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Initiation | Investment companies

28 March 2018

CQS New City High Yield

"Conservative and boring"

In the words of its manager, Ian Francis, CQS New City High Yield Fund (NCYF) is really conservative and boring! However, we think Ian's description undersells the fund. NCYF offers a compelling yield and has beaten the consumer price index, Libor and the MSCI UK Index by significant margins over the last 10 years; all the while providing low volatility returns. Furthermore, its premium rating (an average of 5.5% during the last year) and its ongoing share issuance (5.3% during the last year) suggest that it is delivering what investors want.

Ian is able to draw on the resources of CQS, which has the capability to calculate its own proprietary rating on any bond. Ian describes this as NCYF's 'secret sauce' as it allows it to invest in niche and unrated issues that typically earn a premium of 150-200 basis points (bp) to an equivalent rated bond with the same level of risk.

High dividend yield and potential for capital growth

NCYF aims to provide investors with a high dividend yield and the potential for capital growth by investing mainly in high yielding fixed interest securities. These include, but are not limited to, preference shares, loan stocks, corporate bonds (convertible and/or redeemable) and government stocks. The company also invests in equities and other income yielding securities. The manager has a strong focus on capital preservation and is conservative when in its approach to growing NCYF's capital.

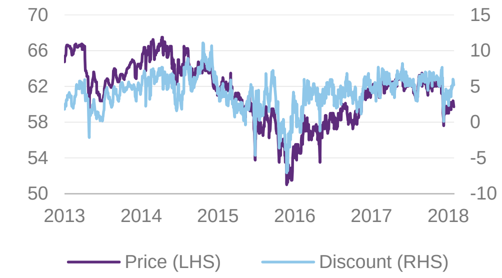
Year ended	Share price total return (%)	NAV total return (%)	Libor + 3% (%)	CPI + 4% (%)	MSCI UK total return (%)
28/02/14	6.5	3.3	3.5	6.5	10.6
28/02/15	1.2	2.4	3.5	5.4	5.4
29/02/16	(4.1)	(2.1)	3.6	4.1	(9.2)
29/02/17	21.0	19.3	3.5	4.7	24.2
28/02/18	4.1	5.7	3.4	6.8	3.2

Source: Morningstar, Marten & Co

Sector	UK equity and bond income
Ticker	NCYF LN
Base currency	GBP
Price	59.71p
NAV	56.75p
Premium/(discount)	5.2%
Yield	7.4%

Share price and discount

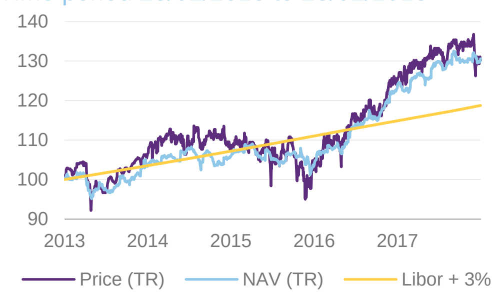
Time period 28/02/2013 to 26/03/2018



Source: Morningstar, Marten & Co

Performance over five years

Time period 28/02/2013 to 28/02/2018



Source: Morningstar, Marten & Co

Domicile	Jersey
Inception date	17 January 2007
Manager	Ian Francis
Market cap	233.2m
Shares outstanding	390.5m
Daily vol. (1-yr. avg.)	762.8k shares
Net gearing	10.2%

Contents

Fund profile

A predominantly higher yielding fixed income exposure

Further information can be found at: ncim.co.uk

NCYF's aim is to provide a high level of quarterly income, with the prospect of capital growth, through investment in a portfolio of predominantly higher yielding fixed income securities, with the flexibility to invest in equities and equity-related securities.

The manager seeks securities that are undervalued by the market.

Investments are typically made in securities which the manager has identified as undervalued by the market and which it believes will generate above average income returns relative to their risk, thereby also generating the scope for capital appreciation. The manager seeks to exploit opportunities presented by the fluctuating yield base of the market and from redemptions, conversions, reconstructions and take-overs to generate capital growth.

CQS Group and New City Investment Managers

NCIM has managed NCYF since its launch in March 2007.

New City Investment Managers (NCIM) has been NCYF's investment manager since its launch in March 2007. NCIM also managed NCYF's immediate predecessor (NCYT) from 2004 until its assets were rolled over into NCYF in March 2007 (see page 16).

On 1 October 2007, NCIM joined the CQS Group, a global diversified asset manager running multiple strategies with AUM of US$13.7bn as at 31 August 2017.

Ian "Franco" Francis

Lead manager, Ian Francis, has over 35 years of investment experience.

Ian Francis, a partner at CQS and Head of New City, has day to day responsibility for managing NCYF's portfolio. Ian joined NCIM in 2007. He has over 35 years' investment experience, primarily in the fixed interest and convertible spheres, having worked for Collins Stewart, West LB Panmure, James Capel and Hoare Govett. Ian is able to draw on the expertise of a 16-strong credit analysis team at CQS.

Constructed without reference to a benchmark

We believe that, over the longer term, NCYF should be able to provide both a real return as well as a return that exceeds Libor by a margin. We are therefore including comparisons against Libor + 3% and CPI + 4% in this report.

Reflecting its fixed income focus, the manager's absolute return mindset and the diversity of its holdings, NCYF's portfolio is not constructed with reference to any benchmark index. NCYF uses the FTSE 100 index for performance comparison purposes in its reports but its board explicitly says that this is used in the absence of a meaningful benchmark index. We have included comparisons against the MSCI UK index in this report. We also believe that, over the longer term, NCYF should be able to provide both a real return (one that exceeds consumer inflation by a margin) as well as a return that exceeds the Libor rate by a margin. We are therefore including comparisons against Libor + 3% and CPI + 4% but we would stress that these are not formal benchmarks for NCYF.

Manager's view

Further interest rate rises likely

With interest rates having been so low for so long and with unprecedented liquidity pumped into the financial systems through quantitative easing, the prospect of further interest rate rises is clearly heightened. The global economy is now performing ahead of expectations and we are approaching the top of the economic cycle.

