'When we pick the stocks for our fund, you can see they are not outrageously expensive and they seem to be delivering the growth'

Philip Wolstencroft, manager of the £1.48bn Artemis European Growth fund, talks about how SmartGarp can beat other managers to the best stocks and why country allocation plays little part

Q: You devised the SmartGarp system. How does it provide better results than traditional fund management?
Philip Wolstencroft: It looks at the stocks that everyone else covers, but if they appear to be cheaper or growing at a faster rate and have good news flows, the system simply buys them rather than having to have a major discussion about it – SmartGarp is much quicker to act.

Q: How does it break down the factors?
PW: SmartGarp has half a dozen factors or overall themes it considers. We look at these factors and try to find a blend of stocks that have all the right characteristics. We look at value, and try and find cheaper stocks than average that are growing faster than the market. We particularly want those companies where the stock price is going up and analysts are raising their earnings estimates. These are the four bottom-up factors, which are combined with two top-down factors, the first of which is the economic backdrop. If the world economy suddenly accelerated, then the model would be likely to buy cyclical sectors. We also look at fund manager sentiment. For example, if every fund manager was overweight in a particular sector, the system would advise caution.

The SmartGarp system looks at all these factors, then measures them objectively to determine which stocks to buy and which to avoid.

Q: One of the factors is growth at a reasonable price, but what exactly does that mean?
PW: In essence, we want to find stocks that will grow faster than the rest of the market, but we do not want to pay huge prices. We want to pay an average price for a great stock, but that is not easy. But there are some stocks that appear to have these characteristics. For example, consider the situation if the market multiple was 12, general stocks were on 12 times next year's earnings and earnings were growing by 12 per cent per annum. If we found a stock that is on 12 times earnings – the same valuation – and growing at 15 per cent then that is attractive. If we found stocks that were on a 10 per cent growth rate but on a price to earnings ratio of 8 per cent then they also would be attractive. We try to buy the fastest growing stocks for the same valuations, or cheaper stocks with the same growth rate.

Q: If the SmartGarp system effectively systematises the investment process why do investors have to pay for a fund manager?
PW: We apply a reality check. The machine might go off and buy 50 stocks from different sectors, but it might turn out they have a very high correlation. You might find you are overweight four airline stocks, four construction stocks and four steel stocks. These may appear to be in different sectors, but all of them are very volatile businesses and very time sensitive. We examine these factors to be able to determine whether we should be elsewhere. Even though these stocks are in different sectors, they are highly concentrated bets. As fund managers, we decide whether we should try and diversify.

75%
Proportion of fund invested in large cap stocks

The process is about applying common sense and monitoring news flow from companies. For example, if a company appears to be great on SmartGarp but there are interviews with the chief executive suggesting the short-term future may be volatile, then we might decide to pull out. In this scenario, the numbers might be great but it may not fit with the subjective information we receive. We cross check the subjective information to confirm the quantitative factors are actually correct.

Q: Does the system vary according to geography? For example, do you employ a different process for investing in Europe?
PW: We use the same system for all stocks across Europe. There is no prior reason why a Greek stock should be more attractive than a German stock.

Q: How about the fact the UK has a separate interest rate to the eurozone? Surely that difference must be factored in?
PW: We are generally more interested in stocks and sectors rather than countries, and the country allocation tends to be driven by this. It tends to be the case that this is a good working assumption to use.

Generally the process is far more micro than macro. The extent of the macro factors we look at is the extent to which sectors are driven up or down. If utilities are going up in Germany, for example, then it is likely you will find utilities going up in the UK and Switzerland, even though they have different currencies and interest rates. In a similar fashion, if oil stocks were going up in the UK, it probably has little to do with the UK stock market but

CV

PHILIP WOLSTENCROFT
2001 Manager, Artemis European Growth fund, for Artemis Investment Management
1991 Head of pan-European equity strategy for Merrill Lynch Investment Management
1989 Global strategist for County NatWest Investment Management
1986 Global bond and currency fund manager for WorldInvest
1985 Trainee equity analyst for British Rail Pension Fund
1983 Warwick University, MA economics
1980 Sheffield University, BA Economics

is more likely to be related to the oil price.

