

# Stripping It Down to Stock Selection

*Simple short term performance is relatively unimportant, according to Lee Gardhouse, the manager of the HL Multi Manager Special Situations fund, as performance is influenced by the style or geographical bias of the manager. That's why, when selecting the underlying funds, his goal is to strip all the external effects on performance until he reaches the core - the pure stock selection ability of the managers.*

## Q: What's the investment philosophy of the fund?

**A:** This is a fund of funds and our philosophy is based on the belief that most returns of the underlying funds are generated not by the skill of the manager but by the style in which they manage money. Once that's stripped out, what's left is the manager skill and that's what we're really looking for.

When we're looking for the managers, our first and foremost goal is to understand what the key drivers of their performance are. We keep the process simple in the sense that we look at individual countries rather than at funds that invest in different asset classes and different geographical regions.

For instance, when we consider the U.K. market, our starting point would be the fund's particular investment style, if it is driven by value or by growth philosophy. Second, we look at whether they invest in larger or smaller companies, in a mix between the two, or in a mix between investment style and market cap. We use a quantitative model to get to the core of why a fund performs in the way it does.

We find relatively few managers able to add value through judicious stock picking. Our work suggests that managers perform well or badly because they stick to a style that comes in and out of

vogue, not because of any particular skill they've got. So our starting philosophy is that there are many external factors that are influencing the fund's performance and as such simple short term performance itself can be relatively unimportant.

## Q: How do you translate that philosophy into an investment strategy and process?

**A:** We've built an in-house manager and fund research program, which tracks the returns of the manager over a long period of time and compares them against different indices. It is country dependent and the program is basically trying to find the best fit for the funds return versus those indices.

For example, most funds don't just buy small-cap stocks; they usually blend different styles of stocks across market capitalization ranges. But if the fund continuously acts like a small-cap value index, then our program would suggest that the portfolio is biased toward small-cap value investing style. Of course, we would check that against the current holdings to see if the fund looks interesting. If we find that most of the time the investment process at the fund is consistent with the investment charter predicted we will organize a meeting with the fund manager.

## FUND FACTS

Symbol	GB0030281066
Website	<a href="http://www.hargreaveslansdown.co.uk">www.hargreaveslansdown.co.uk</a>
Address	Hargreaves Lansdown Kendal House, 4 Brighton Mews Clifton, Bristol BS8 2NX
Tel. No.	0044 117 900 9000
Inception	3/4/2001

## PORTFOLIO

Total Net Assets *	GBP 153.04
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## INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	GBP 2,500
Min Subsequent Investment	N/A
Min Regular Investment	N/A
UK ISA	yes
CAT standard	no
UK PEP	yes

## RETURNS VS. FTSE ALL-SHARE CR INDEX

	GB0030281066	Index
1 Year (Cum.)	14.59%	7.36%
3 Year (Ann.)	18.16%	13.66%
5 Year (Ann.)	8.64%	2.43%

## RETURNS VS. LGC - EQUITY GLOBAL

	GB0030281066	Index
1 Year (Cum.)	14.59%	7.36%
3 Year (Ann.)	18.16%	10.45%
5 Year (Ann.)	8.64%	0.90%

## FEES AND EXPENSES

Initial charge	5.00%
Annual charge	1.00%
Exit charge	0.00%

## PORTFOLIO MANAGER

Lee Gardhouse	3/4/2001
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\* millions

Data through: 31/8/2006

Source: Company Documents



## Q: How long-term is your investment horizon?

**A:** The longer the better. What differentiates our strategy is that we actually track the managers over time. In the U.K. there's quite a lot of turnover

of people moving between companies. We'd piece together their track record and we can re-build manager track record that goes back over 15 years, even if the manager has managed money at five different companies. We believe that it's really important to track the people who make the difference in the portfolio rather than just to look at how the portfolio has changed over time. A lot of the performance fluctuation might be just because the manager has changed.

