24 December 2009

For professional investors only

Daniel Nickols, Head of the 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.

2010 outlook

The recovery that we have seen so far remains far from being a 'normal' one. It is still intervention driven and the extent to which it is - or is likely to become - self sustaining remains unclear. Although the US economy is currently growing at an annualised rate of around 3% and looks set to continue to expand at a similar pace over the early part of 2010, it is uncertain whether trend type rates of growth will be sustainable if the considerable fiscal and monetary stimulus measures are withdrawn.

Closer to home, of all the world's major industrialised economies the UK has been the last to emerge from recession. Looking into 2010, while the UK economy should at least return to growth (if only at an anaemic level), a host of headwinds will continue to make the UK domestic environment difficult. Unemployment is likely to rise further; credit, for businesses and consumers alike, will remain tight; and a new government will have to address the budget deficit, which will exert considerable pressure on public spending. The international environment is likely to look considerably more attractive than the domestic one.

The improved picture for global growth in 2010 (with forecasts of 4% or more already consensual) and the internationally exposed nature of many UK quoted businesses, even in the UK mid and small cap arena, mean that weak prospects for the domestic economy will not necessarily preclude the UK equity market from making further progress, despite the strong recovery in 2009. Valuations arguably do not look stretched, with the FTSE All-Share Index currently trading on a one year prospective price/earnings multiple of 12 times. Company newsflow has been improving demonstrably since the summer of 2009 and has continued to be strong as autumn trading updates have been issued. Forecasts for most economically sensitive businesses assume little, if any, top line growth in 2010, with profit growth based mainly on the full year effect of prior cost savings. It is highly likely that forecast upgrades will be delivered as the reality of economic recovery makes itself felt through improved volumes.

Given that volume recovery expectations (and in a world of 4% GDP growth there must surely be some volume recovery) are unrealistically low for many economically sensitive businesses, the opportunity remains for such companies to deliver meaningful upgrades to forecasts. Selecting stocks which do so in the context of still depressed valuations should deliver significant share price appreciation.

However, reflecting the fact that macroeconomic data is not uniformly strong, we are already seeing the process of market leadership broadening out. Whereas in the initial stages of the recovery it was the economically and market sensitive stocks that led the rally, in the mid and small cap arena those stocks with strong secular or structural growth characteristics are now showing signs of outperforming.

As we move through 2010, a longer term picture of more muted trend growth is expected to emerge in the developed world as deleveraging for both consumers and corporates, and the process of deficit reduction for governments, is seen to be a multi-year phenomenon. The market is therefore increasingly likely to rerate those companies that deliver strong

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

Please see important information overleaf

profits growth through sustainable sales growth (for example by virtue of low current market share or through exposure to a strongly growing market niche), rather than as a result of economic recovery or the largely one off effect of cost cutting.

Indices have traded within very narrow ranges over the closing weeks of 2009 and there has been a clear rotation away from risk and cyclicality towards relative certainty. Looking ahead, it will be important to balance the near term prospects for positive top-line growth and profits surprises from economically sensitive businesses with - once the initial recovery phase of the economic cycle has passed - the emergence of weaker trend growth for a number of years from many developed world economies, as the excesses of the credit boom are gradually worked off. As a result we expect stock selection to be key as we seek to construct a portfolio which combines the highest conviction cyclicals with those companies expected to deliver secular growth at a reasonable price.

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

OLD MUTUAL ASSET MANAGERS