LWM Consultants Ltd

Meeting the fund manager

Standard Life Smaller Companies

We have met Harry a number of times and he would certainly fall into the rock star hall of fame if such a thing existed for fund managers!

What we like about Harry is his process which has delivered consistent outperformance. He is a great believer in smaller companies, in fact in the meeting we had, he demonstrated how smaller companies have outperformed larger companies by 3.2% p.a. over a 57 year period.

Of course the counter argument to that is that this growth can be lost because of the volatility and risk associated with smaller companies. However, with Harry's style of investing he is looking to invest in lower risk smaller companies – he does this by holding stocks for longer and running his winners.

Effectively he is buying tomorrow's large companies today. This process was launched in January 1997 and hasn't changed.

We hold both the UK smaller companies fund and the global smaller companies fund so the meeting was a good opportunity to get a view from Harry as to how the fund may perform long term.

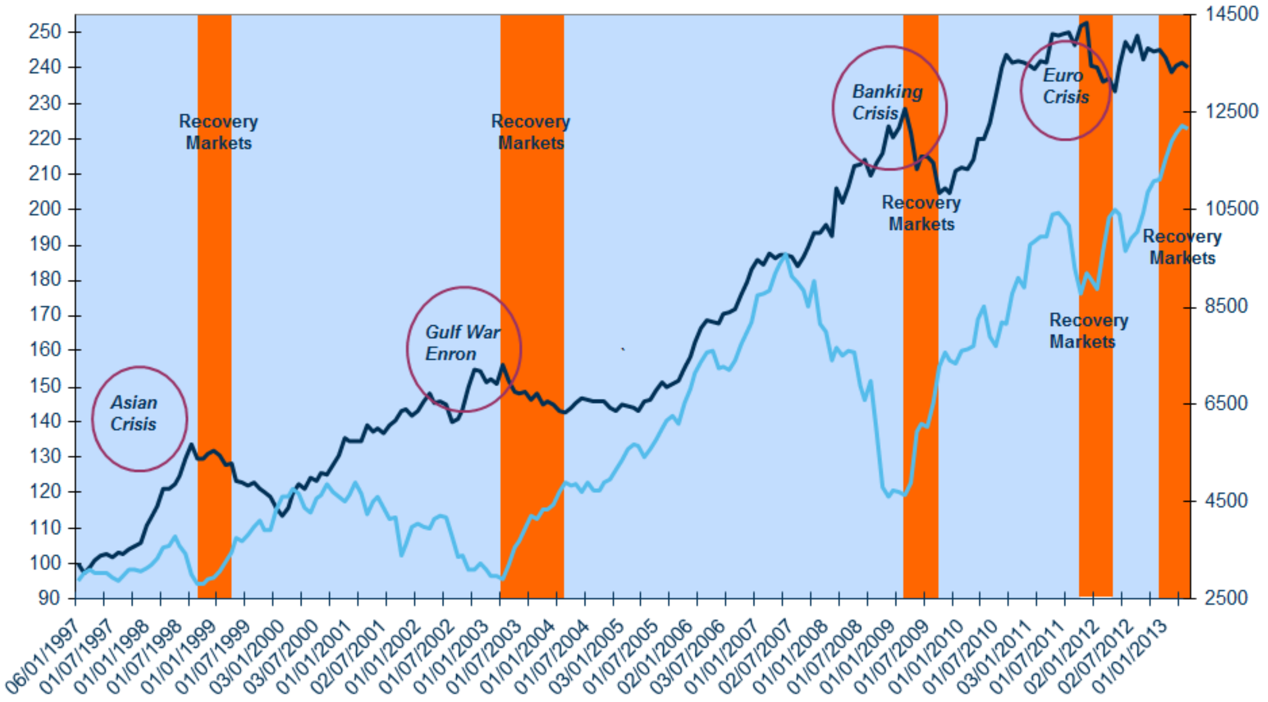
Overview

It is worth remembering what Harry looks for in companies, some of the factors include:

- Proven business model
- Recurring revenue sources
- Companies that make money
- Firms which are lower risk/turnover

The screening process is important in identifying potential companies. Harry sees it as important to meet the companies so he sees first-hand the resilience of the business model. He also likes companies which are price makers rather than takers. So for example he wouldn't invest in a supplier of Tesco who would set the price they pay.

