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[INTRODUCTION]

**Staci West (SW):** Welcome back to the Investing on the go podcast brought to you by FundCalibre. This week we're focusing on how rising interest rates and shifting market conditions create opportunities for investors, from behavioural changes in corporate decision-making to strategic stock picking.

**Darius McDermott (DM):** I'm Darius McDermott from FundCalibre. Today I'm delighted to be joined by Luke Newman, co-manager of the Janus Henderson Absolute Return fund. Good morning, Luke.

**Luke Newman (LN):** Morning, how are things?

**DM:** Yeah, pretty good.

[INTERVIEW]

**DM**: So look, I have known this fund since its inception, and I know what it's trying to achieve. So let's see if we can't explain some of a bit more detail about the fund. Now it's trying to beat cash. Now we've been through different environments of what cash was when particularly in the QE era when rates went to historic lows. I think you've recently said that this type of environment more suits humans rather than machines. Maybe if you could elaborate a bit on that and what it's meant for the fund in this now higher rate environment.

**LN:** Yeah, absolutely. We've been running the strategy for 20 years now. And the investment process is very consistent as you know very well. We're looking in the same areas. We invest in larger mega-cap equities across Europe, UK, and the US. I think one thing we've realised over that period is the importance of the environment we're investing within.

And really since the summer of 2022, as we jawboned interest rates higher or central banks did it's returned us to an environment where money has a cost again. And I think the contrast to us through those, let's call them the QE years where we were in that extended period of ultra monetary policy, has returned to an environment where I think as a stock picker, our approach is really suited. And I think the contrast in machines were slightly tongue in cheek, but what we've seen in this period are the primary driver of a share price returning back to bottom up fundamentals again, rather than what correlations have existed.

Macro drivers, it's much more about things that used to drive share prices, quality of management, team margin structure, what's the state of the balance sheet, what's the valuation? And I think all of those things in totality mean that as a human stock picker, who's meeting management teams, who's trying to triangulate

valuation fundamentals of the share price. Our experience of the last two years in this more organised environment is that it's made our job a lot easier.

**DM:** And then through the period of lower rates, is it just QE raised all asset prices and all shares went up. Given that this is a long/short strategy - is that differentiation between companies was less prevalent?

**LN:** I think like so many things, it's easier in hindsight to see what was going on. And I think, you know, why was the less of an alpha opportunity out in the market? Why were share prices moving with greater correlation? I think there's probably two main reasons. One's technical and one's more behavioural.

I think the technical side — I won't disappear into the statistics of valuation — but the discount rates or prevailing interest rate, of course, is crucial when it comes to valuing any asset. And I think the closer we got to zero, or obviously in some countries we had a negative interest rate there. You end up with huge correlation between those assets that becomes the primary driver of how any asset, let alone share prices is then valued. And we saw huge waves of the market just correlating with US treasury bills particularly asset like growthy technology businesses that just became bond proxies. So you know, that was an unusual period. And one we had to learn how to adapt to and how to cope with that environment. But the release from that has been very pronounced. So really, that technical element is really the removal of those ultra low interest rates or discount rates or cost of money.

The behavioural ones probably more interesting though because if I was and, you know we are investors rather than executives of listed companies, but what we started to observe through that period, particularly for those companies that were benefiting from lower interest rates, were seeing their valuation, their PE multiples, their valuation multiples increase is it was possibly a temptation to sit on your hands.

You know, if you were perceived by the market as having good structural growth and were correlating with the NASDAQ or with the t-bills then why take a risk with strategy? You know, why disclose too much? Why be too front footed in terms of pursuing growth because you were already being rewarded for having those characteristics since this jaw burning hire of interest rates, then what we've seen is much more pro-action really in boardrooms.

And I think the UK is a great test case for that, where we've seen executive teams having to justify growth plans, having to think about financing, one of the things that's changed with higher interest rates is that debt now has a cost. So if you're going to borrow then you need to justify why. So we're, you know, we're seeing much more concise growth plans. We're seeing difficult decisions for executives and boards as well. I mean, if you've got an inbound takeover approach for a whole company or maybe just one of your divisions that would account for the majority of your overall value.

I think there was a lot of those discussions we didn't hear about as shareholders because actually we were seeing these asset prices move ever upwards. We're now seeing some difficult decisions being made. So there's behavioural change as well in this return to money having a cost. And I think the combination of those two is leading to not simply one factor, low rates driving XY markets and share prices. We've now got multiple factors and styles. We talked about some of them already that are driving whether a share price goes up or down, and that's a much more manageable environment for us, not only to deliver consistent absolute returns, but importantly to manage the risks side of the equation as well. You know, and our mandate is a combination of the two.

