Investment update

22 July 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.

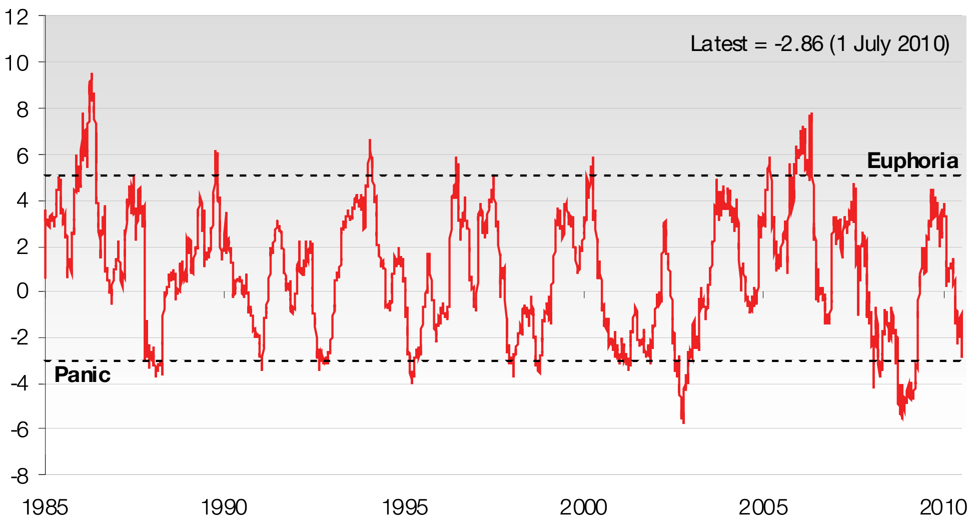
Are the only bulls left the ones in Pamplona?

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

As the traditional summer lull descends on the UK equity market the recent sharp correction in prices, which saw the FTSE 100 Index fall 17.5% from peak to trough in 11 weeks, has led to such a dramatic rise in bearish sentiment among market participants that some have been prompted to wonder if the only bulls left are the ones in Pamplona. Every market discussion currently encompasses the dreaded economic 'double dip', eurozone sovereign debt crises, deflation, leading indicators rolling over, no weapons left in policymakers' armoury, Chinese hard landings and technicalities such as the 'death cross'. I'm sure you get the picture.

This negative mood manifests itself in a variety of sentiment surveys and risk appetite indicators. Chart 1 depicts Credit Suisse's proprietary Global Risk Appetite model, showing risk appetite at near panic levels and not far from the extremes of pessimism seen during the March 2009 lows.

Chart 1: Global risk appetite



Source: Credit Suisse

Given such prevailing negative sentiment it is timely to consider the arguments for retaining a bullish stance towards risky assets in general and equities in particular. In no particular order of preference we would identify the following points as being relevant to the debate.

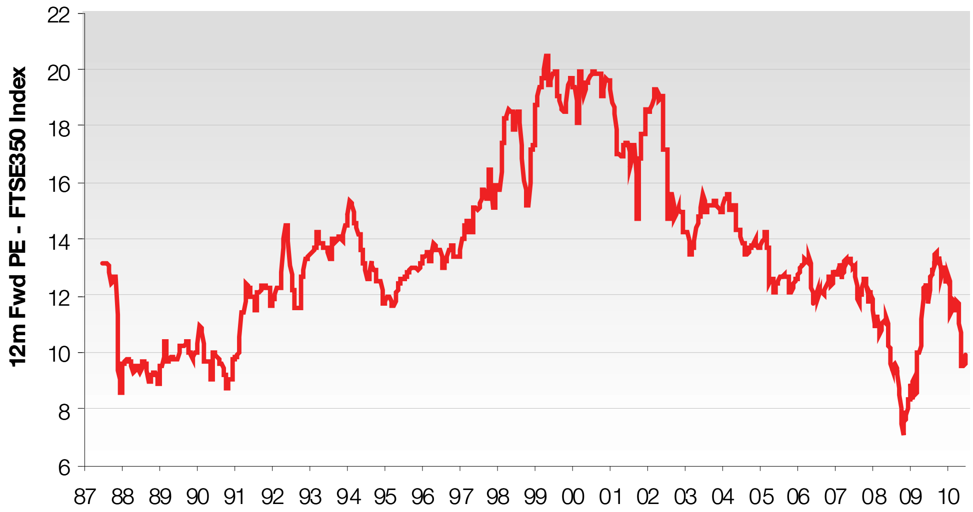
- Prior to this correction the FTSE 100 Index had risen 66% in just over a year, during which time there were just two relatively minor (8% or so) corrections. We therefore felt that it was inevitable that at some stage there would be a more meaningful and longer lasting correction.

