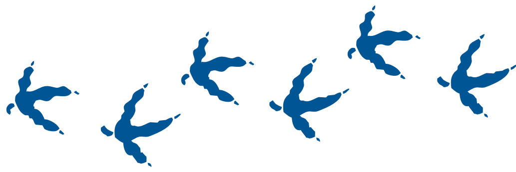

ARTEMIS
The PROFIT Hunter

Adrian Paterson – UK Growth Fund

Adrian Paterson:

Thank you, Dick and good morning, everyone. Thanks for tuning in this morning.

I have just put a few slides together, just really concentrating on the recent performance and what I am up to at the moment, sort of how I feel about life I suppose. And I think the first thing to say, as Dick has mentioned, is actually I am very pleased with the way the portfolio is going at the moment, and we did have a strong last quarter to last year and first quarter of this year too, I will come on to the reasons why a bit later.

But I think one of the important messages I would like to get across is, for those of you who don't know me, I do try and invest with a long-term hat on and I personally am not too bothered about short-term volatility – and you are going to get short-term volatility in a portfolio that is multi-cap, that has got some decent small and mid cap exposure, and really when I am looking to buy shares, I am looking to buy things on a three to five year view and make really good returns over that period.

And it follows from that, I suppose, which is quite interesting for me looking back, that really the sort of foundations for the recent good performance were of course actually laid really at the beginning of 2006. You don't just buy shares or make big sort of thematic investments which I have actually got at the moment in the portfolio and expect that they are suddenly going to shoot up the following day or the next week.

And I certainly felt that I had really got a grip of this portfolio at the beginning of last year, and even though over the summer period some of the sort of smaller overseas AIM companies were still to some extent hurting me, I could feel the sort of underlying movement and sort of positive things going on in the portfolio, and it was just a matter of waiting for them to come through and I am pleased to say they have started to do that.

So there is always, as I say, a sort of lag period between making new investment decisions and actually reaping the benefits.

On the next slide, clearly over any period it would be a bit churlish to pretend absolutely everything went right – although I have to say, over the last six months most things have gone right, which is obviously great.

Some of the sort of negative issues were more to do with being underweight in some of the bigger sectors like telecoms, which actually performed well. We have got a decent position in Cable & Wireless which has done well, and I hold Vodafone but no BT. So that was sort of modest negative – because actually the whole sector performed very well.

And I suppose the other negative is I have still got two or three sort of second-line oil companies which have been a bit disappointing. I am actually very happy with them, but perhaps a bit disappointing.

And at the individual stock level I have just listed a few companies that, for obviously different reasons, failed to perform. I actually like all of these businesses. They had individual reasons for specific problems why they have done badly, and I suppose the most frustrating one of all is probably EMI Group, which has had countless bid approaches rebuffed by the management and they really know how to infuriate investors, but the fact of the matter is, they have got the largest music back catalogue in the industry; it is worth an absolute fortune. And I suppose they know that when they are rebuffing people, but it has been a source of great frustration to have several bidders turned away and have to watch the management producing poor results after poor results.

But in all these cases I still hold the shares. That is why I have put them down. They have been disappointing but I am still very positive about the outcome.

Richard Turpin:

Adrian, if I could just ask a question; on an asset allocation point of view, from a multi-cap base, I can see that overall you are quite high in terms of your large cap exposure. There is a question that has come in from somebody asking – there is a lot of talk about mega caps and large caps being the place to be invested this year – do you feel, in terms of fundamentally obviously, from a multi-cap perspective, you have to retain exposure to sort of small and mid-caps but obviously you have increased your large cap exposure, and do you feel comfortable with the sort of levels you have got overall.

Adrian Paterson:

I mean the great thing about running a multi-cap fund (I have always thought this) is you have got the freedom of flexibility to obviously invest any way you like, and that is fantastic and it means you can move the portfolio where you see value, and the fact is, over the last – practically since I have been running this fund over the last four or five years, small and mid caps have beaten large cap every single year. And a consequence of that is that there is some relative valuation attractions to some of the large companies which have not been apparent for many years.

