Investment update

April 2010

Simon Murphy, manager of the Old Mutual UK Select Equity Fund

Simon Murphy has been the manager of the Old Mutual UK Select Equity Fund since he joined OMAM in March 2008. Prior to joining OMAM, Simon worked for almost 10 years at M&G Investments, spending the last three as the manager of the M&G UK Growth Fund. He is a qualified chartered accountant and a specialist in corporate taxation.

To rotate or not rotate - is that the question?

Current thoughts from the Old Mutual Large Cap equity desk

The sun is coming out and temperatures are rising as the onset of summer finally approaches following one of the longest coldest winters in recent memory. Similar conditions are being experienced in the stock market, which, following one of the worst bear markets in history has been enjoying something akin to a 'heat wave' over the past 12 months. What a difference a year makes!

We have been of the view for some time that the most likely outcome this year was for positive economic surprise relative to somewhat downbeat expectations as to the durability of the snap-back in economic activity around the globe. This, in combination with aggressive cost control on the part of corporations worldwide, was likely to drive a continuation of the positive earnings trends which began during the second half of 2009.

Given this stance, and not withstanding the strength of the cyclical rally during 2009, a highly cyclical fund positioning still seemed appropriate as we entered 2010 and broadly speaking that is what we have maintained. The question we now find ourselves pondering is whether such a positioning is still appropriate for the remainder of the year?

Our suspicion is that now is the time to moderate our heavy cyclical bias, a view which is influenced by a number of observations.

First, the FTSE All Share index has now risen by around 65% from its lows of March 2009. Whilst we remain constructive on the medium term outlook, we expect a period of consolidation soon, which would be entirely healthy.

Second, consolidation periods at this stage in a recovery cycle are typically associated with rotation within the market and the broadening out of market leadership from the often highly cyclical drivers of the initial phase of recovery.

Third, cyclical stocks and industrial cyclical companies in particular are highly popular in the market currently. Analysis of client flow data by UBS recently indicated that net client flows into cyclical companies were back to the peaks of May 2009. Meanwhile the widely followed Bank of America Merrill Lynch Fund Manager Survey shows that currently the biggest overweight sector positioning among fund managers in Europe is in industrials.

Fourth, for most of the past year we have encountered high levels of scepticism as to the likely strength and duration of the economic rebound. With economists and strategists seemingly falling over themselves to upgrade economic forecasts in the light of improving data at the moment, our sense is that this scepticism is rapidly diminishing and consequently being factored into share prices.

Fifth, if our contention of an economic recovery that surprises positively as to its strength and duration proves to be correct, then the next issue market participants will have to deal with

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will almost inevitably be tightening of monetary policy. Our suspicion is that this too may come into focus more quickly than the consensus currently expects. Changes in monetary policy are almost always associated with changes in leadership within the equity market.

To be clear, we remain positive on the medium term outlook for equities by virtue primarily of their relative valuation appeal against competing asset classes. However, markets rarely go up (or down) in a straight line and given the incredible strength of the last 12 months or so, we should anticipate at the very least a moderation in upward momentum from here.

In addition, having found ourselves in what felt like a fairly small minority of investors expecting a relatively strong economic recovery even just a few months ago, our sense is that this is rapidly becoming a more crowded viewpoint. As such, and recognising there will still be plenty of cyclical companies that perform well over the next period, we find ourselves compelled to at least start the rotation process.

Bring on the sunshine.

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