ARTEMIS
The PROFIT Hunter

Derek Stuart and Ruth Keattch – UK Special Situations Fund

Transcript from the Artemis UK Special Situations Fund webcast recorded on 16 September 2009.

Dick Turpin: Good morning ladies and gentlemen; welcome to the continuing series of Artemis webcasts and specifically this morning's on the Artemis UK Special Situations Fund.

Derek and Ruth have navigated their way through the last 18 months of market turbulence, I think, with great success. At the risk of being flippant, would an x-ray of your prospective investments be helpful, Derek?

Derek Stuart: An x-ray is always useful to find out exactly what we're investing in. We do spend a lot of time going through the companies and actually understanding where we're going to get the returns from. The key for us in any investment that we're making is understanding how the company gets from A to B. We try, and we've said this many times, not to be wavered by the macroeconomic environment and not to try to analyse the macroeconomic environment. That macro-analysis is very difficult, wrong as often as right and no more so than at a time like today.

So we try to identify those companies which can get from A to B, get the rerating, produce the returns through internal changes, through cost-cutting, et cetera, through the breaking up of business or enhancement of existing processes. The key for us is to get right under the skin and really to analyse what's going on.

The key thing for us in the way we run this fund is that nothing has changed over the years. It's a question of focusing on those companies that can produce the results, and not minding too much over what's happening in the wider economy.

What we're going to do today is just spend some time going through exactly what we've been doing in the portfolio. It has changed quite markedly in the past few months. We'll also talk about some of the stocks and areas we've been investing in and then just a few comments on the future – which is obviously very interesting.

At the end of last year we'd had the highest weighting ever in large cap companies, 60% in the FTSE 100, and we were talking then about investing in some mid and small cap companies. We'd started to see some value for the first time for a long while and we were quite excited about the prospects.

If you look to the bottom of the slide, that's what we've done; we've actually increased the weighting in mid and small caps up to nearly half of the portfolio. It's actually been a bit higher than that and the reason it's been higher than that and come back down again is the way that these mid and small caps have performed. Some of them have performed way ahead our expectations in a very short period of time. So we've booked some profits from some of these investments already and we'll talk about a few of those as we go on.

In going through the basic sector breakdown, we've not changed the weightings in the mining sector and basic materials. That underweight was great for us in terms of performance in the second half of last year. But we've been surprised by how quickly some of the metal prices have performed, how they've reacted; we've been surprised how quickly the mining sector has de-geared. The real difficulty for us ultimately is actually what's driving these metal prices. We've seen an amazing stimulus package in China and there seems to be Chinese demand driving this; inventories are higher; they seem to be stockpiling all these metals. The question for us is when does it stop? Because at that point the metal prices will start to decline and the very basis of the valuation of these companies is very geared into that. We've not changed our view on mining; there has been cost in the first half of this year, but we haven't changed our view on it at all.

We have certainly increased our weighting in consumer goods. It's not that we're bullish on the UK consumer, but because we've had some interesting opportunities there in some of the drinks areas. Rather luckily, we had a position in Cadbury's, not because we expected the bid but primarily because there's a turnaround story going on here, a cost saving opportunity within Cadbury's, a margin enhancement facility, exactly the things we looked for before. We were just very fortunate that Kraft decided to come in and to look to buy Cadbury's.

The big change in the fund has been the financials. We got down to as low as 8% in the fourth quarter of last year; now we have 25% of the fund in financials. We have HBSC and Close Brothers, and we'll talk about Close Brothers later. Elsewhere within financials we've taken positions in property companies, in insurance companies and in fund management companies.

Next, oil and gas. In the fourth quarter of last year the oil price collapsed to $40, therefore the risk/reward for us was more attractive to buy into those oil companies. We bought into three explorations companies last year and two oil services companies and they performed very well. Again, we'll talk about that later on, but they performed so well that we've actually been selling those again. Our oil weighting is at a quite low level now after some of the share price performances we've seen.

Finally, and quite cheerily I'm saying that we are now underweight utilities. It's been an embarrassment for the past 18 months being overweight utilities. They have provided the cash for us to do other things in the marketplace, so again we have a negligible position in the utilities.

