



Philip Wolstencroft – European Growth Fund

Richard Turpin

Thank you, Donna. Ladies and gentlemen, good morning. Welcome to the continuing series of the Artemis Webcast Conference calls. May I thank you, those of who've been waiting some time. We have got a significant number of people dialled in this morning, so thank you for your patience as well. We've got everybody listening in and hooked in to the website.

Today, as you know, we have with us Philip Wolstencroft. Philip is the architect of the investment process SmartGARP™ and manager of the European Growth Fund since the Fund was launched back on the 7th March, 2001. Prior to that, Philip managed the process on the sell side at Merrill Lynch from the early days of 1991 and has developed the process throughout that period. Philip has very openly entitled this conference call "A great five years, a lousy five months, what happens next?". Now, to put that into context, since the Fund was launched, as I said back in March 2001, it's been the number one fund in its sector. Over five years, it's currently ranked second in its sector with a return of a 138.4% against the FTSE Euro ex UK benchmark, returning some 70%. And over three years, it's currently ranked fifth, with a return of 93.9% versus the benchmark return of 79%. Now, it's a very different story over the last year. Currently the Fund is some 6% behind the benchmark sitting in the fourth quartile. Now Philip is going to look back at how the investment has handled the changing markets and what his views are on the position today and how the process is identifying investments that lead us going forward.

Now quickly on a house keeping point and apologies to those who have used this system before, but on the screen in front of you, those of you have got logged into the website, you will see a picture of Philip and to the right of that picture in the centre of the screen there is a tab you can click on to type in questions. Please feel free at any time during the conference call to send us a question. Just simply type the question into the box and then click the submit button at the bottom of the box. We will be receiving those questions and I will be passing them over to Philip at appropriate moments during the conference call. So without further ado, I'll hand over to Philip.

Philip Wolstencroft

Ok, thanks Dick. I would like to spend about twenty minutes talking about the Fund. As you know, the European Fund, like the Global one

and the UK Capital Fund, are all run off the system that we call SmartGARP. The intention today is not to spend too much time on how and why we use this system of picking stocks, but rather focus on the performance of the Fund and what kind of things SmartGARP is telling us at the moment.

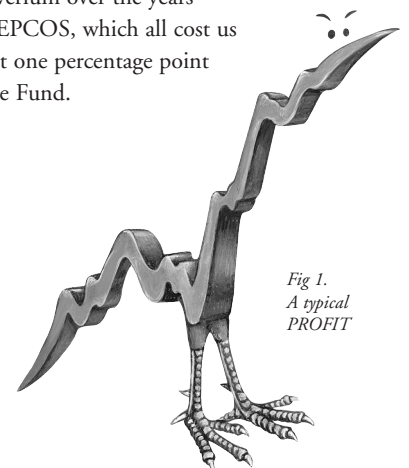
Since we launched the Fund five and a half years ago; it's up about 10% per annum against the index and it's top of the pile. Nevertheless, after a cranky start to the year earlier this year, we had a lousy few months and now we are on the bottom of the heap for the year to date. So the question that a lot of people will be probably asking, is what's gone wrong with the current run of poor performance? Is it because we're too big? Is it that we're struggling because lots of other people are copying what we are doing? Are the wheels falling off the system? Or is it just part and parcel of the ebb and flow of financial markets. Now, our view is that it's the latter; that this is just another wobble in performance which often occurs when investment themes within financial markets change direction.

You know, we looked at that earlier slide of the factors that go in there and essentially there were two contrarian factors; that's the value and investor sentiment which were one of the turning points and the following things such as the growth, the estimate revisions; the price momentum and the economic factors. So a full round of trend following that works when the long trends leave a bit of money when the trends change direction and so for example, back in the fourth quarter 2001 when stock markets had been going down and suddenly went up, we under-performed the markets then. The same thing happened in the fourth quarter 2002 when the markets reversed then as well. So it's not been the first time that that's happened and even as Dick was saying, in my previous incarnation as a strategist at Merrill Lynch, we ran a system there and we had other wobbles as well. So for example, in going to the ERM crisis in 1992, had a black Wednesday – you know, that didn't work. Then the Fed tightened in 1994, we had the Asian crisis in LTCM in '98 and the Tech Bubble as well. So usually the case is, then people start to get nervous and think that the wheels have fallen off, but I'd say that it is basically a trait of the system that we essentially follow trends until they reverse and that's the kind of first point to make on how we run the money.

