



LWM Consultants Ltd

Meeting the fund manager

Scottish Conference – Standard Life Investments



We were recently invited to attend the Scottish Conference in Edinburgh; the conference provided us with access to managers from Baillie Gifford and Standard Life Investments. This update includes updates from three managers at Standard Life Investments (SLI).

The Standard Life Global Absolute Return Strategy (GARS) Fund was established, as a retail offering, in 2008 and has been a foundation stone of our portfolios since they were established in 2009. Another key holding has been the UK Smaller Companies, and last year we added the UK Equity Income Unconstrained Fund.

This update covers the thoughts from these managers.

Global Absolute Return Strategy



The GARS Fund has been a foundation stone for our portfolios since 2009. The strategies it uses to deliver returns can be seen as complex instruments but effectively it looks to invest in a broad range of return opportunities – by this it means that it will hold equities, bonds and other investment strategies.

It then overlays this by looking to squeeze down the volatility but not the performance – so it creates the best of both worlds, bond like volatility with equity type returns.

There are two strategies – traditional and advanced.

Traditional - Market Returns / Stock Selection

How the strategy works

Market returns are earned by investing in assets that are expected to provide a long-term return that is superior to cash, e.g. equities, corporate bonds and real estate. The risk from holding these assets is that they can also give negative returns over significant time periods.

Stock selection exploits the stock selection expertise of a variety of traditional fund managers who are tasked with out-performing market benchmarks. Also known as alpha generation, they target a 1% per annum contribution to GARS overall from this source.

Example of how this works

From inception, GARS benefited from a significant investment in equity markets until late 2007, when they significantly cut this exposure. During the volatile markets of 2008, the fund's exposure to equity holdings fell in line with market movements to a low of 18%. They topped these up to 25% in October 2008 and again in February 2009, with GARS benefiting from strong market gains in 2009.

Advanced - Directional

How the strategy works

These strategies, often based on interest rate and currency views, are cyclical market opportunities, so may not offer a significant long-term reward for holding them continuously. On a two-to-five-year view, however, they can offer significant rewards that are often uncorrelated to long-term market returns.

Example of how this works



European interest rates. In 2008, they believed European shorter-term interest rates were too high and put in place strategies that would deliver returns as interest rates fell. As traditional risk assets collapsed in value in the second half of 2008, this strategy performed better than they expected, offering an element of resilience to the overall value of the Fund. Interest rate or duration positions, especially at longer maturities, also provide diversification to their equity strategies, again benefiting the Fund's risk-return characteristics.

Advanced - Relative value

How the strategy works

Highly correlated markets may behave significantly differently over extended periods. This can be as straightforward as the comparison of two equity markets. They may reach relative valuation levels that are unsustainable. Relative value strategies can take advantage of the normalisation of markets without exposure to the direction of underlying asset class. For example, they can implement a strategy that delivers returns if one stock market outperforms another irrespective of whether equity markets are going up or down. The strategies add further diversification.

Example of how this works

Financial vs corporate credit. Credit rating downgrades for financial companies were a prominent feature of investment markets in 2008 as the financial system cracked and banks sought government support. In the midst of this financial crisis, investor aversion to financial bonds was

reflected in their high yield. Their relative value strategy exploited the fact that financial companies have to vigorously defend their creditworthiness more than most in order to operate profitably. They expected to benefit from an improvement in the relative credit quality of financial companies versus the market as a whole, which was subsequently the case in 2009.

With this in mind the meeting was with Guy Stern and Andrew Milligan who are two key members of the management team. The key aim for the fund over the long term is to deliver positive returns however on a monthly basis you may have up months and down months. This update was to go through some of the strategies they are using in the fund.

One of key elements looks to understand the markets and this comes through the Global Investment Group. This group considers the shape of the world, what the world might look like in the next 12 to 18 months and where there are potential opportunities. There is a tremendous range of views however the group does see opportunities in the US and Japan.

