

INVESTOR *FOCUS*

April 2005

Returns from stockmarkets in the six months to March 31st continued to be encouraging. In particular the UK stockmarket has been a robust and strong performer and in contrast to previous periods there seems to be a good degree of buying interest in

stockmarkets from a variety of sources. The companies themselves have been major buyers of their own shares seeing this as an effective use of their surplus capital. From our perspective it makes good economic sense for companies to do this. So in summary market returns have been healthy, valuations are still attractive and it remains a good time to be invested. Of course, to beat markets rather than just keep the pace with them you need to entrust your money to a manager who can pick the right shares, and this continues to be crucial in delivering growth for investors.

What has been happening in the last six months?

Over the last six months all markets have continued to make progress and the UK has been amongst the best performers rising by just under 10%*. Interestingly the US market provided a much lower return of just under 3%* but this was in part due to the weakness of the Dollar. The performance of stock markets is all the more impressive given that the period saw a very strong rise in the oil price which historically has led to fears of reduced company profits and increasing inflation. However, this time around the economic impact seems to have been fairly muted and markets have been encouraged by this. In addition companies continued to behave rationally in that, during this period of better economic growth, they have been careful with their money. In the past companies have tended to get carried away with

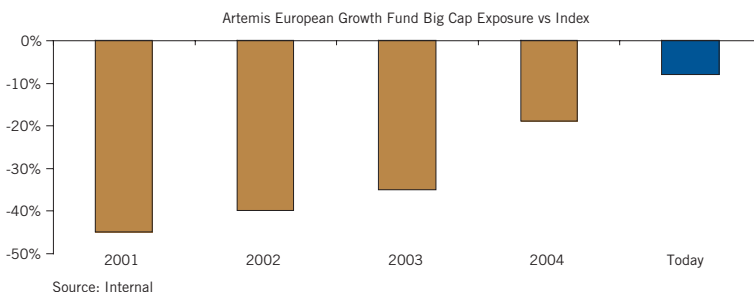
*Source: citigroup UK Market Review, total return for 6 months to 31st March 2005.

the strength of their underlying businesses and have deployed a lot of their surplus profits into acquisitions and growth plans which more often than not proved to be disappointing. This time around companies have been more cautious spending time in ensuring that their existing operations have run more efficiently, that their finances are stronger and healthier and then beginning to use their surplus cash to buy back shares. That is not to say there have been no acquisitions whatsoever but in the main they have been rational and have been welcomed by investors rather than seen as reckless. A final feature during the period has been the high level of bid activity from private equity firms wanting to buy companies from the stockmarket. This has accounted for a large amount of the takeover activity and in the main we would regard this as good news for shareholders as it leads to rises in share prices and improves performance. In the main we would like to think that selling out to these interests is a sensible thing to do and we are getting good value for money and the bidder less so!

All the above has been encouraging and augurs well for the future. Inevitably there are some concerns, the foremost of which is that the consumer spending boom in the UK is over or at the very least is moderating quite rapidly. Since Christmas retail sales have been lacklustre and it seems clear that this is due to a greater degree of caution plus the fact that consumers are having to cope with higher interest rates and increases in expenses such as utility bills and local taxes. This may not be the full story because at the same time the power of some dominant competitors such as Tesco means that this is encroaching on the business of some of the more traditional and smaller retailers. The fact that house price rises appear to have stalled and recent evidence would suggest fallen further adds the argument that the consumer is likely to be at the very least much more subdued in the coming months and years.

What type of company is most popular in this environment?

In the stock market recovery of the last two or three years shares in mid sized and small companies have done particularly well and have far out paced their larger brethren, the FTSE 100. This move has not been without justification in as much as these companies have generally been growing faster and initially were on lower valuations. As we look at the market today whilst these companies are still growing a bit faster than the larger companies they are certainly not cheaper. At Artemis we are finding that in our hunt for profits it is the larger companies that are beginning to grab our attention, for example in the Artemis Income Fund our managers are spending their time looking more at larger companies and at the same time a number of their mid size holdings have reached full valuations and are being sold. It is a similar story in our European Growth Fund. Our managers are not making a conscious decision to buy or sell a company on the base of its size, that is not how we work as we prefer to look at each share on its individual merits. Rather, we are just not finding the valuations of mid sized companies as attractive as we were in the past and conversely the valuations of large companies are more attractive. Do not interpret this as a whole sale move to turn the portfolio upside down and make a huge trade from one size to another. As we review and manage the portfolio it is the larger, traditionally more stable companies that are coming back into favour. If you look at the graph for our European Growth Fund it shows exposure to larger companies compared to the FTSE Europe ex UK index.



