

Allocation and Appraisal

Using an absolute valuation-based approach to fund management, the Royal London European Growth Trust seeks to achieve capital growth by investing mainly in quoted European equities. The fund manager Kevin Lilley bases his portfolio construction on the macro background in the marketplace because he believes that stocks' profitability is dependent on what happens within the economic cycle.

Q: What is your investment philosophy?

A: I look at one company at a time because I value companies on an absolute valuation method. I don't look at companies relative to the other companies within their sector or their market. I look at companies on a standalone basis and review that with my top-down macro view of the world. This helps me determine my overall investment allocation in three broad categories - financials, cyclical, and defensives. My view of the economic cycle will determine the relative weightings among these three sectors.

I value all individual companies on an enterprise value (EV) to capital employed basis. I look at the return on capital employed that these companies are generating against the cost of capital for each company. For example, if an individual company earns a return on capital of 10% with a stable cost of capital of 10%, I would value that company on an EV to capital employed at a ratio of 1.

I also make an adjustment for growth within these ratios as well because

the valuation approach does not recognize growth in return on capital. For financial companies I use a price to book value calculation rather than EV and then compare that with a return on equity versus cost of equity.

We are looking at forward earnings to determine our valuations.

Q: How is your research process organized?

A: I meet approximately 400 companies every year, either within our offices in London or during my trips. That gives me a broad knowledge of the underlying stocks within the marketplace. I've been looking at these stocks since 1991, so over the years I have managed to establish a good knowledge base on the majority of the larger cap stocks within the European markets.

Our European equity team is small but focused, with two fund managers carrying out research in all sectors. We look at sell side research and we identify the best analysts in each sector; we will look at a selection of work on a company; we'll challenge the as-



KEVIN LILLEY joined Royal London Asset Management in 2001, with a sole focus on managing the Royal London European Growth Trust. He is also a member of the Securities Institute.

Lilley has a rich and varied career history, with the benefit of experience across a range of disciplines. He initially trained as a Local Government Accountant with Lincolnshire County Council, helping him hone his strong analytical skills in assessing cashflows, profitability and organizational performance.

In 1989, Lilley moved into the Council's investment department where he worked as an Assistant Investment Manager until 1994. He then joined investment specialists, NPI as Director of European Equities managing unit trust and pension fund assets before moving to TT International in 1999 to manage a high alpha European equity mandate.

“My portfolio construction is linked to the macro background in the marketplace because stocks don’t operate in a vacuum and their profitability is often dependent on what happens within the economic cycle.”

assumptions that are made in the building up of the numbers in the profit and loss accounts and balance sheet and then base our valuation calculations on that.

I’ve also developed my own internal screens for the top 600 companies in Europe. I can look on a general basis and determine what I think each company is worth on my valuation criteria.

Q: How do you go about constructing your portfolio?

A: My approach to portfolio construction uses a contrarian style. I follow the Merrill Lynch survey of portfolio managers’ asset allocation by sector and see where the overweight and underweight positions are in people’s portfolios. If I see that, within the Merrill Lynch survey for Europe, a particular sector is overweight and popular among fund managers and my asset allocation reflects a similar bias, I get uncomfortable and will review my positions closely. I fear that a popular sector may not be able to attract new funds in such a scenario.

Similarly, if the majority of managers are underweight in a sector, that’s where I’m going to look for stock ideas.

Q: Do your investment decisions depend on macro-economic events?

A: Yes, my portfolio construction has a view on the macro economic backdrop in the marketplace because stocks don’t operate in a vacuum and their profitability is often dependent on what happens within the economic cycle. If I think we are in the early stages of the economic cycle the likelihood is my portfolio will be significantly overweight with cyclical related sectors and if I think we are towards the rollover phase of the economic cycle, then I’m more likely to be defensively biased.

In order to determine where we are in the cycle I’m looking at leading indicators of economic growth. Then, within each of those areas, whether it be cyclical, defensive or financial, I’ve got other screens that I look at to determine where the value lies.

I also look at macro trends for the global economic cycle. The U.S. is entering a recession and I think this will lead to a slowdown within the emerging market areas as well. A lot of the western European companies over the last number of years have outsourced a lot of their supply to Eastern Europe and to the Far East so, if growth within the U.S. and Europe slows down, this will have an impact on those eastern European and Asian companies.

For example, if you’re a capital goods company within Europe and you’re outsourcing your sub components from Romania or China, you’re going to cut back on your orders to those nations. It’s a lot easier to cut back on workforce within those remote areas than it is domestically where you might have political opposition to doing so.

If you look at my portfolio in the broad sector categories, at the moment I’m

10% underweight in the cyclical sectors within the marketplace, I’m 6% overweight in the defensive sectors, I’m 1% underweight in financials and I’ve got 5% cash. So my positioning is for a slowing and weakening economic cycle.

