Artemis
The Profit Hunter

Artemis UK Special Situations Fund

The aim of the Artemis UK Special Situations Fund has been the same since its launch in 2000: long-term capital gain through exploiting special situations. The investment approach is pragmatic: neither of the fund's managers, Derek Stuart and Ruth Keattch, restrict themselves to 'value' or 'growth'. Instead, they pick stocks on their fundamentals. The portfolio reflects different stages of the economic cycle. Derek and Ruth spend most of their time meeting management. They identify the people who can change businesses and improve returns.

A key focus is to identify businesses which, although fundamentally sound, have been through a period of disruption or poor trading. Often these situations require new management to sort out these difficulties. An important element to the investment is therefore a degree of self-help. If much of the expected return is based on what the management can control, then returns become more realistic as they are not dependant on the vagaries of the economy.

But 'value' in stocks is not enough. Any investor who picks stocks on this criterion alone will regret it. That's because while most stocks are cheap, many aren't yet cheap enough. In this demanding economic environment, many will go bust – and get a lot cheaper still. One truism of investing that is true is the saying 'You can always lose 100%.' So the prudent investor must choose stocks with great care. On what grounds? The most important, we think, is debt.

It is very important to understand the dynamics of a company – the risks. For instance the combination of operational and financial gearing is the 'death spot' for companies – whatever sector or market a company is in. Financial leverage is fine in company with predictable cash flow. It is very dangerous in a company with a more cyclical earnings stream. So in their stock selection, Derek and Ruth spend a lot of time on a business's cash flow and balance sheet. By focussing on the downside risks, they hope to avoid the 'torpedoes' that really affect a portfolio's performance.

A second key criterion for the fund's stock selection, which over-rules sectoral or thematic factors, also relates to debt: a company's pension liabilities. Without details of funding deficits, payment schedules and composition of a pension scheme's members, you can't analyse company pension deficits properly. Even where there is quite full disclosure, analysts are constantly caught out because of the many moving parts (witness poor BT). Companies with large pension liabilities, a high proportion of pension fund equities and high (estimated) buyout deficits should be questioned carefully - or avoided on principle.

Under current rules, many company pension funds are actually reporting a lower accounting deficit. That's because the effect of discounting liabilities at a higher rate (based on current, higher corporate bond yields) has more than compensated for falling asset values. Good news? Misleading, in our view. The funding deficit is based on discounting at the 'risk-free' rate. Even less flattering are buyout deficits, typically 30% larger than accounting deficits. This is very much a rule of thumb: for Boots, for example, an accounting surplus of £20m translated into a funding deficit of £305m and a buyout deficit of £1bn.

So we are checking the pension funds of each of our holdings – and checking again. It works both ways. Take Invensys, much maligned for pension liabilities that are some 300% more than its market cap. Our view is different. Invensys' pension fund is large (£4.9bn liabilities, £285m deficit) but well-structured and stable: it switched substantially to fixed interest (average 80%) in 2008. The company's £36m annual contribution is fixed to 2017. Any corporate disposals require an 8% remittance to the fund. That is not onerous. We hold Invensys, and happily.

Historically, the fund has been highly focused on the smaller company area of the stockmarket. But as value has appeared in larger companies and as the economic climate has impacted on the smaller company sector, the fund has moved up the size scale over the past two years. At the moment the fund is split equally between the FTSE 100 Index and the rest of the market.

In the current climate, Derek and Ruth are finding many 'special situations'. A high number of re-financings and re-structurings are offering opportunity. Some re-financings are for companies that can exploit the problems of their competitors. A classic example is Debenhams, whose recent fund-raising not only improves its balance sheet but also gives the management funds to exploit the problems within the retail sector.

Or take consumer goods firm Unilever as a core holding. Almost half of its business is in emerging markets, which are always as quick to recover as they are fast to fall. It's seen as a staid old lady (with no disrespect to ladies, staid, old or otherwise) and the market dislikes it. Yet under new senior management, the firm is reinvigorating itself. It shows the type of appetite for change and self-help that characterise many of the fund's investments.

And banks or financial services? No way, many still say. But look at Close Brothers, another company with great promise – in Derek and Ruth's view. Bid approaches in late 2007 and early 2008 prompted a re-think for the group. Close has been quietly refocusing under strengthened management, de-emphasising volatile transaction-related activities in favour of more stable lending and wealth management. The business is strongly capitalised with a healthy deposit base and a risk-averse approach to lending. And in the meantime, it's paying investors a very handsome 7% yield.

These are just three of many companies whose potential is great. In these testing times of corporate Darwinism, some companies will not just survive: they will thrive.

4 September 2009

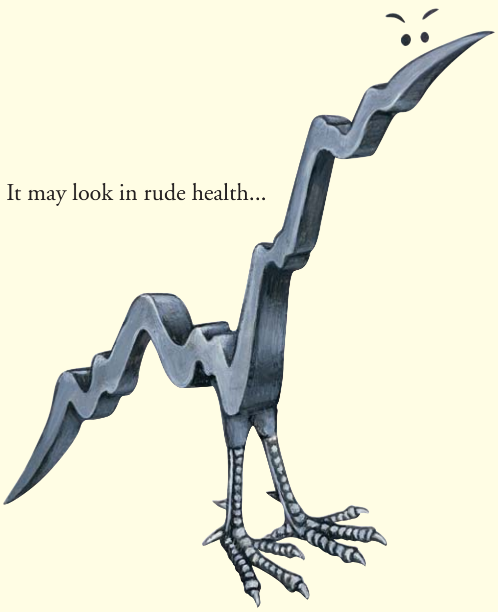
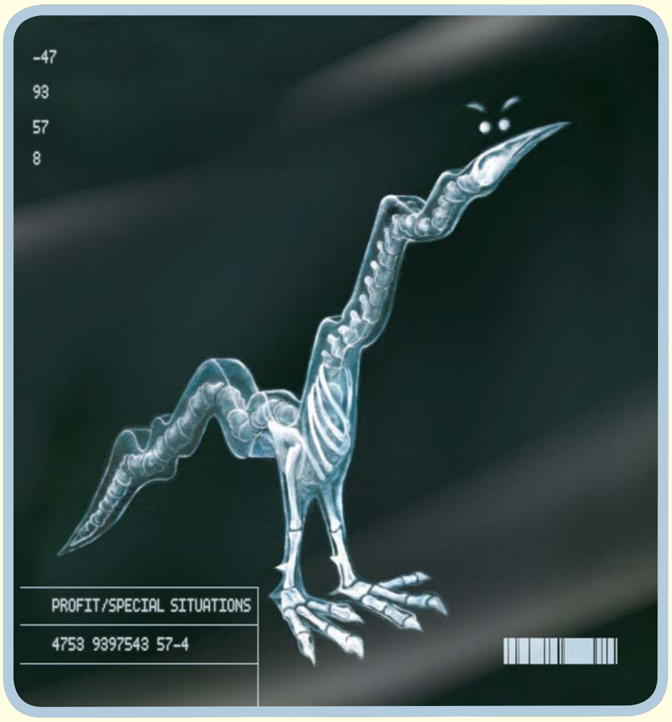


Fig. 1: It may look in rude health...

Fig. 2: ...but look a little deeper...



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