

**Artemis Special Situations Conference Call**

Duration: 0:40:48

**Presenters**

- Richard Turpin
- Derek Stuart

**Richard Turpin**

Thank you very much. Ladies and gentlemen good morning, welcome. Thank you very much for joining us today for this Special Situations conference call and also thank you for your patience while we've been getting everybody booked onto conference itself. We're continuing in our series of web based conference calls which have proved to be very popular and I'm sure today will be the same as always. Today we have with us Derek Stuart who as many of you know is the manager of the Artemis UK Special Situations Fund. Welcome Derek, thank you very much for coming down from Edinburgh today to be with us.

**Derek Stuart**

Thank you, Dick.

**Richard Turpin**

Derek has managed the fund since launch in March 2000 and has an enviable track record currently in top decile over one year and three years. Now with so much comment and discussions circulating around in the Special Situations arena, we thought that this update would prove useful and helpful to our audience. Now just before I hand over to Derek, if I could have a couple of seconds on sort of housekeeping points. My apologies to those of you who have used the system before but for those of you who haven't, if you look at the screen in front of you in the bottom left-hand corner you'll see a small box just below a picture of Derek. If you click on the 'questions' tab you'll then be able to type in a question into the box below the tab and then click on the send button. Please feel free to send us questions during the conference call. As these come in I will try and take the opportunity during Derek's talk to pose some of the questions to him that you sent to us. So without further ado I'll hand over to Derek and ask him to talk us through what he's seeing at the moment in the Special Situations arena. Derek, thank you.

## **Derek Stuart**

Thank you, Dick. Good morning everyone. Briefly what I'm going to do this morning is talk briefly all about what the Special Situations Fund is all about, the kind of stocks I look for, the type of [reverses] I look for and briefly update you on how the fund is positioned at the moment and what I'm looking forward to getting in the future. So on the first slide basically I've made the comment that we're trying to identify special situations to enhance capital growth and basically we're looking for [microphone interference] specifically investments outside the mainstream and you might see the odd position like Glaxo and BP in the Fund, but the fund's real performance and the fund's real focus is on investments that are typically outside the mainstream, turnaround situations etc.

If you go onto page three, what I'm looking for on the fund's bias is towards turnaround companies. These are companies which have typically had some short term trading issues, typically have had problems in the past, the cost base is wrong, the balance sheet is wrong, something has gone wrong in the business but still there's a fundamentally strong business. Secondly I love fallen angels and fallen angels are basically the stock market darlings of yesterday, the ones that were highly rated, the ones that everyone in the market loved until one day they woke up and found that company had a profits warning or the company had changed slightly, or the product range wasn't quite as snappy as it used to be a la Marks & Spencer's or whatever; and these companies get de-rated very, very quickly. What the market fails to realise is these companies don't become bad companies overnight. They get de-rated, people get worried about them and start to sell them aggressively and it gives someone like me an opportunity to buy these companies at very attractive valuations.

Finally I'm attracted to industry restructurings. Now these are basically changes in industry such as the construction industry moving into PFI, you get a re-rating of that particular area. Also the drinks industry where you've seen a lot of consolidation, retail again you've seen a lot of consolidation anywhere where there's a change I'm attracted to and whether that's industry restructuring or internal change, I like both areas.

Target qualities are basically the things I'm looking at when I try to identify a business. Now the greatest thing is that I can identify businesses as a strong franchise and what I do is I spend all my time visiting companies, seeing companies in Edinburgh and London and trying to identify what that franchise is; it might be a market share, it might be a product offering, it might be a bit of IP, whatever, but the key thing is trying to identify that franchise. If I can identify that franchise and I'm happy with that, that's key one because the key thing is if I can identify a

franchise, that's where I get my return because that franchise will be either attractive to other investors or be attractive to a corporate buyer.

Typically if I have a strong franchise in a business, the thing that goes wrong is management and what's typically goes wrong with management is that they get over ambitious, they do the wrong acquisition and they get sloppy, they let costs grow, the balance sheet gets out of kilter, it's over geared and therefore we have to change the management. Now I don't get involved in changing the management [microphone interference] the management changes happen but the key thing is that because of this, the incompetence of certain management groups within the stock market I can buy these strong franchises at pretty low valuations.

