LWM Consultants Ltd

Meeting the fund manager

The Alpha Generators Conference

ALPHA GENERATORS | Delivering performance through active management

We are always keen to meet new fund managers for a number of reasons. Firstly, they can provide fresh insight and secondly it enables us to challenge the funds and fund managers we currently use in our portfolios.

We recently attended the Alpha Generators conference which included managers from Neptune, First State, Martin Currie, F&C, BlackRock and Aberdeen. The conference covered a range of topics from the hunt for income to resources to emerging market debt.

All the discussions with the managers were fascinating but there were two discussions which really stood out for me – firstly Gary Potter who is the fund manager of the F&C Distribution Fund. This is an income fund and he was explaining how cash is no longer king, in fact he went onto to explain that interest from cash has fallen by £8 billion in five years. With inflation likely to only increase cash is no longer the place to be and private investors need to move away from risk aversion to identify other means of generating income.

The second discussion which was fascinating was around emerging market debt and there was a discussion on whether this is a bubble or fad. Philip Fielding, who is a Portfolio Manager within First State Investments’ Emerging Markets Debt team, believes that that there isn’t a bubble and there are plenty of opportunities for a number of reasons – there are no debt crisis, there are greater opportunities for these countries to have upgrades so they become investment grade, their GDP is more lower and ultimately they don’t borrow as much money.

Alpha Generators is ultimately about introducing fund managers who believe you can add value through active management. In the introduction it was clear that the market believes that 2013 will be a positive year but many managers believe this will be a transitional year with 2014 being a much better year. There are no guarantees in life and we have to remember that many of the problems have not gone away but they are being better managed.

In this briefing I will provide an insight to the discussions which includes comments on stocks like Redrow, BTG and Heinz. We don’t use the funds mentioned but with the exception of Martin Currie we do use the fund managers. We select from just over 50 funds and use 25 different fund managers in our portfolios so we believe this overview will be of interest.

Neptune Fund Managers – Mark Martin

Mark joined Neptune in February 2008 as an Investment Analyst and is now Fund Manager of the Neptune UK Mid Cap Fund. He is also Assistant Fund Manager on the Neptune UK Alpha Fund and, together with Felix Wintle, is responsible for global research on the healthcare sector. Over a four year period he has outperformed his peer group composite four times.

Mark started by discussing the UK brand or image which he believes has been enhanced by the Olympics and is sitting in a very good place. The reasons behind this are that we have a trusted global brand with a long heritage, we have an independent currency, good positioning and a stable political environment.

This combined with the fact that equities even with the recent rally are relatively cheap. The forward PE ratio is below Spain and is behind Europe as a whole. Putting this in context in 1998 / 1999 the PE ratio sat at around 24 to 26 times and what followed was ten years of negative real returns. During the depression in the seventies PE ratios sat around 6 to 7 times and over the next ten years the returns were around 17% p.a.

Currently the PE ratios are around 12 times and if history repeats itself we could see returns of around 10% p.a. over the next ten years.

Many investors have seen the sudden spike in the markets and fear they have missed the boat but Mark believes that prices are still attractively priced and is positive for 2013. The funding for lending scheme plays a big part of this. For individuals secure credit availability is at its highest level for six years and on the corporate side for mid to large private businesses the credit is the highest for six years as well.

He feels that the availability of credit impacts growth, so where it is held back it stifles growth so if the trend continues then this is good news.

Another driver for the economy is housing. The housing supply is at all-time low and it was in the thirties where house building was used as a means of generating recovery. With a regulatory tailwind he believes house building is in a good place to be. One of his holdings is Redrow; the Chairman is Steve Morgan. Steve Morgan is a successful businessman who built the business over a relative short period of time before stepping down in 2000 and then re-joining in 2009. He was looking to bring it back into private ownership which demonstrates his belief in the sector.

Redrow as a business is a niche house builder with expanding margins and with Steve Morgan on board Mark believes this company is well positioned to benefit from the changes to the housing market.

We then looked at a company called BTG. This is a healthcare company and is currently developing a new product for varicose veins which means patients can be treated as out-patients in half an hour rather than the previous lengthy process, this is expected to be approved soon. It also developed Zytiga which is used for prostate cancer and is the most successful oral oncology drug ever and has the potential to save millions of lives.

