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[INTRODUCTION]
Darius McDermott (DM): I'm Darius McDermott from FundCalibre, and this is the latest edition of the Investing on the go podcast. I'm delighted to be joined by Hugh Sergeant, the Elite Rated manager of the ES R&M UK Recovery fund. Hugh, how are you?

Hugh Sergeant (HS): Yeah very good. Thank you, Darius.

[INTERVIEW]
[0:20]

DM: Good, good. So I know the last time we did a podcast together, we looked at performance and, you know, in spite of the fact that growth having dominated value styles in the market, your fund now outperforms over 1, 3, 5, and 10 years. And by quite a long way, by over a 100%, how have you managed to do this with a value-oriented strategy in a growth market?

HS: Thanks for that very positive question that Darius, obviously it was good to have been able to generate strong, strong returns over the last few years. Especially as you suggested in the context of quite a headwind against our, you know, core investment philosophy, the value component in particular. I'd split it down into, you know, a few, a number of things that have supported us.

I mean, the first is, in investment, you need a bit of luck. So we've had some lucky stock picks as well as some very well thought-out stock picks. I think our definition of the value philosophy is a broader one, and you know, than our value peers, some of the, you know, traditional more deeper value. So our philosophy is 'potential, valuation and timing'. So we're looking at complimentary factors either alongside value. So 'potential' is just looking for companies that grow their shareholder value at above average pace. And then we also think about the timing aspect, and we look at share price technicals and earnings revisions, and we want those to bottom out before putting decent amount of capital to work. So I think having that kind of broader definition of value has, has definitely, definitely helped.

We've had a consistent multi-cap approach. So by that, I mean, as well as looking at large cap companies we've been investing in and mid and smalls, and I think the mid and small component has definitely been more supportive than you know, value stock-picking at the larger cap end. And so that that's helped.

I think we are typically pretty gradualist into position. So we build up positions really quite slowly, which is one reason why we've got a higher stock count than I suppose most investors, but we're gradualist and we look for you know, positive fundamentals to start coming through. So when it's a recovery stock you want the company to start delivering that recovery before you get too excited. So being pretty gradualist, and I think we've got some aspects of the big picture right. So we didn't go too aggressive immediately after the, you know, the Brexit referendum, I think again some of the peers might've been more aggressive into domestic value stocks and we just held back a little bit. So I think that was, that was a good, good big picture decision.

And we went pretty aggressive, you know, during the peak of COVID, 18 months ago when really there were lots of very distressed investors and investments out there. So we went quite aggressive there when that, you know, particularly strong opportunities at that point. And I think that stood us in good stead for the recovery since then. So it's a kind of multi-dimensional answer, but yeah.

[3:43]

DM: Yeah. Now one of the things that you've already touched on it there was the number of stocks that you hold in the portfolio, which is extraordinarily unusual in the asset managers that we talk to - over 300, in fact. I mean, clearly there's a lot of diversification benefits there, but do you feel sometimes maybe it's over diversified and how do you possibly keep on top of 300 stocks at any one time?

HS: Yeah, I mean, it's been an observation, I think in terms of the funds that I manage over quite a few years, I've typically been more diversified, ie a larger number of holdings. I mean, in the early stage of my career, I remember one or two, you know, large positions that went wrong and that created quite a high degree of angst. So I think since then, I've always said well actually the value in recovery is an approach that probably lends itself to being more gradualist and being more diversified, rather than being really concentrated. I think if you're running quality or you know franchise leaders or whatever, then you can probably stick to a very concentrated approach. I think with value and recovery it lends itself to being more, more diversified. So that's always been probably my approach.

And I don't think it's, you know held back returns, for example, you know, the returns that you mentioned in the first question have been delivered with you know, a relatively large, larger number of individual stocks. I think the gradualism is a particularly supportive part of the approach you know, getting exposure relatively slowly, waiting for the fundamentals to come through, you know, things like Marks and Spencer's, for example, it's starting to beat expectations before you put a decent amount of capital into that. So it was starting to beat expectations, a few quarters ago, and then we became more, more aggressive. So in terms of the actual, you know, physical coverage, all I'd say to that is that, you know, we have invested in the team here. So we started off with you know, four of us right at the beginning 15 years ago, and there's now 13 in the team.

So we've, you know, invested in the team, invested in analysts. And then we also have this very important quants front-end, so quantitative. So, you know, we use the power of computers to help us do our jobs, screening the universe for new for new ideas and also monitoring existing portfolios. So it's a combination of investing in head count, using quants and also, I suppose my experience which is over 30 years. So most companies I've come across at some point during my 30 year career.

[6:32]

DM: Well, it is extraordinary, especially as I'm aware that you also run a global fund and you know, that you know, attention to detail across so many stocks is, it's quite exceptional.