Finally I'm attracted to things in internal recovery situations. I think there's a less risky route to making money by targeting those companies which could be turned around or the earnings can be grown where the changes that have had to occur are internal, and that means basically improving the margins by cutting costs, by improving the business process, by improving the whole distribution network of the product offering, and therefore if I've got a choice out of two companies and one is going to give me the returns through top line growth and one is going to give me a return of the change in cost base and margin enhancements, I will always be attracted to the one with the margin enhancements because it is easier for the management team to get a result, to turn the business around by taking costs out than it is hoping that their top line will grow. So these are the target qualities that I'm looking for, and the great thing as I say, never underestimate the ability of a management team to destroy a decent business but the key thing is destroyed basically on a balance sheet basis or the cost basis, it can be fixed. The problem arises if the franchise is destroyed. So what I spend all my doing is making sure that franchise is still intact.

The result is a fund that is very uncorrelated to the benchmark. My benchmark is the FTSE AllShare and we have a fund here that bears no resemblance from time to time to that benchmark because I'm attracted to stocks not because they represent X% of the benchmark but because they represent a fantastic opportunity to make money. Secondly the fund can have a significant sector bias. So for instance when the fund was launched in March of 2000, there was easy money to be in this market because at that time you had zero in telcos and technology and you had lots in house builders, you had lots in construction, you had lots in the old economy; and to give you a sliver at the time when we launched the fund 25% of the UK market was in the telco sector and we had less than 2% in the telcos and 2.5% of the UK market was accounted for by the construction sector and we had nigh on 20%, so there's a significant sector bias and again from time to time when the market allows me to move that sector bias I will do it and again going back to March 2003, the IT sector at that time represented 1% of the market and this fund had 12% of its assets in the IT sector – again I was attracted to that sector for money making opportunities, not because it represented X% of the market.

And finally the fund that will have a large, mid and small cap bias. The reason is that is two or threefold. Firstly, arithmetically, there's about 1,500 companies in the UK market, we only have 100 clearly in the FTSE 100 therefore I have more choice outside the FTSE 100. Secondly I find it easier to find turnarounds and turnarounds that succeed outside the FTSE 100 because basically it is easier to turn around a smaller company than it is a large cap with the high level of bureaucracy and culture to change; and finally clearly we all know about the under-researched nature of mid and small caps and the ability for them to grow quicker and therefore I will always be attracted to mid and small cap on that basis.

Now it's interesting, I say all this of course and we go to the slide of top ten of Special Situations Fund and the accusation is that it looks the most boring special situations fund that anyone has ever seen because I have things like BP and Glaxo and Xstrata in there, and basically what we've seen over the past two years, two and a half, three years in actual fact has been a significant re-rating in mid and business small cap. The market has bought back into these companies and especially from the low point of the market in March 2003, mid and small caps have significantly outperformed large caps. Now as I've mentioned before, I target stocks not because of what they represent of an index but because of what they represent in terms of making money. We had a situation at the back end of last year for the first time in a number of years that small caps were trading at a premium to large cap and I could buy high quality large cap companies at a higher yield and a lower P/E basis than I could small cap, because for me, my price targets in a lot of the small caps had been hit, so I started unwinding the position I had in small caps and reinvesting that in large cap.

Now if you look at the basic fund over the past two years, back in March '03 we had 55% of the fund in small cap, 15% in the FTSE 100 and the balance in mid cap. As we stand today what we have is 50% in large cap and 25% in small cap and 25% in mid Cap and this represents the highest level of FTSE 100 weighting I have ever had in the fund. And I say it's not there because of the size of the fund, it's not there because I've become an index tracker overnight, basically it's because I find more value. I find more value in Unilever, Scottish & Newcastle, BP, Xstrata, all these kind of companies again offered me the upside I was attracted to and as I was giving them at a lower rating than I was paying for on the small caps, then it made absolute sense to actually move the fund into that way.

Now if you look down that top ten there are some classic names, you've probably, some of you may of heard of. But we have classic special situations in there, there's Regus, Morgan Crucible, Aggreko, BT etc. Regus, a property company, short term office leasing business, fantastic company, it was nearly bust...nearly bust in the UK, went to Chapter 11 in the US, we refinanced that business in '03 and again in '04 and it's a typical refinancing special situations of identifying a franchise, identifying a strong management team and basically the biggest problem in that company was their balance sheet was all out of kilter because the management team had taken on too much debt and too many onerous leases at a time of the dotcom mania.