What is interesting is the tie up with Johnson and Johnson who used their marketing muscle to promote Zytiga. This tie up reflects that large pharmaceutical companies with cash are now turning to small companies either to form strategic partnerships or M&A activity.

Finally he discussed a company called Berendsen. A new management team came in 2010 with a private equity type focus and what they have done is cut away the fat that had accumulated in the business and as a result returns to shareholders have improved significantly. Mark believes this type of management will become more prevalent to drive successful businesses.

In summary these are just three examples but Mark believes even with the recent returns valuations are still cheap and the outlook globally is starting to look very good.

BlackRock – Alex Ball

Alex Ball is an analyst and product specialist for the Natural Resources Equity products. Alex joined BlackRock in 2009 as part of the graduate scheme. Prior to working on the Natural Resources team, he was a member of the Proprietary Alpha Strategies team.

We hold City Natural Resources in the higher risk portfolios and it was interesting to get an independent view of resources and what to be looking for going forward. In 2012 there was a continued concern around global growth and that is not good for resources. Going into 2013 we have seen these fears ease a bit as economic data has improved.

Clearly when we look at Natural Resources China plays a major part in the commodity market. Although people have voiced concerns around the lower growth Alex believes people are missing the bigger picture and that is that China had bigger growth with a smaller economy now it has lower growth but a bigger economy. Putting this in context currently 7.2 million tons of cooper are exported to China, this is expected to increase to 16.4 million tons by 2025 but currently the world produces 20 million tons.

Clearly there will be a supply issue so they are very positive for cooper; however aluminium they believe has an oversupply so are not keen to play in this market.

Many see energy and in particular Oil and Natural Gas coming to a mature cycle but this hasn't felt the China effect yet and it is well behind the US. Although they do not expect China to match the US in terms of demand they believe there is the opportunity to expand and the demand outlook is very strong.

Agriculture is an area we have looked at and see a good long term future and BlackRock concur with this. There are two factors which are not linked to GDP growth – demographic increases and dietary factors. The supply side has been quick to respond but it needs to increase further. Where BlackRock see opportunities are in the supply side. One of the holdings in World Resources Fund is Monsanto. Taken from their website statement really explains what they do. The shares have over 12 months gone from a low of $69.70 to a high of $104.19.

Finally we turned to Gold; this has seen the 12th straight year of gains. This has been driven through a number of areas, governments are buying it so it is effectively a currency, there has been a growth in the ETF industry and finally in an environment where interest rates are low gold does well but if interest rates go up then this will be bad news for gold. However, gold equities have not performed as well.

In summary Alex and his team are very bullish about resources but with a caveat that investors need to be more selective on where they invest as there are areas where there is an oversupply.

Aberdeen Asset Managers – Mike Turner

Mike Turner is head of global strategy & asset allocation on the multi-asset team, overseeing the asset allocation process for the group working closely with the CIO. Mike is also a director of Aberdeen Asset Managers Ltd., the UK operating subsidiary of AAM plc, and Aberdeen Pension Trustees Ltd. Mike joined Aberdeen via the acquisition of Edinburgh Fund Managers in 2003. Mike joined Edinburgh Fund Managers in 1998 as Head of Fixed Interest & Strategy, a director of the investment management divisional board and a member of the asset allocation committee.

Unlike the other discussions Mike didn't talk in great detail about his fund but more about behavioural finance which is something we follow very closely. A lot of what he said is what we have written about but I think in this particular environment it is worth pulling out some of the key messages that he made.

He started by talking about the fact that rational investors didn't create bubbles? Then reminded us of the Tulip Bubble, South Sea Bubble, Wall Street Bubble, TNT and US Housing Bubble. The point being that many investors make decisions on biases and not on logic.

So when we come to investing we need to keep our feet on the ground and to do this we must have a sound strategic framework in place.

We talked about the potential bubble that is out there now, all around us we see how this has been a lost decade for equities and how bonds have provided excellent returns that are both above equities and inflation. The problem is that people are still being sucked in because they perceive safety.

Gilt yields have dropped from over 12% in the early nineties to around 2% today and yet the return gap is massive. At some point that gap will narrow and bonds will fall. The point is like other bubbles we don't know when.

The problem with the environment we are in today is that with cash providing negative real returns investors want to avoid permanent loss of capital. Bonds because of their performance appear to offer that protection but when you look beneath the surface you see that all is not right and it will correct.