These are the major moves in the portfolio over the past few months.

In terms of what has actually gone well for us this year, and what has gone badly for us, let's start with the bad, because I'm going to give you the good news later on.

As I mentioned before, the zero weighting in the mining sector has been painful for us. Secondly, even though we've had some weighting in the banks, we were not in the distressed banks. Again, with the mining sector the issue for us is can we analyse the company? The mistakes that I certainly have made in the past have been to invest in companies you don't fully understand and are unable to analyse.

We have this with the banking sector; it was very difficult to find out exactly what the underlying profitability of these companies was, and I still think that's true today. It's very difficult to analyse where they're making their money. A lot of the money that's been made in the first half of this year has been in investment banking and the question is: can that continue? We basically avoided the sector in general terms and intended to invest in other areas of the financial sector, so it has been costly. HSBC has performed well; Close Brothers has performed exceptionally well; but as everyone's aware, Lloyds, Barclays and RBS have performed even more strongly.

Finally, an old favourite of mine for those of you that have been following the fund for a while: the bus companies have been a drag on performance. It's nice to see them performing a bit better of late. We have been changing the focus on these; we have reduced our exposure to FirstGroup which has been a major holding. We've done so because of the company's debt not getting paid down quite as quickly as we'd hoped. But we have established a new position in Stagecoach, a slightly less levered balance sheet and more flexibility in developing its business and making earnings and enhancing our position.

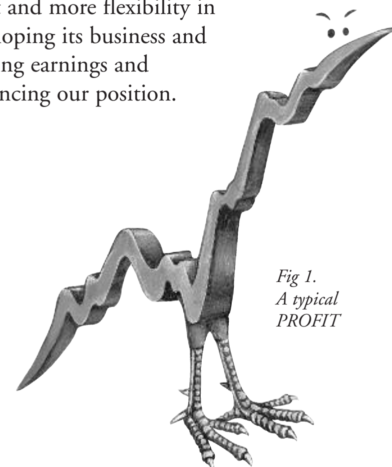

Fig 1. A typical PROFIT

We still believe that there's value in this area of the market. I think what we're doing is placing a different emphasis on where that value is.

I mentioned oil exposure at the beginning. We were lucky with two or three oil exploration companies. We bought back into Premier Oil, which is an old favourite of ours. They did a fantastic deal buying some distressed assets. At Oilexco, we supported a rights issue and their shares have rerated quite smartly. Secondly, the whole sector rerated quite smartly on the back of corporate activity in the case of Venture Production and Addax Petroleum. We also invested in a little company called Heritage Oil, which made some major discoveries and the shares have gone up quite phenomenally well for us – two or three times since purchase. We have sold that completely and we have reduced our exposure a bit in Premier Oil again, because the shares have nearly doubled in the space of holding. We did an investment in oil services companies again. Historically we've invested in Wood Group and we took a holding in them partly because the management took a significant holding in the first quarter and we folded them in quite nicely and they performed well.

Petrofac, again, was a company in the fourth quarter of last year that was on its knees and we picked that up. Our exposure in general terms has been a positive for the fund – though as I mentioned before, we have reduced our exposure quite considerably.

At the risk of boring you all intensely, an old favourite of ours, Booker, performed well in the first half. The key thing is that Charles Wilson and his team are continuing to eke out the margin and eke out the top line growth in this cash and carry business. It's a typical special situation for us, a mature business, not terribly exciting, but it's a strong management team that are producing internal returns. We've also got the FKI Industrial Engineering business. It has squeezed the cash out, improved returns and it's just a vintage special situation stock which performed incredibly well in the first half of this year.

Ruth Keattch: Thank you Derek. Inchcape I think we have talked about before. It's a motor dealer which struck big problems, got over-borrowed and the profits disappeared. I have followed the management over the years and they did have an exceptionally good Finance Director, who proceeded to dig them out of a hole very quickly, much more quickly than the market expected. We backed a small equity fund raising. The miracle was that the debt was going down so quickly through internal steps that were being taken, that they didn't have to make that expensive call on banks that has been a problem for a lot of companies.

