PRESENTER: I'm joined now by Hugh Sergeant of River and Mercantile. He runs a 20-stock recovery portfolio of behalf of the Alliance Trust. Hugh, tell us a bit more about the investment style and philosophy behind the mandate? HUGH SERGEANT: At River and Mercantile, our investment approach is called PVT, short for potential, valuation and timing. Potential simply describes looking for companies that can grow their shareholder value at above average pace over the medium-term. Valuation, the second factor that we exploit, is just a traditional approach to value, looking to pay 50p for £1 worth of medium-term intrinsic value. Timing, the third factor that we focus on, is recognising that you can use timing tools to improve when you allocate capital to companies with potential and valuation, the timing tools that we use would be share price technicals. Is the share price heading in a positive direction? Profitability, are earnings revisions becoming positive? And also fundamental catalysts which help timing, so management becoming more focused on shareholder value, or perhaps new management coming in and adding that element of increased focus on shareholder value. So our philosophy is PVT, potential, valuation and timing. Now for Alliance Trust we focus on recovery PVT stocks, recovery, potential, valuation and timing. Recovery simply describes companies which have strong underlying franchises in the past and made attractive returns on capital, but where those returns are temporarily depressed, perhaps because they're exposed to an economic downturn, or just a downturn in their own industry, anyway profits temporarily depressed creates a very significant valuation anomaly, because other investors will always focus on the short-term profitability. That will depress the share price, create a significant valuation anomaly for us to exploit. Recovery PVT, so recovery stocks. What we want is clear evidence of self-help. So that management have put in place a self-help programme to improve their profitability, to recover their profitability and that will allow the share price to close the significant valuation gap. PRESENTER: And how did approach work in 2018? HUGH SERGEANT: 2018 was a difficult year for our recovery PVT style. The market went through a period of fear. There was economic dislocation, the threat of trade wars, worries about the economic environment being less supportive. In that type of environment other investors focused on safety first, I would describe it, safety first type of investing. So the key factors that we look to exploit, which is recovery stocks, cheap stocks, i.e. attractively valued companies, and also multi-cap investing, looking down to mid and small cap type of stocks, those factors actually struggled in that type of safety first environment. So it was a difficult year for us 2018. But difficulty creates opportunities. So there are some fantastic PVT anomalies in our portfolio that we manage for the Alliance Trust. The difficulties last year made those stocks particularly attractive from a valuation perspective. PRESENTER: What are two stocks that you've got really high hopes for in 2019? HUGH SERGEANT: A couple of our highest conviction stocks would be Baidu and Prada. Just quickly taking you through, the Baidu investment case, I mean this is actually a very large mega cap company. It's China's leading search engine: the Google of China. From our perspective the franchise is a very strong one. They're going through a period of significant reinvestment. So they're investing in video, they're investing in AI, they're investing in autonomous vehicles. So that very significant investment is temporarily depressing their profitability. The combination of that temporarily depressed profitability and other investors' fears about China has meant that Baidu is available at a very attractive valuation today. So if you strip out the value of its equity stakes in other internet digital franchises, and look at its current free cashflow versus that valuation stripping out those investments, the free cashflow yield today is well north of 10%, so very attractive free cashflow yield. And this is a business that's still growing its top line by over 20% per annum, so very attractive starting valuation with material medium-term growth. PRESENTER: But should you be a little concerned; you're a minority foreign shareholder in a Communist country, might that not all go wrong for you? HUGH SERGEANT: I think it's slightly unfair to describe one of the leading companies in China in that context. Their governance is strong. Their shares are actually listed offshore in the form of ADRs in the US. They're exposed to one of the largest economies in the world, which is growing faster than any other large economy. The digital economy in China is a very vibrant one. Just to give you an example of some of the areas they're investing in. AI, in the area of AI they have a million developers working on their AI product. Not directly employed by them, but working on the Baidu platform, a million developers. So you can imagine the potential business opportunities that could arrive from there. China has been significantly derated because of short-term concerns. Some of the concerns you've alluded to over the last 18 months to two years, and we think that presents an opportunity. It's a classic area for us to apply our PVT, recovery PVT investing to. PRESENTER: That's one of the stocks, what's your second high conviction stock? HUGH SERGEANT: The second one was Prada. So this is obviously an iconic luxury brand. It's also been derated short term because of its exposure to China, to the Chinese consumer who are spending a little less than they were two or three years ago. So that's led to a derating of the stock. But this is a business that's going through a multi-year change programme, reinvigorating its brand, reinvigorating its product range and also taking out costs, so all that in combination should allow their margins to significantly improve over the next two to three years. Meanwhile the starting valuation is really attractive versus its global peers. An attractive starting valuation, lots of potential as it delivers over the next two to three years. And again we'd expect China facing companies to actually see more positive sentiment develop over the next few years. PRESENTER: You mentioned 2018 was a tough year for stock pickers, but which of your stocks did