Q: Could you highlight one or two stocks and explain how you identified them and why you added them to the fund?

A: In January 2007 I bought a significant position in Daimler Chrysler (now Daimler). The automotive sector was probably the most underweighted sector within the Merrill Lynch survey of fund managers. My screening work on valuation within the sector showed that virtually every automotive company looked extremely good value with significant upside if the numbers were correct. That led me to do a lot more work on the underlying automotive companies and to go to an overweight position within the auto sector.

There had been management changes at Daimler Chrysler in the previous year. The stock had gone to sleep whereas other companies within the sector where there had been management changes the stocks had seen some semblance of revaluation. There were three catalysts to lead me to invest within the company – one, I’d identified the stock with significant valuation upside; two, the marketplace as a whole was very underweight in the automotive sector so in the future there were likely to be more buyers of the sector rather than sellers; and three, Daimler Chrysler was by far the largest in the sector so that would be a major participant if the auto sector outperformed.

Q: What could be a catalyst for a sell decision?

A: I monitor all the companies within my portfolio against what I think that company is worth on an absolute ba-

sis. When the companies are reaching the appraisal value that I've attributed to them I will be looking to replace them with companies that have better prospects or I'll be reviewing my appraisal values to factor the changes in the marketplace.

Q: Do you measure yourself against a particular benchmark?

A: The benchmark we are working towards is the FTSE Developed Europe ex-UK Index.

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

A: The benchmark is part of the risk determinant because as far as risk management is concerned we have a tracking error of 5% versus the particular benchmark. That 5% doesn't constrain me in any major ways at all.

Ours is a fairly tight portfolio - I tend to operate with 40 to 50-stock list. There's a reasonable diversification within that to spread the risk.

Another way to spread the risk is to look at the three broad sector categories because I aggregate those to see where fund positions are in financials, cyclical, and defensive stocks. Although I will take large positions against the benchmark weightings, I always have a presence in each broad category.

In December 2006, the fund's risk parameters were relaxed slightly to allow me to express my higher conviction investment approach. The fund's tracking error constraint widened from 3% to 5% and I reduced the minimum number of stocks from 60 to between 40 and 50. Previous constraints as to what I could hold in each sector and each stock also changed to help me generate the performance demanded by investors.


Q: Are there certain areas or industries that you would avoid?

A: I think that alternative energy stocks are a bubble and they're extremely overvalued. They've got pumped up on the back of the news flow from environmental campaigns. They're inherently small or mid cap in nature and if you try and buy the stock you're more likely to have a positive impact on the share price.

Over the last year the number of stocks that have come to market has increased purely because of high investor demand and not because of proven industry fundamentals. You have a situation where you've got companies that are very highly valued and there's more supply of new companies coming to the market from what had been an undersupplied market.

Q: Your valuations are based on forward looking earnings. How do you handle a situation in the financial sector when suddenly all the earnings estimated are inadequate and many large banks are reporting losses when estimates were for large profits. What do you do in such situations?

A: Everybody in that scenario was wrong and even the most respected stock market analysts in the banking sector had been in the dark to the extent of the sub-prime problem. So what I try to do in such situations is mitigate the risk.

First of all, I look to see where other funds are positioned within the sector so I can mitigate my relative risk against the competition. The tendencies in that situation are to move to a more neutral position versus your competition and your benchmark, and on a stock basis see which stocks hold up well on valuation even with aggressive earnings cuts. 

Royal London European Growth Trust

Symbol	GB0030229487
Fund Type	Unit Trust
Website	www.rlam.co.uk
Address	Royal London Asset Management 55 Gracechurch Street London EC3V 0UF
Tel. No.	0044 (0)207 506 6500
Inception	01/04/1987

PORTFOLIO	
Total Net Assets*	GBP 203.6

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	GBP 1,000
Min Subsequent Investment	GBP 100
Min Regular Investment	GBP 50
UK ISA	YES
CAT standard	N/A
UK PEP	YES

RETURNS VS. FTSE WORLD EUROPE EX UK TR INDEX		
Gross of fees	GB0030229487	Index
1 Year (Cum.)	-1.04%	1.99%
3 Year (Ann.)	14.15%	15.68%
5 Year (Ann.)	17.85%	19.03%

RETURNS VS. IMA EUROPE EXCLUDING UK SECTOR		
Net of fees	GB0030229487	Sector
1 Year (Cum.)	-2.27%	-1.42%
3 Year (Ann.)	12.75%	13.97%
5 Year (Ann.)	16.48%	17.62%

FEEES AND EXPENSES	
Initial Charge**	4.00%
Annual Management Charge	1.25%
Net Expense Ratio	1.30%
Switching Fee	0.00%
Exit Charge	N/A

PORTFOLIO MANAGER	
Kevin Lilley	01/07/2001
*millions	
Data through: 31/01/2008	
Source: Company Documents; Morningstar	

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