainable in nature. Several of the companies present within the top dividend payers are companies that we naturally avoid anyway, meaning that the Castlefield B.E.S.T Sustainable Income fund has entered the crisis from a position of much greater dividend stability.

Oil and gas majors, which have traditionally been significant contributors to the FTSE100's yield, are being forced to cut dividends as low commodity prices put their cashflows under pressure. We exclude these companies from our B.E.S.T Sustainable fund range as we, and most of our investors, do not believe that investing in companies involved in fossil fuel production is compatible with the principles of sustainable development and the efforts to slow the effects of climate change.

Large tobacco firms have also been seen as steadfast payers of dividends, where we have again seen cuts to dividends from companies citing difficult trading. This is another industry we exclude from our investments, whose harmful and addictive products damage lives and put strain on healthcare systems globally. Other industries impacted include mining, which we exclude from our investment universe, and the banking sector, which while not explicitly excluded from the fund, is an area where we have been underweight versus the index due to environmental, social and governance (ESG) concerns.

The result of these companies being excluded from our investment universe is that we must 'replace' this income from other sectors. Infrastructure is a core sector for the fund and renewable energy holdings such as Greencoat UK Wind amongst others have contributed to the income levels of the fund.

1 AJ Bell, as at 30th June 2020.

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Fund Activity

The past few months have seen plenty of activity within the fund. From the outset of the coronavirus crisis, our core aim for the fund remains unchanged – securing above market income levels from sustainable businesses. We took swift action to assess our holdings, exiting a number of holdings where dividend payments were at risk for the foreseeable future or where the path to recovery appeared rocky. Instead we introduced new positions where we could secure income from high quality companies with resilient business models.

Two new holdings introduced in recent months have been PayPoint and EMIS Group.

PayPoint is a provider of payment services to the convenience retail sector, utility companies, local governments and housing associations. They do so by providing payment solutions through its EPoS (electronic point of sale) systems, mobile and e-top ups, bill payment solutions, ATM machines and parcel services throughout the UK and Romania. PayPoint's main customers are smaller independents, such as local off-licences or the larger chain Nisa. These types of independent retailers, off-licences and convenience stores were included as part of the Government's list of essential businesses. With 99.5% of urban populations living within one mile of a store and 98.5% of rural population living within five miles of a store this model has been especially relevant in a period of restricted travel.[2] Paypoint's terminals also allow for services to be provided without approaching a staffed counter and support contactless card services.

The Group possesses a strong balance sheet, especially important in today's climate and is cash generative with the ability to flex its capital spend depending on market dynamics without being detrimental to its business. We have engaged with management prior to investing and we believe that the Group is well-placed to be a near-term winner but more importantly, also over the long-term. The company has maintained its above market dividend yield.

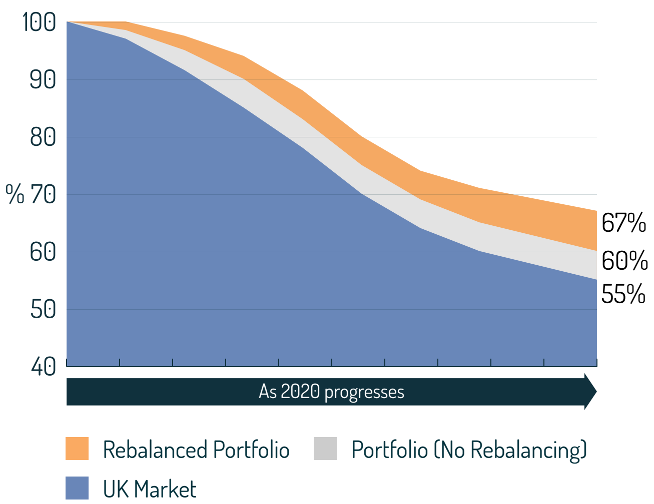
EMIS Group is a software company involved in the provision of IT service to the NHS, other key healthcare groups, pharmacies and also the public via its Patient Access app. Unusually for a software business, the group has a sufficiently established and cash generative business model that it is also able to pay an attractive dividend.

It is directly involved in improving access to health services and ensuring the efficient and secure storage of NHS patient records. As patient records frequently need to be transferred from GP services to primary care or hospital settings, a secure and efficient method of storing and sharing this data can improve patient outcomes, reduce waiting times and lower costs as this technology is increasingly adopted and rolled out.

The company has continued to trade well through the coronavirus crisis and has a strong balance sheet position with net cash to support it. EMIS have also been working to support their customers in these challenging circumstances by offering free access to video consultations to their GP customers. They have also been partnering with NHS Digital in developing templates to efficiently map cases of coronavirus on their existing web platform and track vulnerable patients.

Our rebalancing of the fund's holdings has allowed us to increase the portfolio's prospective income levels by a significant margin from they would have fallen to. As a result of the action taken so far, we estimate that we will limit the income reduction of the fund to approximately 33% rather than the c.45% we are anticipating for the wider UK market. With no rebalancing action, we estimate the fund would have seen a reduction of closer to 40%.

Estimated Income Relative to 2019



2 PayPoint 2019 Annual Report

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The Investor Experience

The fund collects dividends from investee companies as they are paid out, before in turn making its own distributions to fund investors on a quarterly basis. This adds a natural buffer to the flow of income between the point that it is received from underlying companies to the ultimate payment to unitholders of the fund. In practice, this means that the income most recently paid out to investors at the start of August had been built up over the end of Q2 and into Q3. Whilst the coronavirus pandemic has been with us some time, this most recent payment will be the first that investors will have received that will begin to really reflect the level of income reduction that has so far been announced.

With over £200bn currently invested in UK equity funds,[3] there are many, many investors who will only now be becoming aware of the impact on their income levels due to the coronavirus pandemic. The positive reaction that equities have shown to global stimulus measures has led to a significant recovery in capital values, however the next twelve months will be key in determining the path to a recovery in income levels too. Where actively managed funds can add value for investors is in their ability to refocus investments on areas where income is more sustainable, both now, in the immediate aftermath of the crisis and into the future.

Conclusion

We know that for many investors, income is an important part of their overall investment returns. Whilst income levels will undeniably be lower this year than last, by taking decisive action now to rebalance the portfolio we have been able to mitigate a substantial portion of this decline. We will continue to assess our investment universe for further opportunities in line with our B.E.S.T Sustainable process. The Castlefield Screening Policy has seen us enter the crisis with a portfolio better protected against the vagaries of the various lockdown measures intended to protect peoples' health but that have also been disastrous to some companies' business models. While health must take priority, we will continue to use our active investment approach to navigate the path between what is right for the safety of the population, what can produce a viable income and what meets our stringent B.E.S.T screening criteria.

3 The Investment Association, as at 30th June 2020.