As you can see the fund starts off by holding far fewer of these types of companies than the index but this gap has steadily lessened over the past five years. Although the fund still contains around 10% fewer large companies than the index, it does show just how things have changed. Of course there will always be smaller companies that offer compelling value so being an investor with a manager who has the skill and technique to spot these has become even more important.

Another change that is of interest to us is the performance of companies that pay dividends. High yielding, dividend orientated companies have done very well over the last four or five years, particularly in the wake of the bursting of the tech bubble. In this environment people retreated to the relative safety of shares that offered a dividend as this not only cushioned them against further stockmarket declines but also meant that they had a good annual return on their investment even before taking into account any rise in the share price. The sorts of companies that came into this category were bus and rail companies, tobacco shares, utilities, and consumer staples. These companies and the sectors have done tremendously well in recent years and now as we look at the market we see fewer shares that are paying high yields and at the same time are able to grow their dividends materially. So when the Artemis Income Fund first started looking for suitable investments nearly five years ago, there were lots of shares to choose from whereas today there are still some but the choice has shrunk markedly.

As active managers we are making the most of this situation by selling some of the shares and sectors that have done particularly well. We find that we can replace them with shares that offer slightly lower dividends but this is more than counter balanced by the fact that they have the potential to grow these dividends faster than the market in general. So in our view the right place to be is in companies that have decent yields and good dividend growth rather than very high yields and slow dividend growth. Dividend growth has been

very strong in the UK in the last couple of years and that trend seems to be gathering momentum at the time of writing. Not unconnected with these thoughts on dividends is the fact that when we look at the attractive industries from a stockmarket point of view, whilst we are not terribly sector driven, we observe that there are some fairly traditional industries such as chemicals, construction, oil refining and power where the businesses are enjoying a stronger outlook not just because demand is strong but more importantly because there has been little new investment in facilities for a considerable number of years. What is more, even if people were to decide to say build a new oil refinery today it will probably take some 3-4 years before such a refinery is up and running. So as long as the demand background remains robust then these sorts of companies have a lot more pricing power than they had historically and should continue to give investors good returns. Of the sectors that look “avoidable” it is no surprise that they relate to our earlier comments about the consumer. This comment is largely confined to the US and the UK where the consumer has been buoyant. It would be wrong to suppose that there had been a consumer boom in many of the mainland European companies. So consumer sectors in the UK in particular have begun to perform poorly and at present we see no hurry to buy into these areas.

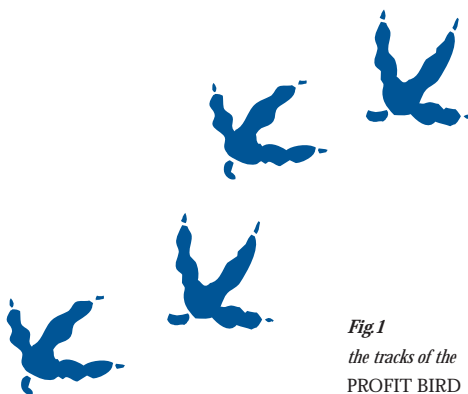


Fig 1
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PROFIT BIRD

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ARTEMIS & *The Profit* HUNTER

SHY by nature and remarkably fast, the Profit is a notoriously elusive creature. Indeed to flush and bag one of these magnificent beasts takes a hunter of particularly rare ability. Like the Artemis Profit Hunter.

BLESSED with instinct and agility, these experienced hunters like to go after large Profits wherever they may be, unlike their bigger peers who are consigned to tracking mangy Profits along well-worn paths. This independent style of hunting has certainly paid dividends with the Artemis Hunter able to return some of the best Profits around.

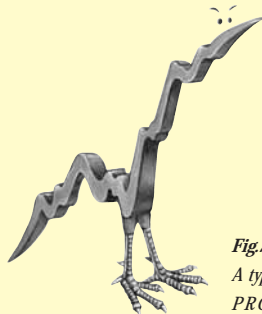


Fig.2
A typical
PROFIT

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