In each occasion, then what happens typically is

that there is a major shock to financial markets and people suddenly became experts on the currency exchange rate mechanism in 1992; on US economics in '94 and back in '98 people suddenly became experts on Asian economies or tech in the new paradigm in the Tech Bubble. And on each occasion people do that for a while, but as time goes by, they do get back to their day jobs and focus on buying good companies and avoiding bad ones. It's at that point then that our traction regains and the system starts to work. So essentially what we're doing is buying stocks that other investors will find attractive; i.e. ones which generally are a little bit cheaper than average; which are growing faster than average and which is delivering pleasant surprises. So that is typically what, if we're describing the structure of what we're doing, of what happens.

So it's fair to say that what have been the turning points of the passing months, mostly is they usually they get the odd stock every now and again and we took one hit on the funds from a stock-specific factor in July or August – July it was – so that's bet and win and this has been a stock in which has been phenomenal growth and our system we're showing is a great growth company. The share price falling back in May and June as people got nervous about all sorts of things – when we saw the insiders buying some shares quite heavily and they announced the World Cup which was a big money spinner for them, was going fantastically, we followed them in there and bought some shares and of course within about two or three weeks, they had their first profit warning. So that cost the Fund about 40-odd basis points – the under-performance and we kicked that one into touch; we sold that position. So every now and again you have these kinds of torpedoes which do their best to sink the Fund and typically we've had about one a year. Over the past five years we've had things like Convergium over the years and EPCOS, which all cost us about one percentage point to the Fund.



*Fig 1.
A typical
PROFIT*

The background then is that sometimes estimates change – earnings forecasts change and you make or lose money. In that instance we lost money, but in general estimate revisions are not random – although they typically go in long trends. As an example, on slide 6 Valorec's stock, we've been in a couple of times over the years, but most recently bought in October of last year – July of last year rather – and basically at the time the stock was being a good value stock with great forecasts and all the other kinds of things and you know, most people look at earnings revisions and say, well it's been upgraded one or two percent and that's kind of in the price. What people forget is that the world never turns out the way you anticipate it and sometimes there are major, major changes and Vallourec is a kind of example of that, of say back a year and a bit ago, people thought this company would make about €300 million of profit and now for next year, people forecast it's going to make over a billion. So it's a two and half times increase in profit forecast over that period and hopefully the share price went up two and a half times.

It's those kinds of stocks that we are constantly looking for and every now and again you get a light on. So Valorec's been a big win, but we have had other stocks such as Puma, Continental, Anglo Irish Banks; these are big winners for the Fund and they all basically come about because analysts raise their forecasts by a little bit and they keep raising their forecasts and over the years it turns out the profits grow exponentially and those are the kind of things that we're trying to find. Those are the trends we're trying to find, but nevertheless there are turning points every now and again and one turning point in the financial markets in the past few months, has been the economic cycle.

So since May 11, when the Fund started to weaken in the stock markets – you know, suddenly came off; then people become – they see more data on economic weakness; it's still growing, but not quite as strongly as before, when people started becoming more nervous. When we look at investor sentiment, which is one of the factors that goes into SmartGARP, what we see is a form of a cliff and slide 7 shows you how economic optimism is falling very, very sharply and that has then gone through a turning point. SmartGARP has become less optimistic on cyclical-type things; we've scaled our cyclical exposure back a little bit, but we haven't scaled back entirely and part of the reason for that is although the top-down factors are turning more negative, the bottom-up factors are still very positive. A lot of companies that we own are still coming out with very positive trading statements. We've seen the economy slow down but we're also seeing these companies keep raising the profit forecasts and so although the share prices have come back in some of these things, the businesses that we own are still doing very good.

Richard Turpin

I would like to pick up on that. Keith Speck sent in a question, saying that in the past we've been accustomed to see relatively sharp rebounds in

performance following these sort of periods that you've just been talking about and he is asking the question: What do you think is different this time, with a more protracted period of recovery? Do you see something fundamentally different in this particular period we've been through?

Philip Wolstencroft

No, nothing fundamentally different. I think each case is different. I think the client base, for perfectly good reasons, has focused on the past five years, saying; well this five month period is worse than before – it's been two or three months in the past. You know, that's part of the reason why I pulled out that chart on how we did at Merrill Lynch and there you know. There were longer periods but you had ten years at Merrill's and five years at Artemis where it's been working. I think what has changed over the past few months is that you've had this economic down-turn if you like, which has undermined the market. You had an increase in risk aversion, which has now come back as that sort of – arguably not being a turning point. The other one is oil prices, which have been on a rising trend for four and a half years – they've suddenly pulled back as well and that's now a negative signal. So the two top-down trends have reversed. In essence you have two trends reverse, it's not a huge surprise you have a few lousy months. So I feel as though we understand what's gone wrong and still feel pretty comfortable with what we're doing.