Like a lot of special situations at the turn of the year, the pace of recovery in share prices has been astonishing. I am slightly ashamed to say that we exited Inchcape and C&C with indecent haste, because the shares doubled. With hindsight of course we should have stayed in, because they've subsequently gone up even more, but I think that's a feature of a bit of irrational exuberance in the market.

C&C is a cider maker; we wouldn't normally invest in a cider maker, but it was a very interesting turnaround story, again under new management. Old management had over-expanded the business on a wave of optimism which was partly driven by a hot summer. That turned out to be very poorly founded and they built themselves a fancy new factory, which actually is hardly being utilised. New management came in, ex Scottish & Newcastle, very experienced, who've actually developed the Bulmers brand with Scottish & Newcastle, so they know all about the cider market and they got to work very quickly to stabilize the business.

Again, as I say, the shares took off dramatically in the early part of the year and they had an accounting issue which, going back to the x-ray theme, did alarm us. We felt very grateful to have doubled our money and we're safely out of that one for the moment. We'll keep an eye on it, it's a company that needs a finance director and that may well prove interesting if they just introduce a bit more management.

Close Brothers has been the slower burn. It's much more the situation we enjoy, because hopefully we'll be able to hold onto this stock for a long time. It's a turnaround situation again. It was a company that was subject to bids two years ago. It's just warming up nicely, new management coming in, making sure the business is efficiently run and focussing on the areas that are core to the business, which are wealth management and lending. Of course the lending environment has changed dramatically; so Close Brothers have seen a lot of its competition disappear and they are one of the most well-financed lenders in the market, with a Tier-1 ratio of 16% which is quite a staggering number. We hope we will be holding onto this one for some considerable time.

Derek Stuart: I think the key point to make is that the companies that we have been investing in follow the exact same pattern as the companies we've invested in over the years. They are decent cash generative, somewhat boring businesses, but where a new management team or change of management team has basically produced a result. As I say, Close Brothers are a classic example. We're not forecasting increased lending, we're not forecasting massive improvements in the banking market, what was there was perhaps a sleepy business that needed a bit of invigoration and has got that and is benefiting from that new management and ditto with C&C and the rest of our stocks. The formula that we've used over the years has not changed within the fund.

We've looked at a number of re-financings, and we've invested in eight of those re-financings to different degrees. Some of them like Premier Oil we've supported for their buying distressed assets. In the case of Inchcape we've actually supported them paying down some debt. We've invested in property companies and we've invested in insurance companies and a wide variety of things.

The key thing is that we've also turned down a lot of re-financings. A number of those companies that came to see us have business plans that say, give us some money just now and then by the way the economic environment will change in 2010 and we'll boost our profits that way.

Those are typically the kind of companies we've turned down, because again we don't like to take the risk on the economy. In the short term that's been wrong because a lot of these companies have actually gone on and produced very strong share price performances. We turned down two fundings and six weeks post the fundings the companies had significant profits warnings. Some of them still do require a very, very strong economy next year to bail them out of the situations they're in. Again, I stress, we try and not forecast economies because it's incredibly difficult.

Dick Turpin: Maybe I could interject there Derek just for a second, there is a question from Graham O'Neil about operational gearing and presumably that's something that you're focussing on quite closely in terms of looking at these re-financings?

Derek Stuart: Absolutely. I mean our very optimistic colleague – Mr Adrian Frost – talks about the wheel of debt, which is operational leverage, financial leverage and a big pension fund. The key thing is that those companies that have high operational leverage should not have debt. We have no problem with leverage, financial leverage and debt, if it's backed by a company with visible and sustainable cash flows and earnings. The problem has been with a number of companies in the cyclical area. Analysts assumed those earnings could continue and encouraged management teams to take on large amounts of debt; which is why you saw the gearing in terms of equity share prices in odd companies, in industrial companies, in finance companies, that we saw at the backend of last year/beginning of this year.

Now we have no problem investing in so-called cyclical businesses, if we can get them at the right valuation and the right management teams that can produce the results. What we don't want to do is back a management team that has been an operationally geared business that has also had financial revisions recently; have a second roll of the dice is not the game we're in.

So we have to recognise that, as I say, we don't mind leverage. In certain businesses, leverage is absolutely correct. It's just that everyone thought leverage was appropriate in every business and that's where the problems were.

