

# Ignis International Cartesian Enhanced Alpha Fund



Jeremy Hall

## Fund Management

Jeremy Hall is lead manager of the fund, and employs the Cartesian team-based investment approach focused on company fundamentals and bottom-up stock picking. The Edinburgh-based Cartesian boutique was launched in December 2005, and is a 50-50 joint venture between Cartesian's Andrew Kelly, Jeremy Hall and Susan Rafferty, and Ignis Asset Management. The partnership enables Cartesian to focus entirely on investment management while Ignis delivers the distribution, sales, marketing and back office operations.

## Fund overview

- a high conviction portfolio of long and short positions in UK equities (maintaining approximately 100% net long exposure)
- actively seeks alpha from geared long book and short positions
- employs successful long/short Cartesian investment approach
- delivered outperformance since launch while demonstrating lower volatility than the peer group\*
- offers diversification through lower correlation to the index and peer group than sector average
- S&P 'A' rated (at 30/11/11)

## Fund aim

The fund, launched on 8 November 2007, aims to provide long-term capital growth through investments primarily in equity and equity derivative products which include contracts for difference (swaps), traded options and financial futures. The fund aims to hold a controlled combination of long and short equity exposure while generally maintaining close to 100% net long exposure. The fund is a sub-fund of Ignis International Funds plc, an open-ended investment company with variable capital incorporated in Ireland. The GBP A Distribution share class is registered for sale within the UK.

## Investment philosophy

The Cartesian philosophy is influenced by the 'safety-first' traditions on which Scottish investment management was built. Managing money entrusted by wealthy and aristocratic families required a careful, diligent approach to risk and a detailed understanding of the companies invested in. This was not an attempt to chase short-term gains or asset bubbles but a considered, long-term approach to investing in companies with genuine potential and no hidden risks.

This forms the basis of the Cartesian approach. The team is naturally sceptical of investment opportunities and this caution remains until the fund managers have been comprehensively persuaded otherwise. A healthy scepticism is very much the default option. Consensus stock market views on a company are registered by the team but always challenged. The Cartesian fund managers prefer to analyse company reports and accounts themselves to form their own opinion before checking the verdict of the wider market. This approach, with its focus on the true health of a company rather than consensus views, is perfectly suited to shorting strategies.

The fund managers' actuarial and accountancy backgrounds mean they are well equipped to examine whether a company's balance sheet and accounts support the 'investment story'. Opportunities are approached with a business ownership mindset, rather than as short-term investments. The closely aligned interests of the Cartesian team and their investors mean potential portfolio constituents have to satisfy stringent requirements. If the managers would not be entirely happy investing their own money, the company will be quickly discarded from the ideas pool of the portfolios.

## Keeping it simple

In the same way as managers of Scottish investment trusts in the past were careful how they chose investments, so Cartesian go to great lengths to understand a company's business model. Many of the key measures the team uses to judge a company's likelihood of success are similar to those analysed in years gone by. Cashflow, for example, is a prime consideration, providing a 'hard and fast' barometer of the health of a company and not subject to potentially 'creative accounting'.

The Cartesian fund managers believe they should be able to explain in straightforward terms the investment case for all the holdings in their portfolios. This means they need a detailed understanding that encompasses all aspects of the business. They actively avoid companies overly reliant on complex financial gearing or high levels of engineered debt. Notably it was these companies that were hit the hardest during the credit crunch. By avoiding such companies, or shorting them, and establishing a detailed knowledge of the workings of all their portfolio holdings, the Cartesian team has been able to produce strong performance and build trust with their investors.

\*Source: Lipper, NAV to NAV, gross income reinvested and annualised standard deviation to 30/11/11.

**Past performance is not a guide to future performance.**

### Truly active stock picking

Cartesian employs an unconstrained approach to stock picking. The team's investment universe spans the full spectrum of the UK market and the team deliberately maintains a high degree of flexibility rather than fitting neatly into 'pigeon-hole' fund management categories. The team is agnostic in terms of company size and sector, preferring to explore the best opportunities wherever they sit in the marketplace.

