Investment update

18 March 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.

Old Mutual UK Select Mid Cap Fund

Q and A with fund manager Richard Watts

How did you negotiate the markets in 2009, and what do you expect in 2010?

We entered 2009 very defensively positioned, which was a reflection of the dire economic backdrop at that time. Market action was very strong from March 2009 onwards and that was led by a cyclical rally in the market, so we had to reposition from our defensive stance and introduce more cyclicality into the portfolios.

Equity market returns we saw in 2009 were very good indeed, and although we think further progress can be made from here, markets will remain volatile, certainly in the near term. Overall market valuation levels are not particularly expensive, trading on around about 12 times 2010 earnings, which compares to a long term average of 13-14 times. So from a valuation perspective we think markets offer good value at the moment, however, given the economic uncertainty that still persists, we think that discount valuation is reasonable at this point in time and from here performance will be led by good stock picking. We have been successful at doing that historically, and I think there are good opportunities for us at the moment.

Do you think the UK might slip back into recession?

You can't rule out the possibility, but that's certainly not our central view. At the moment we expect an anaemic economic recovery in developed economies and strong growth from emerging markets, so a recovery overall in global GDP. In terms of growth across developed economies, we see stronger growth coming through in the US, around 3% in 2010; but more anaemic growth in the UK and in Europe, perhaps about 1%. That's not particularly strong compared to historic levels in the UK, but does reflect a number of structural pressures in the economy; the fiscal deficit and government net debt obviously running at high levels, and the fact that unemployment, whilst it didn't rise as far as people expected, nonetheless does pose pressures for the UK consumer in 2010, coupled with the likelihood of rising tax rates as well.

Is now the time to take cyclicality out of your portfolios?

We think it would be wrong to remove all cyclicality, however, where we do have cyclicals, they are focused in stocks that we consider to be high conviction ideas. This reflects our top down view that a balanced portfolio is most appropriate for current conditions; whilst we expect near term economic recovery (an environment where cyclical names will do well), we're also aware that in the medium to longer term, there are structural challenges in a number of the developed economies around the world and therefore achieving growth will be more difficult. So for that reason having exposure to structural growth stocks as well as high conviction cyclicals seems to make sense to us, producing a balanced portfolio.

What happens when the government stimulus package comes to an end?

From a UK perspective, we think government stimulus measures amounted to around 1.5% of GDP in 2009. The majority of this came through in the VAT cut to 15% in December 2008.

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Whilst this was helpful to the economy in 2009, I'm not sure if the full benefits of the VAT cut really got through to the economy, so I'm not convinced that the stimulus measures in the UK actually benefited the economy that greatly. Looking into 2010, UK government stimulus is virtually non-existent and the reversal of the VAT cut back to 17.5% will be a headwind and constrain consumption growth, albeit as previously mentioned I suspect the benefit was over-stated in 2009. As for the US, the government stimulus package there has been far more significant than in the UK in terms of its overall size, which meant that the support to the US economy was larger in 2009, we think at around 2% of GDP, but, just as importantly, the fiscal stimulus will be maintained at or marginally above this level in 2010, so still providing a boost to US GDP in 2010 unlike in the UK.

How does your portfolio look now?

From a top-down perspective, the portfolio positioning is balanced with good exposure to high conviction cyclical names and also exposure to quality, growth companies. This reflects our near term view that a global economic recovery is underway, which will benefit cyclical companies, particularly those with international exposure, but also that we recognise that there are underlying structural issues in many advanced economies that may constrain economic growth in the medium-to-longer term, which will make those companies that can generate strong growth in a more subdued economic environment very attractive.

At a sector level, the structural growth theme can be seen in the fund's overweight positioning in the technology sector, for example. What is less apparent but is, nonetheless, a very strong theme throughout the portfolio is the fund's positioning within many sectors is tilted towards growth stocks. For example, in the travel & leisure sector, the fund has its largest positions in Wetherspoon's, the pub operator, and Restaurant Group, which operates the Frankie & Benny's format. Both of these stocks are well capitalised and offer attractive roll-out stories as they open more sites, which gives them the capability to deliver sustainable earnings growth. In the media sector, the fund is running a large position in Rightmove, the fast growing on-line property portal, whilst in the retail sector, the fund has exposure to companies that offer the ability to grow profitability despite the difficult UK consumer backdrop, with Dunelm being an example. This highlights another feature of the fund's positioning; where the fund does have UK exposure it is generally to those businesses that are able to grow despite the challenging UK consumer backdrop.

Looking at the fund's cyclical exposure it is to those stocks where we are able to make strong investment cases. We believe these high conviction ideas offer the potential to significantly beat earnings estimates, whilst valuation levels are inexpensive, in our opinion, failing to reflect the earnings potential of these businesses as the economic recovery comes through. In effect, we believe the market is failing to correctly price in the cyclical earnings recovery that we believe these stocks will deliver and this will become apparent as we move through 2010. Examples include industrial companies such as Cookson, Meggitt, Victrex, BBA Aviation and Wood Group, media stocks such as Informa and ITE and financials such as Intermediate Capital and International Personal Finance.

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