Ian expects the investment grade market to suffer more heavily than the high yield market as interest rates rise.

Rising interest rates are broadly considered negative for both equities and fixed-rate bonds. Ian is not unduly concerned. NCYF's portfolio has a relatively short duration of around three-and-a-half to four years, which limits its sensitivity to interest rate rises and he believes that the investment grade market will suffer more heavily. Ian also thinks that the higher yield market, with its greater exposure to niche issues, is less sensitive to interest rate rises and should have ample prospects to replace bonds that mature or are called at similar rates.

Global economy strengthening

Ian considers that recent rising interest rates are a signal that the global economy is strengthening, which all things being equal should improve the abilities of corporates to meet their obligations. The US, for example, has a strong economy in his view and he expects to see further interest rate rises in 2018. Despite the potential negative impacts of Brexit, Ian is comfortable on the prospects for the UK companies behind the issues in NCYF's portfolio. He expects further rate rises in the UK, but thinks the path to normalisation will be slow. Looking at Europe, he thinks that this is now growing at a sensible rate and there are prospects of rising interest rates but with careful progression. As noted above, the global economy is increasingly late cycle but, given the analysis the CQS team has conducted on its holdings, and Ian's long-term view, he is comfortable that NCYF's portfolio will prove to be resilient during any economic downturn.

Financials – banks and insurance

Banks and insurance companies are much better capitalised.

The portfolio has a high allocation to issues from banks and insurance companies, with names such as OneSavings Bank, Barclays, Shawbrook and Virgin Money. There is also a significant allocation to other diversified financials. The manager says that these institutions are now much better capitalised than they were previously, but the market's attitude towards them has seen remarkably little change. As such, their issues tend to pay a relatively high yield for their level of risk, making them suitable for NCYF's portfolio.

Strong pipeline of new issuance coming to market

There are a lot of new issues coming to the market, but investors need to be selective.

The manager advises that there are a lot of new issues coming to the market at present, offering a range of opportunities, although he cautions that investors need to be selective. He notes that, with a rising oil price, there has been a resurgence in issuance from companies exposed to this sector, particularly from Scandinavia. Ian thinks that much of this is opportunistic and involves financing deep sea exploration. He is avoiding these issues as he holds the view that these types of operations are higher up the cost curve for exploration and are less likely to prove economically viable. He thinks that the returns on offer are not commensurate with the risks and sees better opportunities elsewhere.

Similarly, there has been demand for equity and debt to finance shipping. Clearly these operations have tangible assets against which finance can be secured but, once again, Ian urges caution. These assets need to be well managed and it is key to ensure that the right team, with a strong track record, is in place.

Bottom-up investment process

NCYF's portfolio is constructed using a bottom-up process that is based on extensive fundamental analysis of the credit risk and return prospects for potential investments. This analysis, which is conducted in house, includes:

- an assessment of the free cash flow available to the various security holders within a corporate's capital structure (for example, equity holders, debt holders, preferred stock holders and convertible security holders);
- the prospect of changes to cash flows (for example, from changes in interest rates or the competitive landscape);
- as well as an assessment of the company's track record in managing its obligations and the quality of the company's management.

Ian Francis can draw on the expertise of a 16-strong team of strong credit analysts at CQS.

Ian Francis makes the final decision on what enters NCYF's portfolio, but he is able to draw on the expertise of a 16-strong team of credit analysts at CQS when assessing and comparing potential investments.

When selecting candidates for the portfolio, the manager seeks to identify securities that it considers to be undervalued by the market. He expects these to generate superior income returns relative to their risk, with the scope for capital appreciation as the market rerates them. While income generation and the sustainability of income are key, capital preservation is also a major focus and the manager is not prepared to sacrifice capital in the pursuit of income.

Low turnover portfolio

NCYF maintains a moderately concentrated portfolio. The top 10 holdings account for 25% - 30% of the portfolio.

The manager maintains a portfolio of around 110-120 issues. This tends to be moderately concentrated, with the top 10 issues accounting for around 25% - 30% of the portfolio. The manager maintains a core set of holdings that are well understood, with the top 10 being relatively liquid in normal market conditions. The portfolio is inherently low turnover, excluding called positions. Many positions do not have an active secondary market and so the manager selects positions based on the view that they offer an attractive return, relative to their risk, all the way through to their ultimate maturity. As such, the manager is not looking to trade positions. If holdings leave the portfolio prior to their maturity, it is usually because they have been called by the issuer, although the issuer frequently pays a decent premium for the privilege of doing so. Turnover for a typical year is in the region of 50% but Ian expects that 30% to 40% will be due to forced redemptions.

NCYF's portfolio has a duration of around three-and-a-half to four years. It earns a geared return of around 8% per annum and pays out a yield in the region of 7%.

The portfolio tends to have a relatively short duration, of around three-and-a-half to four years, and earns a geared return of around 8% per annum, while paying out a 7% yield. This has been achieved without the use of options or dividend stripping. The manager does not hedge currency risk although he will take a macro view on currencies and avoid those that he does not favour. For example, NCYF's portfolio has not held any Australian dollar denominated assets since 2014/15.

Exposure to niche issues and unrated bonds

Exposure to smaller niche issues and unrated bonds allows NCYF to earn a yield premium.

The manager's ability to calculate its own internal ratings on any bond, allows it to properly assess smaller niche and unrated issues. These issues will tend to earn a premium of 150-200bp for an equivalent level of risk, which is key in allowing NCYF's portfolio to generate superior risk adjusted returns.

Investment restrictions

There are no defined limits on type of securities, countries, issue size or sectors.

In addition to fixed income securities, NCYF also invests in equities and other income yielding securities. There are no defined limits on type of securities, countries, issue size or sectors, although the board has set a limit whereby NCYF will not invest more than 5% of its total investments in securities issued by the same investee company.

A maximum of 10% of total assets can be invested in collective investment vehicles.

NCYF may invest in derivatives, financial instruments, money market instruments and currencies, for the purpose of efficient portfolio management, although it is not obliged to do so. NCYF can invest in both closed-end and open-ended funds but will not invest more than 10% of its total assets, as at the time of investment, in such collective undertakings.

