Sticking to core principles during a momentum crash

In recent months, the relatively steady climb of FTSE 350 has masked a degree of turmoil behind the headline figures. What some observers have been calling a ‘great rotation’ had begun, in which supposedly ‘defensive’ value style stocks were outperforming more growth orientated companies. What we in fact witnessed was a ‘momentum crash’ where companies which had been performing well, fell precipitously, in almost uniform fashion.

This effect reached its nadir in mid-May and some commentators believed these events marked a new phase of the market cycle. Value characteristics were coming into favour after some five years or more in which equity valuations have risen significantly. But with the end of QE and interest rate rises in sight, at least in US and UK, if not the Euro bloc and Japan, investors may have been rotating into defensive and value style businesses.

Although we pay heed to macro factors, as bottom up stock pickers we look for companies with strong operational momentum and the ability to grow their earnings faster than consensus expectations. Because many of our holdings enjoyed positive momentum, the past few months were difficult for some of the shares we hold.

But despite some of these stocks recording double digit drops in this period, many have since recovered and our fund remains top quartile in the IMA UK All Companies Sector year to date (and since launch in May 2012). Our view is that this recent period can be seen in terms of a short, sharp correction. We believe the prevailing market and economic backdrop, which had favoured our holdings in the preceding quarters, will now begin to reassert itself.

In our analysis, little has actually changed at a macro level. Although Bank of England Governor Mark Carney is flagging interest rates could happen sooner than had been the market consensus of Q1 2015, rises are likely to be slow and incremental in order to avoid jeopardising recovery. And, as for the idea that monetary stimulus is being uniformly wound up, with potentially destabilising consequences, you only need look at the European Central Bank adopting a negative interest rate policy to help stimulate Eurozone economies, and China, which is said to be considering forms of asset purchases to support growth, to see this is not the case.

There are of course other risks which could undermine our positioning of the fund. Widespread deflation is certainly a concern, but rather than take a dogmatic stance in this debate, we prefer to focus on where we can readily identify pockets of inflation and deflation, and link these directly to the prospects for shares, owning those we like, avoiding – and occasionally shorting – those we don’t. That leads us to think that UK-listed companies exposed to downward global pricing pressures and currency fluctuations are better avoided in favour of companies that have pricing power and are positioned to benefit from the domestic UK recovery.

Tesco amply serves to demonstrate the characteristics we want to avoid. The majority of its profits may be from the UK, but they are declining amid fierce competition at the high and low ends of the market. Meanwhile, its experience in hitherto high growth overseas markets is chastening, as its Q1 results highlight.

International sales were up in like-for-like terms, but only a meagre 0.5%. The region with the best growth, Asia, saw a 1.5% rise in sales transformed into an 8.9% drop in sterling terms as a result of currency movements. For further evidence of the challenges faced by companies with high levels of overseas earnings, take a look at Diageo, where sales in some previously surging international markets where down when it reported its results in January - in China by 23%!

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Back at home, the prospects for the domestically-focused businesses that we like continue to look good. Housebuilder Barratt Developments and related companies such as Howden Joinery Group are positioned to benefit from long-term structural factors, such as a chronic housing shortage, coupled with policy support in the form of Help to Buy and related initiatives. Both sold-off heavily in the recent ‘great rotation’. While they have recovered some ground, Barratt remains some 21% off its March high and Howden is currently down 20% from its peak in the same month. Barratt now looks very attractive on a PE of 8.8x. Its forecast dividend is 3.8%, growth of 43% on the previous year’s payout. Howden is forecast to grow its dividend by 18% next year.

Other high conviction holdings include Ashtead Group, which is currently down 9% from its April high, and Easyjet, which is some 10% off its April price but in our view remains one of the most attractive shares in the market. Due to their projected earnings and free cash flow growth, businesses such as these are often in a position to grow their dividends faster than the market. This is currently contributing to a 3.7% indicative net yield on our UK equity holdings, exceeding the FTSE 350’s 3.5% but with the potential to grow at a faster rate owing to the underlying companies’ superior forecast dividend growth. This translates into 23% forecast dividend growth at portfolio level this year compared to 7.5% for the market.

David Urch, Fund Manager
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**David Urch - Fund Manager**
David joined EEA Fund Management Limited from Oriel Asset Management LLP in October 2013 and manages the TB EEA UK Equity Market Fund (launched May 2012). An experienced investor, he has a record of delivering superior risk adjusted returns in the UK equity market over a 17 year period. David began his career on the UK Specialist Team at Mercury Asset Management/Merrill Lynch Investment Managers in London and was subsequently appointed to develop and grow a UK specialist business at Martin Currie. In 2003 he joined Scottish Widows Investment Partnership as manager of the flagship SWIP UK Opportunities Fund. Prior to founding Oriel Asset Management he worked for Fidelity International, helping to relaunch their UK institutional offering. David graduated from the University of Edinburgh with an MA (Hons) in Politics and Modern History.

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1 Indicative net yield reflects the most recent dividend, annualised as a percentage of NAV.

2 Source: Bloomberg, June 3rd

3 Source: Bloomberg, June 3rd

4 Source: Deutsche Bank, May 28th 2014

All figures quoted in this article were correct at the time of writing to June 3rd 2014