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[INTRODUCTION]

Staci West (SW): Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Today's interview combines contrarian thinking with a focus on long-term investment trends within the UK market.

Joss Murphy (JM): I am Joss Murphy. Today I've been joined by Alessandro Dicorrado, manager of the Ninety One UK Special Situations fund. Hi, Alessandro, how are you?

Alessandro Dicorrado (AD): I'm good, Joss. Thanks so much for having me.

[INTERVIEW]

JM: Let's start with the UK stock market. It's been a bit up and down this year. Is it being driven purely by sentiment or are UK companies struggling generally?

AD: <laugh> It's always hard to know exactly what markets are being driven by, but clearly sentiment isn't great. For the UK, interest rates have risen a lot and potentially are going to rise a lot more or a bit more. And I think there are generally lots of fears around the impact of that on the economy – [a] potential recession [and the] depth of it. But I mean, we pay attention to it, but it's not something we base our investments on. We really just use the environment to try and find opportunities. And, in this case, what's happening is that because of the fear around recession and around how bad things are going to be, a lot of economically-sensitive companies in the UK are priced for like they're going out of business, really. So, that's what makes it interesting for us.

JM: Certainly. And you look for - correct me if I'm wrong - stocks where the share price has fallen and potentially unloved stocks as well. Are you seeing a plethora of opportunities today then?

AD: Fundamentally, we look for the biggest discount to what we call 'fair value' that we can find. Now, that often happens with stocks for which the share price has fallen, but it could be a situation in which the share price hasn't done anything, but the business has grown. Really, we're looking for a disconnect between the price and our assessment of what the real 'fair value' of the company is.

And, either way, yes, we are getting a lot of opportunities in the UK. I think, from any quantitative metric that you look at, the UK market appears to be among the cheapest around, and not only because you've got some big resource stocks like the oil majors and miners and banks, but also if

you exclude those the mid-caps, [the] small and mid-caps in the UK look cheap, both in [an] historic context and in a global context. And for us, it's very interesting to be running a UK strategy at a time like this. And we really have more ideas than we know what to do with, which is a nice situation to be in because then you get to pick the best ones.

JM: Yeah, that certainly makes sense. And lots of funds are all about ESG at the moment, at least for the last couple of years, picking companies that are helping society. Your top 10 is full of what we'd call 'sin stocks', tobacco companies, oil and gas, the world's second largest producer of sugar - why them? Simply because no one wants them?

AD: The definition of 'a sin stock' is an interesting one because we find that people apply that judgement a little bit too quickly, and all you have to ask yourself is basically, what would happen if we stopped all oil and gas production today, for example? Or we stopped all air travel today? And the key here, we think, is to think about these stocks as being in a transition that's going to last some decades, rather than hoping that today we live in a world that we actually want to live in, in 2050, for example. And we think people are forgetting about this transition aspect of things, and they try and construct a portfolio as if we were already in the world in 2050, and we don't think that's a realistic way to be.

We don't own really any materials companies, but you could definitely make the same arguments about materials, mining, cement, all those things that clearly are high emitters. You know, try, imagine a world without cement. So, it's a difficult mental gymnastics if you want, to reconcile the fact that yes, these companies are high emitters or are difficult to decarbonise, but at the same time, we need them for now. And if we need them for now, it's hard to call them unethical, which means why not invest in them, especially when they're cheap? Because what you're getting is a situation in which everybody wants to look good, and the stocks are currently priced as if no one wants them. And you get an attractive price when that sort of situation happens.

JM: In a way, could you say that, you know, helping these companies transition into being more ESG is actually more ESG than some of these kind of pure play ESG companies?

AD: Well, I do think that, but I'm glad that you said it because coming from me sounds a bit salesy, but I think that's right. I think that's right. I think that's a good point. I think if you want to really make a difference, you have to take on the hard problems. It's too easy to just take on the easy ones.

JM: You mentioned we're not in 2050 yet. Does this mean you see your portfolio changing and evolving over time as the world changes and potentially since stocks will be faded out [of] the portfolio in this period?

AD: Yeah. So hypothetically, if you were to, let's say, not touch our portfolio from today until 2050, we would expect most of today's sin stocks to have largely become much less sinful. It's hard to say

completely zero because, for example, how do you find a substitute for plastic? Obviously, plastic needs oil as a feedstock, but I would expect our companies to have done something about that as well. So, for example, you can attach carbon capture facilities to the plants that make plastic so that okay, you're technically still emitting emissions, but you're capturing them and not emitting into the atmosphere, you're capturing them and storing them in the ground. So, I would expect mitigation actions like that.

JM: And would you be working at kind of shareholder meetings to help provide these companies with guidelines to make sure that they are sticking to commitments on the ESG front? Or how does that work?