best? HUGH SERGEANT: I think our best performing stock over last year was Anglo American, so the global mining company. If you go back a few years again this was a classic recovery PVT stock. A few years ago profitability was depressed as commodity prices had come under pressure. Anglo's went through a classic self-help programme, cutting costs aggressively, selling off some non-core assets to improve their balance sheet, their financial sustainability. All this against a background over the last couple of years of a significantly improving market in terms of their commodity prices has allowed their profitability and cashflow to pick up really materially. At the beginning of last year we saw that coming through aggressively. That combined with an attractive starting valuation at the beginning of 2018 allowed the share price to perform very strongly last year. PRESENTER: What prompts you to sell a stock? HUGH SERGEANT: The key thing for us in terms of sell discipline is essentially the inverse of our buy discipline. So if you look at potential valuation and timing, potential when we are buying a company would describe a company where profitability is temporarily depressed but starting to pick up with an attractive VE valuation and timing that's supportive. And we'd be selling that same stock when there's no longer significant potential, profitability is back at peak levels. Typically that would be accompanied by a valuation, a significant rerating in terms of valuation, so there'd no longer be a material valuation gap. And we'll also be looking for timing starting to roll over, so earnings revisions and share price technicals no longer as supportive as they were. So PVT in combination being far less supportive would encourage us to exit a position. Anglo's is a good example where we're gradually reducing our exposure there. It's not fully rerated, but some of the PVT aspects are a little less supportive than they were if you go back a couple of years, and particularly the valuation gap. So we're taking a little bit of capital out of Anglo's for the Alliance Trust portfolio. PRESENTER: It's a 20 stock portfolio, so how long can you afford to have a stock that's in there that isn't performing? You think it's value and it's got recovery potential, but the market just doesn't see it. HUGH SERGEANT: As long as the underlying PVT fundamentals are being delivered by the company, we'll stick with that investment. The market will always eventually catch up in terms of share price with that fundamental story. A good example of a company that we're having to be very patient with in the portfolio would be Lloyds. So we think Lloyds is a really strong banking franchise in the UK, and it's delivered everything that it could have done over the last few years. Improved profitability, much strengthened balance sheet, much clearer disciplines in terms of lending etc. etc. and a huge amount of free capital that it's paying back to shareholders. But largely because of the Brexit uncertainty the share price hasn't really caught up with those fundamentals. But the fundamentals remain very much in place, and we're sticking with that investment. PRESENTER: There's a lot of top-down uncertainty out there at the moment, does that make it a good time to be a stock picker? HUGH SERGEANT: Yes, we think so. I mean recent markets have reflected I think quite a lot of short termism, and that's been encouraged by economic uncertainty, that short-term uncertainty. Which has made life I think difficult in the short term for our type of stock picking, but it does create fantastic anomalies, fantastic stock picking opportunities; in particular from a recovery PVT perspective. So the portfolio that we run for Alliance Trust, if you look at the valuation characteristics, I mean they are very compelling, it trades at only a small premium to book value, the earnings yield for the overall portfolio is almost 10%, the gross cashflow yield is in double digit percentage yield. So the valuation characteristics are very supportive. Meanwhile the 20 stocks that we have will be capable of delivering really strong profits and cashflow growth over the medium term, so attractive starting valuation, strong medium-term growth, should really create significant absolute and relative returns for the portfolio that we run for Alliance Trust. PRESENTER: Are you confident about that even if we're heading towards a recession at some point? I mean it's been a very long cycle. HUGH SERGEANT: It's been a long cycle, but we still see, I mean if you look over at the US, I mean the US is part of the global equity market where we do think the cycle is mature. So profits are high in the US versus history and valuations are really quite high. But other parts around the world are much more mid-cycle or earlier in the cycle, and we see more opportunities there. If the globe does go into a global recession, I think that will be a difficult environment for all stock pickers. We will, because of the valuation characteristics we would expect to do reasonable well in that type of environment, just how cheap can our portfolio get, we would think not much cheaper than it is today. But clearly that uncertainty will be a little bit difficult for equity markets. But our central view is that we've gone through this period of uncertainty, dislocation, the short-term economic numbers have been weak. But we'd actually expect them to be pick up over the medium term. So we think we've gone through the short-term correction in terms of sentiment towards economies, and we would think the background should improve. Monetary policy in the US is stepping back from monetary policy tightening. The same can be said in Europe. In China they're actually loosening, fiscal stimulus is coming in, tax cuts for example. So we think actually the economic background will pick up relative to what has been very cautious sentiment over the last six to nine months. PRESENTER: So in summary you're quite optimistic for 2019. HUGH SERGEANT: I think that's a fair summary. Underlying economies are in a reasonable position. That short-term sentiment should pick up from low point. Meanwhile the portfolio that we run for Alliance Trust is full of fantastic franchises on really exceptional valuations. And we think that should stand the portfolio in really good stead. PRESENTER: We have to leave it there. Hugh Sergeant, thank you. HUGH SERGEANT: Thank you very much.