So let's just drill down then into the last year. It's almost plus or minus, I think a day since the vaccine bounce that, you know, the, the announcement of the vaccine efficacy from Pfizer, and we saw a substantial bounce in the value areas of the stock market. I think it's been captured the reopening trade or whatever you want to call it, but it's been a very strong year for the fund. What's your sort of outlook on the reopening or are we fully opened and not going back? How do you see that playing out?

HS: Yeah, I mean, were actually, you know, comfortable and optimistic about you know, the outlook from here. I mean, you know UK equities have been strong enough within that. The value and recovery trade has been robust, but actually you know, UK equities in terms of the valuations today are still really quite, quite modest. UK equities have actually been de-rated over the last year. So if you actually look at you know, share price returns relative to profits growth or earnings growth, actually there's been a de-rating and the UK market's earnings multiple for next year is sort of 12 and a half times so relatively modest valuation. And then the recovery strategy is trading at, you know, a similarly modest valuation from an earnings perspective, the price-to-book is only 1.4 times, price-to-sales only one times. So the valuation metrics are supportive.

I mean, value had a relativity strong bounce, immediately post the vaccine news, but actually the last couple of quarters, the last six months, you know, value's retraced, quite a lot of outperformance. So we're actually describing it as an opportunity to go again. And actually quite a few of the, you know, theoretical reopening beneficiaries have been relative laggards over last again, over the last couple of quarters - perhaps they got a little bit overexcited at the beginning of the year. There have been some short-term worries for the market, cost-price increases, taking money out of the consumer's pocket, things like that, which is created, you know, sort of a sentiment headwind. So actually we think, you know, the reopening trades, reopening stocks are actually, you know, should be really well positioned over the next year because sentiment is actually relatively low at the moment. And we'll pick up valuations to support it.

A good example would be something like Restaurant Group. The, you know, that runs the Wagamama chain, the shares are down 30 or 40% over the last two to three months and has retraced much of its relative outperformance post the vaccine news. So if you look at the airline stocks IAG or British Airways, for example, you know, is hardly recovered, recovered at all, you know, despite the really positive news about the transatlantic routes now reopening up. So yeah, I think, you know, really pretty positive.

[9:50]

DM: Yeah. Another thing that we've noticed, cause this is a UK fund and all the funds are allowed to have a portion of their, up to 20%, outside of their home geographies. But I notice you've recently invested in China via two positions - the Fidelity China Special Situations investment trust, and a holding in Baidu. I'm guessing the sell-off has probably led you into that and better valuations, or what specifically did you like about those?

HS: Yeah, let me take you through that Darius. So, I mean, we've always within the UK Recovery strategy used up, the opportunity to invest up to 20% outside of the UK. So we've consistently run between I suppose, 15% and 18% of the strategy in non UK stocks. Actually, when we launched the fund back in 2008/9, our focus then was on US recovery opportunities. Obviously, the US has been a particularly strong market. And now one of the most interesting areas from our perspective is China. I mean, clearly you know, there are risks associated, significant risks associated with China, but the market's very, very aware of them and great opportunities never come without a background of risk. And we would describe, you know, China as a significant opportunity today - it's only 4% of the MSCI World benchmark when it's you know, the second largest economy in the world on a PPP basis, actually now the largest economy in the world. So I think it's underrepresented.

I don’t think we've got time to go into all the kind of regulatory issues that have, have led to, you know, the digital stocks coming back aggressively, but we just think it's now fully discounted in share prices. So there's an opportunity to buy those sorts of companies on single digit earnings multiples. If you strip out the cash and other equities at their holdings, a single digit earnings multiples for some of the best businesses in the world and given the opportunity to, I suppose, invested in Amazon or Microsoft on a single digit earnings multiple most people that you've mentioned would grab the chance of doing that. There are still much, much higher valuations today. So there is an opportunity and Baidu is what is one of those I've actually described it as, you know, the cheapest mega-cap stock I've ever seen in my investing career.

DM: Wow.

HS: Again I probably haven't got the time to go through that, but you know, if you strip out the cash and equities, equity holdings, it has it's valued on about 10 times the free cash flow from its core search engine. But that's not what Baidu is, you know, just about these days, it's got a leading AI business in China, artificial intelligence business in China, it's got the largest, but the leading autonomous vehicle. So driverless vehicles franchise, and it's got the number three cloud business in China. So those are all in, for free. And then on the investment trust side of things, we know we're comfortable investing 2% to 3% of the fund in investment trusts. And we typically look for regions or parts of the investment universe that are temporarily out of favour and you can buy

DM: Buy them at a discount, I guess.

HS: And buy them at a discount, so we think the Fidelity China very much fits that at the moment. So, you know a good track record over the years and available on you know, a discount at the moment. So hence its inclusion in the portfolio.