Richard Turpin

As part of that, do you feel that investors are not focusing on the sort of earnings growth and earnings momentum that has traditionally underpinned SmartGARP?

Philip Wolstencroft

No, I think it's perfectly natural. I think the system doesn't work all the time. And what happens when there is a turning point, then people get very nervous and say, well the world has changed. I've got to do the opposite of what I was doing last month. People worry about that and after a while those worries start to dissipate as they identify what are the trends and I think that's the process we're going through at the moment. You've seen the market, stock markets have rebounded back to the highs of where they were back in May and despite that, I think investors are still nervous and I think the asset allocators are getting more optimistic on financial markets, but the people who are buying stocks are still very nervous and they are reluctant to buy into the companies which are delivering on their promises, but that's a fairly normal phenomena. You know, you've seen psychologists have said at least eleven months to recover from a bereavement. In a certain way, a lot of people had stocks which have died on them and will take a little bit of time to get over that; but that's a normal process.

Richard Turpin

A nice of way looking at it. One other question from James Thompson; he holds both the Artemis and the Fidelity European Funds.

And he was asking why with those two funds that have delivered a similar sort of average return, your fund has sort of shown an increased volatility and a higher beta – presumably, quite easy to address?

Philip Wolstencroft

Yes, I think the Fund does at the moment have a higher beta and it's kind of interesting, at a time when the market has rebounded, you might have thought we would have been back at all time highs and I think again it comes to that point I was making a couple of minutes ago that although markets have kind of regained some of the points, I think there's a reluctance to buy into kind of risky stocks within the market. We simply have stocks which have on average a bit more debt on the balance sheets, a bit more risk in them and we have them basically because they appear to be on very low valuations of journey out, very high growth and accelerating growth. So it happens that we look at these things and think these are sound companies and as people lose some of their fears, then we'd expect people to move back into their stocks. You've seen them move back into the market and I guess the next stage is the individual stop-start moves. I think that's the next stage we're looking for.

Richard Turpin

One other question if I may, before you sort of go back to the slides. Alan Sippix has sent a question in; whether the experience you've had is leading you to revise any of the factors within the model, within SmartGARP, and if indeed you have revised those factors, why have you done it?

Philip Wolstencroft

Ok. That's a good question. The answer is we haven't changed the factors. The issue is, can we understand what's happened already? And you know, we look at how the stocks have performed over the past five months and how our screens have worked, then our contrarian cases such as the value indicators and investor sentiments have worked very, very well – you know, buying the most unloved stocks and chief stocks would have been great strategy, but that's been offset, more than offset, by our trend systems. In essence, the upgrade stocks have lost money, the stocks which have been rising have lost money, the higher grade stocks have lost money, the economic-type things have lost money. So, in essence, what happened so far is, shows all the hallmarks of a classic turning point and would always think well at a turning point, we'd expect to lose money. So in the sense that everything's working so far doesn't see as we ought to change our system. So we've been through this over fifteen years of various turning points of Bull Markets to Bear Markets, cyclical to defensive, growth–devalue kind of stuff and we've adapted over the years and it's been pretty glacial of the changes and I wouldn't envisage changes, any major changes to the system.

Richard Turpin

Thank you. Talking of changes, there's one last question in terms of changes within the portfolio and I know you have addressed in the past in our roadshows. Craig Hall asks: "With the relatively low p's on the mega-caps at the moment, has SmartGARP been signalling a move to the sort of larger cap end of the scale, which indeed it has?"

Philip Wolstencroft

So, that's a good point and in general we have a much higher large cap exposure today than we did say three or four years ago. So around about 80% of the Fund is in large cap stocks and that's large cap in the sense that they're put to a hundred type stocks. Nevertheless, that scaled back a little bit in the past couple of months, where actually, the new money has often gone into some of the mid-cap names. So it's come down to about 78% at the moment, as we speak, but broadly speaking the big caps look fine and good. When we look at the top ten stocks in Europe, we could own nine out of those ten. I think Novartis always looks poor, but we could own any of those top ten. In reality, we own one or two, I think it is because we find other FTSE equivalent-type stocks which are even better. So certainly the big cap exposure is high but it's not, you know, it could be higher if it wants to, but I think the system is still saying there are – the objective is to look for fantastic stocks, rather than pick themes and our objective is still to pick 50-odd fantastic stocks which we think would shoot the lights out.

Richard Turpin

Thank you. I think you want to get back to ...

