Investment update

22 November 2011

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

Cautious, but not defensive

In difficult market conditions, the aim is to balance the fund between structural growth and international earnings, always with an eye to quality

It's been a turbulent year for equity markets, how are you managing the volatility?

It has been a turbulent year. If I am honest, I have tended to have a more optimistic view on markets and economies than events have ultimately justified. While I have not changed my view on the fundamentals, there has been a shift in the emphasis of the fund, de-risking those parts of the portfolio that are perhaps more sensitive to the economic cycle.

One of your key investment themes has been structural growth. What do you mean by that?

Structural growth, as a theme, has been a strong positive contributor to fund performance over the past year. What it means to us is companies with a distinctive market niche which enable it to grow almost irrespective of what's happening in the wider economy. It's about identifying pockets of growth not correlated to either the UK or the global economy. Some of the strongest examples are in the media and technology sectors, such as Rightmove, Aveva or TeleCity. But there is any number of characteristics that might be relevant, such as changes to management or business strategy, regulatory change, a merger or acquisition.

But are these stocks expensive? They sound like the sort of thing everybody would want to own.

Well and I think therein lies the rub, because for the most part it's very rare to find a stock which clearly exhibits structural growth characteristics and which is exceptionally cheap as well. In essence, they do tend to be more expensive than the average stock and in some cases considerably more so. As an investor, the judgment is to balance the benefits of exposure to significantly above average growth against the price you have to pay.

You mention international earnings. Is that still a key theme in the portfolio?

This is something we've thought long and hard about over the course of the year, because again the news flow has not necessarily been consistent. Also, as with structural growth, stocks with good international earnings are increasingly priced more expensively than those that are more domestically orientated. Having gone through the debates, we have broadly kept with our desire to be exposed to overseas growth, because in the final analysis whichever way we look at it we still conclude that growth in economies like China, like India, in the BRIC economies is going to far outpace what we see in the developed world.

What exposure do you have to the UK economy?

If we think of the main sectors that give exposure to the UK economy, they are areas such as retail, travel & leisure, support services. Those are industries that are oriented to the consumer or to the public sector, areas of the economy that are facing cutbacks and declining spending power. As a result, in most cases we have been materially underweight for a long time and we expect to remain that way. Where we do have exposure, as discussed above, it is to companies with a structural growth dynamic.

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One stock you've been investing in recently is Bellway. Why buy a British housebuilder now?

If we look at the housebuilding sector from a risk control perspective, it is an industry that makes up a material proportion of our investment universe. We are therefore unlikely to close down our exposure entirely. When we look at the opportunity set, Bellway to our mind seems to have that combination of being exceptionally well managed and still at the cheaper end of the pack, trading on about 0.8 times NAV.

Over and above that, we are underweight the housebuilding sector as a whole. But it is a sector where the perception and the reality are not identical. If you look at the news, the headlines will tell you that the UK housing market is in a dire state. I think the reality on the ground is that it's bumping along the bottom with largely static prices. Mortgage availability and indeed transaction levels, however, are gradually improving. It is an environment in which a lot of the smaller competitors have fallen by the wayside, leaving the larger player, the quoted housebuilders, in a relatively strong position to improve their margins and improve their net asset values.

The market is being driven by macro concerns. How is that affecting company managements you meet?

What's noticeable for a team like ours, which spends a lot of time meeting with company management, is that I think it's probably fair to say there has been a shift in terms of sentiment. For example, if we were to look at a globally facing business, until the late summer period they would have been putting forward a very positive view of their trading and prospects. But more recently, I have detected a tempering of their views. I don't think it's translated into outright conservatism or fear of the future, but like everyone else they are pausing and reflecting as to where they go from here.

What is your outlook for the rest of this year and 2012?

That is always a difficult question and it is triply difficult right now because of the range of countervailing influences in play. On the one hand, we have ostensibly attractive valuations, with the UK market trading on about 9.5 times prospective earnings. On a global basis, there is reasonable evidence that the key economies, China and increasingly America, are beginning to deliver improving data. However, set against that we have the eurozone situation, which persistently defies simple answers, which retains the capacity to provoke significant risk aversion and which could carry on for an indeterminate amount of time.

In that context, the sort of positioning we are aim for represents a balance between structural growth and a degree of higher quality economic sensitivity, the latter targeted to the pockets of growth in the global economy and emerging markets in particular. I am cautious, but I think it's premature to be overly defensive. I think the world is not a sufficiently bad place to warrant that type of positioning right now.

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