Peter Saacke – Global Growth Fund

Richard Turpin:

Ladies and gentlemen, good morning, welcome to the continuing series of Artemis Webcast Conferences. Thank you very much for waiting while we got everybody logged in. Today, as you know, is the Artemis Global Growth Fund webcast and I am here with Peter Saacke, the fund manager.

We are joined by Peter, a member of our SmartGARP™ team who is specifically responsible for the Artemis Global Growth Fund. As I am sure many of you are fully aware, SmartGARP is our core large cap investment process that drives our Global Fund, our European Fund and our UK Capital Fund. The process is commonly available to all our fund managers, but as I say, is the investment process that drives those three large cap funds. Now as you may remember, Peter took over the management of the Global Growth Fund back on 1st January 2004, and over the three years of Peter's stewardship the Fund has returned some 80% versus an MSCI World benchmark of 39.1%, as measured at the end of February. (Source: Lipper Limited, bid to bid with net income reinvested as at 28/02/2007)

Now, I think it is a particularly interesting time for global investing at the moment because over the last 12 to 18 months the trends towards the use of global funds has certainly accelerated. Certainly here at Artemis, we see clear evidence that institutional clients, advisory clients and private investors are increasingly using global funds and mandates in preference to the old, traditional regional funds and some single country funds. Indeed the experience here at Artemis with our own global fund is that during the last three years the Fund has grown from a tiny £3 million to its current position now of £158 million.

So at this point, without further a do – and I know Peter is going to pick up a little bit on this in his presentation about the whole change in attitudes towards global investing – I will hand over to Peter. Peter, thank you.

Peter Saacke:

Thank you very much Dick. I thought rather than start by raving and ranting about my Fund immediately; it would be a good idea if I started off with some general observations about what makes investing globally interesting, and what makes global investing difficult at the same time. I will then go on to talk about a few stock-specific ideas and some sectoral and regional themes that SmartGARP is highlighting at the moment. But first things first.

The main advantage people generally cite about why it makes sense to invest globally, is the mantra of diversification, which essentially means that you can get as high, or maybe even slightly higher, returns by investing globally, compared to investing just in the UK. But the main benefit is that you can get these returns whilst lowering your risk profile. A lot of people find this counter-intuitive, but in the next few minutes I will give you some evidence and some intuition of why you can actually lower your risk by investing globally, as opposed to investing just in the UK.

The other argument, which is pretty obvious why global investing makes sense, is that you have got a larger opportunity set. You have got in my universe 4,000 stocks to choose from, compared with merely 400 or, at most, 500 in the UK. Of course, having more stocks to choose from sort of cuts both ways, it also means, and that is one of the disadvantages of global investing, that there are so many more stocks that you need to stay on top of. You know 4,000 stocks in the universe - staying on top of what is happening in 4,000 companies globally is quite some task.

The other disadvantage or the other difficulty in investing globally that people generally cite is doing asset allocation. Everybody knows that getting your asset allocation right makes a huge difference to fund returns. At the same time, apart from the George Soros' of the world, there is very little evidence that a lot of people are any good at doing global asset allocation, and what I will argue and try to illustrate, is how SmartGARP helps me overcome these difficulties in global investing and makes my life easier and helps me get the asset allocation right.

Let's go back to the issue of diversification and how that might lower the risk profile in your portfolio. What you see on this slide is – if you want a history lesson – it shows global equity returns since the beginning of last century, so over more than 100 years. The yellow bar, and the chart on the left shows you the returns you've got on investing in any of 17 countries around the globe and the chart on the right shows you the volatility of those returns over the last 105 years. The yellow bar shows the UK, the green bar shows where you would have been if you had invested globally and what is quite apparent is that you would have been able to enhance your returns a little bit investing globally as opposed to investing just in the UK, but the main benefit from investing globally came from a major reduction in the volatility, and you know, this is long term empirical evidence, so the empirical evidence is very strong. The intuition of why this is the case is – well there is two ways of looking at it. One is just to say that it is much less likely that things go wrong in 17 countries around the globe at the same time rather than in just one, even if that is a country run by a very prudent Chancellor of the Exchequer, and soon Prime Minister. So it is less likely for things to go wrong in 17 countries rather than one country. Another way of looking at the notion of risk is that having a much larger universe means that effectively you have less stock-specific risk in your portfolio.