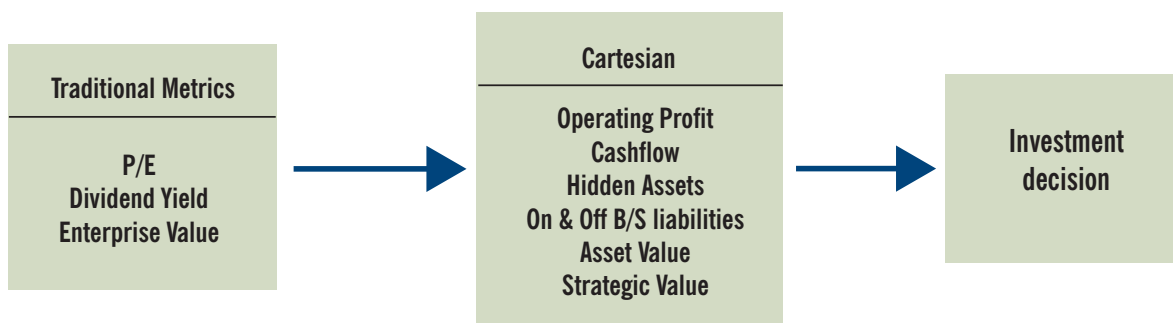
The heavy coverage of the UK universe by brokers and analysts means the prospects for most companies are fairly valued by the stock market. Subsequently share prices generally offer only modest returns. A small subset of the universe is, however, not properly analysed. It is here that more material investment potential can be found, providing a fund manager has the proper analytical tools and capabilities to do so. This is Cartesian's area of expertise.

#### Typical long positions taken in the subset by Cartesian may include:

- companies offering premium growth that has been overlooked by the stock market,
- companies offering long-term sustainable growth that is undervalued by the stock market,
- companies going through a process of change or value release that the stock market has been slow to understand.

The same principles are applied to Cartesian's search for short positions. A subset of the market includes poor quality companies that have been over-valued by the stock market. In the same way as detailed analysis can reveal uncovered potential, so it can reveal fundamental faults in a business that the wider investment community has yet to understand.

### Valuing businesses



### Understanding a business

Cartesian's approach is to understand in detail how business models work, rather than spending too much time watching share price charts. Good and bad business models do not change overnight and tend to outlive stock market sentiment or share price trends. The Cartesian aim is to exploit anomalies between the managers' valuations of a business, which tend to remain stable, and the more volatile share price. Investment is made on a medium to long-term view and Cartesian's funds remain invested throughout the stock market cycle.

The Cartesian approach is based upon the belief that value can be added as much by avoiding bad investments as finding good ones. While it is sufficient to own only a sample of the best performing stocks to outperform, it is crucial to avoid, or short, the bad ones. Cartesian's emphasis on caution and scepticism, combined with the team's analytical rigour, means they are well equipped to unearth potential pitfalls when assessing company prospects. The fund managers' experience in corporate finance and private equity means they are quick to spot potential balance sheet risks. This technical ability has led to Cartesian uncovering both some of the best and worst performing stocks. It means the same investment process works equally well in long/short strategies as well as long-only funds.

### Valuation is key

There are many attractive companies in the stock market but at any point in time most have valuations that already reflect their potential. This is relevant to Cartesian's long and short portfolios. For them, the valuation must offer significant material up or downside. The valuation approach employed by Cartesian treats investment as part-ownership of an individual business. The team therefore values the entire enterprise, adjusting for debt and off balance sheet commitments, such as pensions, as well as assets that are less apparent or 'hidden'. The value of a company's equity is calculated as the residual value after the other assets and liabilities have been taken into account.

A wide range of valuation measures are used as part of the process. The Cartesian fund managers are conscious that simple earnings multiples can be distorted by the effects of capital structure and tax strategy, and may not truly reflect underlying operating performance. For this reason they also use operating profit, cashflow multiples and asset-based valuations.

