

## Contrarian and Selective

*Sectors and stocks can go in and out of favor, and the market discards companies with longer-term potential more often than one would think. Bradley Mitchell, portfolio manager at Royal London UK Growth Fund, has a core view about an industry and a stock and takes a different view from what the market is doing short term. The Fund takes a pragmatic approach to investing in industries which have attractive returns and are growing revenue and earnings*

**Q: What's your investment philosophy?**

**A:** We take a pragmatic approach and we like to invest in industries which have attractive returns and which are growing both revenue and earnings. Whilst there are well managed companies in the industries that are shrinking or have historically low returns, we believe that over a longer period of time, financial returns of industry leaders converge to the industry returns and these companies do not generate wealth for shareholders.

We like to find companies where we have a clear view about what the management wants to achieve and how they want to achieve it. We are reluctant to invest in highly acquisitive companies that are serial acquirers and therefore you can't measure the health of core business. We shy away from companies that are highly aggressive in their acquisition accounting.

**Q: What are the key elements of your research process?**

**A:** We have an active policy of meeting companies. We try to learn about management, long-term strategy and business fundamentals. During the reporting season

when companies are visiting investors and making presentations we rarely get a chance to learn longer-term aspects of managing the business and industry fundamentals. However when we visit companies our discussions tend to be more focused on the business and where the management wants to be in five to ten years from now than on what is reported in the latest quarter.

**Q: How do you go about finding ideas?**

**A.:** Sectors and stocks can go in and out of favor. When stocks and sectors are out of favor, we look at the fundamentals of the company and decide if we agree with market assessment. If we find a value and if the stock meets our criteria of the long-term health of the business, then we analyze at the company in detail. We do not believe that market always discards companies with longer-term potential but it does happen more often than one would think.

**Q: Can you give an example of how you put your core investment beliefs into practice?**

**A:** The oil service sector is a good example. I think the companies in



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**“We like to find companies where we have a clear view about what the management wants to achieve and how they plan to achieve it.”**

the sector will have sustained earnings for the next three to five years. If you talk to the large oil companies about the short and long term outlook for the oil price, you can get a slightly different story from them. But the consistent story you get, whether you are talking to BP or Shell, is that they cannot spend enough money to find and process oil. The constraint they face is not how much cash they can generate to fund capital expenditure, but it is the lack of engineering human resources, the lack of additional drilling equipment and the slow pace of refinery upgrades. That tells me that the pricing power in this industry lies with the engineer and not with the customer, whereas if you were talking about most normal engineering companies they rarely have had pricing power.

In recent months, when the oil price and the share prices of large-cap oil companies have been going down, that has led to a sell-off in the oil service sector. In our view this is an excellent opportunity to add positions in the oil service sector, because the fundamental need to expand capacity has not changed and bargaining power is still with the oil services company.

**Q: Do you look to find mid and small-cap companies or do you generally look across all spectrum of the capitalization?**

**A:** It's good to find small and interesting companies that have exciting potential but we don't want to fill the portfolio with too many of these because you then become hostage to any size bias within the market. Liquidity is also an issue in terms of trading out of any position which doesn't go according to expectations.

**Q: Can you give an example of such a holding from your portfolio?**

**A:** GTL Resources is a small company we have been holding this year. It's only quoted in the UK and all its operations are in America. They are building a large bio-ethanol plant in Illinois, so there is a conversion of corn into ethanol. In America, there appears to be an industry level effort in generating alternative energy sources that can be environmentally friendlier.

In my estimate the company will take 12 to 18 months to generate sufficient earnings to justify a much higher share price. That is the time horizon that I'm working on for this investment.

**Q: Do you like to anchor your portfolio with larger names and then build satellite holdings of these small and mid-cap stocks?**

**A:** I am not rigidly committed to any market cap in the portfolio. Opportunities come in at all market cap levels. At the moment the firm has a heavy weighting in the larger companies, but that reflects current attractive valuations, that seems to be common in the UK market that is also the case with sectors that we are exposed to.

If I felt there was value in the mid to small-cap market, if I felt that the market sentiment was likely to move in that direction, then the fund would quite quickly change its view about the relative weight that would occur.

**Q: How is your research process organized? Do you prefer technical research or fundamental research?**

**A:** Let's look at Tate and Lyle as an example. At the beginning of the year, all the attention at Tate and Lyle was on Sucralose, which is an artificial sugar. They have a large customer base for the product and very high patent protected, operat-

ing margins. But the concern in the market is how long those excessive margins can last.