Now obviously not all of them, and you can split out maybe the mega caps from some of the other FTSE 100 companies, but definitely I have wanted from an investment point of view, not just because they are large companies, to increase my exposure to that area. And over the last couple of years it has probably increased from the FTSE 100 exposure being about a third to somewhere nearer the 50%; and I feel quite comfortable with that sort of arrangement.

But obviously, at the same time, there are lots of other things I want to invest in but just from a sort of valuation point of view, some of those big companies really do look quite…

Richard Turpin:

That is what is driving your large cap exposure, it is fundamentally sort of…

Adrian Paterson:

It is fundamentally valuation-based, yes it is fundamentally based and not just buying something – oh that's big and it's done badly, I'll buy it. And I don't hold all big caps but over the last twelve months I have increased exposure to a lot of those companies and some of the very large ones.

Richard Turpin:

Great. Now we have got a couple of questions regarding slides. I do hope you are able to see the slides on the webcast. I do apologise if any of you are experiencing some problems in actually seeing the slides. Adrian – we come to the sort of positives that we are seeing in the portfolio.

Adrian Paterson:

Yes, let's go on to some of the positives. I mean there is a combination of positives going on at the moment

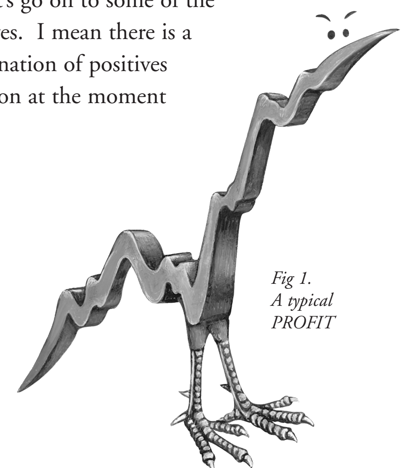

Fig 1. A typical PROFIT

and some are sort of sector-thematic based and some are individual stocks. But I think that the most important part really is some of the sector positions that I have taken over the last twelve months which I feel quite strongly about.

And certainly in the case of both food retailers and pub companies, I have actually invested in both of those areas for the same reason, and that reason in particular is that is has become increasingly apparent over the last year or so that there was a high degree of undervaluation of companies that had strong property backing and very stable and predictable cash flows.

And a lot of the properties in the supermarkets, for example, and pub companies have not revalued their property assets for many years and, as everyone knows, property has been a very strong performing asset class over the last few years. And if you revalue a lot of this property you can actually get to the market caps of most of these companies, which means effectively your operating business is being valued at virtually nothing.

Now I think two things alerted people to this. First of all, as everyone knows, there is a huge amount of money in private equity coffers at the moment and the types of businesses they are attracted to are companies which are underleveraged and have got strong asset backing, where they can sell the property, return the cash to themselves to pay down debt and obviously take advantage of that mispricing.

In the middle of last year Mitchells & Butler, which is one of the portfolio's larger holdings, was approached by Robert Tchenguiz. He was in fact rebuffed, but he highlighted the huge inherent value in that business and the shares have doubled over the past twelve months.

And I was just saying to Dick earlier on this morning, which is very good news for this portfolio, you may or may not be aware that 15% of Sainsbury's has changed hands this morning. So in spite of the fact the bid fell away because the family were intransigent about selling the company, seemingly at almost any price, 15% of the company has gone. We don't know exactly where at the moment, at a large premium to the share price yesterday, highlighting the sort of value that people see in these businesses as well. And these are some of, obviously, the market's larger companies. I mean Sainsbury's value is about £11 billion.

So I have actually got, in aggregate, probably about 20% of the whole portfolio is positioned in what I would call 'asset-backed' cash flow-positive companies and that is not just pubs and food retailers, although I have got a big holding there, but I have also got some nursing home exposure, and even an old friend of mine, Majestic Wine at the smaller level does own a lot of freehold properties and generates huge amounts of surplus cash and throws up all sorts of interesting possibilities for them.

So that is the big theme I really want us to concentrate on today. Then just a couple of other positives from a sort of sectoral point of view.

