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investing ON THE go

TRANSCRIPT: EPISODE 275

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[INTRODUCTION]
Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Today's guest tells us why the UK market is becoming increasingly attractive and why striping out short term macro news and focusing on the long term is key to a sound night's sleep.

Chris Salih (CS): I'm Chris Salih, and today we are joined by Rosemary Banyard, manager of the Elite rated VT Downing Unique Opportunities fund. Rosemary, thank you for joining us today.

Rosemary Banyard (RB): A pleasure.

CS: Let's obviously go straight into the fund. It had its three-year anniversary at the start of the year, and let's just say it's been a busy three years; you launched as the first Covid lockdowns were announced; you've had [the] Ukraine invasion; obviously the high end levels of inflation … that's just to start with! Maybe just tell us how you sort of managed to work your way through this and, you know, has your experience in previous roles helped with this? Give us a bit of an insight [into] how you circumnavigate these challenges.

RB: Yes, yes, so, you're quite right that it's been a period with the most amazing number of unforeseen challenges, of which, I guess the two main ones are the Covid virus and the invasion of Ukraine. And a lot of the other stuff has been knock-on effects from that, whether it's sort of labour shortages, lockdown effects, logistics problems. And I probably would add to that, political upheaval in a lot of places that we read about. You know, the rise of populism. Even in some places, the rise of the right wing, such as in Italy, there's a whole load of stuff been going on.

One of the ways that I cope with it is that I'm quite clear that I don't attempt to forecast macroeconomic factors, and I don't base investment decisions on what we would call a top-down method. I don't sit there and think, well, I think this macro event's going to be the trend and therefore I'm going to find things to take advantage of that trend - I don't do that at all. And that is incredibly liberating when you've got all this stuff going on. It's not that I'm blind to it; obviously I read stuff the same as everybody else, but it's just that I'm looking for really excellent companies that have strong finances, sound business models, things that keep the competition out, that can keep growing. And that, in itself, lends you to invest in businesses which hopefully can survive all this.

CS: Keeping the emotion out of it as well, and …

RB: … And it keeps the emotion out of it and it helps you to sleep at night, actually.

CS: Ok. Let's go into the focus of the fund. Obviously, there's a bit of a focus more on the smaller-[to]-mid-caps, small are always in the eye of the storm, but mid has also had a lot of headwinds in the past 18 months or so. How do you approach that? Is it the same as what we've just discussed? I mean, talk about that and the impact on performance and also, you know, just how confident perhaps you are in these companies now, the levels [being what] they are?

RB: Yes, well, it is extremely relevant because, as you rightly say, I focus on UK small and mid-cap investing and AIM, and that's my heartland; it's my core competence, it's what I've been doing for decades. And so I'm not about to change that. It would be foolish indeed for any fund manager to go outside of their experience and go and do something completely different. You know, people can buy a range of funds run by people with different experiences, but that's my area. But it has been a massive headwind in the last certainly two years. And just to put some numbers around that; if you take it from the launch of this fund, which was, you know, March 2020 to the end of June this year, so three and a quarter years, it's interesting that the FTSE 100 is up 49%. The Mid-250 [FTSE 250] is up 37%. And the AIM 100, the top 100 companies on AIM, are only up 18%. So, when you think this fund has had roughly 30% on AIM and over 40% in the mid-cap and I'm up, well, at the end of June, [I] was up 43.5%, I've clearly outperformed - massively - AIM and have outperformed the mid cap [FTSE 250]. But it's still a struggle to keep up with the peer group, many of whom are investing in the very largest companies.

So, it is very important that people understand that, because a lot of people will look at where you rank against your peers and they'll look at it and think, gosh, this woman's not … she's just lost the plot. I don't believe I have lost the plot. It's just there's been a big size effect. And it's not just in the UK. It's very famously happened also particularly in the [United] States where, you know, the top seven tech companies have massively outperformed and virtually nothing else has.

CS: You must have hope as well that, you know, when some of these headwinds for these areas turn into tailwinds, that's when you'll see further upside as well. I mean, some of these are really …

RB: Yes, yes, absolutely. So, you know, there are reasons why I - other than just basic experience - why I personally choose not to invest in some very large companies. You know, one would be banks where they have good returns on equity only because they have a thin amount of equity capital and then they gear that up a lot, so they have a …[the] margin for safety is quite thin there. And they, of course, are vulnerable to regulation and windfall taxes. Same is true of oil and gas. So, I just prefer to stay out of areas which are in the political limelight because you can never quite tell when the regulation or the taxes are coming. But in terms of the small and mid-caps, there's been a steady stream of bid activity, which we no doubt will come on and talk about, and some companies, of course, have been hit, but many others are just continuing to do what they do well and they're just getting on with it actually.

