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Fund Manager

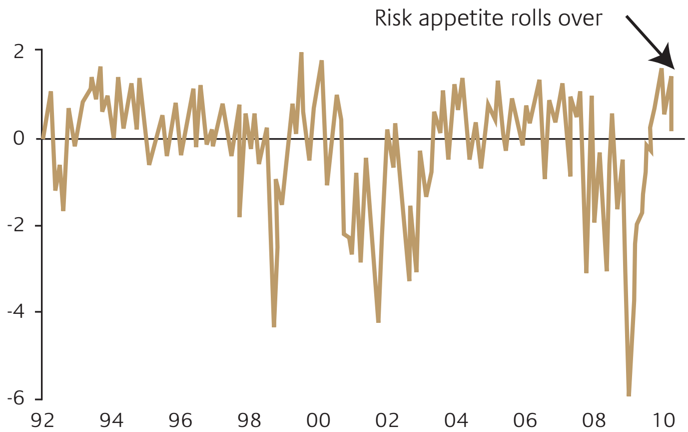
A welcome return to a stock picking environment in which quality prevails

Cartesian is a fundamental UK stock picking boutique focused on quality. As such, with markets in 2009 being led by weak companies, Cartesian suffered their first year of underperformance relative to the peer group in a decade. David Stevenson, manager of the Ignis Cartesian UK Opportunities Fund, explains that the long-term focus on quality companies makes the portfolio particularly well positioned for 2010, with markets again focusing on company fundamentals in order to identify the best opportunities.

2009 – a stay of execution

The record levels of liquidity that were pumped into financial markets, combined with easy access to borrowing, provided a shot in the arm to the economy in 2009. What was unexpected, however, was the level of risk investors would be prepared to take. Risk appetite went from its lowest level in decades to one of its highest (see chart 1) and it was companies carrying the most debt and displaying the weakest fundamentals that led the market rally. Many companies that in normal conditions would have been in financial distress used the suspension of risk aversion to re-equitise, pay off bank debt and, apparently, recover.

Chart 1: Risk appetite - biggest annual move in 20 years, but has now rolled over



Source: UBS Global Risk Appetite Indicator, February 2010

2010 – return of a hostile environment

The progress of the FTSE All Share, which was up nearly 50% in the 12 months to the end of February 2010, can give rise to misplaced optimism. As mentioned, the rally was fuelled by unprecedented intervention and a realisation that the broader economic environment was not as dire as previously feared. The recovery in the UK is, however, still somewhat tentative with notable hurdles remaining, including a weak currency, national debt and the potential of a hung parliament reducing the likelihood of the necessary firm fiscal action being taken.

So while the stock market may be behaving as if this is a normal recovery, we believe it is definitely not. Indeed many weak companies, while given a temporary reprieve, will come under renewed pressure in 2010 as risk appetite moves sharply lower.

Quality to prevail

While there are hurdles, it is not to say that the market cannot make further progress this year, and, we believe it will. It is, however, more likely to be led by 'quality' companies; companies with a record of generating free cashflows and paying dividends, rather than those reliant on stimulus or debt finance. This is a welcome return to rationality.

The intent to 'invest in quality' is nothing new in fund management. At Cartesian, however, it has been at the cornerstone of our investment approach for the last decade. As a team comprising two accountants and an actuary, the process is focused on the rigorous analysis of companies from the balance sheet upwards. Companies we currently favour are those able to demonstrate attainable recovery targets; value creation; undervalued growth; a secure yield and with an international bias. Those we are avoiding tend to exhibit recovery risk, value destruction; strained balance sheets and a heavy reliance on domestic discretionary spending.

'Quality' is in growing demand as investors seek to fortify portfolios against potential headwinds later in the year. It may, however, not prove easy for fund managers to move up the quality scale. As sentiment shifts further, the prices of the more resilient UK listed companies, and the portfolios in which these are already held, such as our own, have the potential to rise sharply.

A broader perspective

While the domestic economy will face challenges going forward, there are still attractive opportunities to be found. The make-up of the FTSE, of which the earnings of two thirds of the top 100 companies come from overseas, means there are ample opportunities to invest in stocks that are not reliant on the domestic economy.

Inmarsat, the global satellite telecommunications network operator, is one example currently held in the portfolio. This is a stock operating in an oligopolistic market with high barriers to entry and the stock demonstrates good margins and attractive cashflow levels. Inmarsat also offers sustainable revenue growth, with handset development and increasing data demand.

Chemring, which manufactures defence products, also has a global reach. As hostilities continue in Afghanistan, and a lesser extent Iraq, spending on frontline operational defence is likely to continue, meaning Chemring is less exposed to capital spend cutbacks. The stock also provides strong visibility within its order pipeline.

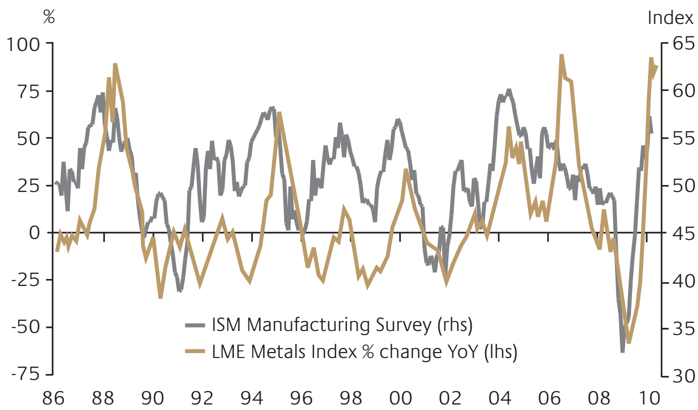
Niche opportunities

In addition it is possible to find companies with a UK focus that have established a niche in the market and are therefore likely to remain profitable in leaner times. An example of this is **Halfords**, the UK retailer of car parts and accessories and bicycles; a recent addition to the portfolio. In February the company announced the acquisition of car servicing and repair chain Nationwide Autocentres, which will be rebranded as Halfords Autocentres. This provides the opportunity for sales and cost synergies through the dual rollout of operations, with Halfords capable of double digit earnings growth for the next two years. The stock is currently trading on a cheap valuation and offers an attractive dividend yield.

Commodity bubble?

A theme that, unlike many of our peers, we are largely avoiding is commodities. This, we believe, is an area of the market demonstrating classic signs of an investment bubble. In the last year, much of the demand has been artificial, with the injections of liquidity and rising appetite for risk leading to commodity reflation. The chart below shows the steep rise in manufacturing in the US from multi decade lows, but this is easily surpassed by the speculation-fuelled gains of the London Metals Exchange Index. When the liquidity tap is turned off, as is currently occurring, demand is likely to evaporate and there could be a sharp retraction of gains.

Chart 2: LME Metals Index and US ISM-Manufacturing Survey



Source: Reuters Eco Win at 23/03/10

A recent Merrill Lynch survey shows the majority of funds to be heavily overweight in commodities despite almost all fund managers considering these stocks to be overvalued. In this situation there could be a rush for the exits if sentiment shifts. At Cartesian, we believe more attractive international growth opportunities are available away from commodities.

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