I looked at some of the less exciting sides of Tate and Lyle's business. They are a large manufacturer of High Fructose Corn Syrup, (HFCS) which has been an unappealing market to be involved in as there have been far too many manufacturers of HFCS operating at below optimum capacity. They had no pricing power, margins were low, profits were going sideways and this was regarded as a deeply unattractive business, both in terms of the profitability and perceived earnings quality.

However I thought that this could be an interesting market to be in going forward because we were seeing operators leaving the industry, so capacity was reducing. We also had a high natural sugar price and customers of corn syrup can either buy corn syrup or sugar and if the price of sugar is going up, then they'll switch to corn syrup.

Our research on Archer Daniels Midlands which is very much involved in this industry, revealed to us that this industry is set for better days. With that research and insight we bought shares in Tate's. We were hoping for the price of corn syrup to start going up. A small change in the corn syrup price would lead to a large increase in Tate's profits. A re-evaluation of the medium term growth rate for HFCS revenues would lead to a re-rating of the shares on the back of upgraded earnings.

**Q: How do you go about building a portfolio?**

**A:** There's nothing revolutionary about what we do. The fund has around 65 holdings, which is a little less than it had at the start of the year. We select companies

based on fundamentals and if that leads to concentration in a sector we do not mind it.

We measure ourselves against FTSE All Share Index. There are around 650 stocks in the index and there are about 65 in the portfolio. So 90% of the companies out there don't make it.

### Q: What are your buy and sell disciplines?

**A:** An ex-colleague used to say, every morning, when you turn on your computer you're buying your own portfolio all over again. Every morning you say which stocks and their positions in the portfolio you are comfortable with. And if you can't be happy about every position or every stock in your portfolio, then you should consider selling it. So I do try to be tough on stock losses and on using the sell discipline. I think it's a good discipline to have.

For example, we bought a holding in Countrywide Properties, the estates agent. We bought it for two reasons – first, we felt that it was a far better business, operating in a far stronger market than the stock market was prepared to give it a credit for. The other reason was that there was going to be a change in legislation in the UK about how houses are sold. Countrywide was extremely well placed to take advantage of that.


What happened was that at the very last minute the government decided to abandon the change in the law and the shares fell 10% on the day of the announcement, which was quite painful for us.

What we did is we looked at the company again and asked ourselves whether we would want to buy the shares just on the industry fundamentals given the cur-

rent share price despite the falling shares and the change in the law. And the answer was 'yes'. To us the business appeared robust. The short-term outlook is very buoyant, that at this share price it's a buy though it may be a while before the market gets over the disappointment of the change in the law not taking place.

We also had a meeting with the company and not only were they quite unhappy with what the government had done, but we felt that if the stock market didn't properly start to value the company then the company would do something about that themselves. So instead of selling the shares we added to our holdings. And the company then announced they were going to take themselves private. That's a perfect example of reassessing a stock and recent changes in business environment and then taking a decision.

### Q: What kinds of risks do you monitor and what do you do to mitigate them?

**A:** A lot of our risk control is common sense. We have limits in terms of the overweight and underweight in our holding in relation to the index. We tend not to go above 2% either side of stock and 5% of sector allocation in the FTSE All Share Index on an individual stock. This guideline covers 99% of the likely outcomes in terms of building this portfolio and managing portfolio risk. 

## Royal London UK Growth

Symbol	<b>GB0007557084</b>
Fund Type	Unit Trust
Website	<a href="http://www.riam.co.uk">www.riam.co.uk</a>
Address	Royal London Asset Management 55 Gracechurch Street London EC3V 0UF
Tel. No.	0044 (0)20 7506 6500
Inception	23/6/1981

<b>PORTFOLIO</b>	
Total Net Assets *	GBP 102.35

<b>INVESTMENT INFORMATION</b>	
New Investment	Open
Min Initial Investment	GBP 1,000
Min Subsequent Investment	N/A
Min Regular Investment	GBP 50
UK ISA	YES
CAT standard	N/A
UK PEP	YES

<b>RETURNS VS. FTSE ALL-SHARE TR INDEX</b>		
	GB0007557084	Index
1 Year (Cum.)	12.87%	11.10%
3 Year (Ann.)	15.76%	14.58%
5 Year (Ann.)	6.64%	5.44%

<b>RETURNS VS. IMA UK EQUITY INCOME</b>		
	GB0007557084	IMA UK
1 Year (Cum.)	12.87%	14.40%
3 Year (Ann.)	15.76%	16.83%
5 Year (Ann.)	6.64%	9.22%

<b>FEES AND EXPENSES</b>	
Initial charge	4.00%
Annual charge	1.25%
Exit charge	0.00%

<b>PORTFOLIO MANAGER</b>	
Bradley Mitchell	01/01/2006

* millions	
Data through: 29/9/2006	
Source: Company Documents; Lipper	

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