I mean the mining sector, as everyone knows, has been strong for two or three years and this portfolio has had good overweight position in mining. I have actually been reducing it over the last twelve months and, to some extent, have stepped that up a bit this year so I am taking some profits there but it certainly has been a strong positive over the last year or so.

I suppose the last area is other financials. We have got a fairly broad spread of other financial companies. I am not talking about banks per se but more some fund management companies, some broking companies, and obviously they perform well in good markets and we have had good markets and I think that the outlook is quite positive there.

And also, I always feel that one should know more about the industry one is actually in than a lot of other industries, and we clearly, being part of the fund management industry you know, I feel it's a good place to be.

Richard Turpin:

Can I just take you back there for a second – on the subject of asset-backed parts of your portfolio? There is an interesting question come in here from Peter Buxtall. Good morning, Peter. Thank you for sending in a question. Peter is just reflecting on whether we think there is either a perceived or real danger to the stock market as a result of the sort of UK property bubble. I mean on the one hand it has obviously been a positive, the sort of asset price growth in terms of your portfolio; but do you have any concerns about the position? Maybe it is more of a retail thing than a…

Adrian Paterson:

Well, I mean that is a very sort of fair point and a good question and it is obviously something I have to keep an eye on because the one potential fly in the ointment, I suppose, would be a real property crash; but I just don't foresee that happening.

I think interest rates do look as if they are going to rise a bit, and I don't think that is going to do anything other than just steady everything down. And so far as these asset-backed companies are concerned, which I didn't mention earlier, the real fillip for them really at the end of last year was the government introducing this real estate investment trust legislation, this REIT legislation, which gives huge tax breaks to property companies or any companies with property assets to put their property into real estate investment trusts – they pay no tax at all on the income that accrues from it. And as a result, people are prepared to buy real estate investment trusts or REITs, effectively parcels of property, for yields of 4% because they are not paying tax on it. So that has actually boosted the value of a lot of these property-backed companies, which wasn't necessarily the case the middle of last year.

So it's a real one-off benefit and so far a lot of these companies are looking at it, nobody has yet formally hived their property off into a REIT but it is looking increasingly likely that they are going to start, and I think we are going to get a lot of news on this in the next month or so and I think, certainly for the foreseeable future that should give quite a decent leg-up in the share prices of a lot of these businesses.

Richard Turpin:

Great – and thank you very much for that.

Adrian Paterson:

So just turning over to slide 5, I mean I have sort of alluded to most of this already but I suppose it is just worth reiterating that, on the previous slide I was sort of talking about what is in the portfolio and what has done well, and I suppose the message really is that I am continuing to run these themes that I have talked about because I believe that, even though we have had the first step up in the valuations of these businesses, we haven't really seen a full step-up and the reason I believe that is, as I just mentioned, none of these companies have yet actually done anything so far as REITs are concerned or to hive off their properties and I think part of the reason for that is that a lot of the managements of these businesses are quite conservative. They are not really property people; they are retailers and they haven't really looked at it.

The fact is: the property people are having a good look at these businesses. There are activists arriving on the share registers of these companies and it is becoming increasingly clear that a lot of these balance sheets are really quite inefficient.

So I think, as I mentioned a moment ago, we are getting to a point where we are actually going to see some pressure applied to these companies. They are going to be forced, in some cases, to actually address these inefficient balance sheets and the sort of domino effect that will have on other like-minded businesses could be very positive and that is why I have got this position and, if anything, over the last couple of months I have actually increased my exposure to this area, not the other way. So I think it is really a strong theme for the future.

Just to mention a few other things, we have done the sectoral basis of the themes that I am really into but obviously, as you would expect in a portfolio like this, there is always going to be some bottom-up ideas thrown into the mix where, for differing reasons, I meet companies and I think they have got a very attractive story to tell and they are running very attractive

businesses and where the stock market has perhaps overlooked them.

And it is not always very small companies that I think people, in particular, can overlook. It can actually be some larger ones, and one of my favourite investments at the moment, which is a turnaround situation really, is Compass Group. Now Compass was a company which, I mean it's a very large company, it's a FTSE 100 company and five or six years ago it was a real glamour stock as far as the stock market was concerned. It was very highly regarded, traded on high multiple; and the reason for that and the reason remains as to why it could be attractive again is that the market they are operating in is attractive. It's a growth market, it's a non-cyclical market, outsourced catering. It should grow at 5% a year irrespective really of the economic cycle; it's a defensive type business.