CS: Let's turn to another part of another sort of issue with the fund. I mean, a key part of your philosophy is around long-term compounding. You said that you believe markets tend to underestimate the power of compounding in businesses with superior returns on equities. Could you maybe just go into a bit more detail, explain that and give us a classic example of that? Because it's true, it just maybe needs to be explained a bit more to [our audience].

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RB: Yeah, yeah, absolutely. So, you can have two businesses. They could be earning, having the same revenue sales; they could even actually be earning the same level of profit, but they might be doing it off very different levels of capital. So, one might be very capital intensive and it might be manufacturing or retailing or something. And it has to keep putting in lots of capital to keep generating those revenues and profits. The other business might be relatively low on the need for capital. I would say these businesses will tend to be long on intellectual property - they won't necessarily have so much need for physical assets, for stocks or factories or whatever. And I'm aiming to invest in the latter because you find that those businesses then generate loads more cash, because they don't have to keep reinvesting in stocks or fixed assets or whatever it is, and they generate lots of cash.

This gives them options. You know, you can buy back shares, pay lots of dividends, you can go and make bolt-on acquisitions, all sorts of things that you've just got lots of flexibility. And what you tend to find over the very long term is that those businesses - because they're earning such good returns on the capital, the value of those businesses - that the profits compound up far faster than when you are having to sort of redeploy a lot of that capital back into the business. And so, if you wait long enough, they perform really very well. Of course, it requires them to sustain a good, strong position to keep doing that.

But - and it's very interesting with this fund, you know, it's been going sort of three and a half years - if I look at the companies that have performed the best in the fund, there's a very clear group that have done the best, and they are the ones with the highest returns on equity, by and large. Yeah, there's one exception, a company called Strix [Ltd.] which makes kettle controls, which actually has had a lot of debt and was very badly affected by the extended lockdown in China. But, generally speaking, these very high return businesses have just performed the best.

And an example that many people might know as consumers is Games Workshop [Limited], obviously known for [its] shops that sell these fantasy, toy soldiers. They have these fantasy worlds that they have created, Warhammer, Warhammer 40,000. And Games Workshop is a classic example of a company that's makes very high returns on its capital. It's well invested. And it's very interesting [if you] consider the long term; so, it's been on the market now about 30 years. It floated in 1994, valued at £35m pounds. The market now values it at £3.5bn. So, that's a hundred bagger. And I should hasten to add that it's hardly issued any shares. So, it really is close to a hundred bagger

CS: If it can survive Covid, it can survive anything!

RB: Yes, absolutely! And just the power of it is incredible. So, the revenues have gone up 7 times in 30 years; profits have gone up 34 times; and they just announced a dividend of 130 pence. They pay five dividends a year at the moment - they're not all at that level, but - and that 130 pence dividend, so one dividend is now more than the price you would've had to pay for a share when they floated when you had to pay 115pence. So, that's the power of compounding. Absolutely, in, you know, in real numbers.

CS: Just quickly on that, is it easy to spot those type of companies quite quickly? Because in the area, small and mid-cap, can it take a couple of years to actually spot those type of companies before they get into full flow?

RB: Yes, there's usually plenty of time actually, because they keep going and, in this case, actually, I would say a lot of the big returns in the share price have come in the last five or so years. It's been investing and it's been developing these fantasy worlds for years; it's been investing in manufacturing and in shops and things, but it had a new CEO a few years ago - internally promoted - who seems to have galvanised the company into growing even faster. And, in particular, to have exploited their intellectual property. So, they now get quite a lot of royalties from licensing out their intellectual property on computer games, and they're talking to Amazon TV about some TV shows as well. So, I think, yes, it's not at all the case that these sort of companies are one year wonders and that you can miss them. It's well worth hunting around and finding them in my view.

CS: You mentioned mergers and acquisitions earlier. I mean, obviously the UK market is significantly undervalued; it has been for a number of years now. M&A, although a good sign, can also be unwelcome in some cases in terms of losing good businesses at prices that aren't necessarily reflecting their true value. That's something you said you've seen it. How prevalent has it been? How painful has it been for you?

RB: Well, I would say that companies have been disappearing from the UK market for decades; good businesses, either to trade buyers or more commonly actually, to private equity. But, of course, at times like this, when the market is down and, as you say, cheap compared with internationally, it is particularly painful when you get directors recommending a bid and most bids come at a 30% premium to the price - why it's always 30%, nobody's ever satisfactorily explained to me but it seems to be some sort of unwritten rule in the market. So, you get this bid, it's a 30% premium, you then get the directors recommending it because it's a premium. The advisors are sort of saying to them, well, you know, it's going to be a year or two before you get this price any other way. So, they feel under pressure to recommend it. And these deals get sort of done and dusted and it is very painful.