Now, that is demonstrated on the next page, I am sure most of you will be familiar with the table on the left which shows you the index weights of the biggest ten stocks in the UK market and you will also be familiar with the fact that these index weights add up to 46% of the FTSE market cap and what that actually means is that even if you own three or four different UK funds, you are very likely to have material exposure to these ten stocks, and so you run material stocks risk. Whereas if you compare this with the breakdown of the Dow Jones World Index, where the top ten stocks only make up 7.5% of the index, and so your stock-specific risk, your concentration risk is much lower. So the reasons why you can lower your risk profile is less likely for things to go wrong in 17 countries as opposed to one and there is less concentration risk.

Of course the difficulty, as I mentioned with investing globally, is as you've got these thousands of stocks to choose from - and this is in fact where SmartGARP helps us and makes our lives easier or even makes your life more tolerable. Essentially SmartGARP is a gigantic information filter;

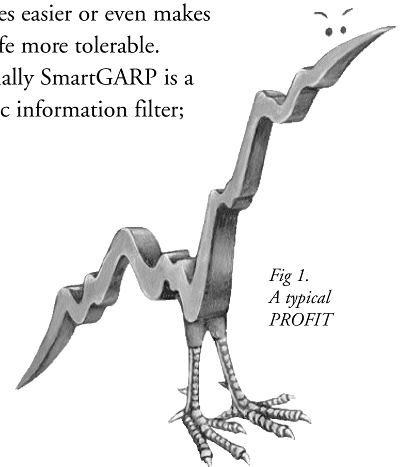

Fig 1.
A typical PROFIT

it screens a whole raft of information from thousands of analysts, economists and fund managers every night for us and allows us to focus our attention on the stocks with the most extreme financial characteristics. Rather than try and stay on top of those top 4,000 globally, this narrows it down to say the top 400 stocks around the world. So the big help with SmartGARP is dealing with information overload. I have got a few examples of the kind of things SmartGARP is showing us at the moment in the next few slides.

The first example that I like to talk about is stock clusters. It's basically when, in a particular region, I find many companies that are in the same sector, doing well at the same time. One example I have taken here is European airlines. In all of these charts what you see is a red line and a black line. The red line shows the expected, the forward earnings for, if we take the top left hand example, Air France relative to the expected earnings for the global equity market. The black line shows you the price of Air France shares relative to that of the global equity market, and in fact the gap between the two shows you something about the relative valuation of Air France compared with the market. And if the earnings line is above the price line, the stock is trading cheap, and the key thing to remember – and that is basically how we make money – where the earnings line is heading generally, the price line is following. If a stock is seeing significant outbreaks of problem forecasts, in general the price action will follow. And what you see with these four airlines is – and I've just taken four, I could have chosen eight or ten of these – but in each case the earnings are roofing it and the price action is growing hard to keep up. We have a lot of exposure there and we have made good money there so far. An area where you have a similar cluster of stocks is US oil drilling shares. Again you can see the red lines are moving smartly higher. So far the price action has not yet responded, but we are hopeful that it will. And finally, a more juicy example is, if you want, Russian telecoms, where again you can see a nice acceleration in the earnings momentum of these shares with prices playing catch up. So these are three stock clusters that I currently exploit. In effect we have ten or twelve at any point in time in the portfolio.

Where does this leave us in terms of our sector bets? What is the most noticeable thing that SmartGARP is giving us at the sector level at the moment? That it's extremely keen on industrials around the globe and these will be both in the US or European industrial. SmartGARP is sending a very strong message that capex has so far lagged in the cycle and the businesses are seeing very strong order books and very strong news flow. Telecoms is another material bet. I have already alluded to the Russian telecoms, in fact most of the exposure in telecoms is in the US; there is no telecomms exposure in Europe, while there is telecomms exposure in emerging markets, whether it is Russia, whether it is Africa or whether it is Asia where there is very strong growth at reasonable valuations. Areas we are not attracted to are technology and healthcare where the valuations are certainly not justified by what we are actually hearing from the companies.