This approach is more aligned with the mindset of a company's finance director or a trade investor. It leads Cartesian to naturally favour areas of the market in which bid activity frequently takes place, although there is no attempt to second guess the next individual takeover candidate.

## The analytical process

The Cartesian process is based upon sound analysis of the business and financial components of a company, with certain characteristics favoured for long and short portfolio candidates (see Fundamental analysis section). This results in best idea long and short portfolios in the Cartesian funds.

### Long portfolios

The long portfolios run by Cartesian consist of the team's current best ideas. This is a high conviction process with individual weightings sufficient in size to have a material impact on performance. An overall portfolio size of 30-60 stocks is targeted. All positions are held on a 'need to own' basis, continually challenged by fresh ideas, with benchmark considerations of secondary importance.

Holding periods depend on a variety of factors. Cartesian invests with a clear view as to valuation targets and the time limits to deliver investment returns. This view can, however, be flexible through time. The team is prepared to run with particularly strong stocks, and has held some positions for more than five years. When targets are approached, however, the Cartesian fund managers are ready to take profits or liquidate holdings unless the investment case has changed. With a steady stream of replacement ideas, there is no reason to run overly large or stale positions. Share price weakness is also not an automatic trigger for liquidation. If the fundamentals remain intact, then the immediate reaction would be to exploit a buying opportunity. If, however, the story has changed, then Cartesian may sell immediately. Stocks can also be 'timed out' of the portfolio, by not generating the required return within an acceptable timescale.

### Shorting

The Cartesian team's short positions are a product of the same analytical process as that used to select long positions. This is not to say that shorts are simply the mirror image of long decisions.

Share price appreciation with longs can be much more gradual than adverse price movements with shorts. Equity markets are typically long-biased in terms of the weight of analytical effort and, with the exception of bid approaches, longs tend to accrue performance steadily. In contrast a much more violent reaction can be expected from shares in companies that disappoint, or become financially distressed. Identifying shorts, or stocks

to avoid in a long-only fund, follows the same process of business model assessment and valuation described above. Nevertheless, there are a number of specific issues relevant to the management of the short books in the Cartesian Enhanced Alpha Fund and the Cartesian UK Equity Long/Short Fund.

The fund managers see good stock selection in shorts as an equally important source of alpha as high conviction longs. They look to keep a focused, well-researched short portfolio, and retain short exposure throughout market cycles. Short weightings will, on average, be smaller in size than long positions.

Cartesian do not use stop loss as a method of risk control. Experience has shown that significant downward moves in share prices can often be interrupted by short-term spikes. The decision to retain a short will be primarily based on the team's company analysis and valuation view. Cartesian's dynamic boutique approach provides a competitive advantage in this respect. Most investor and broker commentary still focuses on a narrow range of companies and Cartesian actively looks to avoid crowded short trades that can move against the fund despite the underlying company newsflow.

As with longs, the Cartesian fund managers are pragmatic about holding periods for shorts. As indicated, however, a successful short can see a swift and extreme price correction, fully recognising investment expectations quicker than would necessarily be the case with longs. For this reason the average holding period for shorts is typically somewhat less than for longs.

### In depth company research

The use of broker research notes is limited to providing background information and initial forecasts. The added value in the Cartesian process comes from an in depth understanding of the financial dynamics of a company or sector. This includes the stress-testing of forecasts under various scenarios, for example adjusting for cost sensitivities, revenue slippages and a variety of cashflow changes. Cartesian's unconstrained approach means that when the managers identify a company characteristic that has been mispriced, related stocks or areas of the market are searched for further opportunities.

A key aspect of the value Cartesian can add remains the diligent application of fundamental analysis. The fund managers make a point of

thoroughly reading company announcements and accounts, which they believe remain the best source of good quality and legally verified information, before they pay any attention to media and market views and commentaries.

### Investment themes

The team's research effort is also influenced by significant investment themes that have an impact across the whole market. While the fund managers recognise the relevance of important macroeconomic factors, such as interest rate changes or currency moves, these are generally well understood by the market. Share prices can, however, be slow to react to new secular themes, such as pension funding issues or the growth of outsourcing.

