

seeking out the fundamentals

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Derek Stuart explains his approach to stock selection and how it allows him to uncover 'special situations'.

Stock selection? A robust business franchise should be a prerequisite of buying any share. Then it is down to the judgement of the fund manager or investor. He or she must determine the absolute value of a company, and hence the potential rewards, before mainstream investors turn their attention to it.

Investors need to understand the inherent value of a business and the upside that a particular management team can deliver. The reward is recovery in the earnings of a stock, as well as a re-rating. This is the opposite of picking stocks for much broader reasons. Forecasting macro-economics is not only incredibly difficult: it is also wrong as often as it is right.

A key to the right outcome in stock selection is an understanding that 'value' in stocks is not enough. Today many stocks are still not expensive, even after the remarkable run since March, but many are not yet cheap enough. In this demanding economic environment, many will go bust – and get cheaper still.

focus on fundamentals

So, special situations managers do not restrict themselves to 'value' or 'growth'. Instead, they pick stocks on their fundamentals. The portfolio reflects different stages of the economic cycle.

The managers spend most of their time meeting companies' management, and trying to identify the people who can change businesses and improve returns.

A key aim is to identify businesses which, although fundamentally sound, have been through a period of disruption or poor trading. Often these situations require new management. So an important element to the investment case is a degree of self-help. If much of the expected return is based on what the management can control, rather than on the vagaries of the economy, then returns become more realistic.

understanding the risks

Thus the prudent investor must choose stocks with great care. On what criteria? A very important one is debt. It is essential to understand the dynamics of a company – the risks. For instance the combination of operational and financial gearing is the 'death spot' for companies. Financial leverage is fine in a company with predictable cash flow. It is very dangerous in a company with a more cyclical earnings stream. So special situations managers spend a lot of time on a business cash flow and balance sheet. By focusing on the downside risks, managers hope to avoid the 'torpedoes' that really affect a portfolio's performance.

This said about debt, canny investors realise that the exception can be as important as the rule. A good example of this is Ashtead, an equipment hire company operating mainly in the US. It is a very operationally geared business that is going to make no money over the next couple of years. But what it will be doing is generating at least £100 million of cash in that period. Although it does have debt, it has got very sensible covenants which were put in place by a management team that understood the nature of the cycle. So they are not going to have the banks banging on their door and making life difficult. Meanwhile, US construction is an area likely to be first out of this recession. Also, hopefully, it will benefit until then from the US stimulus package. So, operational gearing can work very nicely for companies. But it is important to understand what the downside risk is in all these things.

good prospects

In the current climate, similar 'special situations' abound. 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 good example is Debenhams, whose recent fundraising not only improves its balance sheet but also gives the management money to exploit the problems within the retail sector.

By contrast with Debenhams, a number of companies asking for re-financing have business plans that say: 'Give us some money now and the economic environment will change in 2010 and we will boost our profits that way.'

Typically, those are the kind of companies that most prudent investors will turn down: invest in a company per se, and do not take risk on the economy. In the short term, such stock selection – or rejection – can be wrong. A lot of these companies have gone on to produce very strong share price performances, even though they still do require a very, very strong economy next year to bail them out of the situations they are in. The unconstrained investor just has to stick to his or her conviction in such situations, even if that is painful over the shorter or even medium term when sentiment is driving markets up – or down. ●●

some special situations

Close Brothers

A classic example of a 'special situation' is the banking group Close Brothers. Bid approaches in late 2007 and early 2008 prompted a re-think for the group. Close has been refocusing quietly under strengthened management, favouring more stable lending and wealth management over volatile, transaction-related activities. 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 yield.

London Stock Exchange

Another example is the London Stock Exchange (LSE). With Clara Furse as CEO, the business was struggling. It was the subject of a number of hostile bids and Clara Furse missed her time sending these off. As a result the LSE lost its way.

It now has a new CEO, Xavier Rolet, an ex-banker who understands what his banking customers want.

What is also attractive about this company is that the shareholder base is irregular. Following the bid activities of last year, it has Kuwaitis and Qataris on its register and a number of Italian banks, following the purchase of the Italian Stock Exchange by the LSE. That means the shares are under-owned in the UK, which is something investors can exploit.

These are just two of many UK companies whose potential is great. In these testing times of corporate Darwinism, some companies will not just survive, but will thrive. The job of the fund manager, whatever the overall economic environment, is to tell these two categories apart.

Derek Stuart co-manages the Artemis UK Special Situations Fund.

The Artemis UK Special Situations Fund is available through the Skandia Investment Solutions platform and Skandia's Life and Pensions fund ranges.

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