[13:31]

DM: Well, I know slightly earlier in the podcast, we did touch on the outlook for the UK, with the reopening trade and everything that's gone on with pandemic. And the UK has been quite unloved, let's be honest, and you pointed to the de-rating. Are you optimistic, has maybe it's the last region with some valuation support left in the globe? Or do you, is it just at a company level, those valuations, which are maybe keeping you smiling?

HS: Yeah, I mean, yeah. I mean, it's interesting. I mean, I do run a global coverage strategy as well. I mean, the interesting point, I mean, one of my key observations at the moment is that in a pretty expensive, or very expensive world, it's actually very easy to find, you know, really good value around the world. And typically, it's in markets that for whatever reason are out of favour, or maybe they have more value exposure rather than growth. I mean, there's a really high correlation between equity markets around the world. If they're perceived as, you know, giving you strong exposure to, you know, kind of classical growth stocks, then they're on pretty full valuations like US equities.

DM: Yep.

HS: If they're regions around the world that have had short-term issues, or aren't giving you that much exposure to that kind of growth momentum trade they're on low valuations. So there is that opportunity. And then UK equities, you know, classically fits the bill of unloved post-Brexit and not necessarily giving you the exposure to, you know, the strongest growth sectors of the last 5 or 10 years. So, as a result of that, you know, UK equities do trade, you know, on a really modest valuations at the moment. Actually, if you look at the relative valuation of UK equities versus global equities, US in particular, we're basically where we were back in the mid-seventies during the day working week, et cetera. So very out of, very out of favour, 12 times earnings multiple. I mean, that's, you know, a relatively attractive absolute valuation.

So, and then we think the outlook for, for the UK economy is perhaps more robust than commentators are suggesting. We think in particular, the consumer in the UK has been a little bit written off because of, you know, short-term cost increases. I mentioned earlier, there's this worry that this is you know, taking away spending power from the UK consumer, costs and tax rises, but we think that overwhelmed by some of the positives, the positives being if you looked at savings ratio - has remained really high in the UK over the last two years, even into, you know, as we speak it's remained high. So there's a big pent up potential for consumer spending, unemployment's remained relatively low. And as we know, in lots of parts of the economy, that's pretty full employment at the moment. That means that consumers are pretty confident about the outlook they're getting higher wage increases, wage inflation is running higher in the short term, that's positive for consumer confidence. And then there's the wealth effect of house prices and equity prices going up again, creating quite a high degree of consumer confidence. So we're particularly positive about, you know, the outlook for the consumer versus currently very depressed expectations. And we think that will support you know, a big part of the UK equity market over the next, next 18 months.

[17:12]

DM: Thank you very much for that. So look, we always like to try and drag one stock out and maybe just finish on that: what's been the best stock in the portfolio this year and why has it done so well?

HS: We've had one or two winners, but I might just mention Somero I think just because, you know, we've had a decent position in the portfolio and it has generated, you know, really strong returns over the last year, so it's come out I think around 150%.

DM: Really…

HS: So Somero has a dominant global market position in a quite a specific product area, which is big pieces of kit that go into levelling concrete. And that's been kind of critical, I think in particular for you know, the big warehouses that are going up in the US and, and around the world to fulfill e-commerce et cetera. Now 18 months ago during the COVID downturn, investors really worried about you know the economic downturn and in particular for Somero that, you know, the cyclical downturn in construction spending. So the shares got pretty hit and they did see, you know, a few quarters of demand falling. So it was a difficult short-term background equaling an opportunity to quite significantly add to our position as we went through last year.

Since last year, you know, trading has, has picked up pretty robustly, so there's been a cyclical recovery, and then there's a structural element which is, you know, seeing strong demand for their kit, and strong investment in you know big warehouses in particular. So it's a combination of, you know, cyclical recovery coming through, and strong underlying structural demand set against a relatively modest valuation, which has allowed the share price to progress, but we still see it as very interesting actually, because there's a fear that all that, you know, current cyclical demand is as good as it's going to get.

And therefore the shares are kind of being capped at the current level. But actually we think there's a strong case to be made for, you know, continued structural strength and then being able to extend their you know, their sales from the US into the rest of rest of the world. So we think actually the structural element will continue to be pretty robust over the next few years, and it's probably wrong for the market to get too worried in the short-term, about the cyclical elements. So, you know, we continue to hold a decent exposure to Somero in the portfolio.

DM: Hugh, thank you so much for your time today, talking us through some of the interesting parts of not only your fund, but the market and discussing the sort of valuation anomalies that on UK equities and the fact that it is so unloved, maybe investors will one day return in their droves to UK equities.

But if you'd like to get some more information on the ES R&M UK Recovery fund, please do visit fundcalibre.com. and if you are loving the Investing on the go podcast, please do remember to subscribe via your normal channel.