Ruth Keattch: We've got a nice example of this actually in Ashtead which is an equipment hire company operating mainly in the US. Very operationally geared business and we confidently predict it's going to make no money over the next couple of years, but what it will be doing is generating at least £100 million of cash in that period. Although it does have debt, it's got very sensible covenants which were put in place by a management team that actually understood the nature of the cycle. So they're not going to have the banks banging on the door and making life difficult. A very nice business and the US construction area is an area we think will be first out of this recession. Also,

hopefully, it will benefit in the meantime with a bit of a stimulus package. So yes, operations for gearing can work very nicely for companies and it's important to understand what the downside risk is in all these things.

Derek Stuart: Below on the slide, below the list of re-financings, we've talked about two further stocks. Ruth has mentioned Ashtead; we've taken a position with a company called Aegis which is a media buying and market research company, one that we've followed over the years. Very lowly rated against its US peers, taking a lot of cash out of the business, it's got a strategic shareholder that owns just shy of 30% of its equity. It's paying down some of the debt it's got. Again, it's managed off a lot of the decline through self-help, taking cost out, and it's a strategic asset. It's the sort of thing that at some point I think will be attracted to someone else, but in the meantime we're not waiting for that, we're backing a situation where the costs are coming out. At some point, if this recovery does continue, this company will benefit from advertising spend pick-up

Ruth Keattch: We've got London Stock Exchange which might interest a few of you. We think this is a real hidden gem, and that with Clara Furse as CEO the business was struggling to find its feet, because it was the subject of a number of hostile bids and Clara Furse missed her time sending these off. As a result LSE rather lost its way. It now has a new CEO, the rather exotic Xavier Rolet who has got to grips with this thing very quickly. He's an ex-banker, so he understands what his banking customers want; and actually they've been alienated during the Clara Furse years by a strategy that wasn't really aligned to them. He's moved very quickly to sort that out.

What we also like about this company is that the shareholder base is pretty irregular. It's got Kuwaitis and Qataris in there following the bid activities of last year and it's got a number of Italian banks, following the purchase of the Italian Stock Exchange by the LSE. What that means is the shares are under-owned in the UK, which is something we're looking at quite carefully now. We're looking at shares that are under-owned and shares where analysts are negative or turning their back on a situation. There has been a lot of negative talk about London Stock Exchange, because they're well known as an equity trading house and there have been concerns about their loss of share to rival platforms.

The other interesting thing about LSE is it has a lot of products in its cupboard that it hasn't really exploited yet, such as the very decent government bond trading platform.

So we're looking forward at the end of this month to Monsieur Rolet coming out and telling us all about his plans for the future.

Derek Stuart: Finally, those of you that followed the fund for a while will remember we held a position in Spirent which is in telecoms testing equipment; and basically this company is in a real mess and had a change of management and we backed that management and made nice money out of it and stepped away back in 2007, when the valuation was up there. We met the management again, the new management, and the shares have obviously drifted in past market conditions. This is a company which is in the doldrums, that we've seen in the first half of this year is still earning a 20% operating margin. The company historically has made a 25-26% margin and the company is going to benefit next year from installation of 4G in the telecoms equipment and new telecoms testing equipment required for that. It currently has 10% of its market cap in cash. It trades on at half the equivalent multiple of its US peers. Again, it's an invigorated management team, it's taken the cost out, adjusted the portfolio and should benefit from the turnaround in spending going into next year on the telecoms side. It's a classic for us, it's a business that didn't fundamentally change after we sold it. The problem was, and the reason we sold it, that the valuation had got too high for us at that particular time and so we've been buying back into that one in recent weeks.

Dick Turpin: Of course the question is, where to now?

Derek Stuart: We've been surprised at the level of positive economic data coming out; but certainly the quantitative easing and the support is happening, the economic data is improving in the US and UK etc and valuations in general terms, in aggregate for the UK market, are not excessive. What that does is disguise the fact that the big companies, the pharmas, the big oils etc are lowly valued and have not performed in the past six months. What has performed has been the cyclical areas and I think we have more issue with the valuation on some of these more cyclical areas at the moment.