Lastly, I wanted to touch on the issue of asset allocation. I said that asset allocation is one of the things that makes global investing difficult because that is the thing that, you know, it makes a huge difference in performance but there is very little evidence of people being any good at it, apart from the George Soros. Now, I don't claim to be George Soros and I don't try to be George Soros. Rather I take a totally different view, I say 'leave this asset allocation lot to George Soros'. I do my asset allocation as a function of where SmartGARP finds the greatest number, the greatest proportion of attractive ideas. And basically what you see in this chart, on this slide, is the proportion of SmartGARP's best ideas globally, broken down by region, and you can see, for instance, about 40% of the best ideas currently are in Europe and that compares with the benchmark rating below 30% for Europe, hence we are overweight Europe. Similarly, North America, it's the second one from the right, makes up about half of the global benchmark, but has only less than 30% of SmartGARP's best ideas hence I am sharply underweight in North America. The only other one to highlight is the emerging markets, which only make 5% of the benchmark, but make up 25% of the best ideas and hence invariably overweight in emerging markets.

That is basically how I do my asset allocations, no grand visions about what is happening with the cycle, what any Central Banks are doing, it's only a function of where I find the greatest proportion of stock ideas.

Richard Turpin:

Peter, while you are talking about asset allocation, I would aim to just mention there is a question about asset classes from Thomas Grace at Raymond James and he is just asking whether you have any thoughts on asset classes showing any correlation, and indeed whether there is any sort of macro-economic impact that might come from that. Do you see any evidence of that?

Peter Saacke:

Well, I mean I am an equity investor and what you get if you invest in this Fund is you get exposure to equity risk. I am not a balanced fund investor that puts some money in equities and some in bonds and I do not spend a lot of time looking at the correlation of equities versus bonds versus commodities. So from that, you know, it's something people like to talk about whether there is a lot of increase in correlation in asset classes, it is not something I spend an awful lot of time thinking about. My focus is essentially on finding stocks that are going to shoot the lights out rather than lying awake at night worrying about the situation.

Richard Turpin:

Thank you for that.

Peter Saacke:

Just to wrap up about the characteristics of the Artemis Global Growth Fund, as Dick said at the beginning, I took over the Fund in late December 2003 and turned it around, turned it around into a SmartGARP fund at the end of the year. There are 75 positions out of the top 4,000 stocks globally. Sector bets, as a risk management exercise, I kept within plus or minus 10% away from the benchmark, regional bets plus or minus 20% from the benchmark and there is a current hedge for North American equities that I am happy to expand further, but it is essentially there to avoid being too exposed to the US dollar.

Currently about 95% of the Fund are active bets versus the benchmark, i.e. there is hardly any overlap with my benchmark in the Fund at the moment. So it is a truly aggressive, actively managed equity fund. Having said that, don't get the idea that the Fund has invested in lots of pokey mid cap bets that nobody has ever heard of. The average market cap of a stock in the Fund is in excess of £5 billion, around £5.5 billion, that compares with the FTSE average market cap of about £6.5 billion, so it has a slight bias towards mid caps, but these are large global stocks, they just don't have massive index ratings.

That is essentially all that I wanted to say, I leave you with the last slide which is basically gloating about the performance track record of the Fund and throw the floor open to questions.

Richard Turpin:

Peter, thank you very much indeed. There is one question in terms you mentioned about being very actively managed, actively positioned fund and a question from an investor in New Zealand, which we are delighted to take, I hope that person is online so to speak, but the Fund does take the odd hit when there is negative market volatility, but indeed recovers very strongly when the markets settle. I just wondered whether you wanted to address that in light of your comments about your active sort of management.

Peter Saacke:

That is certainly a true observation and in fact an observation that all potential investors in this Fund should be aware of. The way the

Fund is currently positioned, is with a material tilt towards higher risk stocks, towards stocks with higher operational and financial gearing for instance, and we have this bias because we see that these are the companies with the best combination of strong corporate yields flow and reasonable valuations. So we have this portfolio of high risk stocks, what it does mean is that when investors become fearful, when they become nervous, when risk aversion rises, the first thing they do is they sell high risk stocks, and so when you have these spikes in risk appetite, the Fund tends to take a hit. We make no attempt at trying to compensate this ebb and flow of risk appetite, we rather try to ensure that we're happy with individual stocks that are in the Fund, rather than throw the portfolio this way and that, to ride out this ebb and flow in risk appetite.

