



Head of Old Mutual UK Mid & Small Cap team

Daniel has been the manager of the Old Mutual UK Select Smaller Companies Fund since 2004. He was appointed head of OMAM's highly successful UK Mid & Small Cap team and manager of the Old Mutual (Dublin) UK Select Smaller Companies Fund in January 2009.

Daniel was previously a smaller companies manager at Gerrard Investment Funds, which merged with OMAM in 2001. Daniel has over 13 years' investment experience of UK smaller companies. He is IIMR qualified.

UK mid & small cap update

Given a combination of valuation considerations and the current stage in the economic cycle, Daniel Nickols, head of OMAM's UK Mid & Small Cap team, believes that market risks are becoming more balanced and is rotating portfolios into more economically sensitive sectors.

Across the developed world there are scant immediate signs of economic stabilisation. However, it seems clear from the sector rotation that is now underway across equity indices that market participants increasingly believe that governments and central banks will do whatever it takes to cushion economies from the worst effects of recession and stimulate a resumption of growth. Given the magnitude of the stimulus being applied to economies globally, it is now possible to argue credibly that the trough in the business cycle will happen towards the end of 2009. In anticipation of this recovery, market leadership does now seem to be swinging decisively towards a range of economically sensitive sectors and away from the more defensive sectors of the market that have been relatively strong through the worst of the credit crunch.

Mid and small cap stocks should benefit from these trends, as cyclically sensitive sectors are well represented within these areas of the UK market. Sectors such as retail, housebuilders and travel & leisure - typically amongst the earliest beneficiaries of any economic recovery - have indeed begun to demonstrate a pattern of outperformance against the wider market.

In the near term we expect markets to remain volatile, as the sharp recovery from recent lows suggests that some weakness may follow the euphoria engendered by the most recent announcements of stimulus packages.

Nonetheless, given that equity markets typically successfully pre-empt an economic recovery by between three and six months, we have felt it appropriate to move away from our 'cautious' stance on the mid and small cap area and adopt a neutral view. We increasingly believe that the downside risks to mid and small caps arising from their greater likely susceptibility to further earnings downgrades (relative to large caps) are balanced by the opportunity to participate disproportionately in any recovery arising from their more overt economic sensitivity.

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Accordingly, we have now moved to an overweight position in a range of early cycle, consumer discretionary sectors such as general retailers, pubs & restaurants and housebuilders. We believe that substantial interest rate cuts in the UK will drive lower mortgage costs, which combined with lower utility bills should underpin the discretionary element of consumer spending in the coming months, in spite of rising unemployment and an increasing savings ratio. Such companies are likely to be amongst the earliest beneficiaries of improving macroeconomic newsflow, both at a corporate level and in share price terms.

Within the retail sector, investments have included retailers WH Smith, N Brown, Mothercare and Halfords, all well capitalised companies paying reasonably attractive dividends. They are positioned at the more resilient end of the consumer market, selling small ticket items or 'must have' products. Within the travel and leisure space, we have recently moved to an overweight position in the pubs & restaurants sector, as we believe that trading for the better-managed operators, such as JD Wetherspoon and Restaurant Group should prove resilient, while cost pressures should also begin to abate. Meanwhile within housebuilders, recent data would suggest that conditions seem to be stabilising in the UK housing market. This should be supportive for the better financed players such as Bellway and Persimmon, which continue to trade at a discount to NAV.

In conclusion, we expect the market to remain uncertain and volatile for the time being, but are increasingly of the view that equity market leadership will swing away from defensive areas that have led the market since the peak in the market in 2007 and towards more economically sensitive sectors which stand to benefit as markets begin to discount better times ahead. Mid and small caps, where economic sensitivity is well represented, should therefore benefit progressively from this trend.

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