The second on that list, Morgan Crucible, to me is the classic special situation. This is a company, it's a materials technology business, a billion of turnover, this company got down to March '03, a market capital of 100 million. The basic problem with this company is it had done far too many acquisitions and never integrated them. The balance sheet was completely wrong and the cost base was out of control. The main franchise was still intact. This is a business of 40% gross margin. So therefore it was actually a high value added business. So that was still intact, the biggest problems as I mentioned were the cost base and the balance sheet. What happened was it needed a new management team, a new management team came in, in the name of Warren Knowlton, a big gruff American chap and he sorted this business out. And his reputation was as a cost cutter and oddly enough that's exactly what Morgan Crucible needed. And this situation, this is a fantastic situation, he spent the last two years sorting this business out, we sold them after two years, I still think these shares are incredibly cheap. I think it's one of the best management teams I've come across in the market place and I think as I say we've actually added to the holding over the past three months.

You go down, further down, we have Agrekko which is a topical situation at the moment. It's a power generation hire business for sporting events, for outdoor events, for disaster events and clearly all the disasters we've been seeing in the US have been to a degree beneficial. I have to say I didn't forecast what would happen in the hurricanes on the basis of why I bought Agrekko. The reason I bought Agrekko was this is a unique business, it's a good franchise business, a high degree of market share. The problem was with Agrekko, it went to the wrong valuation two or three years ago, went up to 30 times earnings, now I cannot buy shares with 30 times earnings to make money out of them. I have to buy them at a less in the market and then hope I can see some serious upside. We spent basically two and a half years following this company, seeing the company, spending time analysing it and then we started to buy them about a year ago and we've been buying them for a year, and all of sudden they have a new management team that have come in there, they've taken a lot of cost out so it's a much leaner business. They've refocused the strategy of the business and even without the hurricanes, even without all these disaster events, this company was motoring anyway. On top of that obviously we've had the hurricane events and the shares have just gone through the roof.

But as I said, you know, mid and small cap are fine, I will look at large cap, and I mean Shell to me was a classic special situation. Thinking they had more reserves than they thought, new management team getting that business sorted out, BT is exactly the same, Anglo American, a fantastic break-up story, industrial business, metals business, they've got a strategic review coming up. That whole sector is very, very strong anyway but an overlay on top of that, the reorganization of Anglo American, for me it's just a classic special situation.

Anyway...

**Richard Turpin**

If I could just interject there a second, please don't hesitate to send through some questions. If I could just let Luke Pipton know that his test question has arrived so Luke, please feel free to send us through another one. It's a great opportunity to send questions through so please don't hesitate to type something into the box and send it through to us and we'll obviously take the opportunity to ask Derek his thoughts.

Just moving on then Derek, the sort of sector breakdown.

**Derek Stuart**

Yeah, the fund over past year has been heavily weighted in the one sector which is the oil and gas sector and that has been beneficial for performance. We've had large weightings in Cairn Energy and oil exploration stocks, we've had large weightings in the oil services companies. The weighting is actually up at 21% and now of course normally that doesn't look a fantastic bet because of the re-weighting of Shell within the benchmark, so at one point we had 21% against the benchmark weighting of 13, so it was decent bet beginning of the year, now with the Shell re-weighting and us taking profits in some companies, our weighting has come down and actually today stands at just over 17% of the fund rather than the 19% you see in front of you.

The reason for that is that Cairn Energy had a fantastic run on the back of the oil price, on the back of upgrades to its discovery in Rajasthan. The shares have gone from basically £10.50-11 at the beginning of the year up to £20, and at that point it represented 4% of the fund, we've taken that back to 2.5% of the fund because it absolutely makes absolute sense. For those who have followed the fund for a while, followed Cairn Energy for a while, if you remember last year was a fantastic year for Cairn Energy as well but it did have a rather large wobble in December when the shares fell 20% in a day and I always have to have a cold shower because this is oil exploration stock, it may be a very good one and they may have discovered a world class asset base but it's still an oil exploration stock and therefore the shares can be incredibly volatile, so it's absolutely right to take profit on this situation.

**Richard Turpin**

Talking about that, if I could just interject there because we have got a question from Matthew Billman about once you've made good gains, and there was a classic example, having made some superlative gains out of Cairn Energy, what is your trigger? You've explained the trigger there in respect to the type of stock you're invested in but are there any other sort of general philosophical points you'd raise about taking profits?