NCYF may invest up to 10% (calculated at the time of any relevant investment) of its total assets in other securities that are neither listed nor traded at the time of investment. It may also acquire securities that are unlisted or unquoted (at the time of investment) but which are about to be convertible, at the option of NCYF, into securities which are listed or traded on a stock exchange. NCYF is permitted to hold securities that cease to be listed or traded if the manager considers this appropriate but such securities are limited to 10% of NCYF's total assets (calculated at the time of any relevant investment).

Gearing is currently limited to 25% of net assets by the board. This limit is reviewed periodically.

NCYF is permitted to borrow and the board has set a gearing limit of 25% of net assets, at the time of borrowing, which it reviews periodically (see page 15). The manager expects that NCYF's portfolio will normally be fully invested. However, during periods in which changes in economic circumstances, market conditions or other factors so warrant, NCYF is permitted to reduce its exposure to securities and increase its positions in cash, money market instruments and derivative instruments in order to seek protection from stock market falls or volatility.

Risk management

NCYF's board monitors the spread of investments.

In addition to the above investment restrictions, the board monitors the spread of investments to ensure that it is adequate to minimise the risk associated with particular countries or factors specific to particular sectors. The manager also employs risk management disciplines which monitor NCYF's portfolio and to quantify and manage the associated market and other risks.

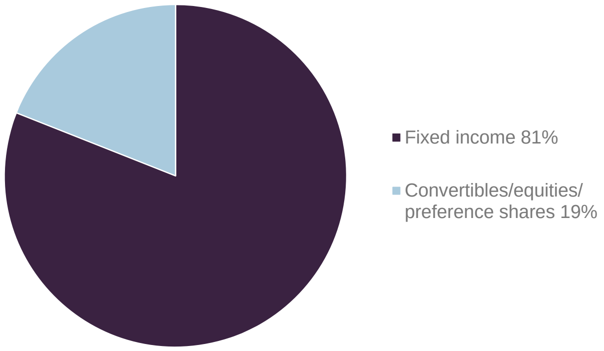
Oversight is provided by the risk management and performance analysis team within CQS.

CQS has established a permanent department, independent of the portfolio manager, to perform the risk management function. This risk management and performance analysis team (RMPA) is not involved in the performance activities of NCYF and has policies, processes and procedures designed to identify, quantify, analyse, monitor, report on and manage all material risks relevant to NCYF's investment strategy. The systems include third party vendor applications such as Tradar, Sungard Front Arena and MSCI Risk Metrics, complemented by a number of proprietary applications.

Asset allocation

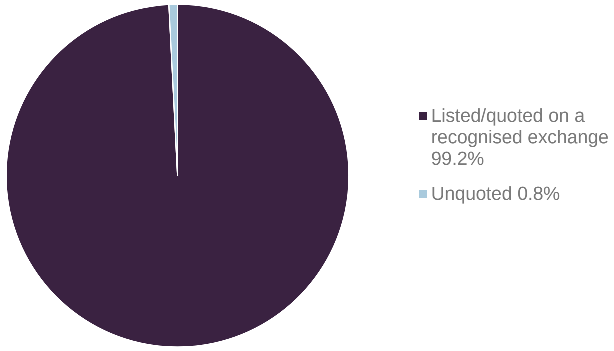
As at 31 January, NCYF's portfolio had had exposure to 117 issues (down from 129 issues as at 31 July 2017) and, as illustrated in Figure 5, the top 10 issues accounted for 26.7% of the portfolio (up from 25.3% as at 31 July 2017). Figures 1 to 4 show various splits of the portfolio (asset class, quotation, sector and currency), with the data provided being the most data that is publicly available.

Figure 1: NCYF portfolio split by asset class at 31 January 2018



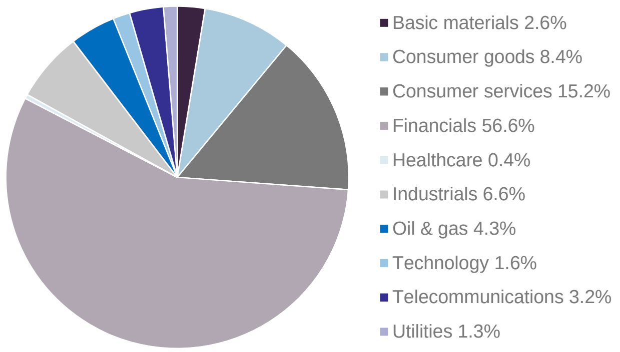
Source: CQS New City High Yield Fund, Marten & Co

Figure 2: NCYF portfolio split by quotation at 30 June 2017



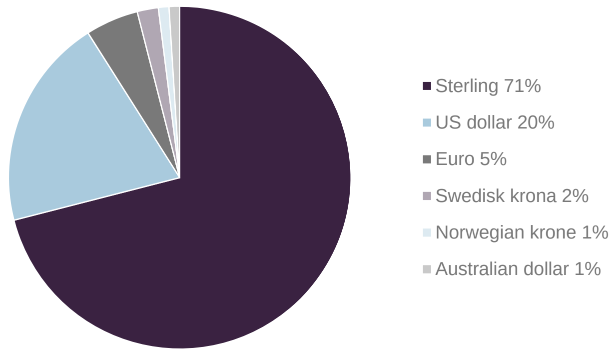
Source: CQS New City High Yield Fund, Marten & Co

Figure 3: NCYF portfolio split by sector at 30 June 2017



Source: CQS New City High Yield Fund, Marten & Co

Figure 4: NCYF portfolio split by currency at 31 December 2017



Source: CQS New City High Yield Fund, Marten & Co

These charts illustrate a number of themes:

- The portfolio is overwhelmingly invested in pure fixed income securities
- All but a tiny percentage of the portfolio is quoted on a recognised exchange (although around 70% trades OTC and so will be relatively illiquid)
- The portfolio has exposure to issues from companies in a diverse range of sectors, with a heavy concentration in financials that reflects the manager's views on bank and insurance issues (see page 4)

The portfolio is predominantly exposed to sterling (around 70%) and has a US-dollar exposure of around 20%.

