SPECIAL REPORT

HOW DO FUND MANAGERS RUN YOUR MONEY?

ANTHONY BOLTON

MANAGER: FIDELITY CHINA SPECIAL SITUATIONS INVESTMENT TRUST

Anthony Bolton is one of the UK's most successful investment fund managers, having run Fidelity's flagship Special Situations Fund between 1979 and 2007, delivering growth far in excess of the wider stock market. In April 2010 he moved to Hong Kong to manage the Fidelity China Special Situations Investment Trust.

SANJEEV SHAH

MANAGER: FIDELITY SPECIAL SITUATIONS FUND

Sanjeev Shah took over as manager of the Fidelity Special Situations Fund in January 2008. He adopts a highly contrarian approach, seeking out unloved, undervalued companies where there is scope for a transformation in fortunes.

Today we are getting a unique behind the scenes look into the world of fund management.

Have you ever wondered how funds really work? What they do with your money? What approach they take to investment and what tools and resources they employ to identify the best investment opportunities? Why should you consider the fund management route in the first place?

To help answer those questions we are here in the shadow of London's St Paul's Cathedral at the headquarters of Fidelity Worldwide Investment, one of the world's best known fund management businesses with more than 660,000 clients in the UK alone. Not only will we discover how they run their clients' money but we will find out where they currently see the best opportunities for investors.

Fidelity Worldwide Investment, founded over 40 years ago, is a major player in the fund management industry, with over £135 billion worth of

This transcript is not personal advice based on your circumstances. If you are unsure about the suitability of an investment please contact us for advice.

The value of investments can go down in value as well as up, so you could get back less than you invest. It is therefore important that you understand the risks and commitments. So you can make informed decisions for yourself we aim to provide you with the best information, best service and best prices. The views expressed are those of the speaker and do not necessarily reflect the views of Hargreaves Lansdown or Fidelity.

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funds under management run from 11 investment offices worldwide. Dominic Rossi is the group's global chief investment officer for equities. First we asked him the most obvious question: why invest through a fund manager in the first place?

Dominic Rossi: Fidelity Global Chief Investment Officer, Equities One of the big differences between being a single stock investor and being a portfolio investor are simply from the diversification benefits which you will get from a collection of 30, 40, 50 stocks rather than the specific risk associated with 1 or 2 stocks. One of the great advances we have made in fund management over the course of the last 15-20 years is understanding how groups of shares react together when they are in a portfolio, and it is through those enhanced risk systems that we can make a portfolio a far more efficient way to invest than single stock selection.

So all the tangent risk analysis and all the assessment has been done for you effectively if you go for a fund?

Dominic Rossi That's right because when you are buying a stock you are not simply buying a company or a stream of cash flows; you are also buying a lot of other stuff as well. You are buying currency risk, you are buying sector risk, you are buying political risk, and being able to understand how those risks are mixed together in a portfolio is key to making your portfolio efficient.

The opposite of Fidelity's active management approach is passive management where funds track a stock market index and don't try to beat the market. These tracker funds are becoming increasingly popular, so why does Fidelity remain committed to the stock picking approach?

Dominic Rossi I think because we fundamentally believe that research really can add value to your portfolio. We believe by analysing companies better than our competitors we can really identify which companies are going to succeed in the future in absolute terms but also in relative terms as well. Through buying those investments and holding them for years, not weeks, but years, we think we can compound your wealth over time.

Active management of course relies on a fund manager's ability to select the best investments. At Fidelity they take a 360° approach to research, examining investment opportunities from every angle.

Dominic Rossi The basis of our equity research is really about engagement with companies. I don't simply mean just meeting with management once a year, I mean meeting with the whole board, the whole of the executive team, meeting with the clients and the competitors of those companies, so we get a real 360° view of that company. It's not simply about taking a view of that company but it's through our engagement process and our stewardship responsibilities that we actually seek to improve the performance of the companies in which we invest, rather than being a passive stand-bye.

Sanjeev Shah runs the Fidelity Special Situations Fund which invests in unloved, undervalued companies. The fund is a member of Hargreaves Lansdown's Wealth 150, a list of its favourite funds in the major sectors. Sanjeev explains how this 360° research approach was applied to Ladbrokes, a top 10 holding in his fund.