**Derek Stuart**

Yeah, I mean the key thing for me is that when I invest in a business, I have to have a price target for that company and I have to understand what valuation I think the company should be at, otherwise how can I invest in the business because how do I know if it's a discount of that valuation whatever, which as a sideline it's why I never invest in biotechnology stocks because I can never create value out of them, I can never find exactly what they're worth because in my experience no-one I've ever met can actually work out what a biotechnology company is worth, so that's a sideline.

So basically I have a price target for each investment I have and when it's close to that price target or reaches that price target I review the situation. So for instance, in the case of Morgan Crucible, a classic example for me, we started buying the shares at £0.55, brought them all the way down to £0.40 but my price target at the time was £1.70. Now we reached £1.70 within the space of 18 months, now the key thing with a price target is, it has to be fluid in so far as the market is fluid. The market may put a different rating on the sector than it did two or three years ago or the management may change or the management, you may feel more comfortable with the management. What's actually happened in the case of Morgan Crucible is that the more I got to know the company and the management, the more I believe this company could obtain a higher rating. So my new price target for Morgan Crucible actually is £3.25. The shares currently stand today at £2.30. But the key for me is I have to identify and put a valuation on a company because how can I buy a company if I don't know what it's worth? On that basis the sale trigger tends to be the price target. The flip side of that is we tend to run pretty fully invested funds and it's always a relative return situation, so if I get a new investment, potential investment that perhaps has 50-70% upside and one of my incumbent holdings has only got 20% upside left because it's already produced a return, the buy/sell discipline is obviously to sell the one with the 20% upside and then buy the one with the 50-70% upside. So hopefully that answers your question.

**Richard Turpin**

Yeah, just coming on from that, there's a supplementary question from Homesh about whether you'd consider Compass Group as one of your fallen angels, in terms of whether you've cast an eye over it.

**Derek Stuart**

Not yet. I haven't really got a lot of detail on it yet, I worked through the accounts, tried to look through acquisitions etc and I don't feel very comfortable with it and

the key lesson I've learnt over the years is don't push yourself too hard in trying to buy a turnaround situation if you do not feel comfortable with it because the mistakes I've made are when I've felt that it's absolutely right to buy a situation but actually you cannot cross all the t's and dot all the i's on a situation, you know there's something else wrong in there, and Compass I still don't feel happy enough with.

You miss the ones like that, you sometimes miss quite a few situations because of being over cautious, but again, lessons hard learnt is that when a turnaround situation goes wrong, it goes badly wrong. You're not left with just 50% of the value you paid for it, you're left with nothing. And we've had a couple of those over the years and I learned the lessons from those, and one of the classics going back to a situation is that I thought it was a strong franchise, when the franchise of a business goes then that's a very difficult turnaround. Because when the franchise goes, what is there to hang your hat on? What is there to leverage off to get your return? I've done that in a situation before and I thought the franchise was still intact, the franchise had gone and I left a lot of money in that situation so, you learn by your mistakes and I'm still learning.

#### **Richard Turpin**

Derek, thank you for that. While we're looking at sort of sector weightings on this particular slide that's in front of us, I've got a question from Amanda Zillas about whether there are any typical structural or sectoral sort of underweights or overweights that you maintain in the fund and whether it's very much driven from a bottom-up basis and you end up with your sector position?

#### **Derek Stuart**

Hi Amanda, how are you? I think basically there are structural issues in the fund, in the nature of this fund. Firstly, I have an internal rule that I will not have any more than 5% of the fund's assets in one stock. So clearly with stocks like BP and Shell and Vodafone & Glaxo I will be underweight structurally, that's one issue.

Secondly, by the nature of the fact that I have these 1,500 companies basically outside the FTSE 100, that will tend maybe underweight the big sectors, so I would tend to be structurally underweight in things like banks, telcos, the pharma companies because to me in many respects having to own a bank, it's a bit like admitting defeat in that I can't find anything else in the market to own. Now, at the moment I'm sitting there with the fund and I think it's 4.5% in banks against 18% of the market, and 4.5% doesn't get me overly excited against some of the other

things I've talked about. But there are situations where I think we can make money in.

