Investment update

24 June 2010

Richard Watts, manager of the Old Mutual UK Select Mid Cap Fund

The fund manager is Richard Watts, who was appointed manager of the Old Mutual UK Select Mid Cap Fund in December 2008, having been deputy manager since 2006. Prior to joining OMAM in 2002 he was an equity analyst at Orbis Investment. Richard is IIMR qualified and a CFA Charterholder.

Q&A with Richard Watts

Richard Watts, manager of the Standard & Poor's and OBSR AA rated Old Mutual UK Select Mid Cap Fund, looks at the prospects for UK equities. Richard's fund is top quartile YTD and over 1, 2, 3, 4 and 5 years, to 31 May 2010*.

Is the coalition government proving to be a positive for equity markets?

It is too early to tell. The formation of the coalition government cleared some uncertainty, but we need to see the outcome of the emergency budget to assess the likely impact on the UK economy, and subsequently the UK market. We are expecting fairly low growth in the UK economy. Obviously you can't entirely rule out things like the double dip recession feared by some, but our view is more one of cautious optimism.

What impact will reduced government spending have on the market?

Everyone knows that there will be spending cuts, and the issue is where they will fall. We think the axe will fall on companies exposed to UK government capital expenditure, but there may also be an opportunity here for companies to which business processes can be outsourced. However, even for the companies that benefit, the path won't necessarily be straightforward and there will probably be a transition period of uncertainty and risk.

In volatile markets, is there a temptation to trade more?

I think the danger with trading more in such markets is that you can easily get your timing wrong and sell companies too soon, before the value materialises and likewise, sell poor performers too late. So you have to be extremely disciplined in this environment. Our portfolio is broadly balanced from a top down perspective, with good exposure to high conviction cyclical names. Equally, however, we have good exposure to high quality defensive growth stocks, so the temptation to trade in this market is therefore much reduced.

Are the companies in your portfolio healthy?

Generally in our portfolio, company health is very good. Eighteen months ago, there were some highly indebted companies across the market, but the last 18 months have seen a number of fund raisings in the market, so companies have replenished their equity base by raising money. In addition, corporate cashflow has been strong, reflecting the strong recovery seen in profits, further strengthening company balance sheets. So most of the companies in our portfolio are in very good shape.

Do you favour defensives or cyclicals at present?

Market performance has been very strong but in recent weeks risk aversion has returned. Given the events in southern European economies and the fiscal situation there, the markets have sold off aggressively. Defensive growth stocks have performed well in that environment; however, lots of cyclical companies are oversold. So it is not really the best time to switch

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

out of cyclicals and into defensive growth names. But I have to caveat that by saying that of course events change, and we will be responsive to that should the need arise.

What types of stocks do you favour?

A good example of a structural growth stock would be Rightmove, which we have owned for some time. Rightmove is an online property portal, and has been growing extremely quickly. Indeed, the 2009 recession enhanced its competitive position. The key driver for Rightmove is to grow revenue by increasing the take-up of new products and services and by leveraging on its clear value proposition to its clients. With an online business the cost structure tends to be fairly fixed so if the top line grows in excess of cost, operational gearing and profit growth can be substantial, which is why we like the stock.

We also want exposure to stocks that offer some defensive characteristics but cyclical upside as well: high conviction ideas that are trading at reasonable valuations. A good example is Informa, which offers defensive attributes but also cyclical exposure. And we like these qualities, especially as Informa is trading at around 11 times the forecast in the market which, for a business of Informa's quality, is actually very cheap. Historically it would trade on 14 to 15 times.

What about fund performance in 2010?

It has been an extremely volatile year so far, and at one point, our mid cap benchmark index was up around 18% year to date. It has given a lot of that performance back in recent weeks, and generally the fund has performed in line with its benchmark. So given the volatility and the change in economic backdrop, I'm reasonably pleased with the fund's performance.

As for the rest of the year, I think there is a lot of uncertainty. So far, economic newsflow has been very strong, and some of the data from the US has been better than expected; notwithstanding the recent disappointing payrolls number. Elsewhere, emerging market economies continue to grow strongly. However, there are issues, particularly in regard to the poor fiscal positions of a number of European countries, and the key question is whether events in Europe could potentially derail the economic recovery both in the UK and globally.

On this basis, I think volatility is likely to persist into the second half of the year. But against that, market valuations levels are very attractive, trading at substantial discounts to historic levels, and providing an attractive entry point. So despite the volatility, I think markets can make progress from here if the economic newsflow continues to be favourable.

**Source: Morningstar, bid to bid, net income reinvested.*

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

www.omam.co.uk
+44 (0)20 7332 7500

OLD MUTUAL ASSET MANAGERS