

EUROPE EX UK » Manager of the £417.4m ResolutionAsset Argonaut European Income fund, Oliver Russ, talks about having a concentrated, conviction-led portfolio

Reaping the benefits of a fruitful hunting ground

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The £417.4m ResolutionAsset Argonaut European Income fund is achieving great success in transporting the popular genre of income investing from the UK to continental Europe.

While funds within the IMA UK Equity Income sector have always been popular with domestic investors, there is now scope to find more interesting propositions in other regions, with shareholder value increasingly becoming a common commodity across different countries.

For Oliver Russ, who has been at the helm of the fund since launch, Europe provides a particularly fruitful hunting ground for the sort of stocks he favours for his concentrated, conviction-driven portfolio.

“There have been very strong returns from UK income vehicles and there is absolutely no reason why you cannot put this discipline in place in continental Europe,” he says. “It is actually becoming easier in Europe as UK income, to some extent, has become a victim of its own success, with yields driven down as a result.”

“This has not happened in Europe yet, and there are still very high yields to be found.”

The ability of the fund to tap into these opportunities since its launch in December 2005 has been reflected in the performance, with a return of 38.4 per cent since launch, compared with a sector average of 34.1 per cent.

It has also fared well over the past year in the face of turbulent market conditions and a bleak economic outlook across Europe, returning 13.3 per cent compared with 11.3 per cent for the sector. It ranks third in the IMA Europe ex UK universe of 98 funds over the past three months, demonstrating it is far from being a fair-weather product.

Stock selection is carried out using a three-pronged approach. First, the team uses a series of quantitative screens, looking not only at current dividend yield, but also the sustainability of that yield.

Second, Mr Russ relies upon the recommendations of his network of brokers, which provide a valuable insight into some of the less well-known stocks that are slightly off-the-beaten-track.

Finally, he also looks at the news flow surrounding particular stocks and may increase or reduce a holding based on this information.

Growth stocks

As well as the aforementioned high-yield stocks that can also provide evidence of the ability to not only sustain these yields but also increase them too in the future, Mr Russ also seeks growth stocks.

“Perhaps this is slightly unusual for an income manager, but I find with many growth stocks with a high earnings growth rate, there is no need for them to retain the capital as they have fixed costs and so they have to return it to shareholders,” he explains.

An example of a growth stock within

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the portfolio is Hellenic Exchanges, the Greek stock market, which is benefiting from increased investor interest in Greek stocks.

As well as being a prime candidate for takeover, it also has the potential to pay out larger than average dividends. “With the volumes of trades set to increase further, and with fixed costs, it will have to return some of the profits to shareholders,” Mr Russ says.

The fund also opts for stocks that fall into the special situations category, where current low yields could be set to rise as a result of a change within the company or within the wider market acting as a catalyst.

“For firms which have a lazy balance sheet, a restructuring or a change of management, for example, can lead to share prices reacting positively very quickly,” the manager says. “It is the same strategy as is used by private equity firms, but obviously you do not need to be a private equity vehicle to achieve that same result.”

The fund operates a best ideas approach, with an average of 50 stocks, which can fall as low as 30 if there are not enough ideas to comfortably furnish the portfolio. Of these 50 stocks, all of them are on a flight path to yield a minimum of 3 per cent and Mr Russ does not use a barbell approach as is the case with some of his peers.

Diversification

In terms of diversification, Mr Russ believes by keeping within these parameters exposure can remain balanced, although he is obviously mindful of sector and country allocation.

For the latter, he tends to favour less well-travelled areas and therefore has a significant underweight in France, Germany and Switzerland when compared to the benchmark MSCI Europe ex UK index.

On a sector level, there is unsurprisingly a bias towards the typically high yielding telecoms and utilities. For the former, the manager has maintained an overweight because of the resilience of earnings and their non-cyclical nature.

In terms of specific stock selection, as well as using a series of quantitative screens and in-house research, he also considers the typical value plays among UK companies and thinks laterally across the investable universe in Europe.

