Investment update

23 January 2012

Stephen Message, manager of the Old Mutual Equity Income Fund

Stephen Message took over management of this fund in November 2009. Stephen joined OMAM in October 2008 from US private wealth manager Bessemer Trust, where he worked for two years, firstly as an analyst covering Asia ex Japan and UK equities and then as manager of the UK component of Bessemer's international equity fund. Prior to this he was a business analyst at technology consultancy Detica. Stephen has a masters degree in engineering from Imperial College London and is a CFA Charterholder.

The challenge of growth

We may be facing a low growth economy, but there are still companies increasing their profits… not always where you expect to find them

In an environment of low economic growth and subdued levels of consumer confidence, as we are currently witnessing in the UK, the task of growing profits for many businesses becomes increasingly challenging.

The recent profit warning from Tesco is a good example. In our view, it indicates the high level of competition in the food retail sector. Whilst many would consider this sector to be fairly defensive in nature given that demand for food does not fluctuate materially, competition is fierce and retailers have to work hard to win their share of consumer spending through a range of promotions and offers. Unfortunately, cutting prices to win business often means lower profits and in Tesco's case a tougher than expected festive sales period ultimately wiped almost £5bn off the company's value.

The food retail industry has been successful in growing profits over the past decade through expansion of their selling space, improvement in supply chain efficiencies, diversification into non-food and also previously through a more buoyant consumer. Given that it feels we are at a saturation point in terms of selling space (Tesco highlighted it would build fewer out of town megastores going forward), and a more price conscious shopper, it seem likely that it will be more difficult for the industry to enjoy the rates of growth that it has in the past and we currently have little exposure to this area in our portfolio.

In a mature market with a commoditized product offering you can often only charge as much as the cheapest competitor. Another industry cutting prices at the moment is the domestic energy sector. EDF Energy recently announced it would be reducing its gas bills to its customers by 5%. In order to hold on to their customers we imagine the other energy suppliers will follow suit, which could have implications for the profits at UK listed energy suppliers SSE and Centrica.

The dynamic in this industry is similar to that in food retail; a sector dominated by a few large players where demand for the end-product is fairly robust, however the pricing environment is challenging putting pressure on industry profits. Therefore we also have little exposure to the utility sector.

Whilst we think life will be tough for some of the businesses operating in the food and energy retail space, we are still able to find a number of interesting investment opportunities operating in the UK that can continue to deliver healthy levels of profit growth. The key is finding those businesses in strong competitive positions or those that can grow through self help measures.

One example is Booker Group, the cash and carry operator. Cash and carry is by no means a growth industry yet the team at Booker have managed to consistently post improvements

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in sales over the past few years as they have taken market share from their peers. This has been achieved through improving the range and pricing of products on offer, a better store environment and improved customer service. We believe they will continue to do this and see scope for further expansion of their profit margins. The company is also increasing its presence in the delivery market which will also add another leg to their growth.

Another example would be Restaurant Group, the operator of several restaurant franchises including Frankie and Benny's, Garfunkels and Chiquitos. The company is benefitting from the increasing trend in casual dining and will be rolling out further outlets this year. Many of its competitors have cut prices and offered promotions in an attempt to lure in customers, but this will have likely lowered their profit margins which will be difficult to recover (would you ever visit many of these places without a 2-4-1 voucher now?). However the team at Restaurant Group have been fairly disciplined in their pricing approach which has ensured that returns haven't deteriorated.

Looking at companies operating internationally, there are other examples in our portfolio where we expect the businesses to outperform their industry. One example is Wolseley, the plumbing merchant supplier. Having suffered as a result of weak end markets and several years of rapid expansion, poorly performing businesses have been disposed and levels of profitability have begun to improve. Through an improved service offering the company is growing whilst its end markets are broadly flat and we expect this outperformance to continue.

Another example is Filtrona, the specialty plastics and fibre products business. Having delivered fairly pedestrian rates of sales growth since the demerger from distribution business Bunzl in 2005, the company is under a new management team who we think will deliver higher rates of growth through a number of measures including better utilisation of their production capacity. With a strong balance sheet we also see potential for acquisitions to complement their growth. So with competition intensifying in a number of industries we are aiming to seek out those companies in strong positions that can continue to grow. Whilst price cuts and promotions are welcomed by the consumer, they are often not great for the shareholder.

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