Within the philosophy, we do actually believe that the individuals that can add value above and beyond their styles are very, very rare. However if you can pinpoint the added value that came through stock selection, the figure itself is quite consistent. The bottom line is that if you're a good stock picker, you tend to consistently add value over time. Your style drives up major out or under performance as it falls into or out of favor, but the actual stock picking abilities of the manager tend to be stable over time. When you just look at the performance tables, you see style and size disrupting the return.

**Q: Once you discern this type of performance, how do you proceed in selecting the managers?**

**A:** The key thing is the stock selection ability, so when we run the funds through the model, we test how much value is being added above and beyond the specific style. When we rank and compare funds, we're also looking at the consistency of added value through stock selection. We measure both the outperformance of stock selection and the volatility of that outperformance. The two combined lead us to whether we are interested or not in this fund.

If we find managers with good stock selection abilities and consistency over a longer period of time, our next job would be to meet those managers and to understand their investment process. We want to know why they've produced these returns, whether our expectations are in line with what he thinks, and whether they've just been lucky or they have a process that can lead to consistent out-

performance going forward. We're not that interested in their macroeconomic views because we believe that the stock-picking area is where they add value.

We also heavily focus on the incentivization of the team, whether the manager or the team own the company. Quite often when you find a relationship that goes beyond being a paid fund manager with a bonus, there's a massive extra incentivization to perform. We believe that there's a strong tie between future performance and how well the individual or the team is rewarded. That's very attractive to us because in such cases they are really after good performance, not after just growing assets.

Of course, if you produce performance you tend to grow the assets as well, but it's about the right balance. If it is all about growing the assets, the manager may be spends too much time on the road selling the product, which obviously isn't good from a fund management perspective. We want the managers to sit at their desk doing their day job. So we're trying to see if the key is performance or the size of assets under management. We're more interested in funds where the manager is incentivized for performance and we often invest in some of the smaller U.K. boutique fund management groups, where if you don't perform, you don't get assets, and you go out of business.

**Q: How many managers do you keep on your radar and how many do you invest in?**

**A:** There aren't that many fund managers that make it through our screening process. Probably less than 10% of the managers that we sift through actually look attractive and worth to be seriously considered for the portfolio. We do have a B list, but when we find a good fund manager we tend to invest with him over a very long period of time. The portfolio turnover is very low and the B list is there as a backup.

Including the fund management division and the research department that is providing a lot of information to our clients, I'd say that we visit between

250 and 300 managers a year. Across all the different strategies, we probably have about 50 managers, while there are about 3,000 funds out there which we could buy. In the U.K. we've got a sector called UK Equity Income, which has slightly higher yielding orientation and we only have 10 managers in that particular strategy. In the Special Situations fund we have about 25 managers.

**Q: What would be a reason to sell a fund?**

**A:** There would be two major reasons. The first one is if the expected stock selection didn't come through over a period of time, and if we don't see a good reason for future improvement. That's the more difficult decision after all the work for finding the individuals you believe are exceptional. Obviously, even great fund managers have tough times so the last thing you want to do is to sell them after a poor period of performance. The other reason, which is an easier decision, would be if we find someone that we believe is better than the manager we currently hold in the same area.

**Q: Do you pay specific attention to tax efficiency when building the fund?**

**A:** Actually, in the U.K. it is different because the tax issue is relatively simple. We pay tax on dividend from equities so we can buy U.K. and European funds sold in the U.K. market and they are taxed in the same way. Very occasionally there might be a fund with tax implications. For instance, if we have bought the HSBC India Fund, any capital gain would have been taxed as income. In those circumstances we would avoid that fund but that's pretty rare.

**Q: What's your approach towards portfolio construction?**

**A:** Our starting point is that the fund is always the purest representation of looking for the stock selection skill and that overrides everything else. We could have run it against an index, such as the MSCI World Index, but we have a different approach. The funds make it into the portfolio based on the qual-

ity and the level of added value through stock selection. So if we find a number of exceptional managers in Japan, then we would have a relatively high weighting towards Japan. The asset allocation is driven by where we find the best managers, not by whether we believe in that market itself.