As an aside, today the Fund has got a higher risk profile, so far that is what SmartGARP is telling us - that high risk is where you should be because you are being rewarded for your risks, but this is not always the case. Go back five years, SmartGARP at that time was telling us that high risk – you know this was in the depths of a bear market – this was a time when SmartGARP was telling us that high risk stocks were expensive and had poor news flow. So SmartGARP takes us to different parts of the market in different market environments and in general it is in fact very good at doing that. So it does mean that there are the occasional bumps in the road, which can be painful, but which we are relaxed about accepting.

Richard Turpin:

Peter, thank you. In fact we have just had a question from Tim Smith on a similar subject, hopefully what you have just said has covered that question regarding performance last year. Also from Anthony Heather at Chris Leach & Associates, a question relating to the relative performance of global funds against pure sort of single country funds in the UK, that over the last couple of years, actually global overall performance hasn't quite caught up with some of the UK funds and I think that is addressed overall in terms of the longevity of global investing, but do you have any thoughts about relative performance against the UK?

Peter Saacke:

I generally don't spend an awful lot of time looking at my competition, but I do know that it is a very heterogeneous competition. I mean you've got some people who are quite restricted in their asset allocation decisions, you have many people in there whose way of running global money is basically dividing their assets into different pools and then running regional portfolios and then doing some asset allocation overlay. And I think it is true to say that the evidence of the effectiveness of this strategy, this approach to running global money is quite mixed and I would not be surprised to hear that that hasn't done particularly well compared to the UK. Having said that, you can – and I am aware of a few other funds that are aggressive global funds, concentrated portfolios prepared to take big active steps that have done extremely well and they will have left most of the UK market in the dust.

Richard Turpin:

Thank you. Another question interestingly comes in from Stephen Girling at SG Wealth Management. I think he was talking about your sort of sector bets, there was a slide showing that your largest sector underweight was a minus 6% and Stephen makes the point that with the sort of 75 stocks out of the universal 4,000, does that imply that you're as constrained by the benchmark, but I think this is probably reflected at the sector level rather than the individual stock level.

Peter Saacke:

Yes, there is some element of looking at the benchmark that I do. I mean it doesn't happen at the stock level, I haven't the faintest idea and no interest in the benchmark weightings of individual stocks. But I do try to insure that at the overall portfolio level I have a diverse portfolio and a sensible way of doing that is by comparing my sector bets with the sector weights in the benchmark. My tolerances are reasonably large, plus or minus 10%, it's a pretty wide margin and one that I very rarely feel that I need to go out of and I find that I can take enough active risk within these risk constraints and I think they are useful to make sure that the Fund stays on the straight and narrow.

Richard Turpin:

Thank you. Question from Dane Halling. Dane has asked what would you say the sort of strike rate in terms of SmartGARP picks is? I know it's a subject dear to your heart, and his sort of follow on question is what sort of average holding period do you find results from SmartGARP?

Peter Saacke:

Right. I think if I tell sort of my family or my children about my strike rate they are always very disappointed because the strike rate of SmartGARP funds lie something between maybe 56 and 62%, i.e. between 38 and 44% of our decisions are wrong and that is sort of quite humbling when you bear that in mind, but it is a fact of life. The good news is that obviously the things we get right tend to make us lots more money than the things we get wrong cost us money. And in terms of the average holding period for SmartGARP funds, like the UK Capital Fund, the Global Growth Fund, we'll be talking about ten to eleven months average holding period and so this will be reasonably high turn over compared to some. For instance value investors, it is actually relatively low turn over compared with pure quant funds. Remember, the Global Growth Fund we generally say is 90% quantitative, but there is an important element of judgemental overlay which is used up in particular to do the portfolio construction and the risk management and also to make sure that there are real life stories behind the great financial characteristics that SmartGARP has highlighted. But compared with quant funds the turnover is low. Compared with a deep value investor, then the turn over is quite high.

