Investment update

22 April 2010

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

Investment outlook

Over the last 12 months UK smaller companies, as measured by the Hoare Govett Smaller Companies (ex Investment Companies) Index ('HGSCI') has rallied by around 70%, experiencing a dramatic rerating as fears over the onset of a depression have given way to renewed optimism that the global economy has passed through a period of stabilisation and is now set for renewed growth. Given the magnitude of this rally, it is tempting to conclude that prospects for further upside from here for smaller companies indices are limited. Notwithstanding various structural impediments to the re-establishment of the sort of trend rates of growth we have come to expect across the developed world (including overly indebted governments and consumers and a still-dysfunctional banking sector), we are optimistic that the rally can continue.

While we know that economic growth across parts of the developed world will be anaemic for the foreseeable future, we maintain that the UK equity market looks well supported, with the FTSE All-Share Index on a 12 month prospective P/E multiple of around 12x. Given that we are arguably in only the first year of a global economic recovery, this multiple compares favourably with a 20 year average of 13x. Focusing more specifically on UK smaller companies, on a 12 month prospective multiple of 12.2x, the HGSCI is currently at a modest premium to the All-Share. Aggregate analyst forecasts for the constituents of the HGSCI suggest earnings growth for the forthcoming 12 months of just 9%; we think that these forecasts are too conservative and that in reality, earnings growth will turn out to be materially higher.

Given that GDP growth rates internationally are likely to exceed that of the UK over the next couple of years, the ability to invest in internationally exposed stocks and sectors must be viewed as an obvious positive. The sheer diversity of the HGSCI is a key point in its favour, from which many appealing attributes flow: firstly, while at an aggregate level, the UK small cap indices are by definition more focused on the domestic economy than are their larger capitalisation counterparts (an overt negative given the host of issues facing our economy), a range of sectors representing material components of the HGSCI do offer obvious international exposure. These include resources, chemicals, capital goods, IT hardware and software. While we estimate that the HGSCI is around 40% internationally exposed, our portfolios are positioned such that they are around 60% internationally exposed. Our universe also offers scope to find domestically exposed beneficiaries of structural growth drivers (such as Rightmove) which should be capable of delivering premium growth into the medium term, even given an anaemic domestic recovery.

As a team, we spend a lot of time meeting with company management. We view the recent results season as being very pleasing, particularly for internationally exposed businesses, with many companies seeing upgrades to forecasts and management teams noticeably more confident about prospects now than was the case during the closing months of 2009.

As for portfolio construction, we have argued for some time that we need exposure to both ongoing cyclical recovery (given that, in aggregate, global growth seems to be surprising to the upside) as well as to secular/structural growth, reflecting the likelihood of this being a sub-par developed world recovery. Given that we don't consider current market valuations to be demanding, we believe that the UK equity market can continue to trend upwards from

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here, but remain mindful of the likelihood of further episodes of risk aversion. Being either too defensively or too cyclically oriented in such potentially volatile conditions seems wrong. Having a blend of highest-conviction cyclical ideas along with a range of structural growth companies that can deliver sales and profits growth even in an anaemic overall recovery should serve us well, given the likely equity market conditions.

Whereas 2008 and 2009 were arguably years in which correct top down calls held the key to adding value, 2010 will be a more balanced environment in which good stock selection will make the difference. Given its diversity, the HGSCI remains an attractive universe in which to pursue a stock-picking approach.

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