

Investment  
update

3 February 2012


**Kevin Lilley, manager of  
the Old Mutual  
European Equity Fund**

Kevin Lilley joined OMAM in October 2011 as a Europe ex UK equity manager. He was previously senior portfolio manager, European equities, at Royal London Asset Management, where his funds saw strong medium to long-term performance and he was AA-rated by CityWire. Prior to RLAM, he managed Continental European equities for TT International and NPI. Kevin is a Fellow of the Chartered Institute for Securities & Investment (FCSI).

# High conviction, low valuations

European companies have significant exposure to global growth ... and they trade on low valuations

**You took over the fund in December 2011. Could you talk us through your investment style?**

For me, it's all about building a portfolio of strong conviction ideas that will outperform the market and outperform my competition. I like to see my name rising up those league tables of performance - that's what drives me personally. As far as the process is concerned, it's about finding stocks that I feel are undervalued and applying certain criteria to determine a correct valuation. I try to identify where we are in the global economic cycle and look for companies where consensus earnings projections don't reflect where we are on that top-down model. The final stage is to see a short term catalyst to lead to a re-rating to the level of valuation that I think is right.

**How do you go about taking that philosophy and applying it to a portfolio?**

I value every company in the benchmark on an absolute basis, which tells me whether each company is cheap or expensive. I can then aggregate that information up to a sector level, a country level and an overall market level. This lets me see the potential upside at each level and to build a portfolio taking the best units of each area, bearing in mind my view on the economic cycle.

**What is your benchmark and how important it is to the way you run money?**

The benchmark is the MSCI Europe ex-UK. It's important in that that reflects the underlying market. It's a reference which enables you to manage the risk. But I'm not slavishly following the benchmark. It's a guide and a reference.

**So could you - for example - say I'm not going to have any pharmaceuticals, even though they're a big part of the benchmark?**

Yes, I can do that. In the example of pharmaceuticals it's probably unlikely because they're a very large sector in the market and it's likely that there's always going to be at least one that has strong potential upside. But the portfolio is ultimately constructed on the basis of conviction, not benchmark representation. In some of the smaller areas, some of the sub-sectors, I might definitely be out of completely.

**How many stocks do you run in the fund?**

The portfolio I'm running is between 45 and 50 stocks, 50 is an absolute maximum.

**BNP Paribas' amongst your biggest active overweight positions in the portfolio. What's attracting you to a bank at the moment?**

Mainly the valuation. I think BNP Paribas is a good quality European bank that's been penalised because of the banking woes in Europe. But I'm not buying it as a stand-alone stock, I'm buying BNP Paribas as part of a risk-managed balanced portfolio. I'm buying BNP Paribas on a price to book ratio of 0.5-0.6, generating a return on equity of around 10% and a dividend yield approaching 5%. Those number suggest to me that the bad news is more than in the price and this has got strong potential upside.

**Tell us what you like about Publicis. Surely you'd expect an advertising agency to be struggling in the current environment?**

The economic environment is tough in the eurozone but it's not tough across the globe. I mean there are clear signs that economic activity is picking up outside of the eurozone. Publicis has strong exposure to the US, and this year you've got the US presidential election, the Olympic games and the European Football Championship, all of which will be a strong boost to advertising revenues. I think the other thing that's important about Publicis is that it's got a strong presence in internet advertising, and clearly as some of the older media declines, the internet side picks up. All in all, you're buying a company that generates a strong return on what I think is a very reasonable valuation.

**You mentioned the US there, how international are the earnings from your portfolio?**

They're very international. I mean if you look at the construction of the European benchmark, only about half of sales are intra-Europe for European companies, and in my portfolio it will be a bit less than half.

**EADS, the makers of Airbus are a key position for you, what's the story there?**

It's really the strength in the civil aviation cycle, and also because of fuel economy. Airbus have created new planes that are a lot more fuel efficient than the old ones, leading airlines to replace their fleets earlier than they would have done because the fuel economy pays for it. On top of that, you have emerging market airlines that are still growing, while the decline of the euro against the dollar is also positive.

**What is the key attraction of European equities right now?**

Valuations. The valuation on European equities compared with other markets is a lot lower. The Euro Stoxx 50, the big cap European index, is trading on a price/earnings ratio for 2011 of approximately 9 times, with a yield around 5%. For me, those are compelling valuations and they are a lot cheaper than anywhere else in the world.

**What's the future for the euro?**

I believe the eurozone will remain intact. There's a strong political will to maintain the currency and I think that's been evidenced by what's happened over the last couple of years with the introduction of institutions and facilities to support the currency and help refinance the banks. The pace has been slower than the market wants, but I think what's been happening is that the German government, in particular, has been enforcing discipline and waiting for austerity and reform promises to start delivering before they relax the criteria and start being more accommodative.

**Are you confident that 2012 is going to be a good year for European equities?**

I believe so. I think the starting point on valuation is a very low point and because of the global nature of European companies they have exposure to strong GDP growth outside of the eurozone, so I believe we will see profit growth for European companies this year. And on these kinds of valuation levels there's clearly potential for the market to re-rate.

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