Sanjeev Shah: Manager, Fidelity Special Situations Fund It started off about 2 or 3 years ago when we had a meeting with the chairman of the company and really reflected on some of the key issues that the company was facing, and some of the key priorities for the chairman who was relatively new to the organisation. Following that a new CEO arrived at the company and we did some fairly strong bespoke work around the background of this CEO, his past achievements etc, which gave us a flavour of the new man who was going to be leading the company going forward. We have also had surveys done on the customers for example; what they think of Ladbrokes as a brand and how they perceive the overall franchise of Ladbrokes. We have also spoken to suppliers, for example suppliers of machines to their estate. All of that has enabled us to get a real complete picture on the overall franchise and the overall industry in which Ladbrokes operates. Finally we have also spoken across the board to competitors, so William Hill for example and some of the online competitors, as to some of the issues that Ladbrokes face and how easy it is to turn around the franchise.

The quality of research in any fund management business relies on the quality of its people. This means they put huge emphasis on the recruitment and training of their analysts in search of the fund managers of tomorrow. Dominic Rossi, Fidelity's Global Chief Investment Officer for Equities, explains Fidelity's approach to recruitment and training:

Dominic Rossi We spend a great deal of time with the various universities across the United States and Europe and increasingly in Asia. We will be recruiting several dozen graduates a year some from MBA schools, but some straight out of their bachelor's degrees, and then they will join what is a pretty vigorous first few weeks. If they don't know anything about company accounts at the start they certainly will by the end of that period. Then they will start an apprenticeship where they will spend a good 7 or 8 years within our analyst ranks, focusing on particular sectors within a market, and we will rotate them from sector to sector over the course of that 7/8 year period. By the end of those 8 years we are pretty confident if they have survived that they are pretty good analysts.

Eight years is quite a commitment for them to make and presumably only the strongest and best get through that process?

Dominic Rossi Yes you need to be smart to be successful in our industry but you also need to have stamina as well. Once you have done your 8 years you will then go into what we call our PM academy and that's effectively our in-house university where we start teaching you the practical issues of running portfolios. You will do that for a year or so and then only after that are we likely to allow you to run assets that belong to our clients; so really you are going to be at Fidelity 10 years before you start managing client money.

One of the biggest challenges of modern fund management is seeking out investment opportunities in the emerging markets. The culture in these territories is very different and the risks present themselves differently too. Companies here are often less transparent than their western counterparts making accurate company research and analysis even more difficult. Fidelity has had a major presence in Asia for over 40 years. It's a vast area that includes China, India, Malaysia and Australia. John Ford, Fidelity's Chief Investment Officer for the Asia Pacific region, understands the particular challenges of these markets well:

John Ford: Fidelity Chief Investment Officer for the Asia Pacific We have a team of corporate governance specialists supporting our analysts and portfolio managers in the region to help us sort out the wheat from the chaff, and we also engage with companies in the region behind the scenes to try and make sure that they understand why putting shareholder interests at the front of their minds is actually beneficial to their companies, their operations, as well as to investors. I think one thing that's true though is that since in particular the Asian crisis at the end of the 1990s, standards of corporate governance have improved dramatically, company balance sheets have improved dramatically, and so the risks are still there but it's not as risky an area as I think sometimes people think. I think that sort of view of Asia is somewhat out of date now.

So perhaps the investment risks are decreasing in Asia as a whole but China, the region's largest economy, still has a reputation for a lack of transparency. Anthony Bolton who runs Fidelity's China Special Situations Investment Trust sees this as a key factor:

Anthony Bolton: Manager, Fidelity China Special Situations Investment Trust One of the challenges I have in China is finding out what the truth is. I meet lots of companies and our analysts meet lots of companies but there is a greater likelihood that they are distorting or putting a spin on the story; maybe even telling us things that are not true relative to probably what you get in developed markets. So part of what our team of analysts are looking to do is to crosscheck what they are being told by companies with other data points that will either confirm or conflict with what we are being told. In addition to that we use a number of outside firms that specialise in things like business intelligence and market research which are extremely helpful in China, again reaffirming whether what we think is going on in a company is the actuality.

As you can see investing in China and other emerging markets brings with it very specific challenges for fund management businesses. Another popular area for investment is fixed income, including corporate and government bonds. This brings a different set of challenges and investment criteria. Andrew Wells, Global Head of Fixed Income Investments at Fidelity explains more:

Andrew Wells: Fidelity Global Chief Investment Officer, Fixed Income and Solutions I think there are a number of different types of fixed income investing so in investment grade investing what we are looking for is companies with big strong balance sheets, that are highly diversified and have very strong fundamentals so they can survive different economic climates, allowing us to get a very consistent return of principal and interest. If you are looking at high yield we are looking for companies that have improving debt profiles over time. They are slightly riskier companies so you need to have a diversified approach to portfolio management.

So can we talk now about the difference between investment grade and high yield bonds? It might be a subtle one but what is that?