Looking through, we're seeing people prepared to pay multiples today that effectively are multiples of back in 2007 and they're assuming that these multiples, these earnings figures will be reached again in 2011 and are prepared to put 10-12 times on those companies. So we see two risks there; one, that they don't get back to those earnings and secondly, that at 12 times where is the upside for us in buying those companies anyway? So we have shied away from that, we have taken a lot of profits in the industrial holdings that we have.

The negatives at the moment are trying to find out what the end demand actually is. We have this massive stimulus package in China. We have quantitative easing in the UK and the US and we have cash for clunkers. The question is, actually at the end of the day what is the real demand; and it's a very difficult question to answer. So, as we've said many times, we try and avoid answering that question, by just looking at those companies that are not dependant on those things to get us to our end result.

Then the final thing is; debt is still an issue. Debt has not gone away, we've not waved the magic wand and said right debt in March was lots and today in September, it's not. What is happening is that debt has been transferred from the private sector to the public sector and ultimately that will be transferred back to the private sector as we have to pay for that at some point.

So there is an issue within that; and I've been asked many times about my feelings on the UK economy. I say, in general terms, I feel quite cautious about the UK economy. I think we've got a lot of issues in the UK economy. The basic one being that over the past seven or eight years that public spending has boosted GDP by anything between 0.5-1%; and if we expect cuts in public sector or at least a standstill or no growth in the public sector, that has to impact the growth in GDP in the UK. So I cannot get excited about the UK as an economy. I think there are a number of issues that we have to face; and I think we're still a very uneven economy. Nowhere more so than in Scotland where I'm based, because we have a massive financial sector and a massive public sector. Those two sectors are not exactly going to grow over the next couple of years.

You can get quite downbeat on the economy. Indeed it's reflected in the portfolio, where 75% of the earnings of the portfolio are overseas. Because no matter how fast we grow in the UK, I still think the economies of the US and the Far East and emerging markets will grow clearly a lot faster. That's typically why we are attracted to businesses that have overseas type earnings.

Dick Turpin: You've partly answered a question here Derek, forgive me for interrupting, but I think you've already answered most of it; but Martin Smith asks that listening to economists and very much listening to what you've just said. Should clients actually start reducing their UK equity holdings as a percentage of their portfolios and the expectation that maybe other international markets will do better? Probably an unfair question to ask a UK manager but….

Derek Stuart: It's a difficult one, because since the bottom in March, emerging markets have performed even better than Western markets because that's ultimately in the next few years where we're going to see growth. As to whether you should reduce UK now; I think I'd be wary of investing in cyclical UK companies at the moment, because they are assuming now that the UK is going to turn round quite significantly. That might be the case, we don't know. We may be too cautious here and actually things will be a lot better. I think it's just a big assumption to believe that on the anniversary of the mess last year, that we should expect everything now to be right as rain. Because the debt is still there, the debt has to be sorted out and it will have to get paid back other ways. It will impact what our economy does over the next two or three years, but I think the real growth in the world economy is not going to be in the UK, it's going to be outside the UK.

Dick Turpin: You mentioned, another question just come in from David [Clinkard] on this very subject. He's asked the question: in terms of the companies you're investing in in the UK, the relationship with their emerging markets, are they – obviously they are going to see growth feeding through from the emerging markets into their activities here in the UK?

Derek Stuart: Absolutely.

Dick Turpin: That's an area you are keeping your eye on?

Derek Stuart: Yes, absolutely. We've got a number of such companies. Again, a lot of growth. If you are a strong company with an international franchise, be it Ashtead or be it Spirent or be it Agrekko and all these kind of companies we like to invest in; if you're a strong player in that, you're a strong player in the international markets and they're typically supplying kit to the emerging markets, that's where the real growth is; management teams have not been building up UK bases, they've been building up overseas basis in emerging markets, because the real growth is going to be in China and India and Latin America. It's not going to be steady growth, it's going to be volatile growth, but it's going to be long term, and much better than the UK.

