Investment update

21 December 2011

A positive response

Avoid the negative and capture the positive - the key is balance between structural growth, quality and cyclicals exposed to strong end-markets

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

Richard Watts 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.

It's been a tough year for equities. How have you responded to that in the portfolio?
It has been a difficult year for equities. If we look back to the start of this year, I think it's fair to say that it's been disappointing relative to our expectations. We've had to pull back. We've introduced more structural growth, more quality and have retained only to those cyclical stocks which are justified through exposure to the strongest end-markets.

Fiscal austerity is gripping the UK. What's your strategy against this backdrop?
We've been underweight UK domestically focused stocks for some time, such as retailers or government-exposed companies.

You've been adding to Domino's Pizza. Why add to a domestic consumer stock?
What we're trying to do here is identify stocks which we believe have structural growth drivers. Domino's Pizza is a space growth story. It is opening more franchises in the UK. More recently it announced an initiative to expand into the German market where takeout pizza is fairly undeveloped. We own Domino's Pizza for the structural growth angle.

Another stock you have is Greene King, again exposure to the UK consumer. Why?
I would say Greene King is at the more resilient end of UK consumer spending. It is people eating out for relatively low cost. The average spend per head in a Greene King pub is somewhere £7-8 a head, so not expensive, and people still like to go out for a drink. And historically pubs have performed very well in recessions. It's not an expensively rated stock so the valuation to my mind looks compelling. It has an attractive dividend yield of somewhere around about 6%, earnings growth in the region of 7%. This suggests to me a total return in the low teens, say 12%-13%. Given the resilience of the earnings, that looks attractive in the context of an overall underweight positioning towards UK consumer spending stocks.

Are structural growth stories cheap? Presumably everybody wants to own them?
That's a fair point but across the piece structural growth is no more expensive than it was this time last year, and indeed before that. There are still plenty of attractive opportunities that you can find where valuation multiples look attractive. I would argue a good example of that would be TeleCity which is a technology stock. It operates data centres where companies co-locate servers, network switches - equipment relating to the internet, mobile telephone networks, banking, e-commerce. This is a stock that trades on around 20 times forward earnings, which compared to many other structural growth stocks I think is an attractive multiple.

The fund is underweight property but you like Capital & Counties, what's the story?
I would describe Capital & Counties as a special situation. What I mean by that, when you actually look at the exposures that Capital & Counties offers - nearly half of the portfolio is Covent Garden and if you have been there recently you will see immediately that the tone of

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the estate is improving significantly. The retailers who have opened there within the last three years are the likes of Burberry, Apple, Polo Ralph Lauren. The result has been strong rental growth which has benefited asset value. The other significant part of Capital & Counties' portfolio is Earl's Court, specifically the Earl's Court exhibition arena. This is a 72 acre site and the plan is effectively to redevelop it into residential property. The book value of the site is roughly £6m an acre, but clearly with the right plan in place it could be worth substantially more.

What's your outlook for 2012?

Looking at the way economic forecasts have been revised downwards in recent months, I think we're preparing for a difficult 2012, where profit growth will be hard to come by. Our aim will be to keep the portfolio balanced, which think of as being exposed to structural growth, quality and those cyclicals exposed to the strongest end-markets.

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