### Brokers

Cartesian maintains a wide range of contacts. This reflects both the diversity of companies researched and also the valuable contribution of many of the smaller, boutique brokerages. Rather than taking brokers at face value, however, the Cartesian managers prefer to focus on areas of the market they have identified as particularly interesting and challenge consensus views. The process is very much two-way with brokers challenged to provide arguments to counter the fund managers' initially sceptical view of a company's investment case. This fits with the over-arching emphasis on care and diligence applied throughout the Cartesian process.

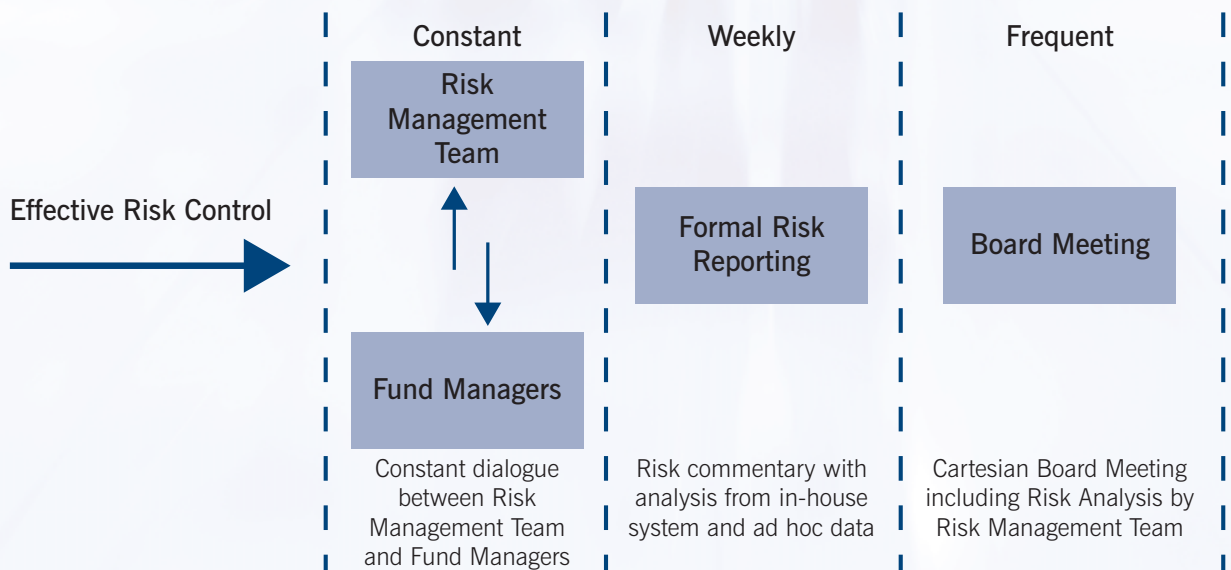
# Risk management

Risk management in the portfolios takes various forms. The primary source of risk control comes from the fund managers' detailed understanding of the concentrated pool of companies invested in. Running a focused fund makes it easier to maintain full coverage of all positions, and to recognise the stock specific risk inherent within the portfolio.

As a consequence of the heavy benchmark weight of the leading four sectors in the UK (banks, telecoms, pharmaceuticals and oil), many managers carry a high absolute exposure to a limited number of stocks and sectors, which are not necessarily representative of the wider economy. Outside these heavyweight sectors, however, the stock market offers a good level of diversity and the Cartesian fund managers maintain a broad spread of ideas within their portfolios.

Stock liquidity is another aspect of risk control that must be constantly monitored to maintain weightings as the portfolio sizes increase and also to achieve ultimate liquidation. The Cartesian team is not, however, afraid to take a significant stake in a good company.

