

## Highlights of conference call for the Rathbone Recovery Fund Tuesday 1<sup>st</sup> June 2010

**Julian Chillingworth**, Chief Investment Officer and Board Director (specialising in large caps)

**Marina Bond**, Investment Manager (Mid and small caps)

**Alan Dobbie**, Assistant Fund Manager (European equities)

### Julian Chillingworth:

We seek companies whose potential recovery value is unappreciated by the market. This means looking at macroeconomic recovery situations (cyclicals such as advertising agency *WPP*); or sector recovery stories (pharmaceuticals, for example); an individual stock story where we're backing a management team (*Booker*, the cash and carry business); or a recovery in sentiment (for example, in the tech sector where the likes of *Pace*, the set-top box manufacturer, is offering great recovery potential).

### Selecting recovery stocks

We identify the reason for the weakness in the share price and identify a potential trigger to drive the price higher. The portfolio is a focused core list of 60 stocks (81 in total, 28.05.10) - conviction holdings. We will aim to hold around 3 to 4% in individual large cap names and 2 to 4% in mid and small caps - so we are really backing our judgement. We are benchmarked against the IMA All Companies sector, and we're also looking to make investors a positive return over the fullness of time. That's very important - a real return. There is no sector or stock-anchoring. It's very much a stock-picking fund, and we're quite prepared to take contrarian views. Our universe is very wide, from the UK to Europe, so we need to drill down, making use of both quantitative and qualitative techniques to analyse management teams; cash-flow and debt.

### Portfolio breakdown

We've got an underweight in basic materials where we are concerned about a slowdown in China and the impact on mining stocks, where we're already seeing a fall-back. This may well throw up opportunities, but we think there is further to go. We have been playing resources via the oil and gas sector, and we've got holdings in *Tullow Oil*, *Statoil*, and smaller plays like *Gulfsands Petroleum*. We believe industrials are a recovery area. Global growth should improve as the year unfolds, and these companies should do reasonably well. We have shied away from the banking sector, but have a good spread of other financials, from insurers to financial services. In summary, this portfolio breakdown demonstrates that we are prepared to go against the FTSE All-share weightings and impress our views on the portfolio.

### Marina Bond:

*Volax* produces electronic and fibre optic cables, assemblies and power cords. This was a low margin contract manufacturer, but it is now moving towards contra-engineering which is high margin. There are two parts to the organisation; however, it is the interconnect side that's the most exciting. This is where they sell items such as cable assemblies into computer and communications markets. Although a bit lumpy, this is higher grade and higher margin, and demand is coming from growth in mobile networks from India and China. A new management team came in last year. Management is key in turnaround situations, and I often back a team or person who's done well for us in a previous outfit. This new team has been sorting out suppliers; reducing their numbers in order to improve buying power, and increase control and improve payments. Freight has also been streamlined, and IT systems across the group have been upgraded; however,

there is more to do. These actions clearly make this a margin story. The management team aims to increase growth margins from 15% over the next two years. The key is now top-line growth, and as announced in their full-year results, Volex has produced quarter-on-quarter top-line growth for the last three quarters. The final point to make on this company - and it's a very important point for us - is that management have renegotiated their banking arrangements. In conclusion, this is a management story; a turnaround situation where improvements to operations are leading to higher margins and with a rating that is still extremely attractive.

**Alan Dobbie:**

The stock I've chosen as a case study is the large cap French pharmaceutical company *Sanofi-Aventis*. Similar to some of the other stocks I've spoken about, it wouldn't necessarily be considered as a candidate for a recovery fund. Hopefully I can persuade here that, yes, it is a defensive stock, but it is also a recovery play and, most importantly, it is also good value. The company is the sixth largest by revenues, globally. The sector has undergone a massive de-rating over the last decade or so. Admittedly, this is from what was an unrealistically high level, but there has been a radical shift in investor expectations for returns on growth from the sector. In many respects, that de-rating was understandable and justified. Pharmaceuticals have gone from being one of the darlings of the late 90s to a sector that now faces a multitude of risks. However, this negativity has gone too far, and that's really the crux of the investment case for the pharmaceuticals as a whole, and more specifically for Sanofi-Aventis.

As I said, this sector is considered to be relatively risky. We tend to think of the risks in terms of the 'Four Ps': Patents, Pipeline, Politics and Pricing. Basically, what has happened over the last ten years or so is that pharmaceuticals have struggled to cope with a number of the blockbuster drugs going off-patent, and at the same time suffered from poor R&D - so their pipeline productivity has decreased. There are also many threats from politics; we know all about President Obama's healthcare reforms and EU drug-pricing. There are some massive changes going on but, to coin a phrase, these are all 'known-knowns' - to a fair degree we can calculate the impact of a drug going off-patent. We now understand many of the implications of President Obama's healthcare reforms; so although there are uncertainties in the outlook over the next ten years or so, it's a lot clearer when compared to other sectors that are priced on higher multiples. Furthermore, we shouldn't forget that the demand side is essentially taken care of in terms of ageing populations.

On Sanofi itself, it's a company that is facing quite a steep patent cliff over the next three or four years. They've got several blockbuster drugs going off-patent, and the plan is essentially one of diversification: trying to replace those lost sales with those of more sustainable products built around five growth platforms. These are animal health, vaccines, emerging markets, generics and over-the-counter drugs - all non-patent protected, fast-growing product lines. The aim of this is to move the valuation of the company onto a more going-concern franchise basis, rather than having investors view the company as a portfolio of drugs with a limited lifespan. The result will be that by 2014 around three-quarters of the firm's revenues will be generated by non-patent protected products, and hopefully this should afford the company a much higher valuation multiple. On this valuation, the stock is trading on about seven times this year's earnings and, very importantly, it's got a dividend yield of 5%. So, in my opinion, we're being paid a pretty decent return over the next few years, whilst the company transforms itself into an exciting healthcare franchise.

**Julian Chillingworth:**

The Rathbone Recovery Fund has brought together a team that has skills across the market cap spectrum and Europe, and this creates a truly holistic portfolio. We have a very structured investment process and a strong conviction in what we're doing and in the investments we hold. We're bringing together analysis at the macro level; looking at industry and stock-specifics, and identifying areas that are out of favour in other investors' psyche. We believe that by doing this, we can construct a portfolio that will offer good value and performance across a prolonged economic cycle, and not just during an immediate tick-up in global growth. The fund has made a very solid start, and despite the buffeting that we've seen in stock markets over the last few weeks, has performed reasonably well. We remain confident that it will continue to do so in the future.

**Julian Chillingworth (Chief Investment Officer)**

**Marina Bond (Investment Manager)**

**Alan Dobbie (Assistant Fund Manager)**

**Should you require any further information, or wish to raise any points from this call, please contact one of our sales representatives or ring the help line 020 7399 0399.**

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