SVM UK Absolute Alpha Fund
Conference Call with Colin McLean
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Presenters

- *Hugo Huggett*
- *Colin McLean*
- *Mark Noble*

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Hugo Huggett: Hello. Welcome to the SVM UK Absolute Alpha Fund Conference Call. As you just heard, I'm Hugo Huggett. I'm joined today by Colin McLean, the Manager of the Fund, and of course, the MD and founder of SVM Asset Management, and by Mark Noble, who many of you may know as their Head of Sales and Marketing. The SVM UK Absolute Alpha Fund was launched 10 weeks ago, so it's approaching its First Quarter end, and Colin today is going to talk about first of all, how he sees the market, and then the opportunities, and how the Fund's portfolio is positioned to exploit these opportunities. This call is going to run for probably about 20 to 25 minutes, so please do submit questions throughout the call. We'll take them as we go along, and if not, we'll try and address as many as we can at the Q&A session at the very end, but before I hand over to Colin, Mark Noble is going to take just a few minutes to remind us what the SVM UK Absolute Alpha Fund is trying to do.

Mark Noble: Thanks, Hugo. Yes, I just want to spend two minutes, just to remind you what the SVM UK Absolute Fund is, what it seeks to do, and now, what platforms investments can be made through. The SVM Fund is a very clear, single strategy fund. We make investments in UK equities; both long and we sell short. This means that we can basically profit from exposure to stocks that we think will rise, and also from those where we think the value may fall. Colin has been running long/short portfolios since 1992. SVM itself has been running long/short hedge funds in our own name since 1998. One of the things that differentiates us from many others in this space, certainly in the UK retail market, is our ability to take a tactical approach. We don't seek to always be market neutral. There are times when we will have a greater number of short ideas, and the portfolio will be net short, and consequently, in other times, there will be periods when the portfolio will be net long, simply reflecting a greater number of high conviction long ideas. Colin will talk to you later on about the current position of this Fund.

We have two risk managers that ensure that Colin is fully aware of the risks that are being taken within the Fund, and how the Fund is performing in real time, and we think that that is quite important, to ensure that we always understand how the Fund is positioned. The Fund was launched, as Hugo said, around 10 weeks ago. We've now attracted just over £18 million of investment, so we're delighted with the level of support that we're achieving and this is primarily from the UK retail market. Very quickly, now, I'll move on to what the objectives of the Fund are. This is in the UK, in the Absolute Returns sector space, and therefore, we have to have an objective we feel, that merits being in that area, and quite simply, we're seeking to try and make money for investors, over and above cash, over any 12 month period. Achieving that will mean that over three year periods, we're likely to substantially out perform cash, and so for the slightly longer term, three years, that is our second objective. Finally, we have an objective which we think is probably more important, and that is – this is an equity fund, albeit it has the ability to prosper in both rising and falling markets. That ability means that we'd hope to be able to capture sufficient of the upside to mean that the Fund can deliver some very attractive performance in rising markets, but protect in periods where the market can fall, and over the full equity cycle, we believe that we can deliver better than the overall equity market; again, making this fund rather attractive to those who are long term investors in UK equities – particularly for SIPP investors, and those who have got a requirement for capital at sometime in the future.

Very briefly, the Fund is available now on a very broad range of platforms. Obviously, the more popular FundsNetwork and Cofunds, where very early on in the Fund's launch we were available, but more recently, the Fund has been included on the Selestia Platform for all of their product lines, and for the Skandia Life and Pensions products. That has opened up quite an interesting area of business opportunity for us. In the last couple of weeks, Standard Life have now included the product within their core list, on their Wrap structure. Our charging structure is relatively attractive – well, we think it's very attractive, in that we try to make sure that we have got a charge structure that appeals to any IFAs business model. At the moment, on our Retail Share Class, we're paying initial commission up to the front end charge of 5.25%. This can obviously be rebated back to the client if advisers are keen to waive that front end fee. On the retail share class, we pay a 0.5% trail fee as a standard.

When we look down at other business models, where IFAs or intermediaries are looking for a very clean structure, we also have an institutional share class, which currently is available with an AMC of 75 basis points, and investments can be made without a front end charge, and this makes it ideal for platforms such as transact, or some of the newer Wrap structures, where a clean product line – a clean charge structure – is appealing. With that, I'm now going to hand over to Colin, who is going to give a review of the market, and how the Fund is performing.