**DM:** So maybe then just one final question on rates, having had that real steep rise throughout 2022 and a bit of 2023, we now look as if we've reached the other side of the mountain and that rates are now in fact coming down, having had one cut in the UK and one larger cut in the US. Does that worry you that we are returning into a sort of a meaningfully lower interest rate, or do you just think we've peaked and rates which would gradually come down and still keep that differentiation in the market that we've just been discussing?

**LN:** I mean our view is that market and interest rate regimes don't change rapidly. And if you listen to central bankers, you know, in general and politicians, I think there's a really strong set that all certainly western economies want to avoid going back to that period of ultra low interest rates. And that's partly for economic reasons you ended up with huge economic inequalities in valuation and in wealth. But I think you can park a lot of the social equality that accelerates that period, but you know at the same doorstep.

So I think even if we do see a mild recession, and I wouldn't say that's our base scenario, but let's say we did in Europe or the US, I think there's real resilience to avoid simply going back to money being free and interest rates at zero again.

So within that, I think again, it feels more normal. You know, we didn't used to cut interest rates to zero because we had a recession. It was tough times for households, tough times for firms and for economies. But actually you work through that de-stocking cycle and there was a natural cycle and wherever we look across economies, sectors, industries, we're seeing more of a normal cycle beginning to reestablish itself. And that isn't simply 10 years ago.

Actually, if you look over decades, it's a much more normalised environment. So we don't see rates going back to zero again. I mean, if they do, we're gonna have to rethink, but actually, as long as we don't move back to towards zero, I think there's better stock picking environment. And because we've got a short book as well as the long, I think the benefit to us is doubled. We've got better stock picking opportunities on the long book, but obviously there are some businesses and firms and sectors and industries that will struggle for various reasons. And we've got a short book that can look to capitalise on those as well.

**DM:** Well, let's get into the fund itself then. We talked about the environment and how it is now a better environment for that company dispersion, stock picking especially when a fund is looking for companies that can go both up in share price and down. But historically, you've been sort of more two thirds in the tactical and one third in your core, but I believe that's a bit more sort of 50/50 now. Is that because you're just finding more core holdings as a good long-term positions, or is there a nuance in the market on the tactical side being less obvious? Tell us a bit about that.

**LN:** Yeah, absolutely. I mean and this is probably more peculiar to our strategy and that we like to keep things simple. And so there's no complex options or derivatives within the absolute return fund. We like everything to be on a single stock basis where we can including the short book. And we find that it's a much more effective hedging tool on the short book, but also we can use the short book to actually look to make money for our investors as well as protect on the downside.

The next differentiation we make, as you said, is between the core and the tactical book. And those core positions tend to be larger, more overtly fundamental. So we're looking for real equity change here. So if you see a new management team in the FTSE or the Euro stocks or the S&P, we're gonna be looking to meet that management team as quickly as possible to see if what they plan to change and whether it will affect the share price and the strategy.

That core book is the perfect vehicle for this environment that we found ourselves in over the last two years. More fundamentally driven share prices, more structural trends, more themes, driving share prices rather than simply where are US rates. So that's why we've been looking more towards our core book, and we can certainly look at some of those ideas in a second.

The tactical book remains critical to what we do. You know, we have a job to do, not only in terms of delivering that consistent, stable, absolute return, but also to manage the term volatility from budgets geopolitical events. And that tactical book becomes a critical part of taking the daily, weekly volatility of noise, in the news cycle and within stock markets and dumping it down.

So it becomes, you know, it always remains a very important part of what we do. The change though is we're seeing more opportunity in that core book. So if we look on what's changed, where are we finding those ideas?

On the long side of the core book, we spent most of the last decade looking in the US actually most of our time is back in Europe and the UK again, and particularly the UK where saying the UK stock market is lowly valued was not a reason to buy shares. But actually the performance over the last few months and year or so is starting to show you that something's changed. And I think it's linked to all of the things we've been saying.