AD: Yes. I mean, sometimes we tend to invest in the ones that are already pretty advanced or that already have a decent strategy. We think it's quite hard as a shareholder to completely change the strategy of a company. And we've done it in the past, but I can count it on the fingers of one hand in which we think we've maybe made a tiny bit of difference in there. So, really, what we do is we invest in companies that already get it, and the good thing in the current market is that the companies that already get it, are priced basically the same as the companies that don't get it <laugh>. And so, you're really paying a very small premium for this.

So, yes, if you were not to touch the portfolio from today until 2050, I would imagine it to have largely sorted itself out. But that's because we buy companies that we think already have a good ESG strategy, rather than relying on us doing something about it. And the problem, if you rely on you doing something about, it's that you really need to be very, very active. And often, you're also dealing with, if a company hasn't done anything about this theme so far, first, they might be too late; and secondly, you might be dealing with a very stubborn management team or something, it'd be a difficult challenge to take on.

JM: And while the rest of the world, Alessandro, is focused on Tesla, your largest holding is Rolls Royce. What's the rationale here?

AD: The holding is that large because it's done very well. But it was a large holding to start with. And if you accept that air travel is a thing and that we're going to have it for some time to come, then that problem of the emissions generated by travel is going to be solved by companies like Rolls Royce and a couple of peers. There's GE [General Electric Company] in the US and Safran [S.A.] in France, and a couple of other businesses that make jet engines. And the only way that these companies become irrelevant is if you say, well, actually let's stop all air travel. We did that during Covid, and I think a lot of people were, well, I don't think anyone was happy about that. So, I think you have to accept that you need to decarbonise this industry, and the people who are going to do it are people like Rolls Royce.

Now, because if you buy Rolls Royce, it increases your carbon emissions in the portfolio - we think that's one of the reasons why the stock was cheap in the first place - it's a very, or should be a very high quality company - the last 5 or 6 years, the company has had plenty of problems - and so, we think that quality has been hard to find or hard to see in an obvious way, but it is starting to show and the market's slowly realising its value. And if you think about what you've got here in terms of potential, is an annuity business because these jet engines, they fly for 20 - 30 years and you get paid by the hour of flight; [it’s] super predictable; [it’s] very hard to disrupt - it's very hard to make a jet engine from scratch, [so] the barriers to entry are incredibly high; and you can buy it for, you know, just over 10 times free cash flow. And if you think about if this were making shampoo or if it were making, I don't know, some other consumer staple, the rating would be much, much higher. And so we think it's just a good opportunity. And again, we don't see any problem with this business, as long as it's doing the right things in terms of trying to decarbonise.

JM: Add a bit of balance. You do have some good stocks too, Vitesco Technologies [Group AG], for example, which is looking at electrification technologies for vehicles. Could you tell us more about that?

AD: Yeah, well actually, so I'm glad you bring that up. Because Vitesco is a company that is a company that would've been seen maybe six or seven years ago - a bit like Rolls Royce today - this was a company that was making injectors for gasoline engines, except that it was part of Continental at the time. So, it wasn't an independent business, you couldn't have actually bought the shares. But imagine that it had been an independent company. This was making injectors for internal combustion engines and actuators for internal combustion engines and things like that. But it had a very, very strong R&D programme in terms of electrification and hybrid vehicles and obviously contributing virtually no revenues, because 6 or 7 years ago, there were virtually no electric cars being sold. And so, if you looked at it purely on a revenue basis, you would've said, well, this is entirely dependent on [the] internal combustion engine. But really the crux was that these guys were investing for the future.

And today, fast forward 5 years, 6 years to today,- Vitesco and another American company called Borg-Warner [Corporation] are basically the two leaders in providing electrification solutions to cars. They still do the internal combustion stuff but that's going to naturally decline as people buy fewer and fewer internal combustion engine vehicles, and the electrification products are going to take over the company.

It's exactly the type of situation that we think is worth exploiting because the market doesn't price these things in until they become obvious. So, if you get involved a little bit earlier then you can catch these big electrification trends or these big future trends, but you have to get [in] early enough. If you wait for everybody to know this, then the price is going to reflect that.

JM: Do you have any other auto suppliers? And… it seems like a sector you are quite bullish on. Is this true?

AD: Yeah, yeah, it's true. We have, well, Vitesco is one of them. We have three others, one of which is in Germany - Continental, one of which is in the US - Borg-Warner, I mentioned it I think when we were talking about Vitesco. And then we have a UK-based one, which is TI Fluid Systems [Plc]. And plus, we have a small position in a business called Dowlais [Group plc], which is a spinoff from Melrose [Industries PLC]. And for people who have been around a while, this was the old GKN Automotive business.