Philip Wolstencroft

Ok, coming back to the slides here, we've been talking the fact that economic optimism has fallen and it's not unjustified, there's been a bit more weakness around the world. People have focused on the US housing market as one clear example. But the same time, we keep observing that profits in Europe are very strong and when we look at things like the return on equity in Europe, it's high and it keeps rising. Obviously a lot of people say, well it's high now but it's bound to fall pretty shortly and I suppose I have some sympathy with that and you'd be looking at the TV to see if there are signs that it is deteriorating and so in May you were seeing lots of upgrades to forecasts – profit forecasts. In June, there were still lots; in July quite a lot and in August there was still upgrades but not quite so many. So people say that obviously it's a sign that you're starting to head down and before you know it, within a year we'll be in recession and that's the psychology of markets, when you see sentiments deteriorate.

Also quite interesting is back in September, then you see things start to accelerate again in the profit cycle and I think that's caused a few people to have some doubts about this. And certainly a lot of the cyclical stocks we have in our portfolio tend to be pointing at the corporate sector. So it would be companies which make capital goods. It will be

companies like Schneider, maybe Metro, ASML and even the airline stocks – we've got Lufthansa and Air France in the portfolio. And these are classified as consumer stocks, but a big chunk of increase in profits that they're seeing is because more and more people are sitting at the front of the plane – companies are making lots of profits, they send their executives to the front of the plane, rather than the back. So these airlines are doing very well.

So a lot of our exposure, there is some exposure to the corporate sector. And again, back in 1995, in America, the return on capital was at similar levels and people said "it was very high, it's bound to revert", and it actually took five years for return on equity to start to fall and that's when, that was because the world economy slowed down. So it's basically five years of being proved wrong and over that period, corporate type stocks did very well. I suspect we're in a similar environment where certainly profits are very high, but there is nothing major out there to sort of call this reverse, so we're quite happy with the big exposure there.

Another big exposure we have is in the banking sector. I think our biggest over-weight in the sector level is to be over-weight banks. Again the same old story, sort of low valuations and good growth and positive surprises. One of the things we found ourselves doing in the past couple of months is to increase our exposure to the Irish banks again; so we bought Anglo Irish Bank and Allied Irish banks in the past couple months and again the same old story of positive trading updates and this kind of stuff and when I looked in Economist a couple of weeks ago, I saw some stuff on house price inflation around the world and reproduced that table in the slide here. Again it's interesting that a place like Ireland, the house price inflation was accelerating again and again. That maybe ties in with the Irish banks. But as a theme across Europe, it is the case that house price inflation is still very robust. It's above ... it might cost you 3 or 4% to borrow money and you end up buying assets which are growing by 7% per annum. So money growth is very, very strong in Europe and bad debts are low and falling and that isn't such a bad environment for the banking sector as we find ourselves with a very high exposure to the banks.

So these are some of the themes that are currently in the portfolio. To recap on what we do, a lot of what we do, is we make money on the really big trends, so we've made money on the oil sector in the past few years, we've made some money on a lot of industrial stocks, given some of that back in the passing months but that's to be expected when you get to the turning points, because certainly Artemis has gone through some sort of turning points, but nevertheless there are still big, big themes out there and one of the, or a couple of things which we identify as corporate sector are still very robust and the housing market in Europe's still very robust, so we've got a fair amount of our exposure to those two factors there.

And so we don't really see – we understand why

SmartGARP works; how it's worked over the years; some of the turning points – being there were a couple of turning points so you'd expect to see a few months of poor performance, but I don't think that is extraordinary, still very happy with the way it's working and so we're not looking to override SmartGARP in any way.

Richard Turpin

Thank you. A couple of questions if I may. Talking of overriding SmartGARP, Gill was saying that with the multiple contractions that we're seeing on cyclicals, presuming SmartGARP quite likes cyclicals, your position on cyclicals, I think you've cut back a little bit recently?

Philip Wolstencroft

We cut back because although, essentially, there's two kinds of any ports of sales, one is that the top-down stuff is saying hold on a minute here, you know the world economy is slowing down and this is the environment where the cyclicals get derated so that has tension dominate and that's pulled our cyclical exposure back. The counter prevailing force is that the evaluations are going better and you find lots of stocks which are fantastic. So we are still over-weight in this area and I guess if we have the same conference call in six months time, you'd say well either the earnings forecast fall because the world's economy is heading towards recession and we scale back our cyclical exposure to under-weight, or the world economy is actually not going to fall off a cliff and these companies are correct in saying that their operating environment is pretty good and you find that people lose some of their worst nightmares and optimism recovers a little bit and we'll have a good time and we'll retain our positions in these kind of stocks.

Richard Turpin

Next question from Sharon Seagle about that other fund managers are clearly using some quant systems and some of them have a degree of similarity towards SmartGARP. Some of those have come through this period a little better than we have. Do you think that presumably the way that these quant models are put together, can actually influence the output and whether the sort of fact weightings that fund managers choose in the compilation of these models ...