Abbey National we owned because again it had a decent franchise that had been neglected, as the previous management went on to a worldwide tour to of buying wholesale banking operations. But if you remember the core of that business was fantastic. So Abbey National to me was a fantastic special situation because the new management came in and sold off most of their banking, focused on the retail franchise and then we got lucky obviously with the bid. But I think it's absolutely right to recognise this fund will be overweight mid and small cap, at probably at any time, all the time.

Then I talk about this move up that I've gone from 15% in the FTSE 100 to 50% and bear in mind that the FTSE AllShare is 83% FTSE 100 stocks, I can never imagine a scenario when this fund will have 83% of its assets in the FTSE 100. It might go from 50% to 55%, maybe even 60% if I get more interesting ideas in the FTSE 100, but this fund will always be structurally underweight in the FTSE 100. Because, arithmetically I've got to find more interesting stocks outside the FTSE 100 from time to time.

### **Richard Turpin**

I had a question from Dale about portfolio splits amongst other sectors, which I think you've covered, hopefully to Dale's satisfaction. I've got a question here from Gavin Haines at Whitechurch – morning Gavin. Very much looking at the retail sector and I remember that you called the consumer some time ago, the consumer slowdown, sometime ago. I was deliberately careful with what I said when you'd called it, but you've called him absolutely right in respect of the slowdown we're seeing. Gavin's point is that the retail sector is clearly an investment pariah at the moment. Are you beginning to see value emerge in this sector and do you think the negative sentiment is justified?

### **Derek Stuart**

Firstly I think the negative sentiment is absolutely justified. I go back to the basic issue that we have had a 12-year bull market in retail, of a 12-year market when people have been spending more of their incomes, a 12-year market when there's been more capacity come on in terms of retail capacity than at any time in the history of the marketplace. And therefore, to expect that to unwind in the space of nine months is highly unlikely. I think there's still more downside in the retail sector.

Having said that, I have to look to the future and I'm always positioning the fund for the next 6-12 months, so what I'm basically doing is starting to look at some stocks and whether that's JJB, that's moving away from selling sports goods and into health clubs or whether it's gas and you've got a break-up story in gas or other companies. Yes, I'm looking at these sort of stocks, but at the moment, I still think they're overvalued and I've only had one, I've only got one decent weighting in the fund and that was [N Brown] and that had its problems two years ago and that was way ahead of the problems in the retail sector for slightly different issues and it's now coming through that. And obviously you saw the results yesterday. But we've been selling into that over the past two or three weeks and months.

But I think there will come a time in retail, the market will overdo it, but we need to see companies going bust, AllSports have gone bust, MFI is looking flaky, we need to see more of those companies going bust because there's still capacity going in the high street. And we forget that it's only recently that the consumer has suddenly realised that they don't have as much money, the situation where a lot of the discount mortgages that were offered in the good times of middle of '03 and the beginning of '04 are starting to unwind and your 1.5%, 2% discount on mortgage means that you are probably paying £200-300 more a month on your mortgage. You're reading in the Daily Mail every day about your house not being worth as much. Your pension is not there, to fill a tank of petrol now is costing you £70 for a car. All these kind of things are starting to impinge on the consumer.

I just think it's foolhardy for me to jump into this sector yet. I have very little...in fact, I've only got one real proper retail exposure and that's My Travel, which was a turnaround situation obviously in the travel sector – and it's done pretty well. But I still am slightly wary of it, because again it's a been a good time for people taking money out of their property and then buying cars and buying holidays and I've got to be mindful of that.

So long winded answer to the question, the retail sector is still too early to go in before we start to dust down some of the spreadsheets, dust down some of the accounts to go through them and identify the ones we want to buy at some point, because the market will go a long way and will over-sell the sector, just as we overbought it 12 months ago.

### **Richard Turpin**

A quick question I was going to ask you, if I may Derek, touching on what you've just said that during the last bear market, clearly companies prepare their balance sheets to sort of enhance their cost controls and we've seen some excellent earnings

growth coming through in many sectors. Do you feel that corporate Britain is better positioned to face a slow down, hopefully the slow down is only going to be in the high street, but if it does expand further out?