And although their market is very fragmented, the larger players should actually get more than their fair share of business because they are actually able to service large multi-national companies which small one-man bands couldn't possible do.

So if the market is overall growing at 5% a year the bigger players should be able to grow at least in excess of 5% and possibly up to 10% so there is good top-line growth.

Now the real excitement for me here is that the company really lost its way following a disastrous acquisition of Granada's catering business and discovered all sorts of black holes everywhere. But a whole new management team has gone in and that has really transformed the prospects, I believe. They got a good track record and they have all bought shares in the company, which for a large company is quite unusual, and they are in the business of getting the margins up and getting the turnover up and I expect, you know, we can really even in a large company make some really quite decent returns on it.

Just a couple of others, recent activity. I bought some Marks & Spencer; they obviously performed very well in the initial phases of their recovery but actually have been quite dull recently and I just took advantage of some recent weakness to actually buy some shares. A fantastic brand, obviously great management and no real apparent reason why they should have come off in the last two or three months.

And of the smaller ones, I mentioned nursing homes. I mean that is a very attractive area to get involved in, I believe, particularly because of the demographics. I bought shares in a company called Care UK which owns all its freehold property so you have got your downside protection there and the demographics of the aging population and real shortage of supply in that sector is as attractive an investment area as I can remember really getting involved in. I mean it's hugely attractive, so I have taken a position in Care UK and conceivably might take positions in other ones as and when they come up. I mean there are only three or four quoted ones and they are not terribly large companies so one has to be relatively patient.

And then I suppose the last area where I have been buying shares in the last two or three months has been in the bus companies. The reason for that is that there is clearly changing legislation, a real push to get people out of cars, the almost certain rolling out of congestion charge across all the cities in the country. And you know, consequently what had been historically a rather sort of staid utility is now moving into growth mode where there is ever-increasing demand and companies are able to put their prices up. So there are some examples of some of the smaller, small bottom-up style investments I have been making.

Richard Turpin:

One gets the feeling that corporate UK is in good health with strong balance sheets, so if there was a slowdown in the economy do you feel that most companies are in a position to weather any slowdown, any storm ahead.

Adrian Paterson:

Yes, I think so. I mean that is the real positive I suppose that the times we are in at the moment is that company balance sheets in general are incredibly strong, and consequently investors are getting huge amounts of cash given back to them plus you have got this very active bid and takeover market. I'm going to call that some of these big bids are going to fail, I mean that's inevitable; they are incredibly difficult to pull off. But even year to date we have had Gallaher go, we have had Scottish Power go and now, barring some unforeseen circumstances, it looks like Boots is going to go for what appears to be an enormous price. All this money comes flooding back into the market and oils the wheels.

And as I say, clearly there is sort of, the danger that lurks is interest rates going up a lot higher than people think, caused by very excessive levels of inflation and we have just got to keep a handle on that. But in terms of the companies themselves, they are in robust health and that is confirmed by the statements that they make and the businesses we are seeing on a day-to-day basis. And you know, that is why I am pretty positive.

And I mean, on the last slide it is part of the conclusion I suppose to sort of add to that: equities are as cheap versus bonds as they have been for thirty years. Now you could say: well, doesn't that make bonds look rather expensive? You know, that makes it more about bonds than equities, and maybe it does; but still that is amazing, a powerful statement to be able to make that equities are as cheap versus bonds over such a long period of time, which includes all sorts of strange economic things that have happened over that period.

And that is just a statistical fact and if you lay on top of that the sort of levels of liquidity that we are talking, well the strength of company balance sheets plus all these private equity people, who are not by any means guaranteed to make returns or money on their investments but they are obliged to spend the money that has been pledged to them otherwise they don't get paid. So they are there, they are real and they are fully funded and I think we are going to see a lot more of this sort of activity, which implies to me that the market is pretty good value.

Richard Turpin:

Do you see these private equity groups as barbarians at the gate or do you see them as liberators of stodgy businesses?