Old Mutual Asset Managers (UK) Limited
2 Lambeth Hill
London, EC4P 4WR, UK

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

- It is undoubtedly the case that a number of recent indicators are signalling a slowdown in the momentum of economic growth in various parts of the world. However, we are of the view that these reflect the natural course of events at this stage in an economic recovery (i.e. momentum cannot keep accelerating indefinitely) and do not, currently, signify an imminent return to a recessionary environment. Indeed it is worth noting that despite all the talk of 'double dip' recessions (a third of fund managers are expecting such a scenario, according to one respected survey) they are in fact extremely rare. In the US there have arguably only been two such occurrences in the last 110 years; the recessions of 1937 and 1981. Of course that is not to say that we couldn't have one this time, but that is certainly not our base case.
- UK companies by and large remain in very good health, with balance sheets generally strong, corporate free cash flow at record levels and positive earnings momentum continuing, even if the rate has slowed more recently. What is most encouraging in this regard is the degree to which earnings growth is now being driven by top line growth surprises, rather just being reliant on cost efficiencies. Recent trading statements from companies across a variety of sectors ranging from industrials to pubs to car dealerships have been pleasing and are hopefully a sign of things to come when the forthcoming earnings season gets under way.
- We believe that the equity market is cheap, regardless of which valuation metric is used. Chart 2 shows that the UK stock market currently trades on a P/E of around 10 times next year's earnings, a discount of around 25% to its long run average of 13.6 times.

Chart 2: 12m forward PE for FTSE 350 Index is 9.9 (LT avg=13.6)



Source: Datastream, MSCI, Morgan Stanley Research

- Even if the assumption of aggregate earnings growth of around 16% in 2011 proves too optimistic (an assertion which is currently far from obviously correct) there is still significant headroom for valuation multiples to expand further. Indeed this is one of our key reasons for being optimistic on UK equities. We do not expect a particularly vigorous economic recovery – in fact we see the same deleveraging headwinds that others see – but providing we see some form of recovery and continued profits growth, we believe that there is significant scope for stock market valuations to rise, which in turn will deliver a reasonable return to shareholders.

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- We do not wish to gloss over the very real issues faced by the global economy. Indeed to us the most significant issue is the sovereign debt situation in the peripheral eurozone countries and its potential to cause a further round of banking difficulties across wider Europe. In this regard we are encouraged by the willingness of governments to attempt significant fiscal retrenchment at the same time that mechanisms for providing emergency liquidity are nearing operational readiness. The soon to be revealed 'stress tests' for European banks should also provide some clarity as to the capital strength of major financial institutions across the continent and hopefully provide some comfort to nervous market participants.

In summary, whilst being aware of the significant challenges the world currently faces, we remain optimistic that UK equities can continue to make upward progress in the months ahead. We understand that sentiment remains extremely fragile – and after two vicious bear markets in the last 10 years that is hardly surprising – but we should focus on the fundamentals rather than the fear. For the time being at least those fundamentals are telling us that UK equities remain an attractive investment proposition and that we should run with the bulls.

Now where is my ticket to Pamplona?

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