Top 10 holdings

Figure 5: 10 largest holdings at 31 January 2018

Holding/issue	Industry	Allocation 31 January 2018 (%)*1	Allocation 31 July 2017 (%)*1	Percentage point change
Punch Taverns 7.75% 30/12/2025	Restaurants & bars	3.5	2.3	1.2
CYBG 8% variable perpetual	Banks	3.4	3.1	0.3
Garfunkelux Holdco 11% 01/11/2023	Insurance	2.8	2.7	0.1
REA Finance 8.75% 31/08/2020	Food products	2.7	2.6	0.1
Galaxy Finco Ltd 7.875% 15/11/2021	Insurance	2.6	2.9	(0.3)
OneSavings Bank Plc 9.125% variable perpetual	Banks	2.5	2.6	(0.1)
Barclays Bank 7% variable perpetual	Banks	2.5	2.4	0.1
Partnership Life Assurance 9.5% 24/03/2025	Insurance	2.3	2.3	0.0
Pizza Express financing 8.625% 01/08/2022	Restaurants & bars	2.3	2.7	(0.4)
Unique Pub finance 7.395% 28/03/2024	Restaurants & bars	2.2	3.2	(1.0)
Total of top 10		**26.7**	**25.3**	**1.4**

Source: CQS New City High Yield Fund, Marten & Co

Figure 5 provides a summary of the top 10 issues within NCYF's portfolio as at 31 January 2018. The names of the issuers will all be familiar to regular followers of NCYF, which is arguably a reflection of the manager's long term, low turnover approach to managing the portfolio. Comparison of this list with NCYF's annual report for 2017 shows all of these names to be within NCYF's top 11 holdings as at 30 June 2017. We discuss a couple of the larger issues below.

Punch Taverns 7.75% 30 December 2025

Owned by Patron and May Capital, Punch Taverns (**www.punchtaverns.com**) has around 1,100 Pubs and bars in the UK. The estate is mixed with a blend of leased, tenanted and retail businesses ranging from sports bars to village pubs. First established from the Bass leased pubs in 1997, the company is actively managing the estate to remove non-core locations. Ian says that the company currently operates on a free cash flow to debt service ratio of 1.2:1, which, when added to the asset backing of the company, makes this a target investment for the fund.

CYBG 8% variable perpetual

CYBG (**www.cybg.com**) is a holding company that owns Clydesdale Bank, Yorkshire Bank and the app-based bank, B. It was formed by National Australia Bank (NAB) in advance of a stock market flotation in February 2016 that allowed NAB to divest its UK business arm (NAB having previously acquired Clydesdale Bank in 1987 and Yorkshire Bank in 1995). This is a £450m issue which was initially sold to NAB in 2015 (the then parent of the Clydesdale and Yorkshire Banking Group) and was remarketed at a discount shortly after NAB divested their CYBG holding in early 2016.

Although sometimes regarded as a “challenger bank” by the media, CYBG has a long history and a balance sheet in excess of £40bn; in Ian’s view it is a mid-sized bank similar to Virgin Money. The CYBG retail branch network is spread across Scotland and Northern England. Ian says that, under NAB’s ownership, CYBG’s management lacked focus and costs became bloated, which current management are addressing, albeit somewhat offset by the cost of new IT infrastructure. The bank has a stable net interest margin 227bp, and 12.4% common equity tier 1 capital (Sep-17). He says that the bank is conservatively run with a £23.5bn mortgage book, £7.3bn SME loans and £1.2bn unsecured lending, while the £27.7bn deposit book is dominated by cheaper current accounts. Currently ROTE remains low at 7.5% (year to Sep-17) but continues to improve. In Scotland, Clydesdale Bank issues bank notes which are in wide circulation. Clydesdale has been printing bank notes since 1838, and the current denominations include a £100 pound note.

Performance

There is a long-term trend of outperformance coupled with lower volatility.

As illustrated in Figure 6, NCYF has provided NAV and share price total returns, over the longer-term 10-year period, that have outperformed both the UK equity market (as represented by the MSCI UK Index), Libor + 3% and CPI + 4% – all by some margin. We think this is impressive given NCYF’s fixed income focus. As illustrated in Figure 7, this long-term outperformance has been achieved while providing markedly lower return volatility than the peer group averages and the MSCI UK Index. While NCYF’s NAV performance against the MSCI UK Index is mixed (comparable over three-years while underperforming over five-years), it consistently outperforms both Libor + 3% and CPI + 4% for the periods provided, one-year and above.

Figure 6: Cumulative total return performance to 28 February 2018

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
NCYF NAV	(0.6)	0.8	0.5	5.7	23.5	30.6	135.3
NCYF share price	(2.9)	(3.1)	(1.5)	4.1	20.8	30.2	129.1
Libor + 3%	0.3	0.9	1.7	3.4	10.8	18.8	49.4
CPI + 4%	0.5	1.7	3.4	6.8	16.3	30.6	85.5
MSCI UK	(3.4)	(0.5)	(1.4)	3.2	16.4	35.6	78.4

Source: Morningstar, Marten & Co. *Note: NCYF does not have a formal benchmark. The MSCI UK index, Libor + 3% and CPI + 4% are included purely for performance comparison purposes.

Figure 7: Annualised standard deviation of NAV returns to 28 February 2018*

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)	10 years (%)
NCYF NAV	5.42	4.07	4.23	4.00	4.64	4.61	7.93
NCYF share price	21.80	16.33	13.92	14.02	18.18	16.16	15.35
UK equity & bond income NAV	9.75	6.78	5.97	5.90	8.50	7.97	12.11
UK equity & bond income price	23.04	16.10	13.87	13.70	16.92	16.01	20.96
MSCI UK	20.53	14.13	11.87	11.44	17.72	16.38	23.13

Source: Morningstar, Marten & Co. *Note: As discussed in the peer group section below, Aberdeen Smaller Companies Income Trust has been excluded from the UK equity and bond income peer group.