Colin McLean: Thank you Mark. Good afternoon. I would like to run through some slides, showing how we're positioned, and the market background, and I will be taking questions as we move through that. We launched in early April, and this was as the market was going through this very sharp recovery from 9th March. There has been continued since then, better economic news, but actually, what we've seen from a perhaps – later on in April – is signs of a bit more realism in the market. Although we've seen a strong rally March, April and May, we're starting to see some realism to how company results are viewed. There has been good news, in the form of narrower corporate spreads, and injection of cash, via corporate easing, into insurance companies, and we're also seeing – in industrial companies, restocking going on, which is feeding through into resources, particularly some of the leading indicators – i.e. copper, iron ore. We think that pattern will continue, and indeed, China will lead the recovery in this area, and be the first to pick up in demand. We've seen a sharp rally in financials and cyclical stocks – i.e. we've seen the US Dollar weaken again, having been viewed as a safe haven, through into March, but we're still getting poor data on unemployment, and indeed, deflation continues to be the issue for this year, although there may be more risk of inflation coming through next year.

We move on to just exactly how the Fund is positioned. Starting from the bigger picture, I think the areas that are being stimulated, and it includes not only global demand and restocking in terms of A, resources, but also, the benefits insurers have had from government purchase of bonds through quantitative easing, and the stimulation that's come through into the auto sector – not only through scrappage in the UK, but we're seeing a realignment in Europe and we're also seeing, too, the demise of the major US auto manufacturers, a realism coming in. Undoubtedly, the world is producing far too many cars, but actually, the companies will be more profitable on the smaller number that's been produced from here on in, as this very bad competition, i.e. from the US, fades.

So, there are some areas that I think will continue to recover, although given that the recovery is more led by China resources and developments internationally, in an emerging market, I think there is still pressure on the consumer in the UK in particular, but also across Western Europe. There are some particular issues that I think we can take advantage of, and that includes the fact that some companies have raised finance quite easily in the early stages of the rally, in March and April, but the market is becoming more discriminating now, and investors are certainly a lot less happy to fund the issues that have come along since. We've seen just over the last week fundraisings by Marston, Sainsbury's. Ostensibly companies that didn't look like they needed money, and the market has reacted negatively to that, as indeed companies that seem to be suddenly forced to raise money by banks, like GKN and Drax, so there are a number of companies where the position is changing, and investors are becoming a bit more discriminating now, about what they're going to bank – so the overall picture I think has been a move from euphoria, into recovery with realism.

Hugo Huggett: Colin, can I just interrupt with a quick question that's come through? How is the extreme sector volatility impacting the Fund?

Colin McLean: Well, we have the advantage of being able to run long and short positions, within each sector, so we have kept the overall net sector exposure down quite a bit, not taken big bets on sectors – I think the figures that we're showing there, even with the biggest section being about 7% net long; it shows we're really controlling the risk quite a bit, and focussing fundamentals and stock selection, rather than trying to make a thematic bid.

In a number of sectors, we're seeing good long and short opportunities, so there are consumer winners, for example, and in the auto sector, Inchcape, which distributes, benefits from scrappage and improvement in second hand car prices. Some others say we've had good results from Dixons [A to D], and that's a troubled business, but with refinancing, and with some loss of some competition, quite well placed, but equally, on consumer services, there are some, and particularly in media, and we're going to come on to the actual portfolio positioning in a minute – there are some there where I think the broken models or at least the business models are essentially broken – that they're actually going to be quite difficult to finance, so we've gone past the easy financing into some losers now, who I don't think will be able to get the extra money that the banks are demanding.

In terms of current portfolio positioning, out of our portfolio, there are presently more than 50 companies. We're just showing the larger positions, but the reason we've represented the overall themes that we've got running in the portfolio – during the bull market, a lot of companies were able to manipulate their earnings and growth – share buy backs were one way in which that happened, and flatter growth, but we also had companies over distributing dividends. A number of companies whose growth now is being shown not to be what it was, and whose buy backs have just increased their leverage. We're focussing really on genuine top line growth rather than the businesses which try to achieve gains by restructuring, and there are some companies, undoubtedly, where there's a trade value where there is the potential for bids.

