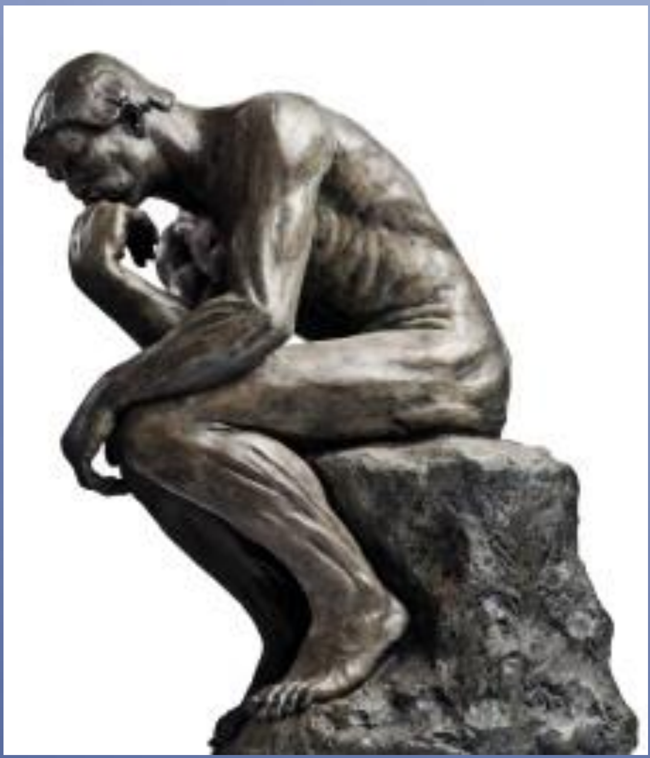

Fund Bites

Somerset Global Emerging Markets Fund

The Somerset Global Emerging Markets Fund is being added to the Portfolios from July. This “fund bites” is our research on the fund, and includes notes from meeting the fund manager.

Introduction

With high profile Emerging Market and Asian Funds reaching fund flow capacity we have been for some time researching the options open to clients. This research has identified some excellent funds which perhaps don't contain the usual household names within their portfolios.

However, one of those options is traded on a weekly basis so currently cannot be used by clients and others are Dublin Based. With the later we are confident that Dublin Based Funds will be available in time for the 2014 / 15 Portfolio Rebalance.

One name we have come across a lot is Lloyd George who are specialists in Asian, Frontier and Emerging Markets. From this boutique management house we have seen managers set up Asian Specialist Funds at JOHCM and in our latest review Emerging Market Specialists at Somerset Capital Management LLP.

Somerset Capital was founded in 2007 by Edward Robertson, Dominic Johnson and Jacob Rees-Mogg as a specialist Global Emerging Markets investment management firm. Over time the firm has grown to 23 members of staff with 11 investment managers and analysts based in London and Singapore. The firm manages $609 million in its Emerging Markets Strategy and is looking to cap its total investment at $2.5 billion.

The partners and associated partners have a proportion of their wealth invested in the funds and part of their discretionary bonus is paid into the strategies. This means that their wealth is aligned to investor's wealth.

It is very clear what this fund aims to achieve and therefore in what markets it will perform at its best. The aim is to significantly outperform against the benchmark over the market cycle.

The strategy was launched at a time when the markets faced meltdown and this impacted on early performance. Since 1 January 2010 it has consistently outperformed the benchmark.

We asked Edward why the fund had underperformed in 2009 and what lessons had been learnt from this. In 2008 the fund was overweight Russia, going into 2009 it moved to a more defensive position and by doing this missed the early rally in quarter 1 2009. It is clear in a market like 2009 the fund will underperform but as Edward admitted he would not expect it to underperform by such a margin.

Clearly he has learned from this experience and with a similar market in 2012 the fund performed on par with the benchmark.

In analysing funds, managers will underperform but we need to understand the reasons for this. We believe that the size of the fund, the strength and specialism of the team will drive the performance going forward and clearly this has reflected in the performance since 2010.

The Fund

So what is it about the fund that is different to other funds that are out in the market?

Firstly Somerset is a pure Emerging Market (EM) specialist. They believe allocation to EM Equity is still relatively low in relation to global allocations to developed markets and therefore they expect this to shift over time. They also believe that EM markets provide more varied opportunities than the developed markets.

This is a conviction based fund with a portfolio of between 38 and 42 stocks. This is a lot smaller than a lot of funds out in the market.

The key to success is what they call forensic analysis which is what I like about the fund.