Peer group

NCYF is a member of the AIC's UK equity and bond income sector, which comprises four members: NCYF, City Merchants High Yield (CMHY), Henderson High Income (HHI) and Aberdeen Smaller Companies Income Trust (ASCI). Members of this sector invest both in equities and bonds with the aim of producing a high income. For the purposes of this analysis, we have excluded ASCI from the peer group as we do not consider it to be a useful comparator to NCYF. With a market cap of £64m it is much smaller than the other funds in the sector and its strategy is generating a much lower yield (2.49%). Perhaps in part reflecting these key differences, ASCI trades at a much wider discount than its peers (10.8% for ASCI versus 0.9% for the peer group).

Please click here to visit QuotedData.com for a live comparison of the UK equity and bond income peer group.

As illustrated in Figure 8, NCYF's cumulative NAV total return performance is ahead of the peer-group average for most of the time horizons provided; the five-year period being the exception. In this instance, the average has been pulled up primarily by HHI which, as is illustrated in Figure 10 below, tends to run with much higher levels of gearing. With this higher gearing, HHI will tend to benefit more from rising markets but suffer more heavily in falling markets. As such, HHI's superior five-year NAV performance comes with the expense of much higher NAV return volatility. As illustrated in Figure 10, HHI has a standard deviation of NAV returns, over five-years, that is nearly three and a half times that of NCYF and four and a half times that of CMHY.

Figure 8: Peer group cumulative NAV total return performance to 28 February 2018

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
NCYF	(0.6)	0.8	0.5	5.7	23.5	30.6
City Merchants High	(0.5)	(0.0)	0.6	5.3	20.5	44.2
Henderson High Inc.	(4.5)	(3.8)	(3.4)	3.0	14.4	58.5
NCYF rank	1	1	2	1	1	3
Sector arithmetic avg.	(1.7)	(1.0)	(0.8)	4.7	19.4	44.5

Source: Morningstar, Marten & Co.

Figure 9 illustrates a similar story for share price total return although NCYF is ahead of the peer group average and ranks first for all periods other than the five-year period.

Figure 9: Peer group cumulative share price total return performance to 28 February 2018

	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (%)	5 years (%)
NCYF	(2.9)	(3.1)	(1.5)	4.1	20.8	30.2
City Merchants High	(4.2)	(7.6)	(6.5)	(1.2)	11.6	39.8
Henderson High Inc.	(4.3)	(5.8)	(7.0)	(0.6)	9.4	50.8
NCYF rank	1	1	1	1	1	3
Sector arithmetic avg.	(3.8)	(5.5)	(5.0)	0.7	13.9	40.3

Source: Morningstar, Marten & Co.

NCYF is the largest fund in the sector and, while its size is only just ahead of HHI, it appears better placed to continue to grow. NCYF is trading at a premium rating (HHI is trading at a mild discount), which has allowed NCYF to continue to issue stock. With the exception of stock issued in conjunction with the rollover of Threadneedle UK Select, HHI has not issued any new stock since November 2016. CMHY last issued stock in December 2017 and NCYF in January 2018.

Figure 10: Peer group comparison – size, fees, discount, yield and gearing as at 22 March 2018

	Market cap (£m)	St. dev. of NAV returns over 5 years	Ongoing charges (%)	Perf. fee	Discount (%)	Dividend yield (%)	Gross gearing	Net gearing
NCYF	235.9	4.6	1.21	No	6.0	7.30	113	111
City Merchants High	172.2	3.4	1.01	No	(5.9)	5.60	100	100
Henderson High Inc.	216.0	15.9	0.82	Yes	(2.8)	5.70	125	124
NCYF rank	1	2	3		1	1	2	2
Sector arithmetic avg.	208.0	8.0	1.01		(0.9)	6.2	112.7	111.7

Source: Morningstar, Marten & Co.

While not unduly high, NCYF's ongoing charges are the highest in its peer group. However, all things being equal, these should continue to fall as NCYF grows and its fixed costs are spread over a larger asset base. HHI's ongoing charges are markedly lower than NCYF's and CMHY's but it should be remembered that HHI's management fee structure also includes a performance fee element, although this is capped at 0.40% of average gross assets in any one year.

For high yield funds such as these, the yield level is a key determinant in the attractiveness of the fund to investors and so, perhaps, it is not surprising that NCYF, with its peer group topping yield (some 250bp above its closest peer), has the lowest discount. Gearing is another consideration and maybe more of a concern for investors when markets are at more elevated levels. NCYF's gearing levels are comparable to the sector average although, in reality, it finds itself roughly in the middle between CMHY's ungeared position and HHI's heavily geared position.

Quarterly dividend payments

The board intends to pay an attractive level of dividend income.