Formal controls involve communication with the Ignis risk analysis team, who provide Cartesian with regular reporting on portfolio parameters such as tracking errors, volatility and value-at-risk. This risk decomposition is built upon EM Applications, which Cartesian supplements with in-house attribution tools based on Bloomberg real time pricing. These spreadsheets measure daily stock contributions within each portfolio, allowing the managers to monitor longer-term correlations with the UK stock market.



## Fundamental analysis

The starting point for assessing a potential investment, whether long or short, is to analyse the business and financial components of a company. There are a number of distinct characteristics, good and bad, that Cartesian looks for.

### Cartesian favours companies with the following characteristics:

**Growth:** Sustainable in the long term. May come from organic development or be supplemented by sensible acquisitions. If possible, should be supported by a historic pattern of sales volume and profit margin progression.

**Market position:** Secure position based on supply barriers and/or excess demand, providing some pricing power.

**Free cashflow:** Sufficient to fund a combination of organic growth, acquisition activity, sustainable dividends and share buybacks.

**Financial strength:** Robust under a range of market and economic conditions. Likely to reflect asset-backing and sensible levels of gearing.

**Restructuring:** Potential for strategic change leading to value release through divestment or demerger.

**Corporate activity:** Background transactions involving private equity or trade buyers at premium valuations.

**Recovery:** 'Below-normal' trading performance with catalyst for change either through management or market environment.

### Cartesian avoids or shorts companies with the following characteristics:

**Aggressive accounting:** In spite of the implementation of International Financial Reporting Standards, there is still scope for companies to manipulate their earnings and financial position, for example through accelerated revenue recognition, cost deferrals or off balance sheet liabilities. Cartesian is alert to this and unexpected changes in accounting policies.

**Low earnings quality:** Cartesian likes to see a close relationship between reported profit, cash generated and tax paid. Poor conversion of profit into cash, low effective tax rates or cash tax paid to the Inland Revenue, are all warning signals of low earnings quality. The team also looks for recurring exceptional costs, which may indicate underlying trading difficulties. They are also suspicious of profit margins that significantly exceed a company's historic record, or that of its peer group, and which may be unsustainable.

**Financial weakness:** Symptoms include heavy on and off balance sheet debt levels, overdependence on short-term facilities, large working capital requirements and significant pension or lease commitments. This could lead to excessive dependency on the support of capital markets. Cartesian also monitors rating agencies and debt market activity to identify distress potential.

## Cartesian team



**Jeremy Hall**  
Lead manager  
Investment experience: 11 years

Jeremy graduated in History and Management Studies from Glasgow University. He is a Chartered Accountant and CFA Charterholder with investment experience across European and UK markets. He worked on the European desks at Scottish Life and Abbey National Asset Managers before joining SVM in January 2004 as a member of the UK team. Between March 2006 and April 2007 Jeremy was a UK equities analyst with stockbroker Teather and Greenwood. Jeremy joined Cartesian in August 2007.



**Andrew Kelly**  
Investment experience: 19 years

Andrew began his career at Standard Life in 1987 shortly after completing a Mathematics degree at Durham University. While at Standard Life, Andrew qualified as a Fellow of the Faculty of Actuaries, and completed an MSc in Investment Analysis (with Distinction) through Stirling University. He moved to SVM in early 1996 and was a contributing analyst to hedge funds and to various long-only funds. Andrew was also portfolio manager of the SVM Saltire Long Short Equity Fund. In December 2005, Andrew became one of the founding partners of Cartesian.



**Susan Rafferty**  
Investment experience: 27 years

Susan Rafferty has over 27 years' experience working in the financial sector for companies such as Baillie Gifford and Aegon. In 1996, Susan joined SVM, where she first met Andrew Kelly. Andrew invited Susan to join Cartesian at launch, where her role is to take care of all non-investment activity, acting as the link between the managers and Ignis Asset Management. Susan became a partner of Cartesian Capital Partners in 2008.

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### Further information:

Call: +44 (0)845 60 50 444

Email: [brokersales@ignisasset.com](mailto:brokersales@ignisasset.com)

Web: [www.cartesiancapital.co.uk](http://www.cartesiancapital.co.uk)

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