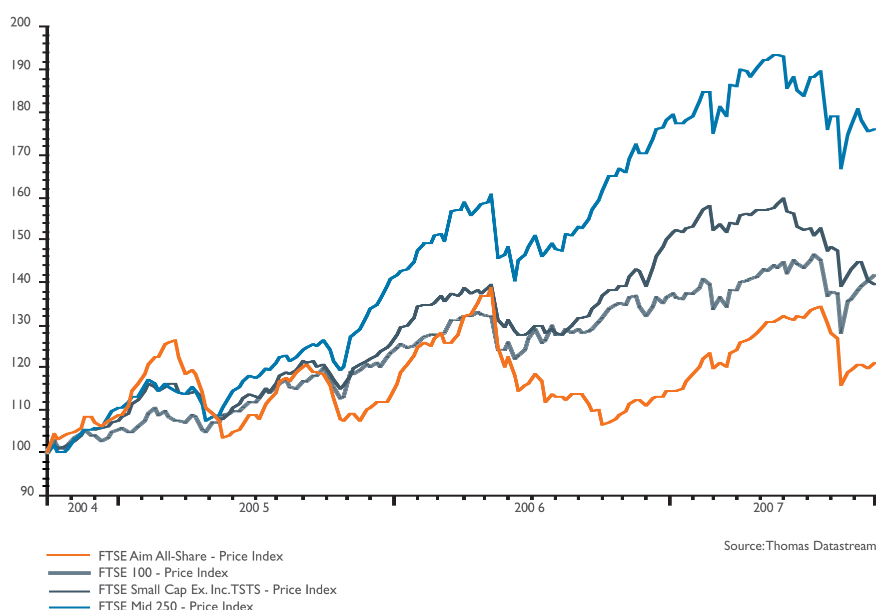
UK DYNAMIC - PERFORMANCE DELIVERED THE HARD WAY

by Neil Pegrum

I joined Cazenove Capital in August 2004 with a brief to launch a new product for our Pan European range namely Cazenove UK Dynamic. At the end of September 2007, the Fund completed its first three years, and this is a therefore an opportune moment to check on our progress, and the main issues now facing equity investors.

On a top down view the best sectors have been mining and oil E&P stocks and FTSE 250 mid caps generally. If an investor had been overweight these areas then his stockpicking would have had to be poor to underperform. Mining has been driven by strong demand, rising prices and constrained supply – an extremely supportive background. The strength in mid caps reflects several takeovers, earnings growth that has outstripped the FTSE 100, and the very shape of the index (there has been very little crossover with the duller sectors of the FTSE 100 namely pharmaceuticals, banks and the integrated oils).

Our performance has been delivered the hard way, as the Fund has been consistently underweight the FTSE 250 and has had nil exposure to mining/oil E&P. This decision should not earn us plaudits but will hopefully reassure investors that we can stock pick from some of the less exciting areas of the market and still do well; and there has been no worse area than AIM as the chart demonstrates.



Certainly AIM has become a dirty word, and while we are not apologists for it, and will pragmatically seek value from any listed UK equity, there are reasons for thinking that the adverse publicity has been overdone. Not every stock is like Torex, though stocks that implode are great for newspaper column inches and headlines.

At the risk of making a huge generalisation, AIM can be viewed in two parts. The first is a number of solid UK companies, producing excellent earnings and dividend growth, and which would very clearly not look out of place on the Full List. Our opportunity having identified such stocks is buying them at a valuation discount to comparable companies on the Full List. Important contributors to the Fund have included:

IX Europe – a leading provider of datacentres, recently acquired by a US company.

Cape – an international provider of scaffolding and ancillary services to demanding end user sectors such as nuclear and oil & gas.

Plus Markets – the former OFEX, now emerging as a fledgling challenger to the LSE itself, as MIFID changes the regulatory background.

The second area can perhaps be best described as investment exotica. Russian oil, online gaming, Indian film distributors, Chinese citrus plantations, Bulgarian property, Ukrainian dairies are a few examples of the sort of businesses that have listed on AIM. This is not to say that there haven't been real winners in such areas. However we find it hard to get real investment conviction when looking at such businesses, not understanding the business background sufficiently. Moreover if anything does go wrong, then liquidity in the stock will evaporate, and it is a lot harder making the trip to Kiev than Birmingham to perhaps try to sort out the situation. So this is an area that we have largely avoided.

What can we say about the forthcoming period particularly following the market turbulence of the summer?

- We have not experienced a very significant correction in equity markets, especially considering the run since Q2 2003. The correction has been nothing compared to October 1987. We have got (too) used to very decent equity returns.
- Higher volatility is likely to continue in the short term (which I admit is hardly a heroic prediction).
- Debt has been excessive, far too cheap and freely available. Such excessive levels will not be rebuilt in a hurry. This has a number of implications. Private equity may have substantial uncommitted funds, but the supporting debt will be much harder to arrange. Banks are likely to be far more parochial in their lending. In addition some of the more adventurous hedge funds are unlikely to releverage, and indeed may use any rallies to reduce leverage further
- The ultimate impact on the real economy is unclear, but the most bullish scenario is that the background for corporate profits has deteriorated a little.
- While I hate categorising stocks, growth rather than cyclicals are likely to be the more interesting area, with consumer related businesses particularly susceptible (though expectations here are already low). The bigger test will be if corporate spending slows, of which there is clearly a reasonable risk. Finally slowing western economies should have some impact on developing economies and ultimately even commodity prices. At some point it will not be right to own mining stocks!

This makes it a challenging period for stockpicking but one in which we feel comfortable given the hurdles we have faced to produce the returns over the Fund's first three years.

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