

Power in the right hands

By **Jeremy Hall**,
investment
manager,
Cartesian Capital



When we presented at the *Investment Week* conference in Cape Town in February 2008, we proposed that, in the right hands, the 130/30 concept was a powerful investment strategy. Moreover, we urged investors to seek a successful history of shorting in their chosen manager, which was particularly appropriate given the state of the UK equity market. Notwithstanding two sentiment-driven rallies in the UK market in February and April, the Cartesian 130/30 fund has generated performance considerably ahead of the benchmark and significant returns across both the long and the short book.

At the time of presenting, Cartesian urged caution with regard to the UK economy and the UK equity market, with the fundamental belief that the UK would suffer from an overdue cyclical downturn, magnified by restrictive conditions within debt markets. Despite the fall in equity markets from the middle of 2007, we proposed that investors had still not fully considered the impact of the health of the domestic economy and potentially severe impact on a number of key sectors.

We highlighted for some time the difficulties facing the UK economy, from the weak financial sector through to deteriorating consumer confidence impacting cyclical sectors such as housebuilding and retail. Recent years have seen strong growth in global financial services and the financial sector has made a disproportionate contribution to growth in the US and especially in the UK. In the first half of 2007, the financial sector in the UK expanded at a double digit rate and contributed 0.8 percentage points to overall GDP growth. Any slowdown, or indeed decline, in the financial sector in the UK was always likely to have a significant knock-on effect on the broader economy.

Regardless, the resilience of equity markets was remarkable in the period to mid-May. Indeed, despite adverse data and clear signals of problems to come, this remarkable market optimism has been one of the most prominent features of the past 12 months. Equity investors chose to 'look across the valley' to recovery, sending equity markets sharply higher in both February and April. However, these bear market rallies proved to be narrowly driven, primarily by commodity stocks, and were notable for very low trading volumes. It hardly seems necessary to point out, but at that time the market had witnessed a high street bank being nationalised; a significant downturn in the commercial and residential property market; ever-rising household bills; the drying up of credit availability; and a sharply falling currency.

If we needed confirmation of our well-stated caution in the UK economy, it came from the Bank of England inflation report in the middle of May, a combination of slowing growth and rising inflation left the monetary policy committee "facing its most difficult challenge yet". Of course, the backdrop to this report had been continuing profit warnings from housebuilders, further rightdowns

and cash-calls from banks and poor trading updates from retailers. A comment that we consistently heard was that the UK market may be "good value". As of the middle of May, stripping out the 'big five' sectors (oil, mining, banks, pharma and telcos) the market traded on a 12.5 times forward earnings multiple with expectations of 7% growth in earnings. Given the commentary surrounding consumer spending and output growth, and that economists were cutting GDP forecasts in half, that struck us as anomalous.

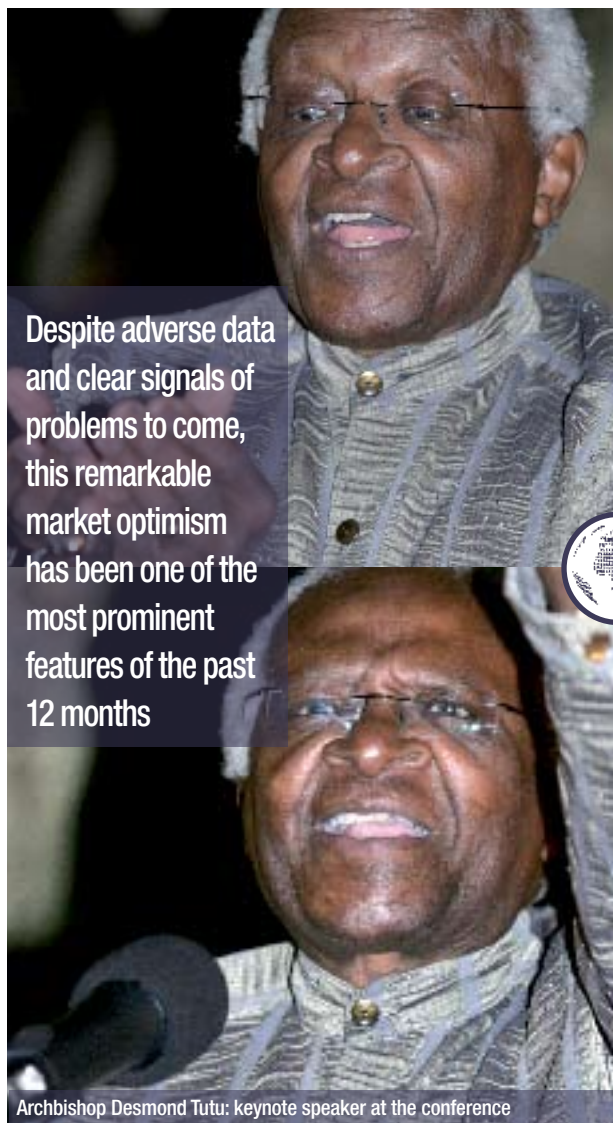
Moreover, analysts were forecasting a decline in earnings this year for only four out of 39 UK sectors. A recent, and continuing, feature of the UK market is earnings downgrades. We continue to believe profitability is unusually high for many sectors. This makes companies appear attractively valued, provided that normalised margins are close to current levels. Excessive margins also flatter near-term cashflow. Analysts, however, are generally slow to downgrade. To do so pre-emptively, without the benefit of a company announcement, might leave an analyst out in the cold both with the company and his/her own corporate department. A cynical view, perhaps, but one built from long experience.

More recently, we have seen investors return to well-funded, earnings-visible companies as the market re-connects with fundamentals. Cartesian's focus for long positions remains on companies which have sound balance sheets and where the risk of earnings disappointment is low. In contrast, shorts have been sought where trading weakness is likely to be compounded by a fragile balance sheet. Such companies came under severe pressure in June.

We expect 2008 and 2009 to see progressive downgrades to forecasts, and for many companies to seek further equity funding. Key areas to avoid/short will be those with exposure to discretionary consumer spending, financials, housing- and construction-related stocks, and those businesses which have become over-gearred or where strategy is reliant on readily available credit. In contrast, we favour those businesses which, paradoxically, have little need to be quoted. These include strong cash-generators and low capital-intensive businesses with long-term organic growth, eg many stocks in the outsourcing sectors. In addition, we look specifically for those companies whose customers are less sensitive to an economic downturn, eg food retail and bus and rail stocks.

There has been a degree of scepticism surrounding the 130/30 investment strategy, but Cartesian has argued that, in the right hands, it will prove to be a very powerful investment tool. A tough investing environment requires experienced stockpicking and Cartesian's long/short investment process has been tested over a period in excess of 10 years. Cartesian continues to find interesting investment opportunities both long and short and expect through the 130/30 strategy to generate significant returns.

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Archbishop Desmond Tutu: keynote speaker at the conference