Investment update

19 December 2011

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.

Getting the balance right

The priority for 2012 will be to avoid the negative and capture the positive. the key themes will be structural growth, quality and cyclical exposure to strong end-markets

The past year has not been easy in equity markets. A number of extraordinary, non-financial events - floods in Queensland, the tsunami in Japan, political unrest in the Middle East - rocked investors in the early months of 2011. Most of the rest of the year was weighed with uncertainty about the eurozone, with ever larger numbers emerging in respect of deficits, debts and potential defaults.

But while macro events drove - and for the most part depressed - markets, the news on the 'real economy' was usually better. Growth in China may be moderating, but it remains positive, while news from the US has surprised on the upside. Corporate news was broadly positive, with non-financial businesses generally in good shape.

The concern now is which way will events tip? A meltdown in the eurozone could have a significant negative impact, sapping corporate confidence and slowing US recovery. A comprehensive settlement, a so-called 'big bazooka', could have a significant positive impact. The most likely outcome is neither of these, but a continuation of 'muddling through', with the global economy on two tracks - flagging in some areas and growing well in others.

In our view, this is not telling us to move to a completely defensive portfolio, missing out on evident opportunities for growth. But neither is it the time to sit on our hands. What we have done is to try to respond intelligently and sensitively to real conditions, shifting the fund to a position where it is balanced, so that it avoids the negative and captures the positive. The key three themes are structural growth, quality and cyclical exposure where it is justified by strong end-markets.

One interesting structural growth story at the moment is Ashtead, a company whose earnings have run substantially ahead of forecasts. The focus of the business is in the US, where it hires out construction equipment. It benefits from a profound change in the business practices of its customers, which increasingly prefer the flexibility of hire over the outlay of purchase when it comes to capital equipment. Another example, a quite different business and closer to home is Domino's Pizza, a success story on a number of levels. As it continues to roll out stores, its margins improve through economies of scale. It has minimal debt, and while its cash inflows are rising its capital expenditure is falling.

An example of a quality stock is Fenner. Its primary exposure is to power generation, through its provision of key equipment to the coal industry, but it is also involved in the mining and aggregate industries more broadly. The company has been moving up the value-added curve, increasing sales and improving margins.

Melrose is a cyclical story which we believe justifies continued commitment. Growth in sales and new orders remains robust, with the focus on energy and lifting equipment.

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This is reflected in forecasts for overall earnings growth, even when adjusted for slower global recovery. The stock was marked down sharply in the summer turmoil, but it has recovered well, with investors appreciating the strength of its position.

Natural occurrences and political events are almost equally difficult to predict, but it is probably safe to say that 2012 will be another challenging year, based on what we already know. In our view, responsiveness and balance will be the keys to success.

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