They are very clear where they are looking and what they are looking for. The types of stocks are mainly Mid Cap Stocks with market cap above $1 billion but it does invest in Large Cap as well. (36% Mid Cap, 30% Mid to Large Cap, 15% Large Cap and 13% Mega Cap).

The focus is on the downside risk, and through this it is clear what they like. So companies which:

- Have low debt to equity or high cash to assets
- Higher equity as a percentage of total liabilities
- Lower sensitivity to foreign exchange volatility or interest rate volatility

What they mean by forensic analysis is the process by which they keep reducing down the available stocks until they have a core of stocks. This is where the deep analysis begins and involves company analysis and visits. The stock turnover is low so it enables them to create strong relationships with the companies they invest in.

The fund is split into two – core stocks. These are quality companies with sustainable earnings (stable quality) combined with strong profitability and free cash flow which allows for sustainable earnings growth. This currently makes up around 53% of the fund.

The second area is satellite stocks which are quality cyclical companies at attractive relative valuations (cyclical quality). These are strong franchises which allow for future earnings and growth prospects. This makes up around 36% of the fund.

For satellite stocks they expect the competitive advantage that these businesses show to come through once a more positive economic environment returns. Holding period tends to be less for these stocks but still around two years.
Core stocks tend to be more expensive and held for longer time periods.

This is a stocks picker fund making up 70% of the holdings but there is a macro overlay which accounts for about 30% of the decisions.

Weightings are around 2.5% and tend to be trimmed back if they reach 5% so no one stock dominates the fund. This is very much a team driven approach although the fund manager, Edward Robertson, makes the final decision. He works closely with Eric Tan who is the co-manager based in Asia. There are also weekly investment committee meetings to discuss holdings. Where stock holdings have dropped below 2% or risen above 3.5% this triggers discussions around whether to buy, hold or trim.

We covered some stock examples, for example Semen Gresik is the largest cement producer in Indonesia with 43% market share. The market is dominated by three companies. It has the highest profitability rates of the three companies. We went through the original reason for purchasing the stock and the potential upside but like Lloyd George the risks are also highlighted. Since the stock was purchased the report has shown hold and reduce periods. The reduction was recommended on the basis that the shares had reached fair value.

Another example is M Dias Branco which is the largest manufacturer of branded cookies, crackers and pasta by way of volume in Brazil. It has recently completed two acquisitions and has a market share of 25.6% in Brazil. The second largest player is Nestle at 8.9% and Kraft at 7.2%. There were opportunities to expand in other areas of the country where it has a much lower market share. It has strong network distribution with Brazil which puts it at a competitive advantage. The upside for the company was seen as good but the risk was being priced out by international brands.

During the holding period the stock has been trimmed back where it was trading at a fair value.

Clearly the focus is about protecting capital but at the same time not losing sight of opportunities.

This then turns to the performance of the fund. As at the 31 March 2013 the fund had returned 98.36% against a benchmark of 110.22%*; this is important because when we analyse the performance we can identify periods where the fund will underperform.

These tend to be periods where the market is overheated and valuations excessive. So the fund expects to perform well in most market conditions. If we analysis the performance in 2009 when QE1 came through the benchmark performance was 61.12% and the fund returned 36.82% which reflects the periods when they will underperform. In 2012 with LTRO again the fund did slightly outperform the benchmark but not significantly. Knowing this means that we can blend the fund with others that perform better in this type of market.

*Source: Bloomberg. The fund inception date is 17 November 2008. The index is the MSCI Emerging Markets Index with net dividends reinvestment. Past performance is no guide to future performance and investments can fall as well as rise.

Picking up on the first point we discussed whether EM still has the ability to deliver i.e. are they now maturing markets. Edward believes they have some way to go. For example, many EM countries are similar to the US of the twenties. Over time the US have developed a good legal and tax system which many EM economies do not have.

Also manufacturing is still laboured intensive and only now are the likes of China investing in machines to replace people.

This chaotic muddle shows through in the likes of rich asset countries like Argentina and Venezuela who have almost taken a step backwards. Ultimately with a conviction led portfolio although the macro situation is important Edward argues that there are always good companies which are cheap. Of course there is danger. They recently sold out of a Chinese designer brand who had some low level corporate governance issues.

So although some economies appear to be maturing they still have some way to go.

Conclusion

Change brings opportunities, with the soft closure of some key funds it means we can look deeper and discover hidden opportunities. This fund is one of opportunities.

It comes with risks as Somerset focus on one thing, Emerging Markets and nothing else. But equally it comes with opportunities. The team have come out of Lloyd George and have extensive experience in investing in Emerging Markets. This is why we believe this fund is an excellent replacement.

The source of information in this note has been provided by Somerset Capital Management and is correct as at 20 May. 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.