

SHINING A LIGHT ON..... JUPITER US SMALL AND MIDCAP COMPANIES FUND

At a glance

The US market is notoriously difficult for active managers to outperform; the argument is that it is highly efficient and therefore investors would be better to hold a fund that tracks the index rather than paying for active management.

Many managers privately agree that the only way to achieve consistent long term outperformance is by exploiting short term inefficiencies in the market. This sounds obvious but with the US market it can only be done by luck or a sound and tested process.

Therefore unless investors can uncover those hidden gems (exceptional fund managers) then they are probably better to take the passive route.

One hidden gem which seems to have been under promoted is Robert Siddles who for over 12 years managed the F&C US Smaller Companies Fund, and previous to that was head of the US team at Gartmore. The F&C Fund has an exceptional track record and Robert recently left F&C to set up and run the Jupiter US Small and Midcap Companies Fund.

It is testament to his skill that the board of the F&C US Smaller Companies Trust also moved this to Jupiter to ensure that the fund continued to benefit from his skills.

We first met Robert in 2013 when he was at F&C and this update follows a meeting with him now he is at Jupiter. The key message is that nothing has changed it is the same process but has the advantage of a larger support network to feed in ideas.

Who are the team behind the fund?

The lead manager is Robert Siddles. He has an excellent long term track record, working at Gartmore for a number of years as Head of the US Desk and then F&C for the last 12 years. In 2013 the F&C US Smaller Companies Investment Trust was awarded the FE Alpha Manager Award.

He works with Sebastian Radcliffe who has been at Jupiter since 1999 and manages the North American Income Fund.

What is the story behind the investment?

Since March 2009, the US market has more than doubled.

The US economy is still on the road to recovery. Consumer sentiment has improved and nationally housing prices are recovering.

Opportunities remain in cyclical parts of the economy (i.e. those that tend to contract faster in recession and grow faster in recovery) and demand for autos, housing and rebuilding inventories will help boost the economy and support company profits.

Interest rates are likely to remain low and although tapering has started this will be a gradual process.

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There are differing views as to whether investors can gain much more from holding US stocks, some argue that certain sectors are now expensive others argue there are still plenty of opportunities. In this environment we believe a good active fund manager picking out the attractive special situations can outperform the general market.

Fund highlights?

The trap that we can fall into is assuming this is a high risk fund because it invests in smaller and midcap companies. When we talked to Robert about this he reiterated what he told us back in 2013. His approach is about achieving long term capital growth but at the same time aiming to avoid capital loss. Effectively what he is saying is that he has demonstrated that he can achieve out performance without forcing additional risk onto the fund.

The way Robert approaches this is threefold – firstly he looks to exploit market inefficiencies, secondly he doesn't look to hold more than 2 to 3% of any one holding and thirdly he only invests in sound companies which he feels are not recognised in the market.

Smaller companies are traditionally seen as high risk and illiquid; to reduce the risk Robert restricts the maximum holding to around 2% to 3%. So investors shouldn't expect high conviction in one holding but across a number of holdings. He has proved that by doing this it lessens the risk but at the same time doesn't compromise performance.

The only way to beat the index is to exploit market inefficiencies and Robert as a two pronged approach to this. The fund focuses on its long term core holdings which Robert refers to as Buffett compounders. The theory is that these companies could in theory be held for ever, he may sell if the stock is too expensive and there are new opportunities to exploit. The second type of holding is best described as bombed out and troubled cheap stocks.

There is a recovery slant to the fund and most investors would consider investing in bombed out and troubled cheap stocks would be dangerous but Robert explained his approach. He will only invest where he feels the risk is low, so back to good quality companies gone bad. If he feels there is too much risk he won't invest. The second point is that some companies fall into value traps and they remain cheap for a reason, these companies are also avoided.

Unlike the core holdings these fall under what he calls Graham Cigar Butts. His view is that when the company recovers the share price will recover and therefore he will sell out. These are short term holdings but will add additional alpha to the overall return on the portfolio.

Touching on the types of companies is as much part of the process as anything else and contributes to the low risk approach to investing. He follows a good company concept which covers five areas, every company must pass these tests:

1. Strong franchise – a clear edge over the competition
2. Free cash flow – which considers how capital is used over the competition
3. Insider ownership – the right incentive for management. Robert likes family ownership but is worried if for example a son is placed on the board with no management experience
4. Customer concentration – Robert will avoid businesses which solely distribute to one business
5. Inexpensive valuations – Robert is looking for at least 50% upside to the business value

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The types of holdings tend to be US focused, and possibly businesses which are not in many US Funds. A couple of examples include a Retail REIT which exploits the US consumers desire for outlet centres and another is an insurance underwriter which insures tattoo parlours.

We talked about the outlook for the US and whether it is too expensive especially in the small cap area. Robert said that it is expensive but highlighted that pricey can stay pricey for a long period. He highlighted a warning in 1992 that large cap US stocks were expensive but the run continued until 2000.

He also explained that there are a number of factors helping the US. Firstly demographics, the US is benefiting from labour force growth from large Hispanic immigrants and this is in contrast to the likes of Japan, South Korea, China, Germany and Italy which are all facing a shrinking labour force. Manufacturing is becoming more competitive, shale gas is bringing chemical companies back to the US because it is easier to turn into chemicals. The third factor is something called the 'brain belt' – the attitude of the US person is different to anywhere else. The lack of a safety net means Americans are prepared to take risks, this means business men are prepared to take risks and be more aggressive to achieve the end result.

Robert went onto to explain that there are many temporarily embarrassed people all waiting to be the next millionaire! The point is that at any point their fortunes can change because of what is on offer in the US.

What we have always liked about Robert is his ability to deliver long term outperformance without taking outside risks. Investors focusing on short term performance shouldn't look to this fund. They have to be prepared to accept this is a long term investment opportunity (5 years plus) and only over this period should they be rewarded with Robert's style.

The question is whether there are risks with this fund and of course there are. Firstly the question has to be whether Robert can repeat the process at a new company, if we look at the analogy of good football managers at small clubs moving to big clubs – often the smaller environment suited their style and they are unable to respond in the bigger environment – a once great track record is quickly ruined. Secondly the fund is new and it is too early to look at fund performance. For this reason we have not included this.

In summary Robert has demonstrated over a number years the ability to achieve long term out performance without taking extreme risk, moving to Jupiter has not changed his approach or his style and on that basis investors looking for an excellent long US fund wouldn't be too far out in considering this fund. The only thing for investors to consider is whether he can repeat the success in a new firm or whether he was better suited to the environment he had before. Only time will tell.

The source of information in this note has been provided by Jupiter and is correct as at September 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.