It's interesting – not only have we got some businesses that have taken on finance, and are trading quite well now, like Debenhams, but some of them might be seen in a more defensive area. BAT's is quite an interesting stock. There's been significant underperformance by many of the defensives over the first four or five months of this year, after a strong performance last year, by companies like BAT's, also food retailers, Pharma. They lost quite a lot of that. They unwound the last quarter of last year's relative performance. They're now starting to pick up again, and they look pretty good value. They give exposure to earnings outside the UK, i.e. exposure to emerging markets and BAT's, a yield that's approaching 5%, and a degree of defensiveness as well. So I think investors, not just value investors, but others looking for income and looking for more solid growth, I think are coming back into these sorts of businesses now.

On the negative side, I don't think many would be running short positions in utilities like Drax, but Drax had a credit downgrade last month – has been forced this week to raise money at a discount, and has proved quite an attractive short, as indeed we think the weakening consumer market is going to start to bring some credit impairment through in companies like Provident Financial, and some more problems for others, like easyJet. Challenged consumer businesses are one of the short areas, but in overall, we're looking, even as the market recovers through this year, for the businesses that are not well placed to take advantage of that, and that includes themes like pension fund deficits, which we've seen coming through as a big issue for British Airways, but in fact, there has been disappointing news for a number of others. BT, Rolls Royce, and a number of other companies, have been at the losing end of these pension fund deficits.

If I could just illustrate that with a couple of examples – Pace is the top TV Box manufacturer. It's a business which share price was really left aside in last year's bear market, but it's been recovering strongly since it entered the portfolio, helped initially with some refinancing, but it's now clearly positioned to exploit quite rapidly, increasing demand, and investor's negative use, based on previous management, are being corrected as they capitalise on this demand pick up. The counterpart to the strength I expect to continue in resources, against a background of a weak US Dollar. It's putting pressure on some travel companies, i.e. airlines, bus companies, and other travel businesses are suffering from some consumer pressures now, and indeed, easyJet has rather over ordered in terms of its future jet supply. There are a number of companies, surprisingly, in the market, that are premium rated, although they do have a degree of economic sensitivity, and I think we're going to see that coming through in the course of this year.

If I could move on to the overall portfolio positioning – I think many would be pleased to see in the current volatility that we're reasonably neutral at present, although the absolute net market exposure is just marginally net short, but that's Beta adjusted for the likely sensitivity to market direction. We're still slightly net positive, overall, which is mainly by a focus on specific resource businesses. Interestingly, in the resources, there has been M&A activity, and we have seen bids and bid approaches from the Chinese, amongst others, for some of the oil and gas companies, so we think we're quite well positioned there. The portfolio is about half invested at present. We're moving towards – in the space of the next quarter, by fully investing, which will take us up to between 90% and 110% gross invested, but that will be done steadily, adding on some more positions, against a volatile background – we run quite gradually.

I could move on from here to the investment outlook. It's not a simple one of whether the economy or markets are going up or down from here, because I think there are winners and losers emerging.

We've had a very sharp sell off in markets in 2008. We've seen an unprecedented stimulus of liquidity injection and easing by Western economies and still seeing some growth in the Far East. I think that will see equities higher in the course of the year. I think a number of investors, not just conventional investors, but some hedge funds too have insufficient exposure to the more sensitive areas of that.

But against that, unemployment will remain high; it's going to cause problems for consumer sectors and also surprisingly for some other areas where deflation is bad.

Deflation is adverse for utilities and some others who can't pass those costs on through their pricing.

I think there's still going to be a problem of unemployment slowing that recovery down and of some more troubled businesses – business models that are broken and those that can't justify re-financing, struggling to exploit this; while undoubtedly the strong businesses like HSBC, BAT's and other businesses that are well placed and strong businesses, will come through this stimulus quite well.

So I think although inflation risks are building up in the future, deflation is still the main risk just now and the unemployment figures, I don't think have come through yet to the extent they will in the course of this year. So I think it's important that we position the portfolio to recognise that there are short opportunities in some areas exposed to unemployment and this year's problems, while there will be some winners as growth comes through next year.