So, in this year, in the fund, I've had two bids - both in the healthcare area actually. So, one is EMIS [Group plc]. This is a company that provides … it's the leading provider of software for GP surgeries and pharmacies. So, chances are that either your pharmacy or your GP will use this system. And they have recommended a bid - actually, it's at a bigger premium than the 30% - but it's from UnitedHealth of America [UnitedHealth Group, Inc.] – a huge company. But I'm sad to see it go because when you think about the data that passes through EMIS' systems - and I'm talking here unnamed patient data, they don't have the access to your identity as an individual - but there's a vast wealth of patient data there going back years, which is clearly of great value to pharmaceutical companies and other people who want to use that data to develop products, services, so that value in the longer term is now lost to us as investors.

The other one which is very recent actually, only this week, is called Ergomed [PLC]. And they are a company that manages clinical trials on potential new drugs. And they also carry out safety testing on drugs that have been already launched. And they have particular specialisms in cancer drugs, orphan drugs and in areas where they run trials, for example, [in] Eastern Europe and north Africa, where others find that difficult. And you know, they've now had a private equity bid. And again, you know, you lose a company like this off the market and finding something else equivalent is actually is not that easy.

CS: You obviously run a very concentrated portfolio. You talked about the need to sort of manage out that emotion and focus on that bottom-up side of things; how often are you making changes due to market conditions or is there ever any point where the noise gets so loud that you think you have to react?

RB: Yes, not the macro noise, I honestly don't react to that, which says something about the confidence I have in the businesses I own. You know, for example, only two of them [businesses] needed to raise any money during Covid, and they - the two in question - only raised 5% placings, which is not a lot. So, even in that extreme stress, they weren't in a great deal of difficulty.

CS: Is it ever hard to ignore the noise?

RB: It is hard to ignore the noise. But I'm very much an investor with a long-term focus for the reasons, we talked about - the compounding effect, etc. And so, the turnover, for example, on the fund in 2022 was 12%, and in the first half of this year 6%, which I think would be considered pretty low by markets standards. So, I will add to known investments if they fall too low for a reason. And then, of course, there's these sort of bids, so you end up sort of getting cash for those.

And then the only other real thing that's going on here is just trying to improve the quality the whole time. So, you come across a company that's better quality than some that we own, that has a stronger competitive position, and maybe it's cheaper, then there'll be a case for switching. But it's at that level, it's not at the level of 'oh help, interest rates are staying higher longer, so I need to think about my whole strategy' or something. That's not what's going on.

CS: I'm going to finish off by just talking to this UK sentiment, which has been pretty low for a number of years. I mean, for listeners who are pensive and a bit wary of the home market, what would you say to those who are looking at [it] now and thinking, is it a good entry point? Is it not a good entry point? Maybe just sell UK plc to us for us?

RB: Yes. So, I think there are some interesting things going on.

Firstly, there's been a much-publicised shrinkage in the number of companies on the UK market, and, you know, we've talked a bit about that with the bids, etc. So, clearly UK plc is attractive to others and remains so. And I've discussed a couple of bid situations of my own, and I don't see any reason why that isn't going to continue. There is quite a lot of concern now out there, on the part of market practitioners, even government, about the shrinkage of the UK equity market, the fact that people are thinking about floating in the [United] States or whatever. And I think that concern is moving towards changing incentives, whether that be possibly more tax incentives or the carrot and the stick type thing. So, I think we could well see more of that coming, which will help.

The other thing is that it is always necessary to be careful when you see a big surge in a market, where that surge is very narrowly based. So, I'm thinking here, the US and those seven companies, and people do need to spread their bets and be careful about these 'fashions' if you can call it that, where certain things become incredibly popular and what we would call a crowded trade. The UK is not a crowded trade, it's the opposite.

And the other thing I'd just say on the size front is that there've only been, I think, three previous occasions in the last 20 years when the mid-cap index in the UK has been valued at the same level as the FTSE 100. [The] FTSE 100 is normally cheaper – it has more cyclical businesses in it. And we are at a fourth period where that's the same, there's no premium now on mid-caps. It last happened in 2003 after the tech boom and bust, it happened [in] 2016, and it happened in Covid in 2020. And after each of those, there was a very major recovery in small and mid-caps. And so, I think there is a feeling that we're now at that point again.

CS: That's great, Rosemary, thank you very much for joining us today.

RB: Pleasure.

SW: Launched in 2020, the VT Downing Unique Opportunities fund seeks companies with sustained competitive advantages, low debt, and strong management. The portfolio is highly concentrated at just 25-40 names - primarily from the UK, although some overseas names can be added if the opportunity arises. To learn more about the VT Downing Unique Opportunities fund, visit FundCalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.