Adrian Paterson:

Well, that's more of a sort of moralistic-type argument, that I mean we discuss this in the office sometimes. I mean Adrian Frost sort of says well, I think it's disgraceful what these people do and so on, and private equity of course have been dragged into the press and the Labour Party obviously hate them and so on, and the evidence has to be mixed on this. I mean you know, if you have a very left-wing persuasion you are inclined to sort of say they are just awful asset-strippers but the actual industry itself has fought back to some extent to demonstrate that by no means is that always the case – in fact, may quite rarely be the case you know. They, some of these businesses, do get invested in and they do grow and you know it is to the benefit of everyone.

I mean it's on the front page of the FT today they are so on the back foot, these private equity people, in this sort of thing, and KKR are sort of pledging new jobs that have been created at Boots and they are going to expand and grow it. They are really on the front foot from a PR point of view but, to be completely honest, from my personal point of view obviously I am just trying to get the best returns I can for the investors and the portfolio and sort of try and keep the sort of moralistic stuff slightly on the side line.

Richard Turpin:

I mean there is one question coming out – I don't know if you have had a chance to pick up on it yet this morning, but apparently there have been some management changes at Marks & Spencers. I don't know if you have…

Adrian Paterson:

Yes, I have…

Richard Turpin:

I am asked for any thoughts you might have on what's going on there.

Adrian Paterson:

Yes, well I have seen that and I don't actually know a lot about the two people involved, but clearly it was put forward as part of succession planning. I mean Stuart Rose has said that he is going to go in two years and he has always said that he is going to go and he is going to go. And I think it is just sort of preparing for the future really. I mean I don't think it's a sort of plus or a minus other than to say – from Stuart Rose's point of view, he is going and he has got to build up a team. I mean, one of the criticisms of Marks & Spencer I suppose has been it's a bit of a one-man band and my suspicion on that is that Stuart Rose is a great self-publicist and obviously a very good retailer, he has done a brilliant job. I wouldn't knock him at all but I bet you – and I'm sure he would say – that you know that he might take all the glamour and the glory but there is a hell of a good team working behind him because it is a massive business and it's performing incredibly strong there.

Richard Turpin:

He does seem to have engineered a remarkable recovery.

Adrian Paterson:

I mean it's amazing and it shows, important, one of the things for fund managers is to sort of remember these things and learn from them. I mean actually I have always been a great admirer of Stuart Rose and we held Marks & Spencer from much, much lower levels at the beginning of the recovery and then, as the recovery came through, we sold out and it was a very, very good investment for us and I have re-entered the fray as it were, because of the short-term weakness. There has been some talk of weakness on the high street and so on, but clearly they are taking market share from almost everyone.

And it just shows that Philip Green rode over the hill, tried to buy that company at £4, he is no mug. He knew there was value in that business, somebody just had to extract it, and the shares are now £7.20. And I feel very similarly about the situation at Mitchells & Butler and Sainsbury's and so on, and Robert Tchenguiz who was a sort of younger version of Philip Green but no less hungry and keen and bright, he bought 16% of Mitchells and Butler at £4. He knew there was value there, the shares are now nearly £8, and he has just very recently done the same in Sainsbury's and I just think history does repeat itself in some of these things and one needs to be alert to it.

Richard Turpin:

Adrian, conscious of the time, thank you very much indeed for taking us through your thoughts. I do apologise if any of our listeners have been unable to access the slides. Hopefully we rectified that on the system at an early point, and thank you for those of you who pointed it out. If for any reason you did not get the slides then please let us know on broker support: our email address brokersupport@artemisfunds.com, and we will be delighted to email the slides thorough to you. Equally if you do have any further questions that you haven't sent through this morning please send them through to us on that email address – that's brokersupport@artemisfunds.com, or indeed phone our broker support team on 0800 092 2090.

If I could just finish off by saying that there will be a recording of this conference call on our website in the next couple of days, and if I can thank you again for taking the time to join us. I hope it's been useful and we look forward to continuing the series over the next few weeks. But Adrian, thank you very much for your time today and thank you to all our listeners for tuning in. Thank you very much indeed.

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