The underlying philosophy is that we spend no time considering whether Japan will be better than the U.S or the U.K. Our assumption is that over time markets will produce pretty similar returns and, therefore, we're focused on the managers that add value above and beyond their market or their particular style set.

To those ends we tend to have quite a significant overweight in the U.K. and Europe where we find a lot of exceptional fund managers. That's because there are a lot of funds managing money in the U.K. or Europe that we can actually buy. The best managers available to us tend to be the ones that are managing the greatest amount of money and those funds tend to be in the U.K. or Europe.

So the strategy is that stock selection dictates our global allocation but we've made the exception to restrict our U.K. exposure to a maximum of 60% of the portfolio because we want to have a global portfolio. So the fund has always tended to have 50% in the U.K. and the overseas exposure is dictated by the managers we can find in the different regions. The international exposure hasn't actually been beneficial but in times when the Sterling weakens and the U.K. market underperforms, our international exposure will help.

The portfolio has a tendency to invest away from the larger stocks in the market because we find that the advantage of stock picking is not that great within the large areas of the market. Obviously, that's beneficial when mid- and small-cap stocks do well and can be detrimental when those markets shake out. But it is our belief that the managers will add more value by being in that area over time even if in some periods that works against us. Everything keeps feeding back to the idea that stock selec-

tion drives our long term returns and so far that's been the case.

**Q: When you have multiple managers in the U.K market, how do you avoid the overlap in terms of holdings?**

**A:** We actually don't try to avoid the overlap. Fundamentally, if a lot of our managers like the same stocks, and we believe that they're all exceptional stock pickers, then this stock is most probably going to be pretty good. So we don't mind relatively high exposure to a certain stock. In fact, we want high exposure to the stocks that our managers like the most as we see that as a positive thing that gives us confidence in that stock.

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**LEE GARDHOUSE** has managed Hargreaves Lansdown Multi-Manager Special Situations Trust since its launch in April, 2001. Lee holds a BA in Economics from Liverpool John Moores University. He has managed Hargreaves Lansdown's in house wealth management solution since April 2004 consisting of 5,000 clients with assets of £500 million. Lee is an Associate Member of the Society of Investment Professionals.

**Q: What kind of risks do you perceive and how do you mitigate them?**

**A:** The portfolio originally was launched under the name Boutique Opportunities because we tended to invest in the boutique groups. That's still the case and we always want to have at least 80% of our investments in the groups where, as a culture, performance comes through proper incentivization. Quite often, the boutique groups themselves are quite risk averse. They do take risks in their portfolios but the average manager tends to be more concentrated on downside risk.

The large managers that wouldn't get into this portfolio are probably more concerned with tracking error than with absolute risk, while our managers want to massively outperform the index without losing much money when the equity markets go down. The result for our portfolio is relatively low beta during the down market and relatively high beta during the up market. I think that the focus of the underlying managers and the type of groups that we're buying, give us a slight edge on the risk perspective.

We don't necessarily influence the underlying managers and we're not overly controlling the funds from a stock-by-stock perspective. As I said, we wouldn't try to minimize the risk by stopping the managers from holding the same stock. To a certain extent the risk in the portfolio is a byproduct of the risk of the underlying managers and we're not deliberately targeting a specific tracking error; we're trying to generate the best possible returns.

Within its own sector, the U.K global growth funds, the fund has had the second lowest risk since it was launched as a byproduct of the way the underlying managers manage money. Also, we've got enormous diversification. Within the U.K. market we have exposure to hundreds of underlying stocks. Many of these stocks aren't in the big indexes because many of the managers tend to add value outside the main market. With 25 funds in the portfolio and close to 1,000 underlying companies, there's enormous diversification that helps to cut the risk down. **T**