

EUROPEAN EQUITY INCOME » European corporate earnings have been powering ahead, proving they are now lean and efficient

A question of margins

main points

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» The fund is managed with three main investment themes, searching for companies offering good prospects in value, growth and special situations



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For Oliver Russ it is all about the margins. As manager of the ResolutionAsset Argonaut European Income fund, he is well placed to analyse why European corporate earnings have been powering ahead recently. "It is a margin story," he says. "European earnings have gone higher than other major regions over the last few years – even higher than emerging markets because of cost improvements. There has been a return to growth in the core European economy, as companies have become very successful in outsourcing to Eastern Europe and China."

Fat has been cut from many European corporates, Mr Russ explains, leaving them lean and efficient. "We are now looking at levels of returns on equities that we have never seen before in corporate Europe." These levels have driven Mr Russ to ramp up the high-conviction fund's holdings to 52 stocks, close to the 55-company limit. It is a struggle at times, he says, to exclude companies rather than find those to include in the portfolio. "There are so many ideas at the moment," he continues. "If you did a scan of everything in Europe – including the UK – that yields 3.5 per cent you would come up with 130 names in the UK. It may be the biggest single yielding market, but there are also over 370 companies yielding that amount that are outside the UK – even before you get to the former Soviet Union countries."

The portfolio is mostly invested in Western Europe at present, Mr Russ adds, apart from one holding in Turkey.

Investment themes

Mr Russ manages the fund with three main investment themes, searching for companies offering good prospects in value, growth and special situations. To the outsider the mix might seem incongruous, but the manager argues the level of diversification inherent in such a strategy provides good performance whatever the current place in the economic cycle.

"It is a good idea to diversify the strategies within the portfolio as much as you can to reduce risk," he argues. "This fund is for lower-risk investors and has one of the lowest risk numbers in its sector. It is advantageous, therefore, to combine different approaches within the overall income strategy."

But even the growth stories within the portfolio are fairly low risk, Mr Russ adds, "in that they are generating lots of cash already. What's unusual about these growth stories is they don't need capital to finance their growth – they just pay it all straight back to shareholders."

Mr Russ cites the example of Hellenic Exchanges, the Greek stock market. "It delivers a lot of cash," he says, "because it only employs 100 people and has been steadily reducing the head count to become a much more efficient operation. As the Greek stock market matures and becomes more mainstream for global investors, the volume of trades have gone up massively. It is hugely dynamic for their earnings, which have doubled over the last couple of years."

Alongside, the manager looks for value stories. "Value is the sort of thing you would see in any UK income fund," Mr Russ explains. "At the moment we are seeing it in large caps, including Telcos, financials, which have lots of free cash, but the market does not want to give them much of a multiple because they are large and dull and perhaps not

growing as fast as they might." The advantage they have, he continues, is they pay large dividends and there is generally a lot of value in their assets. "Many will be old companies that have built up brands over the years," he adds, "and sooner or later that value is released."

ABN Amro is one example, Mr Russ says. "It was a firm that always marginally missed estimates – it would be 5 per cent down on results day, for example – and the assets weren't managed as well as they might have been. Then suddenly there were two competing buyers for those assets and then the value is crystallised very quickly. Effectively, you are being paid to wait."

France Telecom is one firm he is currently monitoring. "It has a free cash-flow yield of almost 12 per cent and a dividend yield of about 6 per cent, so we see quite a lot of value there."

The final plank of Mr Russ's investment philosophy is searching for special situations. "These are companies that have large cash balances or the potential to restructure or re-gear and return a special dividend or an enhanced ongoing dividend to shareholders," he explains. "About a third of European companies have net cash on their balance sheets, which means there is a lot of cash around that could easily come back to shareholders. The advantage when they do that is you get a re-rating of the share upwards."

"There is a discount put on cash balances at present because investors think management will waste it on some sort of value-destroying acquisition. If the cash is handed back then that removes the temptation and the share tends to get rerated upward – and you also get the dividend out the other side so it works both ways."

He cites Fortum, a Scandinavian utility, as a good example. "It generates all its power from clean sources such as nuclear and hydro-electricity, so it is not exposed to the input costs of power generation, which are coal oil, gas and carbon credits – its costs are relatively fixed. They pay out a regular dividend and an ongoing special dividend as they are very committed to capital discipline. This is exactly the type of stock we want to see."

Stability is key, Mr Russ explains, especially given the low-risk nature of the fund's investors and the recent market turbulence. European stock markets, he says, are still very interrelated with those in the US. What happens in the States will have a knock-on effect on continental Europe.

"Continental Europe is bit more geared to US earnings in terms of the stock market rather than domestic earnings," he says. And while debate rages over whether the US is in recession or not, Mr Russ argues it is clear the country is in a fairly prolonged period of sub-par growth. "But other parts of the world are in a period of very strong above-par growth," he counters. "Although China is not going to grow at a double-digit rate for ever and is a smaller economy than the US, it is creating a certain amount of domestic demand that is taking up the slack from America."

Car and truck manufacturer Volvo, he says, is exposed to the US, and business has been slow for the last few years. But in the Far East they are short of components and cannot get enough to make more trucks. "Demand is outstripping supply," he explains.

But despite the fears over the state of the financial markets, Mr Russ argues the worst seems to have passed. "One never wants to call the bottom," he says cautiously, "but the feeling is that systemic risk has now receded to a large degree. Even six weeks ago there was a fear that financial institutions were

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going to collapse like dominos, and now that fear has largely been removed from the market – it is unlikely that more financial institutions will fold. The feeling the market was over a precipice has been removed, and what we are left with is an earnings slowdown. It is in the US at the moment and we will probably see it here later on.

"The market can cope with that because that is what the market does year in year out."

This has led Mr Russ to look at early cyclicals, which are displaying inherent value. "Volvo, for example, a year ago was yielding 3 per cent and now it is yielding 7 per cent, because the share price has halved. We couldn't own it a year ago and now it offers compelling value – and there are a lot of stocks like that."

M&A activity in the Telcos sector has also led to greater opportunities for the fund, Mr Russ continues. "It has become a white-hot sector for M&A activity because these companies are very under-gear relative to their own history. They are very cash rich, and not only have they started to return this to their shareholders, but they hold so much money that they're starting to look at M&A."

Ultimately, though, Mr Russ concludes, investing in continental Europe offers UK investors the chance to diversify their assets. "People want to invest in overseas assets, purely to diversify risk – and the beauty of a fund like this is you can diversify into an area that is known quite well and can diversify by sector. Investors can get access to hugely diverse stocks, sectors and economic stories all within the basic EU legal framework without taking on lots of political risk."

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Oliver Russ, fund manager, ResolutionAsset Argonaut European Income fund



WHO IS ARGONAUT?

» Argonaut Capital Partners is a concentrated European high-alpha boutique set up as a 50/50 joint venture between top fund managers Barry Norris and Oliver Russ, and Resolution Asset Management

» Both Investment managers have a considerable track record in the management of European equities through the European Alpha and European Income funds, and are responsible for all aspects of stock selection and portfolio management. This boutique environment is supported by Resolution, which provides all the necessary back office, marketing and administration

» In short: a unique structure which leaves Barry and Oliver free to concentrate on what they do best – picking the winners in the European stock market.