The group also look to analyse what is happening with monetary transmission. Looking at US banks these have changed since 2008 and are now in a healthy position. When we consider Lloyds and RBS if you strip out the losses these are now profitable banks. Europe is some way behind the trend.

This is important because in the US it is now in a position to start lending, and this combined with an environment where both the domestic and export drivers are working together demonstrates a potentially positive outlook. Lending is important to help drive growth and in the UK we are closer to being in a position where the balance sheets are strong enough to start lending again and therefore stimulate growth.



However, when considering the debt market the fund is very light on government debt because interest rates are unlikely to go up any time soon.



So considering the banks Europe is still a mess and it is their view that it is not working but the US and the UK are in a better position. Japan is another interesting market where they are using exchange rates to boost the economy. Their view is that Japan could be changing because of the fiscal changes which could bring about inflation. With a weaker Yen it grows earnings and therefore the fund has adopted a Dollar vs Yen strategy.

The view is that this could be a 12 – 18 month strategy or it could be longer term. They will review this holding in the autumn.

Turning back to Europe and why it is not working – borrowing costs for Spanish and Italian companies are still too high and this reflects the fact that growth is falling. When the UK growth figures were slightly up and this was criticised it was at a time when German growth was falling. It is not that Europe can't work it is just that it is not working yet and the like of the US are ahead of the curve and the UK has the potential to catch up sooner. The fund is anti-Euro and has a Dollar vs Euro strategy to reflect this. So for example with the trouble in Italy the Dollar to Euro dropped from \$133 to \$130 and they expect over time for this to fall further.

The fund has some volatility trades running at the moment because they do not believe this is priced into the market. This trends around 15 to 30 and they believe going forward the market will be more volatile, Italy is an example of this. The markets expected one thing and the opposite happened. There are many things that can make the market nervous, North Korea, Middle East and the US Fiscal Plan is now running into May.

China is embarking on a new ten year programme where reform is key - it is clear that things will be more difficult and the expectation is that Chinese equities will be more volatile than that of say UK equities. So the strategy is to buy more Chinese volatility whilst selling western volatility.

Another area they are exploiting are REITS, these behave like bonds in terms of yield but have greater volatility.

To me what was demonstrated in the discussion was that this is a fund with lots of different trades and strategies which when blended together squeeze down the volatility. It should be reminded that it will not always be positive but over the long term it should deliver equity type returns. When you consider the holdings you will see currency plays like the Dollar vs Yen as well as volatility trades like China Equity vs UK Equity volatility but also through market returns you will see European, US and UK Equity holdings. Crucial to making this work is the team and the fact that not one person pulls the control stick.

UK Equity Income Unconstrained Fund



The UK Equity Income Unconstrained Fund was added to the portfolios last year. Clearly bond yields are not as good as they were and to drive yield then there may be a need to rotate to slightly more risky assets to drive that yield.

The problem is that the main equity income funds drive yield from the mega caps and therefore the concentration risk is greater. So many of them hold similar stocks which includes the likes of GlaxoSmithKline and AstraZeneca. So if we look at the Schroder Income Maximiser which we hold it has two of the key stocks in its top five holdings however we like the different approach to investing that they adopt and we wanted to blend this with an alternative driver for income.

This is a conviction portfolio which has no exposure to pharmaceuticals, tobacco and utilities. This is important because when you compare the top ten holdings in the UK Equity Income sector against the top holdings in the fund you can see the potential. The fund provides average dividend growth of 8% compared to 6% with the standard UK Equity Income Sector, the earnings per share on the fund are 12% compared to 3%. So automatically you can see the potential and Thomas was keen to stress that this is not done through added undue risk.

He is looking for companies which can continue to grow earnings and he feels that dividend yields in the FTSE 100 will come down and that these companies will have to make tough decisions over the coming years. The growth will come from FTSE 250 companies.

