



Derek Stuart – Artemis UK Special Situations Fund Q109

Transcript from the Q109 Film Club recorded on 24 February 2009.

Q1. There's been little to cheer about in equity markets in the last year, do you feel some degree of stability is returning to the marketplace?

I think it's very difficult to say with any degree of certainty that stability has returned to the equity markets. We're still in a period of deleveraging, a significant change in the financial sector and a significant change in the economy. But one or two things give me some confidence that we are seeing some genuine value in the markets.

First of all, stocks in general are considerably cheaper than they were 18 – 24 months ago. I'm finding value in the small caps for the first time in a very, very long time.

Secondly, a lot of the indicators we use in terms of sentiment indicate a higher degree of negativity and that's always a good sign for equity markets. Also, on that point, is that the cash levels in most people's funds are very high. Again, that cash at some point will come back into the markets.

Finally, for those equities that are left, it's going to be a fantastic time to make an investment in those companies because those companies' competitive position is improving drastically because a lot of the competition is falling by the wayside. A competitive environment for those companies will be much more attractive going forward and therefore the potential returns from these businesses will be higher.

Q2. You place a lot of emphasis on meeting company management. What are company directors telling you when you speak with them?

We see company management teams all the time and it's absolutely key for us to make a judgment about that company, that management's ability to manage a business and also get much more information about the company itself. And at times like these it's even more important. You can understand at the moment that the sort of noise coming out of the market's, economic data which is very confusing, everyone is breeding fear everywhere, and therefore trying to cut through that. The best thing to do is to actually see company management teams and spend time with them to find out what is happening in the real world.

At the moment, there's no really strong indicator of what is happening. There's a high degree of uncertainty out there. People don't quite know what's happening; there's been a significant level of destocking over the past three or four months across industry and consumer sectors. The turmoil within the financial sector is causing much more uncertainty than it ever has before.

The management teams are addressing the problems. They are much more realistic than they were last year. They are taking cost out of their businesses and focusing on ways of rationalising the markets going forward.

The companies are telling us at the moment that things are uncertain but they are dealing with it. Again that gives us confidence in certain areas and in certain stocks because there's enough fat to come out in terms of costs to offset the downturn in the economic growth.

Q3. Your move up the market-cap scale into big, defensive stocks helped protect investors' capital in 2008. Are you remaining defensive now that we have entered 2009?

The history of this fund is that it has a large bias to mid and small cap areas of the market and that has really been what has driven the performance over a number of years. But 18 – 24 months ago we moved up the cap scale. We sold a lot of our small caps because they performed incredibly well and we bought into large cap companies which had not performed so well, but interestingly they were in areas that were more defensive such as pharmaceuticals and utilities and we've been running with that for about the past 18 months. At the back-end of 2008 we were sitting with 60% of the fund in FTSE 100 companies. We've now started to reduce that weighting by investing in more interesting areas of the market, e.g. areas that have suffered. That typically is in the mid and small cap area; so that 60% weighting in large cap has come down already to about 55% and that should continue to fall throughout the year as we find more interesting opportunities in the mid and small cap area of the market.

Q4. Turning to specific sectors, you have benefited greatly from not owning the banks and miners, has your stance changed on these two areas as we move forward?

One of the largest calls that we've made in the fund over the past 24 months has been to be underweight banks and underweight the mining sector. In the bank sector – we've had very little weighting over the past because we've had significant concerns about the growth of those particular companies. There's been massive growth and proprietary trading in structured products which we didn't particularly understand, and the growth in lending has been unsustainable. We were very concerned about the earnings prospects and the balance sheets of these particular banks.

Today, after the significant price falls you would have thought as a contrarian I'd be very interested in the banking sector. We are monitoring it, but are yet to feel confident to actually buy into the banking sector yet. The main reason is the transparency.

Nobody knows what is going on inside these banks. The leverage is still incredibly high; they are required to be recapitalised again. The history of banking crises in Japan and in Scandinavia indicate not just one recapitalisation of the sector, but two or three or more and we've been through two recapitalisations. I think a third is going to happen at some point and maybe at that point we will be able to understand what is left in the balance sheets of these particular banks, but at the moment we are remaining incredibly underweight banks.

We used to have a significant weighting in the mining sector. Again, I can buy completely into growth stories in China and India, but having said that, those areas of the world are slowing down as well because the western world is not buying their products. These countries cannot particularly make them and therefore the demand for basic commodities has collapsed. Therefore the mining sector again is an area we are not particularly focussed on at the moment. There's been significant collapses in the underlying commodity prices. The companies in general terms have significant debt which is clearly not attractive. At the moment, again, we are watching from the sidelines as that whole sector has been recapitalised with a view at some point in the future to increase weightings there.

Q5. Which sectors are you favouring at the moment?

At this point the fund is still very skewed towards the more defensive areas of the market; we're overweight pharmaceuticals; utilities and food retailers in the FTSE 100. However, what is happening at the moment is we are witnessing a fantastic derating of some of the most cyclical areas of the market – property shares, industrial companies, some of the leisure companies in the UK – their share prices have collapsed. Some of them require refinancing and there are a number of rights issues, especially happening in the property sector.