There's more rationality in markets. We've seen some stability in terms of policy decisions. And that's something we need to keep on watching brief on of course, particularly the next few weeks. But if you look at the inbound M&A we're seeing into the UK, I think, empirically what we can say here is, you know, if investors like ourselves are not taking advantage of these low valuations for domestically exposed UK businesses, as well as those that are internationally exposed, then we're seeing trade buyers, other companies, particularly US ones stepping in and taking advantage and acquiring those companies or financial buyers like private equity who are still sat on a lot of firepower coming in and doing exactly the same. So those areas have been very interesting.

But on the short side of the core book, lots of themes of at work there as well. So financial leverage you know, as one important one, you know, compared to the last 10 years, as we said earlier, debt now has a cost. So if your financial director of your listed company has not addressed the balance sheet, they've now got a problem. You know, do they roll over on expensive debts or look to raise equity to plug that a poll? We're seeing the US consumer particularly challenged at the moment, generally more leverage, the household level in the US, the economy was heavily stimulated at a direct level through covid, and there's an unwind to that. So whether it's US retail, US consumer goods, we're seeing a lot of opportunities within those sorts of areas in the US on the core book and they're working really well.

**DM:** Yeah. And that is a key difference. You know, you have two jobs, you've got to look for companies that share price will go up, but unlike most fund managers, I think our listeners will understand you try to buy low sell high. You've also got the other job, which is trying to look for companies that are either overvalued or over leveraged, as we've discussed. They have too much debt. Are you, I mean, everybody talks about the US being overvalued potentially at a market level, the UK being undervalued, particularly in the US, you are seeing that opportunity for making money for companies, share prices actually going down. And I know you touched a bit on the consumer, but is the US an obvious region?

**LN:** It is at the moment. You know, we try to be very flexible and emotional. And when…let's wind back the clock a bit, you know, unplugging political sensibilities you know, in 2016 for the next four years, you know,

obviously the UK domestics were in a tough spot and there was capital flight out of the UK market. Now, in a fund like ours, that that means that we ended up with a net short in UK domestic exposed shares. That's now a net long. So, for the reasons we discussed a second ago. So when we look at the US, just because there have been a lot of businesses that have created a lot of value over the last few years, doesn't mean that if we see excessive valuation with negative operational news, that we're not gonna look for shorts.

And that's exactly the setup we've had over the last 18 months to two years. And I think the starting point of high valuation is, again, something we can lay at the doorstep of those seven or eight years of ultra loose monetary policy. The distorted markets we saw technical flows and passive flows flying into the US market at the expense of other areas. And that's created some dislocations as we're starting to see normalisation and trading patterns. It also means seeing normalisation in valuation.

So one good example over the last few months would be the work we've done on the GLP-1, obesity drugs. Now, you know, for a fund like ours, you know, that creates almost endless possibilities when we think about how the future will change potentially for all of us going forward let alone health budgets and consumer trends.

So, as well as having had long exposure to the manufacturers like Nova Nordisk and Eli Lilly you know, then they've worked very well on a long book. We've done a lot of work looking at this early stage of adoption how consumer habits are already changing and what we can see within US food manufacturers. What we can see within US retail, US restaurants is that the looks to be the start of some trends in terms of lower consumption in terms of the the 80/20 rules that seem to apply. And it's true most businesses, if you look hard enough, but actually you end up with a smaller number of consumers that account for a disproportionately large number of amounts of the demand. And what we think we can see already is that even if there's just one user of these GLP-1 drugs within a household, it's beginning to impact that super consumption.

Could be hamburgers, could be cans of Coke or Pepsi. And we're beginning to see lower volumes and lower, lower calorie intakes, not just for the user, but for the whole household. Now, if we start to look forward over the next few years, we're beginning to join the dots on one of the great things about the equity market and it's not always right, is that it's forward looking. So if we can start to see more evidence, then the stock market will move ahead of that data and reduce the value of some of those exposed businesses.

**DM:** Luke thank you very much. Maybe a nice way to end it sort of long of, you know, obesity drugs and short of busy pop and maybe hamburgers, as a nice sort of thematic way to wrap this up. So thank you very much for taking us through your fund and the opportunity set and the environment in which, you now have a good chance of winning on both the long and the short side.

**SW:** The Janus Henderson Absolute Return is a long/short equity fund with a UK bias, that aims to deliver a positive absolute return over rolling 12-month periods. The managers look to identify stocks that will either exceed or fall short of analysts' expectations and construct a portfolio of both long and short positions. There are limits on the overall market exposure, which serves to reduce the volatility of the fund. To learn more about the Janus Henderson Absolute Return fund please visit fundcalibre.com