Two companies which have prospered well in austerity conditions are Easyjet and Whitbread. These companies have strong balance sheets and are able to fill their jets (in the case of Easyjet) and hotels (in the case of Whitbread). In the case of Easyjet they are expanding their fleet and will be making a special dividend.

When you look at these types of companies and compare to the likes of AstraZeneca Thomas feels that in 4 to 5 years Easyjet will be a bigger company whereas AstraZeneca will be smaller. You are looking at smaller, growing companies against larger, stagnating companies.

This is a conviction portfolio of 60 holdings currently and the yield is currently around 4%.

In summary we have indicated before that bond yields will be squeezed going forward so obtaining yield and growth will be crucial. Opting for the funds which have been the winners in the past may be a dangerous strategy as these struggle to generate the same returns in the future. We believe this fund provides the opportunity to provide a good level of income and growth and blends well with the Schroder Income Maximiser Strategy.

Smaller Companies Strategy



We have done several updates with Harry Nimmo who is the manager of the SLI UK Smaller Companies Fund and the new Global Smaller Companies Fund.

Clearly Harry has a passion for what he does, and believes that over the long term smaller companies will outperform most markets and therefore shouldn't be ignored.

He has simple rules to investing – concentrate your efforts, look for sustainable growth, go for quality, run your winners, management longevity and valuation is secondary.

Harry has been running the smaller companies fund since 1997 and took over the investment trust 9 years ago, there is a 80% stock overlap between the funds. The Pan European Fund was launched in 2007 and the Global Fund was launched in 2012. In this discussion Harry talked in more detail around his rules of investing.

Concentrate your efforts

He uses a matrix screening system which identifies the top 15% of stocks in the smaller company's universe. So in the UK this is around 700 companies to choose from, Europe 1,500 and globally 6,000.

They are looking for the highest scoring companies and these are the companies they will focus on. Looking at the team behind the companies they are looking for personal management responsibility and a tight knit team.

Look for sustainable growth

There are lots of different markets whether emerging markets consumers or shale gas and lots of opportunities to grow. Therefore Harry is looking for companies that can exploit those opportunities.

Go for quality

The argument is that smaller companies mean more risk but it depends what companies you back. They prefer proven businesses with revenue, profits and possible dividends. An example would be something like Rightmove where dividends are up 28% compared to Zoopla which is a challenge to the business model but continuing to make a loss.

What is important is the long term contracts / customer relationships they have and that they are in control of the pricing.

Running winners

Harry believes in being a patient investor, the average holding is around 5 years. Some have been held longer. Hargreaves Lansdown is an example of winners where he purchased at just over £2 a share and these are now £8 a share. He accepted there may be challenges on pricing but this will be a hiatus to the business rather than a show stopper. When the charges become clear clients are unlikely to move and the fees they charge will no doubt compensate them for the loss of the income trail they currently get.

For him this is a long term winner which is here to stay for the long term and has the potential to be larger in terms of market cap than some well-known insurance companies.

Management longevity

Management longevity is crucial of the top 20 companies in the fund 17 CEOs or founders have been on the board for 10 or more years. Most of the businesses have little or no private equity money. This stability is an important part of the mix.

Valuation

Harry sees valuation as secondary, shares can be cheap for a reason could be a profit warning or dividend cut. If the factors are right and it is cheap then that is just part of the overall mix.

In summary Harry has been successful with the strategy in the UK and the team have delivered a success strategy in Europe. The new global strategy opens up a greater opportunity set and the ability to be involved with tomorrow's companies today. Examples of this would be <http://kakaku.com/> which is a Japanese price comparison site or Cosmos Pharmaceutical which is a value for money convenience store in Japan.

Conclusion

The Standard Life GARS Fund provides a good alternative in the fixed interest space to drive down volatility and we see no reason to change that strategy. The opportunities in the global smaller companies space provide opportunities in some of the portfolios and this is reflected in the blend. The income strategy provides a good blend and looks to seek alternative means of delivering income in the UK.

The source of information in this note has been provided by SLI and is correct as at 1 March. 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.