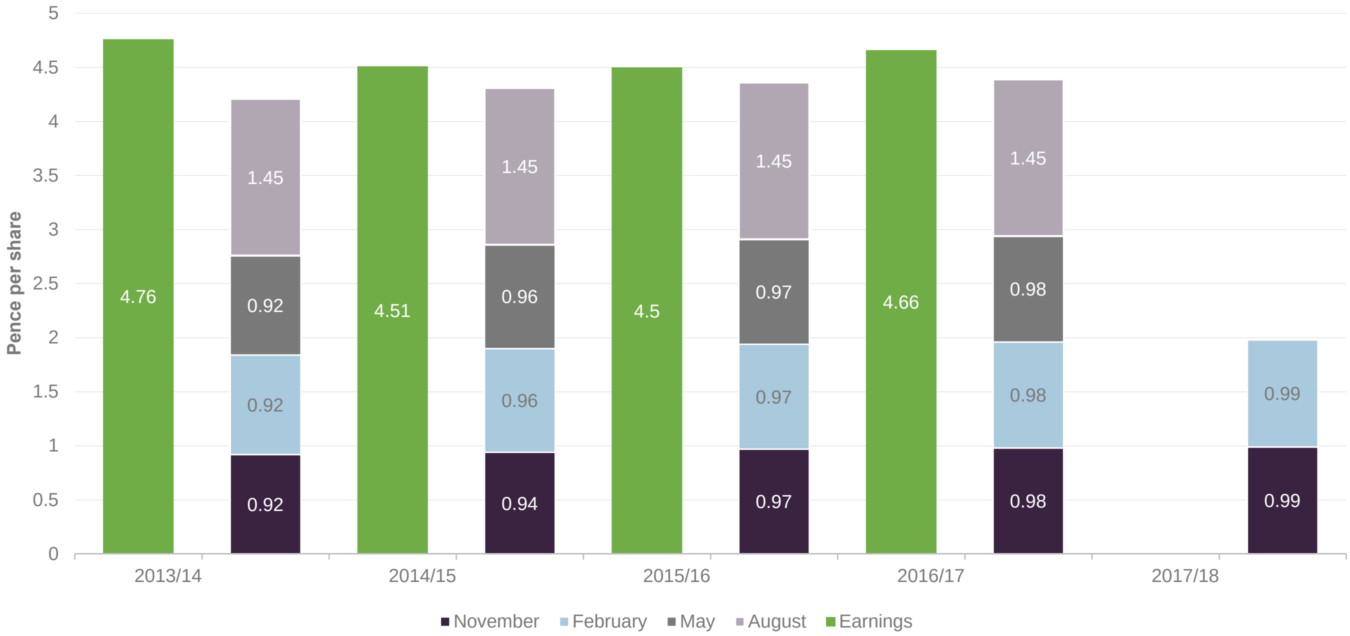
Subject to market conditions and the company's performance, financial position and financial outlook, the board intends to pay an attractive level of dividend income to shareholders on a quarterly basis. The company intends to pay all dividends as interim dividends.

The total annual dividend has increased every year since launch.

For a given financial year, the first interim dividend is paid in November (2017: 0.99p) with the second, third and fourth interims paid in February, May and August. As illustrated in Figure 11 below, the quarterly dividend rate paid for the first quarter has been maintained for the second and third interims in December and March, which is followed by a larger 'balloon payment' for the fourth quarter. Although not a formal aspect of NCYF's dividend policy, the total annual dividend has increased every year since launch.

As illustrated in Figure 11, for the year ending 30 June 2017 NCYF paid a total dividend for the year of 4.39p (2016: 4.36p), which is a yield of 7.4% on NCYF's share price of 59.71p as at 26 March 2018. However, assuming that NCYF maintains its interim dividend at 0.99p per share for the third interim dividend and at least matches last year's final dividend payment of 1.45p per share, this suggests a minimum total dividend of 4.42p per share. This an 7.4% yield on NCYF's share price as at 26 March 2018.

Figure 11: NCYF five-year dividend history



Source: CQS New City High Yield Fund, Marten & Co

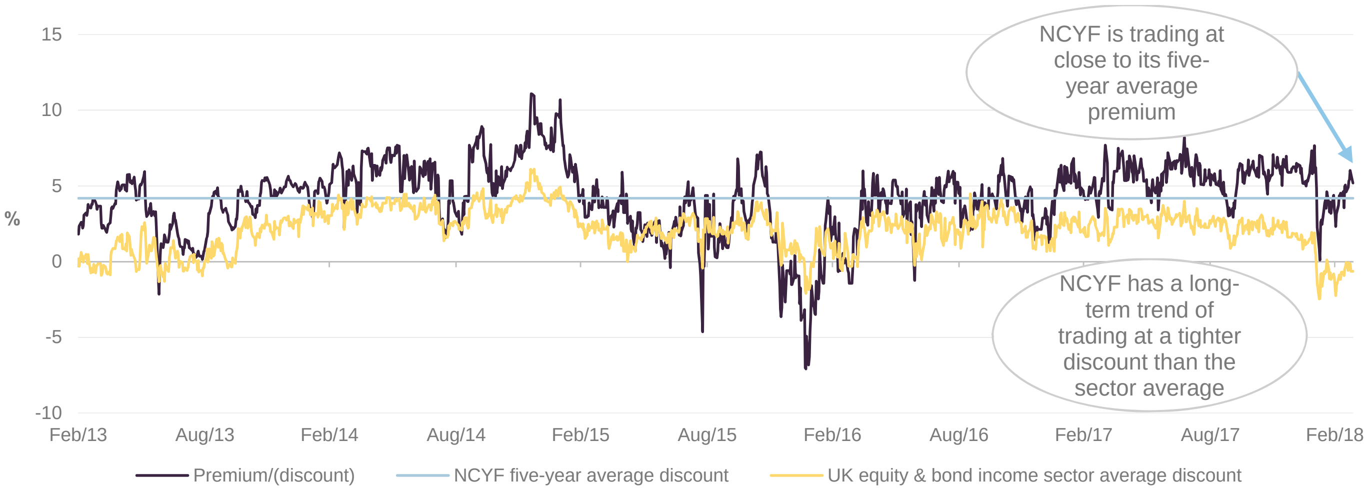
Over one year's worth of dividends in reserve

The board avoids issuing stock close to ex-dividend dates to protect NCYF's revenue reserve.

As Figure 11 shows, NCYF's revenue income has also exceeded its dividend in recent years allowing the company to build on its revenue reserve. As at 30 June 2017, NCYF had a revenue reserve of 4.43p per share (2016: 4.36p). As such, NCYF has revenue reserves that are sufficient to cover just over one year's worth of dividend payments. It should also be noted that the board is conscious of the diluting effects of share issuance on the revenue reserve and avoid issuing stock close to ex-dividend dates.

Premium/(discount)

Figure 12: Premium/(discount) over five years



Source: Morningstar, Marten & Co.

Persistent premium indicates strong demand for NCYF's strategy

NCYF has predominantly traded at a premium during the last five years.

As illustrated in Figure 12, NCYF has predominantly traded at a premium during the last five years. This suggests good demand for NCYF's strategy, which is reflected in an ongoing programme of share issuance. During the last 12 months, NCYF has issued 27.0m shares, or 7.4% of its issued share capital.

NCYF has the authority to issue up to 10% of its issued share capital and repurchase up to 14.99% of its issued share capital, which gives it mechanisms through which it can moderate its premium or discount. The board says that it monitors the level of the company's discount or premium to NAV although there is no formal target for either and there is no formal discount control mechanism in place.