**Derek Stuart**

I agree with that. I think corporate Britain is a lot better, in fact that's the [unclear] because the debt the Government has got, the debt the consumer has got, they are both massive negatives. But then as the corporates UK that's in good health and what you're seeing is obviously a situation, a lot of share buy-backs coming through and it reflects the idea that people just don't have the investment ideas in their own business and the acquisitions to actually enhance the earnings as well. So, I'm relaxed about that in general terms about the health of corporate UK.

I just have a slight issue with the lack of understanding of operational gearing in certain sectors, because again it's been 12 years since the last real downturn, 12, 13, 14 years actually, and some of the analysts out there are surprised with how MFI goes into a loss. Well, they shouldn't be surprised because it's operationally a good business and the problem is that the average analyst out there has not got the experience of actually gearing and forecasting in an environment which is a lot tougher than it's been over the past few years. So when your like-for-likes were +2%, in other words they're now going -1% and 2% and the gross margin gets impinged, all of a sudden your operating profit collapses pretty quickly. But I think your right Dick, in general terms I think corporate UK is in better health in terms of liquidity and on that basis the companies that we've been buying, we've been focusing a lot more on the balance sheets. Because I think as I say there will be slightly tougher times ahead.

But on that note I was just going to say, one thing is I've mentioned that my move up the large cap scale into the FTSE 100, part of the fact is that I couldn't find a lot of volume business in small cap. The one thing I'm very excited about going forward is the next 6-12 months, there's going to be a lot of profit warnings, there's going to be a lot of disappointments in trading and for me that's fertile ground, that's just fantastic. When I see computer centre profits warning, when I see MFI profits warning, when I see the small mid cap we'll be getting one or two profits warning today, that's fantastic news for me, because I can get a chance to buy decent businesses with the good franchises we've talked about at a low valuation, I can't pay 16, 17 times for them, but if they get the profits and because of and currency, because of cost base, because of the energy cost, oil costs going up; that gives me an opportunity then to buy some of these on the cheap.

So at the moment, I'm actually quite excited about mid and small cap on a 6 month view in terms of my ability to select more stocks there. So I would suggest to you that what might happen 6-12 months from now is that small cap weighting of 25%, 27% will start to climb again as I find more value in it.

### **Richard Turpin**

That's neatly answered the question of Adam Horner about prospects for the next quarter and...the last quarter of 2005 and the beginning of 2006. But just coming back to your point you made, the disconnect that we're seeing at the moment between the stock market and the macro economic environment, do think that's very much a reflection of what you've just said about corporate Britain?

### **Derek Stuart**

To a degree. Since then, we've had a great year in the market. The market has gone up a lot more than I thought it would do and all those of you who have [unclear], I'm always cautious of the market anyway. But it has gone up a lot more than I thought it would do. But partly of that is that there has been a skew to that, it has gone up a lot more in the oil and gas shares and in mining shares and it certainly...and on industrial shares – Rolls Royce, British Aerospace, the mining stocks, oil stocks have all done incredibly well.

I think what's actually happened in retail, the retail stocks have been down, construction stocks down, transport and media stocks have been dreadful. I've actually been buying some media stocks recently because again the media sector is at a 7-year relative low. What I love about media of course is it's got unique assets whether it's magazines or whether it's radio stations, they are quite unique assets to me that are worth something to somebody else. These sectors, all the economic sensitive sectors have actually underperformed and it's actually been a very narrow range of sectors have actually outperformed, you could easily have lost a lot of money in this market in a relative basis by not being overweight oils and mining and industrial and they've actually been too skewed towards the consumer.

So again, there is a disconnect going on. I don't think anyone quite knows what's going to happen because again we've been lulled into a slightly false sense of security because we haven't seen inflation for a while, we've had growth rates that have been ahead of long term rates for such a long time and of course we're in this unusual situation of course with very cheap money. It doesn't look like that interest rates are going to go up rapidly because of the fragile health of the economy and all that means is that there's very cheap money, it allows corporates to buy all the

corporates, it allows us to buy more assets and if you take a long term view of these things and fixed rates, this is a great time to do that.

So you've got a funny situation at the moment where there's a lot of negative news coming out in the UK and in US, but underneath it all there's also some positive things because you're getting this takeover activity, you're getting commodity price inflation and certainly the aerospace cycle is kicking and they're all performing quite well; and to me it's just a classic example of what the market is all about because you're stock picking and you're sector picking, that's how you make your money that's to make your value added and I've said to many people over the years that every stock and every sector I've come across is cyclical. There's a right time to own it and a right time not to own it, and there's been a right time to own oil and mining and I still think it's there, I still think there's upside in these shares. In six months' time we won't be running as many of these shares because we're moving onto the next area because something else will be more attractive on that basis.

