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[INTRODUCTION]
James Yardley (JY): Hello and welcome to the Investing on the go podcast. Today I'm joined by Anthony Cross, the Elite Rated manager of Liontrust Special Situations. Hi Anthony, thanks for joining us.

Anthony Cross (AC): Good morning.

JY: How are you at the moment and how's your year been so far?

AC: Well, so far not too bad. We have had a reasonable spell of outperformance, particularly in the last few months, things have kicked up for the sort of quality businesses that we own. So we're feeling pretty chirpy. Thanks.

[INTERVIEW]
[0:32]

JY: Great. And your fund, the Liontrust Special Situations fund, has a bias towards mid and smaller companies. You've got quite a lot in the AIM market, almost 25% - what are your thoughts on the AIM market now? I mean, for a long time, I think a lot of investors thought of it as a bit of a basket case, but has it really now evolved and become a lot more investible?

AC: Yes, no, definitely it's evolved. I mean, when I started work back in the 1990s, it was the beginnings of AIM and it felt very much like sort of venture capital, really early-stage businesses. And still, of course you've got those sort of companies on the AIM market, but you've also got a lot of businesses now that have been listed for a long period of time. Many companies are quite big businesses now and we've got companies in the fund like Cranewear, or RWS or Peyton Translation or Gamma Communications, you know big businesses that have been established for a long period of time and are very profitable.

One of the other important things with AIM to consider is just quite how you select your companies. And through our process, one of the very important things we do is we'll only invest in profitable businesses. So, you know, we are getting into the more grown-up AIM companies that have achieved profitability and started to prove their business models. And that can make a big difference in terms of the risk profile of the sort of companies that you're taking on.

[1:57]

JY: And you've got a big overweight to consumer discretionary in the portfolio at the moment. Is that a, does that mean you've got a positive view on the UK economy, at the moment?

AC: No, because the consumer exposure that we have in the fund tends to be very much more international. So those will be the big consumer goods companies, companies like Unilever or Reckitts or Diageo, is where we're getting our main consumer exposure to. And we have a bit of a exposure via Domino's Pizza to the UK market, but overall, we tend to be underweight in classic UK consumer cyclical businesses. We don't own house builders or construction companies. We have very little in retailing, very little in sort of leisure and hospitality or travel. So our style - it focuses upon intellectual capital and high returns on invested capital - actually positions us away from many UK cyclical, consumer stocks. So we're underweighted in that area - not because we particularly have a particular view on the UK economy, but purely because of the style, the economic advantage process that we use, tends to push us more towards those international consumer stocks and away from UK consumer stocks.

[3:16]

JY: And one of the things you look for is companies with hidden intangible assets. I noticed you've got BP and Shell in your top 10 at the moment. So what are the intangible assets which they have and what makes them attractive?

AC: Yeah, so there's two in particular that we think are very valuable to these businesses. The first is intellectual property and it is one of the areas for both companies that tends to be overlooked by the market. These are businesses that have deep intellectual property. They are big spenders on research and development - both directly, but also via joint ventures and via academia. They've built up a lot of strong know-how. You think of the, know-how for example, BP and in exploration is very high. They've got quite a lot of know-how and intellectual property built into the actual refined products that they make. So intellectual property is one angle that these businesses have.

And the second very important asset they have is distribution power. And you think, for example, with Shell its position in liquid gas is number one in the world. They are one of the top three or four energy trading businesses in the world. Shell is the biggest retailer by individual footprint in the world with all their retail sites. So these are big distribution network businesses, and we think those, the combination of their intellectual property, alongside their distribution networks, alongside also their brands, their regulatory knowledge, their governance and government contacts. We think these businesses will be very important in energy transition over the next 20 or 30 years.

Obviously the focus is all very much at the moment on pure renewables. People are very concerned obviously about climate change and carbon. But we would argue that these businesses, Shell and BP, will be a very important part in enabling us as individuals and then individual sectors and governments to make that transition to a lower carbon world over the next 20 or 30 years.

[5:32]

JY: And another type of intangible asset you look for is company culture, which I think is quite interesting because, you know, as analysts, we love our sort of spreadsheets and models and things, but actually culture is such an important thing. So can you give us some examples of what you look for there? What are some good, what's a good company culture, and what's a bad company culture which you avoid?

AC: Yeah, so our big three intangible assets that we look for in any company before we buy it, is that a company must have either a strength in intellectual property or a strength in distribution network or high recurring income of at least 70% of turnover. We then look for also some of the softer intangible assets that are perhaps more difficult to identify, but can be very important in a business. And as you say, culture is one of those.