NCYF is currently trading at around its five-year average premium.

NCYF is currently trading at around its five-year average premium and has tended to trade within a premium range of 5% to 8% during the last 12 months. It is also clear from Figure 12 that NCYF generally trades at a premium to the wider UK equity and bond income peer group.

Stock issuance continues at a 5% to 6% premium

We estimate that NCYF has issued shares at an average premium of 5.3% during the last 12 months.

Using the closing cum fair NAV on the day of the trade, we estimate that the average premium at which NCYF has issued shares is 5.3% during the last 12 months. The premium to the closing price ranges between 4.8% and 6.0% but it would appear that the board is open to providing liquidity to the market at the 5% to 6% premium level, although this is by no means guaranteed. However, issuing new shares at a premium to NAV is accretive to existing shareholders.

Significant room to grow

NCYF's strategy could support an AUM a multiple of its current size

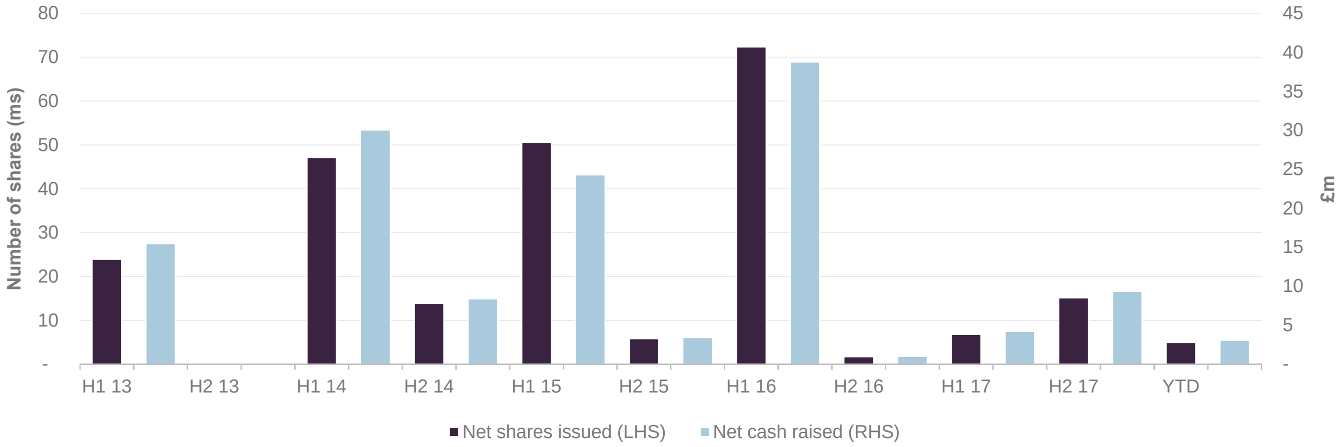
The managers say that NCYF's strategy could comfortably support an AUM that is a multiple of its current size, without negatively impacting on their ability to generate returns, and so there is considerable room to expand the fund from here. The managers are keen to do this in a controlled and measured way that allows them to be selective in their asset purchases but, subject to this proviso, we would welcome further issuance as it should not only improve liquidity in NCYF's shares but, all things being equal, should reduce its ongoing charges ratio by spreading its fixed costs over a larger asset base.

NCYF created treasury shares as an efficient means of raising capital

NCYF has 7.4m left of the 36.2m treasury shares it created in March 2016.

The only repurchase that NCYF has made during the last five years was the immediate repurchase of 36,177,417 shares, in March 2016, that were issued for the sole purpose of creating treasury shares. This was undertaken to give NCYF an efficient and cost effective means of raising capital. As at 26 March 2018, NCYF had 7,427,441 shares left in treasury.

Figure 13: Net stock issuance and net amount raised, by quarter, over five years



Source: Morningstar, Marten & Co.

Assuming that the board continues to issue shares at similar premium levels, this should prevent the average premium from expanding much beyond the current level. Rising interest rates, or perhaps a surge in equity markets, could see a reduction in demand for NCYF's shares, putting downward pressure on the premium. However, the prospects for this could be limited given that equity markets are trading at valuations that are moderately high compared to history and that the duration of NCYF's portfolio is relatively short, limiting its sensitivity to interest rate rises.

NCYF's strong yield is a key factor driving the demand for its shares. There is clear support for the current premium level.

NCYF's strong yield is a key factor driving the demand for its shares, in our view. We believe that, provided NCYF continues to deliver its high yield and attractive returns, and investors continue to seek assets that are less correlated with traditional equity markets, there is clear support for the current premium level, and further asset growth from here.

Fees and costs

Base management fee of 0.8% per annum; no performance fee

NCYF has a tiered management fee – 0.7% for total assets in excess of £200m

Under the terms of the investment management agreement, CQS is entitled to receive a basic management fee of 0.8% per annum of total assets (less current liabilities other than bank borrowings) up to £200m and 0.7% per annum above this. The management fee is paid monthly in arrears and there is no performance fee element. The management agreement can be terminated on 12 months' notice by either side.

Secretarial and administrative services

Company secretarial services are provided by R&H Fund Services (Jersey) Limited. Administration functions, including UK compliance oversight, has been delegated to Maitland Administration Services (Scotland) Limited (formerly R&H Fund Services Limited). Custody and settlement services are undertaken by HSBC Bank plc.

The UK administrator is entitled to a fixed fee of £130,000 per annum and a variable fee of 0.01% of total assets (less current liabilities excluding any bank borrowings) in excess of £200m.

Allocation of fees and costs

In NCYF's accounts, the investment management fees are allocated 25% to capital and 75% to revenue. The ongoing charges ratio for the year ended 30 June 2017 was 1.2% (2016: 1.2%).

Capital structure and life

NCYF has one class of ordinary share in issue.

NCYF has a simple capital structure with one class of ordinary share in issue. Its ordinary shares have a premium main market listing on the London Stock Exchange and, as at 26 March 2018, there were 397,951,858 in issue with 7,427,441 held in treasury.