Philip Wolstencroft

Yes, I think there is a certain similarity in various quantitative models – there are pluses and minuses and we have devised for what we think are good reasons and no doubt others have got differences for what they think are good reasons. I guess the proof of the pudding is in the eating and at the moment people will be saying, are there better systems out there on the basis of the past few months – you know, I created this fifteen years ago and been running it fifteen years and it's not been too

shabby and I don't really have any difficulty in what we're doing. I have no doubt that we will adapt and evolve the system over the next few years. So I am still very happy with the way we're doing this. I think in general, whilst there are many quantitative managers today than there were five years ago, it's still very much a minority sport and I don't really see that many other funds that are run in a similar way to the way we're running our money. So I don't think it is a crowded space in any way.

Richard Turpin

Does the Fund's size have an influence over you? Ian in Scotland asks a question relating to investing in mid and small cap names.

Philip Wolstencroft

Sure, the Fund is undoubtedly bigger than it used to be. There is about £1.5 billion now, so it is a reasonable size. I think on average for the whole Fund it takes about six days to buy or sell our positions and given that we hold positions for about nine or ten months, that's not going to hold us back and I guess the danger is that as you get bigger, you become more and more an index closet-type, because they have to do that. We don't feel as though we have to do that and certainly the fact that we were top decile in the first four months and bottom decile in the last four months, would suggest that we are not a closet indexer. So I think it basically falls down to our stock selection and portfolio construction rather than anything else. So I don't really think size is an issue.

Richard Turpin

Adam Hughes asks whether any of the principal contributors from a negative standpoint during May and June and July you're still owning – are there positions that you're looking slightly less firm on?

Philip Wolstencroft

Yes, well just to recap, I think if you looked at our twenty best stocks through to May 11, then since that time, nineteen of those stocks have gone on to under-perform the index and of those nineteen, we've killed six positions I think it is. Six where we said, ok something's changed, let's get rid of it. So EADS had a warning back in June or whatever it was, when we killed position there and then – but not a lot of stocks – 13 stocks still upgrade stocks so for example Valorec we touched on earlier where the stock price roofed in the first few months of the year, is down 20% since May 11. So it is a big loser and yet they constantly guided people on – you know, guided forecasts up.

So I think there are still a lot of stocks out there which individually are doing the right things and we still feel comfortable with them. What, the common theme amongst them is that they share – you know, people have suddenly said I want to buy downgrade stocks because the world's changed Philip. And that's fine, that's what happens in financial markets. But I guess the longer these guys keep churning out their results, then the high

probability is that we'll make money it seems. I was actually looking at those numbers this morning – it's been a great five, five and a half years and over that period we've actually lost money on 45% of days where the Fund's under-performed on 45% days and out-performed on 55% days. It's a pretty small margin but the trick in fund management is just to keep taking lots and lots of little bits and over time they'll compound and that's basically what we do. Just take lots and lots of little bits which over time compound and I think a lot of these stocks we have, the Valorecs, the Metros of the world, they keep just churning it out and you have good days, bad days, but hopefully more good days than bad days.

Richard Turpin

Thank you very much. A question here from Eugene Keenen which I think I can answer. We've been asked how the fund flows or flows into the Fund and stable picking up or falling off and I think remarkably – not remarkably, it's indicative of the belief in your ability and the process behind that – that fund flows have actually been very stable throughout the period. Undoubtedly some of our discretionary investors have made changes based on an asset allocation basis, but in principle the fund flows have been very stable which is very encouraging to see in this period that we're all going through.

Philip Wolstencroft

Stable and positive!

Richard Turpin

Stable and indeed positive. So, those of you who are continuing to support us and continue to stick with us, thank you very much indeed for that continued support. Now I'm conscious of the time and I think I'll bring it to a close now. We've had more than the allocated half an hour and I'm very grateful to you, for those of you that have sent your questions in. If indeed for any reason we haven't answered your question, we will get back to you and email back and indeed if you have any further questions, please don't hesitate to email us on brokersupport@artemisfunds.com, or give us a call on 0800 092 2090.

If I can thank Philip for his time and taking us through this and hopefully it has answered a lot of questions and given you a feel for where we are positioned on some of the experiences we've had over the last few months. And finally, if I could just tell you the next webcast conference call will be on the 25th October and James Foster will be talking about his Strategic Bond Fund.

So, thank you very much indeed for your time Ladies and Gentlemen. I hope it's been helpful and I very much look forward to speaking to you again in the future. Thank you very much indeed.

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