“For income investors in Europe it is often a case of thinking of the type of companies a UK investor would choose and then swapping it for its European counterpart,” he says. “If you think of the typical value holding Vodafone, a fair swap would be the Spanish version, Telefonica, which offers the same yield growth potential.”

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The overweight in telecoms is part of an overriding defensiveness across the fund, as concerns about the longer-term effects of the credit crisis remain. Mr Russ also remains underweight in materials and cyclicals as, even though efforts have been made by central banks, inflation is still an issue and investor sentiment is bearish.

“In this environment, it is important to focus on good stock picking and finding the companies which still have solid fundamentals,” Mr Russ says. “However, there are still some really attractive stocks out there on good valuations and more options in Europe than in the UK.”

The turnover on the fund is relatively low at around 20 per cent a year, demonstrating Mr Russ’s philosophy of maintaining a concentrated portfolio and retaining those stocks that are on the right trajectory to produce the yields he is looking for. “It is not a buy and hold fund, but it is not a million miles away from that,” he confirms.

Overall, the fund provides a good option for investors who have enjoyed the outperformance of UK Equity Income funds and are now seeking to further diversify their portfolios.

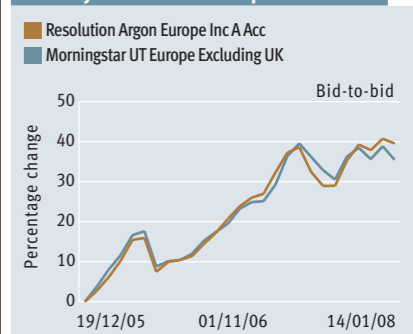
In addition, there is the diversifying effect of foreign currency exposure. Sterling declined almost 10 per cent against the euro last year and this weakness should continue in 2008, which is good news for UK clients investing in Europe where returns are being boosted by this weakness.

Stock opportunities within Europe abound, particularly in certain sector and country pockets, with some set to pay double-digit dividends in 2008, and the ResolutionAsset Argonaut European Income fund is well placed to tap into this potential.

Fund footprint

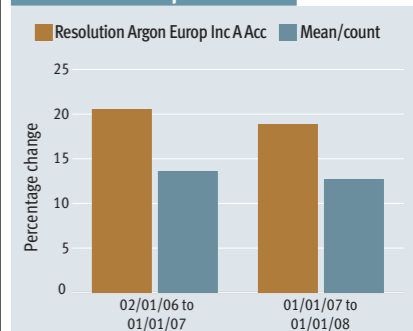
Launch date: 12/05
 Manager start date: 12/05
 Previous manager: n/a
 Fund size: £417.4m
 Number of holdings: 52
 Benchmark: MSCI Europe ex UK index
 Tracking error: 3.19

Three-year cumulative performance



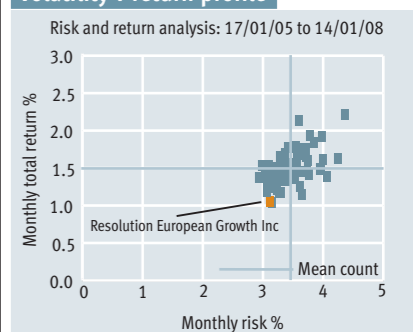
Source: Morningstar

Discrete annual performance



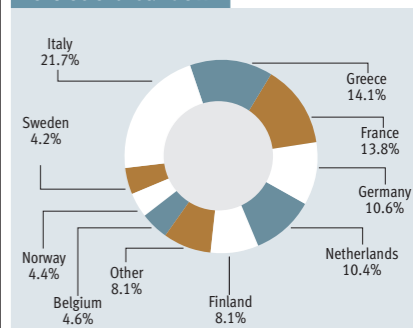
Source: Morningstar

Volatility v return profile



Source: Morningstar

Portfolio breakdown



Source: Resolution Asset Management