The board has set a borrowing limit equal to 25% of NCYF's net assets. NCYF has a £30m loan facility with Scotiabank.

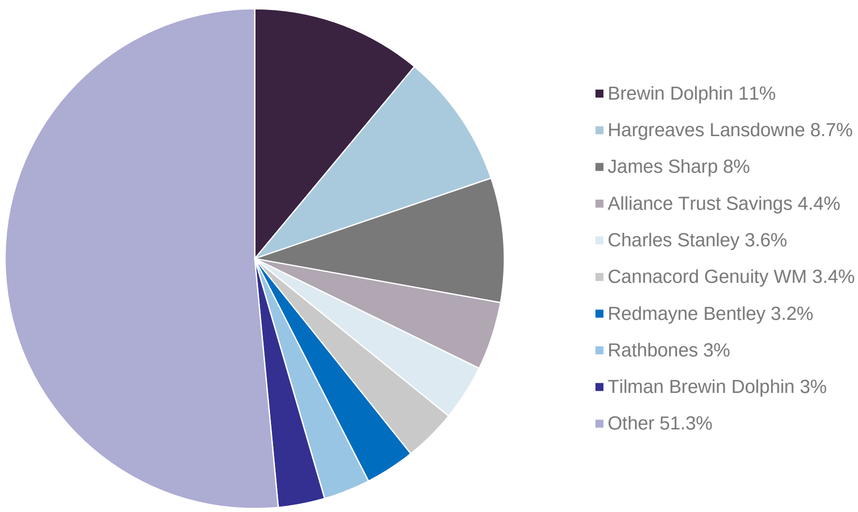
NCYF is permitted to borrow and the board sets borrowing limits, which it reviews on a regular basis, to ensure gearing levels are appropriate to market conditions. As at 5 October 2017, the maximum gearing level was set at 25% of net assets. NCYF has a £30m loan facility with Scotiabank which bears an all-in rate of 1.27%. As at 28 January 2018, NCYF had gross gearing of 12.4% and net gearing of 10.2%.

Unlimited life with an annual continuation vote

NCYF does not have a fixed winding-up date but, at each annual general meeting (AGM), shareholders are given the opportunity to vote on the continuation of the company as an investment company. This is an ordinary resolution. If this resolution was not passed, the board would put forward proposals to liquidate or otherwise reconstruct or reorganise the company.

Major shareholders

Figure 14: NCYF major shareholders



Source: CQS New City High Yield Fund

Financial calendar

The trust's year-end is 30 June. The annual results are usually released in October (interims in March) and its AGMs are usually held in November of each year. As discussed on page 11, NCYF pays quarterly dividends in November, February, May and August.

Corporate history

NCYF was established for the purposes of moving the domicile of its predecessor vehicle, New City High Yield Trust.

NCYF is a Jersey-domiciled closed-ended investment company incorporated on 17 January 2007. Its shares, which have a premium main market listing, have been listed on the London Stock Exchange since 7 March 2007. NCYF was established for the purposes of moving the domicile of its predecessor vehicle, New City High Yield Trust Plc (NCYT), from the UK to Jersey. On 6 March 2007, the net assets, which totalled £52.9m, were transferred from NCYT into NCYF and an additional £15m of new capital was raised at the same time. The primary rationale for this change was to enhance net distributable income and increase investment flexibility. Prior to becoming NCYT, the trust had been through a number of iterations but always had a high yield focus. The original vehicle was launched by Lazards in 1993.

Board

NCYF's board comprises six directors, all of whom are non-executive and considered to be independent of the investment manager Other than NCYF's board, its directors do not have any other shared directorships. The company's articles of association limit the aggregate fees payable to the directors to a total of £250,000 per annum.

Board members offer themselves for re-election every three years.

NCYF's articles of association require that board members offer themselves for re-election at least once every three years. Board members that have served for nine or more years must offer themselves for re-election annually. Of NCYF's board members, the only director to have served more than nine years is the chairman, James West, who has been a board member since NCYF's launch in 2007. James was last re-elected to the board on November 2017 and, assuming that he wishes to serve as a director beyond the current financial year, we would expect James to offer himself for re-election at NCYF's next AGM (scheduled for November 2018). Readers may wish to note that James West was also chairman of NCYF's predecessor (NCYT - see section on corporate history above). James was originally appointed to the board of NCYT in July 1993, before coming chairman in October 2001.

Recent refresh

Five of the six directors have been appointed during the last five years.

The board has undergone a refresh in the last two years. Alistair Carey, Gavin Breeze and Adrian Collins, all members of NCYF's board since the 2007 launch, stood down in March 2016, July 2016 and November 2017 respectively. Wendy Dorman, Ian Cadby and John Newlands joined in their place. On 16 March 2018, NCYF announced that Caroline Hitch had been appointed to NCYF's board with immediate effect. Caroline worked for 24 years at HSBC, where she had an investment focus on multi asset portfolios and a particular interest in transparency and governance. Prior to this, Caroline spent a number of years with James Capel and Standard Chartered. Five of the current six directors have been appointed during the last five years.

Figure 15: Board member - length of service and shareholdings

Director	Position	Date of appointment	Length of service (years)	Annual director's fee (GBP)	Share-holding*	Years of fee invested*
James West	Chairman	17 January 2007	11.2	37,500	55,850	0.9
Wendy Dorman	Chairman of the audit and risk committee	2 March 2016	2.7	31,250	64,000	2.6
Duncan Baxter	Director	31 July 2015	2.1	25,000	109,412	1.2
Caroline Hitch	Director	16 March 2018	0.0	25,000	92,000	2.2
John Newlands	Director	5 October 2017	0.5	25,000	10,000	0.2
Ian Cadby	Director	18 January 2017	1.2	50,000	25,000	0.3
Average (service length, fee, shareholding, fees invested)			2.9	32,292	59,377	1.2

Source: CQS New City High Yield Fund, Marten & Co. *Note: shareholdings as per most recent company announcements as at 26 March 2018. Years of fee invested based on NCYF's ordinary share price of 59.71p as at 26 March 2018.

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