



FIDELITY UK AGGRESSIVE FUND

AGGRESSIVELY OUTPERFORMING

JUNE 2008

Aruna Karunathilake

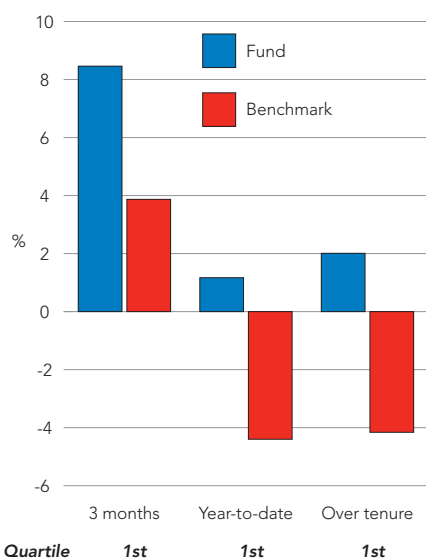
Portfolio Manager

Aruna joined Fidelity as an equity analyst in 2000. After covering the construction, real estate, telecom equipment and technology sectors, he became a portfolio manager in May 2006. His first portfolio management assignment was a UK equity portfolio for institutional clients. He continues to run this alongside Fidelity UK Aggressive Fund, for which he assumed responsibility in December 2007.

Prior to joining Fidelity, Aruna worked in equity research at Dresdner Kleinwort. He holds an MChem in Chemistry from Oxford University and is a CFA Charterholder.

CUMULATIVE PERFORMANCE

as at 31.05.08



Source: Morningstar Workstation.
 Bid-bid, net income reinvested excluding initial charge.
 Tenure covers the period from 03.12.07.
 Benchmark: FTSE All Share Index
 Sector: UK All Companies

Aruna Karunathilake has assumed management of Fidelity UK Aggressive Fund in one of the most challenging times in recent market history. The credit crunch has taken a bite from both the UK housing market and the wider economy. Inflationary pressures are mounting too, underpinned by rising commodity prices. Against this backdrop, Aruna has delivered top quartile returns against his peers. Here, he explains the process behind that success and shares some thoughts on these tough conditions.

WHAT MAKES THE PORTFOLIO "AGGRESSIVE"?

Let me start by saying what is not "aggressive." It's not a case of only buying stocks that will treble or go bust. It's not about owning risky stocks. It's about running a concentrated portfolio, hence 35-55 holdings. It's about active money; you will see stock positions where there are 100-400 basis points of active money. And, as a consequence of that, it's also about being comfortable with sector positions which could be plus or minus 5% of the benchmark weight. That may also mean that sometimes I look outside the UK. If I think there are better opportunities abroad, I'm happy to put up to 20% of the assets overseas. The strength of my conviction in my holdings is what makes the portfolio aggressive.

HOW DO YOU GO ABOUT NARROWING YOUR UNIVERSE DOWN TO THE FINAL PORTFOLIO OF STOCKS?

I have a three stage process to filter the 750 or so stocks in the FTSE All Share universe down to the final 35-55 which appear in the portfolio. The first step narrows the list down to around 100 names and is achieved through quite a lot of quantitative screening. I screen for factors such as momentum, value and fundamentals. What I'm looking for here are not necessarily the cheapest stocks but for anomalies that justify some extra research.

Once I have that list of 100 companies, I start to make use of my Fidelity colleagues, Street research and various experts. The UK is a very global market and the competitive edge that comes from having Fidelity's analyst team based around the world is invaluable. It is great that I can find out how a company's Asian business is doing by talking to someone out in Hong Kong who can see it first hand. It's also useful to bounce ideas off my portfolio manager colleagues in the UK team. If there is something that we don't know and can't answer from our own research or experience, then we have the scale to justify bringing in experts who can help us. That could involve, for example, commissioning a survey of consumers to find out if a retailers new spring collection is fashionable. We can go that extra mile to get the information we need to make the right decision.

From that fundamental research, I get down to a short list of around 60 companies that I think are buys. This is still not tight enough for an aggressive portfolio and so the last stage involves thinking of those ideas in terms of their contribution to the risk budget. I want to make sure I don't end up taking unintended risks in terms of exposure to certain areas such as the oil price and interest rates, or other factors I don't have a strong view on. (However, if I do have a strong view on a certain economic influence or sector, this is the stage where I will actively tilt the portfolio to reflect that.) From that analysis, I end up with the final portfolio of 35-55 names.

WHEN YOU ARE CONDUCTING YOUR FUNDAMENTAL RESEARCH, WHAT FACTORS DO YOU LOOK FOR TO MAKE A STOCK A BUY?

I believe there are five factors which are important in evaluating stocks: fundamentals, valuation, sentiment, technicals and change. That last point, change, is a sort of catch-all which could include things like change of ownership, M&A, management change or regulatory change.