The interesting thing about all of these companies is that, well, actually the interesting thing about the auto supplier space in the last few years is that, if you think about Covid, you had a chip shortage, which meant that fewer cars were getting produced - about 20% fewer cars than in a normal year. This impacts auto suppliers enormously, because auto suppliers make money on volume, not necessarily on the end price of the car. It's been well advertised that prices for end cars, have gone up in the last few years, but all of that margin is kept by the manufacturer. The auto suppliers have fixed-price contracts and they make money on volume. And so, their volumes were 20% lower than in a normal year, which meant that many of them were making very little money. They were operating at breakeven or barely profitable. So, the market really, really punished them. And of course, at the same time, you have this overhang of the internal combustion engine probably disappearing over some uncertain but period of time. And generally, it was easy not to touch them.

Now, the interesting thing about that situation is you had companies with very little debt, very little leverage, so, they were making no money, but it wasn't a solvency problem, it was just a question of when they would make more money. And if you imagined a normal year where auto production resumed to normal levels, then you could also calculate how much money they would make, and you could buy basically the entire auto supply sector - I'm generalising, but basically you could buy most auto suppliers for five or six times normal earnings.

Now the trick was, that there were a lot of auto suppliers that were very dependent on the internal combustion engine, and so, maybe deserved to trade on six times earnings - because if you're in a declining business, that's more or less the multiple that you deserve. But the market was not differentiating between the suppliers that were going to decline and the ones that were well positioned to take advantage of electrification. And so, that’s when we took our big bet on auto suppliers. We think it has played out a little bit, but we think it still has a lot more to play out, particularly once the market realises that a lot of these companies are going to make the same amount of money that they used to make with internal combustion engine, with electrified products. So, we think it's an interesting place to be.

JM: Alessandro, you mentioned the theme of electrification. Do you look at long-term themes when constructing the portfolio, such as decarbonisation or globalisation, or is it purely a bottom-up stock selection process?

AD: I think if you take it back to what kind of stock we look for - which, just to repeat it, it's one where the current price doesn't reflect the true, future value of the business - you want to keep abreast of all the main themes that influence current society. So, electrification is one of them. AI is obviously another one. The whole debate around microchips is something you want to be on top of, renewables, generally, you want to be on top of that. I think the problem with - and these are all very relevant themes - [but] I think the problem with, I'm going to say most investors, is that once these themes become hotly debated and very well advertised, then there's this feeling that creeps in that, oh, I've got to be involved in this. The problem being that when everybody's talking about it, the opportunity is largely gone.

So, the way we use these themes is that we keep on top of them. We research a lot of them, but we don't necessarily do anything about it until an opportunity happens to intersect with one of these themes. So, in the case of auto suppliers, at the moment you've got a situation in which, well, really during Covid you had a situation in which the entire auto supply space was heavily, heavily discounted, and there, you could pick the ones that were most exposed to electrification themes, that were going to be the winner[s] in the long term, but they were priced as if they were going to go the way of the internal combustion engine, which, you know, potentially is going to disappear over the next 20 / 30 years.

But I think you need to wait for the opportunity to present itself, an opportunity that intersects with one of these themes. And then you know that you're buying something that isn't just a … you're not buying just for a little pop because, you know, maybe they pay a big dividend, or they do a little corporate engineering or something. You're actually buying it for strong, long-term fundamental growth reasons. But you're paying a price that is a value price, you know generally less than 10 times earnings. So, that's the way we use these big themes. We really keep on top of them, but don't necessarily do anything about them at the moment. For example, in AI today, it's a very, very interesting theme, but everybody's talking about it. And where's the opportunity going to be? Well, it's hard to find the discounted AI stock!

One of the things we did with - I'm going to go slightly in a different direction now - but one of the things we did last year, or 18 months ago, on a loosely-related theme of AI, which is one of the unintended consequences of computing power and AI becoming more widespread, is that you have a lot of cyber-crime. And you had a situation in which the people providing cyber-insurance, so insurance to companies that get hacked for example, alongside the entire insurance sector last year, a couple of years ago, was heavily, heavily discounted. So, we bought companies like Beazley [Plc]. Beazley in particular is the leader in cyber-insurance and even Hiscox [Ltd.] which has a

small business in cyber insurance. And so, you can tangentially make money out of these sectors, when an opportunity intersects with one of these themes because you know that there's going to be a lot more interest in cyber-insurance. So, if you're the leader there, and at the moment for some reason the company isn't making much money because it's going through a tough year, you know that over time you're going to have a growing business. So, that's the way we use these things.

JM: Certainly an interesting point to end on Alessandro, I just want to say thank you very much for your time today.

AD: Hey, my pleasure. Thanks again for organising it.

SW: Ninety One UK Special Situations aims to deliver capital growth by investing in unloved UK companies that the managers believe are undervalued. To learn more about the Ninety One UK Special Situations fund, visit FundCalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.