Andrew Wells It's an intriguing difference and perhaps one that has become mixed over the last few years, particularly with all of the sovereign problems we have had in Europe. Traditionally an investment grade bond is one issued by a large multinational corporate or a high quality government and a sub-investment grade bond, or high yield bond, is issued by a smaller entity with poorer credit quality and has traditionally been a riskier asset class for investors to buy.

So what about the strategic bond asset class?

Andrew Wells It is an asset class that has grown in enormous popularity over the last couple of years and it is predicated really on the uncertainty that exists in the world. An investment manager has the ability to look at the economic climate and to make an asset allocation decision. They can see if inflation is coming down the road and protect investors' money by buying inflation protected bonds, maybe high yield bonds to increase the income, or alternatively government bonds to preserve the capital, and this dynamic mix of flexing those different assets in the portfolio is the strategic bond asset class.

So we have had a close look at how fund management works by analysing Fidelity's investment philosophy and processes. Now let's take a look at where the team here thinks the opportunities are. First let's look at the outlook for bonds:

Andrew Wells With all the quantitative easing taking place around the world we are preparing ourselves for a low interest rate environment for a long period of time. The US Fed have said that they are targeting unemployment to get down to 7% but they are a long way off that at the moment and the main tool they are using is a low interest rate policy to do that. Well in that environment it's unlikely that high quality bonds, be they governments or corporates, will go out of fashion or get much cheaper. But longer term there will be a change in the interest rate environment and as soon as we start to see inflation come through, perhaps the back of 2013/2014, then we will get a change and we will start to see particularly government bonds fall in price and the yields rise. Investors can do different things to protect themselves in that environment. They can move to a more strategic bond type portfolio, they can include more inflation linked securities or high yield and emerging market bonds that will benefit from spread compression in that economic environment.

Next we asked Dominic Rossi, Fidelity's Global Chief Investment Officer for Equities, about the outlook for global stock markets:

Dominic Rossi I mean first of all we should appreciate that the equity market overall is offering you very attractive yields at the moment, you know 3.5% - 4%, whereas government bonds are yielding you 1.5%, and it has certainly not been in my career that equity markets have offered you twice the income of a government bond market. More specifically though we can point to some of the more defensive areas of the equity market, not simply in the UK but in Europe and globally, where we are seeing very attractive dividend yields and where those dividend yields are likely to grow over the course of the next few years. So we are talking about the food industry, the beverage industry, the tobacco industry, certainly the pharmaceutical industry companies like Sanofi or AstraZeneca, Glaxo; these are companies with very significant dividend yields of 4% - 5%, higher in some instances, and those dividend yields may indeed grow over the course of the next few years.

Do you have any worries about valuations for those companies? Are they perhaps as high as they are going to get given that they have had a good run recently?

Dominic Rossi They have certainly performed well over the course of the last 12 months but I think what we are really beginning to see is the new leadership of the equity market. So whilst they have performed well one still has to compare those dividend yields with what you can get on a bank account and you can see on that basis those incomes still look very attractive.

Next we asked Sanjeev Shah, manager of the Fidelity Special Situations Fund, about his outlook for UK equities and where he is finding the best opportunities:

Sanjeev Shah In terms of the outlook going forward I am still positive on equities as an asset class. Too many people out there are very bearish on equities as an asset class and that leads to them being very underweight equities and sentiment being very depressed. I am also not of the view that we are in a depression type of environment, and I think although the recovery will be very prolonged, the healing is taking place and for that reason I do see some very attractive opportunities out there for value investors. I tend to look for valuation anomalies which are significantly mis-valued by the market both on a relative basis and also on an absolute basis. That has led me to find quite a lot of recovery situations which are unloved and unfashionable - F&C Asset Management and Home Retail Group for example. It also has led me into the banks. Banks are one of the least owned sectors in the market by other institutional investors and obviously valuations are at very depressed levels. It has also led me into some of the financial services stocks which are unloved and unfashionable - London Stock Exchange which has certainly been a franchise which is very robust going and going through quite a strong strategic evolution, but yet has been unloved by the market place for

several years. So they are the sorts of names that I look for.

What about opportunities further afield in the fast growing Asian economies? We asked John Ford, Fidelity's Global Chief Investment Officer for the Asia Pacific for his views:

John Ford There are so many opportunities in Asia and I think more so now because investors from outside the region have de-risked from equities and have tended to sell in particular Asian equities. They view them, rightly or wrongly, as being risky or more risky than the alternatives. So you have seen actually a fairly indiscriminate sell down over the past couple of years in particular in Asian markets and so there hasn't been too much distinction between the good and the bad. That's actually I think an opportunity because it means that if you have got that sort of bottom up approach to stock picking, if you have got the resources on the ground as we do, we have got happy pickings I think, and yes markets will recover; they may not recover next week or next month even, but now is the time actually to be looking very closely. If you can live with the valuations where they are now, and they are pretty cheap, and if you can enjoy the dividend yield which is something that people haven't generally thought about when investing in Asia, and which are well covered and actually quite high, nearing 4% and in some markets higher still, that's quite a nice carry to tide you over whilst you wait for markets to recover. So plenty of opportunity wherever you look I think.