#### **Richard Turpin**

A couple of questions there if I may follow on, Tim has asked whether the performance is coming from sector pools or stock pools and listening to you it's clearly a combination of both.

#### **Derek Stuart**

I think that's fair. This fund tends to perform in lumps, and when the market allows me to form anything and get my sector positioning right, we can make a lot of money. We did that when the fund started and we did it in '03, again there was a large sector cull which was being overweight IT and media at the time and then the market came out of its doldrums. I suggest going forward, this year we've had the oil and the gas sector. Going forward I think it would be more stock selective again. So it's a combination of both. I need the winners like Regus and Morgan Crucible and Severfield-Rowan and Torex Retail – these kind of companies that are doublers and go up two and threefold, because in terms of drivers, they're obviously at the moment getting things like oil and gas and mining sector right has been a big driver as well, so as usual with me a long winded answer to your question, it's a mixture of both.

#### **Richard Turpin**

If I could just pick up on the oil and gas sector, I've got a question from Bamber Panley, morning Bamber. He's mentioning that a number of managers have now zero weighted or even underweight resources on the view that they're at the top of the cycle. Do you want to make any comment because clearly you're still heavily exposed in those areas?

## **Derek Stuart**

Yes, as I mentioned we have been taking some profit in it. I think that the earnings upgrades that we're seeing in the oil and gas and mining sectors are still way above anything seen in the general UK market. Bear in mind that what we're...I don't like these kind of terminologies like super cycles and this kind of stuff, but we forget that the investment decisions that are required to bring on capacity in both mining and oil and gas are significant lengthy periods, and what we've seen is for the mining sector you've had very little investment over a number of years because of low commodity prices. Oil and gas sector has been exactly the same because what has basically happened is that the shareholders of Exxon and BP and Shell have all said 'listen, give us your cash back' and they'll be using all their excess cash to buy back shares, and what you've seen is a slight change in sentiment over the past six months where the leaders of those businesses recognise that the oil price will stay high for a number of reasons, and primarily on a supply basis, and they will have to invest more in the capacity, refining, exploration etc, and that's one of the reasons that we've had a decent weighting of 6% of the fund in oil services that provide a lot of the services that go around exploration, production etc.

So I think there's still momentum with those sectors. I think it was right to recognise we've seen a degree of froth in effect, there's a lot of very flaky companies coming to the market, especially the AIM market, there was no hope of actually producing any oil at all but I mean what we've basically been doing is recycling a lot of the cash we've stocked from the oil exploration side and whether that's Cairn or Nelson Resources etc. and using that to buy some of the more integrated companies like Shell and BP, because Shell and BP are still very cheap if you believe the oil price is going to stay higher than \$40 oil for a period of time.

We have a consultant that works for us on the oil side and we had an update with him last week and again going through the supply and demand dynamics as a market, even in quite cautious scenarios about China slowing down, India slowing down, the oil price is going to stay higher for longer. It probably won't stay at \$60, it will probably come down to whatever, 50 or 55 or whatever the figure is, but it's still way above the long term average and the cash flow can be generated by these companies from that oil price. It has not yet been properly valued by the market, but I agree that certain areas when you've got the AIM index at 25 is in resources, that to me is not a good sign but that's a lot of flaky companies. Guys that go in the back garden and try to float the market. I mean we get that from time to time but we don't go near those companies. It doesn't make any sense.

### **Richard Turpin**

Brilliant. Well, conscious of the time, I'm sorry I've taken you away from your presentation but having said that, we've had some excellent questions. So maybe if you just want to finish off on those last couple of slides Derek and then I've got a couple of questions we might sort of finish off with.

### **Derek Stuart**

Sure, well again here's the breakdown slide. I've mentioned we've taken a bit of profit in the oil and gas sector, we've taken out profit in the mining sector but that's it. There's nothing overly interesting about that because we've had good runs in the sectors. I am coming across one or two interesting small caps. We've got a little entertainment cartoon rights company that we've just taken an investment in that we owned in a modest way and then [unclear]. A couple of companies that have an interest in, John Moreland, again new management team, had a horrendous run, a number of write-offs in the construction area. First Technology, crash test dummies and Census, again have been absolutely astonishing in the past twelve months and again start to look quite interesting value.