Now, the way that we try and capture culture in our small companies is via the owner/manager culture. So we like equity ownership, and we like the directors of businesses to own at least 3% of the listed equity. We think that owner/manager culture is positive for two particular reasons. One is that the owners, the founders, tend to be more focused upon the long-term and quite often more organic growth than those businesses where the directors don't own equity. So equity-owned, founder-managed businesses will tend to think long term, invest for the long term, develop their business for the long term. And they also then tend to be more careful with regards to acquisitions. So they're more worried about shareholder value. They're more worried about things going wrong, and we think that's good. And therefore there tends to be more of a focus on organic growth. We will have acquisitions occurring, but overall they tend to be more focused on organic growth. And that with that we think is good too.

So in our small caps, we like that owner manager/culture and we like organic growth because quite often that means that the businesses focus more on developing their existing employees and promoting from within, rather than what you have with acquired companies is there's always outside talent or maybe not talent coming into the business. Whereas if you're focused on organic growth, you're developing your own employees more and that we think is better.

So a nice example or two of that kind of organic growth and focus upon your existing employees. One would be for example, PageGroup in recruitment, here's a business which doesn't go out acquiring other companies. They develop their own people. Sometimes people might join from outside the company, but they're not bringing in loads of fresh people through acquisitions all the time, they're developing their own people. And those staff will have the chance of going and working within the Michael Page network all over the world.

Another example might be Renishaw, now Renishaw has made the odd small acquisition over its life, but overall it's much more of a business that's focused upon organic growth. Now it's a manufacturing company. It makes very highly patented measurement probes. They've built a very strong global distribution network. It's a very strong brand within what they do, but there's a big emphasis on organic growth and a big emphasis upon company culture. They have their own graduate training schemes. They take in people from local colleges. They develop people a lot. There's lots of training. There's very nice facilities within which they work there's again good scope for development and career progression within Renishaw. A very strong culture has been developed within that business. So where we can see it, we value it, and we see it as a positive aspect of the business. It's important for us to, to feel that we're positively seeing it, not persuading ourselves that it's there. So not all of our stocks, we would say have got strong culture, merely some of them.

[9:38]

JY: Just finally Anthony, what are your thoughts on valuations at the moment? We've had quite a strong run for small and mid-caps, in particular, are you still seeing good opportunity out there in the UK at the moment?

AC: Yeah. The opportunity in the business model sense is as strong as it ever has been. You know, we're finding lots of potential new ideas. We've got lots of companies out there with the strength of intellectual capital and high returns on invested capital that we like. But as you rightly say, in some areas of the market, valuations are quite high. So certain areas of software, for example, valuations are pretty high. Some of the AIM companies who've been performing well, their valuations are high. You know, if you look at businesses in again, software or in media, pretty high valuations.

Elsewhere in the market, there could be more attractive valuations, you mentioned earlier BP and Shell. Now they are not expensive businesses. They are some of the cheapest businesses in the UK market now. We own companies like TP Icap that hasn't been a great performer for us, but it is a cheap looking business. So it really depends where you put your search light. But overall, with, you know, the market having rebounded since the problems at the early part of 2020, there are large parts of the market, particularly small and mid-cap that yes, do look quite expensive, but they are still attractive businesses with long term compounding, which we know can erode expensiveness over time. So our style is not to have target prices. We don't actually spend a lot of time concerning ourselves with marketing valuations. What we think is much more important to get right, is the aspects of the business. For us it’s intellectual capital and high returns on invested capital. The ability for a company to have pricing power barriers to competition, the ability to compound that growth over a long period of time. If we get that right within the portfolio we think we can add a lot of value to unit holders over time.

At any particular moment, the market might well be overly expensive, or it might well be cheap, but that's not really where our focus lies. Our focus lies much more on getting the business models for you right, that can then add value for you over a long period of time. And as I said earlier, it's that long term compounding can erode near to market expensiveness, and you can take individual companies over many, many years. You know, Spirax-Sarco for example, is an expensive looking share today, but it's been one of the great long term compounding businesses since it floated in the 1950s, it's grown its dividend every year, since it's been floated on the London market. So those sort of companies, if you can capture them for the long term, can be hugely rewarding. Over the next 12, 24 months, who knows really where the share price might go. But the long term compounding of businesses is really what you want to try and capture.

JY: Great. Well, that's been really interesting. Thank you very much for joining us today Anthony.

AC: Thank you very much. I enjoyed that. Thank you.

JY: And if you'd like to learn more about the Liontrust Special Situations fund, please visit fundcalibre.com and please remember to subscribe to the Investing on the go podcast.