Q: On this basis, which factors should investors be considering when investing in Europe?
PW: It is first a matter of whether they are buying funds or buying stocks. Most people tend to look at the economies, gauge whether they are good or bad and then go out and buy funds on the back of this information. Our philosophy is to search for great stocks – and once we find them to invest your money.

If we can find stocks that are on great valuations and are growing steadily, then the chance is we will make money. We are not overly concerned about whether the German economy is booming or collapsing.

Across Europe, very little money went into equity mutual funds last year. This is sharp contrast to 1999 to 2000, when there was massive investment into equity mutual funds. That was a sign people were falling in love with equities and at the moment, stock prices are going up in Europe but the retail investor has not fallen in love with the stock market. Together this suggests we are not at the end of the party yet.

Q: How much has the European Growth fund benefited from tilting the SmartGarp system towards large-cap, cyclical, high-risk stocks?
PW: There are three different factors at work here: large caps, cyclicals and capital stocks with higher leverage. We have about 75 per cent of the portfolio in large cap stocks, which is less than the average fund would have, but more than we have had in the past. In general, the size of the large cap component has not affected us very much. What has had more of an impact has been the cyclical nature of stocks in the fund and their risk profile. We have been overweight in cyclicals and stocks with more financial gearing on their balance sheets. Both of these things have been broadly helpful.

From late May through to August, people decided these stocks were the wrong type to hold and their decision to sell drove the price down. We looked at them and said the news flow and the financial characteristic on these types of stocks was pretty good, so maybe we should still remain with them. We still have a cyclical bias, and still hold it towards financially leveraged stocks, which have been broadly helpful. We have found the size of the companies held has been largely irrelevant.

Q: But this does come after a period of bad performance, when the fund was the second-worst performing fund in the sector between March and May 2006. It is a high-conviction play that must, surely, make investors nervous.
PW: It is a matter of understanding what we do. If you are invested in a fund where the managers have their own money tied up in that strategy, where the results have been pretty good over the past few years, and there is a slim chance that we would move elsewhere, then that ought to give clients a bit of confidence in our process.

The fund has been in the bottom centile, but it is now in the top centile. But over the past few years it has been more at the top than at the bottom and that is what people are interested in, rather than just looking at a three-month performance. If they do not like it then they can remove their money, but we feel confident in what we are doing and are happy to carry on in this fashion. The process is not for everybody, but there are a reasonable number of people for whom it has been a profitable investment strategy.

Q: Many analysts now argue there could be a period of volatility, particularly in Europe. While the system does not allow for a great deal of subjective input, is there a general feeling the fund should be more defensively positioned?
PW: It is certainly the consensus that many funds should be defensively positioned, but I do not believe that is the case. I am happy to bet against the consensus. We have our own money invested in the fund so we have actually put our money where our mouth is.

Q: Looking ahead, what is your outlook for investing in Europe?
PW: I am as upbeat as ever. When we pick the stocks for our fund, you can see they are not outrageously expensive and they seem to be delivering the growth, so maybe we should give it the benefit of the doubt. As long as the fund keeps trading up against returns from cash, then I will be happy. Indeed, as long as the fund keeps beating the index I will be happy. We are not a group of people who take massive asset allocation or sector bets. All we try and do is build a portfolio that will do well over the next year.

At any one time there are always 50 things you could be worried about and 50 things you could be more relaxed about, and the bottom line is whether you are invested or not. And we are – in stocks with more cyclical exposure and more financial leverage. There are many people who moved to become defensive in the second half of last year and they got caught out. My guess is they will lose their faith again and come to our way of thinking, which means I am pretty relaxed about the near-term investment future.