A lot of the things he talked about were picked up by Gary Potter of F&C and we can start to see the challenge for investors looking for income.

In summary Mike provide a checklist for investors:

1. Balance is crucial
2. Don't be swayed by recent events
3. Accept that losses can occur
4. View the data carefully
5. Understand the value and risk involved
6. Manage positions carefully – investors tend to sell losses and hold onto winners

F&C – Gary Potter

Gary Potter is co-head of F&C's Multi-manger team. He shares overall responsibility for the performance of the team's portfolios with Rob Burdett and leads research teams for UK income, US, Asia and emerging market equities. Gary joined Thames River Capital in August 2007 and transferred to F&C when the companies merged in 2010. Prior to this he was at Credit Suisse from 2001, jointly responsible with Rob Burdett for their multi-manager funds. He joined from Rothschild Asset Management Limited, where he was a main board director, jointly responsible for their multi-manager business. Gary began his career in 1981 in private client fund management where responsibilities extended to a specific focus on asset allocation and stock research. He moved into the the multi-manager field in 1992.

In the field of multi-management Gary is somewhat of a cult hero and it was clear that at the conference he had many people who knew him and used his funds. Coming on the back of Mike's comment on behavioural finance he re-iterated that we are facing the biggest bubble ever witnessed and that is one of risk aversion.

A recent article in FTMoney stated that investors are in no hurry to rotate investments from bonds to equities. In the same survey 71% of these interviewed said that they not would be prepared to take any risk with their money. This to Gary is the big bubble that is about to burst.

Between 1992 and 1997 inflation was at 14.9%, consider:

Halifax Liquid Gold returned 16.4%
Property returned 19.6%
Equity Income funds returned 29.5%

Between 2007 and 2012 inflation was 16.5%, consider:

Halifax Liquid Gold returned 0.8%
Property returned 3.3%
Equity Income funds returned 12.2%

And this is going to get worse, the new Bank of England Governor has made it clear that he is more interested in stimulating growth than in inflation which means that inflation will increase substantially over the coming years. Consider also in the last 5 years interest on cash has fallen by £8 billion.

Interest rates are unlikely to increase until 2017 and even then it is unlikely savers will benefit immediately from this.

Gary's point is that cash is no longer king. With people living longer you have to take risk to get income.

The Thames River Distribution fund is made up of funds and seeks to deliver investors a high level of income. The key drivers are:

1. To seek out natural income
2. To keep the capital base stable and if possible growing
3. Identify potential risks
4. And carry no passengers – diversify, diversify, diversify

The income conundrum is here to stay for years and years and it is important to look for alternative means of driving income. The UK has been a natural driver for income but this has come down 30% in ten years so we have to look globally including emerging market debt.

It was interesting to hear some of the funds he uses to drive income – these include Chelverton UK Equity Income Fund, Veritas Global Income Fund, Somerset Emerging Markets Dividend Growth Fund and Prusisk Asian Equity fund. His point was to drive income we need to look wider and deeper to get the returns; just turning to a well-known equity income fund will not deliver in the future.

So in summary Gary was articulating really what Mike was saying and that is that it is very easy to follow what everyone else is doing but we are in a bubble and that will burst. Papers talk about a lost decade of equities but this is not true, the FTSE All Share return 132% over the last ten years, gilts 56% and RPI was 38%.

However we have to accept the additional volatility that comes with this but to do nothing will see the gap widen between equities and gilts. We also have to consider that retirement is 20 years plus and to assume cash or bonds will deliver for 20 years is wrong. Whether it is today, tomorrow or in three or four years the bubble will burst and it will be messy. His view is that now is the time to reconsider holding cash and take advantage of the opportunities that are out there.

The next two discussions focus on income, the first looks at emerging market debt and the second global income.

First State – Philip Fielding

Philip Fielding is a Portfolio Manager within First State Investments' Emerging Markets Debt team, where he has regional responsibility for Central Europe, the Baltics, Turkey and South Africa. Prior to joining First State Investments in October 2011, Philip spent five years in F&C Asset Management's emerging markets debt team where he had research responsibility for Central Europe and managed segregated funds.

When Gary talked about seeking out yield this is one area he mentioned. We moved our portfolios away from UK bonds last year to emerging market debt because we saw greater opportunities in this area.

