SHINING A LIGHT ON……
M&G RECOVERY FUND

At a glance

There are over 400 UK Equity Growth and Income Funds; providing investors with access to many different investment styles. So choosing the right fund depends upon understanding their methods and aims.

Performance is part of the equation but equally the management team is crucial. We have met a number of talented Fund Managers, the likes of Standard Life Investments, Neptune, Schroders, Legal and General, Threadneedle and Liontrust (not all of these are in our portfolios).

In the past we held the M&G Recovery Fund in our portfolios, but we no longer hold it. We carried out due diligence at the time when we met the deputy fund manager but felt that they could not provide the confidence we needed to continue to hold the fund.

At the time this was important because the fund had been suffering a prolonged period of underperformance and we were looking for reassurance on whether to stick with them or look for an alternative option. In the end we choose to end our association with the fund. In hindsight it seems a wise move as the underperformance has continued.

So the question is why anyone would even consider investing in this fund. Clearly (based on short term performance (under 10 years)) the strategy is out of favour or the fund is just too big.

The reason we keep coming back to the fund is the sense of history associated with the fund. It is without doubt a unique fund in the industry. It is one of the oldest in the UK going back over 40 years, during that time it has had just three managers and its long term (10 years plus) track record is excellent.

The style of management is different, it is contrarian and we have had a very different investment environment over the last five years which has clearly not favoured the fund. So is the fund cheap, are there opportunities or is it destined to be a lame duck, at the end of glory years and heading for the dustbin of time.

This time around the update we had was with Tom Dobell and in this review we will share some of the thoughts he shared with us and highlight the investment style.

Who are the team behind the fund?

Tom Dobell is the lead manager and has managed the fund for the past 14 years. He joined M&G in 1992. His track record over 10 plus years is excellent and he has demonstrated his ability to outperform his peers over a longer time frame. However, over short time frames he has underperformed significantly.

He remains well respected but there are differing opinions from different analysts on whether he has the ability to reverse the declining fortunes of the fund.

He is supported by two deputy managers and clearly has the backing of M&G to reverse the performance decline of the fund.

Fund highlights?

Because of the funds recent underperformance it is worth starting at this point and certainly in the update this is where most of the questioning came. There were two key elements of the questioning – firstly whether the fund was too big and secondly how long would the fund suffer underperformance before the manager changed tact.

If we cover the second point first, Tom explained that whatever happens there are no plans to change the strategy of the fund. The strategy requires patience and he admits that the wind is against them. Companies which should be doing well haven't been recognised by the markets. He believes this will change and when it does the patient investor will be rewarded. It was clear from the discussion that there was no arrogance in what he was saying and he was humble in admitting that the short term underperformance was hurting loyal investors.

This brings us onto the second point, the fund size has always been a concern when we reviewed it, it was over £7 billion and now it is closer to £6 billion. Tom stated that he cannot hide behind the size of the fund as a reason for underperformance. He explained that when he took over the fund 14 years ago the fund was around £1.2 billion, it has gradually grown over the years and size doesn't make the fund less liquid and doesn't stop finding good opportunities. The other area is that the fund invests over 50% in the FTSE100 and 20% in the FTSE250 meaning the ability to sell stocks is really easy to do.

So if the strategy remains sound and liquidity is not a problem then how can investors judge whether they should invest in the fund.

Tom explained the four principles of what they do:

1. Only invest in companies they understand
2. Only invest in companies they trust
3. Seek companies that influence their own fate
4. Back the underdog with special potential

Taking three examples:

1. Oil Sector – BP is their largest stock position and has been a company they have been buying into since 2010 when the share price collapsed. They feel the company has been unfairly treated and the share price doesn't reflect where the company is today. It has a strong management team which has made disposals of some of the poor parts of the business and now the company is much stronger and has better cash flow. At the moment this is not being reflected in the share price however they are being paid to be patient as the dividend is 6%.
2. Financials – they remain underweight financials but the sector has changed and they have moved to an overweight position in banks. Lloyds and HSBC are in their top ten holdings with HSBC being their second largest holding
3. Food retail – they have invested in food retail, Bookers is an example which they have now sold out of. They are looking at the sector but Tom explained the problems in the sector have been there for some time. The problems at Tescos are culturally ingrained and this will take time to change. His belief is that this might present an opportunity but it will take time to resolve

BP is a long term holding and demonstrates the style of investment. That is that Tom will wait until the market recognises that the company has recovered and maximum value has been obtained. Lloyds and HSBC show that waiting until change has started to take place enables him to consider long term the benefits of those changes. He may invest in Tescos but clearly he needs to see change before he invests.

With these examples it is clear (and Tom stressed this) that the fund is unlikely to be top of the tree each year because the recovery stories need time to play out. He believes that many of the holdings are positioned for recovery and when they correct, the correction will be sharp. When asked when this will be he said simply that he knows it will happen he just doesn't know when.

He went on to explain that 41 of the 88 holdings have outperformed over the last 12 months but clearly this hasn't helped the overall performance.

For investors looking to invest in recovery and unloved stocks this fund is a great entry point, with a strong long term track record and excellent management team. The difficulty is that the style of management has been out of favour for some time. Investors have to make a call and it is twofold they either believe in the strategy and that it will correct, if this is the case then the argument is that now is a good time because the fund is cheap. Or you believe the strategy cannot operate in this volatile and uncertain environment and therefore although the fund is cheap and it will remain cheap.

In summary it is a fund with a great long term track record, however over the last four years it has underperformed. Investors need to judge whether this will correct or whether the fund has reached a point where its performance will continue to decline.

Fund performance

Performance over the last five years (and year to date) is shown below:

	2009	2010	2011	2012	2013	2014
M&G Recovery Fund	41.17%	16.62%	-6.23%	8.86%	14.25%	-6.67%
Lyxor ETF FTSE All Share	29.16%	15.40%	-4.61%	11.67%	20.16%	0.53%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced. Returns are based on the US share class.

Conclusion

A well respected fund and management team which has suffered 4 years of underperformance. The manager has no intention of changing tact and investors need to decide whether the fund will reverse the current decline or not.

The source of information in this note has been provided by M&G and is correct as at October 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.