Hugo Huggett: Colin, we have a couple of questions that are coming through; as we draw towards the end of Colin's presentation, please do - on the screen you'll see there's a 'questions' tab, if you select that you can quickly key in a question, we will then see it and hopefully address them all. But we've got a couple that will be appropriate to put to Colin now.

Firstly, does the recent set back in the market, tell us that the outlook now has really deteriorated?

Colin McLean: I think bearishness is almost a consensus view now. I think there is a degree of caution and cynicism perhaps, which I think is too broad, too widespread for the news we're getting through from companies. There is still a concern, particularly on some of the financials. We have seen some defaults, California in the US, which I think will feed through to some problems in mono lines, akin to the sort of problems we've seen in previous years. It's not going to have quite the problems of previous years, but it may be more of an issue for the banking sector and highlight just the potential for some further impairment to come through. So the market will have to face some actual company results; face some further bad news from banks.

But against that, the actual economic news – we've even had over the last week, has generally been favourable. We've come from quite a low stock position in many industrial companies. So we're really moving through, what I would see is quite a traditional stock re-building start to a cycle. That's certainly going to carry through into industrials. I think there's a danger of perhaps really just too much into a very short term market setback. I'm certainly moving to look to position ourselves as the year progresses more net long.

Hugo Huggett: Thank you. Related question: If there is another leg-down in the economic climate, how will that impact the Fund do you think?

Colin McLean: I think we have a number of short positions, which are exposed to businesses that will be extremely troubled if we have that leg-down, who really will have trouble re-financing and accelerating problems with pension fund deficits. I think we're quite well covered there. I would say for the market, if it does move down, not necessarily and test the lows of March 6th, but I think if we move down below about 4,100 in the FTSE, I think there are some sectors that are seeing the constituents test low, as the whole market has been testing lows, but there are some individual areas that are testing lows just now. There are short opportunities and we're trying to make sure we cover that downside with those shorts and particularly looking down on some of the medium size or smaller companies that have had real trouble over the last couple of years.

Hugo Huggett: Colin, thank you very much. We're about to move onto the question and answer session; but just before that, Mark I think you have a few words, a few final words you'd like to say.

Mark Noble: I just wanted to thank everybody for the support that you've given us. We're raised over £18 million and we've got a very steady flow of money that comes into the Fund every day. It's down to you who are supporting us, so thank you very much indeed; we've been delighted with that level of support so far. Please keep the money coming in. I'll now pass back to Hugo for questions and answers.

Hugo Huggett: Mark, thank you very much. Colin, if I could start by asking what your view is today on UK banks?

Colin McLean: I am still quite negative on the banks, which did have major problems; there were some with very large balance sheets, partly hidden by the way in which the risk-weighted assets. These were banks like Royals, Barclays, Deutsche Bank, UBS and Citibank. The problems of those are not entirely resolved. Politicians have concluded that the public is simply not up and the taxpayer is not up for putting more money into resolve all the problems.

So some of that is being solved by creating an environment in which banks can make a lot more profit just now, which is good. They've been handed quite a gift from the Americans in the way in which the insurance has been paid out from AIG at the start of this year. They've also been able to fudge a degree of their impairment by not marking things to market.

These things will have to come to roost through the next year. I think we will see some genuine impairment coming out. I don't think they'll be allowed to start resuming dividends and obviously some banks, HSBC still pay dividends; but others I don't think will pay. I think there will be more money put into these. So I don't think there's any rush to buy them. I do think the eventual outcome, we have a negative stance and short stance on Royal Bank still at present, I think the eventual outcome will be quite a low level of value, notwithstanding the fact that the conditions in the banking sector appear to improve, there's two years of losses ahead for it.

What we do like are major banks where they enjoy…government support really is national champions, HSBC, Reserve Bank in Hong Kong, BMP in France in much the same. I think those are winners out of this. But there are many other banks and including those around peripheral Europe, which are going to represent another two or three years struggle to support.

Hugo Huggett: Thank you. Another question. Is it easier, or how easy is it to short stocks in Europe?

