Investment update

20 April 2010

Stephen Message, manager of the Old Mutual Equity Income Fund

Stephen Message took over management of this fund in November 2009. Stephen joined OMAM in October 2008 from US private wealth manager Bessemer Trust, where he worked for two years, firstly as an analyst covering Asia ex Japan and UK equities and then as manager of the UK component of Bessemer's international equity fund. Prior to this he was a business analyst at technology consultancy Detica. Stephen has a masters degree in engineering from Imperial College London and has passed CFA Level III.

Stephen Message: market outlook

Stephen Message, manager of the Old Mutual Equity Income Fund, took on the fund in November 2009. He reviews the fund's current positioning and how he intends to generate income this year.

How have you changed the portfolio since you started managing it?

Before I started managing the fund, I had been an analyst on it for about a year, so a lot of the themes within the fund were ideas that I had already implemented. The main change has been a reduction in the number of holdings, from around 75 to 55; and an increase in the active weight, which is the degree of differentiation of the portfolio relative to the reference index or the peer group median.

Historically this fund had a small exposure to bonds, but I see enough scope to generate income purely from equities, which is my area of expertise. So when I took over the fund I sold the remainder of the bond holdings, and I don't envisage buying into them again.

How would you describe your investment style?

I don't have a particular value or growth bias. What I look for is companies that appear cheap on a long term basis, and that have the potential to re-rate relative to the market. This potential can be driven by several things, including internal factors such as a change in management, or a disposal or acquisition of assets, or external factors such as a change in the macroeconomic outlook, or changes to the supply and demand environment and so on. My aim is for the fund to perform irrespective of market conditions, and because I don't have a bias towards value or growth, the key feature I look for is sufficient differentiation relative to the peer group.

Have income stocks become too concentrated?

Certainly this concentration of stocks can be a challenge. At present, the top ten income-paying stocks cover around 55% of the market income. However, one of the advantages of my fund is that it is relatively small, which means I can invest in companies further down the market cap spectrum, so there are a few mid cap ideas within the fund at the moment, such as Britvic, Amlin, Restaurant Group, SThree. This flexibility means I can buy the kind of shares that don't constrain the fund to just the large income-paying companies.

Is a weak sterling a help or a hindrance?

Because a lot of companies pay dividend income out in dollars, a weak sterling can help the UK domestic investor from a translational point of view. Around 70% of the market revenues are derived abroad so a weak sterling base is essentially positive. Additionally from a competitive point of view, for companies that sell into the rest of the world but have a cost base in the UK, a weak sterling is also advantageous.

What is your outlook for the UK equity income market?

Last year saw a broad brush rally in a lot of cyclical shares, irrespective of their quality, the state of their balance sheets, or the competitive environment. I think the market valuation now, at about 13 times earnings, seems good value. Global growth forecasts stand at about 3.5-4% this year, which should feed into earnings growth going forward. I'm looking at a

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prospective dividend yield of around 3.5%. What I would say is that, given the significant re-rating of last year, managers definitely need to be more selective in their portfolios now, by which I mean much more focused on bottom up stock picking as opposed to the higher level general macro themes.

What are the sectors that you like or dislike at the moment?
The fund definitely has a cyclical bias at the moment, and within that it is very overweight the travel and leisure sectors, such as hotels, restaurants and airlines. British Airways, for example, was brought into the portfolio in September last year, and it fitted my investment criteria of being a company that looked cheap on a long term basis. The supply of aircraft has been much tighter in the last economic cycle relative to the previous cycle at the turn of the century, and I think that when demand recovers, pricing should be better than expected, which should drive a re-rating of the shares.

Another area the fund is overweight is support services, where each individual stock is attractive for its own reasons, but together they make a decent overweight position in the fund.

On the flip side, the fund is pretty underweight utilities and real estate at the moment. The principal reason for this is that I think both sectors have benefited from excess leverage, while at the same time the pricing environment has been positive for them, so they get quite decent operational gearing. Going forward, although these companies have healthy yields now, I am concerned about the potential growth in their dividends given the constraints on their balance sheets, so I am generally avoiding these areas.

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