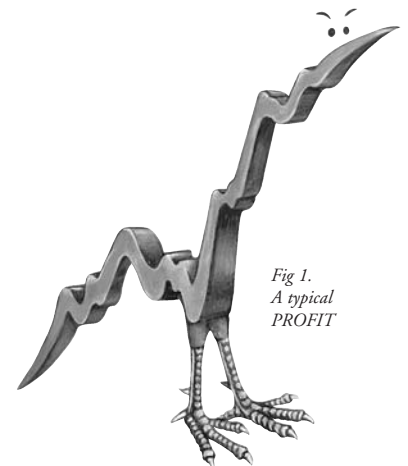


Fig 1.
A typical
PROFIT

We're looking at them now and we're dipping our toe into some of these property companies because these companies have collapsed and under certain situations the yields look quite attractive now on a three to four year view.

In the industrial sector there's been a significant destocking over the past three or four months and again a number of profits warnings. Some of those companies need to be refinanced and again we will invest in those opportunities. Again, the positioning of the portfolio will change radically this year as we move out of the overweights and defensive areas and invest in some of the more interesting cyclical areas of the market going forward.

Q6. Sterling took a battering in the second half of 2008, has this influenced your thinking?

One of the key concerns we had over the past two to three years was the build up of debt in the UK consumer sector and therefore the ability of the consumer to sustain their spending habits. What we've been driven towards is companies typically that have their earnings from overseas and while there is a likelihood clearly of a global recession, as I'm actually seeing at the moment, we do believe that areas outside the UK still offer a growth potential above the UK. This has resulted in basically 75% of the earnings of the fund coming from overseas. So we are a massive beneficiary of Sterling devaluation. It wasn't a particular call on our account. We didn't particularly predict that Sterling would weaken so dramatically, but our feeling was that the UK economy was on very fragile ground to be more focussed towards the consumer and financial sectors. Therefore overseas earnings would be much stronger and much more resilient into this global slowdown.

As I said before, 75% of the earnings are from overseas which means that Sterling's collapse, as we've seen over the past three or four months, is a massive benefit to our companies.

Q7. With investors rushing to the safety of gold and gilts, as a contrarian – could this not be a sign that now is the time to increase equity weightings?

At this moment, there is so much fear in the marketplace. You've witnessed that by the performance of gilts, the massive move into gold etcetera and people are basically throwing out equities and not paying any consideration to what returns they could potentially generate over the next two or three years.

What is basically happening is even good quality equities that are well financed and well run are being left at valuations which we find incredibly attractive. At the moment I'm not forced to go for the areas of the market which are in real distress. I can buy good quality companies at a lower valuation than I was buying two years ago. In the long term, in the next two or three years, that's clearly the right thing to do because at this moment in time, nobody knows what is going to happen to the economy; whether we will suffer from deflation or inflation. If we suffer from inflation I know I'd much rather be in equities than gilts or gold.

Q8. Is this an environment you like to operate in as a special situations investors?

It's always incredibly difficult at times like these to focus on what you're actually doing when you're buying equities because there's so much noise going on. There's so much change; the economic environment's unattractive and everyone's telling you, you should be going for safety. But the key times when we've made real money in this fund and the times that we really enjoy are the times of turmoil. The fund was launched in 2000 after the Dot-com boom and there was lots of value in the market. We had a great time in the end of 2002/beginning of 2003 when again there was significant turmoil in the marketplace and we made investments in equities that made us a lot of money. At the moment I don't know what the catalyst will be and I don't know of the timing of the recession but today I can find selective value in the equity market. I'm buying equities today that over the long-term will actually make us a lot of money.

Risk Warning

Any research or analysis contained in this document has been procured by Artemis for its own use and may be acted on in that connection. The contents of the document are based on sources of information believed to be reliable; however, save to the extent required by applicable law or regulations, no guarantee, warranty or representation is given as to its accuracy or completeness. All data is sourced internally as at 24 February 2009 unless otherwise stated. The document may include forward-looking statements which are based on Artemis' current opinions, expectations and projections. It is provided to you only incidentally, and any opinions expressed are subject to change without notice.

Issued by Artemis Fund Managers Limited, which is authorised and regulated by the Financial Services Authority (www.fsa.gov.uk), 25 The North Colonnade, Canary Wharf, London E14 5HS and is a member of the IMA. Artemis Fund Managers Limited is a member of the Artemis Marketing Group. We only market our own unit trusts. Please remember that past performance is not a guide to future performance. The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested.

Investment in the securities of smaller and/or medium sized companies can involve greater risk than is customarily associated with investment in larger, more established companies. The market for securities in smaller companies is often less liquid than that for securities in larger companies, meaning above average price movements both positive and negative can be expected. The historic yield reflects distributions declared over the past twelve months as a percentage of the mid-market unit price, as at the date shown. It does not include any preliminary charge and investors may be subject to tax on their distributions.