We talked about how the fund performs in different markets and this I think is important to understanding when it will outperform and when it will underperform. Especially as it has a fixed process and style. We will work from the graph below:



Note – Graph Supplied by Standard Life Investments.
Source: Morningstar, 06 January 1997 – 31 January 2013. Black line is the relative performance of the Standard Life UK Smaller Companies Fund against other UK Smaller Companies (around 55 funds). Turquoise line is performance against their benchmark which is Hoare Govett Smaller Companies Index
You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

In a recovery phase the fund tends to underperform. The reason for this is that investors tend to take on more risk and invest in more cyclical companies. However, what tends to happen is that investors become less certain on whether the recovery is sustainable and it is at that point that we move out of the recovery phase. This is when the fund really starts to deliver.

The chart shows examples of this, in 2003 there was a sharp recovery phase where the fund underperformed but then it sharply over performed up to 2009. It then pegged back and regained momentum from 2010 to 2011.

The point he is making is that this is a long term investment where he is buying into companies which are more resilient and have the ability to grow regardless of the economic environment. Because of his style it does provide a degree of protection in difficult markets (this is an equity based fund so capital is not protected).

An example where markets wobble is one of his preferred holdings, ASOS, in 2008 the shares dropped from £4 to £2. They then recovered to £24 and in 2011 they dropped to £12. They are now sitting at £26. The point with this is that no stock is immune to the vagaries of the stock market.

He is a long term holder and the top ten holdings from three years ago are possible similar to the holdings he has today. So the likes of Paddy Power, Right Move, Telecity, Abcam etc. He has sold down Telecity and ASOS to take profits and Paddy Power had become too a large part of the portfolio. Other changes were IG Group and First Quantum which he no longer views as smaller companies.

Harry has also just started to go back into sectors which were damaged by the banking crisis like specialist lenders and real estate. Around 4% of the portfolio is in real estate but the focus is very much on London.

One example of a stock he likes is Workspace which they sold in 2007. It offers managed work spaces in Central London for periods up to 3 months. Since the banking crisis it has been able to re-finance and is now looking like a good investment. During the period Harry has not invested occupancy has remained good but also they have been able to sale some of their space with change of usage which gives the company a kicker to invest in other areas.

The number of holdings is 57 so it is a concentrated portfolio, of the top 20 funds 17 have either the original CEO or founder involved in the business for more than 10 years. Online focus makes up over 22% of the portfolio and the largest holding is 5% of the portfolio.

Harry has moved this style to Europe and has run a successful European fund for five years. Last year he launched the Global Fund. He believes that the process he uses can translate globally. It has outperformed its benchmark but he is aware that whilst we are in this recovery phase it will possible underperform.

The businesses he focuses on tend to be globally spread although there are exceptions to this and there is a cross over with some of the holdings in the UK and European funds.

In summary Harry continues to deliver and when we met him one of my concerns was what would happen if he was no longer at the helm. Clearly as has been demonstrated through the launch of the global fund Harry has no intention of retiring soon. In the discussion we had Harry was keen to emphasis the experienced and close knit team which is part of the funds success.

Looking at the markets there are positive signs, there is a change in investor sentiment, Europe has not gone away but is improving in fact there are more buy ideas appearing in Italy, Portugal and Ireland and China and Emerging markets are being seen in a more positive light. All of this Harry believes is good for the fund going forward.

Conclusion

It is important for us to meet fund managers on a regular basis to identify whether anything has changed. It also helps to understand when a fund might slightly underperform and when it may over perform. With Harry we have a fund manager who has a consistent working strategy that has delivered long term, and one that he believes will continue to deliver and hence the launch of the global fund.

The meeting was a telephone conference but we have been invited to an investment conference at the end of February so hopefully we can have a more one to one discussion at that point.

The source of information in this note has been provided by Standard Life Investments and is correct as at 5 February. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase this fund. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise.