

MAY 2012

# THOMAS REPORT



**Nigel Thomas, Fund Manager**

Nigel joined AXA Framlington in 2002. He is the lead manager for the AXA Framlington UK Select Opportunities Fund.

He trained as an accountant with Robson Rhodes, leaving to join Carrington Pembroke (subsequently ABN AMRO and now Artemis Unit Trust Managers) as a Private Client Portfolio Manager. He subsequently joined Hill Samuel to run the Hill Samuel Smaller Companies Unit Trust for two years, before rejoining Carrington Pembroke in 1986, launching and managing their UK Growth Fund.

Nigel graduated from University College London with a degree in Economics and Geography in 1976.

## The Thomas Report

Nigel Thomas, AXA Framlington



We mentioned in the year end report that the Euro was dominating political and economic thoughts. Over the last six months, this has subsided a little as the European Central Bank's (ECB) lifeboat was launched and investors have returned to investing, witnessed by a strong rise in equities to date in 2012. However, as Easter approached, Spain became a focus of attention and apprehension.

One of our favourite economic commentators, Bill Blain of Newedge, describes the Euro as "Europe's fractured currency suicide pact!" The Euro is here and now, not in some kind of thought experiment like "Schrödinger's Cat", devised by the Austrian physicist trying to explain quantum mechanics. Difficult to explain in one sentence, but Schrödinger, faced with a decision, saw the whole world split into two versions of itself, identical in all respects except that in one version the atom decayed and the cat died, while in the other the atom did not decay and the cat lived. As with the Euro, we are in some kind of state of what he described as "verschränkung" (entanglement). No growth in the Eurozone, global growth extant (but not as strong as it was) and the US recovery, which we believe has cyclical features and some new structural or secular trends. That we have the "verschränkung" should not be an overriding problem or one from which we cannot escape. We must take comfort from Adam Smith's view of mankind that demonstrates "a certain propensity in human nature.... to truck, barter and exchange one thing for another".



*We must take comfort from Adam Smith's view of mankind that demonstrates "a certain propensity in human nature.... to truck, barter and exchange one thing for another".*

The US, Adam Smith's spiritual home of capitalism, is experiencing a manufacturing renaissance which I think is as important as all the mass of bullish material written about India and China. Whereas these two economies suffer from oil at US\$125 a barrel, the US will gain from an abundant source of cheap energy, particularly gas. One observer believes North Dakota will produce more oil (from oil shale) at the end of the year than Alaska. When Henry Hub (US) gas is priced at US\$ 2.33 an Mcf (1,000 cubic feet), and landed Singapore is US\$18 an Mcf, this must give the most entrepreneurial and dynamic capitalist nation some incentive!

By the end of this decade, US oil imports could drop from 9.0 million barrels a day (mbd) to 2.0 mbd, replaced by deep Gulf of Mexico wells, oil shale and more efficient automobile and truck design (Source: Citigroup Global Markets). The balance could be purchased from their neighbours – Canada and Mexico. At the end of last year, Ford Motor and Emerson Electric brought back manufacturing to the US while Intel is building three new facilities in America, and Caterpillar is hiring 1,200 workers for a new excavator plant. Boston Consulting Group (BCG) reckons that 15-20% wage increases in China, vastly inflated Chinese real estate and transportation costs, combined with the tragic natural disasters

in Thailand and Japan, have given many US companies more “near shore” options. It is now cheaper to build a manufacturing site in Tennessee than China. There are sources of cheaper labour in countries such as Vietnam, Mexico and Indonesia but infrastructure there may not support investment. BCG claims that by 2015, low labour content manufacturing cost advantages will be in single digits for China over many low cost states in the US, such as South Carolina, even before considering transport costs.

We have first hand evidence in our portfolio of the benefits of cheap US natural gas. Elementis, a global

speciality chemicals company in industrial and decorative coatings, personal care and oil field fluids and chemicals, converted their Castle Hayne, North Carolina, chromium products site to a flexible natural gas fuel system in April 2011 for an investment of US\$5 million. Chromic acid for both timber treatment and automotive industries and chromic sulphate for softening leather in the tanning industry is produced and the payback on this investment could be in as little as one year. Elementis reported results on 28th February 2012 with revenue growth of 9%, profits before tax up 40%, earnings per share up 37%, operating cash-flow up 12%, the final dividend up 42% and net cash on the balance sheet of US\$26m. The growth of aqueous rheology and its adoption is a major driver for the company, especially in coatings. Also in speciality products, the growth of horizontal drilling down conventional and shale wells needs 10 times more of their additives than vertical drilling. In US chromium products, Elementis has a 75% market share, and in coatings they operate in a US duopoly with Rockwood. The outlook is good in terms of revenue/margins and profits and this is an exciting, if somewhat underrated and misunderstood company, especially given its legacy (Harrison & Crosfield).

We have many companies in the AXA Framlington UK Select Opportunities Fund with significant exposure to the US economy. In descending order, they are Hunting (90%), Shire Pharmaceuticals (73%), BBA Aviation (73%), Pearson (62%), Spirent Communications (55%) and Experian (50%).

We mentioned in our last report that events change investment perception and action. “Verschränkung” is rife in the nuclear industry post the tsunami and Fukushima disaster. Germany is now dismantling its nuclear power generation capacity and Japan has only two out of 54 atomic plants on line. Conversely, China is currently constructing 27 reactors with 50 more planned! The bulk of the Japanese nuclear capacity being off line, not only had a massive effect on the demand for liquefied natural gas (LNG) as a replacement energy source, but also hit parts of the crude oil market.



*It is now cheaper to build a manufacturing site in Tennessee than China*



Duri, Cabinda and Sun Tu Den are in significant supply/demand imbalance. These are the viscous low sulphur or sweet medium heavy crudes of Indonesia, Angola and Vietnam. These crudes are selling at a premium to sweet light Brent type oils. They must have a sulphur content below 0.1% (for environmental reasons) so that Japanese utilities can burn them directly, without first refining them, at oil-fired power plants to fill their energy shortage from the lack of nuclear base load.

Energy, in the round, whether oil, gas, or LNG, is well-represented in the portfolio and so are companies that supply or service the global oil industry.

A further feature of the portfolio, and a big source of growth, is technology. Innovation and penetration of smart mobile devices is creating new companies and investment in businesses doing things differently. The development of “ubiquitous computing” brings the internet, retailing, entertainment and information directly to an individual and this leads to massive investment by companies to accommodate this through investment in software, infrastructure, bandwidth, semiconductors, batteries and content. And which country is the global leader in information technology? Think Google, Facebook and Intel, etc.



*Innovation and penetration of smart mobile devices is creating new companies and investment in businesses doing things differently.*



In terms of content, and as a significant player in the free to air TV advertising market, ITV was purchased in the last six months. The company is in the second year of a five-year transformation led by Chairman Archie Norman and CEO Adam Crozier. We know about the growth of advertising on internet sites, but television around the world and the UK, is growing its share of national advertising revenue because of the demise of printed media. Television has taken advertising share in the recession and ITV is still able to deliver substantial audiences, including its digital channel extensions, plus adding more value from the content and assets of the ITV Studios. Some 55% of ITV advertising revenue comes from retail (21%), entertainment, food, finance, cosmetics and toiletries. Costs are being better controlled and savings made as to how they deliver content, and the balance sheet (although inefficient), has de-geared to net cash and they have restored the dividend. The ITV Studios business is substantial - revenues of £612m with external sales of £320m. The value of controlling its production and archive is demonstrated by recent deals with Sky, Netflix and Lovefilm, with more to come. The four part Titanic mini-series – 100% owned – has been sold to 86 countries. On a price/earnings ratio of 9.5x at 85p per share and a yield of 2.7% for year end 2012, this is attractive with more recovery potential as the transformation continues.

## Outlook

There are many opportunities in the UK stock market, like ITV and Elementis, as both management teams cope with change. The Eurozone noise should not deafen the investor to secular trends evident throughout the world, plus the industrial renaissance of the US to be seen over the coming years. Many UK companies will benefit from global growth and from some ultimate recovery of the UK economy. Our investment mantra “things will not necessarily become better or worse, but different” is very applicable as the co-efficient of Joseph Schumpeter’s “creative destruction” rises year on year.

## AXA Framlington UK Select Opportunities Fund

Discrete performance over 12 month periods to latest quarter end (%)

	30/04/07 to 30/04/08	30/04/08 to 30/04/09	30/04/09 to 30/04/10	30/04/10 to 30/04/11	30/04/11 to 30/04/12
AXA Framlington UK Select Opportunities Fund	-6.8	-24.6	38.5	23.9	4.9

Source: AXA Investment Managers. Basis: Bid to Bid, Net of Fees, Net income reinvested in GBP  
Past performance is not a guide to future performance.

## Top ten holdings as at 30 April 2012

Company	Sector	%
Imagination Technologies Group	Technology	4.5
Weir Group	Industrial Engineering	3.8
Royal Dutch Shell B Shares	Oil & Gas	3.6
GlaxoSmithKline	Healthcare	3.5
BG Group	Oil & Gas	3.2
Vodafone Group	Telecommunications	3.0
Hunting	Oil & Gas	3.0
Diageo	Consumer Goods	2.8
ITV	Media	2.8
Rotork	Industrial Engineering	2.7
<b>Total*</b>		<b>33.0</b>
<b>Total number of holdings</b>		<b>73</b>

\*Total may not equal sum of top ten holdings weightings (above) due to rounding.  
Source: AXA Investment Managers.

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