

The long and short of the UK Dynamic Equity fund

Luke Kerr, the manager of the OMAM UK Dynamic Equity fund, answers questions from Adam Lewis

Q: What is the background behind the new UK Dynamic Equity fund?

A: In July 2005 we launched a hedge fund that uses the same strategy. I ran this fund for four years and in every one of those years it beat all the funds in the IMA UK All Companies sector. It has never had a down year. However, because of tax reasons we could not sell the fund to the right audience, so by popular demand we launched a Ucits III retail version. We launched the new fund at the start of July, closed the hedge fund - which had assets of £14m - and transferred its investors into the retail fund, which now has assets of £37m.

Q: What makes the fund different to what else is available?

A: Firstly, this is a relative return fund not an absolute return fund. It is the flexibility of the structure and the ability to short stocks which marks it as being different. I build a highly focussed, best ideas long portfolio. This takes the best 40 ideas from the range of mid and small caps funds Omam manages. I only ever short where I think I can make money. I don't short to hedge market risk or pair versus my longs. The theory is the more focus I have on my long side, the better the returns have been.

The structure of the fund is also unique. I don't have to be fully invested on my longs. I can raise my cash level up to 40%, with my longs being between 60-100% of the portfolio. In bull markets, I would position the fund to be 100% long and have some short positions, whereas in a bear market I would more likely be 60% longs and up to 30% of the portfolio in shorts.

Q: Is the fund run in the same way as the hedge fund?

A: It is run in exactly the same way. The only difference is the performance fee. In the hedge fund there was a performance fee which took 20% of all absolute performance with a high watermark. In the Ucits III fund the fee takes 20% of any relative outperformance over and above the FTSE 250 (ex investment trusts) with a relative high watermark. This means we only earn a fee if we outperform.

Q: Where is the fund positioned now?

A: The portfolio is 80% net long. I think we have seen the worst of the recession and economies are now moving to recover.

I expect sluggish economic growth in 2010, with GDP growth coming in at between 0.5-1%. But I think we have seen the ultimate bottom in the market, with March being the low point. Right now, I have only one short position in the fund, so the portfolio is predominantly long. I may add to the short positions as and when we generate ideas.

Q: What instruments do you use to short companies?

A: I solely use contracts for difference (CFDs) to short. I do not use futures or options.

Q: How is the long book invested at present?

A: It has a modest cyclical bias because of the view that economies will recover. However, I am careful that the cyclicals are exposed to industries where volumes have been depressed below normal levels in a recession, for example housing transactions in the UK. These transactions need to rise a further 50% from their current level just to hit the trough during the 1990s recession. Stocks which will benefit from this trend are Travis Perkins and Topps Tiles, both of which are held in the fund.

Q: If the fund picks ideas from Omam's small and mid cap desk, in which capitalisation is most of the fund invested?

A: The vast majority of the fund is held in mid caps. Of the 40 positions about 80% is in mid caps, and I hold just six small caps. I can also go into the FTSE 100 if I want to.

Q: Why mid caps?

A: Investor sentiment and risk appetite both remain fragile, therefore, it is more appropriate to stay at the more liquid end of the universe. Small caps are trading at sizable discounts to mid caps, so I do look for selected opportunities down the market cap scale. Topps Tiles is a good example of this.

Q: What themes is the fund playing?

A: I am overweight in general retailers. I think companies are trading more resiliently than forecasts suggest. In this space we hold a couple of pubs, namely JD Wetherspoon and Green King. While a number of pubs are closing, this is good news for the larger players who can open new pubs for half of the previous cost. Both the companies I hold have delivered and continue to deliver earnings upgrades.

The fund is also overweight in information technology, both in software and hardware. There are a number of names in this sector that are trading well, are reasonably valued and are growing nicely. In this space I hold Telecity, Micro Focus and Fidessa.

Meanwhile, I am underweight in industrials, including engineering, electronics and chemicals. I still think analysts's margin expectations are too high and there will be more downgrades to come. There is significant over capacity in industrials. I am also underweight in anything with exposure to government spending, in particular government capital spending.

Q: You also manage a market neutral hedge fund for Omam, is there a significant overlap between the two portfolios?

A: There is a significant overlap in the long only side of the two funds. On the short side I have one pool of shorts, with 40 shorts currently held the market neutral fund. For the purpose of the Ucits III fund, I will select from this pool which shorts I think will go down the most to generate the most money for the fund.

Q: How do you identify a good short position?

A: I look for profit warnings and whether or not we think a company is too expensively rated and will de-rate going forward.

Q: Will you cap the fund in the future?

A: This is a limited capacity product. We have yet to put a cap limit on the fund and will review the situation when the fund hits £150m. We have capped funds on this desk before and it is not something we will be afraid to do again.

Q & A



LUKE KERR joined Old Mutual Asset Managers (Omam) in 2001 as an assistant fund manager and assumed responsibility for the management of the Old Mutual UK Select Smaller Companies offshore fund in 2003. In July he was appointed manager of the newly launched OM UK Dynamic Equity fund.