And what do you think are the risks to Asia if western economies don't pick up?

John Ford Well clearly Asia is not immune from what is going on in the developed world and clearly there has been something of a slowdown in most economies as a result of the more general slowdown in the developed world, but I think what's interesting is that the risks are less again than people might guess. Firstly Asia is much more self-sufficient these days - there is a big middleclass developing in Asia and consumer demand is growing apace in most countries, and also Asian governments, Asian corporates and Asian consumers are in good shape financially. They had their crisis 12 years ago, the western world is having its crisis now; they (Asian companies) have learnt their lessons and as a result of which they are in great shape actually to get through the next few months and ride out the storm that has sort of engulfed the developed world.

Let's end by looking specifically at China. We asked Anthony Bolton, manager of the Fidelity China Special Situations Investment Trust, about the economic outlook and opportunities in the region:

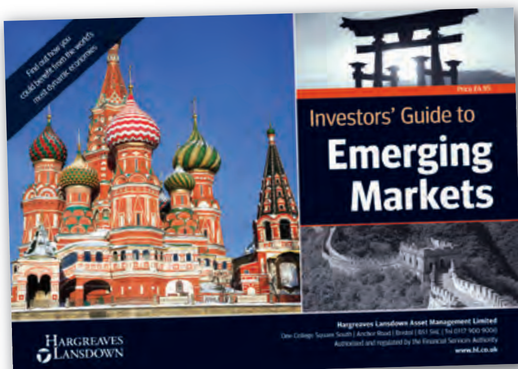
Anthony Bolton My outlook for China is still an optimistic one. I think in a world that is going to be increasingly short of growth the growth that you see in China, even though it is not as high as it used to be, will be looked at as being very attractive to investors. At the moment in the short term the market has been suffering because we were in a tightening process leading to this slowdown in the economy. We are now in an easing cycle and I think there has been some frustration that the easing hasn't been more dramatic than it has. One of the reasons for that is that it is related to the political cycle but I think as we get into the last few months of this year and into next year I really think that the Chinese market can do much better.

We have been in a period where the Chinese economy has been slowing and the very high growth rate is coming down to a lower but more sustainable level, and that has been a tougher environment for some companies. You have seen earnings in the first half of this year slow down. Consensus for the second half of the year is actually earnings will start growing again and on average people are looking probably for about 5% to 10% earnings growth. That's for the market as a whole. I have been looking for stocks in general that can grow faster than that and I still think there are many companies that can grow 15% - 20%, even 20% plus in a slowdown environment.

I have got quite strong views in China about which industries I think are the most attractive to invest in. The economy is changing - the drivers used to be exporting and infrastructure and those are not going to disappear but I don't think they are going to be as strong as they have been say over the last 10 years. The economy is going to be much more driven domestically by what is happening within China rather than outside China and it is going to be driven by the growing middleclass in China and what they are spending their money on. That growing middleclass is buying things like cars, its spending their money on consumption, on retailing, on travel, on hotels etc. and they are spending money on services like education, like financial services, IT services and healthcare, and I think those are the most attractive areas to be in in China.

Against that the areas I am less keen on are the areas that used to be the drivers like exports, like infrastructure and commodities and things related to some of the infrastructure sectors. Growth is not going to disappear quickly but I think it is going to be tough, particularly for low value exporters. If you are making a product such as t-shirts in China and selling them maybe to American department stores I think that's an activity that is probably not going to be done in China in the future and will move to places like Vietnam and Indonesia. Then on the infrastructure front we had this huge spending on infrastructure after the financial crisis which turned the Chinese economy, and probably was one of the factors that turned the whole world economy. Now we will continue to see spending on infrastructure but not at the sort of pace that we saw a couple of years ago.

In terms of the valuations of Chinese companies it's interesting that today in the domestic consumption space you have got a very wide range of valuations. Some of the consumer durable stocks, perhaps companies that are less exposed to the economic trends, are on very high valuations, maybe 30 times this year's earnings. Generally I don't own those stocks because I find the valuations too high. However in the consumer discretionary area you can find valuations that are considerably lower, in some cases in single figure price earnings multiples or just into double figures, and it is mainly in that area that I am looking where I think you get decent valuations with good medium term growth prospects. ■



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