TOP TEN HOLDINGS (%)

as at 31.05.08

	Fund	Benchmark
Royal Dutch Shell	8.3	4.6
BG Group	5.7	2.5
Tesco	5.7	1.9
BP	4.8	6.8
Vodafone Group	4.6	5.1
E.On	4.2	0.0
British American Tobacco	4.1	1.7
Anglo American	4.0	2.7
National Grid Transco	3.4	1.1
International Power	3.3	0.4

*Source: Fidelity.***SECTOR ALLOCATION (%)**

as at 31.05.08

	Fund	Benchmark
Oil & Gas	24.4	19.1
Basic Materials	18.0	12.7
Utilities	13.2	4.3
Financials	12.3	24.3
Consumer Goods	9.6	9.2
Consumer Services	7.7	9.5
Telecommunications	4.6	6.5
Health Care	4.3	6.3
Industrials	2.5	7.0
Cash	1.9	0.0
Technology	1.4	0.9

Source: Fidelity.

“Aggressive means concentrated, active positions and strong thematic and sector influences. That makes risk management important. I don’t want to be blindsided by something that I’m not directly aware of in the portfolio. A group of attractive stocks is not necessarily enough to make a good portfolio”

Aruna Karunathilake, Portfolio Manager

As part of my research process, I rank each stock for each of these factors on a scale of one to five. This simple system helps me compare very different companies. For example, a biotech company may have great fundamentals and a drug with the potential to treble its sales but which trades on 40 times earnings. The potential of the company is exciting but the valuation isn’t great. At the same time, an engineering company could look pretty dull, with little growth and fundamentals which aren’t that great but which is just on seven times earnings and which also offers a 5% yield. I’m excited by that just because it is so cheap. As I’m running a concentrated portfolio, I have to decide which one I want to buy. The scoring system helps me do that.

ARE YOU A BULL OR A BEAR OF THE CURRENT EQUITY MARKET?

Inflation is an issue which has generated quite a bit of negative sentiment in markets recently. I will admit that I am quite worried about inflation but that doesn’t necessarily make me bearish. Quite the opposite in fact. Let’s consider an investor faced with an allocation decision between cash, bonds or equities. Staying in cash will see the value of that cash eroded by inflation. Bonds fare little better as they more often than not pay a nominal return which doesn’t adjust to reflect the inflationary environment. So that leaves equities. If you invest in equities and focus on those sectors which benefit from inflation or, in the very least, aren’t negatively impacted by it, you can make good returns versus the other asset classes.

WHICH SECTORS DO YOU THINK OFFER GOOD INFLATION PROTECTION?

Inflation today is being caused by rising commodity prices, both soft commodities, like foodstuffs, and hard commodities, like metals and oil. The obvious play on commodities is through oil companies. I therefore have several holdings in that sector. You see Royal Dutch Shell and BP both in the top ten. However, another way is to invest in companies with pricing power. Tobacco companies and food retailers have historically been able to pass on higher costs to their customers. Lastly, and possibly the most interesting way to play it, is through the indirect beneficiaries of commodity inflation. Resource-rich countries like Nigeria are getting wealthier on the back of the oil price and accessing their consumer base opens up a strong growth prospect. Some UK companies, like PZ Cussons – a soap and hair care company – have large Nigerian operations.

IS IT THESE EXPOSURES WHICH HAVE BEEN CONTRIBUTING TO THE STRONG PERFORMANCE OF THE FUND SINCE YOU TOOK IT ON?

These positions have generally been good for the fund. For example, my holding in BG Group has benefited from rising energy prices. The group has strong fundamentals which compare favourably with the others in the sector and, whilst the valuation is not cheap, the company does not appear to be over bought on a technical basis. However, the fund’s returns have come from a much broad spectrum of exposures.

Whilst inflation has been one hot topic driving returns, the ongoing credit crunch continues to be another. I’ve been underweight financials for some time now and don’t see any reason to change that position. Bank valuations may have become more interesting as the stocks have fallen back but I don’t think that’s enough to compensate for the weak fundamentals. That below-benchmark exposure has been a positive net contributor to returns. Within financials, I would, however, add that I like the life insurance sector as I think fears for their exposure to the sub-prime sector have brought valuations back to attractive levels.

I’ve also used my flexibility to invest some assets overseas and those positions have proven positive for returns. E.On is a German utility company which has benefited from the rising power prices across Europe. K+S, another German stock, and Israel Chemicals, both plays on the rising demand for – and therefore price of – potash fertiliser, have also been strong performers.



Printed on paper made from 50% recovered fibre and 50% virgin wood fibre. Manufactured at a mill that has been awarded the ISO14001 certificate for environmental management. Pulp bleached using an elemental chlorine free (ECF) process.