So again I'm quite excited about one or two of the opportunities arising with these profit warnings happening, and as I say I hope to have a much more interesting top ten in 12 months' time. I stand accused of looking – I have a very dull Special Situations Fund and at the risk of being dull in the Special Situations Fund what I'm trying to is create value for the unit holders rather than just having a very interesting Special Situation Fund; but at the same time I think that small cap and mid cap weighting will increase going forward the next 6-12 months. There's more opportunity to rise, and the market overall I can't get overly excited about because we've had a such a strong run in the market, but as I say that's never bothered me in the past. We've had to deal with a rollercoaster market over the past five or six years and the question it comes down to is in effect sometimes ignore the market and just focus on actually identifying the stocks that can actually give you return irrespective of what the market does, and that's what we are aiming to do and that hasn't changed, even over the past five years of the fund.

### **Richard Turpin**

In summary if you look at the final slide, your performance slide I think that says it all, that although there have been some quite boring periods, it certainly hasn't been reflected in the performance you've delivered, so great credit to you. Maybe if I could just finish off with one question. I've had the same question from several people so forgive for not mentioning your name, but the inevitable question, do you have a maximum overall value for the fund in terms of the fund size that you're comfortable

in managing and would you consider self closing? I can't imagine where the sort of topicality of that question's coming from at the moment.

**Derek Stuart**

This is in our new special announcement, this is a world exclusive that I'm splitting the fund. I'm taking £5 million of the assets and managing a little portfolio then I'm giving the rest to Adrian Frost of the Income side to manage. Seriously, I don't have a maximum size. I get asked that all the time and I really should come up with a proper answer for that. The style of management that we have is genuinely very contrary and because I have to contrary and because otherwise we don't get liquidity to invest in the small and mid cap stocks we want.

Now, that is how we get the ability to move into these stocks and that won't change, it hasn't changed in the fund for the past five years and it won't continue to change. Clearly our ability to access the sub 50 million market cap stocks is growing and our flexibility is not as great as it was but I'm relaxed about managing a fund this size. I think again the style of management hasn't changed. If I don't like banks, I'll have 0-2% or whatever in banks. If I like oil, I'll have big positions in oil – that doesn't change. At some point maybe the assets will become too much. I don't think it's yet. I don't know when it is. I don't want to put a figure on it because I think when we get to that figure I'll be asked the same question again.

But the fund style, the fund management style hasn't changed. I can't see it changing. I don't think it has to change and I think there are other people out there that manage a lot more money than we do and we're working hard to make sure that we can still do it. We're trying to get rid of this boutique tag that we've been tagged with and demonstrate that we can manage the money. Hopefully we can produce results. I'm finding it more exciting now for the simple reason is that professionally it's tougher because you've more funds to manage therefore I get greater satisfaction now when we actually perform than I did three or four years ago because the fund is of a decent size and as I say, without going on and on about it, I think that the fund size can grow and I think we can continue to manage it in the size style. So at the moment we have no plans to self close and as I say, when I start to fail I will give all my money to Adrian Frost.

**Richard Turpin**

I don't know if Adrian is aware of that yet.

**Derek Stuart**

I hope he's listening.

**Richard Turpin**

That's nice to hear. Thank you very much indeed for carrying that point Derek. I think conscious of the time, I think we've slightly overrun the normal sort of 30-35 minutes but thank you very much indeed. If I could just sum up by thanking Derek for a very interesting and incisive overview of what he's doing within the Special Situations Fund at the moment and also some nice sort of macro economic thoughts which I think help people generally.

If you do have any further questions, hopefully I've answered all the questions you've sent in, please don't hesitate either to email them to our broker support line which is on [broker.support@artemisfunds.com](mailto:broker.support@artemisfunds.com) or call them through on 0800 092 2090.

Thank you everyone for listening today. We will be doing another one of these interestingly enough for the your diary on 15<sup>th</sup> November, we've got Peter Saacke talking about our Global Growth Fund and running that through the smartGARP process, but for the time being thank you. I hope you've enjoyed this morning. I hope it's been useful and I look forward to speaking to you very soon. Thank you very much indeed.

**Derek Stuart**

Thanks for your time.

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