Colin McLean: That's interesting, because the environment has actually improved quite a bit. Probably at the market lows as we entered March, short positions were quite high in many stocks. In some areas, house builders, some industrials, perhaps as much as 20% of the issue was shorted. That's come right back down now. It's interesting, even although we've had warnings in some areas of industrials; short positions are down at quite low levels. Cost of the shorts are down and the actual net short exposure is perhaps 5% or less in many. So I think the environment is actually much better for shorting now. It's not a consensus trade; some people have been so frightened off doing that and it's become an area where few are doing it and yet we're actually getting profit warnings out.

Hugo Huggett: Thank you. What is your time horizon when entering a short position?

Colin McLean: We're generally looking forward to the next results to bring a reality check for companies. We had one, it wasn't a large short, but Michelle fell about 30% last week on disappointing update. I think there is that potential on some of the shorts for an update to cause that amount of disappointment. But we're generally looking for some year term catalyst that will usually be the company's next results.

Hugo Huggett: Great. Do you think technically i.e. do you have a target for the market before the next downturn? Two subsidiary questions: what's your forecast on house prices and commercial properties? A lot there, and answer what you want.

Colin McLean: I think in terms of the market level, it will be quite important as to whether it can support around the 4,000/4,100 level. A number of stocks and indeed some markets have fallen below their 200 a day moving averages; so they don't look in quite as good a technical position as they did a month ago. A number of stocks have fallen below the shorter term moving average as well – 50 days. So that generally does not look good for many of the stocks that have done that. I think some damage has been done to the market, but we'll need to see whether it gets supported around this 4,100 level.

I think on house prices we may have seen a lot of the damage done; 20% falls maybe far enough. Property prices rather differently, there's voids in a lot of High Streets. Some of the property companies have re-financed; I don't think they've raised enough money and it was dependant on being able to make more disposals. A few have been made. But undoubtedly rental increases are not coming through, there are more voids in the High Street and particularly for a property company, say Liberty are much more exposed to the retail sector, I would be quite concerned about them, I think it could be a much longer haul to get value in that area.

Hugo Huggett: Thank you. We have a question on unemployment in the UK. With unemployment levels currently at 7.2%; what is your forecast going forward and when do you think it will trough?

Colin McLean: I think it may not trough until early next year. I do think it will get a bit worse. There's some interesting characteristics of unemployment just now. It hasn't all come through; we're only just starting to see some of the auto sector lay-offs and some of the bank cut-backs. So some of that is just starting to come through now. To some extent, some of the weakness in demand has been shielded, because some older workers are moving back in to supplement retirement pensions; some have been put on part time or lower wage work, so there's more of an impact in demand than perhaps we're seeing from the overall figures. We will see in the summer the new arrival of university graduates and others coming onto that. So there's more will come through.

This time around in unemployment, it's not been focused on any particular sector. We've had in the past in the UK, where we've had a sector turning down. There's usually been a growth area, whether it's government or the finance sector. This time all sectors are hit and across just about every income stratum as well; although interestingly at the lower income bands, they're suffering inflation in food prices where there tends to be deflation for the purchasing of higher income bands. So some of the effects are more subtle than simply looking at the overall employment numbers. But I think there are some reasons why it may be more structural this time and harder to find a sector to pull us out of that sharply.

Hugo Huggett: Thank you. What market cap do you tend to focus on when selecting stocks?

Colin McLean: At the moment I think medium size and larger stocks are attractive and indeed there have been many large cap stocks quite left behind in the rally, not only the tobacco companies for example, but Pharma, food retail and some of the food manufacturing – Lever/Cadbury and others. There's plenty of a liquid attractive large businesses that are running well, that are now at attractive levels and indeed relatively no more expensive than they were entering the fourth quarter of last year. For short positions I prefer, certainly smaller or medium size companies; so we tend to short down at that end, it's less crowded; they're less well researched. More opportunity for us and there are fewer natural buyers for those stocks.

Hugo Huggett: Colin, thank you very much indeed. That draws this conference call to a close. Thank you to everybody very much who participated. Just a final word. We had a lot of questions coming through, I know we haven't answered all of them individually. Mark Noble and his colleagues will endeavour to contact each of you individually and answer questions that we don't feel we've answered fully today. But thank you very much and goodbye.