Richard Turpin:

On a sort of similar one, there in terms of the output from SmartGARP, Geoff Kean asks a question relating to the current sort of M&A activity that clearly tends to target companies that have been underperforming in profit terms or earnings growth terms.

Peter Saacke:

I think it is a fair question; we have two answers. One choice is to chip away at where they perceive the inefficiencies within the market lie and some people's skill set is to uncover potential M&A stories and invest in a basket of those and make money that way, and if you have got the skill set, fine. That is not our skill set, so that is not what we try to do. We are at the sort of nerdy, unemotional, ruthless rigorous end where we try to be more methodical and more systematic about how we go about our business. That is the one answer to the question. The other answer is in fact that if you look back at the history of all SmartGARP funds, it is quite uncanny how often SmartGARP stocks do actually get taken out. So it might seem intuitive that it is only underperforming stocks that get taken out, but we have had a number of take outs last year. So for instance, I take last year, in the Global Growth Fund I had Maverick Tube, that's an oil driller in the States, got taken out at a juicy premium as a JOG – which is an industrial asset and they make variable lift hydraulic little trucks that help you lift things and put things down – got taken out at 42% premium in the spring. So the interesting thing is we don't try to target M&A candidates, but we do have our fair share of wins that way anyway.

Richard Turpin:

Great, thank you. One question has just come in interestingly enough, it doesn't seem attributable to anybody, but they are asking about the sort of situation that has been headlined in the news over the last few weeks and that is sub-prime lending in the United States, whether this has any potential impact on the Fund or whether, indeed, you saw this coming.

Peter Saacke:

Well I didn't quite see the sub-prime lending fall out coming, but it's certainly the case that SmartGARP had for more than a year, I would say close to two years; been very clear in telling us to stay away from US regional banks, US regional lenders some of whom are of course now affected by this. And so the Fund has had no exposure there and is not going to have any exposure there any time soon, given the way the news flows are unfolding. So from where I am sitting, you know I have not lost any money, I have rather gained relative money there and I am pretty relaxed.

Richard Turpin:

Thank you Peter. I have maybe one final question because I am conscious of the time and am very grateful to everybody for staying with us during the conference call. Just really at the macro level, which I know is something you don't focus on in terms of the way the Fund is managed, but the outlook – we have had a couple of questions sort of looking at the overall outlook for markets and I wondered whether you had any thoughts on the sort of disconnect that seems to be appearing between the sort of bottom up view and the top down view?

Peter Saacke:

Yes, well in general we don't take a view on the market. What I would say though, is that you read a lot in the papers about global growth slowing and maybe the sub-prime lending story having a negative following effect, but what I would say is what I generally prefer to focus on is what you actually hear from the companies and if you look at, for instance the sector that the Global Growth Fund currently has, you can see that there is a material tilt towards the more cyclical parts of the market. I mentioned the industrial, I mentioned – there are chemicals also, these are the most cyclical parts of the market. These are the parts of the market that if you do have a sharp slow down in the global economy, should get hit hardest but in terms of what we hear from the companies, the news flow is still very good. So there is a lot of worry in the papers at the headline level, as long as I continue to have positive news flow from the companies that I invest in, I am pretty relaxed and I am happy to continue with the bias towards cyclicals and towards high risk stock. And that is probably not a negative message on the market in general either.

Richard Turpin:

Peter, super. I think it's come to the time where we will probably draw things to a close. If we have been unable to answer you question, we will get back to you and answer it either by e-mail or giving you a call. I would like to just thank everybody for their participation, Peter thank you very much for taking us through your thoughts on the Global Growth Fund at the moment and the implementation of SmartGARP through that Fund. If we can answer any further questions that you haven't had a chance to send to us, please don't hesitate either to e-mail us on broker.support@artemisfunds.com or indeed give us a call on our Broker Support line which is 0800 092 2090. We will be doing further webcast conferences throughout the year and we will be communicating those to you when the dates are set, but thank you very much for joining us today, I hope it has been interesting and useful and may I wish you all the best for the rest of the week. Thank you very much indeed.

Peter Saacke:

Thank you.

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