Philip expanded on this further and so the discussion was one of interest for me. Emerging market debt offers an attractive yield that is 2.62% more than the US treasuries (2.55%) – so around 5.17%. If you compare to the UK this is around 2.00%.

We of course consider emerging markets to be "risky" but actually the fundamentals are very different to developed countries. Firstly there is no debt crisis and therefore there are greater opportunities for upgrades to investment grade. Secondly GDP is lower and thirdly they don't need to borrow as much money. It could be considered it is less risky than UK bonds!

I was interested to see how they select investments and Philip talked about how they carry out a global macro assessment, so looking at global trends and how that translates to emerging market debt.

If we look at LTRO, on initial look it would be considered that there would be no impact on emerging markets however when the banks take the money they are going to give it to sovereigns and they are going to look to emerging market sectors. As an example they invested in Turkey that has indirectly benefited from this and seen its index outperform significantly.

Another area is Venezuela where crazy policies present opportunities. Hugo Chavez is nationalising private companies and spreading his socialist ideals, the country has high inflation of around 30% but Hugo Chavez is able to keep the currency stable through of a mixture of dollar bonds and the vast oil reserves. The risk has actually reduced and the country has outperformed.

So in summary Philip is convinced there are great opportunities in the emerging markets but for them it is about identifying the opportunities and how these can be used to deliver returns. He doesn't believe there is a bubble because the market is very different to the developed market, especially when you consider lower debt and greater growth. At the moment the fund is overweight in the UAE, Turkey, Venezuela and Russia but surprisingly underweight in Chile (he likes the country but he doesn't feel investors are being compensated enough).

Martin Currie – Alan Porter

Alan manages the Martin Currie Global Equity Income fund and Securities Trust of Scotland. He joined Martin Currie in 2008 having worked in London for, among others, Hill Samuel Asset Management and Insight Investment Management.

We don't have any funds with Martin Currie so it was interesting to hear from one of their managers. We do use the M&G Global Dividend Fund so we have exposure to global income equities.

The strategy he uses is one he created when he joined Martin Currie in 2008. He was quick to highlight the opportunities with global equity income.

In 1995 the global world equity index added a global world divided index. Over that period the divided index has outperformed the world index by 2.5% p.a. Going back to bubbles and seeking opportunities clearly finding sustainable businesses that are growing and delivering persistent dividends can provide real benefits.

Gary mentioned how he felt UK Equity Income is dead and Alan follows that view because of choice. As an example when looking at financials in the UK you have a basket of around 8 firms you can turn to, globally its 64. So effectively you don't get a concentration of holdings and you can hold stocks because you want to hold them.

As a manager he doesn't look to make a call on the market or macro bets but basis investment on conviction. One company he mentioned was Heinz; the share price hasn't moved much and has a 12 month low of $51 and high just over $60. It has a sustainable dividend and is expected to increase this by 7% a year.

What the market is missing is the opportunities. 2/3 of its businesses in the US are growing and it is starting to expand in emerging markets. Currently this is around 6% of group sales, this is expected to grow to 25% in six years. However, the management are limiting growth in emerging markets to protect quality.

Another area the market is missing is Project Keystone which is an efficiency programme which is starting to pay dividends. So in summary you have a company which is growing on a PE of 15 times and a dividend of 4% with projected growth at 7%.

Other companies include STM Holdings in Hong Kong. It is a Casino stock based on Cotai. The government has invested in infrastructure which means that it is now accessible to the masses which his helped margins, it also has the opportunity to expand and it has large amounts of cash. The PE ratio is 15 times and it is paying a dividend of 5% which is expected to grow by 15 – 20% a year.

In France Safran is a world-class manufacturer of aircraft and rocket engines and propulsion systems, and aircraft equipment. It benefits from engine servicing, has a link with GE and is benefiting from the demand in new aircraft. It has a PE ratio is 9 times and is paying a dividend of 3% which is expected to grow by 15 – 20% a year.

In summary Alan like Gary believes that globally there are great opportunities to be found.

Conclusion

Clearly the markets do feel positive and the view from the people we met was extremely positive. However, there is a bubble building and investors are finding it difficult to move away from a trusted source of investment. However, when the bubble bursts and assuming that inflation does increase further with little increase in interest rates investors are going to have to look for alternative options when it comes to investing, and seeking income. This discussion was interesting and confirms our belief around emerging market debt and the importance of diversification to deliver long term returns for investors.