Finally, we've put in some charts. We use these sentiment charts just to give us a reality check about what's happening, because it's very easy to get the blood going in the markets, through 5,100 I think this morning or something like that, and we were all getting very excited, but exactly what is everyone telling us about the market? Well the classic one we've always used in the top right hand corner there is the director dealing. You can see directors are obviously filling their boots of stock at the back end of last year/beginning of this year and they've decided they've taken quite enough now and they've booked a profit. It's interesting, in the past few days, we have been offered many lines of private equity stock, a lot of chopping and changing happening and big lines of stock getting placed in the market place. I just recognise the fact that we are 1,500 points higher in the market and therefore the expectations are higher and therefore the risk is marginally higher and insiders are telling you that. I've found over the years that obviously they know their companies better than most of the analysts in the city.

The two volatility charts; People that were really risk averse back in March are now thinking Christmas has come early, everyone is very happy again and everyone feels a bit more relaxed about the situation, which obviously makes us slightly more worried.

Now, what we're finding out obviously is that the momentum plays in the stock market are a stronger force than ever. It can certainly take the market above fair value and it can take some of our stocks beyond fundamental value. I think it's just nonsensical to recognise that a lot of the gain has already been made and we're finding more value elsewhere.

The final slide shows that we're finding more interesting areas that have lagged. Clearly, we're always looking for areas that have lagged. We're looking at businesses that have more sustainable earnings, that are less cyclical and anything that's more defensively focussed has typically under-performed over the past six months.

I also do believe that there will be opportunities to develop these reconstructions and reorganisations. Certainly a lot of the companies that we saw at the beginning of this year, cyclical companies that raise money, we felt didn't raise enough money. I think they could be back next year, in some cases maybe with new management teams that would make them more attractive for us to invest in.

But the key thing for us and it's always a key thing for us and always makes us happy is - we've got lots of ideas. The cash is low at the moment, because we've got lots of things we're buying, looking at, we've seen lots of companies. Companies as I say in the non-cyclical areas are offering us a bit of value, so we remain excited. I think in general terms as I mentioned, the equity market is not expensive, but I think parts of it in the cyclical areas are. We tend to avoid those at the moment and are looking more at the stuff that's lagged.

Dick Turpin: Thank you Derek. There's a couple of questions here, there's a general one, which I think I can answer even, I'll have a go anyway. Asking about money flows into the fund, so I suppose that is my remit. How they've been this year? Well the answer, it's an unnamed question, so apologies for not being able to be specific, but we have seen net positive inflows throughout the year into the special situations fund and indeed those have been accelerating as people are looking to really increase their equity exposure and realising that they want to be in a fund that actually can identify the recovery plays. So that answers the first question.

But the second question from Luke Hyde-Smith is very much with the fund growing and for those of you where the fund is back over a billion pounds sterling, with your move back towards mid cap and even possible small cap, are you finding any or do you have any concerns about liquidity or is the fund size an issue?

Derek Stuart: No, the fund size has not been an issue, it wasn't an issue last time, it got through a billion and I managed to lose some of it last year obviously. The key thing for us is we are buying to book in a contrarian style and therefore, the liquidity is self-generated by buying into things that people are selling.

The issue for us of moving more into mid and small cap, has been we've held off from investing in some of these cyclical areas because we have concerns about the sustainability of the earnings and the re-rating and that's been the reason, not because of liquidity, but it's not an issue at the moment. I often get asked the question: when will it be an issue? The honest answer is I've absolutely no idea. I'd like to try when the fund is at two or three billion, so give me a chance. Or give us the chance, should I say.

Dick Turpin: Well I think we'll draw it to a close there, because we're conscious of the time, we've slightly gone over, but I think it was very interesting and thank you very much indeed for taking us through that. There are a couple of outstanding questions and we'll get back to you specifically on those, if I may, but if I could just thank everybody for being with us today. I hope you've found it interesting and informative. Thank you very much Derek and Ruth for taking us through your thoughts on the Special Situations Fund and indeed the economy and market in general.

If anybody would like to follow-up on any further questions, please don't hesitate either to call us on our broker support line, I'm sure you've seen the number in our literature, which is 0800 0922090 or email us on brokersupport@artemisfund.com. So that only leaves me to thank you all again for tuning in this morning and I look forward to posting our next web cast in the weeks to come. Thank you all very much indeed.

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